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Limiting Superfund Liability in Corporate Acquisitions and Operations

A key question in planning and structuring any acquisition, merger or reorganization is the potential reach of liabilities, both known and undiscovered, for environmental cleanup. Under federal and state "Superfund" statutes, environmental liability may be imposed on a parent corporation, successor entities, or even individual officers, directors or shareholders. The financial magnitude of many cleanups, together with the prospect of joint and several liability for cleanup costs properly attributable to defunct or undercapitalized entities, provide the government and other claimants with strong incentive for challenging traditional limits on corporate liability. Thus, in structuring any transaction, it is important to understand and consider how environmental liability may be allocated beyond the nominally responsible corporate entity.

This bulletin provides an overview of recent trends in parent-subsidiary, successor-in-interest and individual liability for environmental cleanup. In order to avoid potentially costly exposure to environmental liability, corporate managers and counsel are well advised to consider these trends in both planning transactions and managing their operations.

The Superfund Regime

The federal Superfund statute, entitled the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA), was enacted, in large part, to provide funding to clean up orphaned or abandoned hazardous waste disposal sites. CERCLA imposes strict, categorical and retroactive liability. Categorically liable parties, known as "potentially responsible parties" (PRPs), include the operator of a site, the former owner(s) or operator(s) of the site who owned or operated the facility at the time of disposal, and any entity that arranged for disposal of hazardous substances at the site. Any PRP fitting within one of these categories may be held responsible for cleanup costs – proof that a particular act or omission caused a specific injury or remedial cost is not required.

That Congress intended to abrogate common-law standards of liability, in establishing new categorical definitions of parties liable for cleanup costs, was immediately apparent to courts and, as a result, to PRPs. Just how far Congress intended to go – for example, the extent to which CERCLA abolished protections inherent in the corporate form and other structures recognized under state laws for purposes of limiting enterprise liability – has long been a matter of debate.

The U.S. Supreme Court's decision in *United States v. Bestfoods,* 524 U.S. 51 (1998), addressed one key issue, the liability of parent corporations for the actions of their subsidiaries. However, the decision was limited in scope. Since 1998, federal courts have applied and extended the *Bestfoods* decision, not necessarily with consistent results.

Corporate "Operator" Liability after *Bestfoods*

At issue in *Bestfoods* was the operation of a chemical manufacturing plant that had, over a period of 30 years, caused contamination of soil and groundwater. The U.S. EPA oversaw the multimillion-dollar cleanup of the site and then brought suit under CERCLA to recover these expenses from several corporations that had manufactured chemicals at the plant. One of these corporations, now known as Bestfoods, was a wholly owned subsidiary of CPC International. The government claimed that Bestfood's corporate parent was liable, as an "operator," for the costs of cleanup under CERCLA. The central question in the case was whether a parent corporation that actively participated in, and exercised control over, the operations of a subsidiary could, without more, be liable as an operator of a polluting facility owned or operated by the subsidiary.

<u>Direct Liability</u>

In part because the term "operator" was not defined in the CERCLA statute, the federal circuit courts had divided on whether direct "operator" liability required "actual control" over the activities of the subsidiary, or merely the capacity or authority to control, even if it was never exercised. In its *Bestfoods* decision, the Court held that, to be labeled an "operator" under the statute, an organization or individual must "manage, direct, or conduct operations specifically related to pollution, that is, operations having to do with the leakage or disposal of hazardous waste, or decisions about compliance with environmental regulations." Thus, direct operator liability for the parent corporation requires that it exercise actual control over the subsidiary's polluting facility and operations, and not just the subsidiary itself. Such control must go beyond activities that are consistent with the parent's investor status, such as monitoring performance or articulating general policies and procedures.

The Court noted that the practice by directors and officers of holding positions with both the parent corporation and its subsidiary is well established, and that these parties can legitimately "change hats" to represent the two corporations separately, despite their common ownership. It is only when the degree and nature of oversight of the subsidiary-owned facility by an agent of the parent are "eccentric" (as the Court put it) in comparison to the accepted norms of parental oversight that a question of direct parent liability arises. The Court also cited with approval an earlier circuit court decision, *United States v. Kayser-Roth Corp.,* 910 F.2d 24, 26 (1st Cir. 1990), which found liability where a corporate parent exercised "pervasive control" over a subsidiary, and also made clear that CERCLA prevents individuals from using the corporate form as a shield against liability when they, as "operators," directly participate in conduct prohibited by the statute.

<u>Derivative Liability</u>

Charging the parent corporation with derivative liability for a subsidiary's operation of a facility based on mere ownership of the subsidiary requires the use of traditional legal rules for "piercing the corporate veil." The *Bestfoods* Court emphasized that it is a "deeply ingrained" principle of corporate law that a parent corporation is not liable for the acts of its subsidiaries, and nothing in CERCLA changed this "bedrock" principle. The Court noted that it is an "equally fundamental" principle, however,

that the corporate veil may be pierced and the parent held liable for the subsidiary's conduct when, for example, the corporate form is misused to accomplish certain wrongful purposes, such as fraud.

The *Bestfoods* Court declined to address the issue of whether federal courts, in deciding derivative liability claims under CERCLA, should apply state law or develop new federal common law. Although there continues to be a split among the circuits on this issue, the majority of circuits have applied state law in determining whether to pierce through a subsidiary to reach a parent corporation, or they have employed standards which have reached the same result as would likely have been obtained under state law.

Bestfoods also did not address the question of what law determines when the corporate veil may be pierced to reach individual officers and shareholders. Again, many circuits have held that state law controls derivative liability for such individuals under CERCLA. The standards vary by state but look to factors such as the existence of independent corporate management, compliance with corporate formalities, and considerations of fairness and equity. At least one circuit court uses a two-prong, multi-factor federal common law piercing test in assessing such claims, considering whether the separate identity of the corporation was maintained, and if adherence to the "corporate fiction" would promote injustice. Whether the use of federal common law rather than state law in a veil-piercing analysis would change the outcome cannot be assessed without reference to the specific facts of a case. Also, the federal common law standards can vary among the circuit courts that apply them, further complicating the derivative liability picture.

Successor Liability

At least until recently, it appeared that the majority of courts addressing the liability of successor corporations for response costs under CERCLA would have held that federal common law, rather than state law, supplied the rule of decision. The statute itself is silent on the issue. Normally, under state law, a corporation that acquires the stock of (or merges with) another corporation acquires the predecessor's liability. By contrast, a corporation that purchases the assets of another corporation is not generally liable for the obligations of the seller. There are four widely-recognized exceptions to this general "asset purchase" rule: 1) the purchasing corporation expressly or implicitly agrees to assume the selling corporation's debts; 2) there has been *de facto* consolidation or merger of the two corporations; 3) the purchasing corporation is a "mere continuation" of the selling corporation; or 4) the transaction is entered into fraudulently, in order to escape liability for the obligations of the selling corporation.

In developing a federal common law, a number of circuit courts have added what may be construed as a fifth exception, expanding the "mere continuation" exception to one of "substantial continuation." However, this exception, as well as its roots in a federal rule of decision, was recently rejected in *United States v. Davis,* 1st Cir., No. 00-1234 (8/17/01), based largely on *Bestfoods.*

In *Davis,* the First Circuit held that it must apply Connecticut's "mere continuation" standard, rather than a federal "substantial continuation" test. In applying the Connecticut standard, the court examined: (1) the divesting corporation's transfer of assets; (2) whether there was payment of fair market value for those assets; (3) continuation by the buyer of the divesting corporation's business; (4) whether there was a common officer of the buyer and divesting corporation who was instrumental in the transfer; and (5) any inability of the divesting corporation to pay its debts after the assets transfer. The "substantial continuation" test, in contrast, focuses on factors such as retention by the buyer of the seller's employees, supervisory personnel and production facilities in the same

location; production of the same product; and whether the buyer holds itself out as a continuation of the divesting corporation. Not surprisingly, the "substantial continuation" test is more likely to result in a finding of successor liability.

The First Circuit cited *Bestfoods* in concluding in *Davis* that state law should decide the successor liability question, noting that the Supreme Court had indicated in *Bestfoods* that to justify the creation of a federal rule of decision, there must be a specific federal policy or interest that is compromised by the application of state law. The First Circuit found no evidence that application of state law to the facts of the *Davis* case would frustrate any federal objective. In *Davis* the court concluded that since the corporation and its successor did not share a common officer or director who was involved in the transfer, the seller received fair compensation for its assets, and the seller continued as a financially viable business following the sale, there was no reason to except this transaction from the rule that successor liability does not transfer when one company buys another's assets.

The rationale cited by various circuit courts for developing a federal common law of successor liability for CERCLA, on the other hand, was that national uniformity was necessary in order to prevent parties from escaping liability under the statute simply by arranging an asset purchase under laws of particular states that may unduly limit such liability. The circuit courts that continue to apply this "substantial continuity" approach find that it better serves the broad remedial purpose of CERCLA (*i.e.,* finding a viable party to pay for the cleanup). In general, however, there appears to be a trend – evidenced by the *Bestfoods* and *Davis* cases – to limit derivative liability (absent compelling factual circumstances) through stricter application of traditional doctrines limiting corporate liability.

Implications and Conclusions

Although recent decisions involving CERCLA liability are highly fact specific, a few practical conclusions can nevertheless be drawn, which provide some guidance in structuring corporate transactions and managing corporate operations.

Direct Corporate Parent Liability. A parent must be actively engaged in controlling a subsidiary's facility and operations in order to be found directly liable as an operator. General oversight by the parent of the subsidiary's environmental affairs, for example, should not subject the parent to operator liability as long as the parent does not attempt to exert a degree of control over the subsidiary that is in excess of generally accepted corporate parent norms.

Derivative Parent Liability. A parent that employs "eccentric" management practices or structures (*e.g.,* creating an undercapitalized corporate "shell" in an attempt to avoid liability for known environmental problems) is likely to be derivatively liable under either state or federal common law. A parent officer who assumes the "hat" of a subsidiary officer should exercise care to act on the subsidiary's behalf, and not the parent's, when making decisions regarding operations of the facility.

Individual Liability. Corporate officers should be mindful that, to the extent they engage in activities that directly result in releases of hazardous substances or directly oversee operations concerning hazardous substances, they may be exposed to operator liability under CERCLA. Particularly in the case of closely held corporations, the corporate veil can provide only illusory protection. Indeed, officers, directors and shareholders have been held liable under CERCLA for a subsidiary's operations, where they exercised pervasive control either directly or through a closely held parent corporation.

Successor Liability. While the "substantial continuity test" still may be applied in a number of circuits, as a result of *Bestfoods,* federal courts are reexamining the appropriateness of departing from existing state standards. Regardless of the jurisdiction, dealmakers should take note of the risks inherent in any transaction in which the resulting business entity is so similar in management and operations that it may be portrayed as a *de facto* extension of the seller's business.

In sum, CERCLA established categorical standards of liability that depart from traditional common-law principles. The extent to which these categorical standards can override protections ordinarily available under state law, through the corporate form and other limited liability entities, is less clear. *Bestfoods,* and recent federal decisions construing it, suggest an emerging trend toward more conservative principles of limited liability traditionally applicable under states' corporate laws.

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