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The Effect of Environmental Regulation on Business Transactions in the United States

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I. Introduction - Environmental regulations in the United States have permeated nearly every aspect of the corporate decision-making process. Traditional common law notions of *caveat emptor* (let the buyer beware), termination of liability after a sale, fault and causation have been replaced by a statutory scheme of strict, joint and several liability for even a minor role in, or relationship to, a release of hazardous substances at a facility. Failure to heed environmental regulations or investigate environmental conditions before entering into a transaction could cost a business millions of dollars in litigation and cleanup expenses. To illustrate how environmental laws and regulations enter into the business decision-making process, this paper examines a "simple" land purchase transaction: ABC Corp., a publicly traded corporation, wants to expand its existing manufacturing facility by purchasing an adjacent facility from XYZ Corp. In particular, the focus is on the various alternatives available to ABC and XYZ to limit their exposure to environmental liability. Lender liability issues and Securities and Exchange Commission ("SEC") reporting requirements are also discussed.

II. Principal Environmental Regulations Affecting Business Decisions

A. History of Environmental Regulation - The birth of modern federal environmental regulation took place in the 1970s.

1. The National Environmental Policy Act of 1969 ("NEPA"), 42 U.S.C. § 4321, requires that a federal agency prepare an environmental impact statement ("EIS") for major federal actions that may have a significant impact on the environment.

a. Federal projects and actions that require an EIS include: (1) actions undertaken directly by federal agencies, such as operation of their programs and construction of

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facilities; (2) funding of projects supported by federal contracts, grants, subsidies, loans or other forms of federal assistance; and (3) granting by federal agencies of certain permits, licenses, approvals, leases, certificates or other entitlements.

b. An EIS is not required if an environmental assessment discloses a "finding of no significant impact" ("FONSI").

2. The Clean Water Act ("CWA"), 33 U.S.C. § 1251, establishes uniform standards and permit requirements for discharges into the waters of the United States and provides for the establishment of ambient water quality standards by the states.

a. The CWA requires a National Pollutant Discharge Elimination System ("NPDES") permit for the discharge of any pollutant from any point source (a pipe, ditch or similar conveyance) into waters of the United States. Permits generally impose technology-based and/or water quality-based discharge limitations, which reflect the level of treatment achievable by appropriate pollution control equipment and any more stringent limitations necessary to attain and maintain water quality standards in the receiving stream.

b. Facilities that discharge pollutants indirectly into waters of the United States through a publicly owned treatment works ("indirect dischargers") are subject to general pretreatment regulations. These regulations prohibit the introduction of any pollutants which pass through or interfere with the treatment works. In addition, certain industrial indirect dischargers are subject to specific categorical pretreatment requirements.

c. The CWA requires a permit to conduct any dredging or filling activities in waters of the United States, including wetlands adjacent thereto, and certain other wetlands. 33 U.S.C. § 1344.

3. The Clean Air Act ("CAA"), 42 U.S.C. § 7401, provides for the establishment of uniform ambient air quality standards and certain emission standards, state air quality planning, permit requirements for air emissions and certain other requirements such as stratospheric ozone protection and mobile source control.

a. The federal government sets national uniform ambient air quality standards, and the states must develop the

plans under which these standards will be achieved. New source performance standards and emission standards for hazardous air pollutants are also provided for under the CAA.

b. The CAA was substantially amended in 1990. The 1990 amendments add significant new requirements on emission sources that contribute to acid rain, air toxics and urban smog.

4. The Resource Conservation and Recovery Act ("RCRA"), 42 U.S.C. § 6901, established cradle-to-grave management requirements for hazardous waste generators, transporters and treatment, storage and disposal facilities. RCRA also established extensive permit requirements for the latter class of regulated persons.

a. RCRA regulates only certain materials designated by regulation as "hazardous wastes". Hazardous wastes are generally divided into two categories: listed wastes and characteristic wastes. "Listed wastes" are wastes from certain uses of materials (e.g., spent solvents) or wastes from specified sources (e.g., emission control dust from electric arc furnaces used in the primary production of steel). 40 C.F.R. Part 261, Subpart D (1991). "Characteristic wastes" are wastes which exhibit properties such as ignitability, reactivity, corrosivity, or toxicity. 40 C.F.R. Part 261, Subpart C (1991).

b. Generators of hazardous waste may be subject to certain requirements under RCRA, including, but not limited to: (1) preparation of a shipping manifest; (2) use of only authorized transporters of hazardous waste; (3) acquisition of and use of an United States Environmental Protection Agency ("EPA") identification number; and (4) transportation of hazardous waste only to authorized facilities.

c. Transporters of hazardous waste are required to obtain an EPA identification number, only accept shipments of hazardous waste that are accompanied by a completed manifest, and comply with specific recordkeeping and manifest delivery regulations.

d. Treatment, storage and disposal facilities must generally be permitted under RCRA or an equivalent state statute, or operate under so-called interim status or conduct RCRA-exempt treatment or recycling operations.

5. The Toxic Substances Control Act ("TSCA"), 15 U.S.C. § 2601, regulates the use, storage and disposal of polychlorinated biphenyls ("PCBs") and the manufacture and distribution of toxic chemicals in commerce. Among other things:

a. TSCA PCB disposal regulations extend to all materials which contain PCBs at concentrations greater than or equal to 50 parts per million ("ppm"), and also extend to materials which have a concentration less than 50 ppm if that lower concentration was achieved through dilution of materials which had a PCB concentration equal to or greater than 50 ppm.

b. TSCA also requires chemical manufacturers and importers to notify EPA prior to manufacturing or distributing new chemicals in commerce.

6. The Comprehensive Environmental Response, Compensation and Liability Act ("CERCLA"), 42 U.S.C. § 9601, established a liability scheme for the cleanup of releases of hazardous substances into the environment. The focus of this paper is generally on CERCLA's liability scheme and its impact on business decisions in the United States.

a. CERCLA is primarily remedial in nature, addressing the impacts of past conduct of polluters. Most other environmental laws regulate future conduct. *But see* RCRA proposed corrective action rules, 55 Fed. Reg. 30798 (July 27, 1990) (to be codified at 40 C.F.R. Parts 264, 265, 270, 271); 42 U.S.C. §§ 6924(u), (v) and 6928(h).

b. CERCLA imposes reporting requirements on "any person in charge of" a facility when there is a release of a hazardous substance in a reportable quantity over a 24-hour period from the facility into the environment. 42 U.S.C. § 9603. Failure to report a release is a criminal offense.

c. EPA maintains a computer data base called "CERCLIS" that lists all sites at which EPA believes hazardous substances may have been released. EPA develops a numerical score for each site listed on CERCLIS, based on the "Hazard Ranking System" ("HRS"). Any site which receives a score of 28.5 or higher is included in the "National Priorities List" ("NPL"). Potential purchasers of property often consult both CERCLIS and the NPL as an initial step in determining whether a parcel or neighboring

parcels may be contaminated, and thus, provide a basis for an environmental liability concern.

d. EPA has broad authority to investigate conditions at a site and to obtain information to identify potentially responsible parties ("PRPs"). EPA is also authorized to enter contaminated property and adjacent property to conduct investigations or take removal or remedial actions. 42 U.S.C. § 9604. Such entry upon the land may constitute a taking of property which requires compensation under the Fifth Amendment to the United States Constitution. *Hendler v. United States*, 952 F.2d 1364 (Fed. Cir. 1991). *Cf.*, *Reardon v. United States*, 947 F.2d 1509 (1st Cir. 1991) (imposition of CERCLA lien was taking of property without due process).

e. Either EPA or PRPs may conduct cleanup activities at a facility. EPA may issue unilateral administrative orders compelling a PRP to undertake activities at a site where site conditions present an "imminent and substantial endangerment" to human health or the environment. 42 U.S.C. § 9606(a). EPA may also seek a court order compelling one or more PRPs to perform response activities at a site.

f. Four classes of parties are liable under CERCLA for cleanup costs and natural resource damages caused by a release or threatened release of a hazardous substance at a facility: (1) the current owner or operator of the facility; (2) any person who owned or operated the site at a time when hazardous substances were disposed of; (3) any person who arranged for disposal or treatment of a hazardous substance at the facility ("generator"); and (4) any person who accepted hazardous substances for transport to the facility, if that person also selected the facility. 42 U.S.C. § 9607(a).

g. With certain exceptions, mere ownership of a facility where a release has occurred is enough for liability to attach. Liability may continue after a sale of the facility under certain circumstances as well.

i. Liability continues after the sale of a facility if the release occurred during the prior owner's period of ownership. 42 U.S.C. § 9607(a)(2).

ii. Liability continues after the sale of a facility if the prior owner has knowledge of a release predating his

ownership and transfers the facility without disclosing that knowledge. 42 U.S.C. § 9601(35)(C).

h. Generally, a former owner is liable only if hazardous substances were disposed of during his period of ownership. Thus, a conduit owner may not be liable, except where the conduit owner obtains knowledge of a release and does not disclose that knowledge prior to a transfer of the facility. *See, e.g., Westwood Pharmaceuticals, Inc. v. National Fuel Gas Dist. Corp.*, 767 F. Supp. 456 (W.D.N.Y. 1991), *aff'd*, 964 F.2d 85 (2d Cir. 1992). However, it is not clear what activities constitute a "disposal". *See, e.g., Tanglewood East Homeowners v. Charles-Thomas, Inc.*, 849 F.2d 1568 (5th. Cir. 1988); *Snediker Dev. Ltd. Partnership v. Evans*, 773 F. Supp. 984 (E.D. Mich. 1991); *Ecodyne Corp. v. Shah*, 718 F. Supp. 1454 (N.D. Cal. 1989). *But see Stanley v. Snydergeneral Corp.*, Nos. CV-F88-530 REC, CV-F89-822 REC (E.D. Cal., Oct. 25, 1991), may be found at 1991 WL 280272.

i. Participating in the management of a facility can subject a secured creditor, a parent corporation, a shareholder or even a contracting party to liability as an operator. *FMC Corp. v. Department of Commerce*, No. 90-1761 (E.D. Pa., Feb. 20, 1992). Corporate liability and lender liability issues are discussed more thoroughly below. *See* Sections IV and V, *infra*.

j. A generator may be liable even though he did not own the facility and complied with industry practices and standards and legal requirements at the time of the disposal. *See, e.g., O'Neil v. Picillo*, 682 F. Supp. 706 (D.R.I. 1988), *aff'd*, 883 F.2d 176 (1st Cir. 1989), *cert. denied*, 493 U.S. 1071 (1990). Further, a person may be liable for "arranging for disposal" of hazardous waste even though the person never possessed the waste. *See, e.g., United States v. Velsicol Chem. Corp.*, 28 Env't Rep. Cas. (BNA) 1265 (W.D. Tenn. 1988) (corporation arranged for disposal of hazardous waste when it contracted with third party for the formulation and packaging of various hazardous substances).

k. Liability under CERCLA is strict and without regard to the standard of care exercised or even causation. *United States v. Monsanto Co.*, 858 F.2d 160 (4th Cir. 1988), *cert. denied*, 490 U.S. 1106 (1989). Thus, knowledge, intent or even negligence are not elements of a CERCLA cause of action.

l. Where the harm is indivisible, liability is joint and several; i.e., each PRP is liable for the entire amount of the cleanup costs. The burden is on the PRP to prove divisibility. *United States v. Monsanto Co.*, 858 F.2d 160 (4th Cir. 1988), *cert. denied*, 490 U.S. 1106 (1989). PRPs may seek contribution from other PRPs and a court may "allocate response costs among liable parties using such equitable factors as the court determines are appropriate." 42 U.S.C. § 9613(f)(1). Courts often apply what has become known as the "Gore Factors" in apportioning liability among parties. *See, e.g., United States v. R.W. Meyer, Inc.*, 932 F.2d 568 (6th Cir. 1991); *United States v. Western Processing Co.*, 734 F. Supp. 930 (W.D. Wash. 1990); *South Fla. Water Mgmt. Dist. v. Montalvo*, No. 88-80-38-CIV-DAVIS (S.D. Fla. Feb. 15, 1989), may be found at 1989 WL 260215; *Allied Corp. v. Acme Solvents Reclaiming, Inc.*, 691 F. Supp. 1100 (N.D. Ill. 1988); *United States v. Conservation Chem. Co.*, 619 F. Supp. 162 (W.D. Mo. 1985). The Gore Factors include: "(i) the ability of the parties to demonstrate that their contribution to a discharge, release, or disposal of a hazardous waste can be distinguished; (ii) the amount of the hazardous waste involved; (iii) the degree of toxicity of the hazardous waste involved; (iv) the degree of involvement by the parties in the generation, transportation, treatment, storage, or disposal of the hazardous waste; (v) the degree of care exercised by the parties with respect to the hazardous waste concerned, taking into account the characteristics of such hazardous waste; and (vi) the degree of cooperation by the parties with Federal, State or local officials to prevent any harm to the public health or the environment." *R.W. Meyer*, 932 F.2d at 576, *quoting*, 126 Cong. Rec. 26,779, 26,781 (1980).

m. Generally, a PRP has only three narrow defenses to liability. A PRP will not be liable if he can show that the release was caused *solely* by: (1) an act of God; (2) an act of war; or (3) an act or omission of an unrelated third party ("third party defense"). 42 U.S.C. § 9607(b). The PRP must also exercise due care with respect to the hazardous substance and take precautions against the foreseeable acts or omissions of third parties. The seldom-asserted "act of war" defense was recently raised in *United States v. Shell Oil Co.*, No. CV-91-0589-RJK (D.C. Cal., Jan. 16, 1992), may be found at 1992 WL 144296.

i. The "third party defense" is available only if the third party is not an employee or agent of the PRP, or is not in a contractual relationship with the PRP. 42 U.S.C. § 9607(b).

ii. CERCLA's definition of contractual relationship includes deeds and other instruments transferring title to or possession of land. 42 U.S.C. § 9601(35)(A).

iii. The Superfund Amendments and Reauthorization Act of 1986, Pub. L. No. 99-499, added the "innocent landowner defense", which excludes certain instruments transferring interests in, or possession of, land from the definition of contractual relationship where the purchaser did not know and had no reason to know of a release at the facility prior to the purchase. 42 U.S.C. § 9601(35)(A)(i). The innocent landowner defense is discussed more thoroughly below. *See* Section V.A., *infra*.

n. CERCLA creates a lien on certain real property in favor of the United States for all costs and damages for which a person is liable to the United States under CERCLA. 42 U.S.C. § 9607(l). *See* Section IV.F., *infra*.

B. State Environmental Regulations - In addition to the federal statutes discussed above, many states have enacted their own laws and regulations supplementing and often surpassing the federal requirements. In many cases, state programs are submitted to the federal government for approval to be operated in lieu of the federal programs, but with federal oversight and enforcement.

III. Seller's Perspective - The seller in our hypothetical XYZ Corp. naturally wants to limit, if not extinguish, its liability for the property following the sale. As described above, XYZ would be a PRP if a release of a hazardous substance occurred at its facility during its period of ownership, or if XYZ fails to disclose a known release, regardless of when the release occurred, prior to the transfer. This liability may continue even after the sale to ABC.

A. "As Is" Clause - XYZ may try to limit its liability by inserting a clause in the sales contract which provides that ABC takes the property "as is". However, CERCLA liability generally cannot be contracted away, at least as to third parties not involved in the transaction. Therefore, an "as is" clause would not extinguish XYZ's CERCLA liability. *See, e.g., Westwood Pharmaceuticals, Inc. v. Nat'l Fuel Gas Dist. Corp.*, 737 F. Supp. 1272 (W.D.N.Y. 1990), *aff'd*, 964 F.2d 85 (2d Cir. 1992).

1. An "as is" clause has also been held to be insufficient for a buyer to waive its right to contribution under CERCLA. Such a waiver must generally be explicitly stated in the contract. *Smith Land & Improvement Corp. v. Celotex Corp.*, 851 F.2d 86 (3d Cir.), *cert. denied*, 488 U.S. 1029 (1988).

2. An "as is" clause is generally only a warranty disclaimer, and as such, only precludes claims based on breach of warranty and does not shift CERCLA liability from one party to another. *Wiegmann & Rose Int'l Corp. v. NL Indus.*, 735 F.Supp. 957 (N.D. Cal. 1990); *Int'l Clinical Lab., Inc. v. Stevens*, 30 Env't Rep. Cas. (BNA) 2066 (E.D.N.Y. Jan. 11, 1990), may be found at 1990 WL 43971; *Southland Corp. v. Ashland Oil, Inc.*, 696 F. Supp. 994 (D.N.J. 1988); *Dery v. Becker*, 94 Bankr. 924 (E.D. Mich. 1989).

3. An "as is" clause may prevent a purchaser from rescinding a land sales contract for unknown environmental problems under common law theories of mutual mistake or innocent misrepresentation. However, the clause may not prevent rescission if the seller is aware of the environmental problem. *Niecko v. Emro Mktg. Co.*, 769 F. Supp. 973 (E.D. Mich. 1991), *aff'd*, 973 F.2d 1296 (6th Cir. 1992).

4. A number of states have enacted statutes which require a seller of real property to disclose known environmental problems. *See, e.g.*, Michigan Environmental Response Act, Mich. Comp. Laws § 299.610c; New Jersey Environmental Cleanup Responsibility Act, N.J. Stat. § 13:1K-6. Other state statutes require certain properties to receive a clean bill of environmental health prior to a transfer of interest in the property. *See, e.g.*, New Jersey Environmental Cleanup Responsibility Act, N.J. Stat. § 13:1K-6; Connecticut Transfer of Establishments Act, Conn. Gen. Stat. § 22a-134.

B. Indemnification/Hold Harmless Agreements - Similarly, if ABC agrees to indemnify XYZ for environmental cleanup liability, XYZ will still remain liable to the government and other persons entitled to assert a CERCLA cause of action. *Jones-Hamilton Co. v. Kop-Coat, Inc.*, 750 F. Supp. 1022 (N.D. Cal. 1990), *aff'd in part, rev'd in part*, 973 F.2d 688 (9th Cir. 1992).

1. Section 107(e)(1) of CERCLA provides that "[n]o indemnification, hold harmless, or similar agreement or conveyance shall be effective to transfer [the liability imposed by CERCLA] from . . . any person who may be liable for a release or threat of release . . . to any other person . . . ." 42 U.S.C. § 9607(e)(1). However, "[n]othing in [CERCLA] shall bar a cause of action

that a . . . person subject to liability under [CERCLA] . . . has or would have, by reason of subrogation or otherwise against any person." 42 U.S.C. § 9607(e)(2).

2. A majority of courts hold that indemnification and hold harmless agreements are enforceable between the parties *inter se*. *See, e.g., Rodenbeck v. Marathon Petroleum Co.*, 742 F. Supp. 1448 (N.D. Ind. 1990); *Channel Master Satellite Syst., Inc. v. JFD Elec. Corp.*, 702 F. Supp. 1229 (E.D.N.C. 1988); *Southland Corp. v. Ashland Oil, Inc.*, 696 F. Supp. 994 (D.N.J. 1988); *Versatile Metals, Inc. v. Union Corp.*, 693 F. Supp. 1563 (E.D. Pa. 1988); *Chemical Waste Mgmt., Inc. v. Armstrong World Indus., Inc.*, 669 F. Supp. 1285 (E.D. Pa. 1987); *FMC Corp. v. Northern Pump Co.*, 668 F. Supp. 1285 (D. Minn. 1987); *Mardan Corp. v. C.G.C. Music, Ltd.*, 600 F. Supp. 1049 (D. Ariz. 1984), *aff'd*, 804 F.2d 1454 (9th Cir. 1986).

3. Two recent district court decisions in the Sixth Circuit have interpreted CERCLA Section 107(e) to prevent the enforcement of indemnity, hold harmless and other such agreements if both parties to the agreement are PRPs. *CPC Int'l, Inc. v. Aerojet-General Corp.*, 759 F. Supp. 1269 (W.D. Mich. 1991); *AM Int'l, Inc. v. Int'l Forging Equip.*, 743 F. Supp. 525 (N.D. Ohio 1990). However, these two cases appear to be aberrations, and misinterpret Section 107(e). Several courts have examined and rejected the analysis in *AM Int'l*. *See Purolator Prods. Corp. v. Allied-Signal, Inc.*, 772 F. Supp. 124 (W.D.N.Y. 1991); *Niecko v. Emro Mktg. Co.*, 769 F. Supp. 973 (E.D. Mich. 1991), *aff'd*, 1992 WL 208522 (6th Cir. Sept. 1, 1992); *Jones-Hamilton Co. v. Kop-Coat, Inc.*, 750 F. Supp. 1022 (N.D. Cal. 1990), *aff'd in part, rev'd in part*, 1992 WL 201121 (9th Cir. Mar. 12, 1992).

4. The Sixth Circuit recently held that indemnification agreements between PRPs are permissible under similar provisions contained in the Michigan Leaking Underground Storage Tank Act. *Niecko v. Emro Mktg. Co.*, 1992 WL 208522 (6th Cir. Sept. 1, 1992).

IV. Lender's Perspective - In our hypothetical, ABC intends to finance the transaction with a loan secured by the facility itself. There are several factors that ABC's lender must consider before entering into such a transaction.

A. Environmental Audits - Lenders are generally the most insistent that an environmental audit precede the transaction. Subsequent discovery of a release at the facility can materially and adversely affect the value of the collateral and the viability of the

borrower. More importantly, CERCLA-type liability could reach a secured creditor if it becomes too involved in the day-to-day operations of the borrower, acquires title through foreclosure, or operates the facility.

B. Secured Creditor Exemption - CERCLA exempts a person "who, without participating in the management of a vessel or facility, holds indicia of ownership primarily to protect his security interest in the vessel or facility" from liability. 42 U.S.C. § 9601(20)(A). Courts are split over whether a secured lender must engage in actual management of a facility in order to be deemed liable under CERCLA.

1. One line of cases holds that the secured creditor must exercise at least some actual management authority over the facility. *See, e.g., In re Bergsoe Metal Corp.*, 910 F.2d 668 (9th Cir. 1990); *Tanglewood East Homeowners v. Charles-Thomas, Inc.*, 849 F.2d 1568 (5th Cir. 1988); *United States v. Nicolet, Inc.*, 712 F. Supp. 1193 (E.D. Pa. 1989); *United States v. Mirabile*, 15 Envt'l L. Rep. (Envtl. L. Inst.) 20994 (E.D. Pa. 1985).

2. Other cases hold that extensive participation in the financial management of a facility may be enough to trigger CERCLA liability. *United States v. Fleet Factors Corp.*, 901 F.2d 1550 (11th Cir. 1990), *reh'g denied*, 911 F.2d 742. *See also O'Neil v. Q.L.C.R.I., Inc.*, 750 F. Supp. 551 (D.R.I. 1990) (lender may be liable for aiding and abetting borrower's violation of environmental laws).

C. Foreclosure - In a similar vein, a secured creditor may incur liability as an owner by foreclosing on contaminated property. *Guidice v. BFG Electroplating & Mfg. Co.*, 732 F. Supp. 556 (W.D. Pa. 1989); *United States v. Maryland Bank & Trust Co.*, 632 F. Supp. 573 (D. Md. 1986). *But see United States v. Mirabile*, 15 Envt'l L. Rep. (Envtl. L. Inst.) 20994 (E.D. Pa. 1985); *In re T.P. Long Chem., Inc.*, 45 Bankr. 278 (N.D. Ohio 1985).

D. Legislation - Several bills have been proposed in the United States Congress to limit and more precisely define the contours of a lender's liability.

1. H.R. 1450, proposed by Rep. John LaFalce in March of 1991, would amend CERCLA to clarify what activities a secured lender could undertake without participating in the management of the borrower. This bill is currently pending.

2. S. 651, proposed by Sen. Jake Garn in March of 1991, would amend the Federal Deposit Insurance Act, 12 U.S.C. § 1811, rather than CERCLA. This proposal would also protect public sector lenders from CERCLA liability. This bill is currently pending.

3. Title X of the Senate Banking Bill, S. 543, introduced in September of 1991, was based on the legislation proposed by Sen. Garn. Title X contained safe harbor provisions that would have allowed lenders to conduct a wide range of activities, including foreclosures, inspections, cleanups, and loan restructurings without incurring CERCLA liability. However, S. 543 became law with Title X deleted.

4. S. 2733, proposed by Sen. Donald Riegle in May of 1992, would amend CERCLA by establishing a safe harbor for lenders which would allow lenders to conduct certain activities at facilities without incurring CERCLA liability. However, the bill would impose liability on lenders for any actual benefits the lender would receive by a removal, remedial or other response action taken by another party. The bill would also require the Federal Deposit Insurance Corporation to develop and implement environmental audit procedures for lenders. This bill is currently pending.

5. S. 2794, proposed by Sen. Robert Dole in July of 1992, would amend CERCLA similar to the proposed amendments in S. 2733. S. 2794 is currently pending.

E. Lender Liability Rules - EPA's lender liability rules are promulgated at 40 C.F.R. Part 300, Subpart L. These rules specify the steps a lender must take in order to avoid CERCLA liability by not participating in the management of a facility. Among the activities which a lender may conduct, which are not considered to be "participating in the management of a facility", include: preparing loan workouts, foreclosing on secured property, monitoring or inspecting the facility, examining the financial condition of the property owner or operator, and providing financial or other assistance.

1. The rules interpret three key phrases contained in the CERCLA secured creditor exemption: (1) "indicia of ownership", (2) "primarily to protect his security interest", and (3) "participating in the management of a vessel or facility".

2. The Michigan Attorney General and the Chemical Manufacturers Association have challenged the validity of EPA's lender liability rules. *Michigan v. EPA*, C.A. D.C., No. 92-1312 (July 28, 1992); *Chemical Manufacturers Ass'n. v. EPA*, C.A. D.C., No. 92-1314 (July 28, 1992).

F. Environmental Liens - Section 107(l) of CERCLA creates a lien in favor of the United States for all costs and damages for which a person is liable to the United States under Section 107(a). The lien arises in "all real property and rights to such property" which belongs to the person and which "are subject to and affected by" CERCLA removal or remedial actions. 42 U.S.C. § 9607(l)(1). The lien arises at the time when costs are first incurred by the United States or when the responsible party to which the property at issue belongs receives written notice of his potential liability, whichever is later. 42 U.S.C. § 107(l)(2). The lien lasts until the liability for which it attaches is satisfied, or the lien becomes unenforceable through operation of the statute of limitations in Section 113(g) of CERCLA.

1. The lien applies to the entire property on which the response action is taken, but does not extend to other property held by the responsible party. EPA, GUIDANCE ON FEDERAL SUPERFUND LIENS (Sept. 22, 1987) (memorandum), Thomas L. Adams, Jr., Assistant Administrator.

2. Section 113 of CERCLA "bars the federal courts from hearing pre-enforcement challenges to the merits of any particular lien—challenges, for example, to the liability which a lien secures, or to the conformity of that lien to the CERCLA lien provisions." *Reardon v. United States*, 947 F.2d 1509, 1512 (1st Cir. 1991). *See also Apache Powder Co. v. United States*, 738 F. Supp. 1291 (D. Ariz. 1990); *Juniper Dev. Group v. United States*, 774 F. Supp. 56 (D. Mass. 1990).

3. The CERCLA lien provisions may violate the due process clause of the Fifth Amendment to the United States Constitution, because the lien provisions do not provide for notice or a predeprivation hearing. *Reardon v. United States*, 947 F.2d 1509 (1st Cir. 1991).

4. Priority of the CERCLA lien is determined under state law, with the lien afforded priority as a judgment lien arising out of an unsecured obligation at the time of filing. 42 U.S.C. § 9607(l)(3).

5. Certain state environmental cleanup laws provide for liens on the contaminated property which have priority over pre-existing recorded liens or, in other words, "superliens". *See, e.g.*, Michigan Environmental Response Act, Mich. Comp. Laws § 299.616a(2).

V. Buyer's Perspective - ABC has the most to lose in this transaction. Unless ABC is careful, it may unwittingly acquire millions of dollars in liability for legal fees and cleanup costs. ABC must investigate the facil-

ity thoroughly prior to the purchase and weigh the environmental risks disclosed by the investigation against the benefits of acquisition.

A. Innocent Landowner Defense - Naturally, ABC would like to purchase XYZ's facility without incurring any CERCLA liability. CERCLA provides a defense to liability for purchasers of property who did not know, and had no reason to know, that a hazardous substance had been disposed of at the property prior to the sale. 42 U.S.C. § 9601(35)(A).

1. To establish that the purchaser had no reason to know of a disposal of hazardous substances, the purchaser "must have undertaken, at the time of acquisition, 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." 42 U.S.C. § 9601(35)(B). This inquiry is often called "environmental due diligence".

2. There is no uniform concept on what constitutes environmental due diligence. The standard may be higher for lenders and persons engaged in business transactions. *See* Explanatory Statement of the Committee Conference, *reprinted in*, 51 Cong. Rec. H9083 (daily ed. Oct. 3, 1986).

3. Several proposals have been put forward for defining adequate due diligence.

a. H.R. 1217, introduced by Rep. Curt Weldon, provides a specific definition of the inquiry required in order to raise a rebuttable presumption of the innocent landowner defense. H.R. 1217 is still pending.

b. State governments have issued environmental audit guidelines in connection with property transfer statutes. *See, e.g.*, Connecticut Transfer of Establishments Act, Conn. Gen. Stats. § 22a-134.

c. The lending industry has issued due diligence guidelines. *See* Fannie Mae Announcement No. 89-16 (July 5, 1989); Thrift Activities Handbook Section 210, TB 16 (Feb. 6, 1989).

d. The private sector is also working on several proposals. The Michigan Association of Environmental Professionals ("MAEP") issued recommended due diligence guidelines for Phase I audits in October of 1991. The American Society of Testing and Materials ("ASTM") issued proposed due diligence guidelines in February of 1991. The Association of Groundwater Scientists & Engineers released an interim final draft of its Guidance of En-

vironmental Site Assessments in March of 1992. The Ohio State Bar Association issued Guidance on Customary Practice for Environmental Investigations Prior to Asset Conveyance or Encumbrances in March of 1990.

4. For cases discussing the innocent landowner defense, see, e.g., *Int'l Clinical Labs., Inc. v. Stevens*, 30 Env't Rep. Cas. (BNA) 2066 (E.D.N.Y. 1990); *United States v. Pacific Hide & Fur Depot, Inc.*, 716 F. Supp. 1341 (D. Idaho 1989); *United States v. Serafini*, 711 F. Supp. 197 (M.D. Pa. 1988); *Washington v. Time Oil Co.*, 687 F. Supp. 529 (W.D. Wash. 1988); *Wickland Oil Terminals v. Asarco, Inc.*, 19 Envtl. L. Rep. (Envtl. L. Inst.) 20855 (N.D. Cal. Feb. 23, 1988), may be found at 1988 WL 167247; *Jersey City Redevelopment Auth. v. PPG Indus.*, 655 F. Supp. 1257 (D.N.J. 1987); *Dery v. Becker*, 94 Bankr. 924 (E.D. Mich. 1989).

5. EPA may expedite settlement with an owner who has not conducted a sufficient due diligence investigation to qualify for the innocent landowner defense, but has otherwise not contributed to the release or threat of release in any way. 42 U.S.C. § 9622(g)(1)(B). However, EPA may not expedite settlement if the person acquired the facility with actual or constructive knowledge of the release or threat of release. 42 U.S.C. § 9622(g)(1). EPA stated its settlement policy towards prospective purchasers in a June 6, 1989, memorandum entitled, "Guidance on Landowner Liability under Section 107(a)(1) of CERCLA, *De Minimis* Settlements under Section 122(g)(1)(B) of CERCLA, and Settlements with Prospective Purchasers of Contaminated Property" (OSWER Directive 9835.9).

6. Insurance may be available at the time of closing to insure the buyer from any environmental remediation liability associated with pre-existing contamination not discovered prior to closing. Such insurance policies specifically require that an environmental audit be conducted prior to the transfer. *See, e.g.*, ERIC Underwriters, Inc., Property Transfer Liability Insurance (informational pamphlet) (on file with authors).

B. Permits and Licenses - Among the things ABC will want to look for while performing its due diligence audit on the facility is whether XYZ has obtained all of the required permits and licenses for its operations and whether the environmental condition of the property (i.e., presence of wetlands, air quality status, etc.) will allow the existing or proposed use of the facility. Permit requirements may arise under the CWA, the CAA, RCRA, and various other federal and state statutes. *See* Section II, *infra*. The types of potential liability which ABC should be concerned about in connection with

permits and licenses include: (1) the potential for fines and penalties for operating without, or in violation of, required permits; (2) the inability to obtain necessary permits after the purchase; (3) constraints on facility operations imposed in a permit; (4) the cost of maintaining compliance with the permits; and (5) whether the permits remain in effect and are transferable to ABC.

1. ABC should be certain that XYZ has obtained all the necessary permits and is in compliance with the restrictions imposed in the permits prior to the purchase.

2. ABC should thoroughly investigate what is required to obtain any missing permits. A facility operating without a permit may be subject to a shut down order, an order to install costly new control equipment, or even an order to restore natural resources. For example, if XYZ had conducted dredging and filling activities in waters of the United States at its facility without a permit required under the CWA, ABC could be required to restore the area after the transfer. *See, e.g.*, 33 U.S.C. § 1344; *United States v. Norris*, 937 F.2d 286 (6th Cir. 1991).

3. ABC may be anticipating an increase in production at the XYZ facility in order to offset the purchase cost. If so, ABC should be certain that permit restrictions or other environmental requirements will not prevent such an increase or render it unduly expensive.

4. ABC should factor into the cost of purchasing the facility the cost of maintaining compliance with the facility's permits. For example, the facility may be subject to compliance schedules which require new control equipment.

C. EPA's Policy on Prospective Purchasers of Contaminated Property - If ABC's due diligence audit discloses contamination at the facility, it might request EPA to issue a covenant not to sue under CERCLA for the contamination at the facility. EPA stated its policy on issuing covenants not to sue prospective purchasers in OSWER Directive 9835.9. This document states that "a covenant not to sue a prospective purchaser might appropriately be considered if an enforcement action is anticipated and if performance of or payment for clean-up would not otherwise be available except from the Superfund and if the prospective purchaser participates in a clean-up. A prospective purchaser may participate in the clean-up either through the payment of a substantial sum of money to be applied towards a clean-up of the site or through a commitment to perform substantial response actions." OSWER Directive 9835.9, at 25-26.

1. EPA "will not entertain requests for covenants not to sue from prospective purchasers unless an enforcement action is contemplated with respect to the facility." *Id.* at 28.

2. EPA "will not entertain requests for covenants not to sue unless entering into such a covenant will produce a substantial monetary benefit to be applied to response activities at the facility, or an agreement to conduct response actions, which otherwise would not be available." *Id.*

3. The continued operation of the facility or new development of the site must not aggravate or contribute to the existing contamination or interfere with the remedy.

4. Due consideration must be given to the effect which continued operations at the facility or new development is likely to have on the health risks to those persons likely to be present at the site.

5. The prospective purchaser must demonstrate that it is financially viable and capable of fulfilling its obligations under the agreement.

D. Protection Under the Corporate Structure - ABC may try to limit its exposure to liability by creating a subsidiary, A Corp., which then purchases the facility from XYZ. ABC might still be held liable under CERCLA in two situations: (1) a court could pierce the corporate veil of A Corp.; or (2) ABC could be deemed an operator of the facility.

1. The corporate structure is generally respected under CERCLA. However, some courts may be more willing to pierce the corporate veil if CERCLA liability is involved. Courts generally apply a veil piercing analysis developed under common law. Factors which courts consider significant in veil piercing include: (1) intermingled accounts and records; (2) corporate formalities not observed; (3) inadequate capitalization; and (4) subsidiary policies directed to its parent's interests. *See, e.g., United States v. Kayser-Roth Corp.*, 724 F. Supp. 15 (D.R.I. 1989), *aff'd*, 910 F.2d 24, *cert. denied*, 111 S. Ct. 957 (1991); *United States v. Nicolet, Inc.*, 712 F. Supp. 1193 (E.D. Pa. 1989); *Joslyn Corp. v. T.L. James & Co.*, 696 F. Supp. 222 (W.D. La. 1988), *aff'd*, 893 F.2d 80 (5th Cir. 1990), *cert. denied*, 111 S. Ct. 1017 (1991); *In re Acushnet River & New Bedford Harbor Proceedings*, 675 F. Supp. 22 (D. Mass. 1987).

2. A parent corporation may be deemed liable as an operator if it participates in the management of the subsidiary. *CPC Int'l, Inc. v. Aerojet-General Corp.*, 777 F. Supp. 549 (W.D. Mich. 1991). The court in *CPC Int'l* considered the following

factors important in determining whether a parent is liable as an operator of a subsidiary's facility: (1) the parent's percent ownership of the subsidiary; (2) the parent's active participation in, and at times majority control over, the subsidiary's board of directors; (3) the parent's involvement in major decision-making and day-to-day operations of the subsidiary; (4) the conduct of the parent's officials with respect to the subsidiary's affairs; (5) the function of the parent as a source of policy making for the subsidiary; (6) the active participation of and control by the parent's officials in the subsidiary's environmental matters; (7) the active participation of the parent's officials in the subsidiary's labor problems; and (8) the financial control exerted by the parent through its approval of the subsidiary's budgets and major capital expenditures.

E. Other Ways in Which ABC Might Protect Itself - ABC could also attempt to limit its exposure to liability in the following ways: (1) indemnification/hold harmless agreements (*see* Section III.B., *infra*); (2) escrows and "holdbacks"; (3) right to inspect the facility before acquisition; (4) financial assurance that XYZ will be able to pay any claim for indemnification, (5) insurance; (6) "baskets" and other risk sharing mechanisms; and (7) purchase price reductions.

F. SEC Reporting Requirements - Finally, assume ABC purchases the facility, either without performing sufficient due diligence or in spite of its due diligence, and ABC has received a PRP letter from EPA stating that ABC may be liable for cleaning up the facility. How will this impact ABC's reporting requirements with the SEC?

1. The Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. § 78a, requires certain corporations to disclose material information which a reasonable investor would consider important in deciding whether to invest. SEC promulgated regulations concerning disclosure of environmental issues as a result of litigation with environmental groups in the 1970s. *Natural Resources Defense Council, Inc. v. SEC*, 606 F.2d 1031 (D.C. Cir. 1979).

a. SEC Regulation S-K, 17 C.F.R. Part 229, governs the non-financial disclosure statements required in registration statements and periodic reports required under the Exchange Act.

b. ABC is a widely-held public corporation in our hypothetical and is, therefore, subject to these requirements.

2. Item 101 requires disclosure of the "material effects that compliance with Federal, State and local provisions . . . relating

to the protection of the environment, may have upon" the business. 17 C.F.R. § 229.101(c)(xii).

3. Item 103 requires disclosure of "material pending legal proceedings, other than ordinary routine litigation incidental to the business." 17 C.F.R. § 229.103.

a. Administrative or judicial proceedings arising under environmental statutes are, by definition, excluded from "ordinary routine litigation incidental to the business" if the proceeding is material to the business, involves a claim in excess of 10% of the business' current assets, or involves the government as a party and sanctions in excess of $100,000. Item 103, Instruction 5.

b. "Designation as a PRP does not in and of itself trigger disclosure under Item 103 . . . ." SEC Release No. 33-6835, 54 Fed. Reg. 22427 (May 24, 1989).

c. Claims similar in nature should be aggregated for determining the 10% threshold, but not for the $100,000 threshold. 47 Fed. Reg. 11388-89 (Mar. 16, 1982).

d. The availability of insurance, indemnification or contribution may be relevant in determining whether the criteria for disclosure have been met. SEC Release No. 33-6835, 54 Fed. Reg. 22427 (May 24, 1989).

4. Item 303, entitled "Management's Discussion and Analysis of Financial Condition and Results of Operations" ("MD&A"), requires a registrant to discuss its financial condition, changes in financial condition, and results of operations in one section of a filing with the SEC. 17 C.F.R. § 229.303(a).

a. The discussion must include data that the registrant believes will enhance a reader's understanding of the company's financial condition. Item 303, Instruction 1.

b. "The discussion and analysis shall focus specifically on material events and uncertainties known to management that would cause reported financial information not to be necessarily indicative of future operating results or of future financial condition." Item 303, Instruction 3. "A disclosure duty exists where a trend, demand, commitment, event, or uncertainty is both presently known to management and reasonably likely to have material effects on the registrant's financial condition or results of operation." SEC Release No. 33-6835, 54 Fed. Reg. 22427 (May 24, 1989).

c. Presently-known material events and uncertainties *must* be disclosed. Registrants are only *encouraged* to disclose information on anticipated future trends or events that are less predictable than a known event, trend or uncertainty. Item 303, Instruction 7.

d. Designation as a PRP may trigger the reporting requirements of Item 303. SEC Release No. 33-6835, 54 Fed. Reg. 22427 (May 24, 1989).

5. "[I]f a corporation voluntarily makes disclosures concerning its environmental policy, such disclosures must be accurate, and the corporation must make any additional disclosures necessary to render the voluntary disclosures not misleading." SEC Release No. 33-6130 (Sept. 27, 1979) (Environmental Disclosure).