

THE THIRD PARTY AND TRANSACTION-RELATED DEFENSES OF CERCLA: AN OVERVIEW

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Enacted in 1980, the Comprehensive Environmental Response Compensation and Liability Act (CERCLA or Superfund), 42 U.S.C. §§ 9601-9675 (2002), dramatically changed the scope of liability and corresponding risks for parties dealing with contaminated properties, resulting in two decades of litigation, which shows no sign of stopping. An effect of Superfund was to chill real estate transactions, especially those involving "Brownfields," congressionally defined as real property, the expansion, redevelopment, or re-use of which may be complicated by the presence or potential presence of contamination. This article first provides a brief overview of Superfund and its defenses, then focuses on the third party defense, and finally compares the third party defense to subsequently added, transaction-related defenses, which were intended to facilitate Brownfields development.

I. Overview of Superfund and its Defenses

Before CERCLA, environmental statutes generally regulated conduct prescriptively, providing for penalties for violations. In CERCLA, Congress created a new paradigm, imposing liability based not on a violation of law, but rather on a person's relationship to a site from which there has been a release or threat of release of a "hazardous substance." Those liable under CERCLA, referred to as potentially responsible parties or PRPs, include present owners and operators of a contaminated site, and those who owned or operated it at the time of disposal, transporters who selected the site, and those who arranged for disposal of their wastes at the site. 42 U.S.C. § 9607(a) (2002). CERCLA liability is strict, generally joint and several, and unlimited. Damages recoverable under CERCLA include costs of investigating and remediating

hazardous substance-contaminated sites and associated natural resource damages.

As originally enacted, CERCLA provided three defenses: (1) act of God; (2) act of war; or (3) act or omission of a third party ("third party defense"). 42 U.S.C. § 9607 (b). To claim one of these defenses, a PRP must show that the release or threat of release of hazardous substances and the resulting damages were caused solely by one or a combination of these three actors. Of these three original defenses, the most viable has proved to be the third party defense.

To claim the third party defense, the defendant must show not only that the release or threat of release was caused solely by the act or omission of a third party, but also that: (1) the third party was not the defendant's employee or agent, or one whose act or omission occurred in connection with a contractual relationship, existing directly or indirectly, with the defendant; (2) the defendant exercised due care with respect to the hazardous substances; and (3) the defendant took precautions against the foreseeable acts or omissions of the third party and the consequences that could foreseeably result from the acts or omissions.

In 1986, Congress enacted the 1986 Superfund Amendments and Reauthorization Act (SARA), Pub. L. 99-499, 100 Stat. 1728 (2002), which modified the third party defense by creating the innocent landowner (ILO) defense. The ILO affords protection to three types of acquirers of property: (1) innocent purchasers; (2) government entities acquiring a facility by involuntary transfer, condemnation or eminent domain; and (3) those acquiring a facility by inheritance. The ILO defense was the first CERCLA defense to focus on parties to a real estate transaction. Under the ILO defense, even if the proscribed contractual relationship were present, the PRP nonetheless could take advantage of the third party defense if it prove that it satisfied the requirements for establishing that it was an innocent landowner. To be an innocent purchaser – the first type of ILO – the PRP must prove that it acquired the property after

disposal of the hazardous substances and that, at the time of acquisition, it did not know and had no reason to know that any hazardous substances were disposed at the facility. 42 U.S.C. § 9607(b)(3) and § 9601(35)(A)(i). The standard for determining whether the PRP had “reason to know” is whether the PRP made “all appropriate inquiry” (AAI). 42 U.S.C. § 9604(35)(B). While there remained some areas requiring clarification, the innocent purchaser defense was born with AAI as its defining criterion.

In 2002, to specifically encourage Brownfields development, Congress enacted the 2002 Small Business Liability Relief and Brownfields Revitalization Act (the “Brownfields Amendments”), Pub. L. No. 107-118, 115 Stat. 2356 (2002). The Brownfields Amendments clarified that a “contractual relationship” included land contracts, deeds, easements, leases or other instruments transferring title or possession, and, by amending the definition of contractual relationship, added to CERCLA two new, transaction-related defenses – the bona fide prospective purchaser (BFPP) defense and the contiguous landowner (CLO) defense, 42 U.S.C. §§ 9607(r) & (q). Congress provided for EPA rulemaking to clarify AAI, and included AAI and certain continuing obligations as a prerequisite to the innocent purchaser, BFPP and CLO defenses. For BFPP and CLO defenses, it also required a showing of no affiliation with a liable party,

The relationships among the two new defenses, the ILO defense, and the third party defense are confusing. At the end of this article, we include a chart to help explain the relationship of the various CERCLA defenses to each other.

II. The Third Party Defense, the Contractual Relationship Exclusion and the Innocent Landowner Defense

Various elements of the third party defense have been litigated; of particular interest is the contractual relationship exclusion, *i.e.*, whether the act or omission of the third party that gave rise to the release occurred in connection with a contractual relationship with the defendant, in particular, as that defense might apply to parties to a real estate transaction.

Prior to SARA, there was a dearth of pertinent case law. In a 1984 case, *U.S. v. Argent Corp.*, 1984 WL 2567 (D.N.M. 1984), the court found a lease to be a proscribed “contractual relationship” without bothering to analyze the nature of that relationship. Following SARA, a number of courts focused on the contractual relationship exclusion of the third party defense. The case law fell into two categories: those in which the courts disregarded the “in connection with” exclusion and those that considered it. Of those cases that considered this exclusion, some considered the effect of SARA’s legislative changes and other courts appear to have ignored them.

Disregarded “in connection with”

The Ninth Circuit, in *Carson Harbor Village, Ltd. V. Unocal Corp.*, 270 F.3d 863 (9th Cir. 2001), read SARA as “clarifying” that one who buys property from a polluting owner cannot present a third party defense. The Third Circuit similarly noted that the third party defense “is generally not available if the third party causing the release is in the chain of title with the defendant.” *United States v. CDMG Realty Company*, 96 F.3d 706, 716 (3d Cir. 1996).

The Sixth Circuit, in *United States v. 150 Acres of Land (150 Acres)*, 204 F.3d 698, 704 (6th Cir. 2000), took the same stance, holding that “Present owners who acquired their interests by land contracts, deeds, or other instruments transferring title or possession, and *not* by inheritance or bequest, must also have undertaken ‘all appropriate inquiry’ when they acquired the property to avoid liability.” *But see, U.S. v. Cordova*, 113 F.3d 572 (6th Cir. 1997), *discussed infra*, which acknowledges the “in connection with” requirement.

Many of the district courts that disregard the nexus requirement also view the adoption of SARA as confirmation that a subsequent purchaser has a contractual relationship with all predecessors in title that is sufficient to bar the third party defense. *See M&M Realty Co. v. Eberton Terminal Corp.*, 977 F. Supp. 683, 686 (M.D. Pa. 1997); *Goe Engineering Co., Inc. v. Physicians Formula Cosmetics, Inc.* 1997 WL 889278 (C.D. Cal. 1997)

(enactment of SARA confirms that the sale of land is the “contractual relationship” that precludes a third party defense); *State ex rel. Howes v. W.R. Peele, Sr. Trust*, 876 F. Supp. 733, 745 (E.D.N.C. 1995) (purchase of the property created a contractual relationship sufficient to defeat the third party defense, leaving only the innocent landowner defense available). Other courts, without relying on SARA, ignore the nexus requirements or mistakenly merge the third party and innocent purchaser defenses.

A number of courts discuss the contract requirement, but fail to recognize any requirement that there be a nexus linking the contract to the act or omission causing the release. For example, in *U.S. v. Serafini*, the court found that the defendants received title to a portion of the land comprising the facility. The court then immediately moved into discussion of the “knew or had reason to know” standards for the contamination element of the innocent purchaser defense, but the court failed to discuss whether the contract was causally linked in any way to the hazardous substances. 706 F. Supp. 346, 352 (M.D. Pa. 1988). In *U.S. v. Domenic Lombardi Realty, Inc.*, 204 F. Supp. 2d 318, 332 (D.R.I. 2002), the court found that the land contract provided a sufficient nexus for the purchaser to be left only with the innocent purchaser defense.

Another group of decisions completely fails to consider the contractual relationship and merges the innocent purchaser and third party defenses, simply requiring a demonstration of the elements of the innocent purchaser defense. See *Hidden Lakes Development, LP v. Allina Health System*, 2004 WL 2203406 (D. Minn. Sept. 27, 2004) (current property owner ineligible for third party defense unless it can show that it did not know of the contamination at time of purchase); see also *Lefebvre v. Central Maine Power Co.*, 7 F. Supp. 2d 64 (D. Me. 1998); *1325 G Street Associates, LP v. Rockwood Pigments NA, Inc.*, 2004 U.S. Dist. LEXIS 19178 (D. Md. 2004) (subsequent owner required to meet the requirements for ILO defense); *Kaufman and Broad-South Bay v. Unisys Corp.*, 868 F. Supp. 1212 (N.D. Cal. 1994)(purchaser must rely upon the ILO defense).

Considered the “in connection with” contractual nexus

Among the appeals courts, only the Second Circuit has consistently required that full meaning be given to the “in connection with” statutory language. In *Westwood Pharmaceuticals, Inc. v. National Fuel Gas Dist. Corp.*, the Second Circuit held “a landowner is precluded from raising the third-party defense *only if* the contract between the landowner and the third party somehow is connected with the handling of hazardous substances.” 964 F.2d 85, 89, 91-92 (2d Cir. 1992), (emphasis added). The court also determined that a contract created the requisite connection if the contract allowed the landowner to “exert some control over the third party’s actions so that the landowner fairly can be held liable for the release or threatened release of hazardous substances caused solely by the actions of the third party.” 964 F.2d at 89, 91-92.

The Second Circuit again addressed the connection between the contract and the release, in *New York v. Lashins Arcade Company*, 91 F.3d 353 (2d Cir. 1996). In *Lashins*, the court found that there need be something more than a contract for the purchase of land for the contract to void the third party defense. A “straightforward sale” did not “relate to hazardous substances” or give the purchaser an ability to “exert some element of control” over the third party’s hazardous substance activities. 91 F.3d at 360.

A Sixth Circuit opinion prior to *150 Acres* instructed a lower court to give meaning to the “in connection with” language. *United States v. Cordova Chemical Company of Michigan*, 113 F.3d 572, 583 (6th Cir. 1997) (“The district court, however, ignored the requirement that, in order to render the defense inapplicable, the hazardous substance release must have resulted from the act of a third party ‘in connection with’ the contractual relationship with the defendant. The ‘in connection with’ language of the defense appears to have been designed to preclude a person from escaping liability by contracting for a third party to do his dirty work for him.”). The *Cordova* decision was vacated by the Supreme Court in the *Bestfoods* case and was ignored by the Sixth Circuit in its subsequent consideration of the defense in *150 Acres*.

Courts following *Westwood's* reasoning require something more than a purchase agreement to rule out the third party defense. In *American National Bank and Trust Co. v. Harcross Chemicals, Inc.*, 997 F. Supp. 994, 1001 (N.D. Ill. 1998), a contract for the sale of land was found not to be “in connection with” the contamination, and thus the purchaser was not precluded from asserting a third party defense. See also, *Delaney v. Town of Carmel*, 55 F. Supp. 2d 237, 253-254 (S.D.N.Y. 1999). Similarly, other district courts also have required that the act or omission causing the release must be connected to the contractual relationship. *Shapiro v. Alexanderson*, 743 F. Supp. 268, 270-271 (S.D.N.Y. 1990); *Bob's Beverage, Inc. v. ACME, Inc.*, 169 F. Supp. 2d 695 (N.D. Ohio 1999).

In *Emerson Enterprises, LLC v. Kenneth Crosby Acquisition Corp.*, 2004 WL 1454389 (W.D.N.Y. 2004), a case involving a lease rather than a sale, the district court articulated the nexus test – the contract must either “relate to the hazardous substances or allow the landowner to exert some element of control over the third party's activities” in order to negate the third party defense. In looking at a lease, the Emerson court focused on whether the lease anticipated handling of hazardous substances on the premises or whether the tenant's business “obviously involved the handling of hazardous substances.” *Id.* Applying similar reasoning, many other courts have found that leases preclude a third party defense for the actions of tenants, reasoning that the lease, in allowing the conduct of the business that necessarily involved the use of hazardous substances, is connected to the release. See, e.g., *Bedford Affiliates v. Sills*, 156 F.3d 416, 425 (2d Cir. 1998) (a lessee could not claim a third party defense when the acts of its sublessee, a dry cleaner, caused the contamination); *Briggs & Stratton Corp. v. Concrete Sales & Services*, 20 F. Supp. 2d 1356, 1366-1367 (M.D. Ga. 1998) (lease to a metal plating and finishing business necessarily involved the use of hazardous substances on the premises).

III. Transaction-Related Defenses vs. The Third Party Defense

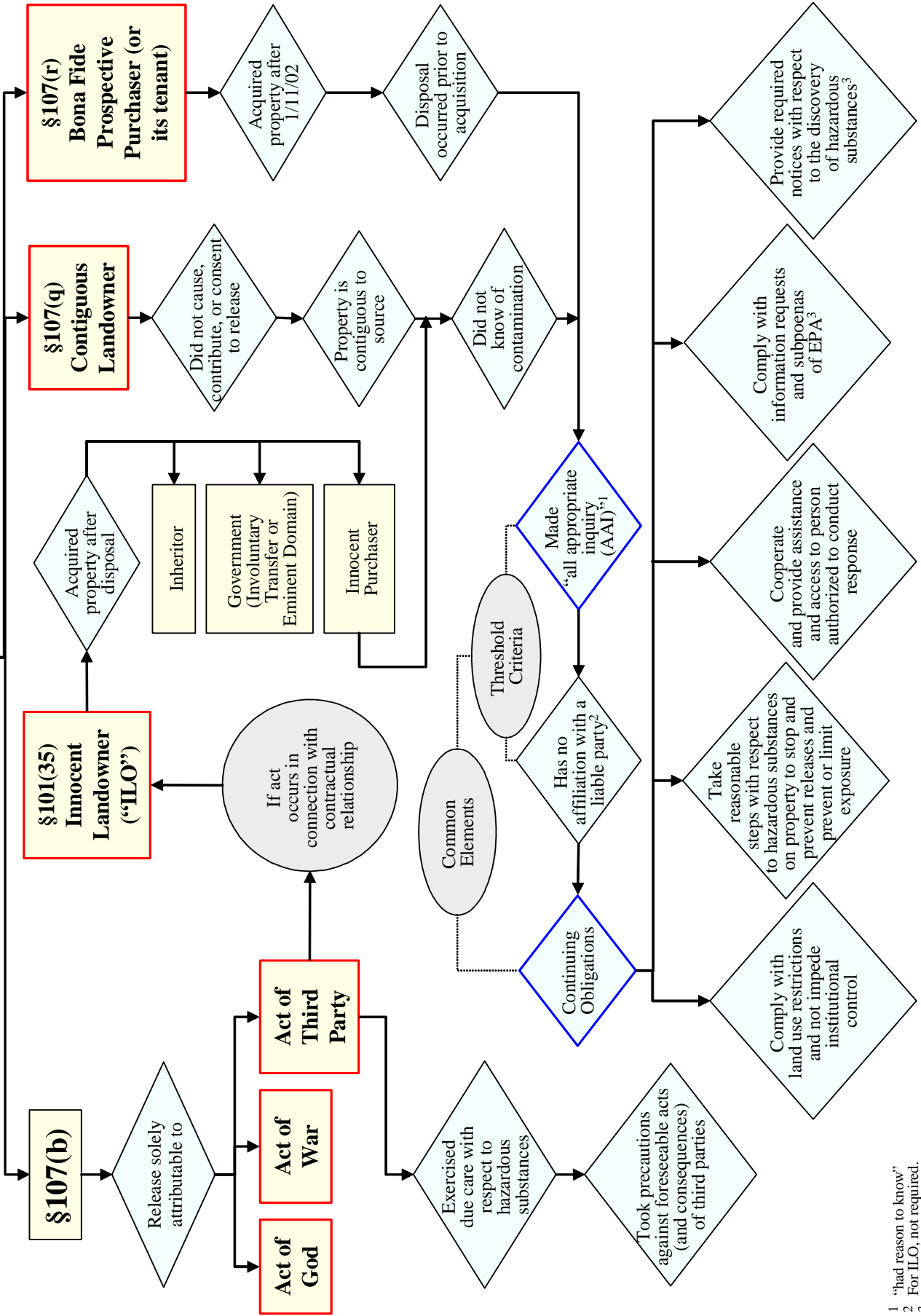
The transaction-related defenses – innocent purchaser, BFPP and CLO – each seek to protect purchasers of contaminated property. In general, however, none of these defenses would be necessary if courts were to focus on the nexus requirement of the contractual exclusion of the third party defense. Moreover, as a practical matter, the elements necessary to satisfy each of the transaction-related defenses make their utility problematic.

All three of the transaction-related defenses require AAI. But even assuming the prospective purchaser conducts AAI, if it learns of contamination, the CLO defense, which applies to persons whose property has been contaminated by an offsite source owned by another, as well as the innocent purchaser defense, become unavailable because the purchaser has knowledge of the contamination. On the other hand, as long as the purchaser acquired the property after disposal and after Jan. 11, 2002, it may take advantage of the BFPP defense, even if the purchaser knows of the contamination.

The Brownfields Amendments require that EPA define standards and practices for AAI to include: (1) results of an inquiry by an environmental professional; (2) interviews with past and present owners, operators and occupants; (3) reviews of historical sources of information; (4) searches for recorded environmental cleanup liens; (5) reviews of governmental and other records; (6) visual inspection of the site and adjacent properties; (7) specialized knowledge or experience of the PRP claiming the defense and commonly known or reasonably ascertainable information about the site; (8) the relationship of the purchase price to the value of uncontaminated property; and (9) the degree of obviousness of the presence or likely presence of contamination and the ability to detect the contamination by an appropriate investigation. 42 U.S.C. § 101(35)(B)(ii) & (iii). In the Aug. 26, 2004 Federal Register, EPA proposed rules setting AAI standards. 69 Fed. Reg. 52542.

The proposed rules move away from the checklist approach of the interim statutory standard – the ASTM

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1 "had reason to know."
 2 For ILO, not required.
 3 For ILO, not explicitly required.

standard for a Phase I Environmental Site Assessment – toward a performance based approach, including the identification and assessment of data gaps, with more reliance upon the judgment of the environmental professional conducting the inquiry. Such a move makes compliance more difficult, and leaves uncertainty whether the inquiry was adequately conducted.

In addition to satisfying AAI, to qualify for the BFPP and CLO defenses under the Brownfields Amendments and the innocent purchaser defense under SARA, purchasers also must satisfy prescribed ongoing requirements. Like AAI, the continuing obligations necessary to take advantage of the transaction-related defenses may be quite burdensome. These continuing obligations include: (1) providing full cooperation, assistance and facility access to the persons that are authorized to conduct response actions at the facility; (2) complying with any land use restrictions established or relied on in connection with the response action at a facility and not impede the effectiveness or integrity or any institutional control employed at the facility in connection with a response action; (3) providing required notices; and (4) taking reasonable steps with respect to hazardous substances on the property to stop and prevent release and prevent or limit exposure. These continuing obligations together, but especially the requirement to stop or prevent releases and to prevent exposure, may be prohibitively costly.

The third party defense, on the other hand, requires neither pre-transaction AAI nor post-transaction compliance with continuing obligations. In addition to making the requisite showings regarding when the disposal occurred and the acts of the third party, the PRP must only establish that it exercised due care with respect to the hazardous substances and that it took precautions against foreseeable acts or omissions of the third party and the consequences that could result. 42 U.S.C. § 9607(b)(3). Presumably, therefore, had courts followed the lead of the Second Circuit and focused on the nexus requirement of the contractual exclusion, parties to real estate transactions would have relied more on the third party defense. Inasmuch as the new transaction-related defenses do contain

burdensome prerequisites and continuing obligations, perhaps we may see more defendants seeking to resuscitate the often neglected third party defense.

As a closing admonition, parties to real estate transactions should realize that the CERCLA defenses, even if available, are affirmative defenses, which must be proved up, and even if established, afford only limited protection. None of the CERCLA defenses protect against liabilities arising under other federal or state statutes, or the common law. Although state analogs of CERCLA generally have incorporated the third party defense, they have not yet incorporated all of the transaction-related defenses. As a result, savvy parties to real estate transactions go beyond AAI in assessing environmental liabilities and risks, realizing there are non-CERCLA liabilities of concern, and look at, among other things, compliance and land use restrictions, as well as potential contamination.