RELIEF UNDER CERCLA: THE INNOCENT SELLER'S DEFENSE

Recent court decisions expand protections in lender liability cases under CERCLA.

by Larry Schnapf

For much of its 12-year history, the federal Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA) has offered few defenses to former property owners who sold contaminated real estate but did not cause the contamination. During the past few years, though, the federal courts have expanded the protections that sellers may use to defend cost recovery or contribution actions filed by their purchasers.

The first defense, known as the passive intervening landowner defense, was discussed by the author in the Fall 1991 issue of *The Real Estate Finance Journal*. Under this defense, a seller who did not own the contaminated property at the time of disposal of hazardous substances may not be liable for clean-up costs incurred by either the government or subsequent owners or operators of the property. Because many courts broadly construe the term "disposal" to include migration of previously deposited contaminants, this defense is only available in a handful of states. Recently, however, a line of cases has emerged that allow former owners to assert an "innocent seller" defense that would act as a complete shield to CERCLA liability.

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CERCLA Liability and Defenses

Section 107(a) of CERCLA provides that owners and operators of facilities or vessels (i.e., equipment, containers, tanks, etc.) may be strictly liable for all clean-up costs associated with the release or threatened release of hazardous substances. This liability extends to current owners or operators of a site even if the owner or operator did not place or deposit the hazardous substances on the property and also reaches past owners or operators who controlled or held title to the property at the time of disposal of the hazardous substances. The EPA has consistently argued that the term "at the time of disposal" includes leaching, leaking, or general movement of previously deposited hazardous substances so that a former owner who had title to property while hazardous wastes were mi-

grating or leaking but who did not deposit the wastes may be liable for the clean-up costs of the contaminated property.

There are only three affirmative statutory defenses that a landowner could assert under CERCLA, although some courts have allowed defendants to raise common law equitable defenses as well.[1] The defense most often raised is the third-party defense contained in Section 107(b)(3), which provides as follows:

> There shall be no liability under subsection (a) of this section for a person otherwise liable who can establish by a preponderance of the evidence that the release or threat of release of a hazardous substance and the damages resulting therefrom were caused solely by—
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> . . .
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> (3) an act or omission of a third party other than an employee or agent of the defendant, or than one whose act or omission occurs in connection with a contractual relationship, existing directly or indirectly, with the defendant (except where the sole contractual arrangement arises from a published tariff and acceptance for carriage by a common carrier by rail), if the defendant establishes by a preponderance of the evidence that (a) he exercised due care with respect to the hazardous substance concerned, taking into consideration the characteristics of such hazardous substances, in light of all relevant facts and circumstances, and (b) he took precautions against foreseeable acts or omissions of any such third party and the consequences that could foreseeably result from such acts or omissions.[2]

Thus, to establish the third-party defense, a landowner must establish by a preponderance of the evidence that the release and resulting damages:

- Were caused *solely* by an act or omission of a third party other than an employee or agent of the defendant.
- That the act did not occur in the context of a contractual relationship with the defendant.
- Demonstrate that it exercised due care regarding the hazardous substances.
- Took precautions against foreseeable acts or omissions of any third parties.

Broad Interpretation. Unfortunately for CERCLA defendants, the courts have broadly construed the meaning of the term contractual relationship so that it encompasses nearly every contractual arrangement between potential defendants. As a result, very few defendants have been able to invoke the third-party defense. For example, by virtue of its contractual relationship with its tenant, a landlord will not be able to raise the third-party defense for contamination solely due to operations of their tenant. In addition, a sublease has been held to constitute a sufficient indirect contractual relationship to preclude a lessor from successfully pleading the third-party defense. Under this interpretation, only the acts of trespassers, adjacent landowners, or midnight dumpers could be used by a landowner as third-party defense, and only then if the landowner demonstrated it had exercised due care.

Since this interpretation even barred previous owners from raising this defense, Congress enacted the "innocent landowner's defense" in 1986 *which* modified the definition of "contractual relationship" to exclude landowners who were not responsible for the contamination. This defense, though, is only available to current landowners or sellers who originally qualified as innocent purchasers.

This statutory scheme has had a particularly harsh impact in situations where actions of a current landowner cause hazardous substances that were placed in secure containment structures by the seller of the real estate to escape into the environment. Because the former landowner owned the property at the time of disposal, it may not assert the innocent purchaser's nor the intervening passive landowner's defense. Thus, the current property owner whose actions caused the release of the hazardous substances could seek to recover its cleanup costs against its seller, who would even be barred from asserting the third-party defense because of its contractual relationship with the current landowner.

The CERCLA Innocent Seller Defense

As a result of this perceived injustice, a series of federal court decisions from New York have narrowly interpreted the meaning of the phrase "in connection with a contractual relationship" to allow former landowners to invoke the third-party defense against current landowners. These cases hold that the former owner will be precluded from raising the defense only when the underlying contract relates to the hazardous substances or allows

the former landowner to exert some sort of control over the third party.

Under this line of cases, the mere existence of such a contractual relationship as a land contract or deed will no longer bar the defense. One of the first hints that former owners could avail themselves of this defense occurred in *United States v. Hooker Chemicals & Plastics Corp.*,[3] where a federal district court for the western district of New York examined the nature of the contractual relationship between the defendant and purchasers of property containing the infamous Love Canal landfill. However, because the defendant had been able to exert control over the purchasers, the court ruled that the defendant could not raise the third-party defense.

Likewise, in *Shapiro v. Alexanderson*,[4] the federal district court for the southern district of New York looked beyond the statutory language to examine the contractual relationship between the parties. Because the contract between the parties gave the defendant the right to operate a dumping operation, the court ruled that the contractual relationship did relate to the disposal of hazardous substances and the third-party defense was not available.

It was not until *Westwood Pharmaceuticals, Inc., v. National Fuel Gas Distribution Corp. (Westwood I)*[5] that prior owners were permitted to invoke the defense in a cost recovery or contribution action filed by a current landowner. This case also illustrates the importance of the innocent seller's defense, since the defendant in this case was not able to assert the intervening passive landowner's defense due to its disposal of hazardous substances during its ownership of the property.

Case History. In *Westwood,* the defendant's predecessor corporation, Iroquois Gas Corp., sold a former natural gas manufacturing and storage facility to the plaintiff in 1972. Prior to the sale, Iroquois had demolished a number of structures on the site, purged and plugged the underground pipelines, pumped the contents of tar separator pits, and then built a clay cap over the demolished pits. The sales contract advised Westwood that residual chemicals would likely remain even after these measures had been completed and that due care would have to be exercised during demolition if cutting tools or torches were to be used that might produce sparks, flames, or generate heat.

During its demolition operations, Westwood collected soil borings which revealed that the soil was contaminated with wastes and by-products from the gas manufacturing operations. In addition, while excavating the foundation for a new warehouse, Westwood exposed the tar pits and, in the process, removed the clay cap that was designed to contain the contents of the pits. Westwood eventually expended over $750,000 in investigation and cleanup costs and sought to recover these costs from National Fuel Gas Distribution Corp. as the successor to Iroquois Gas Corp. under CERCLA and state common law grounds.[6]

Arguments. National argued that it was not liable under CERCLA because it had not owned the property at the time of disposal. The essence of National's defense was that depositing hazardous substances into the concrete tar pits covered by a clay cap did not constitute "disposal." The court, however, ruled that the definition of disposal included depositing wastes in a manner that would allow them to enter into the environment. Since the materials had in fact entered the environment, the court reasoned that placing hazardous substances into underground structures or receptacles was a "disposal" for purposes of CERCLA liability.

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National then raised the third-party defense, claiming that the hazardous substances would have not been released if Westwood's construction activities had not breached the structural integrity of the underground receptacles and the clay cap. Westwood moved for summary judgment, arguing that National was barred as a matter of law from asserting the third-party defense because of the contractual relationship between the two parties. National countered that the mere existence of a contractual relationship did not preclude a former owner from invoking the protection of the third-party defense. The court agreed National was entitled to present proof that the construction activities conducted at the site were not undertaken in connection with the contractual relationship between Iroquois and Westwood.

LENDER LIABILITY UPDATE

Three federal court decisions were recently issued that interpret the EPA's lender liability rule. Two of the cases help to further define the kinds of actions that financial institutions may take without incurring liability under CERCLA. The third case, however, is sure to send shudders through bank trust departments because it holds that banks who have record title to contaminated property in their capacity as an estate trustee will be liable for the clean-up costs associated with the property. These cases are also significant because they demonstrate that the lender liability rule will be applied retroactively to transactions that took place prior to the April 29, 1992 effective date of the lender liability rule.

In *Ashland Oil v. Sonford Products Corp.*,[1] the federal court for the district of Minnesota ruled that a financial institution that had taken title to its borrower's assets fell within the protection of the lender liability rule because it had acquired the property to protect its security interest and sold the land in conformance with the rule's foreclosure requirements.

Another favorable ruling for lenders was *Kelley v. Tiscornia and Manufacturers National Bank of Detroit*,[2] where a federal district court refused to impose liability on a bank that maintained exceedingly tight rein over its borrower during a workout because the lender's actions were protected by the EPA lender liability rule. This was a significant decision that will give the lending community great relief because financial institutions have been held liable in the past on a similar set of facts.

In this case, the state of Michigan sought to recover from Michigan National Bank (MNB) response costs incurred at the Auto Specialities Manufacturing Co. (AUSCO). Michigan argued that MNB had participated in the management of the AUSCO site by taking the following actions:

- An officer of MNB sat on the AUSCO board from 1964–1986.
- Between 1985–1988, MNB monitored AUSCO's cash flow on a daily basis, prohibited outside financing, and banned dividends.
- In 1986, MNB threatened to terminate its financial relationship with AUSCO unless the company terminated its CEO and CFO and hired a turnaround specialist, Benjamin Sachs, recommended by MNB as president and CFO.
- AUSCO officers were told by MNB that it would terminate its relationship if the company did not accede to Sachs' bonus demands.
- MNB representatives and Sachs met weekly to discuss the company's operations.
- Minutes of executive committee meetings indicated that Sachs had cleared expenditures for relocating the company's offices with MNB.
- An MNB loan officer told AUSCO officers that he had authorized Sachs to fire the officers.

Using the doctrine of equitable subordination, however, the court found that none of these actions created the inference that MNB had exercised the kind of operational control over AUSCO that was required to impose CERCLA liablity under the EPA lender liability rule. Instead, the court held that MNB was simply exercising prudent financial oversight.

Based on prior decisions, the court could have ruled either way and the court was apparently not sympathetic to the concept of imposing CERCLA liability on banks. The court said imposing such liability would increase the number of abandoned hazardous waste sites because banks would refuse to extend credit to troubled borrowers and might even call loans instead of nursing financially ill borrowers back to health if such actions could expose the banks to liability.

Under the reasoning of this court, the only way a lender will be able to be liable under CERCLA for participating in the management of a facility will be if a banker actually operates the assembly-line or personally tosses hazardous waste drums out the backyard. Until other jurisdictions endorse the view of the MNB court, however, bankers should continue to cautiously proceed during workouts.

The most important case, though, was *City of Phoenix v. Garbage Services Co.*[3] where a bank was held

Court Rulings. On Westwood's motion for reconsideration (*Westwood II*),[7] the court affirmed its earlier ruling. In trying to convince the court that its earlier decision was erroneous, Westwood had argued that language of Section 101(35)(C) of the innocent landowner's defense indicating that

liable as an owner of a landfill because it held record title as the trustee of an estate. In this case, the Valley National Bank (VNB) was appointed executor of the Wilbur Estes estate. Estes's will also established a testamentary trust that conveyed the balance of Estes's property to VNB as trustee.

VNB subsequently exercised an option to purchase a landfill in 1966 and the warranty deed conveyed the property to VNB "as trustee." At the time of the conveyance, the landfill was leased and operated by Garbage Services Co. (GSC). VNB continued this arrangement, paid property taxes, and also obtained liability insurance for the landfill.

After the landfill ceased operating, the City of Phoenix commenced condemnation proceedings where VNB was found to be the sole record owner of the site. When Phoenix later sought to recover from VNB the clean-up costs incurred to remediate contamination from hazardous substances that had been disposed at the landfill, VNB moved for summary judgment that it was neither an owner or operator of the landfill.

The court agreed that VNB was not an operator of the landfill because the bank was not involved in the day-to-day administration of the landfill. The court indicated that VNB did not know the identity of GSC's customers and its communications with VNB were limited to tax matters involving the estate and not operation of the landfill. The court found, however, that VNB was the owner of the landfill. The court found that Congress intended the term "owner" to have the broadest possible meaning and that under trust law, a trustee holding legal title could be liable as an owner of the land for obligations flowing from the land.

VNB argued that the lender liability rule insulated it from liability but the court gave short shrift to this argument, ruling that the rule only applied to lenders acting in their role as secured creditors and was not controlling when a bank held bare title as a trustee.

To further buttress its holding, the court pointed to PRP letters that the EPA had sent to trustees in other CERCLA actions as evidence that the EPA also agreed that trustees could be liable as owners. The court rationalized that it had to give deference to the EPA's interpretation of the statute. In so doing, however, the court ignored the EPA's comments in the preamble to the lender liability rules where the agency said while a trust's assets may be liable for a cleanup, the agency knew of no case where a trustee could be personally liable solely because trust assets were contaminated.

During the public comment period preceding the adoption of the lender liability rule, the lending industry vigorously pressed to have the rule extended to fiduciaries and trustees. The EPA indicated, however, that it found no colorable basis for construing the secured creditor's exemption to cover instances where financial institutions hold title as trustees and not simply to protect their security interest.[4]

This case demonstrates the limited protection of the lender liability rule. Financial institutions often act in a variety of representative capacities such as trustees of living trusts, testamentary trusts, probate estate personal representative, guardian or conservator of an estate, corporate trustee, retirement plan trustee, and bankruptcy, and the estates that they administer or manage may contain real estate that could be contaminated with hazardous substances from prior operations. Often times, a bank trust department may not be advised of its appointment until just before the will is offered for probate and, therefore, may not have the time to undertake the "appropriate inquiry" required to raise the innocent purchaser's defense. Although the bank may be able to subsequently renounce its appointment after learning of an environmental problem, such action would not abrogate any potential liability that it may already have incurred as an owner or operator of the estate's contaminated property. It remains to be seen whether the *City of Phoenix* case will have the same effect as the *Fleet Factors* case had and serve as a rallying point around which lenders may be able to apply pressure on the EPA or Congress to extend the cloak of protection afforded by the lender liability rule to banks acting as trustees or fiduciaries.

Notes

[1] No. 3-91-0715, 1993 U.S. Dist. LEXIS 259 (D. Minn. January 11, 1993).
[2] No. 5-90-CV-62, 1993 U.S. Dist. LEXIS 370 (January 12, 1993).
[3] No. C 89-1709 SC (D. Ariz. January 19, 1993).
[4] 57 Fed. Reg. 18,349 (April 29, 1992).

the paragraph did not diminish the liability of former owners who are otherwise liable precluded a former owner from invoking the third-party defense. The court, however, expressly agreed with National that Section 107(b)(3) created an innocent seller defense and rejected Westwood's contention that the innocent landowner's defense barred a prior owner from raising the third-party

defense. In so holding, the court observed that the innocent landowner defense only applied to innocent parties and, thus, could not impair the rights of noninnocent parties under the third-party defense. Furthermore, the court reasoned that if Congress had intended to alter such a fundamental change in the scope of the third-party defense, it would have amended Section 107(b)(3) itself.

On appeal, the federal appellate court for the Second Circuit upheld the district court's ruling that the phrase "in connection with a contractual relationship" did not embrace all acts of a third party that were in contractual privity with a defendant (*Westwood III*).[8] Instead, the court ruled that a former landowner would only be precluded from invoking the defense when the contract was somehow connected with the handling of hazardous substances or the contract allowed the former owner to exert some control over the third-party's actions so that the former owner could be fairly held liable for the release of the hazardous substances. The court said that there must be a connection between the acts or omissions of the defendant and the contractual relationship. To hold otherwise, the court went on, would be to render the phrase as mere surplusage.

Likewise, the court dismissed the notion that the innocent landowner's defense precluded a former landowner from asserting the third-party defense. The court found that the language of Section 101(35)(C) that Westwood relied upon merely described the contours of the innocent landowner exception and did not abrogate the right of previous owners to invoke the third-party defense.

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Observation. It is important to recall that even after a former owner establishes that the release was solely to the act or omission of the third party that did not take place in connection with a contractual relationship, the prior owner will also have to demonstrate that it exercised due care with respect to the hazardous substances and also took precautions against the foreseeable acts or omissions of the third party causing the release. These requirements highlight the importance of seller environmental due diligence prior to transferring property. The seller could use the environmental due diligence to demonstrate that it handled the hazardous substance with due care. Furthermore, the environmental due diligence would enable the seller to document that it took precautions against acts or omissions of a third party by alerting the purchaser to the existence and location of hazardous materials stored or disposed at the site.

Applicability to Leaseholds

The premise of the innocent seller line of authority that a former owner may only be barred from invoking the third-party defense if the contractual relationship is somehow related to the handling of hazardous substances should be applicable to leases. After all, except in those few cases where the tenant will be operating a disposal facility, the contractual relationship between the landlord and tenant would not involve the handling of hazardous substances. One could argue, though, that the extension of the innocent seller defense would be less appropriate in circumstances where the tenant is not operating under a true net lease and the landlord continues to retain some responsibility or control over the demised premises. Indeed, in the only post-*Westwood* decision addressing the availability of the third-party defense to landlords, another New York federal district court came down on both sides of this issue.

In *U.S. v A&N Cleaners and Launderers, Inc.*[9], the federal court for the southern district of New York refused to extend the *Westwood III* ruling to a prime lease but allowed the landlord to raise the third-party defense against its sublessee. Relying on principles of landlord/tenant law, the court found that there was no contractual relationship between the landlord and its subtenant that would preclude the landlord from asserting the third-party defense against the sublessor. The court also indicated that while the landlord could exert control over its tenant by virtue of its lease covenants, the landlord had no such authority to control its subtenant. The court made this finding even though the landlord discussed site maintenance issues with the sublessee. It would appear that the

court's ruling was influenced by the fact that the lessor did not receive any rent payments from the sublessee.

The court found, however, that the lease between the landlord and tenant did constitute a contractual relationship that would bar the landlord's third-party defense because the premises were to be used for a dry cleaning establishment and that business used hazardous substances. The problem with this decision is that most businesses use some quantities of hazardous chemicals or materials. If the existence of a contractual relationship involving hazardous substances is determined by whether the tenant will use hazardous substances, then nearly every lease will fall within this category. As a result, very few landlords would be able to assert the third-party defense under the rationale employed by the *A&N Cleaners* court. Perhaps the lesson to be learned is that landlords should not memorialize the nature of their tenant's operations in the lease but, instead, simply provide that the tenant's use of the property will be in accordance with law.

Conclusion

Thus far, the innocent seller defense has been limited to the Second Circuit federal courts serving New York, but since the Second Circuit is extremely influential, other jurisdictions may soon endorse this defense. It remains to be seen, however, if the *Westwood III* decision will be extended to developers or managers of industrial properties or absentee landlords with triple net leases who do not exercise control over their tenants' operations. ■

Notes

[1] Sunnen Prods. v. ChemTech Indus., Inc., 658 F. Supp. 276, 278 note 3 (N.D. Ala. 1987); Mardan Corp. v. C.G.C. Music, Ltd., 600 F. Supp. 1049 (D. Ariz. 1984); Violet v. Picillo, 648 F. Supp. 1283 (D.R.I. 1986); United States v. Mottolo, 605 F. Supp. 898, 909 (D.N.H. 1985).
[2] 42 USC 9607(b)(3).
[3] 680 F. Supp. 546 (W.D.N.Y. 1988).
[4] 741 F. Supp. 472 (S.D.N.Y. 1990).
[5] 964 F.2d 85 (2d Cir. 1992).
[6] 737 F. Supp. 1272 (W.D.N.Y. 1990).
[7] 767 F. Supp. 456 (W.D.N.Y. 1991).
[8] 964 F.2d 85 (2d Cir. 1992).
[9] 788 F. Supp. 1317 (S.D.N.Y. 1992).