The Passive Intervening Landowner—A New CERCLA Defense

by Larry Schnapf

During the past few years, a series of federal court decisions has dramatically broadened the liability that property owners/managers and their lenders may face under the federal Comprehensive Environmental Response, Compensation and Liability Act of 1986 (CERCLA). These rulings not only impose enormous clean-up costs on owners but also severely restrict the defenses to liability that landowners may assert.

Recently, however, a line of cases has emerged that allows truly innocent parties who are in the chain of title but who were not responsible for the contamination to escape liability under CERCLA. This new defense is known as the passive intervening landowner defense.

CERCLA Liability and Defenses. Under CERCLA, two classes of property owners may be liable for all clean-up costs associated with contaminated property. The first category is found in Section 9607(a)(1), which provides that a current owner/operator of a site that is contaminated with hazardous substances will be held liable even if it did not place the hazardous waste on the site or was not responsible for the discharge. The second category is mentioned in Section 9607(a)(2), which extends liability to former owners or operators who owned or operated a site "at the time of disposal." 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 the property while hazardous wastes were migrating or leaking, but who did not deposit the wastes, is liable for the clean-up costs of the contaminated property.

In addition, although CERCLA generally exempts from the definition of owner or operator parties holding security interests in contaminated properties, those parties may lose their immunity if they acquire title to the contaminated property through foreclosure or if they participate in the management of the facility.

There are only three affirmative statutory defenses that a landowner can assert under CERCLA, although some courts have allowed defendants to raise common-law equitable defenses as well. The defense most often raised is the third-party defense. However, in order to establish the third-party defense, a landowner must establish by a preponderance of the evidence that the release and resulting damages were

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caused *solely* by an act or omission of a third party other than an employee or agent of the defendant and that the act did not occur in the context of a direct or indirect contractual relationship with the defendant. Furthermore, the landowner must demonstrate that it exercised due care with respect to the hazardous substances, taking into account the characteristics of the hazardous material and the circumstances or facts involved, and also took precautions against foreseeable acts or omissions of any third parties and the consequences that could foreseeably result from such actions or omissions.

CERCLA specifically defines "contractual relationship" as including "land contracts, deeds or other instruments transferring title or possession."[1] As a result, courts have narrowly construed the scope of the third-party defense so that it is virtually meaningless. For example, by virtue of its contractual relationship with its tenant, a landlord will not be able to raise the third-party defense to CERCLA liability contamination solely due to operations of its 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.[2] Under this interpretation, only the acts of trespassers, adjacent landowners, or midnight dumpers could be used by a landowner as evidence that damages were caused by a third party and then only if the landowner demonstrated it had exercised due care.

Innocent Purchaser's Defense. To reduce the impact of this harsh application of the third-party defense on purchasers who acquire title to property that is already contaminated, Congress adopted in 1986 an innocent purchaser's defense, which completely exonerates such a purchaser from liability. In order to take advantage of this affirmative defense, the owner or operator must establish that it did not know and had no reason to know that any hazardous substances were disposed at the facility. To establish that it had no reason to know of the contamination, a purchaser must demonstrate that it took "all appropriate inquiry into the previous ownership and uses of the property consistent with good commercial or customary practice in an effort to minimize liability." In determining whether there was an appropriate inquiry, CERCLA requires that a court take into consideration any specialized knowledge or experience of the innocent owner, as well as the relationship of the purchase price to the value of the contaminated property, commonly known or reasonably ascertainable information about the property, and whether the presence of contamination was obvious or could be detected by an appropriate site inspection.

In enacting this innocent purchaser's defense, Congress attempted to establish a course of conduct in real estate transactions. It is certain that sophisticated buyers such as real estate developers must perform detailed site investigation in order to take advantage of this defense. In addition, those involved in commercial transactions will be held to a higher standard than persons acquiring residential property for personal use. The duty to inquire will be measured at the time the property was acquired, and the higher standard by which landowners' actions will be judged will be raised with increased public awareness of environmental hazards.

However, exactly what constitutes "all appropriate inquiry" is somewhat unclear because the EPA analyzes each transaction on a case-by-case basis, and the few cases that have interpreted the innocent purchaser's defense have resulted in somewhat conflicting results.

In *Washington v. Time Oil Co.,*[3] the innocent purchaser's defense was not available to the defendant because the court found that the defendant was aware of its sublessee's sloppy operations and failed to exercise due care to prevent the sublessee from contaminating the property. Likewise, the innocent purchaser's defense was also narrowly construed in *Wickland Oil Terminals v. ASARCO, Inc.,*[4] where the court rejected the plaintiff's assertion that it qualified as an innocent purchaser because the presence of slag piles on the property gave the plaintiff reason to know that there were hazardous substances on the property. However, in *U.S. v. Serafini,*[5] where the defendant had purchased a former dump site littered with abandoned drums without a prior inspection, the government's motion for summary judgment was denied because the court wanted to determine whether the defendant's failure to perform a site inspection was inconsistent with good commercial practice in effect in 1969 when the site was acquired.

[1] 42 U.S.C. § 9601(35)(A).

[2] Washington v. Time Oil Co., 687 F. Supp. 529 (W.D. Wash. 1988).

[3] 687 F. Supp. 529 (W.D. Wash. 1988).

[4] No. C-83-5906-SC (N.D. Cal. 1988).

[5] 706 F. Supp. 346 (M.D. Pa. 1988).

The Passive Intervening Landowner Defense. While the innocent purchaser's defense may be a viable tool for prospective property owners, it will most likely be unavailable to former property owners who were in the chain of title prior to the enactment of CERCLA and who did not conduct an environmental due diligence examination before they acquired the land. Since the EPA views anyone in the chain of title as a liable party, former property owners are attractive targets for suits by the government or private parties seeking recovery of their clean-up costs.

However, in *Ecodyne Corp. v. Shah,*[6] the federal district court for the northern district of California adopted a narrow view of the scope of the past owner provision of Section 9607(a)(2). In that case, the plaintiff operated a wood-treating operation between 1969 and 1984. After discovering that the property was contaminated with chromium, the plaintiff reduced the sales price of the property and sold it to the defendant who, in turn, transferred the parcel to a third party. Under the ownership of the subsequent owners, the chromium contamination worsened. After the plaintiff was ordered by state authorities to remedy the site, it brought a cost recovery action against the defendant.

The plaintiff argued that the defendant was the owner of the property while the chromium in the ground was migrating and was therefore an owner "at the time of disposal." However, the court ruled that the term "at the time of disposal" did not refer to mere movement or migration of preexisting contamination.

CERCLA does not contain its own definition of "disposal" but, instead, incorporates the definition used in Section 1004 of the Resource Conservation and Recovery Act (RCRA). Examining the definition of "disposal," the court said that the common thread in the terms used to define disposal was "that someone do something with hazardous substances" and that "disposal" did not include general migration of pollutants. Thus, the court said, an action may be maintained against a past owner or operator only if the hazardous substances were actually introduced or deposited onto the property at the time the prior party owned or operated the site. The mere migration or movement of preexisting contamination during the time a party owned or operated the property, the court went on, was insufficient to impose liability on a past owner when another party placed the pollutants on the property.

The court said that this interpretation was consistent with the liability scheme established under CERCLA. The court said that Section 9607(a)(2) had a more temporal or limited scope than the current owner/operator provision of Section 9607(a)(1) and that to adopt the plaintiff's position would in essence render that section superfluous.

> To define disposal as plaintiff wishes would effectively make all property owners from the time a site became polluted (up to and including the current owner) potentially liable under 9607(a)(2) even if these owners did not introduce the chemicals onto the site. Such a construction conflicts with the scope of 9607(a)(2).[7]

Since it was undisputed that the plaintiff had introduced the chromium to the property, the court ruled that the plaintiff alone was responsible for the cleanup of the contamination. It remains a mystery why the plaintiff did not bring a cost-recovery action against the current owner under Section 9607(a)(1).

The *Ecodyne* reasoning was endorsed by the bankruptcy court for the western district of Michigan in *In re Diamond Reo Trucks, Inc. v. City of Lansing et al.*[8] In this case, the debtor owned and operated an automotive manufacturing facility from 1904 to 1975. In 1972, the debtor sold the property to one of the defendants, EIC, Inc. The firm, in turn, immediately sold the property to a group of individuals known as the Hayes defendants, who then leased the premises back to the plaintiff.

After the debtor ceased operations in 1975, the Hayes defendants sold the property back to EIC. The property was then sold to defendant Southern Salvage who in turn conveyed a portion of the land to defendant Reo Properties. The city of Lansing ultimately acquired title because of nonpayment of taxes. After the city was forced to clean up the site, it filed a claim against the trustee of the estate, who then sought contribution from the other defendants.

In ruling on a number of summary judgment motions brought by the parties, the time of ownership was the key factor in determining liability. In so ruling, the court distinguished between passive and active disposal.

The court ruled that Reo Properties, which held title for a period of time after operations had ceased on the property, could not be liable under Section

[6] 718 F. Supp. 1454 (N.D. Cal. 1989).

[7] *Id.*

[8] 115 Bankr. 559 (Bankr. W.D. Mich. 1990).

9607(a)(2) because it had not actively engaged in disposal activities. The court said that mere ownership of a site during a period of time when hazardous substances were migrating or leaching, without some sort of active disposal, was insufficient to impose liability under the past-owner section of CERCLA.

The court's rulings on two other defendants illustrated the bounds of this defense. The Hayes defendants, who held title while the debtor was operating, argued that they should not be liable because they never operated the plant. However, the court found that they could not avail themselves of the defense because their ownership of the facility during the time that hazardous substances were deposited by the debtor was sufficient to impose liability under Section 9607(a)(2).

In examining the liability of EIC, however, the court stretched this new defense well beyond the *Ecodyne* precedent. In declining to hold EIC liable, the court once again reaffirmed the adage that timing can be everything in life.

It is worth remembering that EIC had held title for two periods. It owned the property for a short period of time in 1972 while operations (and presumably disposal) were occurring and in 1976 after the debtor had ceased operations. The court found that EIC was not liable for the 1976 period because, consistent with its other rulings, no disposal or at least simply passive disposal was taking place at the time. However, the court also found that EIC could not be liable for the 1972 period because it was simply a "straw" (i.e., conduit) through which title passed to the Hayes' defendants. The court held that EIC was simply a constructive owner and that its link to the property was so tenuous that to hold EIC liable "would be extending the statutory language to an absurd plateau, thereby perverting the congressional intent."[9]

Discussion. The *Ecodyne* and *Diamond Reo* courts adopted extremely narrow views of the meaning of "disposal." Under this line of authority, current owners and operators are responsible for any contamination that is present on the site regardless of who introduced the contaminants into the environment, while past owners will avoid liability for preexisting contamination if they are fortunate enough to convey the land before the government learns of the contamination and institutes legal proceedings to compel a cleanup or recover the costs of a cleanup.

These cases reverse a trend toward expanded liability of former property owners. In particular, the treatment of EIC in the *Diamond Reo* ruling could have enormous application in the current economic climate, because it can provide real estate investors and lenders with a vehicle to swiftly develop or turn around a piece of depressed industrial or commercial property without incurring CERCLA liability.

In addition to providing real estate owners with a new defense to liability, the *Ecodyne* line of cases may also encourage lenders to liberalize the credit policies regarding contaminated properties. The thrust of these cases and the decision of the U.S. Court of Appeals for the Ninth Circuit in *In re Bergsoe*[10] is that lenders may foreclose on contaminated property that has redevelopment potential without forfeiting their immunity from liability if operations (and thus any discharges) have ceased and the land is resold after just a short period of time. In a limited-liability environment, lenders may shift their focus from avoiding potential environmental liability to extending credit to sites with solid redevelopment potential.

The *Ecodyne* line of authority is contrary to the long line of cases holding that anyone in the chain of title is liable under CERCLA, regardless of how long they held title. It remains to be seen whether other jurisdictions will adopt this concept. In the meantime, the passive intervening landowner defense remains a valid defense that may afford truly innocent landowners and lenders a glimmer of hope for immunity from CERCLA liability and should be aggressively pursued. ■

[9] *Id.* at 568.

[10] 910 F.2d 668 (9th Cir. 1990). See case summary by the author in Goodman and Shelton, "The Effects of Environmental Law on Secured Lenders," *The Real Estate Finance Journal* 6 (Winter 1991): 39.