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Subtitle C and D Corporate Financial Test Analysis
Issue Paper
Assessment of First Party Trust Funds

Introduction

This paper analyzes issues related to first party trust funds. For this analysis, a "first party" trust fund means a trust fund, set up by a facility owner or operator, in which the funds remain in the administrative custody of the owner or operator, in contrast to a "third party" trust fund, in which the funds are placed in the administrative custody of an independent trustee. Specific issues related to the first party trust fund include:

- Can a first party trust fund guarantee the availability of liquid assets?

- What procedures and associated resources would be necessary for state or tribal authorities to oversee such first party trust funds?

- In comparison to a first party trust fund, what assurance is provided by the financial test that liquid assets or other sources of funds will be available; that is, what mechanisms provide a disincentive under the financial test for transfers of assets away from the firm that has previously passed the test?

Under 40 CFR 264.143(a)(1) and 258.74(a)(1), a trustee must be an entity which has the authority to act as a trustee and whose trust operations are regulated and examined by a Federal or State agency. Section 264.151 trust fund agreement language prescribes any agreement between a trustee and grantor. Under §270.74(a)(7), an owner or operator may request reimbursement from the trustee for closure, post-closure, or corrective action expenditures.

In its rulemakings establishing the basic structure of the financial responsibility requirements and specifying which financial mechanisms could be used, EPA did not approve use of a first party trust fund. However, the Agency did not develop an extensive rationale for why first party trusts were not authorized.[1] As a consequence, this analysis could not

[1] The initial rulemaking in 1978 provided that an owner or operator could use only a trust fund, which was required to be held by a "bank or other financial institution approved by the Regional Administrator," (43 Federal Register 58986 and 59006, December 18, 1978), although the Agency requested comments on other financial mechanisms. In its second and definitive rulemaking on financial assurance, in May 1980, EPA did approve other financial mechanisms, but a first party trust was not included. The Agency explained its rationale for the mechanisms chosen and not chosen as follows: "All the basic methods for providing financial assurance that have been added since the original proposal were among those suggested by commenters on the original proposal. There were a number of other mechanisms suggested that are not in the reproposal, however." After a discussion of escrow accounts and a national fund, the Agency went on as follows: "Other mechanisms suggested included pledges of securities, liens against land and real improvements, interest bearing accounts in financial institutions, and sinking funds. These were not included because the Agency concluded that they suffered from one or more of the following shortcomings: their status is uncertain in the event of financial failure; they would impose unreasonable administrative burdens on the

US EPA ARCHIVE DOCUMENT

evaluate whether the factors that initially caused EPA not to allow first party trusts still existed. The analysis presented in this paper is organized in three sections:

- Section 1 describes first party trusts and examples of their use in situations that resemble financial assurance;

- Section 2 describes the means used to supervise current first-party trusts and assesses the resources necessary to extend a similar level of supervision to first-party trusts used to provide financial assurance; and

- Section 3 evaluates mechanisms that reduce the likelihood of transfers of assets by firms, and therefore support the equivalency of results attained by financial tests and first-party trusts.

The key findings of the analysis presented below are as follows:

- First party trust funds are used in situations that resemble financial assurance, and could be adapted for that purpose.

- Legal mechanisms currently exist that provide for oversight of first party trust funds and similar mechanisms used by public institutions, but they are specific to the current uses, and would need to be amended or new mechanisms enacted to serve equivalent functions for first party trusts used for financial assurance for closure and post-closure care.

- If suitable legal authorities are enacted, supervision of first party trust funds by state governments and tribal organizations would not be any more costly than supervision of third party trust funds.

- There are business considerations and legal mechanisms that make it unlikely that a firm will undertake transfers of assets simply to evade providing financial assurance once the firm has passed a financial test. Therefore, despite the positive features indicated above for first party trust funds, many of the same results can be achieved through the use of financial tests without the increased public and private costs of the trust funds.

1. First Party Trust Funds

Although three parties -- the settlor, the trustee, and the beneficiary -- are usually involved with a trust, trust law does not prohibit the settlor of a trust from making itself the

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Agency; they could be cancelled quickly, providing no long-term guarantee of financial assurance; or they depend on long-term solvency of the owner or operator." 45 Federal Register 33262, May 19, 1980. Aside from the reference to interest-bearing accounts, which could include first-party trust funds, there is no indication that such trust funds were considered or recommended by commenters in 1978-1980.

US EPA ARCHIVE DOCUMENT

trustee who holds title to trust property for the benefit of another (the beneficiary). Because the trustee owes an obligation to the beneficiary, who may enforce the duties of the trustee in court, trustee and beneficiary cannot be the same person, and such trusts are clearly invalid. First party trusts, however, can be effective, if properly established.[2]

Because the settlor/trustee of a first party trust is dealing with its own property, the expression of trust intent, description of the property that is being placed in trust, and the identification of the beneficiary must be especially clear to ensure that a trust is established. In particular, the intent to create a trust rather than a debt must be clear. The former creates a fiduciary relationship, and can be enforced in equity; the latter is not a fiduciary relationship and will be enforced in law under principles of contract.[3]

Frequently, first party trusts are established as separate bank accounts. In these situations, too, the intent to create a trust, rather than simply a bank account, and the terms under which the trust will be paid to the beneficiary, must be very clearly specified. Banks are most familiar with such accounts when they are used in a testamentary manner, and state law may be structured around this use (e.g., state law may allow withdrawal of interest prior to the death of the depositor and allow passage of the corpus of the trust account to the beneficiary only at the death of the depositor). Thus, use of such an account to provide financial assurance would need to be carefully planned to avoid complications that might otherwise be created by state law.[4]

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[2] The general discussion of trusts is based on George T. Bogert, Trusts, Sixth Edition, West Publishing Company, 1987. The Uniform Trusts Act discusses trustees depositing trust funds with themselves, but only in the context of corporate trustees who provide trust services as a business and are subject to supervision and regulation by state or federal agencies. UTA § 4--1.

[3] An interesting implication, that has not been pursued in this paper, is that states and tribal organizations could sue under their rights as someone to whom the first party trustee owned a fiduciary duty as well as to enforce the financial assurance obligation itself.

[4] New York, for example, allows bank accounts in trust form, which are defined as follows: "A 'trust account' includes a savings, share, certificate or deposit account in a financial institution established by a depositor describing himself as trustee for another, other than a depositor describing himself as acting under a will, trust instrument or other instrument, court order or decree." Estates, Powers, and Trusts Law, §7-5.1(d) New York provides that such a trust must be subject to the following terms: "(1) The trust can be revoked, terminated or modified by the depositor during his lifetime only by means of, and to the extent of, withdrawals from or charges against the trust account made or authorized by the depositor or by a writing which specifically names the beneficiary and the financial institution. The writing shall be acknowledged or proved in the manner required to entitle conveyances of real property to be recorded, and shall be filed with the financial institution wherein the account is maintained." §7-5.2(1)

US EPA ARCHIVE DOCUMENT

Examples of the use of first party trusts by business corporations in settings that most closely resemble financial assurance include the following:

- Establishing an account in a bank from which to pay payroll;
- Establishing an account in a bank from which to pay interest coupons on bonds;
- Establishing an account in a bank from which to pay checks in payment of a dividend;
- Establishing a first party trust to manage funds set aside to pay pensions.[5]

Such account trusts, because they are funded with cash and held in the form of bank accounts, are extremely liquid. They frequently, however, involve obligations, such as payroll and pensions, that are closely regulated. Payroll, debts, and dividends also are activities of the firm that are closely tied to its short and long term prospects. Despite the liquidity of the funds, therefore, there is probably a strong incentive not to divert them to other uses unless absolutely necessary.

These account trusts also have several characteristics that somewhat distinguish them from trusts set up for financial assurance purposes. First, the account usually is set up, or if already in existence is funded, immediately prior to the time that disbursements are expected to occur, and the disbursements occur periodically. The relatively long period of time between the point at which the funds are set aside and the time that they are needed, which is generally true of financial assurance for closure and post-closure care, usually does not exist for payroll, interest, and dividend trusts. (Pension trusts may exist for a longer period between creation and the beginning of payments.) Second, these trust accounts are set up to disburse relatively large numbers of small amounts, and therefore require the services of a bank.

Municipalities and public agencies also make use of financial arrangements bearing some similarity to first party trust funds. They may, for example, set up designated funds

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[5] In these situations, courts have debated whether the depositor intended to declare itself trustee of the deposited funds (holding that the depositor's behavior amounted to an implied declaration that he held the property in trust for the creditors) or only had set up a special bank account. Although the trend had been to find the dividend accounts were held in trust, while bond coupon and payroll accounts were not, the Uniform Trusts Act now provides that all such accounts are held in trust, unless expressly provided otherwise. (Bogert, § 28) "Whenever a bank account shall, by entries made on the books of the depositor and the bank at the time of the deposit, be created exclusively for the purpose of paying dividends, interest or interest coupons, salaries, wages, or pensions or other benefits to employees, and the depositor at the time of opening such account does not expressly otherwise declare, the depositor shall be deemed a trustee of such account for the creditors to be paid therefrom, subject to such power of revocation as the depositor may have reserved by agreement with the bank." (Uniform Trusts Act § 2) Use of a first party trust in the pension context was suggested in contacts between ICF staff and corporate financial officers, July 1995.

US EPA ARCHIVE DOCUMENT

within their budget and accounting systems expressly to pay for certain obligations or expenses. Special revenue funds can be set up to account for the proceeds of specific revenue sources or to finance specified activities. Special trust accounts also can be set up to account for assets held by the government unit as a trustee for a special purpose. For example, parks or charitable activities sometimes are funded by gifts to local governments that are designated for a special purpose.[6] These "charitable trusts" probably bear the closest resemblance to first party trusts used for financial assurance for closure and post-closure.

EPA considered use of the charitable trust concept in developing financial assurance mechanisms to enforce the Ocean Dumping Ban Act of 1988. Under the Act, New York City and several adjacent counties in New Jersey and New York were required ultimately to cease dumping sewage sludge in the Atlantic Ocean. While they continued to dump, a fee was to be collected from those jurisdictions and placed in funds that would eventually be used to finance methods of sewage sludge disposal. The jurisdictions suggested use of an internal account, but EPA, in consent decrees, instead required them to set up trust funds. The Agency evaluated whether first party trusts, similar to charitable trusts, could be used. Because the actions were being taken through consent decrees, EPA Region II and DOJ ultimately decided to require corporate trustees to be appointed.

In summary, it appears that first party trusts and similar mechanisms used by public entities such as municipal governments could function as means of financial assurance, although no current examples of such use by EPA could be identified.

2. Procedures and Resources to Oversee First Party Trusts

Depending on the form in which the first party trust is created, mechanisms exist or could be created that would allow for oversight similar to the oversight currently given third party trusts used for financial assurance.

For first party trusts set up as bank accounts, oversight mechanisms could include the following:

- Only banks regulated by state or federal authorities could be used, and the amount of the trust could be limited to the sum protected by depository insurance;

[6] Such property frequently is held under a special trust arrangement established by state law. In New York, for example, "charitable trusts" are authorized as follows: "Property may be disposed of to any incorporated city or village of this state to be held in trust for any educational purpose, the diffusion of knowledge, or for the relief of distress, or for parks, gardens, other ornamental grounds or grounds for military parades, exercise, health and recreation, within or near such incorporated city or village, upon such conditions as may be prescribed by the creator and agreed to by such corporation; and all property so transferred to such corporation may be held by it, under such trust, subject to such conditions as may be prescribed." Estates, Powers and Trusts Law §8-1.2(c)

US EPA ARCHIVE DOCUMENT

- Monthly and/or quarterly statements received by the depositor from the bank could be copied and forwarded to the state or tribal entity. In addition, special provisions could be added to the agreement between the owner/operator and the bank that would allow direct inquiries to be made by the state or tribal entity to the bank by telephone;

- The provisions in state law pertaining to amendments to the account agreement might need to be changed in two ways. First, the ability of the depositor to change the terms of the agreement unilaterally would need to be restricted, and in addition to notice of potential changes, prior approval from the state or tribal entity also would need to be required. Second, the trust account agreement would need to be amended, as well as state law in those states that have statutes similar to New York, setting limits other than death of the depositor on the time period of the trust and the point at which funds would be paid. Additional research would be required to determine how significant a problem this would be.

For first party trusts set up in a form similar to a charitable trust, the pattern followed by states that allow such trusts could be followed. State laws generally require municipalities administering charitable trusts to register and report to the state attorney general on an annual basis. The attorney general may require other reports, as necessary; make rules and regulations to further regulate such trusts; and may investigate transactions of the trustees to ensure that the property being held by them is properly administered. In addition, because the reports are publicly available, other persons may examine them and bring questions about the conduct of the trustees to the attention of the attorney general.

The resources necessary to track and review reports and carry out necessary supervision would not be extensive, and in many cases would already exist within the state government structure (e.g., the attorney general's office). Drafting and enacting new legislation, if such legislation was required, could require substantial resources.

In summary, if new legislation is required to structure the use of first party trusts for financial assurance purposes, that new legislation might require substantial resources. Supervising the use of a first party trust, after necessary rules are in place, however, should require no more resources than supervision of the current third party trust or other financial assurance mechanisms.

3. Limits on Asset Shifting

Both a first party trust and a situation in which a firm passes a financial test and relies on a self-guarantee to provide proof of financial responsibility represent cases in which the firm's assets remain within its ultimate control (although, as noted above, both a trust account and a charitable trust do represent fairly significant limits on the powers of the entity setting up those mechanisms later to gain unrestricted access to the funds in them). Because the financial test and self-guarantee represent the smallest degree of exterior control over such asset transfers, this analysis examined whether any disincentives for such transfers exist. Three such disincentives were identified:

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- First, firms are unlikely to transfer assets and undergo bankruptcy simply to avoid financial assurance obligations. Although cases of voluntary bankruptcy do exist, they are generally triggered by the prospect of massive obligations far outweighing the resources of the firm, in a context in which the firm is otherwise viable. For example, the Texaco bankruptcy was triggered by a multibillion dollar antitrust judgment; large numbers of tort claims and judgments have triggered voluntary bankruptcies by asbestos manufacturers and medical products manufacturers; and Commonwealth Natural Gas declared bankruptcy voluntarily because it faced large numbers of supply contracts at prices substantially above the current market. In each case, the conditions leading to the voluntary bankruptcy appeared to be (a) the sudden and unexpected appearance of a very large financial obligation, and (b) the possibility of regaining financial stability once that obligation had been avoided. In such circumstances, the firms apparently were willing to suffer the loss of good will, and the loss of business autonomy attendant on a bankruptcy proceeding. However, in general, bankruptcy is attended by such severe consequences for the firm and its management that it rarely is entered into for strategic reasons. These consequences include (a) loss of management autonomy to the court, creditors committee, and/or to a trustee in bankruptcy; (b) loss of good will; (c) future difficulties in access to credit; (d) future difficulties in access to suppliers; and (e) potential loss of equity by owners.

- Second, bankruptcy law provides authority for setting aside preferential transfers of property of the debtor to or for the benefit of a creditor for an antecedent debt while the debtor was insolvent made before the filing of the bankruptcy petition. Thus, if an owner/operator transferred funds to another member of its affiliated corporate group, claiming that the transfer was in payment of a debt it owed the other firm, shortly before declaring bankruptcy, the transfer could be examined and might be overturned in a bankruptcy action.

- Third, trustees in bankruptcy can avoid several other types of transfers. The trustee, in particular, can avoid fraudulent conveyances (i.e., conveyances with actual intent to defraud current or future creditors), and "secret" transfers of property (i.e., transfers that have not complied with statutes requiring recording of such transfers).

It should be noted that the second and third of these mechanisms operate within the context of bankruptcy. That is, they provide an opportunity for a bankruptcy trustee to avoid transfers made by the debtor and thereby regain funds to be distributed in the bankruptcy action to the debtor's other creditors. Unless EPA has a claim to those funds, the avoidance of the transfer will not substantially benefit EPA, because the bankruptcy will already be under way. Only the first of these mechanisms can be identified as an unequivocal disincentive to bankruptcy itself.

In 1984-1985 ICF investigated for EPA the circumstances of every bankruptcy then known involving a RCRA Subtitle C permittee. Fifty-four facilities were identified as owned by bankrupt firms. Many of these firms had declared bankruptcy prior to when applicable financial

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assurance requirements became effective. Although the study could not determine the cause of bankruptcy at each facility, contacts from EPA Regions and the states generally believed that most of the firms had entered bankruptcy because of poor business conditions. None of the bankruptcies appeared to be a voluntary bankruptcy undertaken specifically to avoid financial assurance obligations.

Similar, and more recent, evidence that firms are not deliberately transferring assets in anticipation of bankruptcy is provided by work that ICF has performed for the Nuclear Regulatory Commission reviewing the financial records of NRC licensees that are currently bankrupt or potentially approaching bankruptcy. The reviews have investigated, among other topics, whether there is evidence in the firms' financial records, including tax returns, income statements, and a broad range of other detailed financial documents, of asset transfers prior to bankruptcy. However, no clear evidence of such transfers has emerged to date.

Once bankruptcy has been entered into, furthermore, the law of parent-subsidiary liability is so unsettled that uncertainty about outcomes also creates a disincentive to asset transfers, because there can be no certainty that the transfer will be effectively isolated from the bankruptcy.[7]

In summary, therefore, experience indicates that in most cases the business disincentives described above will be sufficient to deter transfers of liquid assets simply to avoid financial assurance obligations.

[7] ICF has investigated issues of parent/subsidiary liability for the Nuclear Regulatory Commission, in the context of the likelihood that if a parent or subsidiary enters bankruptcy, the other member(s) of the corporate group will also be drawn into the bankruptcy action. Analysis of Assurance Provided by Current and Proposed Financial Assurance Mechanisms, November 1992. A summary of the extensive legal analysis of this issue is beyond the scope of this paper, but see: Practising Law Institute (PLI), Protecting the Corporate Parent 1993: Avoiding Liability for Acts of the Subsidiary, 1993 as well as several previous PLI documents on the same subject and Phillip I. Blumberg, The Law of Corporate Groups: Problems in the Bankruptcy or Reorganization of Parent and Subsidiary Corporations, Including the Law of Corporate Guarantees, Little, Brown, and Company, 1991.

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