Property Contamination and Leasing: The Federal Law

By Larry Schnapf

Prior to the enactment of modern environmental laws, liability for contamination in leasing transactions was governed solely by contract and tort principles. In the absence of an express agreement or misrepresentation, the tenant was expected to make its own careful examination of the conditions of the property and the vendor or landlord would not be liable for any existing harm or defects.[1] Tenants were traditionally liable for harm caused to persons or property and for dangerous conditions or nuisances created without the landlord's knowledge or acquiescence.[2]

The general rule was that the lessor would not be liable to the lessee or others for harm for dangerous conditions existing at the time of the transfer[3] or created after the lessee took possession of the property.[4] Over time, the courts crafted a number of exceptions to this principle. One exception was that a landlord could be subject to liability if it knew, or had reason to know, of a condition that posed an unreasonable risk of physical harm to persons, the lessor had reason to believe that the lessee would not discover the dangerous condition, and the lessor concealed or failed to disclose this condition to a lessee or sublessee.[5]

Another exception was that a lessor may be held liable for tenant activities that constitute a nuisance, such as environmental contamination, if the lessor consented to such action or knew that the tenant's operations would likely release contaminants and the landlord failed to take precautions to prevent such damage.[6]

Modern formulations link liability of lessors and lessees to a failure to exercise reasonable care and incorporate concepts of comparative negligence. A lessor has a duty to exercise reasonable care for any risks that are created by the lessor and a duty to disclose any latent dangerous condition that the landlord knows, or should know, is unknown to the lessee.[7] This includes disclosure of dangerous latent conditions that were not created by the lessor.[8] The obligation hinges on whether the lessee appreciates the danger posed by the condition and not simply if the dangerous condition is open or obvious. The lessor's duty is not cut off by a lessee's failure to exercise reasonable care to discover dangerous conditions.[9]

In New York, landlords and tenants have been held liable for contamination under common-law principles such as strict liability, nuisance, trespass and negligence. Owners who have failed to abate contamination caused by their tenants have been found liable for creating or maintaining a nuisance.[10] While some states allow transferees to bring a nuisance action against its transferor on the grounds that "the creator of a nuisance remains liable even after alienating his property," New York courts have held that a nuisance action can only be maintained between adjoining landowners and is not a proper claim in a suit between successive landowners, or operators of the same property.[11]

New York has a three-year statute of limitations for claims for personal injury and damage claims relating to exposure to hazardous substances. The clock starts on the date the injuries are discovered or should have been discovered by a reasonably diligent party.[12]

The Federal Law

Numerous federal environmental laws can impose liability on owners or operators of contaminated property. One of the principal laws of concern is the federal Comprehensive Environmental Response, Compensation and Liability Act (CERCLA).[13]

CERCLA liability is probably the most significant environmental law for commercial leasing transactions. It applies to the release of hazardous substances.[14] The federal Environmental Protection Agency (EPA) is authorized to perform cleanups in cases of release of hazardous substances[15] and seek reimbursement of its costs from four categories of potentially responsible parties (PRPs) who may be strictly, jointly and retroactively liable for cleanup costs.[16] Private parties who incur cleanup costs may also seek reimbursement from PRPs.[17] Indeed, because the New York State Superfund law does not expressly authorize the New York State Department of Environmental Conservation (NYSDEC) to recover its cleanup costs, NYSDEC customarily uses CERCLA to seek cost recovery.

Liability for Property Owners and Tenants Under CERCLA

The types of CERCLA PRPs that may be liable include current and past owners and operators of contaminated property. The liability for past owners or operators under CERCLA is not necessarily congruent with the liability of current owners or operators. Parties that currently hold title or possession of contaminated property may be liable for historic contamination that occurred prior to the time the owner acquired title or the operator came into possession of the property.[18] However, past owners or operators are only liable if they owned or occupied the property "at the time of disposal" of the hazardous substances.[19]

Current landlords may be considered CERCLA owners based on their ownership of property, even if the owner did not place the hazardous waste on the site or cause the release.[20] Furthermore, a current passive landlord or sublessor does not have to exercise any control over the disposal activity to be liable as a CERCLA owner.[21]

Tenants may be liable as an owner if they had sufficient indicia of ownership, or as an operator, based on their

control of a property. When deciding if a tenant should be considered a "*de facto* owner," courts will examine rights and obligations of the tenant under a lease to see if effective control of the property had been handed over to the tenant. Some factors courts have considered include:

- If there is a long-term lease, where the lessor cannot direct how the property is used;
- If the lessee can sublet without permission of the owner;
- Whether the lessee is responsible for paying all costs, including taxes, assessments and operation and maintenance costs; and
- Whether the lessee is responsible for making any and all structural changes and other repairs.

The leading case in New York for determining liability of tenants and subtenants is *Commander Oil v. Barlo Equipment Corp.*,[22] where the plaintiff initially leased one parcel to the defendant, Barlo Equipment Corp. (Barlo), in 1964, and a second parcel to Pasley Solvents & Chemicals, Inc. (Pasley), in 1969. Barlo used its parcel for office and warehouse space, while Pasley operated a solvent repackaging and reclamation business on its leasehold. In 1972, the plaintiff consolidated the leases so that Barlo was the lessee for both parcels and was sublessor for the Pasley lot. Under the new lease, Barlo was responsible for basic maintenance and payment of taxes on both lots.

In 1981, contamination was discovered on the Pasley parcel. Eventually, the plaintiff entered into a consent order with the EPA to implement a cleanup and sought contribution from Barlo for the costs incurred at the former Pasley lot on the theory that Barlo was a CERCLA owner. The plaintiff did not proceed against Barlo under an "operator" theory because Barlo never conducted operations at the Pasley parcel. The district court granted summary judgment to the plaintiff, ruling that Barlo was a CERCLA owner by virtue of its "authority and control" over the Pasley lot.[23] After a bench trial, the district court ruled that although Pasley was responsible for all of the response costs associated with its lot, the costs had to be allocated between the plaintiff and Barlo since Pasley was "financially irresponsible."

On appeal, Barlo argued that CERCLA owner liability was restricted to owners of record, while Commander Oil urged a more expansive definition that relied primarily on the right to control property, whether the right is possessory or is a recorded property interest. The Second Circuit acknowledged that most district courts have held that site control is a sufficient indicator to find lessees or sublessors liable as CERCLA owners. However, the appeals court also noted that the circuit precedent provided that CERCLA "owner" and "operator" liability should be treated separately, and suggested that relying solely on a site control analysis could essentially make all operators into owners and thereby render most operator language superfluous.

The court recognized that while the typical lessee should not be held liable as an owner, there might be circumstances when liability would be appropriate.[24] However, the court emphasized that in reaching such a conclusion, the critical analysis was the relationship between the owner and the tenant/sublessor, and not the lessee/sublessor's relationship with its sublessee.

Turning to the lease, the court concluded that Barlo did not possess sufficient attributes of ownership over the Pasley lot based on, in part, on the following:

- Barlo was limited to using its parcel and only "for that business presently conducted by tenant on a portion of the same premises leased hereunder";
- Barlo was required to obtain written consent from Commander Oil before making "any additions, alterations or improvements" on the land, which alterations would become Commander Oil's property in any event;
- The lease required Barlo to obtain written approval from Commander Oil to sublet the property, and prohibited subletting to any entity that had "any connection with the fuel, fuel oil or oil business";
- Barlo was prohibited from doing anything that would "in any way increase the rate of fire insurance" on the property, and from bringing or keeping upon the premises "any inflammable, combustible or explosive fluid, chemical or substance."

The court acknowledged that Barlo possessed some attributes of ownership with respect to the Pasley lot; however, when viewed in totality, the Second Circuit held that Barlo lacked most of the rights that come with ownership and reversed the district court ruling.

In *Scarlett & Associates, Inc. v. Briarcliff Center Partners, LLC*,[25] a federal district court found there was a genuine dispute of material facts as to whether a managing agent of a shopping center was a CERCLA operator of a tenant dry cleaning business. The agent did not maintain an office or have personnel at the site, nor did it have keys to any leased space or have the power to evict tenants. The managing agent said its principal responsibilities were to attempt to rent space to tenants approved by the owner, collect rent, maintain the common areas of the center, pay bills in a timely manner, and send excess revenues to the owner.

The owner pointed to language in the management services agreement that the agent was to obtain all necessary government approvals and perform such acts necessary to ensure that the owner was in compliance with all laws. The court noted that the managing agent sent the dry cleaner a certified letter advising of certain environmental reporting requirements and requested copies of the documentation that the dry cleaner was required to provide to the EPA or an explanation as to why the dry cleaner was exempt from providing such documentation. The court

said that this correspondence, combined with the other evidence of record indicating that the managing agent generally was responsible for managing and maintaining the shopping center and performing all acts necessary to effect compliance with laws, rules, ordinances, statutes, and regulations, was sufficient to create a genuine issue as to whether the agent managed the operations of the dry cleaner specifically related to pollution, and it therefore met the definition of a former "operator."

Defenses

Third-Party Defense

CERCLA originally contained three affirmative defenses to liability: act of God, act of war, and the third-party defense. From a practical standpoint, the third-party defense was the only viable defense available to property owners or operators. To establish that defense, the owner or operator would have to show that the disposal or release was:

- *solely* caused by a party;
- with whom it had no direct or indirect *contractual relationship*;
- the defendant exercised *due care* with respect to the hazardous substances; and
- took *precautions* against foreseeable actions or omissions of third parties.[26]

Most courts broadly construed the phrase "*in connection with a contractual relationship, existing directly or indirectly*" to encompass virtually all forms of real estate conveyances. As a result, lessors of property that was contaminated by a current or former a tenant could not successfully assert the third-party defense on the grounds that a lease constituted a "contractual relationship" with the responsible party (i.e., lessee).

The concept that the mere existence of a lease can preclude an owner from asserting a third-party defense when the contamination is solely caused by a tenant is rather harsh especially in the case of truly absentee landlords with so-called "triple-net leases" or long-term ground leases.

The good news is that the Second Circuit has adopted an expansive view of the third-party defense so that it is a viable defense for owners or operators in New York. The federal courts in New York generally take a narrow view of the phrase "contractual relationship" and have held that the existence of a "contractual relationship" does not bar an owner or operator from invoking the defense.[27] Instead, a party will be precluded from asserting the defense only if there is some relationship between the disposal or release that caused the contamination and the contract, or a relationship which allows the landlord to exert some form of control over such activities.[28]

Perhaps the seminal case on third-party defense is *New York v. Lashins Arcade*,[29] where a current owner of a shopping center was able to successfully invoke the third-party defense because it did not have a contractual relationship with a former dry cleaner tenant who had discharged hazardous substances into the ground 15 years prior to acquisition.

Assuming that a prospective purchaser or tenant could overcome the "contractual relationship" hurdle, it would still have to establish that it satisfied the third prong of the test to exercise due care in dealing with the hazardous substances, and the fourth prong, which requires taking precautions against the foreseeable actions of omissions of third parties. The property owner in *Lashins Arcade* established that it had exercised due care such as maintaining water filters, sampling drinking water, instructing tenants to avoid discharging into the septic, inserting use restrictions into leases, and it performed periodic inspections to assure compliance with this obligation. In contrast, a bank that had subleased its space to a dry cleaner was unable to assert the third-party defense because it had failed to assess environmental threats after discovery of disposal would be part of due care analysis.[30]

Innocent Landowner Defense

Because the third-party defense was largely unavailable to purchasers or tenants of contaminated property, Congress enacted the innocent purchaser defense in 1986. Under this defense, a purchaser (or tenant) who "did not know or had no reason to know" of contamination would not be liable as a CERCLA owner or operator.[31] To establish that it had no reason to know of the contamination, a defendant must demonstrate that it took "all appropriate inquiries…into the previous ownership and uses of the facility in accordance with generally accepted good commercial and customary standards and practices."[32]

Since it relies on an affirmative defense, the innocent purchaser has the burden of establishing that it satisfied the elements of the defense. Not surprisingly, most courts narrowly construed the innocent purchaser defense. If a purchaser did not discover contamination before taking title, but contamination was subsequently discovered, courts generally concluded that the purchaser did not conduct an adequate inquiry and, therefore, could not avail itself of the defense.

Further complicating matters, CERCLA did not establish specific requirements for what constituted an appropriate inquiry. As part of the 2002 amendments, the EPA was required to promulgate an All Appropriate Inquiries (AAI) rule. The AAI rule became effective on November 1, 2006.[33]

Bona Fide Prospective Purchaser (BFPP) Defense

The principal drawback of the innocent purchaser defense is that a purchaser or tenant cannot know, or have reason to know, that the property was contaminated. To incentivize redevelopment of contaminated properties, Congress added the BFPP to CERCLA as part of the 2002 amendments.[34] This defense allows a landowner or tenant to knowingly acquire or lease contaminated property after

January 11, 2002 without incurring liability for remediation, if it can establish the following pre-acquisition requirements:

- All disposal of hazardous substances occurred before the purchaser acquired the facility;[35]
- The purchaser is not a potentially responsible party or affiliated with any other PRP for the property through any direct or indirect familial relationship, any contractual or corporate relationship, or as a result of a reorganization of a business entity that was a PRP;[36]
- The purchaser conducted "all appropriate inquiries" into the past use and ownership of the site.[37]

After taking title, a purchaser also must comply with a number of "continuing obligations" to maintain its BFPP status.

Contiguous Property Owner (CPO) Defense

Congress also added the CPO[38] defense in 2002. This defense provides liability protection to a person owning or leasing property that has been contaminated by a contiguous or adjacent property.

A person seeking to qualify for the CPO must comply with the same pre-and post-acquisition obligations as a BFPP. However, while the BFPP can knowingly acquire contaminated property, a CPO must not know or have reason to know of the contamination after it has completed its pre-acquisition AAI investigation. If an owner cannot qualify for the CPO defense, it may still be able to qualify for the BFPP defense.

Innocent Seller's Defense

An innocent purchaser who then becomes a seller can assert this defense if it discloses the existence of hazardous substances that may have occurred after taking title and if it complied with the "due care" and "precautionary" prongs of the third-party defense.[39]

CERCLA Secured Creditor Exemption

Lenders who without participating in the management of a facility hold indicia of ownership to protect a security interest in the facility are also exempt from liability.[40] However, banks that have foreclosed on property or have been overly involved in the management of a borrower's operation have been held liable as owners or operators of the property.

Contractual and Equitable Defenses

While the statutory defenses are the only ones available to defendants in government cost recovery actions, traditional equitable defenses are available to defendants in private party cost recovery actions or contribution actions such as laches, release, waiver, or unclean hands to reduce liability in private cost recovery actions. Defendants may also raise procedural defenses to government cost recovery actions such as response costs were not consistent with the National Contingency Plan[41] and the remedy was not cost-effective.

CERCLA Liens

CERCLA provides the EPA with two types of statutory liens. The EPA may impose a non-priority lien on property where it has performed response actions. The lien becomes effective when the EPA incurs response costs or notifies the owner of the property of its potential liability, whichever is later. The lien is subject to the rights of holders of previously perfected security interests.[42]

The EPA may also file a windfall lien when it has performed a response action at a site owned or operated by a BFPP and the response actions have increased the fair market value of the property above the fair market value that existed before the response action was initiated.[43] The windfall lien is to be measured by the increase in fair market value of the property attributable to the response action at the time of a sale or other disposition of the property. The lien will arise at the time the EPA incurs its costs and shall continue until the lien is satisfied by sale or other means, or the EPA recovers all of its response costs incurred at the property. In lieu of the EPA imposing a windfall lien on the property, the BFPP may agree to grant the EPA a lien on any other property that the BFPP owns or provide some other assurance of payment in the amount of the unrecovered response costs that is satisfactory to the EPA.

Resource Conservation and Recovery Act (RCRA)[44]

Under this law owners or operators of facilities that treat, store or dispose of hazardous waste must comply with certain operating standards and may also be required to undertake corrective action to clean up contamination caused by hazardous or solid wastes. The federal government may also issue a corrective action order to an owner or operator of a Treatment, Storage and Disposal Facility or generators of hazardous waste subject to RCRA.[45] The government may also issue orders for injunctive relief to address hazardous waste posing an "imminent and substantial endangerment" to public health and the environment.[46]

RCRA also imposes a full range of regulatory requirements on owners and operators of Underground Storage Tanks that are used to store petroleum or hazardous substances.[47] Some parts of the UST program are administered by the NYSDEC in lieu of EPA enforcement.[48]

Unlike with CERCLA, private parties are not entitled to recover their cleanup costs under RCRA. Instead, private parties may seek injunctive relief ordering persons who contributed to the past or present handling, storage, treatment, transportation, or disposal of hazardous waste to remediate hazardous waste contamination that is posing an "imminent and substantial endangerment" to public health and the environment.[49] Indeed, this provision is becoming

a powerful litigation tool particularly for sites contaminated by gas stations[50] and the dry cleaners.

Endnotes

1. This concept has sometimes been referred to as "caveat lessee."
2. *State of N.Y. v. Monarch Chems.*, 90 A.D.2d 907, 456 N.Y.S.2d 867 (3d Dep't 1982).
3. Restatement of the Law, Second, Torts, § 356.
4. Restatement of the Law, Second, Torts, § 355.
5. Restatement of the Law, Second, Torts, § 358.
6. *Monarch Chems.*, 90 A.D.2d 907.
7. Restatement of the Law, Third, Torts: Liability for Physical and Emotional Harm, § 53.
8. *Id*. comment (e).
9. Consistent with modern notions of comparative responsibility, such failure would constitute negligence and either reduce the recovery of a lessee or subject the lessee to liability to third parties who are harmed by the dangerous condition. *Id*.
10. *Copart Indus., Inc. v. Consolidated Edison Co.*, 41 N.Y.2d 564 (1977); *Monarch Chems.*, 90 A.D.2d 907; *State of N.Y. v. Shore Realty Corp.*, 759 F.2d 1032 (2d Cir. 1985).
11. *Nashua Corp. v. Norton Co.*, 1997 U.S. Dist. LEXIS 5173 (N.D.N.Y. Apr. 15, 1997).
12. CPLR 214-c; *Jensen v. General Elec. Co.*, 82 N.Y.2d 77 (1993); *Aiken v. General Elec. Co*, 57 A.D.3d 1070, 869 N.Y.S.2d 263 (3d Dep't 2008); *Atkins v. Exxon Mobil Corp.*, 9 A.D.3d 758, 780 N.Y.S.2d 666 (3d Dep't 2004).
13. 42 U.S.C. §§ 9601 *et seq*.
14. Petroleum is excluded from the definition of hazardous substances. 42 U.S.C. § 9601(14). Because of the so-called petroleum exclusion, neither EPA nor private parties may seek reimbursement of costs incurred to remediate contamination from leaking gasoline underground storage tanks (USTs). *White Plains Hous. Auth. v. Getty Props. Corp.*, 2014 U.S. Dist. LEXIS 174308 (S.D.N.Y. Dec. 16, 2014). However, the petroleum exclusion does not apply to contaminants added to petroleum during normal use, such as waste oil. *City of N.Y. v. Exxon Corp.*, 766 F. Supp. 177, 186 (S.D.N.Y. 1991).
15. 42 U.S.C. § 9604.
16. 42 U.S.C. § 9607(a).
17. Innocent parties may seek 100% recovery of their costs (known as cost recovery actions) under 42 U.S.C. § 9607(a)(4)(B) while PRPs may file contribution actions under 42 U.S.C. § 9613(f)(1) if they incur costs that exceed their allocated share of the liability.
18. 42 U.S.C. § 9607(a)(1).
19. 42 U.S.C. § 9607(a)(2).
20. *Shore Realty Corp.*, 759 F.2d 1032.
21. *Bedford Affiliates v. Manheimer*, 1997 U.S. Dist. LEXIS 23903 (E.D.N.Y. Aug. 6, 1997); *United States v. A & N Cleaners & Launderers,* 788 F. Supp. 1317 (S.D.N.Y. 1992).
22. 215 F.3d 321 (2d Cir. 2000).
23. For support of its holding that Barlo was a CERCLA owner, the district court relied on *Delaney v. Town of Carmel*, 55 F. Supp. 2d 237 (S.D.N.Y. 1999) and *A & N Cleaners & Launderers, Inc.*, 788 F. Supp. 1317. These cases interpreted the term "owner" to extend beyond the fee or record owner to anyone possessing the requisite degree of control over the property.
24. The court provided three rare instances where the lessee did not have a typical lease but instead may have obtained a priority of ownership rights: (i) sale-leaseback arrangements…if the lessee actually retains most rights of ownership with respect to the new record owner; (ii) extremely long-term leases where, according to the terms of the lease, the lessee retains so many of the indicia of ownership that he is the de facto owner; and (iii) where a lessee/sublessor has impermissibly exploited more rights than originally leased.
25. 2009 U.S. Dist. LEXIS 90483 (N.D. Ga. Oct. 30, 2009).
26. 42 U.S.C. § 9607(b)(3) (emphasis added).
27. *But see U.S. v. Occidental Chemical Corp.*, 965 F. Supp. 408 (W.D.N.Y. 1997) (a deed can serve as an indirect contractual relationship that can prevent a property owner from asserting the third party defense).
28. *Westwood Pharms., Inc. v. Nat'l Fuel Gas Distrib. Corp.*, 964 F.2d 85 (2d Cir. 1992). *But see A & N Cleaners & Launderers, Inc.*, where a bank that was sublessor who maintained complete control and responsibility for property where a release occurred was deemed to be an owner for CERCLA purposes.
29. 91 F.3d. 353 (2d Cir. 1996). Compare *Lashins* conduct to the purchaser/owner in *Idylwoods Assoc. v. Mader Capital Inc.*, 956 F. Supp. 410 (W.D.N.Y. 1997).
30. *United States v. A&N Cleaners & Launderers, Inc.*, 854 F. Supp. 229 (S.D.N.Y. 1994).
31. 42 U.S.C. § 9601(35)(A).
32. 42 U.S.C. § 9601(35)(B)(i)(I).
33. 40 C.F.R. § 312.
34. 42 U.S.C. § 9607(r).
35. 42 U.S.C. § 9601(40)(A).
36. 42 U.S.C. § 9601(40)(H).
37. 42 U.S.C. § 9601(40)(B). EPA promulgated its AAI rule at 40 C.F.R. § 312.
38. 42 U.S.C. § 9607(q).
39. *Westwood Pharms. v. Nat'l Fuel Gas Distrib.*, 964 F.2d 85 (2d Cir. 1992).
40. 42 U.S.C. § 9601(20)(A).
41. 40 C.F.R. § 300.
42. 42 U.S.C. § 9607(l).
43. 42 U.S.C. § 9607(r).
44. 40 C.F.R. pts. 239–282.
45. 42 U.S.C. § 6928(h).
46. 42 U.S.C. § 6973.
47. 42 U.S.C. §§ 6991–6991m.
48. A discussion of New York state law is beyond the scope of this article.
49. 42 U.S.C. § 6972(a)(1)(B).
50. Because petroleum is excluded from the CERCLA definition of hazardous substances, RCRA § 7002 is often the only federal remedy available to owners or operators of property contaminated with petroleum.

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