Environmental Risks: Negotiating and Drafting Lease Agreements

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ENVIRONMENTAL RISKS: NEGOTIATING AND DRAFTING LEASE AGREEMENTS

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Landlords and tenants often negotiate and draft leases without carefully considering how environmental risks and liabilities are to be allocated between the parties. Owners/landlords who fail to account for environmental risks in lease agreements may find themselves subject to considerable liability. A relatively recent example can be found in the case of *United States v. Monsanto Co.*[1] In that case, the owners of a four-acre tract of land in South Carolina verbally leased property on a month-to-month basis to a company for the sole purpose of storing raw materials and finished products. In the mid-70s, the tenant company began using the site as a waste storage and disposal facility for chemical wastes generated by third parties. The landlord/owners were unaware of this new activity for at least several years. As a result of the tenant's new activities, the federal and state governments ultimately brought an enforcement action against the owners under the Comprehensive Environmental Response, Compensation and Liability Act of

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1. 858 F.2d 160 (4th Cir. 1988).

1980 (CERCLA).[2] The court in *Monsanto* held that the owners were "responsible parties" under CERCLA, therefore, jointly and severally liable with other defendants for the $1.8 million in cleanup costs incurred by the government.[3]

The defendant landlords received a minimal amount of rent, reaching a high of $350 per month in 1980.[4] Thus, while the profit from this lease was modest, the liability turned out to be enormous.

The enactment of federal statutes such as CERCLA and similar state statutes, along with court cases such as *Monsanto*, have changed modern leasing practices. Indeed, the allocation of environmental risks and liabilities has become a major negotiating point, both in new lease agreements and in continued cooperative relations among landlords and tenants under existing leases. This article is not intended to be an exhaustive analysis of all potential sources of environmental liability. However, it does present an overview of some of the important statutes and cases which the practitioner should be aware of when negotiating a lease and suggests approaches which may be used to deal with environmental liability issues.

CERCLA

In enacting CERCLA, Congress provided a means for the nationwide cleanup of the many sites contaminated by hazardous substances. CERCLA imposes liability for the cleanup of hazardous substances on a range of potentially responsible parties. Potentially responsible parties include the following: (1) the present owner or operator of the site; (2) any person who, at the time of disposal of any hazardous substance, owned or operated any facility at which the hazardous substances were deposited; (3) any person who arranged for offsite disposal or treatment, or arranged with a transporter for offsite disposal or treatment at a hazardous substance facility; and (4) any person who transported hazardous substances to the site subject to cleanup.[5] CERCLA imposes liability both on those responsible for causing contamination, by either disposing hazardous substances or arranging for their disposal at a given site, and on the current owner or operator of the site, regardless of fault. This statutory scheme maximizes the likelihood that there will be a "responsible party" financially able to fund a cleanup, even in the case where the actual person or persons responsible cannot be found or identified.

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2. 42 U.S.C. §§ 9601-9675 (1988).
3. *Monsanto Co.*, 858 F.2d at 164-66.
4. *Id.* at 164.
5. CERCLA § 107(a), 42 U.S.C. § 9607(a) (1988).

CERCLA defines the term "hazardous substance" broadly to include certain toxic or hazardous materials or wastes regulated under the Clean Water Act, Clean Air Act, Resource Conservation and Recovery Act, Toxic Substances Control Act, as well as materials designated by the U.S. Environmental Protection Agency (EPA).[6] The term does not include petroleum or petroleum products unless the petroleum was mixed with one of the listed hazardous substances.[7] While petroleum by itself is not subject to CERCLA, it is regulated under Idaho's Environmental Protection and Health Act of 1972 (EPHA).[8]

The EPA specifically includes "friable asbestos"[9] as a hazardous substance under CERCLA.[10] In addition, one court held that all asbestos is a hazardous substance under CERCLA by virtue of its listing under the Clean Water Act and Clean Air Act.[11] Therefore, when such a hazard is discovered, the responsible party bears the financial burden for its removal.

Potentially responsible parties under CERCLA are liable for the following: (1) removal or remedial costs incurred by the federal government, or one of the states, in cleaning up a site under the national contingency plan;[12] (2) any other "necessary costs of response" incurred by any other person which are "consistent with the national contingency plan"; (3) damages to natural resources; and (4) any health assessment costs.[13]

The meaning of the phrase "necessary costs of response" has been the subject of frequent litigation. This is because the phrase is not defined in CERCLA.[14] However, CERCLA does define "response" to mean "remove, removal, remedy, and remedial action."[15] In turn, CER-

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6. CERCLA § 101(14), 42 U.S.C. § 9601(14) (1988); *see* 40 C.F.R. § 302.4 (1989) (affected substances).

7. *See* Memorandum from Frances S. Blake, EPA General Counsel, to Jay Winston Porter, Assistant Administrator for Solid Waste and Emergency Response (Jul. 31, 1987).

8. IDAHO CODE tit. 39 ch. 1 (1972). *See generally* the implementing regulations at IDAPA 16.01.2001-16.01.2999; *see also* IDAPA 16.01.2850 ("Hazardous Material and Petroleum Product Spills").

9. *See* 40 C.F.R. § 61.141 (1989) (provides in part that "friable asbestos" is asbestos which is decaying or easily crumbled).

10. *See* 40 C.F.R. § 302.4 (1989).

11. United States v. Metate Asbestos Corp., 584 F. Supp. 1143, 1146 (D. Ariz. 1984). Asbestos is also regulated under the Occupational Health and Safety Act, 29 U.S.C. §§ 651-678 (1988); *see* 29 C.F.R. §§ 1910.1001 & 1926.58 (1989).

12. The national contingency plan is the plan formulated under CERCLA for cleanups.

13. CERCLA § 107(a), 42 U.S.C. § 9607(a) (1988).

14. Jones v. Inmont Corp., 584 F. Supp. 1425, 1429 (S.D. Ohio 1984).

15. CERCLA § 101(25), 42 U.S.C. § 9601(25) (1988).

CLA provides broad statutory definitions for "remove or removal"[16] and "remedy or remedial action,"[17] terms which have been broadly construed by reported cases to cover the cleanup costs of hazardous substances released into the environment.[18]

The EPA may also seek nonmonetary remedies. For example, under CERCLA, the EPA may seek injunctive relief to abate "an imminent and substantial endangerment" to public health or the environment caused by hazardous materials.[19] Such an injunction could require the owner or operator of contaminated property to incur substantial response costs.

Most cases interpreting CERCLA have held that liability under the act is joint and several.[20] Thus, any one single party may be held liable for all damages resulting from hazardous substance contamination. However, the person who incurs cleanup costs or is required to reimburse the government for governmental cleanup may seek contribution from other responsible parties.[21] Further, courts will equitably allocate costs among liable parties.[22]

As noted above, CERCLA extends liability to, among others, "owners" and "operators" of contaminated facilities. The term "owner" includes past owners who owned the site at the time the hazardous substances were stored or discarded.[23] Therefore, past owners are not liable if no waste was deposited during their ownership.[24] The definition of "disposal," however, is broadly construed. For instance, a

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16. CERCLA § 101(23), 42 U.S.C. § 9601(23) (1988) (the terms "remove or removal" are defined as actions necessary to cleanup or remove; to monitor, assess and evaluate; to dispose; to prevent, minimize or mitigate damages when hazardous substances are or threatened to be released).

17. CERCLA § 101(24), 42 U.S.C. § 9601(24) (1988) (the terms "remedy or remedial action" are defined as actions taken instead of or in addition to removal actions to minimize the migration of hazardous substances released or threatened to be released into the environment).

18. *See Jones*, 584 F. Supp. at 1429-30; DAVISON, ENVIRONMENTAL RIGHTS AND REMEDIES § 5:29 n.71 (Supp. 1988).

19. CERCLA § 106(a), 42 U.S.C. § 9606(a) (1988).

20. *See, e.g.*, United States v. Chem-Dyne Corp., 572 F. Supp. 802, 805-10 (S.D. Ohio 1983); United States v. Wade, 577 F. Supp. 1326, 1337-39 (E.D. Pa. 1983). *See also* CERCLA § 101(32), 42 U.S.C. § 9601(32) (1988).

21. CERCLA § 113(f)(1), 42 U.S.C. § 9613(f)(1) (1988).

22. *Id. See, e.g.*, United States v. Hardage, 116 F.R.D. 460, 465-66 (W.D. Okla. 1987); United States v. Conservation Chemical Co., 628 F. Supp. 391, 404-05 (W.D. Mo. 1985).

23. CERCLA §§ 101(20)(A) & 107(a), 42 U.S.C. §§ 9601(20)(A) & 9607(a) (1988); New York v. Shore Realty Corp., 759 F.2d 1032, 1043-44 (2d Cir. 1985) (current owner liable).

24. *See* CERCLA § 107(a)(2), 42 U.S.C. § 9607(a)(2) (1988).

land owner who graded a site containing hazardous substances was deemed to have contributed to their "disposal" by redistributing them.[25]

The manner in which the courts have construed "owner" and "operator" is especially germane in the landlord/tenant context. For example, courts have held that a landlord may be held liable under CERCLA for the acts of its tenants.[26] Further, courts have considered tenants to be both "owners" and "operators" under CERCLA.[27]

Because CERCLA imposes strict liability on the "owners" of real property, a landlord cannot assert as a defense that the contamination at issue resulted solely from the activities of its tenant or sublessee, nor is the landlord's knowledge or consent relevant.[28] The so-called "innocent landowner's" defense of sections 107(b)(3) and 101(35) of CERCLA does not protect owners whose liability stems from the activities of the tenant.[29]

A tenant who occupies or occupied the leased premises will be treated the same as an owner and be strictly liable for response costs.[30] If a tenant is the current occupant or operator, it will be liable irrespective of whether the contamination resulted from its own activities, past or present, of the landlord, prior tenants, or co-tenants. If the tenant subleases property, its liability is directly analogous to that of an owner and landlord.[31]

A question remains whether the so-called "innocent landowner's" defense is available to tenants otherwise liable as operators of contaminated property. Because section 107(b) defenses[32] are available to any-

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25. Tanglewood East Homeowners v. Charles-Thomas, Inc., 849 F.2d 1568, 1573 (5th Cir. 1988).

26. *See, e.g.*, United States v. Argent Corp., 21 E.R.C. (BNA) 1354 (D.N.M. May 4, 1984); United States v. South Carolina Recycling & Disposal, Inc., 653 F. Supp. 984, 1003 (D.S.C. 1984) (lessee who sublet site to a subtenant deemed an owner under CERCLA); United States v. Cauffman, 21 E.R.C. (BNA) 2167, 2168 (C.D. Cal. 1984).

27. *See South Carolina Recycling & Disposal*, 653 F. Supp. at 1003; United States v. Northernaire Plating Co., 670 F. Supp. 742, 747 (W.D. Mich. 1987) (court held tenant was the "operator of the site").

28. *See* United States v. Monsanto Co, 858 F.2d 160, 168-69 (4th Cir. 1988); *Argent Corp.*, 21 E.R.C. (BNA) 1354 (owner of mini-warehouse liable for hazardous waste left by lessee).

29. *See* CERCLA § 107(b)(3), 42 U.S.C. § 9607(b)(3) (1988); CERCLA § 101(35), 42 U.S.C. § 9601(35) (1988).

30. *See* CERCLA § 107, 42 U.S.C. § 9607 (1988).

31. *See South Carolina Recycling & Disposal, Inc.*, 653 F. Supp. at 1003.

32. CERCLA § 107(b), 42 U.S.C. § 9607(b) (1988). Section 107(b) defenses provide, in part, that there shall be no liability under section 107(a) if the release of a hazardous substance was caused by an act of God or an act of War, or if the section 107(b)(3) innocent landowners' defense applies.

one liable under section 107(a),[33] a tenant may invoke the defense if it conducts an adequate environmental investigation of the property before entering into a lease and has no knowledge of, nor involvement in, the activity that contaminated the property.[34]

RESOURCE CONSERVATION & RECOVERY ACT OF 1976

The Resource Conservation & Recovery Act of 1976 (RCRA)[35] governs the management of hazardous waste from generation to disposal. Persons who store, treat, dispose, or transport hazardous waste are required to have RCRA permits. Under RCRA, every state is required to set up procedural guidelines in order to enforce the RCRA program at the state level. The state of Idaho enacted the Idaho Hazardous Waste Management Act of 1983[36] to meet this requirement, and the EPA granted Idaho authority to administer the RCRA program in April of 1990.[37] Many of the provisions in the state act are analogous to RCRA.

As a result, landlords who lease real property must be concerned with RCRA as well as CERCLA. This is because a lease agreement relating to property that is or has been used for the treatment, storage, or disposal of RCRA listed hazardous wastes is subject to RCRA's regulatory requirements. Under RCRA, the EPA may take or impose corrective action against an owner, operator, landlord or tenant of a hazardous waste disposal site for releasing hazardous waste into the environment.[38] If a release or threatened release from any site creates imminent or substantial danger to the public health or environment, the EPA can bring suit against any person who contributed to the contamination.[39] A provision analogous to RCRA is set forth in the Idaho Code.[40]

Furthermore, RCRA can require a property owner and tenant/operator of a waste facility plant to sign permit applications. An owner may be liable if the tenant/operator does not comply with RCRA regulations.[41] Failure to comply with RCRA requirements can lead to civil liability and/or criminal penalties and increase the risk of violating CERCLA. Failure to comply may also restrict the permitted uses of the property, making the land more difficult to lease or sell.

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33. CERCLA § 107(a), 42 U.S.C. § 9607(a) (1988).
34. *See* CERCLA § 107(b), 42 U.S.C. 9607(b) (1988).
35. 42 U.S.C. §§ 6901-6992 (1988).
36. IDAHO CODE tit. 39, ch. 44 (1985).
37. 55 Fed. Reg. 11015 (March 26, 1990).
38. *See* 42 U.S.C. § 6924 (1988).
39. *See* 42 U.S.C. § 6973 (1988).
40. IDAHO CODE § 39-4414(3)(a) (1985).
41. *See* 40 C.F.R. § 270.10(b) (1989).

CLEAN WATER ACT

The federal Clean Water Act (CWA)[42] prohibits the discharge of pollutants into navigable waters without a National Pollutant Discharge Elimination System permit. Under CWA, just like CERCLA, owners or operators of discharging facilities may be strictly liable for cleanup costs. Unlike CERCLA, however, strict liability under the CWA is subject to certain statutory ceilings.[43]

Many courts have also imposed joint and several liability under CWA.[44] Furthermore, violations of CWA requirements can lead to civil liabilities, criminal penalties, CERCLA and common law liabilities, as well as affect the potential uses of the property. The Idaho EPHA also deals with water quality issues and should be consulted as a potential source of liability.[45]

CLEAN AIR ACT

The federal Clean Air Act[46] prohibits the discharge of "hazardous air pollutants" in excess of emission standards. Further, like RCRA and CWA violations, Clean Air Act violations may cause civil, criminal, common law and CERCLA liability, thereby affecting the available uses of a given piece of property and possibly making it more difficult to lease or sell. Under the Clean Air Act, "hazardous air pollutants" include asbestos.[47] The EPA has promulgated extensive regulations dealing with asbestos as it relates to building demolitions and renovations.[48] Therefore, these regulations must be taken into account whenever an owner/landlord or tenant undertakes any building alterations or enters a lease agreement.

TOXIC SUBSTANCES CONTROL ACT

The federal Toxic Substances Control Act (TSCA)[49] regulates the testing and manufacturing of chemical substances and mixtures, including polychlorinated biphenyl (PCB). TSCA bans the manufacture

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42. 33 U.S.C. §§ 1251-1387 (1988).

43. 33 U.S.C. § 1321(f) (1988); *See* Steuart Transportation Co. v. Allied Towing Corp., 596 F.2d 609, 617-19 (4th Cir. 1979).

44. *See, e.g.*, In re Complaint of Berkley Curtis Bay Co., 557 F. Supp. 335, 338 (S.D.N.Y. 1983).

45. IDAHO CODE tit. 39, ch. 1 (1972).

46. 42 U.S.C. §§ 7401-7642 (1988).

47. 42 U.S.C. § 7412(a)(1) (1988).

48. 42 U.S.C. § 7412 (1988); 40 C.F.R. 61 (1989).

49. 15 U.S.C. §§ 2601-2671 (1988).

and use of PCB's except when done in a "totally enclosed manner."[50] Also, the EPA has promulgated extensive regulations concerning transformers and other electrical equipment containing PCB's in commercial buildings.[51] As a result, the practitioner must also be mindful of TSCA provisions when negotiating and drafting lease agreements.

COMMON LAW OF NUISANCE

An owner of land might also be liable for the costs of abating contamination on the property under the common law of nuisance. Section 839 of the *Restatement (Second) of Torts* provides that a possessor of land may be subject to liability for a nuisance caused by an abatable condition on the land if

> (a) the possessor knows or should know of the condition and the nuisance or unreasonable risk of nuisance involved, and (b) he knows or should know that it exists without the consent of those affected by it, and (c) he has failed after a reasonable opportunity to take reasonable steps to abate the condition or to protect the affected persons against it.[52]

The comment to this section further declares that a possessor's liability

> is not based upon responsibility for the creation of the harmful condition, but upon the fact that he has exclusive control over the land and the things done upon it and should have the responsibility of taking reasonable measures to remedy conditions on it that are a source of harm to others.[53]

A vendee or lessee of land upon which a harmful physical condition exists may be liable under this rule for failing to abate the problem after taking possession, even though the vendee or lessee had no part in its creation. The Second Circuit in *New York v. Shore Realty Corp.*[54] adopted this principle by imposing nuisance liability on a landowner. The court held that "it is immaterial therefore that other parties placed the chemicals on [the] site; Shore purchased it with the knowledge of its condition . . . [and] is liable for maintenance of a *public* nuisance irrespective of negligence or fault."[55]

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50. 15 U.S.C. § 2605(e) (1988).
51. 40 C.F.R. § 761 (1989).
52. RESTATEMENT (SECOND) OF TORTS § 839 (1977).
53. *Id.* at comment d.
54. 759 F.2d 1032 (2d Cir. 1985) (citing RESTATEMENT (SECOND) OF TORTS § 839 (1977)).
55. *Id.* at 1051 (emphasis in original).

DRAFTING LEASE PROVISIONS—THE LANDLORD'S PERSPECTIVE

In negotiating the environmental terms of a commercial lease, the landlord's principal interest will be to preserve the value of the property and avoid liability. The landlord should seek provisions that minimize the risk of contamination of the property and allocate responsibility between the landlord and the tenant for compliance with environmental laws and regulations.

As a starting point, a commercial lease should require the tenant to comply with all environmental laws. These requirements should be carefully defined and should include laws applicable to asbestos and petroleum. Further, the landlord should receive a description of the tenant's use of the premises and require the tenant to give timely notification of any use of hazardous substances. The landlord should also receive assurances that the tenant has an adequate plan for dealing with hazardous substances and has the required licenses and/or permits. To ensure compliance with the lease terms, the landlord should reserve the opportunity to conduct environmental audits of the tenant's use of the premises. This should include the right to conduct tests and review the tenant's books, records, and reports to governmental agencies. In addition, responsibility for the payment of audit costs should be established in the lease.

The lease should also require the tenant to provide notice to the landlord of all but *de minimis* spills of hazardous substances. Furthermore, the lease should define *de minimis* and ensure that the landlord has the right to conduct cleanup in the event a tenant fails to do so.

The lease should also contain provisions requiring the tenant to notify the landlord of any plans that may involve the disturbance of asbestos. For example, moving major pieces of equipment or working on boilers which may give rise to "friable asbestos." The landlord should also require notice before any repairing or remodeling is performed.

The tenant should also indemnify the landlord for any fines or costs of testing and monitoring which result from the tenant's activities. These environmental provisions in the lease agreement should also apply to any sublease or license that relates to the premises. However, lease covenants are useful only to the extent that assets back them up. Thus, landlords must also be careful when selecting those with whom they bargain; a consideration quite apart from the terms of the final bargain reached.

The owner/landlord should have the option of terminating the lease in the event that the tenant fails to perform any of the environmental requirements. The lease should further provide that, at the end

of the lease term, the tenant will return the premises to the landlord in the same condition as received. This may require conducting an environmental audit, removing any contamination, removing underground storage tanks installed by tenants, and inspecting asbestos levels at the end of the lease term. Finally, the lease should provide that the tenant's obligations regarding the foregoing matters continue after the end of the lease term.

DRAFTING LEASE PROVISIONS—THE TENANT'S PERSPECTIVE

In negotiating the environmental terms of a commercial lease, the tenant must take steps to determine that the premise is safe and available for the tenant's business and that the tenant will not incur any liability for activities on the premises prior to the tenant's lease. The tenant must explore the environmental status of the property at the beginning of the lease in order to establish a baseline for future environmental issues. This should, at a minimum, include an environmental assessment or inspection of the property. The tenant should obtain representations and warranties from the landlord regarding the environmental status of the property in the written lease or in an estoppel letter coincidental with the lease.

The landlord's or other tenants' actions involving environmental response activities may affect the tenant's occupancy of the property. If the disruption substantially interferes with the tenant's use, the landlord should be required by the lease to provide notice, an offset or abatement of rent, and/or allow for a termination of the lease. The tenant should also seek indemnification from the landlord for all costs and expenses involving environmental problems not caused by the tenant. Further, all representations by the landlord to the tenant involving environmental matters should survive termination of the lease.

CONCLUSION

The public's increased awareness of environmental issues has given birth to a myriad of federal statues governing liability for environmental cleanup.

The analysis presented in this article is not intended to be an exhaustive review of these statutory provisions. Rather, it highlights some of the most important provisions relating to landlords and tenants, focusing on ways to effectively allocate environmental risk and liability between parties to lease agreements.

A commercial lease drafted to fully account for the potential liabilities associated with modern environmental laws is the best tool for

avoiding the imposition of liability on parties not responsible for a given instance of environmental damage.