Structuring Routine Oil and Gas Transactions to Minimize Environmental Liability*

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Minimizing Environmental Liability

I. INTRODUCTION

Environmental considerations are becoming the "tail that wags the dog" in many commercial transactions.¹ The reason for this is quite simple: only the environmental laws impose the risk of incurring unlimited financial losses by merely acquiring an interest in property. Several second-generation environmental laws that rely upon liability instead of regulation to achieve environmental goals create the risk of financial loss.² For example, the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA)³ attempts to deal with environmental problems by imposing liability on certain groups to "fix" an environmental problem. "Fixing" environmental problems can be a technically challenging and economically devastating proposition. The situation is aggravated by the imposition of liability based upon status instead of fault, contribution, or causation.⁴ Someone unfortunate enough to achieve the status of "owner" or "operator" of a contaminated property can become "liable" for its cleanup even though that party did not cause or contribute to the problem.

Therefore, the primary goal in contemporary commercial transactions is to avoid unwittingly assuming the status of a liable party under the environmental laws. Although this has become an accepted tenet of doing business in other commercial settings, it has not been a major focus in routine oil and gas transactions which pose similar, and often greater, environmental risks. Although the purchase and sale of producing properties has received considerable attention,⁵ the more routine transactions, such as mineral and royalty conveyances, oil and gas leases, assignments, farmout agreements, service contracts, and operating, pooling, and unitization agreements, have not been the focus of much restructuring to address environmental risks.⁶ This may be due to a prevalent but erroneous belief among industry participants that

¹. Prior to the advent of environmental law, tax law held the distinction of driving otherwise straightforward transactions into a labyrinth of structural machinations to achieve some tax-driven goal.
４. See, e.g., Nurad, Inc. v. William E. Hooper & Sons Co., 966 F.2d 837, 846 (4th Cir. 1992) ("The trigger to liability ... is ownership or operation of a facility at the time of disposal, not culpability or responsibility for the contamination.").
they are "protected" by the CERCLA "petroleum exclusion" and the Resource Conservation and Recovery Act (RCRA) "associated waste exemption." 

This article identifies environmental risks associated with routine oil and gas transactions and suggests ways several specific types of transactions can be structured to identify, avoid, and leverage environmental risks. Unfortunately, restructuring routine transactions will require additional language in the documents, and additional time and expense to negotiate and draft the necessary language and to assess the environmental status of property. Clients will resist all this "lawyer stuff" until they are fully educated on the massive environmental risks that confront them in even the most "routine" transactions.

7. CERCLA defines "hazardous substance" broadly but provides:
   The term does not include petroleum, including crude oil or any fraction thereof which is not otherwise specifically listed or designated as a hazardous substance under this paragraph, and the term does not include natural gas, natural gas liquids, liquefied natural gas, or synthetic gas usable for fuel (or mixtures of natural gas and such synthetic gas).


9. Section 3001(b)(2)(A) of RCRA provides:
   [D]rilling fluids, produced waters, and other wastes associated with the exploration, development, or production of crude oil or natural gas or geothermal energy shall be subject only to existing State or Federal regulatory programs in lieu of this subchapter [until the U.S. Environmental Protection Agency (EPA) completes a study on whether such wastes should be regulated as hazardous wastes].


10. Additional attorney time is a major transaction cost associated with statutes, like CERCLA, that impose liability based upon a person's status instead of culpability. Many of CERCLA's critics attack the high costs associated with conducting site cleanups. However, they seldom focus on what may be an even greater cost to society: the cost of otherwise "innocent" people trying to acquire and dispose of property while avoiding or leveraging their CERCLA "status."

   For example, if a client wants to purchase a tract of undeveloped land for $50,000, the client would hire an attorney to assist in preparing the purchase agreement and ensuring that the seller had marketable title. The client might also incur expenses to survey the property, to ensure it was properly zoned, and that utilities were available. To do all these things, it might cost from $1,000 to $2,500 in transaction costs. However, with the threat of CERCLA liability in the event the client becomes an "owner" of the property, the client will most likely have an environmental assessment done on the property and the client's attorney, or the client's "environmental" lawyer, will draft and negotiate appropriate environmental provisions for the contract and deed. The assessment alone will probably cost from $1,500 to $3,000, assuming no problems are discovered. The additional attorney time in drafting and negotiating the "environmental" provisions of the contract and deed will probably cost an additional $1,000. In a commercial setting, it would not be unusual to pay several thousand dollars in attorney fees in the process of drafting, negotiating, and administering the "environmental" provisions. This is where the environmental "tail" begins to wag the transaction "dog."

11. Clients that have not experienced a property transaction in the post-CERCLA environment may view it as an attempt by the lawyers to get in the way of a "good" deal.
II. ENVIRONMENTAL RISKS IN ROUTINE OIL AND GAS TRANSACTIONS

A. "Status" Liability

The primary environmental risk in oil and gas transactions is that the client may unwittingly acquire the status of a liable party and be forced to remedy expensive environmental problems at a site. Since statutes like CERCLA impose liability because of the client's "status" instead of the client's culpability, the goal is to avoid attaining the undesirable status. This goal can be achieved in part by either refusing to acquire an interest in contaminated property, or by acquiring an interest which does not create the requisite status.

Under CERCLA, cleanup liability is imposed on persons who have a certain status with respect to a "facility." The term "facility" is defined broadly to include "any site or area where a hazardous substance has been deposited, stored, disposed of, or placed, or otherwise come to be located . . . ." The seven status categories for liability under CERCLA include the following:

(1) Current owners of the vessel or facility.  
(2) Current operators of the vessel or facility.  
(3) Owners of the facility "at the time of disposal" of any hazardous substance" at the facility.

12. A secondary consideration is compliance with environmental laws so that the contemplated operations can continue uninterrupted and without unanticipated expenditures. However, these secondary risks can best be addressed through management and operation practices, rather than through restructuring the underlying transactions. As a result, they are outside the scope of this article.

13. CERCLA § 101(9)(B), 42 U.S.C. § 9601(9)(B) (1988). The statute specifically includes "any building, structure, installation, equipment, pipe or pipeline . . . , well, pit, pond, lagoon, impoundment, ditch, landfill, storage container, motor vehicle, rolling stock, or aircraft . . . ." CERCLA § 101(9)(A). However, the statute specifically excludes "any consumer product in consumer use or any vessel." CERCLA § 101(9)(B).


15. Id. Although the statute imposes liability on the current "owner and operator" of a vessel or facility, courts have held that a current owner who is not also an operator can be held liable as well as a current operator who is not also an owner of the facility. Any party satisfying either the owner or operator status can be liable. E.g., United States v. A & N Cleaners and Launderers, Inc., 788 F. Supp. 1317, 1331 (S.D.N.Y. 1992) ("A party need not be both an owner and an operator to be liable under § 107(a); either status is sufficient to establish CERCLA liability.").

16. "Disposal" is defined broadly in CERCLA § 101(29), by incorporating the definition found in § 1004(3) of RCRA which provides:

The term "disposal" means the discharge, deposit, injection, dumping, spilling, leaking, or placing of any solid waste or hazardous waste into or on any land or water so that such solid waste or hazardous waste or any constituent thereof may enter the environment or be emitted into the air or discharged into any waters, including ground waters.

RCRA, § 1004(3), 42 U.S.C. § 6903(3) (1988) (emphasis added). This definition has been applied broadly in a CERCLA context to hold that liability can be imposed on owners or operators of property whenever hazardous substances were "leaking" into the property; even though the owner did not engage in any affirmative conduct resulting in the leaking. Nurad, Inc. v. William E. Hooper & Sons Co., 966 F.2d 837, 844, 846 (4th Cir. 1992).

(4) Operators of the facility at the time of disposal of any hazardous substance at the facility.18

(5) Persons who "arranged for" the disposal, treatment, or transport for disposal or treatment, of hazardous substances at the facility.19

(6) Persons who created (generated) hazardous substances which have been brought to the facility for disposal or treatment.20

(7) Persons who transported the hazardous substances to the facility—but only when the transporter selected the facility.21

There is also an eighth potential category of liability, created by CERCLA § 101(35)(C), which provides in part:

[I]f the defendant obtained actual knowledge of the release or threatened release of a hazardous substance at such facility when the defendant owned the real property and then subsequently transferred ownership of the property to another person without disclosing such knowledge, such defendant shall be treated as liable under section [107(a)(1)] 9607(a)(1) of this title and no defense under section [107(b)(3)] 9607(b)(3) of this title shall be available to such defendant.22

This section seems to impose liability on a person who would otherwise not be liable under CERCLA § 107(a)(1)-(4). For example, assume Acme Oil Company acquired property in 1950, after all active and passive disposal on the property had ceased. Also assume that during Acme's ownership no hazardous substances were disposed of on the property. In 1990 Acme sells the property to Minor Oil Company and a hazardous substance release is discovered in 1992 that related to activities on the property prior to 1950. Acme should be able to escape liability for cleanup since it is not the current owner or operator of the facility, nor was it an owner or operator "at the time of disposal" of the hazardous substance.

However, suppose one of Acme's employees obtained "actual knowledge" of a release or threatened release of a hazardous sub-

18. Id.
20. Id. Although CERCLA § 107(a)(3) refers only to any person who "arranged for" disposal, treatment, or transport, it covers two categories of "arrangers." One category is for persons who arrange for disposal of "hazardous waste owned or possessed by such person." This category would encompass the persons who created or generated the hazardous substance. The generator might arrange to dispose of its own hazardous substances, or it might contract with a third party to arrange for its disposal. In either case, the generator of the hazardous substance will be a potentially liable party with regard to any facility to which the hazardous substance is taken. The second category of arranger would encompass the third party who contracts with the generator to dispose of hazardous substances "owned or possessed . . . by any other party or entity . . . ."
stance at the facility while Acme owned the property. If Acme fails to disclose this information to its transferee (Minor Oil Company), § 101(35)(C) states Acme would have the same liability as a current owner or operator under § 107(a)(1). It is not clear whether the statute contemplates only a release or threatened release that occurs while Acme owns the property. The statute, however, does not expressly limit when the release or threatened release could have taken place. Therefore, Acme arguably could become liable for a release that took place before Acme obtained the property if Acme merely became aware of the prior release while Acme owned the property.

If the “release” was discovered during Acme’s ownership, Acme, as the “person in charge” of the facility, also may have a reporting obligation under CERCLA § 103(a), but only if there was an actual release of a hazardous substance that exceeded the applicable “reportable quantity.” Therefore, § 101(35)(C) includes situations where Acme would have no obligation to report to governmental authorities but may, nevertheless, have an obligation to disclose the problem to a transferee.

Any transferor of property should carefully consider what it knows about the environmental condition of the property being transferred and decide whether disclosures are required or advisable under § 101(35)(C) to preserve the transferor’s non-liability status under CERCLA. In many instances, if the transferor has knowledge of a release or threatened release of hazardous substances on the property, common law strict liability concepts, or contract language, will require full disclosure. In any event, to protect the integrity of the contract terms and the transaction, full disclosure should be given.

23. Perhaps Acme’s employee finds some old records that indicate that from 1941 to 1945 another company conducted a manufacturing operation on the property and routinely dumped hazardous substances into pits located on the property.

24. CERCLA defines “release” to include: [A]ny spilling, leaking, pumping, pouring, emitting, emptying, discharging, injecting, escaping, leaching, dumping, or disposing into the environment (including the abandonment or discarding of barrels, containers, and other closed receptacles containing any hazardous substance or pollutant or contaminant). CERCLA § 101(22), 42 U.S.C. § 9601(22) (1988). “Environment” is defined to include “surface water, ground water, drinking water supply, land surface or subsurface strata, or ambient air . . . .” CERCLA § 101(8), 42 U.S.C. § 9601(8) (1988).

25. As opposed to a threatened release.

26. CERCLA § 103(a), 42 U.S.C. § 9603(a) (1988); 40 C.F.R. Part 302 (1992). Arguably Acme, as the owner of the property when CERCLA was enacted, may have a reporting obligation under CERCLA § 103(c). As the owner of the property at the time the information became known to Acme, § 103(c) would require Acme to notify the EPA of the existence of hazardous substances at the facility and any “known, suspected, or likely releases” of hazardous substances from the facility. If Acme “knowingly fails” to notify the EPA that the facility exists, Acme is subject to criminal sanctions and “shall not be entitled to any limitation of liability or to any defenses to liability set out in section 107 . . . .” See infra text accompanying notes 107-118 (discussing the continuing nature of the § 103(c) reporting obligation).

27. See infra text accompanying notes 148-75.

28. See infra text accompanying note 148.
B. Protection Not Offered by CERCLA's Petroleum Exclusion and RCRA's Associated Waste Exemption

When considering how to structure oil and gas transactions, attorneys must employ a business planning approach to the issues as opposed to a litigation approach. For example, for litigation purposes, counsel may argue that the "associated waste" exemption under RCRA protects the client from liability under CERCLA. It would be foolish, however, to rely upon such a premise for business planning purposes. Instead, under current law, counsel should consider assuming the "associated waste" exemption will not protect the client and plan, structure, and draft the transactions accordingly.

1. CERCLA's Petroleum Exclusion

The oil industry's front-line defense to CERCLA liability has been the "petroleum exclusion" which specifically exempts certain substances from CERCLA's "hazardous substance" designation. Although CERCLA § 101(14) defines hazardous substances broadly, it also provides:

The term does not include petroleum, including crude oil or any fraction thereof which is not otherwise specifically listed or designated as a hazardous substance . . . and the term does not include natural gas, natural gas liquids, liquefied natural gas, or synthetic gas usable for fuel (or mixtures of natural gas and such synthetic gas).29

The petroleum exclusion has been interpreted by the U.S. Court of Appeals for the Ninth Circuit to include: "[U]nrefined and refined gasoline even though certain of its indigenous components and certain additives during the refining process have themselves been designated as hazardous substances within the meaning of CERCLA."30

The scope of the exclusion becomes less clear when dealing with waste oil. For example, in Southern Pac. Transp. Co. v. California (Caltrans),31 the court concluded that: "[U]sed petroleum products are covered by the petroleum exclusion, provided that CERCLA-listed hazardous substances have not been added to the petroleum product during its use, nor have the concentrations of CERCLA-listed hazardous substances in the petroleum product been increased by its use."32 The court concluded that the petroleum exclusion would apply to a mixture of petroleum and soil that was placed on the plaintiff's property.33

32. Id. at 986.
33. Id. at 986-87.
In *Cose v. Getty Oil Co.*, the court held that the petroleum exclusion does not apply to crude oil "tank bottoms" that contain an indigenous hazardous substance and are discarded. In *United States v. Western Processing Co.*, the court held that sludge (tank bottoms) from leaded gasoline tanks, a diesel oil tank, and an unleaded gasoline tank, and the rinse water from washing out the tanks, were not covered by the CERCLA petroleum exclusion. The court noted that the sludge contained "a rust-like scale of corrosion products from the oxidation of steel in the tank walls." This caused various hazardous substances not ordinarily found in refined or unrefined petroleum to be formed. The court also noted that the "tank bottom sludge is a contaminated waste product, and not a petroleum fraction, as that term is used in the statute."

The petroleum exclusion will not protect against liability when there are other, hazardous, substances mixed with the petroleum. For example, if waste oil is pumped from a reserve pit which has also contained waste solvents or thread dope cans, the mixture does not qualify for the petroleum exclusion if the solvents or thread dope material adds hazardous substances to the oil. As noted by the U.S. Court of Appeals for the Third Circuit in *United States v. Alcan Aluminum Corp.*:

EPA has distinguished between oil that naturally contains low levels of hazardous substances and oil to which hazardous substances have been added through use. Although EPA has extended the petroleum exclusion to the former category of oily substances, it has specifically declined to extend such protection to the latter category. In EPA's words: "EPA does not consider materials such as waste oil to which listed CERCLA substances have been added to be within the petroleum exclusion."
In any event, the petroleum exclusion offers no protection when the material at issue is not petroleum, but instead is merely associated with the development, production, processing, or marketing of petroleum. For example, if the reserve pits contain buckets with lead-based thread dope residue, the presence of the lead can satisfy the “hazardous substance” requirement.42

Also, other statutes may apply to fill the void left by the petroleum exclusion. For example, the Oil Pollution Act of 1990 (OPA)43 imposes liability upon the owner or operator of a facility from which there is a discharge, or substantial threat of a discharge, of “oil” into “waters of the United States.”44 If the necessary nexus with “waters of the United States” can be established, the actual, or threatened, discharge of oil will require the facility owner or operator to clean up the affected area and pay a broad range of damages provided for by the Act.45 However, OPA liability applies only to incidents that occur after August 18, 1990, the effective date of the Act.46

The relationship between the OPA and CERCLA is demonstrated by the OPA’s definition of “oil”:

“Oil” means oil of any kind or in any form, including, but not limited to, petroleum, fuel oil, sludge, oil refuse, and oil mixed with wastes other than dredged spoil, but does not include petroleum, including crude oil or any fraction thereof, which is specifically listed or designated as a hazardous substance under . . . [CERCLA] and which is subject to the provisions of that Act . . . .47

Therefore, if the petroleum substance falls within CERCLA’s petroleum exclusion, it may be subject to the OPA’s liability provisions—assuming the discharge involves an “incident” occurring after August 18, 1990 and involves “waters of the United States.”

Even though the problem may escape CERCLA and OPA liability, it may be subject to action under RCRA’s “imminent hazard” authority. Under RCRA § 700348 the Administrator of the EPA can bring suit against any “past or present” generator or transporter, or any “past or present owner or operator” of a facility, who has contributed to disposal or handling of any “solid waste or hazardous waste,”

42. United States v. Hardage, No. CIV-86-1401-W, slip op. at 4-5, 7 (W.D. Okla. April 15, 1991) (basing liability in part on disposal of thread dope buckets containing thread dope residue which consisted of a lithium grease base and lead).
44. OPA § 1002(a), 33 U.S.C.A. § 2702(a) (West Supp. 1993).
45. OPA § 1002(b), 33 U.S.C.A. § 2702(b) (West. Supp. 1993), provides for CERCLA-like cleanup costs but goes beyond CERCLA’s compensation scheme and establishes a statutory basis to compensate private interests for injury to real or personal property, to include lost profits and impairment of earning capacity.
which "may present an imminent and substantial endangerment to
health or the environment ...."49 The court is authorized "to restrain
such person from such handling, storage, treatment, transportation, or
disposal" and "to order such person to take such action as may be
necessary ...."50 Citizens have similar powers under RCRA § 7002
which provides:

\[
[\text{Any person may commence a civil action on his own behalf }
\]
\[
\ldots against any person \ldots including any past or present generator,
past or present transporter, or past or present owner or operator of
a treatment, storage, or disposal facility, who has contributed or
who is contributing to the past or present handling, storage, treat­
ment, transportation, or disposal of any solid or hazardous waste
which may present an imminent and substantial endangerment to
health or the environment} \ldots.\]

The efficacy of this RCRA authority is demonstrated by the case
of Zands v. Nelson.52 The defendant Nelson owned the land in ques­
piping and pumps to gasoline tanks for a service station. Nelson oper­
ated the service station until 1975 when he leased it to Kramer, who
operated the station from 1975 to 1979. From 1976 through 1980 the
real property was owned as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Owner</th>
</tr>
</thead>
<tbody>
<tr>
<td>1976-78</td>
<td>Tacey</td>
</tr>
<tr>
<td>1978-80</td>
<td>Goodwin</td>
</tr>
<tr>
<td>1980</td>
<td>Purchased by Zands, the plaintiffs.</td>
</tr>
</tbody>
</table>

Apparently the underground storage tank leaked gasoline into the soil
and Zands, as the current owner of the property, was attempting to
force Nelson, Nachant Co., Kramer, Tacey, and Goodwin to clean up
the problem.53

Zands brought a "citizen suit" against the parties pursuant to
RCRA § 7002(a)(1)(B). Although the remedy sought by Zands is not
disclosed in the court's opinion, RCRA § 7002(a) gives the court juris­
diction in a citizen suit to enjoin the disposal or "to order such person
to take such other action as may be necessary \ldots." Zands, if success­
ful, will most likely seek an order requiring the defendants to clean up
the property. The citizen suit provision does not provide for payment
of damages or cleanup costs to private parties.54 However, it does

50. Id.
53. Id. at 1257.
54. It might be argued that the court's authority under § 7002 to "order such person to take
such other action as may be necessary" could include an order to reimburse third parties for
cleanup expenses they have already incurred. Apparently the EPA has been successful in mak­
ing a similar argument under RCRA § 7003. J. BATTLE AND M. LIPELES, HAZARDOUS WASTE
authorize the assessment of civil penalties and the recovery of attorney fees.\textsuperscript{55}

In \textit{Zands} the court held that gasoline leaking from an underground storage tank, and the contaminated soil, constitute disposal of a solid waste. Once the gasoline ceases to be a useful product, it becomes a solid waste subject to RCRA.\textsuperscript{56} The court also held that RCRA § 7002(a) \textit{supplements} the federal underground storage tank statutes found at 42 U.S.C. §§ 6991 to 6991i (1988).\textsuperscript{57}

The court found that RCRA and CERCLA are distinct statutes. Therefore, CERCLA's petroleum exclusion limitations do not similarly limit RCRA's scope. As the court noted: "[W]hereas CERCLA has an explicit exclusion for petroleum, no such similar exclusion exists in RCRA."\textsuperscript{58} The court also held that the "mere creation of solid waste, and the subsequent abandonment of it in the ground, will support a cause of action under section 6972(a)(1)(B) [RCRA § 7002(a)(1)(B)]."\textsuperscript{59} In holding that the parties who created the waste were subject to RCRA the court stated: "The Court simply will not accept defendants' interpretation of the statute which would allow individuals to create solid waste, and avoid the requirements of RCRA by never making any attempt to clean up the mess."\textsuperscript{60}

Before a person can be ordered to take action under § 7002, there must be a showing that the person "contributed" or "is contributing" to the past or present disposal giving rise to the suit. The court held the contribution issue is a factual issue that cannot be resolved, in this case, by summary judgment.\textsuperscript{61} The court also held that each of the defendants could be a contributor under the statute. The court observed:

Here, the defendants are individuals who owned the land during which time the gasoline allegedly leaked, individuals who operated the pumps during which time the gasoline allegedly leaked, and individuals responsible for the installation of the piping and pumps for the gasoline tanks that allegedly leaked. \textit{None of these individu-}

\begin{footnotesize}
\begin{itemize}
\item[56.] \textit{Zands}, 779 F.2d at 1262.
\item[57.] \textit{Id.} at 1263.
\item[58.] \textit{Id.} (emphasis added). The court's statement acknowledges the "catch-all" nature of RCRA §§ 7002 and 7003: even though the petroleum waste is not a listed or characteristic RCRA hazardous waste, it can constitute a "solid waste" which can be addressed under RCRA if it presents an "imminent and substantial endangerment to health or the environment . . . ." \textit{Id.} at 1261.
\item[59.] \textit{Id.} at 1264.
\item[60.] \textit{Id.}.
\item[61.] \textit{Id.}
\end{itemize}
\end{footnotesize}
als are so far removed that it can be said that, as a matter of law, they did not contribute to the leakage. 62

Another matter to always consider when dealing with federal environmental statutes is that they uniformly provide for more stringent state regulation. For example, CERCLA § 114(a) provides: "Nothing in this chapter shall be construed or interpreted as preempts any State from imposing any additional liability or requirements with respect to the release of hazardous substances within such State." 63 Some state remediation statutes may not contain a "petroleum exclusion." 64 States may also have laws that impose liability in circumstances where liability would not be imposed under RCRA, the OPA, and each of the other federal environmental statutes. 65 In addition, state tort law may impose liability beyond that imposed by any environmental statute. 66

2. RCRA's Associated Waste Exemption

As noted previously, the CERCLA petroleum exclusion offers little protection when the material at issue is a waste associated with the development, production, processing, or marketing of petroleum. Also, as Zands v. Nelson demonstrates, RCRA cleanup liability can exist even though the petroleum-related waste is non-hazardous. 67 However, the main thrust of RCRA is on the regulation of hazardous waste. If waste is classified as hazardous under RCRA, it must be stored, treated, and disposed of in accordance with RCRA’s detailed requirements. 68 However, RCRA § 3001(b)(2)(A) provides, in part:

[D]rilling fluids, produced waters, and other wastes associated with the exploration, development, or production of crude oil or natural gas or geothermal energy shall be subject only to existing State or Federal regulatory programs in lieu of this subchapter [until

62. Id. (emphasis added).
64. For example, Mont. Code Ann. § 75-10-701(6) defines "hazardous or deleterious substance" to include CERCLA hazardous substances, RCRA hazardous wastes, and "any petroleum product." Mont. Code Ann. § 75-10-701(6)(d) (1992). "Petroleum product" includes:

1. Gasoline, crude oil (except for crude oil at production facilities . . . ), fuel oil, diesel oil or fuel, lubricating oil, oil sludge or refuse, and any other petroleum-related product or waste or fraction thereof that is liquid at standard conditions of temperature and pressure (60 degrees F and 14.7 pounds per square inch absolute).

65. For example, in West Bay Exploration v. AIG Specialty Agencies, the dispute concerned a lessee’s operation of glycol dehydrators and the release of condensed water vapor containing trace amounts of hazardous substances. Although the waste may have been "exempt" under RCRA’s associated waste exemption, it nevertheless became the focus of an expensive cleanup under a Michigan state law prohibiting "waste." West Bay Exploration v. AIG Specialty Agencies, 915 F.2d 1030, 1032 (6th Cir. 1990).
66. See, e.g., Branch v. Mobil Oil Corp., 788 F. Supp. 531 (W.D. Okla. 1991) (nuisance action for pollution relating to past operation of oil and gas wells, gathering lines, tank batteries, and salt-water and waste pits).
67. See supra text accompanying notes 48-62.
EPA completes a study on whether such wastes should be regulated as hazardous wastes.\(^6^9\)

Pursuant to § 3001(b)(2)(A), EPA completed its study of oil and gas wastes and in 1987 delivered to Congress its report titled: “Management of Wastes from the Exploration, Development, and Production of Crude Oil, Natural Gas and Geothermal Energy.” In July, 1988 EPA issued its decision to exempt many, but not all, exploration and production wastes from RCRA’s hazardous waste provisions.\(^7^0\)

However, even though a waste is classified as an “exempt” waste and therefore non-hazardous under RCRA, the waste is not necessarily considered non-hazardous under CERCLA.\(^7^1\) Cases to date suggest that the exemption of wastes under RCRA will not provide protection from CERCLA cleanup liability.\(^7^2\) Therefore, a lawful waste management technique under RCRA may not be acceptable when CERCLA liability is considered. An otherwise “lawful” disposal of oil and gas wastes for RCRA purposes may create, from a business planning point of view, unacceptable CERCLA risks.

C. Owner/Operator in the Oil and Gas Context

When applying CERCLA, RCRA, the OPA, and similar environmental laws to the oil and gas industry, a major concern is whether courts will adhere to the same ownership and operation niceties which form the foundation of “oil and gas law.” For example, under CERCLA will an overriding royalty owner be deemed an “owner” of a facility even though it merely owns a contract right to receive a share of oil or gas produced from a wellbore on the facility? Will it be considered a CERCLA “operator” if it has the right to convert its over-

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71. Generally speaking, RCRA regulates the present handling and disposal of hazardous wastes; CERCLA seeks to clean up inactive hazardous waste sites by holding parties connected with the problem liable for cleanup costs. Although RCRA exempts certain wastes from regulation as “hazardous wastes” (such as oil and gas wastes, mining wastes, and household wastes), these wastes can still become the target of a CERCLA cleanup action. But see Michael M. Gibson and David P. Young, Oil and Gas Exemptions Under RCRA and CERCLA: Are They Still “Safe Harbors” Eleven Years Later? 32 S. Tex. L. Rev. 361, 370-83 (1991) (arguing that exempt oil and gas wastes under RCRA were intended by Congress to also be exempt under CERCLA); Scott Lansdown, Plugging and Abandoning Issues Encountered by Sellers and Buyers of Producing Properties: A Major’s Perspective, THE LANDMAN 13 (Jan./Feb. 1992) (“The RCRA exemption for drilling fluids, etc., is applicable under CERCLA.”).

riding royalty to a fractional working interest once a well on the facility has paid out? Courts can apply either traditional oil and gas law concepts to define the scope of CERCLA, or they can ignore them and pursue CERCLA policies they perceive as transcending state property law concepts.

Members of the oil and gas bar may have to adjust to new policy-driven federal concepts of property, contract, and corporate law designed to promote CERCLA goals. The oil and gas bar underwent a somewhat similar adjustment when, under federal natural gas legislation, the United States Supreme Court began to scrutinize the form of state law transactions impacting interstate gas sales. For example, in California v. Southland Royalty Co., the Court refused to permit state property law to interfere with federal natural gas policies. In Southland the mineral owner, in 1925, entered into a 50-year lease with Gulf Oil Corporation. In 1951, Gulf entered into a gas contract with El Paso Natural Gas Co. and dedicated production from the leased land to interstate commerce. Gulf’s lease expired in 1975 and all rights in the property reverted to the mineral owner. When the mineral owner attempted to sell gas to an intrastate purchaser, El Paso objected asserting the gas could not be diverted from interstate commerce unless an abandonment was granted by the Federal Power Commission.

The U.S. Court of Appeals for the Fifth Circuit held:

Under applicable Texas law, Gulf’s rights were those of a tenant for a term of years; its interest was a limited one which terminated completely when title reverted to Southland at the expiration of the 50-year term. It is black letter law that a person holding a present interest in real property which is limited in duration cannot create an estate which will extend beyond the term of his interest. Since Gulf never was possessed of rights in the gas under the leasehold lands which could survive the termination of its 50-year term lease, it never could create rights in a third person to that same gas.

The Supreme Court, reversing the Fifth Circuit, stressed the need to prevent producers from “structur[ing] their leasing arrangements to frustrate the aims and goals of the Natural Gas Act.”

It is likely that a similar analysis will be employed by the Supreme Court when evaluating liability issues under CERCLA. For

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75. Southland, 436 U.S. at 521-22.
example, in Pennsylvania v. Union Gas Co.,78 the Court held that Congress in CERCLA had lawfully waived the sovereign immunity of state and local governments thereby subjecting them to private party suits for response costs. In evaluating the underlying policies of CERCLA, the Court stated: "The remedy that Congress felt it needed in CERCLA is sweeping: everyone who is potentially responsible for hazardous-waste contamination may be forced to contribute to the costs of cleanup."79 Some courts have carried this concept one step further by adopting a general rule of CERCLA construction that those who benefit from a polluter's past activities should pay for the cleanup before taxpayers are saddled with the obligation.80

Where the niceties of state property law tend to promote CERCLA goals, they will most likely be applied with a vengeance. For example, consider the Texas cross-conveyance theory articulated in Veal v. Thomason.81 If each party owning a lease in a pooled unit or a fieldwide unit is deemed to have conveyed a proportionate interest in its property to all other contributors to the unit, a single lease owner could become an "owner" of an undivided interest in every lease contributed to the unit.

1. "Owner" Liability

In the oil and gas context, the term "owner" can include several classes of parties. For example, if A conveys Section 30 to B, reserving to A all the oil, gas, and other minerals, both A and B are "owners" of rights in Section 30. CERCLA, however, imposes liability for ownership of a "facility."82 Since the location of the hazardous substances will tend to define the CERCLA facility, the severed surface owner, B, may be the "owner" of the reserve pit where hazardous substances were placed.83 However, since A had the right as the mineral owner to create and use the pit, this may be sufficient to impose

80. See generally Smith Land & Improvement Corp. v. Celotex Corp., 851 F.2d 86, 92 (3d Cir. 1988), cert. denied, 488 U.S. 1029 (1989). Most courts have held that the two essential purposes underlying CERCLA are: (1) Giving the federal government the tools necessary to effectively respond to hazardous substance problems; and (2) "[T]hat those responsible for problems caused by the disposal of chemical poisons bear the costs and responsibility for remedying the harmful conditions they created." Dedham Water Co. v. Cumberland Farms Dairy, Inc., 805 F.2d 1074, 1081 (1st Cir. 1986) (quoting United States v. Reilly Tar & Chemical Corp., 546 F. Supp. 1100 (D. Minn. 1982)). However, the CERCLA liability scheme clearly goes beyond the scope of this statement by imposing liability on persons who are not actually "responsible" for the problem. Instead their liability is based upon their unfortunate status of "owner" or "operator."
81. 159 S.W.2d 472 (Tex. 1942).
82. CERCLA § 107(a)(1) and (2), 42 U.S.C. § 9607(a)(1) and (2) (1988); Nurad, Inc. v. William E. Hooper & Sons Co., 966 F.2d 837, 842-43 (4th Cir. 1992) (the CERCLA "facility" consisted of the underground storage tanks and surrounding contaminated area).
83. See generally Quaker State Corp. v. United States Coast Guard, 681 F. Supp. 280 (W.D. Pa. 1988) (surface owner held to be the "owner" of prior oil and gas lessee's oil containment pit
liability on A.84 If we assume that A had leased to X, and X created the pit in pursuing activities under the A/X oil and gas lease, X would also be an “owner” of the pit.85 As ownership interests are conveyed by A or B, or assigned by X, additional “owners” will be created. The universe of owners can also increase geometrically when the property is pooled or unitized.86

2. “Operator” Liability

Parties having an ownership interest in the oil and gas property will generally be encompassed by the “owner” definition. However, imposing liability on “operators” can bring in parties who never had an ownership interest in the contaminated facility. For example, a contract operator of an oil and gas lease may be liable for hazardous substances disposed on the lease during its period of operational control.87 Operator liability could also include various contractors who had control of lease operations during development.88 For example, a drilling contractor could be considered an “operator” of the reserve pits and other facilities associated with drilling, reworking, or similar activities.

3. Past and Present Owners and Operators

The list of liable parties grows when past owners and operators are considered. As noted previously, CERCLA liability attaches to persons associated with the facility at the time of disposal.89 CERCLA provides that the term “disposal” will have the same meaning as pro-

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84. It does not matter that A did not engage in the disposal activity giving rise to the cleanup. See United States v. Argent Corp., 21 Env’t Rep. Cases (BNA) 1354, 1356 (D.N.M. 1984) (noting that the owner of the real estate had given a lease to the third party who caused the contamination). A may also be liable as an “operator” since A’s contractor, an oil and gas lessee, created the pit pursuant to its oil and gas lease with A.


86. See supra text accompanying note 81; see infra note 414.

87. For example, in Nurad, Inc. v. William E. Hooper & Sons Co. the court defined the CERCLA “operator” as any person possessing the “authority to control” the facility at issue. Nurad, 966 F.2d 837, 842-43 (4th Cir. 1992). The actual exercise of control is not required; the unexercised right of control is sufficient. Nurad, 966 F. 2d at 842. Cf. General Electric Co. v. AAMCO Transmissions, Inc., 962 F.2d 281, 286 (2d Cir. 1992) (for purposes of “arranger” status the party must have the obligation to control, not merely the authority to control, the disposal of hazardous substances).

88. See generally Kaiser Aluminum & Chemical Corp. v. Catellus Development Corp., 976 F.2d 1338 (9th Cir. 1992) (contractor excavating area to build housing development may be a CERCLA operator or transporter when it allegedly spread contaminated soil to uncontaminated portions of the property). See infra text accompanying notes 418-19.

vided in section 1004 of the Solid Waste Disposal Act. Section 1004(3) of the Act provides:

The term "disposal" means the discharge, deposit, injection, dumping, spilling, leaking, or placing of any solid waste or hazardous waste into or on any land or water so that such solid waste or hazardous waste or any constituent thereof may enter the environment or be emitted into the air or discharged into any waters, including ground waters.

In *Nurad, Inc. v. William E. Hooper & Sons Co.*, the court noted that the definition of "disposal" includes both active events, such as "deposit, injection, dumping, . . . or placing," and passive events, such as "spilling" or "leaking." The court held the mere ownership of a facility "at a time that a hazardous substance was 'spilling' or 'leaking'" at the facility, would give rise to liability under CERCLA § 107(a)(2).

The court's interpretation of "disposal" was expanded even further when it adopted a "presumption" that the hazardous substances leaked gradually from the underground tanks throughout the time when the defendants owned the property. In many cases this will amount to an insurmountable burden on the CERCLA defendant to prove that nothing leaked from the facility during its period of ownership.

The impact of past and present owner or operator liability is demonstrated by the following hypothetical: Assume that in 1975 B owned the surface rights to Section 30 at the time a contractor entered the property to drill a well. Assume the drilling contractor was hired by X who obtained its rights through an oil and gas lease from the mineral owner A. The drilling contractor, in accordance with the custom and practice of the time, disposed of various materials which are now classified as CERCLA hazardous substances in the reserve pits. In 1992 a release is discovered and CERCLA is triggered. At the time of the release, the surface is owned by D and the lease is part of a fieldwide unit consisting of several hundred mineral and leasehold interest owners. Who are the potentially responsible parties?

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93. *Id.* at 845.
94. *Id.* at 846.
95. *Id.*
96. The court recognized that the burden may be insurmountable, which is why it created the presumption. The court reasoned:

We do not think in such circumstances that Congress intended to impose upon a CERCLA plaintiff the onerous burden of pinpointing at what precise point a leakage may have begun. This circuit has been careful not to vitiate what was intended as remedial legislation by erecting barrier upon barrier on the road to reimbursement of response costs.

*Nurad*, 966 F.2d at 846.
1. The current owners include D and possibly several hundred mineral and leasehold interest owners who have an interest in the fieldwide unit.

2. The owners at the time of disposal include A, B, and X.

3. The current operators include the unit operator and possibly every party who has a contractual relationship with the unit operator.\textsuperscript{97}

4. The operators at the time of disposal include X and arguably X's drilling contractor.

Suppose the contents of the reserve pits, in 1975, were removed by the Acme Vacuum Truck Company and taken to the Hogg County Landfill. Although no hazardous wastes remain at the lease, in 1992 the Hogg County Landfill experiences a release of hazardous substances similar to the substances contained in the reserve pits. None of the parties noted above are owners or operators, past or present, of the CERCLA "facility"—the landfill. However, liability may attach to some of them as "arrangers."

4. "Arranger" Liability

CERCLA § 107(a)(3) imposes liability on any person:

[W]ho by contract, agreement, or otherwise arranged for disposal or treatment, or arranged with a transporter for transport for disposal or treatment, of hazardous substances owned or possessed by such person, by any other party or entity, at any facility . . . owned or operated by another party or entity and containing such hazardous substances . . . .\textsuperscript{98}

This provision imposes liability on persons who "owned" the hazardous substances or who "possessed" the hazardous substances. Arguably a "contract" arranging for disposal or treatment could include the oil and gas lease entered into by the mineral owner A and the lessee X. The premise would be that A, by authorizing X to develop the property, also authorized X to do whatever was prudent to dispose

\textsuperscript{97} See generally Branch v. Mobil Oil Corp., 788 F. Supp. 531, 533 (W.D. Okla. 1991). In Branch the landowners brought suit against owners who had an interest in the Healdton One Unit. One of the defendants, Atlantic Richfield Company, defended asserting it only had a small interest in the unit and could not control its operation. Mobil Oil Corporation was the unit operator. The court rejected this defense and stated:

The operator of the unit is merely the agent for the lessees who form the unit, . . . each of whom are entitled to designate a representative of the Operating Committee, which "exercise[s] overall supervision and control over all matters pertaining to unit operations . . . ." Accordingly, to the extent an operator of the Unit created or maintained a nuisance, . . . during the time that ARCO was a working interest owner in the Unit, ARCO is liable as a principal for the operator-agent's actions . . . unless the operator was acting outside the scope of its authority, which ARCO has not alleged or shown.

of wastes associated with the authorized activity. X's liability is much more direct. If X, or a unit operator acting in part on X's behalf, entered into a contract with Acme, then X, the unit operator, and arguably all other parties to the unit operating agreement, would be subject to arranger liability for cleanup of the Hogg County Landfill. Acme would also be liable if Acme selected the Hogg County Landfill as the disposal site.

If this all seems a bit far-fetched, consider the case of United States v. Royal N. Hardage. The Hardage waste disposal site is located approximately 15 miles southeast of Norman, Oklahoma. The EPA and other parties incurred cleanup costs responding to a release of hazardous substances at the Hardage site. Arrow Tank Trucks, Inc., was named as a responsible party because in 1973 and 1974 it transported and disposed of salt water, "frac" water, and oil drained from reserve pits located in McClain County, Oklahoma. It was stipulated that the reserve pits drained by Arrow Tank contained drilling mud and frac water. The court, however, found that it was "likely" that asbestos and sodium hydroxide used as drilling mud additives, and thread dope buckets with thread dope residue containing lead, had been placed in the reserve pits.

Based upon these facts, the court found:

[T]he liquids drained from the reserve pits by Arrow Tank and transported to the Hardage site were in contact with hazardous substances, lead, asbestos and sodium hydroxide, the chemical identities of which were not altered during the drilling and completion operations. Thus, the waste transported by Arrow Tank would likewise contain these hazardous substances.

The court also found that lead, asbestos, and sodium hydroxide are CERCLA hazardous substances and each of these substances was found at the Hardage site. In holding Arrow Tank liable, the court summarily rejected defenses based upon the CERCLA petroleum exclusion and the RCRA associated waste exemption.

99. See United States v. Aceto Agricultural Chemicals Corp., 872 F.2d 1373 (8th Cir. 1989) (chemical owner liable as a CERCLA "arranger" for contamination caused by a contractor that mixed and packaged the chemicals; also a RCRA "contributor" under § 7003); Jones-Hamilton Co. v. Beazer Materials & Services, Inc., 959 F.2d 126 (9th Cir. 1992) (chemical owner liable as a CERCLA "arranger" for contamination caused by contractor that formulated wood preservation compounds). But see General Electric Co. v. AAMCO Transmissions, Inc., 962 F.2d 281, 286 (2d Cir. 1992) (for purposes of "arranger" status the party must have the obligation to control, not merely the authority to control, the disposal of hazardous substances); United States v. Arrowhead Refining Co., No. CIV-5-89-202, 1992 WL 437429 (D. Minn. Nov. 10, 1992) (Mobil Oil not responsible for disposal of waste oil generated at independently operated service stations bearing Mobil Oil's brand name). See infra text accompanying notes 338-39.


102. Id. at 8-9.

103. Id. at 7.

104. Id. at 10-13.
Although not the focus of the court's April 15, 1991 order, if Arrow Tank is found liable as a transporter under CERCLA § 107 (a)(4), the parties who generated, or owned or possessed the pit contents and arranged for their disposal, would be liable under CERCLA § 107(a)(3).

III. TECHNIQUES FOR MANAGING ENVIRONMENTAL RISK

A. Avoiding Prospective Liabilities and Managing Existing Liabilities

As the previous section demonstrates, traditional oil and gas relationships and activities can give rise to significant environmental liability risk. This section offers techniques that can be employed to evaluate and manage that risk. Oil and gas interest owners must address three categories of environmental liability risk: risk associated with past oil and gas interests, present interests, and with interests that may be acquired in the future.

1. Risks Associated with Past Interests

There is little that can be done today to manage risk for things done perhaps decades ago—particularly when the client no longer owns an interest in the property. Perhaps the best thing the client can do in this situation is to recognize the potential liability and be prepared to actively participate in dealing with any problem that might be revealed in the future. If the client is aware of past activities at the site that could give rise to a problem, the client should consider whether to affirmatively act to attempt to remedy the situation, including reporting the potential problem to state and federal authorities. In many cases, this course of action will be hard for clients to accept.

At the federal level, the only affirmative reporting obligation that might apply in such a case is CERCLA § 103(c) which contemplated that prior to June 10, 1981:

[A]ny person who owns or operates or who at the time of disposal owned or operated, or who accepted hazardous substances for transport and selected, a facility at which hazardous substances (as defined in section 9601(14)(C) of this title) are or have been stored, treated, or disposed of shall, unless such facility has . . . [a permit or interim status under RCRA], notify the Administrator of the Environmental Protection Agency of the existence of such facility . . . . 105

Any person who "knowingly fails to notify the Administrator of the existence of any such facility" is subject to criminal penalties and

105. CERCLA § 103(c), 42 U.S.C. 9603(c) (1988) (emphasis added).
“shall not be entitled to any limitation of liability or to any defenses to liability set out in section 9707 [CERCLA § 107] . . . .”

However, the reporting requirements under § 103(c) apply only to hazardous substances “defined in section 9601(14)(C).” Section 9601(14)(C) includes only listed or characteristic RCRA hazardous wastes. The EPA has interpreted this provision to eliminate facility reporting under § 103(c) when the waste is otherwise excluded from RCRA regulation. In an interpretative notice the EPA stated:

In regulations identifying and listing hazardous wastes subject to . . . RCRA . . . EPA excluded, for regulatory purposes, certain solid wastes from the definition of hazardous wastes, even though these wastes might otherwise be considered hazardous wastes . . . . These wastes are: . . . (d) drilling fluids, produced waters and other wastes associated with the exploration, development or production of crude oil, natural gas or geothermal energy . . . . Wastes which are excluded from RCRA regulation are not subject to the notification requirement of Section 103(c) and sites which contain only these wastes are not required to notify.

The EPA also noted that since CERCLA expressly excludes petroleum, natural gas, and natural gas liquids, facilities containing such wastes are not required to notify.

It appears that § 103(c) was intended to be a one-time reporting obligation of things known to the owner, operator, or transporter prior to June 10, 1981. The EPA anticipated that the affected parties would consider their situation as of June 1981 and key their notification to their “present knowledge, belief, recollection and reasonably available records.” Subsequent to this time, an obligation is imposed on “any person in charge” to report an actual “release” of hazardous substances.

106. Id.
109. Id. (emphasis added).
110. Id. The EPA stated:

Other petroleum wastes, including waste oil, are not specifically listed in the RCRA regulations, but they may exhibit the characteristics of hazardous waste and therefore be subject to full RCRA regulation. However, because these wastes are excluded from the definition of “hazardous substance” by the specific language of Superfund, regardless of their RCRA status, they are not hazardous substances for purposes of the notification requirement of Section 103(c). Facilities containing only these exempted wastes are not required to notify. Facilities containing these substances together with other hazardous wastes are obligated to report with respect to those other wastes.

111. Professor Rodgers characterizes CERCLA § 103(c) as “a one-time-only notice to EPA by operators and transporters who made use of inactive sites.” 4 WILLIAM RODGERS, JR., ENVIRONMENTAL LAW: HAZARDOUS WASTES AND SUBSTANCES, § 8.7, at 564, and § 8.8, at 587 (1990).
113. CERCLA § 103(a), 42 U.S.C. § 9603(a) (1988) provides, in part:
If a client's only relationship to the facility is as a past owner or operator, it will not be a "person in charge" for reporting releases that occur subsequent to its period of ownership or operation. However, what if the client owned or operated the site from 1975 through 1985, and the client now recalls that some drums of waste chemicals (hazardous substances) were buried on the lease in 1979? Should the client report? Should the client voluntarily seek to dig up the drums and take care of any contamination?

With regard to the reporting issue, it has been suggested:

[O]ne is occasionally faced with a "discovery" of a site formerly owned or operated by one's client. Although there are no regulations making the notification requirement a continuing obligation, it is prudent to notify the EPA of any site that should have been reported in June 1981. 114

Another commentator offers the following guidance:

If a practitioner should discover that a client has neglected to report a facility that has been used in the past for the storage, treatment, and disposal of hazardous substances, it is generally preferable to advise the client to submit late notification under Section 103(c). While the failure to timely report such facilities does result in exposure for criminal sanctions, EPA has generally been lenient with respect to late notifications. In many cases the failure to file a notification was due to excusable neglect. In other cases, the prior use of a site for the storage, treatment, or disposal of hazardous wastes may only recently have come to the attention of an owner and operator. 115 In either case, EPA has little to gain in prosecuting such failures. More importantly, EPA has informally indicated that public policy is better served by encouraging owners and operators to continue to report the existence of such sites . . . than to encourage concealment by routinely prosecuting all "late filers." Therefore, unless there is evidence that a client has deliberately sought to conceal the existence of a facility from EPA, it is likely that EPA will exercise its prosecutorial discretion and decline to prosecute a "late filer." 116

Any person in charge of a vessel or an offshore or an onshore facility shall, as soon as he has knowledge of any release (other than a federally permitted release) of a hazardous substance from such vessel or facility, in quantities equal to or greater than those determined pursuant to section 9602 of this title, immediately notify the National Response Center . . . of such release.


115. An issue under such circumstances would be whether, prior to June 10, 1981, the client has "knowingly failed" to give the required notification. The penalty provisions of § 103(c) apply only to: "Any person who knowingly fails to notify the Administrator of the existence of such facility." CERCLA § 103(c), 42 U.S.C. § 9603(c) (1988) (emphasis added). However, if § 103(c) creates a continuing reporting obligation (continuing until the client has complied by identifying the requisite disposal areas), once a person becomes aware of reportable circumstances, a report would be required and a failure to report would meet the "knowingly" standard.

A decision to attempt to dig up the drums may depend upon the potential harm the situation poses to human health and the environment. The greater the potential harm, the greater the tendency should be to take affirmative action to address the situation. A practical problem that will probably prevent action in low-risk situations is the very real possibility that a similar situation exists on literally hundreds of properties with which the client has had contact during the course of its oil and gas operations.

To minimize potential liability for past activities, it is important to maintain any records relating to the property. This file should include documents that will assist in defining the nature of the client's interest in the property, or activities on the property, and other information that may be useful in identifying the client's contribution to problems at the site. Any contracts concerning the property, including insurance policies, should be retained.

2. Risks Associated with Present Interests

Risk associated with present oil and gas interests will often be difficult to manage because it is doubtful existing agreements attempt to marshal environmental risks. This will pose a problem when the client's lease is subject to an operating agreement or unit operating agreement and the risk is associated with another party's lease which was contributed to the contract or unit area. In most cases the existing agreement will not impose any obligation on the other party to remedy the situation; nor will it permit the operator to take any action.

Other risks may relate to the way on-going operations are being conducted on the property. For example, are the wastes generated during drilling, reworking, and maintenance activities being effectively managed? Are RCRA "exempt" wastes being segregated from non-exempt wastes and disposed of in a manner consistent with the

117. CERCLA also authorizes the EPA to impose recordkeeping obligations that can run for up to 50 years. CERCLA § 103(d), 42 U.S.C. § 9603(d) (1988).
118. If the properties are being transferred, copies of the relevant documents should be retained.
119. In many instances, however, the parties may prefer to not address the issue for fear that addressing the issue will create an even greater status link with the problem. The activity could also give rise to new liabilities. For example, if the operator takes action to clean up existing contamination found on one of the leases in the contract area, the operator and the other parties to the operating agreement will be responsible for "arranging for the disposal" of any contaminants removed from the property. This could impose liability on the parties to the operating agreement for cleanup of the off-site area where the contaminants are properly disposed.
120. For example, does the operator effectively monitor the waste disposal practices of the drilling contractor and other contractors working on the contract area?
121. The segregation of exempt and non-exempt wastes is required to avoid RCRA's "mixture rule" which states that mixing a hazardous waste with a non-hazardous waste can make the entire mixture a hazardous waste. 40 C.F.R. § 261.3(a) & (c) (1991), reinstated, 57 Fed. Reg. 7628 (March 3, 1992). See generally Shell Oil Co. v. Environmental Protection Agency, 950 F.2d
potential CERCLA risks? Are crude oil tank bottoms being spread on lease roads and county roads?122

If CERCLA liability has already attached due to a particular on-site or off-site disposal activity, future disposal activities should be managed to ensure such liability is not significantly expanded. For example, if hazardous substances have been properly taken to site A for disposal, and it is determined that is the best way to manage the waste, future waste shipments should also be taken to site A. Since liability has already attached for disposal of wastes at site A,123 all things being equal, it would be foolish to take wastes to site B, even though it is also a properly licensed disposal facility. Taking waste to site B, or any other site, merely expands the potential cleanup liability of the waste generator to the additional facilities where wastes are taken.

There are several ways to manage a potential risk relating to a lease or other property interest over which the party has control. First, existing operating practices should be evaluated to ensure they account for the associated environmental risks. This step would include evaluating both waste management practices and operational practices. For example, is the operator minimizing the generation of hazardous substances by using non-hazardous products whenever possible? Second, the lease area should be evaluated to identify situations that may pose environmental risks to a lessee as a CERCLA owner, operator, arranger, or generator. The same sort of analysis would be undertaken by a mineral interest owner or fee owner that has leased the property. The goal is to identify potential problems that may require reporting, cleanup, or monitoring.124

Another way of dealing with risks associated with present interests is to attempt to "share" the risks with others. For example, a lessee may offer, on favorable terms, a farmout to a large, financially-
sound developer willing to indemnify the farmor against existing environmental risks. Although the current environmental status of the leased land is disclosed to the potential farmee,\textsuperscript{125} it may be willing to assume the risk to pursue the development opportunity. Although the farmor's liability cannot be transferred to the farmee,\textsuperscript{126} the financial loss associated with liability can be leveraged by the farmee's indemnity—thereby reducing the “risk” associated with the property.

3. Risks Associated with Interests That May Be Acquired in the Future

Where environmental liability risks are associated with interests owned by others, the client can effectively manage liability through defining the level of environmental risk it is willing to accept. If the client avoids becoming an owner or operator of contaminated property, there will be no liability, and therefore no environmental risk, associated with the property.\textsuperscript{127} The techniques for managing prospective liability risks consist of:

1. Discovering the environmental status of the property prior to taking an interest in the property; and
2. Using various contractual devices to leverage environmental risks that cannot be dealt with through an evaluation of the property.

The CERCLA regulatory scheme is designed so that one can tactically acquire property to avoid or limit environmental risks. Therefore, if your client buys, leases, pools, or unitizes only “clean” properties, it will escape liability.\textsuperscript{128} The “dirty,” problem properties will remain with their existing owners and operators, and less vigilant, or perhaps less risk averse, future owners and operators. One of the underlying goals of the CERCLA system is to force prospective transferees of property to look for hazardous substance problems so they can be dealt with by either the transferor, their transferees, or both.

Structuring the transaction becomes important when determining “how” to acquire an otherwise “clean” asset. For example, if company A wants to acquire company B’s oil and gas leases, A can do so by purchasing the leases (an asset purchase), purchasing all of B’s

\textsuperscript{125} See infra text accompanying notes 148-75.

\textsuperscript{126} CERCLA § 107(e)(1), 42 U.S.C. § 9607(e)(1) (1988) (“No indemnification, hold harmless, or similar agreement ... shall be effective to transfer from one owner or operator ... to any other person the liability imposed under this section [107] ...”) (emphasis added). See infra text accompanying notes 233-35.

\textsuperscript{127} This assumes the client has had no contact with the property as an “arranger,” “generator,” or “transporter.”

\textsuperscript{128} See, e.g., Nurad, Inc. v. William E. Hooper & Sons Co., 966 F.2d 837, 843-44 (4th Cir. 1992) (lessee not liable for leaking underground storage tanks because lease did not give lessee any authority to control the tanks).
stock (a stock purchase), or combining the two companies through an exchange of stock (a merger). From an environmental liability perspective, the asset purchase poses the least amount of risk to A. The risk assumed by A will be limited to liability associated with the environmental condition of the acquired properties. 129

However, if A acquires B’s leases through a stock purchase, the leases will be an asset subject to the general liabilities of company B. Therefore, if B has other problem assets, or disposed of hazardous substances at locations owned by third parties, the leases would be a company B asset that could be used to satisfy any of its environmental liabilities. 130 Also, to the extent the corporate separateness of company B is not respected by company A, the assets of company A can become available to satisfy the general liabilities of company B. 131

In a merger, the corporate separateness of company B is formally merged into company A or another surviving enterprise. Similarly, the general corporate obligations and liabilities of company B become the obligations and liabilities of the surviving entity. 132 Therefore, the combined pool of assets owned by former companies A and B is available to satisfy the environmental liabilities associated with either company.

In light of the extensive liability associated with environmental problems, the asset purchase approach should be considered before considering a stock purchase or a merger. 133 If an asset purchase is not feasible, a stock purchase should be considered before considering a merger.

Contracts can be used to leverage risks associated with known problems and to provide financial protection against the unknown. In any property transaction there will be residual environmental risks that cannot be eliminated through an assessment of the property. These risks, however, can be allocated between the parties through representations, warranties, and indemnities. 134 When agreeing to a contractual assumption of liability, the assuming party must carefully

129. See generally Louisiana-Pacific Corp. v. ASARCO, Inc., 909 F.2d 1260, 1263 (9th Cir. 1990) (applying traditional rules of successor non-liability).
133. However, if the desired assets constitute a major portion of the selling company’s value, and the assets present their own environmental risks, purchasing the stock in the company may be preferable to an asset purchase. Assuming the company can be operated and maintained as a separate corporate entity, any liability associated with the assets, and the acquired company’s past and future operations, should be limited to the acquired company’s corporate assets.
134. See infra text accompanying notes 139-44.
evaluate the scope of its undertaking to ensure it is not defeating the benefits sought by structuring the transaction.135

Preparing a client for a transaction in the risk-ridden environment of CERCLA and similar laws can be challenging. However, the only way a client can successfully operate is by having a clear understanding of the risks that confront it and a clear understanding of the level of risk it is willing to accept. Often the task of educating the business manager about environmental risks, and how they can be managed, leveraged, and avoided, will fall on the attorney assisting in a property transfer.

B. Counseling Techniques

The ultimate structure of any transaction should reflect the level of environmental risk a client is willing to accept. However, before a client’s environmental risk tolerance can be measured, the client must be fully informed of the potential risks associated with the proposed transaction. The first portion of this article should assist counsel in educating clients about the relevant environmental risks. The initial consultation with the client should be designed to alert the client to environmental considerations that must be evaluated in any transaction.136 This should be followed by a letter to the client identifying general environmental risks and inviting the client to define the level of environmental risk it is willing to accept in the proposed transaction. The following letters are examples of the types of information the client needs to consider to effectively make decisions concerning a proposed transaction. The letters contemplate that a lawyer who specializes in environmental law is being brought into the process by the lawyer who has primary responsibility for the client and the proposed transaction.

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135. For example, in a stock purchase if company A agrees to assume, and indemnify the shareholders of company B against, all environmental liabilities of company B, company A loses a major benefit of buying company B’s stock as opposed to merging with company B.

136. If the client is unfamiliar with the potential environmental ramifications of “routine” transactions, this will probably be a revealing and painful process for the client. Although the client may ultimately elect to assume all the risk by doing business the way it always has, it is imperative that this be an informed decision made by the client. Since there is always a chance environmental problems will surface in the future, the attorney needs to ensure he has discharged his counseling obligations to the client and that appropriate documentation exists indicating the client’s informed assumption of environmental risks. See Model Rules of Professional Conduct Rule 1.4(b) (1983) (“A lawyer shall explain a matter to the extent reasonably necessary to permit the client to make informed decisions regarding the representation.”).
Martha Rhodes
President
Capitol Development Systems, Inc.
1700 College
Topeka, Kansas 66621

Re: Proposed Purchase of "Jackson Corner" Lease

Dear Martha:

I am very pleased to have the opportunity to work with you and Capitol Development in structuring a transaction to acquire the Jackson Corner property. It is my understanding you want me to participate in the negotiation and preparation of the purchase agreement and other documents required to complete the purchase and to assist you in closing the transaction. I will keep a record of the time I spend on this matter and bill Capitol Development on a monthly basis. My hourly rate is $____ per hour; expenses such as postage, copying, travel, and any other expenditures that may be required in representing Capitol Development will be charged according to the attached “Expense Schedule.”

A matter you should consider before we begin to negotiate this transaction concerns Capitol's potential liability for environmental problems associated with the Jackson Corner property. Although I am not aware of the environmental status of the Jackson Corner property, there are several very important environmental “facts of life” you must consider. Various federal and state laws governing the cleanup of contaminated property impact how Capitol must go about acquiring the Jackson Corner property. Simply put, if Capitol purchases a property that is contaminated, Capitol can become liable for cleaning up the property as the current “owner.” For example, Capitol could pay $100,000 for a property and years later have environmental authorities order it to remedy previously unknown environmental problems associated with the property. If it cost $5,000,000 to clean it up, Capitol could be required to spend, or reimburse others, for the full cost of the cleanup—$5,000,000.

Because of this potential for massive environmental liability, a major part of any transaction today must involve the identification, evaluation, and allocation of environmental risks. To the extent feasible, you want to know the environmental status of the property Capitol plans to acquire. Therefore, the purchase agreement will need to provide Capitol with the opportunity to conduct a “due diligence” review of the property to attempt to identify environmental problems. Unfortunately, many serious environmental problems are not readily apparent from a simple visual inspection of the property in its current state. A more extensive review of the property's history, and that of adjacent properties, will be required.

We will need to hire environmental consultants to assist in the due diligence process. The first consultant will be an environmental lawyer who can participate in negotiating and drafting the precise purchase agreement language to address environmental matters. I have an environmental lawyer in mind who can assist us. His [her] name is ________________________, who is with the law firm of
Although his [her] rate is $____ per hour, his [her] knowledge of the subject matter should actually save Capitol time and money in dealing with the environmental issues associated with this transaction. I would recommend that we get the environmental lawyer involved immediately so he [she] can help us to identify: the potential environmental risks posed by the transaction, the issues that must be addressed in any agreement with the seller, and the level of technical environmental assessment expertise that may be required.

After you have had an opportunity to consider the matters discussed in this letter, please give me a call so that we can discuss how you wish to proceed.

Sincerely,

Doc Hillard

Client Letter #2
13 January 1993

Martha Rhodes
President
Capitol Development Systems, Inc.
1700 College
Topeka, Kansas 66621

Re: Proposed Purchase of "Jackson Corner" Lease

Dear Martha:

I spoke with Doc Hillard today concerning Capitol Development's interest in acquiring the Jackson Corner property. I welcome the opportunity to work with Doc in assisting you and Capitol Development with the environmental issues associated with this transaction. As Doc told you my hourly rate is $____ per hour. Each month I will provide you with a detailed billing for my time and related postage, copying, telephone, and travel expenses.

As we prepare to structure this transaction, you must keep several environmental facts in mind:

1. Upon purchasing the property, your company will become a current "owner" of the property. As a current owner, Capitol Development will be subject to strict liability for any "release" or "threat of a release" of "hazardous substances" from the property pursuant to the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA or "Superfund"). Also, if Capitol Development enters into possession of the property prior to the transfer of title, it may be held liable under CERCLA as an "operator."

2. It does not matter that Capitol Development may have never brought the substances to the property, nor done anything to cause or contribute to the release.

3. Capitol Development's liability is for all practical purposes unlimited—however much it takes to clean up the site to the Environmental Protection Agency's (EPA), or a state agency's, standards. Liability is not limited to the purchase price and even bankruptcy may not shield assets from cleanup obligations.
4. When dealing with a closely-held company, like Capitol Development, the EPA may be inclined to go after personal assets of the major stockholder(s), managing officers, and directors of the company.

5. Things on the property that are not considered hazardous today can be declared hazardous in the future, thereby triggering a cleanup obligation that did not exist at the time Capitol Development purchased the property. Nevertheless, Capitol Development will be obligated to conduct any required cleanup at its expense.

6. If there are hazardous wastes on the property after the deal is closed, and Capitol Development takes action to dispose of them, Capitol Development will incur potential liability to contribute to a cleanup of any facility where the wastes or substances are taken. For example, if the hazardous wastes are taken to the XYZ Hazardous Waste Disposal Site, if there is ever a need for a cleanup at the XYZ Site, Capitol Development could be forced to pay for the cleanup.

7. If there are underground or aboveground storage tanks on the property after the deal is closed, Capitol Development could become liable for the proper maintenance or removal of the tanks and for any cleanup associated with past leaks from the tanks.

8. One narrow defense to CERCLA liability exists, called the "innocent purchaser" defense. Capital Development can qualify for this defense only if no "disposal" affecting the property takes place after Capitol Development takes title. However, prior to taking title Capitol Development must also make "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."

9. Capitol Development, pursuant to CERCLA, may be able to recoup some of its cleanup costs from prior owners and prior operators of the property. However, this assumes Capitol Development has not limited its statutory recovery right by contract. It also assumes Capitol Development is able to invest in the attorney fees and litigation costs required to pursue such action. In any event, if prior owners and operators don't have the funds to reimburse Capitol Development, Capitol Development will most likely suffer the total loss.

Although CERCLA and similar laws make any property transaction a rather scary proposition, the laws are designed to encourage prospective owners and operators to inquire into the environmental status of the properties they buy, sell, or lease. This means your front-line defense against these potential liabilities is to discover, prior to closing, the environmental problems associated with the property. This will require varying degrees of assessment performed by environmental professionals to investigate and characterize the property's environmental condition. This will require time to complete—and additional cost. If you plan to borrow money for this transaction, you will most likely be required to conduct a certain level of environmental assessment as a condition to your financing. We need to ensure that the environmental professionals and assessment program we select will, at a minimum, comply with your lender's requirements.
Keeping the foregoing thoughts in mind, let's get started with the process of screening the property and the people who will be selling the property.

**Step #1: Your Rough Assessment of the Property Involved**

In light of what you now know about environmental risks, I want you to evaluate the proposed transaction to determine whether there are *obvious risks* that make this deal unacceptable. Keep in mind, however, that often the gravest risks are not obvious, so your initial evaluation of the property is not in lieu of a site assessment by an environmental professional. Nevertheless, your evaluation can serve to screen properties which pose obvious, commercially unjustifiable risks before incurring the expenses of technical assessment.

Your initial discussions with the owner should explore what he knows about the property, his operations on the property, past spills and environmental problems, and his knowledge of past uses of the property and past and present activities on adjacent lands. You should take notes so you will have a record of what he tells you.

You should attempt to determine, from a visual inspection of the property, whether there are obvious environmental issues which require further investigation—such as drums of material strewn about the property, waste piles, or discolored soil.

**Step #2: Your Rough Assessment of the Seller**

What is the seller worth? If the seller's net assets are limited, any promise by the seller to pay for cleanup costs or otherwise indemnify you against liabilities will not be worth much. Of course, even if the seller has unencumbered assets today, there is no guarantee it will have assets in the future when a problem is discovered. These are risks that cannot be controlled unless a portion of the purchase price is held back in escrow to secure the seller’s promise to remedy problems and indemnify you from loss. Even such a holdback is of limited value since your cleanup liability could easily exceed the amount in escrow and the total purchase price.

If the seller's net worth is weak, the property assessment takes on even greater importance. However, if the seller has a substantial net worth, and is an established enterprise, the next step will be to determine whether it will agree to assume certain environmental liabilities and indemnify Capitol Development in the event it becomes liable for a cleanup of the property.

**Step #3: Will the Seller Assume Environmental Risks and Indemnify?**

Many of the environmental risks associated with becoming an owner or operator of property *cannot* be eliminated by a thorough environmental assessment. For example, the assessment may not disclose the problem, or the material at the site may not be classified as a hazardous substance at the time of the assessment. These and other significant risks should be specifically assigned by the purchase agreement to either the seller or buyer. In our case, we want the seller to assume any liability for environmental conditions created on the property prior to the transfer of title to Capitol Development. We also want the seller to agree to indemnify you
against any loss you may suffer from claims arising out of such pre-closing conditions.

If the seller refuses to assume this liability and to indemnify Capitol Development, or demands that Capitol Development assume such liabilities and indemnify the seller, you will need to decide whether the environmental risk is such that there is no need to proceed with negotiating a purchase agreement. Once the parties have a general understanding concerning the assignment of environmental liabilities and indemnities, the next step will be for me to prepare the environmental terms of the purchase agreement.

Step #4: Prepare Draft of Environmental Terms

We will not worry about this step until the issues in Steps 1 through 3 have been resolved to your satisfaction. Once we have come to a general understanding with the seller on the environmental terms, then you and Doc can begin to focus on the other terms of the transaction—such as purchase price, financing, title requirements, and closing. However, due to the critical nature of the environmental issues involved with this transaction, there is really no need to proceed with the other portions of the transaction until you know the environmental terms of the deal will be acceptable to Capitol Development.

I know I have presented you with a lot to digest in this letter. After you have had a chance to read and reflect on what I have said, give me a call at ___________ and we can discuss any questions or concerns you may have about the environmental issues we need to deal with in this proposed transaction. I look forward to working with you and Doc on this matter.

Sincerely,
Levi Trail

Identifying the level of risk a client is willing to accept will help to screen transactions by eliminating those that fail to meet the client’s risk-tolerance standards. For example, if the client refuses to accept the risk of environmental problems that might be discovered on leased land after a transaction is closed, proposed transactions in which the seller is unwilling or unable to adequately indemnify the client against such risks need not be pursued. The “environmental” terms of the transaction become the standard for eliminating transactions that fail to meet the client’s environmental risk criteria.

In many cases, the status of the seller or buyer will also serve to screen the transaction. For example, assume the client/buyer requires an indemnity in order to meet its risk-tolerance standards. If the seller is financially unsound, or otherwise unable to secure an indemnity obligation, the transaction need not be pursued. Similarly, if the client/seller wants to limit the potential for future liabilities, it may be unwilling to deal with financially weak buyers who may be unable to adequately respond to future environmental problems associated with the property.
Once identified, the client’s environmental risk standards can provide an effective guide for efficiently marshaling proposed transactions. If the client desires to limit its environmental risk to the maximum extent possible, the initial screening of the transaction would include the following checklist items:

**Client Environmental Risk Checklist**

1. Does the seller/buyer qualify?
   - (a) Does the seller/buyer have sufficient assets to honor a cleanup order and indemnity obligations?
   - (b) Is the seller/buyer likely to have sufficient assets to honor obligations that may arise in the future?
   - (c) Is the seller/buyer able to secure through insurance, guarantees, or other means the equivalent of sufficient assets?

2. Do the terms of the transaction qualify?
   - (a) Assuming the seller/buyer qualifies under item 1, is the seller/buyer willing to assume environmental liabilities?
   - (b) If willing to assume environmental liabilities, is the seller/buyer willing to indemnify against loss the client may suffer due to environmental problems associated with the transaction?
   - (c) Is the offered indemnity broad enough to protect client from the environmental risks it is unwilling to accept?
   - (d) Is the seller willing to permit a detailed inspection of the property associated with the transaction to ascertain its environmental status?
   - (e) Is the seller willing to give client the right to terminate the transaction in the event client determines the environmental status of the property is unacceptable?

Unless the seller/buyer and the environmental terms of the transaction “qualify” under the foregoing checklist, the client need not consider the proposed transaction any further.137

In many instances, a client may be willing to enter into the transaction even though the seller/buyer is unwilling to assume liabilities and indemnify; or the seller/buyer requires the client to assume liabilities and indemnify. In these situations, the focus will shift to the pre-

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137. This avoids having the momentum of the other aspects of the transaction get in the way of the client’s environmental risk analysis. If environmental issues are addressed after the client has engaged in extensive negotiations over price and other non-environmental terms—and after considerable time and effort has been expended in evaluating reserves and other non-environmental considerations—the client may be reluctant to let environmental considerations become a “deal breaker.” However, if the environmental liabilities are addressed upfront, the client’s investment in the deal will be minimal and the client will be more likely to insist upon a transaction that meets its pre-determined level of environmental risk tolerance. Also, since environmental liabilities can result in the greatest total loss to the client, it is logical that they be dealt with before the lesser terms of the deal are addressed; such as purchase price, title, and other issues that pale in significance when compared to the environmental risks.
acquisition assessment of the property to determine its environmental status as a condition to closing. This information can also be used to remedy environmental problems prior to closing or to carve out the higher risk interests from the transaction package.\footnote{138}

After the client's tolerance for environmental risk is defined, the general structure of the transaction will also become defined. The next step is to select the appropriate contractual techniques to achieve the client's environmental goals.

C. Contract Techniques

The contract techniques used to identify and manage environmental risks are similar to those used to deal with other business risks. The techniques include the express allocation of liability and risks using a negotiated mix of representations, warranties, covenants, conditions, and indemnities.\footnote{139} Representations are used to establish the assumed factual basis the parties are relying on in entering a transaction. For example, in a typical farmout agreement the farmor may represent to the farmee that the oil and gas lease at issue is "in full force and effect." The farmor is stating, as a matter of objective fact, the oil and gas lease is valid. If this is not the case, the farmor has misrepresented the status of the lease. If the lease has in fact terminated, the farmee can rescind the farmout agreement.\footnote{140}

Warranties are used to provide for compensation in the event the facts are not as represented.\footnote{141} The warranting party assumes the risk that the facts may not be as stated.\footnote{142} For example, if the farmor rep-

\footnote{138. Although a seller/buyer may be unwilling to assume undefined environmental liabilities, or to give a general indemnity, the seller/buyer may be willing to assume and indemnify against a specific problem identified during the environmental assessment process. It will also be easier to draft contract terms to address a known problem as opposed to potential and undefined problems.}


\footnote{140. Using the Restatement (Second) of Contracts terminology the contract is "voidable." Section 164(1) of the Restatement provides: "If a party's manifestation of assent is induced by either a fraudulent or a material misrepresentation by the other party upon which the recipient is justified in relying, the contract is voidable by the recipient." \textit{Restatement (Second) of Contracts} § 164(1) (1981).}

\footnote{141. See, e.g., Nunn v. Chemical Waste Management, Inc., 856 F.2d 1464 (10th Cir. 1988) (breach of warranty that waste management facility complied with applicable laws). In \textit{Nunn} the court noted: 

"[I]f a material state of facts is warranted to exist which turns out not to be the case, the warrantor is liable for the loss or damage caused . . . ."

"The general measure of damages for breach of warranty of quality is the difference between the value of the article actually furnished the buyer and the value the article would have had if it possessed the warranted qualities." \textit{Nunn}, 856 F.2d at 1469, 1470 (citations omitted).}

\footnote{142. The court in \textit{Nunn v. Chemical Waste Management, Inc.}, noted that if the facts are not as warranted, the warrantor will be liable, "and it is no defense that he [the warrantor] acted upon misinformation and in good faith." \textit{Nunn v. Chemical Waste Management, Inc.}, 856 F.2d 1464, 1469 (10th Cir. 1988).}
resents that the lease is valid when in fact it has terminated, the farmer becomes liable under its warranty to either provide the farmee with a valid lease or pay damages. Covenants are similar to warranties. A warranty is a covenant that a situation exists and if it does not the warranting party agrees to make the other party whole. A covenant is a promise to do, or not to do, something; a warranty is merely a special type of covenant.

Conditions provide a party with the option to defer or avoid its performance until a specified event, or events, have occurred. For example, the farmer might not become obligated to assign the oil and gas lease to the farmee unless and until the farmee completes a well capable of producing in paying quantities on the leased acreage. Similarly, if the required well is obtained, the farmee may be required to reassign a portion of the working interest to the farmer if and when a particular event occurs, such as recovery of the farmee’s drilling and operating costs.

Indemnities attempt to allocate the total risk, and related transaction costs, associated with an actual factual development. One party covenants to reimburse another party for losses that are suffered due to events defined in their indemnity agreement. The indemnity typically requires some sort of "trigger" such as a claim, demand, government order, or judgment resulting in financial loss to the indemnified party. A warranty, in contrast, operates whenever the actual situation varies from the situation as warranted. Sometimes the failure of a warranted fact could give rise to liability without triggering an indemnity obligation. For example, suppose the farmer warrants that all royalties have been properly paid to the lessor. In fact, it is later discovered that the lessor has been improperly paid, but the lessor is unaware of the problem. No claim, demand, order, or judgment has been made to trigger an indemnity obligation. However, the warranty has been breached and the farmer will be obligated to make good on its warranty.

The indemnity, however, may offer protection not available under the warranty. For example, suppose the farmee tenders the additional funds due the lessor and the lessor demands that the farmee pay interest. Although the farmee may have several defenses to the demand, it may require substantial resources in time and personnel, including attorneys, to deal with the lessor’s "claim" or "demand." In this situation, the indemnity would be triggered and, depending upon


144. A representation may not give rise to a claim for damages unless it is coupled with a warranty of the represented fact.
the scope of the indemnity, the farmee may be entitled to reimburse-
ment for all of its losses, including attorney fees and other costs, re-
sulting from the lessor's claim or demand.

Often representations, warranties, and indemnities are drafted to
build on one another. For example, the farmor "represents" the lease
is valid and also covenants to compensate the farmee if the lease is not
valid (the "warranty"). If it turns out the farmor's representation is
not accurate (the lease is not valid) the farmor also covenants to reim-
burse the farmee for any loss it may suffer from the lease being invalid
(the "indemnity"). However, the indemnity covenant is often broader
than the warranty covenant. For example, the farmor might limit its
warranty to a statement that "all delay rental and shut-in royalty pay-
ments have been made when due and farmor is not aware of any
claims by the lessor that the lease is not in full force and effect." This
may be a true representation, therefore, no liability would arise under
the farmor's representation or warranty. However, suppose a year af-

ter the transaction is closed the lessor asserts for the first time the
lease terminated under the cessation of production clause because the
lessee/farmor failed to promptly commence reworking operations.
This event is not encompassed by the farmor's representation or war-
ranty. However, depending upon the scope of the parties' indemnity,
it may be a covered event for which the farmor must reimburse the
farmee, even though no misrepresentation or breach of warranty has
occurred.

Sprinkled throughout the transaction will be various "conditions"
the farmee can rely upon to avoid closing the transaction. If possible,
the farmee wants to ascertain the actual facts and take the appropriate
action without having to rely upon representations, warranties, indem-
nities, and the farmor's contractual and financial integrity. If the lease
is invalid, the farmee wants to discover this prior to proceeding with
the transaction and require the farmor to fix the situation as a "condi-
tion" to closing. If it cannot be fixed, the farmee can avoid buying a
lawsuit and go look for other opportunities.

1. Representations

Since the only way a buyer can hope to completely avoid environ-
mental risk is to acquire "clean" assets,145 the buyer's main concern
will be to obtain accurate information about the targeted property or
business. This will typically be done through two techniques: repre-
sentations by the "seller" and investigation by the "buyer." Representations create problems for buyers and sellers. Buyers must ensure the representations are broad enough to ferret out all the "bad news" the seller may possess concerning the property. The seller must ensure any representations it makes are accurate. The representations form the factual basis on which the buyer agrees to acquire the property; the "inducement" to the bargain.

a. Seller's Concerns

The seller's main concern is to protect the integrity of the transaction by ensuring that all relevant information concerning the property or business is fully disclosed to the buyer. The goal is to avoid violating affirmative representations and to avoid misrepresentation claims for failure to disclose, partial disclosure, or inaccurate disclosure. For example, in *Gopher Oil Co. v. Union Oil Co.* the purchaser, Gopher Oil, sued the seller, Union, when Gopher Oil discovered, almost five years after the sale was closed, that the purchased property was contaminated with oil and industrial chemicals. Although Gopher Oil agreed to accept the property "in an 'as is' condition," the court held that this part of the agreement was ineffective "[b]ecause Union fraudulently induced Gopher to enter into the purchase agreement . . . ." It is not clear, from the reported decisions, whether the agreement between Gopher Oil and Union contained representations re-

146. In this section the term "seller" is used to include any person in the position of a transferor of property, whether a lessor, assignor, farmor, or a contributor to a contract area covered by an operating agreement, a pooling agreement, or unitization agreement.

147. In this section the term "buyer" includes any person who is acquiring an interest in property, such as a lessee, assignee, farmee, or a party to an operating, pooling, or unitization agreement that covers other property interests.

148. 955 F.2d 519 (8th Cir. 1992).

149. The property at issue was owned by W.H. Barber Company which operated a bulk oil and chemical facility on the site from the early 1900s to 1980. Barber was a subsidiary of Pure Oil Company which was merged into Union in 1965. At that time Barber became a wholly-owned subsidiary of Union. The trial court held that because of Union's total domination and control over Barber's activities, and Union's active participation in the transaction, the corporate separateness of Barber and Union would be ignored. *Gopher Oil Co. v. Union Oil Co. of California*, 757 F. Supp. 988, 991, 994 (D. Minn. 1990), aff'd in part, remanded in part *Gopher Oil Co. v. Union Oil Co.*, 955 F.2d 519 (8th Cir. 1992) (remanded with regard to fraud damages and attorney fees issues).

150. *Gopher Oil Co. v. Union Oil Co.,* 955 F.2d 519, 523 n.2 (8th Cir. 1992).

151. *Id.* at 527. The court relies on this finding to support the jury's advisory allocation of CERCLA liability of 100% to Union and 0% to Gopher Oil. Union had argued that the court should consider the "as is" clause in determining how to apportion CERCLA liability for contribution purposes. This allocation applied to reimbursement of the $423,272.81 in cleanup costs already incurred by Gopher Oil plus the declaratory judgment concerning future costs that might be incurred at the site. Testimony at trial suggested the ultimate total cost to clean up the site may approach $10,000,000. *Gopher Oil Co., Inc. v. Union Oil Co. of California*, 757 F. Supp. 998, 1012 (D. Minn. 1991). The court also awarded Gopher Oil $559,380.52 in attorney fees and litigation expenses. However, the Court of Appeals remanded this award so the trial court could exclude expenses associated with the common law fraud claim. *Gopher Oil*, 955 F.2d at 527.
The court instead relied upon oral representations allegedly made by Union employees to Gopher Oil. An examination of what Union disclosed, and did not disclose, is revealing. The court observed:

Union representatives informed Gopher of a 1977 spill of 10,000 gallons of turpentine and another spill of approximately 300 gallons of lubricating oil. Union did not inform Gopher that Barber and AMSCO's normal operating procedures, particularly prior to 1970, resulted in continual minor leaks and dumpings on the site. Further, Gopher asserts that Union assured Gopher on three occasions that no pollution problems existed with the site. A Union internal memorandum, however, noted the need for pollution control and recommended sale of the site rather than a substantial investment in environmental and safety concerns.

The court found that the disclosure of some problems, the two spills, suggested there were no other problems. This is a “partial disclosure” issue; giving rise to circumstances that might require additional disclosure to avoid misleading the buyer. The oral assertion that “no pollution problems existed” at the site, may be taken as a statement of objective fact. Therefore, if a pollution problem does exist, the representation is inaccurate. Contrast this with a person’s assertion that “to the best of my knowledge” no pollution problems exist at the site. If there is a pollution problem, the representation is not necessarily inaccurate. The relevant inquiry is not the objective existence of a problem, but the person’s “knowledge” concerning the problem. Although at the time the assertions were made there were no CERCLA problems, because CERCLA had not been en-
acted, there may have been RCRA problems and problems under other state and federal laws. The Union internal memorandum suggested to the court and jury that: (1) there were pollution problems, (2) Union knew they existed, and (3) Union failed to disclose their existence to Gopher Oil.

The court also found that Union took affirmative steps to "conceal" telltale signs of pollution problems when it engaged in cosmetic landscaping of the area. The court noted: "In preparing the Barber site for sale, Union took steps to conceal the evidence of years of accumulated deposits of oil and chemicals on the site. It removed contaminated ground and replaced it with landscaping gravel. Other contaminated areas were simply covered over with the gravel."159 Although representatives of Gopher Oil visited the site twice before the purchase, during their "guided tour" they "noticed some minor soil discoloration from oil spills, but gravel obscured much of the contaminated ground and any chemical spills would have been primarily colorless."160

The purchase agreement stated that the parties were not relying upon any prior representations that were not contained in the final written agreement.161 However, the court held that Gopher Oil could offer evidence of the alleged oral "pollution free" representation made by Union. The parol evidence rule would not apply when the evidence is offered to show a fraudulent inducement to enter the agreement.162

The Gopher Oil case suggests that sellers should fully, but carefully, disclose any potentially relevant information concerning the environmental status of property. The disclosure should also include a statement concerning the source and scope of the information. For

159. Gopher Oil, 955 F.2d at 522-23.
160. Id. at 523. The Restatement (Second) of Contracts § 160 provides: "Action intended or known to be likely to prevent another from learning a fact is equivalent to an assertion that the fact does not exist." Restatement (Second) of Contracts § 160 (1981). Comment b to § 160 provides two common examples of misrepresentation by concealment:

In the first, a party actively hides something from the other, as when a seller of a building paints over a defect. . . . In such a case his conduct has the same effect as an assertion that the defect does not exist, and it is therefore a misrepresentation. . . . In the second situation, a party prevents the other from making an investigation that would have disclosed a defect. An analogous situation arises where a party frustrates an investigation made by the other, for example by sending him in search of information where it cannot be found. Even a false denial of knowledge by a party who has possession of the facts may amount to a misrepresentation as to the facts that he knows, just as if he had actually misstated them, if its effect on the other is to lead him to believe that the facts do not exist or cannot be discovered.

Restatement (Second) of Contracts § 160, cmt. b (1981).
161. Gopher Oil, 955 F.2d at 526.
162. Id. Applying the exception to the parol evidence rule, the court noted: "Here, Gopher presented evidence that Union knew of the site contamination, that Union attempted to conceal the contamination and affirmatively misrepresented the material fact of contamination to Gopher, and that Gopher relied upon that misrepresentation in entering the transaction." Gopher Oil, 955 F.2d at 526.
example, is the source of the information a particular person’s memory, or is the information the product of employee interviews and a search of company files? Identifying the source and scope of the information provides the recipient with the necessary data to evaluate its value.

A seller should also disclose past or present operating practices that could give rise to environmental problems. In *Gopher Oil* the court suggested that Union should have disclosed its “normal operating procedures” of decades past that resulted in “minor leaks and dumpings on the site.”

For example, if a lessee is entering into a farmout agreement with a prospective assignee, the lessee may want to consider a generic disclosure concerning the leasehold interest to be transferred. Consider the following language which is often found in many major oil company producing property sales packages:

**Environmental Condition**

*Physical Condition of the Assets:* The Assets have been used for oil and gas drilling and production operations, related oil field operations and possibly for the storage and disposal of Hazardous Substances. Physical changes in or under the Property or adjacent lands may have occurred as a result of such uses. The Assets also may contain buried pipelines and other equipment, whether or not of a similar nature, the locations of which may not now be known by Seller or be readily apparent by a physical inspection of the property. Purchaser understands that Seller does not have the requisite information with which to determine the exact nature or condition of the Assets nor the effect any such use has had on the physical condition of the Assets.

Many companies using the above format have expanded it to specifically address naturally occurring radioactive material (NORM) and asbestos. Consider the following provision:

In addition Purchaser acknowledges that some oil field production equipment may contain asbestos and/or naturally occurring radioactive material (NORM). In this regard, Purchaser expressly understands that NORM may affix or attach itself to the inside of wells, materials and equipment as scale or in other forms, and that wells, materials and equipment located on the Assets described herein may contain NORM and that NORM containing materials may be buried or have been otherwise disposed of on the Assets. Purchaser also expressly understands that special procedures may...

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163. *Id.* at 523.
164. A defined term.
165. A defined term.
166. What if the Seller in fact had a production foreman who possessed the requisite information? This is where defining the scope and source of the inquiry can avoid a misrepresentation claim. What the Seller means to say in this situation is they are not going to devote the time and effort to try and obtain information, from its employees or other knowledgeable people, that may not be reflected in the lease, well, and production files. A more accurate statement would be: *Seller has not made an effort to identify or gather the requisite information with which to determine the exact nature or condition of the Assets.*
be required for the removal and disposal of asbestos and NORM from the Assets where it may be found.

At this point, some sellers may attempt to fulfill their disclosure obligations by providing an environmental assessment of the assets that has been prepared at the seller's request. If so, the following language would typically be included:

Seller has caused a "Phase 1" Environmental Assessment to be conducted on the Property, a copy of which has been provided to Purchaser under separate cover, and receipt thereof is hereby acknowledged. In respect to any environmental assessment prepared at the request of seller, the seller makes no and disclaims any express or implied warranty as to the accuracy or completeness of any statement or purported fact or conclusion contained in any such report.

However, if the seller has knowledge of a specific problem on the property which the Environmental Assessment does not address, the seller is not necessarily protected from a misrepresentation claim if it fails to disclose the problem. For example, assume seller's production supervisor knows that for years the lease being assigned has been used as a central disposal site for oil field waste materials, many of which would be classified as "hazardous" today. A careful review of the records, however, did not reveal this fact; nor was it revealed by the Environmental Assessment. The buyer would argue the seller has misrepresented the situation noting:

1. Seller stated the property might "possibly" have been used for the disposal of Hazardous Substances when it in fact "knew" such was the case.

2. Seller stated it "does not have the requisite information to determine the exact nature or condition" of the property when its employees in fact possessed such information.

3. Seller knew, yet failed to disclose, that the Environmental Assessment did not accurately depict the environmental status of the property because the contractor was not aware of the facts, possessed by seller, needed to properly evaluate the property.

In anticipation of such arguments, the same companies using the "Environmental Condition" clauses noted above also include the following language in their assignments:

Independent investigation and disclaimer: Assignee acknowledges that Assignee has relied solely on the basis of its own independent investigation of the Assets. Accordingly, Assignee agrees and hereby acknowledges that Assignor has not made, and assignor hereby expressly disclaims and negates, and this assignment and bill of sale is made by assignor without any representation or warranty, express or implied, at common law, by statute, or otherwise relating to: (i) . . . The condition of the assets (including, without limitation, any implied or express warranty of merchantability, of fitness for a particular purpose . . .); And, (ii) any information, data or
other materials (written or oral) furnished to assignee by or on behalf of assignor . . . . Assignee covenants that Assignee has inspected the Assets and accepts the same "AS IS" and "WHERE IS."

The seller will argue that a buyer asserting a misrepresentation claim in this situation is the contract counterpart of the products liability plaintiff suing for injuries suffered while trimming his hedge with a lawnmower. However, the integrity of the purchase agreement, and the assignment, are nevertheless open for challenge when they are the product of a defect in the bargaining process, such as fraud in the "inducement" to contract. The prominent disclaimers throughout the excerpted provisions will make it difficult for a buyer to prove it relied on the disclosures, and that its reliance was "reasonable" under the circumstances. The goal for the seller, however, is to eliminate all challenges to the integrity of the contract.

If the seller is able to negotiate favorable contractual provisions concerning future liabilities, the seller will want to protect the contract from challenges arising out of inaccurate or incomplete disclosures. As the Gopher Oil case demonstrates, if environmental problems surface after the closing, the contract will be placed under considerable stress and scrutiny if the problems may have been within the seller's range of knowledge but the seller did not remember and affirmatively disclose them prior to the closing. Also, seemingly innocent housekeeping activities in preparing the property for sale may be viewed in a different light if they impair the buyer's ability to detect environmental problems.

167. Professor Farnsworth lists the necessary elements of a misrepresentation claim noting: In the great bulk of cases, the misrepresentation is seen as going only to the inducement, with the result that the contract is voidable. The requirements for avoidance can be grouped under four headings. First, there must be an assertion that is not in accord with the facts. Second, the assertion must be either fraudulent or material. Third, the assertion must be relied on by the recipient in manifesting assent. Fourth, the reliance of the recipient must be justified.

1 E. ALLAN FARNSWORTH, FARNSWORTH ON CONTRACTS § 4.10 at 403-04 (1990).


169. Id. § 4.13.

170. Even though the reasonable reliance requirements are not met to support a contract claim, a federal district court, in a CERCLA contribution action, may be inclined to weigh the representation in determining each party's allocation of CERCLA liability. CERCLA § 113(f)(1) provides that: "In resolving contribution claims, the court may allocate response costs among liable parties using such equitable factors as the court determines appropriate." CERCLA § 113(f)(1), 42 U.S.C. § 9613(f)(1) (1988) (emphasis added). In United States v. R.W. Meyer, Inc., 932 F.2d 568, 572 (6th Cir. 1991), the court noted that "by using the term 'equitable factors' Congress intended to invoke the tradition of equity under which the court must construct a flexible decree balancing all the equities in the light of the total of the circumstances." The court in Gopher Oil did not have to address this issue because it held that the "as is" clause in the contract was invalid because of the misrepresentation. Gopher Oil Co. v. Union Oil Co., 955 F.2d 519, 527 (8th Cir. 1992) ("We reach this result without deciding the effect of the 'as is' clause in the purchase agreement on the apportionment of liability."). In many cases, the court's broad CERCLA § 113(f)(1) discretion to allocate costs has the potential to collide with CERCLA § 107(e)(1) which authorizes the parties to shift CERCLA's ultimate financial burden among parties to the contract.
To preserve the integrity of the contract, the seller should err on the side of disclosure and let the buyer determine whether a problem warrants pre-closing attention. Disclosures should be in writing and will often be included in an “exception exhibit” to an environmental representation or warranty. In addition to site-specific disclosures, the agreement should include a general statement concerning past routine practices on the property that may give rise to environmental problems. For example, in a farmout agreement the farmor might include the following disclosure (properly tailored to accurately represent the situation):

Farmor has had an oil and gas leasehold interest in the Property [and has conducted operations on the Property] for the [exploration, development, production, treatment, processing, storage, and marketing] of oil, gas, and component substances produced with oil and gas. [Other persons or entities have also held and exercised the right to conduct oil and gas operations on the Property.] Consistent with what is known about oil and gas operational practices of the past, it is likely that various wastes associated with oil and gas operations, some which may be classified as “hazardous,” have been disposed of in or on the Property. Similarly, there may be unplugged or improperly plugged wellbores, and pipelines and other underground and aboveground structures, on the Property; spills of various wastes and substances may have occurred on the Property. Any of these situations, events, or practices could give rise to Environmental Liabilities. Also, as an oil and gas lessee, Farmor has not exercised control over all rights in the Property and the mineral interest owners, surface owners, and their contractors and transferees, may have caused, permitted, or suffered activities to occur on the Property which could give rise to Environmental Liabilities. Farmor has not made an effort to identify or gather the information necessary to determine the exact nature or condition of the Property with regard to Environmental Liabilities.

However, the use of such boilerplate is dangerous. For example, if the farmor knows of an unplugged well on the property, or specific spills or other environmental problems, these should be disclosed because the general statements that they “may” exist would be inaccurate. If the farmor is a corporation, or other entity, the agreement should indicate who is making the representation or disclosure. For example, suppose the person making the representation or disclosure is the Vice President of Land for Acme Oil Company. Depending upon the size and structure of Acme the Vice President may know all relevant information or no relevant information about the property. The farmor in such cases will prefer to limit its representations and warranties to situations within the “actual knowledge” of a specified

171. A defined term.
172. A defined term.
173. Gopher Oil Co v. Union Oil Co. of California, 955 F.2d 519, 523 (8th Cir. 1992).
individual,174 or "to the best knowledge and belief" of a specified individual.175 This should be coupled with a description of the sort of inquiry made by the designated individual to acquire information concerning the property. Depending upon these variables, the same boilerplate disclosures for the same farm or may be a true statement or a blatant lie.

b. Buyer's Concerns

The buyer will attempt to force the seller to make representations that are statements of objective fact: "there are no unplugged or improperly plugged wellbores on the leased land." If an unplugged well is discovered on the leased land, it does not matter what the seller may or may not have known, the representation is false. If the seller successfully negotiates for a subjective "knowledge" standard, the buyer should attempt to impose specific inquiry obligations on the seller and try to include as large a group as possible in the knowledge pool. For example, the seller may offer the following compromise: "seller has no actual knowledge of any unplugged or improperly plugged wellbores on the leased land."176 The buyer should respond first by trying to chip away at the "actual" knowledge requirement by suggesting a "no reason to believe" or "knowledge and belief" standard.

The "knowledge and belief" standard is broader than the actual knowledge standard. Although the party making the representation may not actually know of a problem, he may believe there is a problem due to anecdotal information available to him or his knowledge of routine industry practices. For example, the production supervisor does not have actual knowledge that hazardous wastes were disposed on the leased land. However, the production supervisor does know that there is a well on the property that was drilled in the early 1970s when asbestos and sodium hydroxide were used as additives to drilling mud in the area. The supervisor also knows that during the relevant

174. This will generally be the standard preferred by the seller. Under an actual knowledge standard, the designated individual may have been aware of the problem at one time, but may not recall it at the time he makes the representation. For example, assume a production supervisor, twenty years ago, directed the disposal of hazardous wastes on the lease at issue. However, today the production supervisor does not recall the incident, or does not recall that the disposal took place on this particular lease. If the production supervisor represents he has no actual knowledge of any disposal of hazardous wastes on the lease, the representation is true even though, in fact, the production supervisor personally directed the disposal of hazardous wastes at the lease. The "fact" represented is not whether the disposal on the lease took place, but whether the production supervisor presently recalls a disposal on the lease.

175. The "seller" will prefer to define one individual or a small group of individuals who will form the pool of knowledge for purposes of the representation.

176. The seller will also want to define "wellbores" to ensure that only wellbores for the exploration or production of oil or gas are covered by the representation. Many properties contain unplugged or improperly plugged water wells.
time frame it was industry practice to dispose of drilling mud and other hazardous drilling materials in pits located near the drill site. Although the production supervisor does not know that such practices were followed at the particular drill site in question, he may have a "belief" that hazardous wastes have been disposed of on the lease.

The "no reason to believe" standard is even more pro-buyer than the "knowledge and belief" standard. Using the production supervisor example, the supervisor may not have formed a subjective "belief" that hazardous wastes were disposed of on the lease. However, from the supervisor's experience and knowledge of past practices there will often be some "reason to believe" hazardous wastes are present on the leased land. Therefore, the production supervisor cannot safely represent he has "no reason to believe" hazardous wastes have not been disposed of on the leased land.

If the buyer is forced to negotiate for a subjective knowledge standard, it will want the seller to specify that the representation is being made after a diligent search of the relevant files and questioning individuals likely to possess relevant facts. The buyer must also consider the person or persons in the seller's organization who will be making the representation. As with any other corporate matter, individuals become much more cautious when they are stating a fact as opposed to the corporation stating a fact. The impact of this individual corporate soul-searching can be magnified by requiring "certificates" from the seller's personnel concerning their knowledge regarding environmental matters. The buyer's goal is to identify a broad group of people likely to possess the relevant facts and have each make the representation on behalf of the entity.

A carefully negotiated transaction, between parties of relatively equal bargaining power, will usually consist of a mix of representations of objective and subjective facts. The subjective fact representations will often consist of both a mix of inquiry standards and a mix of defined groups within the organization making the representations. Once the pertinent disclosures are made, the stage will be set to determine which facts the seller will warrant.

177. See, e.g., Nunn v. Chemical Waste Management, Inc., 856 F.2d 1464, 1469 (10th Cir. 1988). In Nunn the court observed:

Many of the warranties made by the former owners were expressly made "to the best of [their] knowledge." The face of the agreement leaves no doubt that the former owners well knew how to limit contractual warranties to the best of their knowledge when they so desired. It is significant, then, that the warranties contained in Section 2.12 and 2.30 are not limited by the former owners' knowledge.

Nunn, 856 F.2d at 1469 (emphasis added).
2. Warranties

A warranty is "[a] promise that a proposition of fact is true."178 If the fact is not as warranted, the beneficiary of the warranty can seek damages from the warranting party. In contrast, if a party's representation is inaccurate, the other party may be able to rescind the contract if the representation related to a material fact. However, rescission may offer the injured party little comfort if it has become an "owner" or "operator" of property before the misrepresentation is discovered.179 This is particularly true in jurisdictions which hold that passive releases of hazardous substances constitute acts of "disposal" under CERCLA.180 If the represented fact is warranted, the beneficiary can seek compensation for any loss it may suffer as a result of the warranted fact being false. This is why most representations are made in tandem with a warranty. Therefore, the pertinent section of the agreement is often referred as the "representations and warranties."

However, the careful seller will often insist that certain matters be "represented" and not "warranted." This is often the case when the seller is being forced to represent something as a matter of objective fact. For example, "seller has operated the leased premises in accordance with all applicable local, state, and federal law." The seller may be willing to make this representation and then give the buyer a period of time to conduct its due diligence review to satisfy itself that the representation is accurate. If the buyer discovers the lease has not been operated in accordance with applicable law, it can refuse to close.181 If the representation is warranted, however, the buyer can also seek damages arising out of the inaccurate warranty.

a. Scope of the Warranty

As with representations, the parties can warrant the existence of an objective state of facts182 or subjective knowledge or belief that

179. Often discovery of the misrepresentation coincides with discovery of a release of hazardous substances. See, e.g., Nunn v. Chemical Waste Management, Inc., 856 F.2d 1464, 1467 (10th Cir. 1988) (new owner and operator discovered breach of warranties thirteen months after the sale when state officials shut down the facility).
180. For example, in Nurad, Inc. v. William E. Hooper & Sons Co., 966 F.2d 837, 846 (4th Cir. 1992), the court held CERCLA "imposes liability not only for active involvement in the 'dumping' or 'placing' of hazardous waste at the facility, but for ownership of the facility at a time that hazardous waste was 'spilling' or 'leaking.'"
181. This assumes the contract provides that the accuracy of all representations is a condition to buyer closing. If the contract does not establish the condition, the buyer must show that the inaccurate representation justifies buyer's avoidance of the contract under a misrepresentation theory. See RESTATEMENT (SECOND) OF CONTRACTS § 164(1) (1981) ("If a party's manifestation of assent is induced by either a fraudulent or a material misrepresentation by the other party upon which the recipient is justified in relying, the contract is voidable by the recipient.").
182. For example, "seller has operated the leased premises in accordance with all applicable local, state, and federal law."
certain facts either do, or do not, exist. As noted in the discussion of representations, the seller will prefer to subjectively represent and warrant matters as within the seller’s “actual knowledge,” or “knowledge and belief,” or as matters which it has no reason to believe are not as stated. Buyers prefer objective representations and warranties because a breach will be triggered without regard for the maker’s actual or constructive knowledge of the situation. The importance of this subjective/objective distinction, and other warranty concepts, is illustrated in the case of *Nunn v. Chemical Waste Management, Inc.*

The *Nunn* case began as a suit by the former shareholders of National Industrial Environmental Services, Inc. (NIES) to collect on a promissory note given by Chemical Waste Management, Inc. (CWM) to purchase their stock in NIES. CWM counterclaimed against the former owners stating causes of action for negligence, breach of warranty, and liability under CERCLA. NIES owned and operated an industrial waste disposal facility near Wichita, Kansas. NIES’s shareholders sold all their stock in NIES to CWM for $500,000 cash and a promissory note for $2,400,000. The sale was completed in December 1980. Thirteen months following the sale the facility was closed by the Kansas Department of Health and Environment because “toxic wastes were leaking from the facility’s ponds and polluting nearby groundwaters.” The trial court awarded damages on CWM’s breach of warranty counterclaim, entitling CWM to $6,964,942.17 for its cleanup efforts through August 30, 1984. The Court of Appeals affirmed this portion of the trial court’s judgment.

The breach of warranty counterclaim raised two issues: First, was the event—leakage from the waste facility—covered by any of the sellers’ warranties? Second, if it was, would the warranty be violated if the sellers had no knowledge of the leakage at the time the warranty was made? With regard to the first issue, the court focused on Section 2.2 of the acquisition agreement which contained the following warranty by the former owners:

[NIES] is not in default under any law or ordinance, or under any order of any court or federal, state, municipal or other governmental department, commission, board, bureau, agency, or instrumentality wherever located; its operations are in compliance with all

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183. For example, “to the best of seller’s knowledge and belief, seller has operated the leased premises in accordance with all applicable local, state, and federal law.”
184. See supra text accompanying notes 176-78 and infra text accompanying notes 195-97.
185. 856 F.2d 1464 (10th Cir. 1988).
187. *Id.* The trial court found that: “The groundwater pollution which caused the NIES site to be shut down in 1982, began during the early phase of [the former owners’] operation of the NIES facility, continued thereafter during [the former owners’] operation, up to and including the time of sale to Chem[ical] Waste . . . .”
188. *Id.* at 1466, 1471.
applicable laws, permits and ordinances and there are no claims, actions, suits or proceedings pending, or threatened, against or affecting the Company or any Shareholder, at law or in equity, or before or by any federal, state, municipal, or other governmental department, commission, board, bureau, agency or instrumentality, wherever located, which might result in any material adverse change in the financial condition or business of the Company or which would question the validity or propriety of this agreement or of any action taken or to be taken in accordance with or in connection with this agreement.\textsuperscript{189}

Note that the emphasized language creates a very broad certification of compliance with all applicable laws and permits. This is strategically placed so that the warranting party might think that "compliance" can be assumed if there have been no "claims, actions, suits or proceedings pending, or threatened;" facts which the warranting party would most likely possess. However, there are actually four separate warranties contained in Section 2.12: (1) NIES is not in "default" under any law\textsuperscript{190} or order; (2) NIES is in compliance with all applicable laws; (3) NIES is in compliance with all permits; and (4) no claims, actions, suits, or proceedings are pending or threatened that could adversely and materially impact the financial condition or business. However, to make it clear that compliance with laws and permits was important, the agreement included Section 2.30 which stated: "[NIES], from the inception of operation at the [Wichita] Site, has been and is in compliance with the terms, conditions and requirements of all licenses, permits and authorizations it holds and the laws, ordinances and regulations pursuant to which such licenses, permits and authorizations were granted."\textsuperscript{191}

Relying upon these warranties, the court found that the former owners of NIES had warranted against "leakage" at the Wichita waste facility. The court held:

Both Sections 2.21 and 2.30 warrant that the Wichita facility is in compliance with all applicable laws. One such law is surely K.S.A. § 65-164 which proscribes the placing, discharging, or permitting the flow of any chemical waste into the waters of the state of Kansas.\textsuperscript{192} ... When we look at the warranties in the light of the laws of the state of Kansas, as well as in the context of applicable federal law, we are confident that the trial court correctly interpreted the contract to contain a warranty against leakage at the site.\textsuperscript{193}

\textsuperscript{189} Id. at 1468 (emphasis added).
\textsuperscript{190} This by itself could be construed as another "compliance with all applicable laws" warranty.
\textsuperscript{191} Nunn, 856 F.2d at 1468 (emphasis added).
\textsuperscript{192} KAN. STAT. ANN. § 65-161(a) defines "waters of the state" to mean "all streams and springs, and all bodies of surface and subsurface waters within the boundaries of the state; ..." KAN. STAT. ANN. § 65-161(a) (1985) (emphasis added).
\textsuperscript{193} Nunn, 856 F.2d at 1468.
The terms of the former owners’ warranty allow the buyer to search federal, state, and local law, and relevant government authorizations and permits, for anything that might cover the situation and then raise it as a breach.\(^{194}\)

### b. Warranting Objective vs. Subjective Facts

After determining that “leakage” was covered by the former owners’ warranties, the court had to determine whether those warranties had been breached. Although there was leakage, the former owners argued that because they were not aware of the leakage, the warranties were not breached. The court noted, however, that although many of the other warranties in the agreement were made “‘to the best of [their] knowledge,’” the warranties contained in Section 2.12 and 2.30 were not limited to the former owners’ knowledge.\(^{195}\) The court observed:

> In the absence of such a limitation, we conclude that the trial court did not err when it found that the parties intended that such warranties would not be limited by the former owners’ knowledge. This is not at all an unusual result. Parties to a contract frequently allocate the risks which may arise from unanticipated or unknown events and conditions through warranties. “[I]f a material state of facts is warranted to exist which turns out not to be the case, the warrantor is liable for the loss or damage caused; and it is no defense that he acted upon misinformation and in good faith.”\(^{196}\)

The court’s holding in *Nunn* demonstrates why buyers want representations and warranties of objective facts and why sellers prefer to limit representations and warranties to subjective knowledge of facts.\(^{197}\)

### c. Effective Date of the Warranty

The *Nunn* case also discussed the scope of warranties with regard to the *time* at which they will operate. Absent a special provision in the contract, a representation or warranty may be held to operate only as of the date made, typically the date on which the contract was signed. However, it is common to provide that the representations and warranties will be deemed to have been made as of the date of closing. For example, in *Nunn* Section 2.21 of the acquisition agreement provided:

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194. Such open-ended warranties are particularly troublesome for sellers who take back a promissory note as part of a leveraged sales transaction. The buyer may be inclined to “nickel and dime” the seller on a regular basis, or use the warranty to justify a delay or partial payment on the note. However, in the *Nunn* case the warranty functioned as a proper allocation of liability for an event that turned a $3,000,000 acquisition into a $7,000,000+ liability for the buyer.

195. *Nunn*, 856 F.2d at 1469.

196. *Id*.

197. See *supra* text accompanying notes 157-62.
If the exchange provided for in this agreement is consummated at the Time of Closing, all of the representations and warranties here-inabove contained in this article will be true and correct at and as of the Time of Closing, with the same force and effect as though made at and as of the Time of Closing, except for changes contemplated or permitted by this agreement.198

The court observed that the parties contemplated changes in the “applicable law” by providing in Section 2.17 that: “the business of [NIES] is subject to certain environmental regulation and that revision of such regulations may occur from time to time and is currently contemplated by the Kansas State Legislature and the Kansas Department of Health and Environment.”199

The acquisition agreement was entered into on May 14, 1980 and the closing took place on December 15, 1980.200 CERCLA became law on December 11, 1980201 and the EPA’s primary hazardous waste regulations under RCRA were released in final form on May 19, 1980 and became effective on November 19, 1980.202 Although the buyer did not rely on violations of CERCLA203 and RCRA, the court held that if there had been violations they would have been covered since the warranty operated as of the date of closing, December 15, 1980.

The court observed:

Section 2.21, in effect, provides that the warranties made at the time the acquisition agreement was executed are not static; rather, the parties intended that the warranties would expand or contract along with the “contemplated changes” in the law which transpired prior to the time of closing. While the enactment of RCRA and of CERCLA may have expanded the scope of the warranties beyond that which was warranted at the time the agreement was executed, an expansion was expressly provided for by the terms of the agreement.204

d. Survival of Warranties

The parties should actively negotiate whether the representations and warranties will operate, “survive,” beyond the closing. In many situations the doctrine of merger will be implicated. Merger provides that covenants and other contract rights of a buyer are extinguished

198. Nunn, 856 F.2d at 1468-69 (emphasis added).
199. Id.
200. Id. at 1467.
203. It is doubtful the buyer could have proven any “violation” of CERCLA since most of its relevant provisions impose “liability” on parties without regard to any substantive regulatory standard.
204. Nunn, 856 F.2d at 1469.
once the buyer accepts a deed or other conveying document. For example, in *Perry v. Stewart Title Co.* Perry purchased a house and subsequently discovered part of the driveway and garage encroached upon an underground utility easement. After the sale had been closed, and the deed delivered and accepted, Perry obtained a survey indicating the encroachment. Perry attempted to rescind the transaction relying upon a provision in the sales contract authorizing Perry to make objections to title. However, the deed did not contain such a provision. The court held that any provisions contained in the purchase contract that were not preserved by the deed were merged into the deed. The court noted: "In Texas, as in most other jurisdictions, in the absence of fraud, accident, or mutual mistake, the rights and duties created by a land sales contract are merged into the deed when the seller delivers and the buyer accepts the deed." Many courts, however, take a more limited approach to the merger doctrine. For example, in *Barela v. Locer* the New Mexico Supreme Court enforced a right of first refusal contained in a real estate contract even though the right was not referenced in the subsequent conveyance. The court held that only covenants that "inhere in the very subject-matter of the deed" will become merged stating:

> But where there are stipulations in such preliminary contract of which the delivery and acceptance of the deed is not a performance, the question to be determined is whether the parties have intentionally surrendered or waived such stipulations. If such intention appears in the deed, it is decisive; if not, then resort may be had to other evidence.

The court concluded that a right of first refusal to purchase minerals did not "inhere to the very subject-matter of the deed." Therefore, the court could look to the contract and other evidence to ascertain the parties' intent.

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206. 756 F.2d 1197 (5th Cir. 1985), reh'g on unrelated issue, 761 F.2d 237 (5th Cir. 1985).

207. *Perry v. Stewart Title Co.*, 756 F.2d 1197, 1201 (5th Cir. 1985), reh'g on unrelated issue, 761 F.2d 237 (5th Cir. 1985).

208. *Id.* at 1202. Perry's lender had insisted upon the survey. A copy of the survey was not available at the time of the closing but the parties proceeded with the closing anyway. The survey indicating the encroachment became available the day after closing.

209. *Id.* at 1204.


211. Barela was purchasing real estate from Locer. In their contract signed on May 7, 1970, Locer retained all mineral rights in the property being conveyed, but agreed "to grant to purchaser an option of first refusal to acquire mineral rights on said premises and such option shall survive and be enforceable for a period of one year after death of seller." On June 22, 1970, Locer executed and delivered a deed to Barela reserving all minerals to Locer but made no reference to Barela's right of first refusal. *Barela*, 708 P.2d at 308.

212. *Id.* at 309.

213. *Id.* at 310.
Another more forgiving approach to the merger issue determines from the underlying contract whether the parties intended the covenant to survive delivery and acceptance of a deed. For example, in *Davis v. Weg*\textsuperscript{214} the seller, Weg, warranted that the premises would be conveyed free of all violations of law or municipal ordinances. Weg contended that the warranty merged in the deed which did not address these matters. The court noted:

Generally, the obligations and provisions of a contract for the sale of land are merged in the deed and, as a result, are extinguished upon the closing of title . . . . However, this rule does not apply where there is a clear intent evidenced by the parties that a particular provision shall survive delivery of the deed, or where there exists a collateral undertaking . . . \textsuperscript{215}

The contract between the parties stated: "[a]ll notes or notices of violations of law . . . shall be complied with by the seller and the premises shall be conveyed free of the same, and this provision of the contract shall survive delivery of the deed."\textsuperscript{216} The court found this was a sufficiently "clear intent evidenced by the parties" that the warranty would survive delivery of the deed. Therefore, Weg was "obligated to pay the reasonable costs of curing all Health Code violations in existence at the time title was conveyed."\textsuperscript{217}

The merger cases demonstrate that the survival issue should be expressly addressed in the contract and any subsequent conveyances. In addition to merger problems, however, is the interpretive issue of whether the parties intended the representation or warranty to continue beyond the closing, and, if so, for how long. The contract between the parties should expressly address the survival issue to avoid disputes over merger and intent. For example, a buyer might negotiate for the following provision: "The warranties provided for in this Agreement are continuing obligations of the Seller which survive the closing."

The seller would like to minimize the duration of its warranty obligations. Therefore, if the parties agree that warranties will extend beyond the closing, the seller should try to limit them to a specific term, such as one or two years following the closing. For example, the parties might negotiate for the following provision: "The warranties provided for in this Agreement shall be true as of the closing date and shall survive the closing, but all of Seller's warranties shall terminate two years following the closing date." In a transaction that is partially seller-financed, it is not unusual for the parties to agree that the dura-

\textsuperscript{214} 479 N.Y.S.2d 553 (1984).
\textsuperscript{215} Id. at 555.
\textsuperscript{216} Id.
\textsuperscript{217} Id.
tion of the seller's warranties will coincide with the buyer's final payment to the seller.

e. Warranty Beneficiaries

If a party agrees to provide warranties that survive the closing, another matter to negotiate is who will, or can, benefit from the warranties. For example, if a warranty is made in favor of the buyer, can the buyer subsequently sell, lease, or otherwise transfer the benefit of the warranty to third parties? Often the agreement in which the warranties are made expressly states: "This Agreement shall be binding upon and shall inure to the benefit of the respective personal representatives, heirs, administrators, executors, successors, and assigns of the parties." The ability to transfer the seller's warranties to subsequent purchasers may be highly valued by the buyer; particularly when dealing with properties that have attendant environmental risks. If the seller is a "major" oil company that is likely to be solvent in the future, assignable warranties, and indemnities, can be like an insurance policy against otherwise uninsurable environmental risks.218

The seller will seek to make the buyer the only beneficiary of any warranty.219 The seller may also negotiate for a provision that the warranty will terminate upon the buyer's transfer of the property to a third party. This may be acceptable to the buyer if it can retain a continuing indemnity for its benefit in the event a problem subsequently surfaces with regard to the property. Third parties would not have rights under the indemnity, but the buyer's protection would not be lost if it transfers the property. Consider the following provision which limits third party rights under the indemnity while preserving the buyer's indemnity rights:

The indemnity obligations created by this Agreement are continuing obligations which survive the closing and can be enforced by buyer at any time and shall not merge or otherwise become extinguished by subsequent conveyances of the property. However, the buyer's indemnity rights, and the seller's indemnity obligations, created by this Agreement, shall be non-assignable. In the event buyer sells, leases, or otherwise conveys to a third party all or part of the property covered by this Agreement, none of the buyer's indemnity rights, nor seller's indemnity obligations, shall pass to any third party. However, this limitation does not apply when the sale, lease, or transfer is made to a subsidiary or parent corporation.

218. However, even the "majors" are subject to catastrophic economic events. See generally In re Texaco, Inc., 73 B.R. 960 (Bankr. S.D.N.Y. 1987) (one of the many cases addressing issues associated with the April 12, 1987 Chapter 11 petition of Texaco, Inc., Texaco Capital, Inc., and Texaco Capital N.V.).

219. Often the buyer's lender will insist that it be made a beneficiary of the seller's warranties either directly or derivatively through the seller's indemnities to buyer and buyer's indemnities to its lender.
f. Materiality

Sellers often attempt to soften representations and warranties by including a “significance” standard to evaluate events that could otherwise constitute a misrepresentation or a breach. For example, in *Nunn v. Chemical Waste Management, Inc.* the seller warranted: “[T]here are no claims, actions, suits or proceedings pending, or threatened, against or affecting the Company or any Shareholder . . . which might result in any *material* adverse change in the financial condition or business of the Company . . . .” The interpretive problem then becomes determining what is “material.” In the same agreement the seller warranted certain matters without any sort of significance standard. For example, the seller warranted: “[I]ts operations are in compliance with all applicable laws, permits and ordinances . . . .” Presumably any act of noncompliance with a law or permit could give rise to a breach of warranty. However, the court may impose its own materiality standard as a condition to awarding damages.


g. Remedies

The parties may define in their agreement what the remedy will be for an inaccurate representation or a breach of warranty. Usually, prior to closing, an inaccurate representation triggers a condition to closing: the situation must be remedied to comply with the representation or the buyer will not be obligated to go through with the deal. After closing, the buyer’s remedy will generally be for a breach of warranty or reimbursement under an indemnity. However, the parties can expand or contract the impact of a representation or warranty by stating in the contract the remedy that will apply in the event things are not as stated. For example, the buyer could expand its rescission remedy and the seller could narrow the buyer’s damages remedy.

When the seller provides the buyer with warranties and indemnities concerning environmental matters, the seller may attempt to make them the buyer’s exclusive remedy. Therefore, if the event at issue is not encompassed by a warranty or indemnity, the risk of loss

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220. 856 F.2d 1464 (10th Cir. 1988).
222. The parties could attempt to define the term, in the context of “change in financial condition,” by referring to a dollar impact. For example, a claim for $10,000 may be “material” for a business valued at $500,000 but immaterial for a business valued at $5,000,000.
223. *Nunn*, 856 F.2d at 1468.
224. In *Nunn* the court noted that “[I]f a *material* state of facts is warranted to exist which turns out not to be the case, the warrantor is liable for the loss or damage caused . . . .” *Nunn*, 856 F.2d at 1469 (emphasis added). However, it would appear that any noncompliance which caused the buyer some loss or damage could be argued to be “material.”
225. Which may encompass the existence of a represented fact.
will fall on the buyer. For example, if the event is not covered by a warranty or indemnity, but the buyer may have a cause of action under CERCLA, RCRA, or some subsequently enacted law, the buyer can be foreclosed from pursuing its claim against the seller. This is particularly useful when something that was not classified as hazardous at the time of closing is nevertheless declared hazardous in the future. The risk that something is subsequently declared hazardous may be shifted to the buyer—assuming the event is not otherwise covered by a warranty or indemnity.

The buyer, however, desires to preserve any rights it may have under existing and future laws. Even if the buyer has not been able to obtain broad representations, warranties, and indemnities, it may still have a remedy under CERCLA, RCRA, or subsequently enacted laws. Therefore, the buyer would negotiate for a provision similar to the following: “The terms of this Agreement shall not in any way limit any rights Buyer may have against Seller under any law, whether in effect at the time of closing, or created or recognized after closing, to recover for any environmental liability associated with the property or this transaction.”

The seller would counter by negotiating for a provision similar to the following: “The rights and remedies granted buyer in this section shall constitute buyer’s exclusive remedy against seller for any environmental liability associated with the property or this transaction.”

3. Negotiation and Drafting Checklist for Representations and Warranties

This section summarizes, in checklist fashion, the matters that should be considered when negotiating and drafting representations and warranties. At a minimum, the parties should consider the following matters:

Representations & Warranties Checklist

[ ] 1. Will the representation or warranty be of objective facts or will it depend upon somebody’s knowledge?

[ ] 2. If dependent upon the “seller’s” knowledge:

[ ] (a) Who is the “seller” going to be for purposes of determining knowledge?

[ ] (b) If dependent upon the “seller’s” knowledge, what has the seller done to acquire knowledge?

[ ] (c) If dependent upon the “seller’s” knowledge, what level of knowledge is required?

(1) Actual knowledge?
(2) To the best of seller’s knowledge and belief?
(3) No reason to believe?
3. Define the scope of the representations and warranties.  
   (a) What matters are covered?  
   (b) Will there be a "materiality" standard to determine compliance?  

4. Define the date on which the accuracy of representations and compliance with warranties will be determined.  
   (a) Date the contract is signed? Date of closing?  
   (b) Will the representations or warranties survive the closing? If so, for how long?  
   (c) If representations or warranties are to survive the closing, address the issue in the conveyance to avoid merger problems.  

5. Define the parties who are to benefit from representations and warranties.  
   (a) Lenders? Subsequent transferees?  
   (b) Is the buyer still protected following a transfer to third parties?  
   (c) Are the buyer's subsidiaries and parent corporations covered?  

6. Define the remedy available arising out of an inaccurate representation or a breach of warranty.  
   (a) Rescission?  
   (b) Damages? Consequential damages?  
   (c) Are other remedies available or are those defined in the agreement the exclusive remedies?  

7. Will the representations and warranties be supported by an indemnity?  

4. Allocation of Liabilities  

Cases to date suggest that a general allocation of environmental liability between the contracting parties works—some of the time.\(^{226}\) Obviously "some of the time" is not good enough, so the parties must ensure that the financial burden of environmental liabilities is expressly allocated in their contract.\(^{227}\) The allocation of environmental liabilities.

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\(^{227}\) An express agreement of the buyer to accept the property "as is, in its current condition with all faults" may not preclude the buyer from bringing CERCLA or strict liability claims against the seller. Southland Corp. v. Ashland Oil, Inc., 696 F. Supp. 994 (D. N.J. 1988) ("as is" clause does not bar CERCLA claims); Allied Corp. v. Frola, 730 F. Supp. 626 (D. N.J. 1990) ("as is" clause does not bar common law strict liability claims). See generally Phillip R. Clark, *Continued Liability of Seller After a Sale of Producing Oil and Gas Properties*, 41 Inst. on Oil & Gas L. & Tax’n 5-1, 5-23 to 5-28 (1990) (discussing impact of "as is" clause on environmental liabilities).
risks through representations, warranties, and indemnities will generally result in an express contractual assumption of liabilities by the parties.

For example, assume the seller agrees to indemnify the buyer against any breach of warranty and the seller has warranted that "no hazardous substances exist on the property at the time of closing." If hazardous substances are found to exist on the property, the seller will be obligated to make good on its warranty and reimburse the buyer for any loss it may incur arising out of the breach of warranty. The net effect of the warranty and indemnity is that the seller has assumed the risk of liability associated with the existence of hazardous substances.

In some situations, it may be advisable to have an express assumption of liabilities by the parties. This often occurs when an environmental assessment has disclosed an environmental problem such as elevated levels of lead in the groundwater, causing the buyer to demand specific protection from any risk of loss related to that problem. When a potential liability does not clearly fall under a warranty or a general indemnity, the express assumption can be used to allocate the risk between the parties. In all situations, the parties should be able to identify, from the terms of the proposed agreement, which party will be responsible for each significant environmental risk. Often these risks are allocated through an indemnity clause.

5. Indemnities

The indemnity clause is used to allocate the financial burden of specified risks between the parties. The major task is identifying

228. For example, consider the following provision used by some major oil companies in conjunction with the sale of producing properties:

"As Is, Where Is" Purchase: ... Purchaser shall acquire the Assets [a defined term] in an "AS IS, WHERE IS" condition and shall assume the risk that the Assets may contain Hazardous Substances [a defined term], that adverse physical conditions, including but not limited to the presence of Hazardous Substances or the presence of unknown abandoned oil and gas wells, water wells, sumps and pipelines may not have been revealed by Purchaser's investigation. As of the Effective Date [a defined term], all responsibility and liability related to all such conditions, whether known or unknown, is transferred from Seller to Purchaser. The Purchaser shall at its expense take whatever actions are necessary to reduce any concentration of any "Hazardous Substance" located on the surface or within the subsurface or the subsurface waters of the Property to a level of concentration that is at or below the most stringent level that from time-to-time may be established by any federal, state, or local agency's applicable law, regulation, ordinance or rule ("Environmental Law"), applicable to the use of the Property for residential use ("Remediation", "Remediate", or "Remediated"). "Environmental Law" shall also include any legal requirement in relation to contamination, and/or protection and/or cleanup of the environment, exposure of persons, [including employees], to any Hazardous Substance and shall also include any laws or regulations pertaining to Hazardous Substances, or liability or duty created under any statute or under intentional tort, nuisance, trespass, negligence, or strict liability or common law theory or under any decision of a state or federal court.

229. Several excellent articles have been written addressing the use and drafting of environmental indemnities. See Samuel D. Haas & A. Kay Roska, Environmental Indemnities and Other Environmental Provisions in the Purchase and Sale of Mineral Properties, 38 ROCKY MTN.
the events that will trigger the indemnity obligation. If the agreement contains extensive representations and warranties, and an express allocation of liabilities, then most, if not all, of the triggering events may already be identified. The task is then a simple one of referencing the representations, warranties, and liability allocations as events that will trigger the indemnity obligation.\textsuperscript{230} After this is done, the transaction can be reviewed to determine whether other events need to be specified to make the indemnity coverage complete. If one of the specified events occurs, the indemnifying party will be obligated to take the action specified in the indemnity clause. This often includes mounting a legal defense of the indemnified party, paying or settling claims made against the indemnified party, and reimbursing the indemnified party for its losses associated with the event.\textsuperscript{231}

Often the indemnity will be one of the primary devices for dealing with lingering risks that cannot be eliminated or defined prior to closing a transaction. For example, suppose there have been elevated levels of total petroleum hydrocarbons (TPH) detected in the soils at an operation site. Assume also that the farmore is not willing to conduct a cleanup of the area and the presence of the elevated TPH levels is not reportable under state or federal law. However, the farmore is concerned because although the TPH levels are not "reportable" under any law, state or federal officials can still order a cleanup if they decide to focus on the problem.\textsuperscript{232} The farmore wants to conduct operations on the leased land but the farmore disputes the need for any sort of cleanup and refuses to go through with the farmout if the farmore

\textsuperscript{230} An example of this technique can be found in section IV of this paper where the restrictive covenants in a mineral deed are incorporated into the indemnity provisions of the deed. \textit{See infra} text accompanying notes 312-16.

\textsuperscript{231} A major expense that often receives special attention is reimbursement of the indemnified party's reasonable attorney fees and litigation expenses. Consider the following provision: "Loss includes attorney fees, expenses, and litigation costs the Indemnified Party incurs to evaluate, defend, settle, mediate, litigate, or otherwise dispose of a Claim; including the Indemnified Party's attorney fees, expenses, and litigation costs required to enforce the Indemnifying Party's obligation to indemnify."

\textsuperscript{232} This is probably one of the most difficult lingering environmental risks to address: how dirty is dirty? The problem arises in most transactions where the property has been "used" for industrial purposes. When the parties look for contamination, they usually find it. However, once contamination is found the more perplexing problem is: how bad is it? If the area is clean, or a seething toxic waste dump, the task is simple. You close on the clean area and refuse to close on the seething toxic waste dump. Since discovery of the toxic waste dump will be a reportable event under CERCLA, the owner will be forced to trigger government scrutiny and ultimately a cleanup. However, most properties present a situation in between these extremes: not clean, but still not a reportable condition. In most instances, the environmental consultant will prepare a "risk assessment" to address, based on the nature of the contamination, the use of the property and surrounding properties, the geology and hydrology of the area, and the hazard the situation poses to health and the environment. Often the assessment is more self-serving: what is the likelihood that if state or federal officials focus on the site they would order a cleanup?
insists on a cleanup. In this situation, the parties may rely upon an indemnity agreement to offer the farmee some protection against liability for the TPH problem, and other environmental problems the farmee may encounter on the farmout acreage.

The OPA and CERCLA each contain specific provisions recognizing the validity of indemnity agreements. The CERCLA and OPA provisions are worded identically, but the OPA provision is broken into subsections that more clearly articulate Congress’ intent. OPA § 1010 provides, in part:

(a) Agreements not prohibited

Nothing in this chapter prohibits any agreement to insure, hold harmless, or indemnify a party to such agreement for any liability under this chapter.

(b) Liability not transferred

No indemnification, hold harmless, or similar agreement or conveyance shall be effective to transfer liability imposed under this chapter from a responsible party or from any person who may be liable for an incident under this chapter to any other person.

The intent seems clear that although parties cannot shift their “liability” created by statute, they can agree to reimburse one another, through an indemnity, and thereby shift the financial loss arising out of such liability. However, if the indemnifying party is unable to honor its indemnity agreement, the indemnified party will suffer the loss, not the public or the non-liable parties. This is the ultimate risk with any contractual obligation: that the party making the promise is unable, or unwilling, to honor its promise. This risk is often leveraged through various devices designed to “secure” the promise through insurance, bonding, escrow, letter of credit, or similar devices.


234. OPA § 1010(a) & (b), 33 U.S.C.A. § 2110(a) & (b) (West Supp. 1992).

235. See generally Michael O. Ellis, Private Indemnity Agreements Under Section 107 of CERCLA, 22 ENV'T REP. (BNA) 1953 (Dec. 6, 1991); Samuel D. Haas & A. Kay Roska, Environmental Indemnities and Other Environmental Provisions in the Purchase and Sale of Mineral Properties, 38 ROCKY MTN. MIN. L. INST. 22-1, 22-37 to 22-43 (1992). Although two federal district court judges have held that an indemnity is unenforceable between parties that are each liable under CERCLA, the weight of authority permits the enforcement of such agreements. The cases are collected and discussed in the Ellis and Haas articles.

236. For example, in a producing property sales agreement form used by some major oil companies, it is contemplated that the buyer’s indemnity of the seller will be secured by a letter of credit. The relevant provision states, in part:

Letter of Credit: Multiple Letters of Credit (LOC) in $_________dollar increments increasing to $_________ over a four year period from a mutually acceptable bank in Sellers favor will be provided to protect Seller from the abandonment and environmental liability of the interests transferred to Purchaser. The LOC’s are to be in the form of Exhibit “C” attached hereto and by this reference incorporated herein. Purchaser shall have the option to furnish performance bonds...
Although these security devices “sound” reassuring, in many transactions they will be of limited value. For example, what dollar value should the indemnified party insist on to protect its interests? Environmental liabilities routinely exceed the purchase price of the property involved in the transaction. Will $100,000 be sufficient? $100,000,000? What dollar value will the indemnifying party, as a practical matter, be able to secure? If the indemnifying party currently lacks adequate assets to back its potential indemnity obligations, it probably will not be able to afford the cost required to “secure” its obligations. If the indemnifying party currently possesses assets to back its indemnity obligations, it will probably object to the added expense associated with securing its obligations.

In addition to the practical financial limitations on indemnities, and federal statutory limitations, there are various state law restrictions that need to be considered. When dealing with oil and gas transactions, state anti-indemnity statutes designed to protect oil field contractors must be carefully evaluated.\(^{237}\) Although the statutes do not apply to a surface estate owner who imposes indemnity obligations on its lessee and other developers,\(^{238}\) they can impact agreements between the lessee and third parties conducting oil and gas development activities.\(^{239}\) The Texas statute is unique in that it expressly excludes from the indemnity restrictions agreements concerning “loss or liability for damages or an expense arising from . . . property injury that results from pollution . . . .”\(^{240}\)

State anti-indemnity statutes prohibit only those indemnity agreements which seek to encompass the indemnified party’s own negligence or fault. The Texas statute provides that indemnity agreements are void if they purport “to indemnify a person against loss or liability for damage that . . . is caused or results from the sole or concurrent

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Separate from these specialized statutes, most states require that an intent to indemnify against one's
own negligence must be expressly stated in the agreement. Thus, although by statute the surface owner
may be allowed to obtain an indemnity agreement that encompasses the surface owner’s negli-
gence, state common law will often require that the intent be clearly stated and unconcealed in the document. If the intent is not clearly
expressed in the contract, indemnity against the surface owner’s sole
or concurrent negligence will be denied.

The varying approaches of states to indemnity issues suggest the
need for a choice of law provision to designate which state's law con-
trols the validity and scope of indemnity provisions. Under the Re-
statement (Second) of Conflict of Laws, parties to a contract are given
wide latitude to specify which state's law will govern the validity and
interpretation of their contract. Generally, the chosen state should
have some contact with the transaction. However, the chosen state’s
law will not apply when:

Application of the law of the chosen state would be contrary
to a fundamental policy of a state which has a materially greater
interest than the chosen state in the determination of the particular
issue and which [has the most significant relationship to the transac-
tion and the parties].

A choice of law provision always should indicate that only the
chosen state’s “local” law will apply and not the chosen state’s choice-
of-law rules. This avoids the renvoi problem since reference to the
totality of a state’s law would include the state’s choice-of-law rules.
These rules might then select the law of a state other than that chosen
by the parties—as evidenced by the existence of their expressed
choice of law provision. The Restatement addresses this problem
by providing: “In the absence of a contrary indication of intention,
the reference is to the local law of the state of the chosen law." 248

Once the "contacts" between the transaction and the state of eligible states are identified, the law of each state can be evaluated to determine which, if any, offer interpretive benefits.

Another issue to consider is whether federal common law, as opposed to state law, will be applied to interpret the indemnity provisions of the agreement. To date, courts have taken divergent views on whether they should look to state law for guidance in interpreting indemnity provisions impacting CERCLA liabilities. 249 In any event, a choice of law provision places the parties in a position to argue for the most favorable state's law as a "guide" for what the federal common law should be under the circumstances. 250

In many transactions, negotiation and drafting of the indemnity will be the most time consuming, and therefore the most expensive, task performed by counsel. But in many situations it is also the most important task. Unfortunately, indemnities are like warranties: everybody wants them, but nobody wants to give them. Sellers often begin the process by tendering their "form" agreement which contains assumptions of liability and indemnities by the buyer that are highly favorable to the seller. 251 Buyers often retaliate with an equally one-sided set of favorable assumptions of liability and indemnities, 252 to-

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248. Id. at § 187(3).


250. See Levins Metal Corp. v. Parr-Richmond Terminal Co., 817 F.2d 1448, 1451 (9th Cir. 1987) (applying state law to determine corporations' capacity to be sued following its dissolution).

251. Indemnity language used by one major oil company in their asset sale agreement form provides:

Indemnification and Assumption of Environmental Risks: Buyer assumes full responsibility for, and agrees to indemnify, hold harmless and defend Seller from and against all loss, liability, claims, fines, expenses, costs (including attorney's fees and expenses) and causes of action caused by or arising out of any federal, state or local laws, rules orders and regulations applicable to any waste material or hazardous substances on or included with the Assets [a defined term] or the presence, disposal, release or threatened release of all waste material or hazardous substance from the Assets into the atmosphere or into or upon land or any water course or body of water, including ground water, whether or not attributable to Seller's activities or the activities of Seller's officers, employees or agents, or to the activities of third parties (regardless of whether or not Seller was or is aware of such activities) prior to, during or after the period of Seller's ownership of the Assets. This Indemnification and Assumption shall apply to liability for voluntary environmental response actions undertaken pursuant to the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA) or any other federal, state or local law.

252. For an example of a negotiated indemnity favorable to the buyer, consider the following provision:
d. Indemnity Obligations.

(1) Seller agrees to Indemnify [a defined term] Buyer against any Claim [a defined term] made by any Person [a defined term] resulting in a Loss [a defined term] that arises out of an Environmental Liability [a defined term] associated with the property. Seller’s indemnity obligation is limited to Environmental Liabilities (whether discovered before or after the closing date) that relate, in whole or in part, to the ownership, use, or occupancy of the property by Seller or other persons, on or before the closing date, and includes the migration of Hazardous Substances [a defined term] from other areas onto or under the property. Without limiting the scope of Seller’s indemnity, the parties acknowledge that Seller’s indemnity includes activities by Buyer on the property that reveal or discover an Environmental Liability associated with a pre-closing ownership, use, or occupancy of the property. Seller’s indemnity includes Environmental Liabilities that may be revealed by Buyer’s physical alteration, demolition, excavation, or other construction activity on the property. If Buyer’s activities on the property disturb any pre-closing condition associated with the property, Seller will indemnify Buyer for any resulting Environmental Liabilities.

(2) Seller agrees to Indemnify Buyer against any Loss Buyer may suffer because a representation or warranty contained in subsection a. is not accurate. For purposes of this subsection Buyer will be deemed to have a Claim against Seller for any Loss Buyer may suffer due to an inaccurate representation or warranty.

(3) The indemnity obligations created by this subsection d. are continuing obligations which survive the closing and can be enforced by Buyer at any time and shall not merge or otherwise become extinguished by subsequent conveyances of the property. In the event Buyer exercises its option to terminate this Agreement pursuant to subsection c., Seller will nevertheless indemnify Buyer in accordance with subsection d.

(4) As used in Section 8, the following terms will have the indicated meaning:

(a) Hazardous Substance: Petroleum, including crude oil and any fraction of crude oil, natural gas, natural gas liquids, all other petroleum substances, plus any substance defined, now or in the future, as a hazardous substance pursuant to the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA) or any successor statute or any local or state law counterpart. The term also includes substances and sites on the property which become the focus of “corrective action” under the Resource Conservation and Recovery Act (RCRA) or an “imminent hazard” action pursuant to RCRA §§ 7002 and 7003 or CERCLA § 104, or any local or state law counterpart to CERCLA or RCRA.

(b) Environmental Laws: Any statute, resolution, ordinance, or other public law which is designed, in whole or in part, to protect the environment or the public health, safety, or welfare and which is in effect at the date of Closing. The term also includes common law public and private nuisance, negligence, trespass, and strict liability in tort.

(c) Environmental Liability(ies): Any fine, penalty, injunctive action, administrative order, or other enforcement action pursuant to the Environmental Laws. Any statutory or common law claim for response costs, cleanup costs, damages, natural resource damages, or other compensation due, in whole or in part, to the presence of a Hazardous Substance or the alleged violation of the Environmental Laws.

(d) Indemnify: Seller will pay, defend, settle, and otherwise discharge any Claim against Purchaser.

(e) Claim: Any claim, demand, administrative action, or judicial action, by a Person seeking something from Purchaser.

(f) Person: Any person, private or governmental entity, or private or governmental association. The term also includes, without limitation, the Seller, and any employee, officer, director, stockholder, parent or subsidiary corporation, partner, joint venturer, or other individual, association, or entity of, or associated with, the Seller. The term also includes the Purchaser or its parent, subsidiary, partner, joint venture or other entity of, or associated with, the Purchaser or its successors or assigns.

(g) Loss: Any amount Purchaser pays, voluntarily or involuntarily, in good faith and in response to a Claim. Loss includes reasonable attorney fees, expenses, and litigation costs Purchaser incurs to evaluate, defend, settle, mediate, litigate, or otherwise dispose of a Claim; including Purchaser’s attorney fees, expenses, and litigation costs required to enforce Seller’s obligation to indemnify. Loss does not include Purchaser’s consequential damages such as lost profits and damage due to Purchaser’s inability to conduct its business. However, Loss includes any direct damages suffered by Purchaser, to include any amount Purchaser expends to replace or repair any concrete, building, or other structure or item on the property that is removed, altered, damaged,
together with a battery of representations, warranties, and inspection rights. At this point, the parties need to determine whether either party is willing to at least consider accommodating the interests of the other. If neither party is willing to budge, the exercise is over. If a party is willing to accommodate the other, the transaction will proceed to the “detail” phase of the indemnity negotiations. However, this all assumes that the party offering to indemnify is financially capable of backing up its promise.253

Once the hurdles of financial ability and willingness to indemnify are cleared, the parties must address several sticky issues concerning the scope and duration of the indemnity.254 Among the issues the parties must be prepared to negotiate, are the following:

Indemnity Checklist

1. What is required to create a valid indemnity?
   a. Use a choice of law provision to select the state’s law to be applied to determine the scope and validity of the indemnity.
   b. Evaluate any statutory limitations on indemnity in the selected state.255

or destroyed during Seller’s, Purchaser’s, or a third party’s response to an Environmental Liability.

(h) Seller: The Seller and any parent company of the Seller, to include their successors.

(i) Purchaser: The Purchaser and its officers, directors, stockholders, employees, agents, and contractors, and the successors and assigns of Purchaser.

(j) Property: Includes, without limitation, the surface and subsurface of the property, groundwater, the interior and exterior of all structures on the property, and any fixtures and personal property located on the property.

   e. Conflicts with the Agreement; Effect on Other Rights.

In the event the terms of this Section conflict with any of the other provisions of this Agreement, the terms of this Section will control. The terms of this Agreement shall not in any way limit any rights Purchaser may have against Seller under any law, whether in effect at the time of closing, or created or recognized after closing, to recover for any environmental liability associated with the property or this transaction.

253. See supra text accompanying notes 136-38 (discussing the buyer/seller “qualification” process).

254. See supra text accompanying notes 182-217 (discussing similar issues regarding the scope and duration of warranties).

255. In addition to the anti-indemnity statutes concerning oil field contracts, there may be other statutes that impact the indemnity clause. For example, Tex. Civ. Prac. & Rem. Code Ann. § 16.070 (West 1986) provides:

A person may not enter a stipulation, contract or agreement that purports to limit the time in which to bring suit on the stipulation, contract, or agreement to a period shorter than two years. A stipulation, contract or agreement that establishes a limitations period that is shorter than two years is void in this state.

This statute does not appear to restrict the parties’ ability to limit the “right” to a specified time frame, so long as the ability to bring suit to enforce the “contract” is not unduly limited. For example, indemnity rights under the contract could be limited to one year after the date of closing. This places no restriction on when suit can be brought to enforce rights created under the contract. Therefore, suit may be initiated within the appropriate contract statute of limitations, but if it relates to an indemnity claim arising after the one year period, there will be no indemnity “right” to enforce. This is no different from a situation where no indemnity is given—the right to enforce the contract remains unrestricted, but the rights created by the contract may not give any relief.
c. Evaluate any common law limitations on indemnity in the selected state.

2. Special drafting considerations:
   a. Many jurisdictions require a specific reference to environmental liabilities to encompass CERCLA, RCRA, and similar types of statutory liability.
   b. Many jurisdictions require an express reference to indemnify against the indemnitee’s sole or concurrent negligence.
   c. Express reference should be made to indemnify against the indemnitee’s common law or statutory strict liability.
   d. Express reference should be made to indemnify against the indemnitee’s civil and criminal liability associated with past, as opposed to prospective, acts.

3. What events will trigger the obligation to indemnify?
   a. Breach of a representation or warranty.
   b. Only specific conditions described in the agreement or all environmental matters?
   c. Must there be some sort of judicial or administrative determination of “liability” or will a mere claim, demand, or voluntary action to address a problem trigger the indemnity? Will a mere devaluation of the purchased property because of an environmental problem be included?
   d. Are there any restrictions with regard to the amount at issue that will trigger the indemnity obligation?

4. Define the scope of the indemnity; General Issues:

256. Until local, state, or federal governments establish workable soil and water parameters that will trigger a cleanup, or a well-defined reporting obligation, most properties will fall into the “gray area” of environmental regulation. For example, just because an elevated level of lead is detected in the soil does not mean any corrective action will be required. It depends upon a rather elaborate risk analysis that evaluates whether the lead is going to create an unacceptable risk to health or the environment. However, this determination requires input from the regulatory agency. But if the lead concentration is not the result of a “reportable event” under local, state, or federal law, it may never become known to the regulators. Is this an “environmental problem” that will trigger an obligation to indemnify? If not, could the party make it a problem by notifying the regulatory agency? What if the agency does not “order” a cleanup but “suggests” that the problem should be voluntarily remediated? How much “cleanup” is permissible when the agency fails to specify the precise remedy? Obviously the interests of the parties to the indemnity will vary on these matters and should, to the extent possible, be addressed in their agreement.

257. For example, assume the obligation to indemnify is triggered once total claims exceed $100,000. If so, once the threshold is passed must the first $100,000 be reimbursed as well? Must each individual item pass a de minimis value before it is included in determining the $100,000? For example, only single claims that exceed $10,000 might be included to determine the $100,000 aggregate. Each of these matters should be addressed in the agreement if some sort of dollar “floor” will be used to trigger the indemnity obligation. See generally Penny L. Parker & John Slavich, Contractual Efforts to Allocate the Risk of Environmental Liability: Is There a Way to Make Indemnities Worth More Than the Paper They are Written On?, 44 Sw. L.J. 1349, 1376-77 (1991).
Will the indemnity include defending against covered events?

Must the indemnified party pay out-of-pocket money and then seek reimbursement or will the indemnitor have an obligation to assume certain expenses up-front, such as defense and cleanup costs?

Will the indemnity include attorney fees, litigation costs, consultant costs to evaluate a problem, or in-house personnel expenses associated with a problem?

Will the indemnity include attorney fees and litigation costs in establishing the indemnitor's obligation to indemnify?

What are the parties' respective rights with regard to managing the defense and possible settlement of the covered event?

5. Define the scope of the indemnity; Parties, Duration, and Beneficiaries:

Who are the parties giving the indemnity? Parent and subsidiary corporations? Officers, directors, or stockholders?

How long will the indemnity obligation last? Beyond the closing? Perpetual—no limit? Defined period of time following closing? Will there be a phased reduction in liability over time?258

Who can benefit from the indemnity? Indemnitee's successors and assigns? Only the Indemnitee? Transfers to a subsidiary or parent corporation of Indemnitee? Any intended third party beneficiaries such as a lessor/surface owner?259

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258. For an example of an elaborate provision creating a "sliding scale" adjustment of liabilities through time, see 1 BNA's ENVIRONMENTAL DUE DILIGENCE GUIDE § 121.7(h)(2) at 121:42-43 (1992). The Guide explains the sliding scale approach as follows:

The concept of a "sliding" scale is founded in the equitable notion that upon first assuming ownership, the buyer by definition will have had a much briefer period of operation at the site than the seller. Consequently, the seller initially should assume the larger share of any jointly caused environmental liability. Conversely, as the years go by and the consequences of the seller's past practices become more remote (and, in many cases, environmentally less significant), and the harms caused by the ongoing activities of the buyer cumulate, it is logical that the buyer should assume more liability.

DUE DILIGENCE GUIDE, at 121:42.

259. RESTATEMENT (SECOND) OF CONTRACTS § 302 provides, in part:

(1) Unless otherwise agreed between promisor and promisee, a beneficiary of a promise is an intended beneficiary if recognition of a right to performance in the beneficiary is appropriate to effectuate the intention of the parties and either

(a) the performance of the promise will satisfy an obligation of the promisee to pay money to the beneficiary; or

(b) the circumstances indicate that the promisee intends to give the beneficiary the benefit of the promised performance.

6. Define the scope of the indemnity; Basic Obligations.

a. Any environmental problem associated with the property regardless of when it was created? Only problems associated with things done on the property during indemnitor's tenure? Problems associated with anything that occurs prior to closing, whether done by indemnitor or others?

b. Only that liability arising under the law as it exists at the time of closing? Include liability that may arise under laws to be enacted or amended in the future?

c. Limit the total amount indemnitor will be required to pay? Limit to purchase price? No limit?

d. Limit the types of damages that can be reimbursed? Include fines? Penalties? Punitive damages? Consequential damages? Voluntary cleanup?

e. Limit on indemnitee's ability to respond to environmental problems? Indemnitor right to conduct cleanup or otherwise remedy a problem before liability attaches? Conduct negotiations with governmental agencies concerning problems? Prior approval of significant expenditures?

f. Require indemnitor to pursue other remedies before indemnitee's obligations mature? Insurance coverage? Governmental cleanup funds?

g. Limit to problems that do not arise out of the intentional misconduct of the indemnitee. Include problems arising out of the sole or concurrent negligence of the indemnitee.

7. Define the scope of the indemnity; Impact on Other Remedies.

a. Is the indemnity the indemnitee's sole remedy for an environmental problem?

b. Does the indemnitee have the right to pursue remedies under other law, such as CERCLA, RCRA, and state and local law?

8. Securing Indemnity Obligations:

a. Retain a portion of the purchase price? Escrow arrangements?
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b. Letters of credit?
c. Guarantees by parent or subsidiary corporations, stockholders, or other third parties?
d. Use of other collateral owned by indemnitron to secure indemnity obligations?
e. Performance bonds?
f. Insurance? Will rights under any existing insurance policies be assigned or available to the indemnitee?

9. Reducing the Potential for Triggering Indemnity Obligations:

a. Retain right for indemnitron to enter property to inspect and address potential problems?
b. Impose restrictive covenants on activities that can be conducted on the property?

t. Retain right for indemnitron to enter property to inspect and address potential problems?

10. Procedural Rights and Limitations:

a. Notice by indemnitee to indemnitron that a covered event has occurred; time limit or prejudice standard?
b. Define procedure for making claims under the indemnity?
c. Define procedure for responding to claims under the indemnity?

Although a broad indemnity from a financially sound party can be used to leverage environmental risk, the basic goal, when possible, is to minimize or avoid the risk altogether. Environmental risks are

260. Consider the following provision:

f. Indemnity Procedure.

(1) At Purchaser's option, Purchaser may require Seller to defend any Claim covered by this Section or Purchaser may conduct its own defense. In any event, Purchaser is entitled to retain its own counsel to advise it regarding any Claim covered by this Section and all costs associated with such counsel will be a Loss covered by Seller's indemnity.

(2) When it appears to Purchaser that a Claim is being made that is covered by this Section, Purchaser will notify Seller of the Claim. However, Purchaser's failure to promptly notify Seller of the Claim, or Purchaser's failure to recognize that a Claim covered by this Section is being or has been made, will not affect Purchaser's rights, nor Seller's obligations. Upon being notified of a Claim, Seller will have 10 days from receipt of Purchaser's notice to indicate, in writing, if Seller acknowledges its obligation to indemnify Purchaser pursuant to this Section and whether Seller will indemnify or assume defense of the Claim.

(3) Without in any way reducing Seller's obligation to defend:

(a) If Seller does not acknowledge its obligation to indemnify, Purchaser can deal with the Claim in whatever fashion Purchaser, in its sole discretion, deems appropriate.

(b) If Seller acknowledges its obligation to indemnify, but refuses to defend the Claim, Purchaser can assume defense of the Claim and dispose of the Claim in whatever fashion Seller, consistent with its obligations to Purchaser under this Section, deems appropriate.

(c) If Seller acknowledges its obligation to indemnify, and agrees to defend the Claim, and Purchaser elects not to conduct its own defense, Seller will have the authority to dispose of the Claim in whatever fashion Seller, consistent with its obligations to Purchaser under this Section, deems appropriate.

(d) If Seller agrees to defend the Claim, but Purchaser elects to conduct its own defense, Purchaser must obtain the consent of Seller before any voluntary settlement of the Claim.
minimized or avoided by becoming an owner or operator of relatively "clean" properties. The search for the "clean" property begins with disclosures by the present owner in contract representations. However, the present owner may not be aware of the actual condition of the property. The owner may not have any "knowledge" that the property was used as a hazardous waste disposal site prior to its period of ownership; the particular person making the representation may not have any knowledge—or such person may not have made any inquiry to obtain knowledge.\(^\text{261}\) In any event, even if the parties can negotiate an indemnity agreement, the prospective owner or operator of the property will want to "assess" the property to ensure it is not acquiring property subject to unacceptable environmental risks.

6. Buyer Inspection and Investigation

The main goal of a buyer in inspection and investigation is to identify environmental problems before becoming an owner or operator of the property. If problems are discovered, but the buyer still desires to complete the transaction, the goal will be to have the necessary remediation conducted by the present owner instead of the buyer. In this manner, the buyer avoids becoming the generator, or the party arranging for disposal, of hazardous substances removed from the site. Identification of environmental problems can also allow the buyer to purchase only the "clean" properties and leave the problem properties with the seller.

The contract between the parties should carefully address the buyer's right to enter the property to investigate its environmental status. Such an investigation can be beneficial to both parties. The buyer's goal is to ascertain the current environmental status of the property. This allows the buyer to make an informed choice about acquiring risks of environmental liability. If the seller has no reason to expect environmental problems on the property, the investigation will also help to establish a "baseline" status for the property: if it was "clean" at the time of sale, and a problem arises in the future, the seller can argue it must have been caused by the buyer's activities. The seller, however, always runs the risk that if the buyer looks for contamination, it might be found. In that case, in addition to losing the sale, the seller may have to spend substantial sums of money to remediate the problem.\(^\text{262}\)

\(^{261}\) See supra text accompanying notes 176-77.

\(^{262}\) However, the seller should never play "hide-and-seek" with the buyer. If the seller knows, or suspects, contamination is present on the property, this should be disclosed to the buyer. Failure to do so may render the contract open for attack, constitute an independent tort, or vitiate the seller's potential "innocent seller's" defense. The innocent seller's defense would come into play when the seller had obtained the property after the contaminating activities had occurred. The seller would not be an owner or operator "at the time of disposal" nor a generator or arranger. Once it sells the property to the new buyer, the seller will no longer be a
When investigating a property, the buyer must remember that the relative value of a property has no relationship to the buyer's potential liability for environmental problems found on the property. Therefore, every property must be evaluated. The extent of the evaluation often depends upon whether there are obvious problems associated with the property and the scope and value of any indemnity that might be available. To the extent the seller refuses to give a broad indemnity, or lacks the assets to perform under an indemnity, the pre-closing detection of latent environmental problems becomes more important.

The seller's representations should help to identify the obvious problems of which the seller is aware. However, if the seller has owned the property for a relatively short period of time, it may have no more knowledge of prior activities on the property than the buyer. The initial environmental assessment of the property should identify its prior uses and help determine the likelihood that contaminating activities took place at or near the property. This information, along with a visual inspection of the property, can then be used to determine whether a higher degree of investigation should be pursued. Subsequent investigation may include sampling and testing the soil, subsoil, surface water, water runoff, and ground water.

Not only does a pre-acquisition inspection identify contaminated properties, it also qualifies the buyer for the so-called “innocent purchaser” defense under CERCLA. The innocent purchaser defense can provide protection in situations where the buyer pursued all “appropriate” environmental investigation prior to acquiring title but contamination not revealed in that investigation is subsequently discovered. However, a threshold requirement is that there has been no “disposal” of a hazardous substance on the property since the

"current" owner or operator of the property. Therefore, absent some misdeed on the seller's behalf, it will not be a liable party under CERCLA. However, CERCLA § 101(35)(C) takes away the seller's favored status when the seller "obtained actual knowledge of the release or threatened release" while owning the property and "subsequently transferred ownership of the property to another person without disclosing such knowledge." If the seller fails to make the required disclosure, it will be treated as a current owner or operator of the facility and will be denied the opportunity to raise § 107(b)(3) defenses to liability. See supra text accompanying notes 22-28.

263. For a detailed discussion of the environmental assessment process, see 1 BNA'S ENVIRONMENTAL DUE DILIGENCE GUIDE §§ 111.1 to 111.95 (1992).
264. The “visual” inspection would include a physical on-site viewing of the property in its current state as well as viewing any available aerial and other photographs of the property and surrounding properties.
265. See generally 1 BNA'S ENVIRONMENTAL DUE DILIGENCE GUIDE §§ 111.1 to 111.95 (1992).
266. The unstated premise for the innocent purchaser defense is that a hazardous substance problem associated with the property was not disclosed during a pre-acquisition investigation. The focus will then shift to evaluating the investigation to determine whether it was thorough enough ("appropriate"), in light of the facts available at the time of the investigation.
owner asserting the defense took title. Some courts have broadly defined the term “disposal” to include “passive” disposal through continuous leaking or leaching of hazardous substances into the property. Such a broad definition would eliminate the innocent purchaser defense whenever passive disposal continues after the property is purchased.

Assuming the buyer can establish that all “disposal” took place before it took title, the buyer must also prove that at the time it acquired title it “did not know and had no reason to know” that any hazardous substance, “which is the subject of the release or threatened release”, was disposed of on the property. To satisfy the “no reason to know” standard, the buyer: “[M]ust 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.” The environmental investigation should always be designed to meet or exceed this “appropriate inquiry” standard so that the buyer will have a basis to rely on the innocent purchaser defense, if necessary. However, the overriding goal of the environmental investigation should be to detect any problems prior to purchase so that reliance on the defense is unnecessary.

The most important aspect of a pre-purchase investigation is the buyer's option to walk away from the deal in the event contamination is found, or if the seller is unable or unwilling to remedy the environmental problem. The conditions that will allow the buyer to avoid

267. CERCLA § 101(35)(A), 42 U.S.C. § 9601(35)(A) (1988), provides that the defense is not available: “unless the real property on which the facility concerned is located was acquired by the defendant after the disposal or placement of the hazardous substance on, in, or at the facility . . . .”

268. Compare Nurad, Inc. v. William E. Hooper & Sons Co., 966 F.2d 837, 846 (4th Cir. 1992) (Section 107(a)(2) imposes liability “not only for active involvement in the ‘dumping’ or ‘placing’ of hazardous waste at the facility, but for ownership of the facility at the time that hazardous waste was ‘spilling’ or ‘leaking.’”) with In Re Diamond REO Trucks, Inc., 115 B.R. 559, 559 (Bankr. W.D. Mich. 1990) (“[O]wnership of hazardous waste site during period of time when migration or leaching may have taken place, without any active disposal activities, is not ‘disposal’ subjecting owner to liability under CERCLA . . . .”). See also United States v. Waste Industries, Inc., 734 F.2d 159, 164 (4th Cir. 1984) (“disposal” includes passive occurrences); Ecodyne Corp. v. Shah, 718 F. Supp. 1454, 1457 (N.D. Cal. 1989) (“disposal” requires active conduct).

269. CERCLA § 101(35)(B), 42 U.S.C. § 9601(35)(B) (1988). This section further defines the nature of the required inquiry, stating:

For purposes of the preceding sentence the court shall take into account any specialized knowledge or experience on the part of the defendant, the relationship of the purchase price to the value of the property if uncontaminated, commonly known or reasonably ascertainable information about the property, the obviousness of the presence or likely presence of contamination at the property, and the ability to detect such contamination by appropriate inspection.

270. Since there are no established standards as to what inquiry is “appropriate,” the goal should be to conduct the level of investigation warranted by the reasonably ascertainable facts concerning the property in an effort to detect potential environmental problems. This will generally be a “phased” process which progresses as the available information indicates higher degrees of inquiry are warranted.
closing should be clearly stated in the contract. For example, the fol­
lowing negotiated provision gives the buyer substantial latitude in de­
termining whether the property is environmentally acceptable:

c. Environmental Problems Discovered Prior to Closing.

(1) In the event Buyer discovers, or Seller discloses, an envi­
ronmental problem associated with the property, Buyer is given the
option to terminate this Agreement at which time Buyer's Earnest
Money will be returned, Buyer will be reimbursed as provided in
subsection b.(4) [environmental assessment costs], and the parties
will have no further obligations to each other, except as provided in
subsection d. [seller's indemnity of buyer].

(2) Instead of terminating this Agreement, Buyer, at its op­
tion, may give Seller an agreed upon period of time to eliminate the
environmental problem(s) at Seller's expense. If Seller elects, at its
option, not to eliminate an environmental problem, Seller may ter­
minate this Agreement at which time Buyer's Earnest Money will
be returned, Buyer will be reimbursed as provided in subsection
b.(4) [environmental assessment costs], and the parties will have no
further obligations to each other, except as provided in subsection
d. [seller's indemnity of buyer].

(3) Buyer may rely upon its environmental consultants in de­
termining whether an environmental problem exists and whether
the problem has been eliminated. If Buyer, in good faith, deter­
mines that an environmental problem exists, or that it has not been
eliminated, Buyer can exercise its option to terminate pursuant to
subsection c.(1).

From the seller's perspective, the "environmental problem" trigger
may be too broad a basis for letting a buyer avoid the contract. The
seller may want to tie the trigger to a "release or threatened release of
a CERCLA hazardous substance," or a "reportable" occurrence or
some other event that represents material risk to the buyer.

One or both parties may want to draft the contract so that the
other remains bound under specified circumstances even though an
environmental problem is discovered. In the foregoing example, the
buyer can terminate by declaring a problem exists; but the seller can
also terminate by declining to address the problem. The parties may
instead prefer to define varying cleanup cost levels at which either can
bail out of the contract. For example, instead of giving the buyer the
option to terminate the contract upon discovery of an environmental
problem, the buyer may be required to pay for the first $100,000 of
cleanup costs with the seller bound to pick up anything over that but
not to exceed $500,000. The major weakness with this approach is
obtaining accurate estimates of what it will cost to conduct a cleanup
and what happens where cleanup activities reveal new problems that were not accounted for in the initial cost estimates.  

7. Opinions of Counsel

One commentator has concluded:

[F]ormal legal and engineering opinions on environmental matters in business transactions are expensive and time consuming, are of very narrow and incomplete scope, and may be given far greater weight and significance by an uneducated client than their narrow scope would warrant. In short, they are normally more trouble than they are worth.

The problem is that an attorney may have to extensively qualify any opinion offered with regard to the status of permits, compliance with environmental laws, or the nature and scope of environmental liabilities associated with a property. The relevant information concerning permits, compliance, and liabilities can be more efficiently obtained through the environmental assessment process without forcing an attorney to certify that a liability does or does not exist.

With these limitations in mind, an opinion of counsel may be useful in addressing matters that attorney opinions are often used to certify. For example, if the seller insists upon the buyer accepting an indemnity to deal with potential environmental liabilities, the buyer may require that an opinion of counsel be provided by seller, addressed to buyer and buyer's lender, opining on the enforceability of the indemnity and any letter of credit or other device used to backup the indemnity. This may be in the format of a "Remedies Opinion" under the "Legal Opinion Accord" of the American Bar Association's Section of Business Law. The Remedies Opinion under the Accord addresses the following matters: "(i) [A] contract has been formed; (ii) a remedy will be available with respect to each agreement of the Client in the contract or such agreement will otherwise be given effect; and (iii) any remedy expressly provided for in the contract will be given effect as stated; . . . ."


272. 1 BNA's ENVIRONMENTAL DUE DILIGENCE GUIDE § 121.2(e) at 121:8 (1992).

273. The commentator in BNA's Environmental Due Diligence Guide noted:

As soon as a formal opinion is requested, both the lawyer and the engineer are likely to adopt the posture of one asked to guarantee the matter on which the opinion is given. At that point, costs increase radically since no lawyer or engineer will be willing to stake the future of his enterprise on an opinion as to any aspect of complex and rapidly evolving environmental laws unless the opinion is extremely carefully structured, well-documented, and tied to factual predicates established by others.

1 BNA's ENVIRONMENTAL DUE DILIGENCE GUIDE § 121.2(e), 121:8 (1992).

However, under the Accord, an opinion about the effectiveness of a choice-of-law clause and environmental liability should be expressly requested to avoid the operation of various "Qualifications" that may apply when the opinion is made subject to the Accord.\textsuperscript{275} The beneficiaries of the opinion should also be defined to ensure that a party's lenders will be entitled to rely on the opinion.\textsuperscript{276}

IV. RESTRUCTURING TRANSACTIONS TO ADDRESS ENVIRONMENTAL RISKS

A. Mineral and Royalty Conveyances

Although "owner" or "operator" status plays a major role under the CERCLA liability regime, the statute defines "owner or operator" to mean, in the case of a facility, "any person owning or operating such facility."\textsuperscript{277} Courts have concluded, from this non-definition, that Congress intended the terms to be given their "ordinary" meaning.\textsuperscript{278} In addition, courts will "generally resolve ambiguities in CERCLA's language in favor of imposing the most expansive liability . . . ."\textsuperscript{279} In most cases this will result in a broad, inclusive interpretation of the terms "owner" and "operator."

Therefore, in most situations, particularly in the oil and gas context, there will be the potential for multiple CERCLA "owners."\textsuperscript{280} "Owner" under CERCLA will not be limited to those with a fee simple absolute in property.\textsuperscript{281} Instead, any person holding one of the "sticks" in the "bundle" of property rights could attain the CERCLA status of the owner. At a minimum, the "stick" will probably have to give the holder some right of control over the facility involved.\textsuperscript{282}
However, the right need not be exclusive, nor must it necessarily entail control over the disposal activity creating the problem. For example, the owner of a pipeline easement has the right to use the burdened land but so does the surface owner and its licensees—so long as their use does not interfere with the pipeline’s rights. Although the grantor of the easement may not be able to build permanent structures over the easement, it might be able to authorize the storage of drums filled with hazardous waste in or near the easement boundaries. Even though the easement owner may lack the author-

283. For example, in Pennsylvania v. Union Gas Co., 491 U.S. 1 (1989), the Environmental Protection Agency (EPA) was seeking recovery of cleanup costs from Union Gas due to a release of coal tar associated with the past operation of a coal gasification plant. Union Gas’ predecessor had operated the plant from the late 1800s to 1950 when the plant was dismantled. In 1980 the Commonwealth of Pennsylvania obtained an easement covering part of the property and while excavating on the easement struck a deposit of coal tar which began to seep into nearby Brodhead Creek. The EPA sued Union Gas to recover over $700,000 in cleanup costs. Union Gas filed a third-party claim against the Commonwealth asserting it was liable for a portion of the costs: “[B]ecause it was an ‘owner or operator’ of the hazardous-waste site, 42 U.S.C. § 9607(a) and because its flood-control efforts had negligently caused or contributed to the release of the coal tar into the creek.” Pennsylvania, 109 S. Ct. at 2277. Although the Supreme Court held that Union Gas could sue the State of Pennsylvania, the Court did not address the merits of Union Gas’ “owner or operator” or “negligence” theories.

However, in a subsequent proceeding in United States v. Union Gas Co., No. CIV-83-2456, 1992 U.S. Dist. LEXIS 14834, 35 ENV’T REP. CAS. (BNA) 1750 (E.D. Pa. 1992), the court held the Commonwealth of Pennsylvania liable as an “owner” of the streambed associated with the release and as an “operator” because of its easement rights associated with the facility and the release. The court stated:

Pennsylvania has been an operator at the Site since 1960, when it rechanneled the Creek, and subsequently, when it repaired the levee in 1980. Pennsylvania is also an operator of the site by virtue of its acquisition of the perpetual right of entry over the lands adjoining the Creek on March 14, 1960 and the acquisition of a permanent easement over these lands on March 7, 1980. Since March of 1980 Pennsylvania has essentially exercised complete control and authority over the permanent easement area at the Site and formally inspects this area on an annual basis. . . . Moreover, Pennsylvania’s control over the Site extends to the ground underneath the surface.


285. See generally Magnolia Pipeline Co. v. McCarter, 52 S.W.2d 666 (Tex. Civ. App. 1932) (owner of land subject to easement can use the land in any manner that does not interfere with easement owner’s reasonable enjoyment of its easement rights); Street v. Sinclair Pipeline Co., 386 S.W.2d 350 (Tex. Civ. App. 1965); Kelsay v. Lone Star Gas Co., 296 S.W. 954 (Tex. Civ. App. 1927). Often this relationship is expressed in the easement itself. For example, in Mid-America Pipeline Co. v. Wietharn, 787 P.2d 716 (Kan. 1990), the easement stated:

It is agreed that the pipeline or pipelines to be laid under this grant shall be constructed at sufficient depth below the surface of the ground to permit normal cultivation, and Grantor shall have the right to fully use and enjoy the above described premises, subject to the rights herein granted.

Grantee shall have the right to clear and keep clear all trees, undergrowth and other obstructions from the herein granted right of way, and Grantor agrees not to build, construct or create, nor permit others to build, construct or create any buildings or other structures on the herein granted right of way that will interfere with the normal operation and maintenance of the said line or lines.

Mid-America Pipeline, 787 P.2d at 718 (emphasis added).

286. The issue would then be whether the drum storage activity would, under the terms of the express easement, “create any . . . structures . . . that will interfere with the normal operation and maintenance of the said line or lines.” See generally Mid-America Pipeline v. Lario Enter-
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ity to use the surface of the property for the storage of hazardous wastes, it nevertheless can be an “owner” of the land encompassed by the easement.287

1. Mineral and Surface Interests

The mineral interest owner typically has an express or implied right to make reasonable use of the surface of land to explore for, develop, produce, and market the granted minerals.288 The “surface” owner289 retains the balance of rights in the property and can also use the surface—so long as its use does not interfere with the mineral interest owner’s rights.290 Operations conducted under the mineral interest owner’s implied easement can give rise to potential CERCLA liability for the surface owner.291

The risk to the surface owner is demonstrated by the court’s ruling in Quaker State Corp. v. United States Coast Guard292 where the surface owner was held to be an “owner” under § 311 of the Clean Water Act and therefore responsible for cleanup of an oil containment pit.293 Use of the pit by a previous lessee ceased in 1968,294

prises, 942 F.2d 1519, 1525 (10th Cir. 1991) (racetrack created a material interference with pipeline company’s “reasonable enjoyment of the easement”); Mid-America Pipeline, 787 P.2d at 720-21 (1990) (farm buildings created a material interference with pipeline company’s “reasonable enjoyment of the easement”). The owner of the pipeline easement should be able to argue that even temporary storage of hazardous substances on the easement could constitute a material interference with its easement rights. However, the pipeline company should not leave such matters for interpretation. The document creating the easement should restrict the storage, treatment, use, or disposal of wastes or hazardous substances on the easement area, and lands adjacent to the easement area.

287. One court has indicated that the critical issue is whether the person has any authority to control the area (“facility”) where the hazardous substances are located. Nurad, Inc. v. William E. Hooper & Sons Co., 966 F.2d 837, 842-43 (4th Cir. 1992).


289. In many cases the surface owner will also have title to certain minerals that were not encompassed by the grant or reservation creating the mineral interest. For example, if A grants to B “all the oil, gas, and similar hydrocarbon substances” in Section 30, A will retain the surface rights in Section 30 plus all minerals not encompassed by the grant to B of oil and gas. However, A’s surface rights will be subject to B’s easement to make reasonable use of the surface to effectively exercise its oil and gas rights.

290. 1 HOWARD R. WILLIAMS & CHARLES J. MEYERS, OIL AND GAS LAW § 218.6,210 to 212 (1992).

291. For example, if the “facility” is an abandoned pit used in conjunction with oil and gas operations, the “owners” of the pit may include the surface owner, mineral owner, and the mineral owner’s oil and gas lessee. Since the pit is not presently being used by the mineral owner, the surface owner would be the current “owner” of the pit. However, at the time of disposal, the “owner” of the pit would arguably include the mineral interest owner and its lessee. Similarly, while the pit was being used in conjunction with oil and gas operations, the pit would be “owned” by the mineral interest owners and their lessees.


294. The court noted that “there is no evidence here that Quaker State ever used this pit.” Quaker State Corp. v. United States Coast Guard, 681 F. Supp. 280, 283 (W.D. Pa. 1988).
Quaker States' oil and gas lease expired in 1975. In 1977, at the direction of the surface owner, Quaker State "covered the pit by bulldozing earth over it, compacting and seeding it" and subsequently abandoned its operations in 1978. In 1985, representatives of the Coast Guard and the EPA observed an oil sheen on water in a creek near the oil containment pit. The Coast Guard spent $430,000 to clean up the pit and abate the release.

The court held the owner of the surface, at the time the discharge was discovered, was the "owner or operator" liable for cleanup costs under CWA § 311(f). Therefore, the surface owner of the land where the pit was located, was the "owner" of the pit under § 311 of the Clean Water Act. The court also concluded that the mineral interest owner would not be the current owner "[b]ecause the allegedly offending pit is manmade and at or near the surface . . ." In a subsequent proceeding the court held that Quaker State could not be held liable under CWA § 311(g) as a "third party" that caused the discharge by its "act or omission" because the Coast Guard could not prove that the discharge was caused "solely by an act or omission of Quaker State." However, CWA § 311(h) can provide an opportunity for the owner or operator of the facility, and the United States Government, to pursue other remedies they may have against "any third party whose acts may in any way have caused or contributed to such discharge . . . ." Under a § 311(h) analysis, Quaker State, its

295. At all relevant times the surface of this property was owned by the U.S. Forest Service. Id. at 284.
296. Id. at 283.
297. Id. at 281.
298. Id. at 285. The court justified its holding stating:
If the Government must bear the cost of cleanup, there must be a ready pocket for reimbursement. It is the owner or operator at the time the spill is first discovered who has control of the site and the source of discharge. He is readily identifiable. He is most likely to be in position to halt the discharge, to effect an immediate cleanup, or to prevent a discharge in the first place. If the onus of cleanup falls on the Government, he is the clearest and most expeditious source for reimbursement.

300. Quaker State, 681 F. Supp. at 286 n.3.
302. CWA § 311(h), 33 U.S.C. § 1321(h) (1988) (emphasis added). Section 311(h) provides:
The liabilities established by this section shall in no way affect any rights which (1) the owner or operator of a vessel or of an onshore facility or an offshore facility may have against any third party whose acts may in any way have caused or contributed to such discharge, or (2) the United States Government may have against any third party whose actions may in any way have caused or contributed to the discharge of oil or hazardous substance.
assignors, and the mineral interest owners, would all have some exposure to liability.303

Mining wastes left on the surface of real estate are generally viewed as belonging to the owner of the surface. This is especially true when mining operations have ceased. For example, in Kerr v. Australia Pac. Resource, Ltd.,304 the court held that tailings placed on the surface of property as waste "are deemed to become annexed to the real estate over time."305 The surface owner could therefore be considered the "owner" of the waste material and liable for its management and cleanup.

The surface owner's actions can also impact the liability of the mineral interest owner. If pits are being used by the mineral interest owner, the mineral interest owner, and its lessee, will be CERCLA owners of the pits.306 If the surface owner uses the pits for the disposal of hazardous substances, or they become the local community's illegal disposal site, the mineral interest owner, and its lessee, can become owners of a CERCLA facility even if the mineral interest owner's use of the pit was environmentally sound.

The mineral interest owner, and its lessees, are less likely to be liable when the area has not been used for mineral development. If the surface owner, or third parties, deposit hazardous substances on an area that has not been used for mineral development, the mineral owner, and its lessees, could argue they have no interest in the contaminated area, and therefore no liability. The mineral developer's easement is generally limited to mineral development activities. Since

303. In the latest Quaker State opinion, the court observed: "The likelihood of some responsibility for the discharge resting with the previous owners and operators of the containment pit site is overwhelming. Forest Oil Corporation, Niagra Oil Corporation and Kendall Refining Company all came within this ambit of previous owners and operators." Quaker State Corp. v. United States Coast Guard, 32 Env't Rep. Cas. (BNA) 1623, 1627 (W.D. Pa. 1990) (Forest and Niagra assigned oil and gas leases to Quaker State in 1944 and Kendall owned the mineral interest since 1965; Quaker State owned oil and gas leases on the property from 1944 through 1975).


305. Kerr v. Australia Pacific Resources, Ltd., 841 P.2d 401, 403 (Colo. App. 1992) (court denies real estate commission to unlicensed agent because sale of property with gold mining tailings was a sale of "real estate").

306. The ownership issue will most likely be resolved by considering the authority of each party to control activities at the CERCLA facility. See generally Nurad, Inc. v. William E. Hooper & Sons Co., 966 F.2d 837, 842-43 (4th Cir. 1992) cert. denied, 113 S. Ct. 377 (1992). For example, prior to leasing the mineral interest, the mineral interest owner has the authority to use the surface to conduct operations. The mineral interest owner, through its contractor (the oil and gas lessee), selects a drill site and creates a pit which is used in conjunction with its lessee's oil and gas operations. The lessee and the mineral interest owner (through its lessee) each have the authority to control use of the land where the pit and wellsites are located, to pursue mineral development. The surface owner has a concurrent right to use the land where the pit and wellsites are located, so long as it does not interfere with mineral operations. Once mineral operations cease, the surface owner will again have total control over the area; subject to the mineral interest owner's right to use the site at a later date to support mineral operations. Therefore, there are three parties that have varying degrees of "authority to control" the facility at varying times.

All three would appear to be candidates for CERCLA owner status. See generally Thomas F. Cope, Environmental Liabilities of Non-Operating Parties, 37 ROCKY MTN. MIN. L. INST. 1-1, 1-28 (1991).
no mineral development operations have been conducted on the site at issue, the mineral interest owner and its lessees would have no express or implied right to make use of the site. If there is no present right to use the surface of the site, there is no present ownership interest in the surface of the site.

A more difficult issue is presented when there have been multiple lessees operating a property which consists of active and inactive wells and operation sites. If a lease currently exists on the property, the surface owner will argue, for environmental liability purposes, that the mineral interest owner and its lessee “own” all inactive wells and operation sites located on the property—regardless of their age or use by the current lessee. For example, in *Santa Fe Minerals v. Sanford*, the current lessee was held to be the “owner” of a well bore and pipe located on the leased land, even though the well bore had not been used for many years. The lease was being maintained by production from other wells in the Apache Bromide Sand Unit. Holding that the lessee had the right to rework the well bore, the court noted:

The Sanfords claim that whether the Unit operators intended to relinquish their rights to the Well was a question of fact. We disagree. Here, the lease covering the Sanfords’ land was, and is in full force. The Sanfords have cited no cases, and we know of none, holding that a lessee had lost its rights to a well bore and its associated mechanisms *while a lease was in force*. In every case we have found in which a land owner was held to have title to a well bore, the lease had terminated . . . . That the lease covering the Well is still in force ends the inquiry.

To protect their rights, the surface owner and the mineral owner should police activities of other interest owners that may impact their ownership interests. For example, the surface owner might have a basis to object if the mineral interest owner, its lessee, or its drilling contractor, throw hazardous substances into drilling pits. The surface owner would argue this is not “reasonable use” and therefore exceeds the mineral interest owner’s implied easement rights. In light of the surface owner’s potential CERCLA liability, a court would likely side with the surface owner to prevent the on-site disposal of hazardous substances.

As operations progress, and operating areas are created, the mineral interest owner will want to ensure the surface owner, and third parties, do not use the operating areas for waste disposal. The mineral interest owner would argue that the surface owner’s disposal activities constitute a material interference with the mineral interest owner’s

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309. This would include wastes that may otherwise be classified as “exempt” under RCRA. *See supra* text accompanying notes 67-72.
implied right to make reasonable use of the surface to support mining operations.

When transferring any rights in the property, each party should consider how its environmental ownership risks can be magnified by the rights being granted to the other party. The terms of the mineral deed, or a contract properly referenced in the deed, should carefully define the surface easement rights of the mineral interest grantee. Matters that should be addressed in the mineral deed include the following:

1. Restrictions or limitations of the use of surface and subsurface water found on the property.

2. Limitations or prohibitions of development activities on the property that are likely to create environmental liabilities.
   (a) Restrictions or prohibitions of the use of pits to support drilling, reworking, or production operations.
   (b) Requirements for prompt cleanup and reclamation of all drill sites.

310. One major oil company attempts to include the following paragraph in its deeds when granting a mineral interest or other real property interest:

[Grantors disclaim all representations and warranties, whether express, implied, or statutory concerning the property described herein. Grantee acknowledges and agrees that the property described herein is conveyed, and accepted by Grantee, in an "as is" condition with all faults. Grantee has investigated and has knowledge of operative and proposed governmental laws and regulations (including, but not limited to, zoning, environmental, and land use laws and regulations) to which the Property is or may be subject and accepts the Property upon the basis of its review and determination of the applicability and effect of such laws and regulations. Grantee acknowledges that it is accepting this conveyance on the basis of Grantee's own investigation of the physical and environmental conditions of the Property, including its subsurface conditions. Grantee assumes the risk that adverse physical and environmental conditions may not have been revealed by its own investigation and agrees to indemnify and hold Grantors harmless against any claims, actions, causes of actions, demands, rights, costs, expenses or compensation whatsoever, direct or indirect, known or unknown, foreseen or unforeseen, arising out of the current or prior physical and environmental condition of the Property. Grantee further acknowledges that Grantors, their agents and employees and other persons acting on behalf of Grantors have made no representation or warranty of any kind in connection with any matter relating to the condition, value, fitness, use or zoning of the Property upon which Grantee has relied directly or indirectly for any purpose. Grantee hereby waives and releases Grantors, of and from any claims, actions, causes of actions, demands, rights, damages, costs, expenses or compensation whatsoever, direct or indirect, known or unknown, foreseen or unforeseen, which Grantee now has or which may arise in the future on account of or in any way growing out of or connected with the physical or environmental condition of the Property or any law or regulation applicable to it, including but not limited to the Comprehensive Environmental Response, Compensation and Liability Act, 42 U.S.C. Section 9601 et seq.]

311. This can be done even in cases where there is an existing oil and gas lease covering the property. However, to the extent the terms of the subsequent mineral deed are more restrictive than the rights granted under the lease, the terms of the lease will control. Once the lease terminates, however, the limitations contained in the mineral deed will limit the rights of subsequent lessees.
(c) Restrictions or prohibitions of the placement of oil storage tanks on the property.

(d) Restrictions or prohibitions of the placement of other production-related equipment on the property such as separators, heater-treaters, dehydrators, compressors, processing equipment, and similar equipment not required to bring production to the surface.

(e) Restrictions or prohibitions of the placement of any injection or disposal well on the property.

(f) Prohibitions of the placement, disposal, or discharge of any waste material on the property, or on adjacent lands that may impact the property.

(g) Prohibition of the storage of pipe, chemicals, equipment, or other material on the property that is not for immediate use.

(h) Removal of all development structures and equipment and clean up and reclamation of any production site within sixty days following the cessation of production operations associated with the site.

(i) Rigorous specifications for any flow lines, gathering lines, and other pipeline facilities associated with a well.

3. Managing risks associated with development activities that take place on the property.

(a) Requirement that mineral grantee assume all liability associated with any exploration, development, or production operations on the property.

(b) Requirement that mineral grantee indemnify grantor against any liability or loss the grantor may suffer due to any exploration, development, or production operations on the property.

(c) Requirement that, prior to any exploration or development activity, require that a bond be posted, by the mineral grantee or their lessee, for a specified amount that is adequate to secure the proper plugging of wells and the cleanup and reclamation of exploration, development, and production operation sites on the property.

(d) Making any assumption of liability, and the obligation to indemnify, binding upon all of the mineral grantee's successors and assigns of any interest in the mineral estate—to include an oil and gas lessee.
(e) Avoiding the use of defeasible term mineral interests which result in an automatic reversion of the interest to the grantor; if there is a desire to terminate the interest upon the occurrence of a certain condition, consider using a fee simple subject to a condition subsequent with a power of termination.

4. Managing risks associated with previous development activities on the property.

(a) Requirements that mineral grantee, upon accepting their grant, assume all liability associated with any past exploration, development, or production operations on the property.

(b) Evaluation of the environmental status of the property at the time the mineral interest is conveyed to identify a baseline for defining future contributions to environmental liabilities.

To properly articulate these concerns, and incorporate them into the conveyance document, the attorney will need to select the appropriate mix of conditions, covenants, allocations of liability, and indemnities. For example, assume Doc Hillard is the owner of the property in fee simple absolute and he desires to convey the oil, gas, and similar hydrocarbon substances to Acme Oil Company. However, if Acme fails to comply with various financing requirements specified in the deed, Doc wants the mineral interest to revert back to Doc. Doc should be advised that he does not want an automatic reversion but instead an option to terminate the interest. This will give Doc an opportunity to evaluate whether it would be better to maintain Acme’s ownership status instead of terminating Acme’s interest. Doc should also be advised to include various covenants in the deed that restrict what Acme can do on the property being conveyed. The conveyance should also include a clear statement allocating environmental risks and provide for indemnity.

The general structure of the deed might incorporate the following format:

Mineral Deed
(the “conveyance”)

Doc Hillard, a single person (“Doc”), for valuable consideration and subject to the terms and conditions contained in this Mineral Deed, grants and conveys to Acme Oil Company (“Acme”):

All the oil, gas, and similar hydrocarbon substances (excluding any gas and similar hydrocarbon substances produced from coal seams) in and under Section 30, Township 36 South, Range 10 East, in Eureka County, Texas (the “Conveyed Property”),

but on condition that Acme will pay to Doc, on or before the 10th day of January of each year, the sum of $5,000. In the event Acme fails to comply with this condition, Doc is given the power, at Doc’s option, to re-enter the Conveyed Property and terminate Acme’s
estate. Doc's power of termination can be exercised by providing Acme with written notice stating the required payment was not made pursuant to the condition and that Acme's interest has terminated.\textsuperscript{312}

For purposes of this conveyance, the phrase "area encompassed by the Conveyed Property" includes the surface and subsurface areas encompassed by the legal description defining the surface boundaries of the Conveyed Property.

This conveyance is made subject to the following terms:

1. No warranty. Doc is conveying only such right or title Doc may have in the Conveyed Property. Doc makes this conveyance without any warranty, express, implied, or statutory; Acme accepts the Conveyed Property as is, with all faults.

2. Exceptions to the Grant. There is excepted from this conveyance, and reserved to Doc, the following property interests:
   a. Doc's Surface Use—General. Doc retains the right to construct any structure or improvement, at any location selected by Doc, anywhere on or in the area encompassed by the Conveyed Property. The rights granted by this conveyance will not restrict in any manner Doc's ability to use the surface of the Conveyed Property. Any activities by Acme must accommodate fully Doc's use of the area encompassed by the Conveyed Property, even though such uses are not commenced until some future date after the effective date of this conveyance.\textsuperscript{313}
   b. Doc's Surface Use—Agriculture. Doc reserves the right to raise livestock and to initiate or continue irrigation and other agricultural activities on the area encompassed by the Conveyed Property. If Doc is currently using, or elects in the future to use, all or any part of the area encompassed by the Conveyed Property to raise livestock, Acme will construct the necessary fence gates and cattle guards, and fence all drill sites and other drilling or production facilities on the Conveyed Property, and otherwise adjust its operations to accommodate Doc's use of the Conveyed Property for raising livestock. If Doc decides to conduct agricultural activities on the area encompassed by the Conveyed Property, to include irrigation and recognized soil conservation practices, Acme will adjust its operations to accommodate Doc's agricultural use of the Conveyed Property.
   c. Surface and Subsurface Use—Mining. Doc reserves the right to use the surface and subsurface rights associated with the Conveyed Property as may be reasonably necessary to explore for, extract, and market minerals (other than minerals conveyed to Acme by this conveyance) from the area encompassed by the Conveyed Property.
   d. Water. Doc reserves the right to all water found on or in the area encompassed by the Conveyed Property except for Pro-

\textsuperscript{312} This clause is included merely to demonstrate how a fee simple subject to a condition subsequent can be used instead of a fee simple determinable. For a helpful guide to drafting a fee simple subject to condition subsequent, see RESTATEMENT OF PROPERTY § 44 (1936).

\textsuperscript{313} Since the mineral conveyance creates an implied right to make reasonable use of the surface for mineral development, the grantor should consider excepting from the conveyance those surface rights which it may want to retain. This would include any activity by the grantor that may interfere with the grantee's implied easement rights.
duced Water. "Produced Water" means any water that is necessar­
ily produced in conjunction with the prudent production of minerals
conveyed to Acme by this conveyance. Title to Produced Water will
be in Acme when removed from the oil or gas producing strata.

[additional exceptions to the grant]

3. Restrictive Covenants. Acme promises to comply with the
following restrictions concerning the Conveyed Property, which
shall be deemed covenants that run with the Conveyed Property:
   a. Pits. No pits, ponds, or other surface impoundments will
      be used in developing or operating the Conveyed Property.314
   b. Production-Related Equipment and Storage Tanks. No
      above ground or underground storage tanks will be placed on the
      area encompassed by the Conveyed Property. No equipment
      designed to separate, treat, dehydrate, compress, or process the
      Conveyed Property will be placed on the area encompassed by the
      Conveyed Property.315
   c. Injection and Waste Disposal. No injection or disposal well
      will be placed on the area encompassed by the Conveyed Property.
      No solid, liquid, or gaseous waste will be stored or disposed of on
      the area encompassed by the Conveyed Property.
   d. Hazardous Substances. No substance, defined as a "haz­
      ardous substance" (now or in the future) under the federal Compre­
      hensive Environmental Response, Compensation and Liability Act
      ("CERCLA"), the Texas statutory counterpart to CERCLA, and
      any amendments or substitutions for CERCLA and its Texas coun­
      terpart, will be brought onto the area encompassed by the Con­
      veeyed Property.316
   e. Storage of Equipment or Material. No pipe, chemicals, or
      other material or equipment will be placed on the area encom­
      passed by the Conveyed Property except items that are on-site for
      immediate use in operations. Equipment or material placed on site
      for longer than five consecutive days will be deemed not to be for
      immediate use in operations.
   f. Restore Development and Production Areas. Within five
days after a development or production operation is completed, all
the associated development structures, equipment, and any other
material brought to or generated at the site will be removed from
the site. If any topsoil has been disturbed by the operation, the area

314. Prohibiting the use of pits may be objectionable to the grantee. In such cases, the attor­
ney may try to specify pit construction and lining parameters, or simply require compliance with
the strictest level of protection required by state law. For example:
   Any pits, ponds, or other surface impoundments used in connection with the develop­
ment or operation of the Conveyed Property shall comply with all applicable local,
state, and federal standards and in any case shall meet or exceed the standards for such
structures located within a wellhead protection area as defined by the federal Safe
Drinking Water Act or any state law counterpart.
315. If this is objected to by the grantee, the next step would be to identify the activities that
are essential for location on site and then specify how those activities will be managed to mini­
imize environmental concerns. There may also be new environmental risks created by a restric­
tion. For example, if the grantee cannot locate oil storage tanks and treatment equipment near
the well, it will have to transport production, by pipeline, off-site for treatment and storage. The
pipeline would then present a risk that may require attention in the conveyance.
316. This may be unworkable since many commercial products that are brought to the drill
site are "hazardous."
will be graded to its original contour, and the topsoil replaced, properly seeded, fertilized, and maintained until the original cover in the affected area is re-established.

g. Set-Back Requirements. No equipment, material, or operation site will be located within 300 feet of any house, garage, barn, stream, creek, pond, lake, or other structure, improvement, or water source located on the area encompassed by the Conveyed Property.

[additional covenants]

Acme acknowledges that Doc may, in addition to damages and any other remedy at law or equity, obtain injunctive relief to enforce the covenants specified in this conveyance.

4. Acme's Assumption of Liability. Acme assumes the following liabilities associated with the Conveyed Property:

a. Condition of the Area Encompassed by the Conveyed Property. Acme acknowledges that it is purchasing the Conveyed Property without relying on any representations by Doc concerning the condition, environmental or otherwise, of the Conveyed Property or the area encompassed by the Conveyed Property. Instead, Acme is relying solely upon its independent investigation to determine the status of the Conveyed Property and the area encompassed by the Conveyed Property. As partial consideration for this conveyance, Acme agrees to assume all liabilities it may incur as an owner or operator of the Conveyed Property and the area encompassed by the Conveyed Property, including any environmental cleanup obligations that may be imposed under any local, state, or federal law, including the common law. Acme further agrees to hold Doc harmless from any claim Acme may have or acquire, in contribution or otherwise, associated with the condition of the property or Acme's liability as an owner or operator. This includes, without limitation, any claim or cause of action Acme may have at common law or under any local, state, or federal statute such as CERCLA or a state or local counterpart.

b. Activities on the Area Encompassed by the Conveyed Property. Acme agrees to assume all liabilities associated with any activity conducted on the Conveyed Property or the area encompassed by the Conveyed Property, by Acme, its lessees, contractors, and any other person or entity exercising or purporting to exercise rights through Acme or on Acme's behalf. In addition to such liabilities, Acme will be strictly liable for any damage to: cultivated land, growing crops, pasture land, unimproved land, livestock, fences, roads, ditches, culverts, trees, turf, terraces, springs, water wells, groundwater, personal property, fixtures, and improvements located now or in the future on the area encompassed by the Conveyed Property.

[additional liabilities]

5. Acme's Indemnity of Doc. Acme will protect, indemnify, hold harmless, and defend Doc against any claim, demand, cost, liability, loss, or damage suffered by Doc, including Doc's reasonable attorney fees and litigation costs, associated with or arising out of one or more of the following events:

a. Breach of Covenant. A breach of any restrictive covenant contained in paragraph numbered 3 of this conveyance.
b. Recognize Limits on the Interest Conveyed. A failure to recognize Doc's right of re-entry or any other right excepted by Doc in paragraph numbered 2 of this conveyance.

c. Assumption of Liability. Any matter encompassed by Acme's assumption of liabilities, including environmental liabilities, under paragraphs numbered 1 and 4 of this conveyance.

d. Specific Operations.

(1) Any activity expressly or impliedly authorized or required by this conveyance.

(2) Plugging and abandonment of producing wells, nonproducing wells, existing wellbores, or previously plugged wellbores.

(3) Management, use, and disposal of produced water and wastes or substances associated with the development or operation of the Conveyed Property.

(4) The generation, processing, handling, transportation, storage, treatment, recycling, marketing, use, disposal, release or discharge, or threatened release or discharge, of oil, natural gas, natural gas liquids, all other petroleum substances, any waste material, or any "hazardous substance" or "pollutant or contaminant" as those terms are defined (now or in the future) under the federal Comprehensive Environmental Response, Compensation and Liability Act ("CERCLA"), the Texas statutory counterpart to CERCLA, and any amendments or substitutions for CERCLA and its Texas counterpart.

e. Other Matters. Any matter relating to Acme's ownership, use, or occupancy of the Conveyed Property or the area encompassed by the Conveyed Property.

[additional indemnities]

Although Acme may fail to meet the conditions to this conveyance, Acme's obligations to indemnify, hold harmless, and defend, as specified in this paragraph numbered 5, are continuing obligations which will be enforceable by Doc even after Doc exercises the right to re-enter and terminate Acme's estate.

6. Binding Effect. This conveyance, and all its terms and conditions, are binding upon the heirs, personal representatives, successors, and assigns of Doc and Acme.

SIGNED AND DELIVERED __________ March 1993.

Doc Hillard
123 Mineral Lane
Oiltown, Texas 75275

SIGNED AND ACCEPTED __________ March 1993.

Acme Oil Company

by: Martha Rhodes, President
Acme Oil Company
456 Gusher Street
Oiltown, Texas 75275
ACKNOWLEDGMENTS

____________________ County, Texas

This MINERAL DEED was acknowledged before me on ______ March 1993 by Doc Hillard.

____________________ Notary Public
My Commission Expires: ______

____________________ County, Texas

This MINERAL DEED was acknowledged before me on ______ March 1993 by Martha Rhodes as President of Acme Oil Company, a Texas corporation.

____________________ Notary Public
My Commission Expires: ______

Although the foregoing deed is drafted to maximize the grantor’s position, the grantee must also be alert to its environmental risks. For example, if there are environmental problems on the surface of the property at the time of the conveyance, the mineral grantee may become liable since it owns an easement authorizing it to use the surface to conduct mineral operations. The grantee must therefore scrutinize the transaction, and negotiate for appropriate deed language, to minimize environmental risks associated with becoming an “owner” and “operator” of the property.

2. Forced Pooling of the Fee Simple Estate

Under some pooling statutes a landowner may be forced to permit development on its property even though it has not conveyed or leased the mineral interest.317 For example, in Texas Oil and Gas Corp. v. Rein,318 the Oklahoma Corporation Commission force pooled a 160-acre tract owned by Rein with 480 acres under lease to Texas Oil and Gas Corporation to conform to a 640-acre drilling and spacing unit.319 Rein owned the surface and minerals in the 160-acre tract and refused to lease it for development. The court held that the Oklahoma pooling statute “authorizes the Commission to establish the well location at any location upon the spacing unit”—even though the unleased mineral and surface owner objects to having a well on its property.320

320. Id. at 1279. In a companion case the Oklahoma Supreme Court summarized its holding in Rein as follows:

The essence [of Rein’s] contentions is that the effect of the order in this case, and the order in the companion case concerning the well location, is to grant applicant the
In a subsequent case, the Oklahoma Supreme Court observed: “Appellant, the owner of an unsevered mineral interest, was forced by the Corporation Commission to participate in the unit operation. He was forced to accept the intrusion on his land occasioned by the order directing the well to be drilled there.” 321 Although the court held the unsevered mineral interest owner should be compensated for locating the well on its property, the court reaffirmed that “a forced-pooled surface and mineral owner is required by the State to accept surface damage to his property . . . .” 322

The Oklahoma forced pooling process effectively requires the nonconsenting surface and mineral owner to suffer the environmental risk associated with unit development on its property. This also appears to be the law in Louisiana. 323 One option the targeted surface and mineral owner might pursue is to request provisions in the pooling order to limit or leverage some of the environmental risks. Oklahoma Statutes Title 52, Section 87.1(e) provides, in part:

Where . . . such owners have not agreed to pool their interests and where one such separate owner has drilled or proposes to drill a well on said unit . . . the Commission . . . shall, upon a proper application therefore and a hearing thereon, require such owners to pool and develop their lands in the spacing unit as a unit . . . . All orders requiring such pooling shall be made after notice and hearing, and shall be upon such terms and conditions as are just and reasonable and will afford the owner of such tract in the unit the opportunity to recover or receive without unnecessary expense his just and fair share of the oil and gas. 324

Owners of the tract where the well is to be located could argue that the Commission’s order should require the drilling parties, at a minimum, to indemnify them against environmental liabilities associated with development. The pooling order could also limit development practices, such as the use of pits, which increase the property owner’s environmental liability. Potential CERCLA liability alone would seem to make such “terms and conditions” in a pooling order “just and reasonable.” 325 The types of provisions a landowner might

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322. Id.
323. Nunez v. Wainco Oil & Gas Co., 606 So.2d 1320, 1326 (La. Ct. App. 1992), writ denied, 608 So.2d 1010 (La. 1992) (“The Commissioner of Conservation is authorized to designate a drilling site at the optimum position in the drilling unit for the most efficient and economic drainage of such unit.”).
324. OKLA. STAT. ANN. tit. 52, § 87.1(e) (West 1991).
325. In McDaniel v. Moyer, 662 P.2d 309 (Okla. 1983), the district court ordered the operator of a pooled unit to post a $50,000 bond to secure payment of compensation for surface damages and use of an abandoned and plugged well bore on the nonconsenting party’s land. Id.
ask to be included in a pooling order, or a pooling agreement, would be similar to those described in the previous section concerning a conveyance of minerals.  

3. Nonparticipating Interests

Royalty conveyances will not create any risk for the grantor of the interest since the grantee of a royalty interest has no right to conduct operations on the property. However, the grantee of a royalty interest is not free of all risk. Although it lacks authority to control activities on the property, there is a possibility it could be considered to have “arranged for disposal” of wastes associated with activities necessary to generate the royalty. Even under this theory the royalty interest owner should be liable only for wastes generated during the existence of its interest. However, royalty interest owner liability could extend to disposal sites located off the leased premises if the wastes disposed there were generated during the existence of its interest.

This risk for nonparticipating interests increases as courts hold that royalty, and other nonexecutive mineral interest owners, have the ability to force their grantors to develop the property for their mutual benefit. This is particularly a risk in Texas where the executive rights holder has been held to have a fiduciary obligation to act for the best interests of the nonexecutive in leasing and developing the mineral interest.

There is also a risk that courts will not apply an “authority to control” analysis for defining the scope of CERCLA ownership. Instead, courts might be inclined to impose liability on any person having an ownership interest in the property; particularly if the person has received significant income from the property as a result of oil and gas operations. However, it is ownership of a “facility” that gives rise to the risk.

at 311. The Oklahoma Supreme Court held that the unit operator had the authority to locate the unit well anywhere within the area designated by the Commission in its pooling order, including the disputed surface area. Id. at 312. Although the court held it was improper to impose the bond requirement, the court's holding does not rule out the use of a bond under appropriate circumstances. The court noted: “There had been as yet no invasion of the landowners' asserted rights and no occasion shown for equitable intervention or relief.” Id. at 314. The unit operator's right to use the existing well bore had not been determined so a bonding requirement was premature. Id. at 313 n.13.

326. See supra text accompanying notes 311-16.


329. If the wastes were generated by its contractor (the oil and gas lessee), then the mineral interest owner might incur cleanup liability under CERCLA § 107(a)(3) as: “[A]ny person who by contract, agreement, or otherwise arranged for disposal . . . of hazardous substances owned or possessed by such person . . . [or owned or possessed by any other party] at any facility . . . containing such hazardous substances . . . .” CERCLA § 107(a)(3), 42 U.S.C. § 9607(a)(3) (1988).

to CERCLA liability. One can forcefully argue that the right to merely receive passive income from an oil and gas well does not rise to the level of ownership of the "facility." A right to receive either a money payment or a share of production is the owned thing, not the property used to generate the cash or the production.

B. Oil and Gas Leases

Many of the oil and gas lessee's environmental concerns are similar to those of a fee simple absolute owner conveying a mineral interest to a third party. The lessee will be entering the lessor's property and using the surface and subsurface areas to the extent reasonably necessary to develop the leased minerals. If the lessor owns the property in fee simple absolute, it will have potential liability as an "owner" of the surface and mineral estates. Conversely, the oil and gas lessee's concerns are similar to those of a mineral interest owner. Since the lessee will have an express or implied easement to use the surface and subsurface areas, contamination of such areas may give rise to liability for the lessee.

As noted in previous sections, the mineral interest owner can become an "owner" of a CERCLA facility. Conceptually, the mineral interest owner can also become an "operator" when it enters into an oil and gas lease authorizing a lessee to conduct development opera-

331. Another commentator on this subject has concluded:

The owner of a royalty interest does not have the right to enter the land to prospect for, sever, or remove minerals, but only to share in the minerals, or proceeds from the minerals, as they are produced. The owner of a royalty interest reserved in a lease would be liable in any event as an owner of the fee or, perhaps, as an owner of the minerals. The liability of the owner of an independent royalty (that is, a royalty created apart from a lease, also called a severed or nonparticipating royalty) would, on the other hand, be subject to liability only to the extent that ownership of the royalty made it an "owner" under the environmental statutes. Arguably, the owner of an independent royalty is not an "owner," because it does not own the facility or any interest in the facility, merely in the production; nor can it use, or control the use of, the facility, because its consent is not necessary to authorize the activities of the lessor whose facility gives rise to the environmental liability.


332. This is one area where the courts may try to distinguish between a nonexecutive mineral interest owner and a royalty interest. The argument would be that since the nonexecutive mineral interest owner conceptually owns the oil and gas, and an implied easement to obtain the oil and gas, its interest is actually broader than a mere right to share in cash or production. However, the practical distinction between a nonexecutive mineral interest owner and a nonparticipating royalty interest owner is hard to identify, particularly when the nonexecutive does not share in any bonus or delay rental, and cannot exercise its implied easement for development.

333. See supra text accompanying notes 288-311. In Texas, the typical form of oil and gas lease will create a fee simple determinable in the lessee. Cherokee Water Co. v. Forderhouse, 641 S.W.2d 522, 525 (Tex. 1982).


335. See supra text accompanying notes 288-311.

336. See supra text accompanying notes 309-11.

337. Id.

338. Id.
tions on the leased land. This could expand considerably the lessor's liability if the lessee is deemed the lessor's contractor in generating, disposing, and arranging for the disposal of wastes associated with development operations. The critical inquiry therefore becomes whether the oil and gas lessee was the lessor's "contractor" for purposes of developing the leased land. However, under the typical form of oil and gas lease the lessee is given the right to develop but is under no obligation to develop.339 This makes the relationship more like a conveyance than a development contract and should permit the lessor to argue its lessee is not the lessor's contractor, agent, or joint venturer. Instead, the lessee holds an independent estate or license which the lessor is, to a large extent, powerless to direct.

In the rarer cases where the lessee affirmatively agrees to develop the property, the lessee assumes more the role of a contractor acting on behalf of the lessor. However, where the lessor has no authority to compel or direct the lessee's development activities, the lessee should be viewed as simply the owner of an independent property interest. Therefore, the lessee's development actions, under the typical form of oil and gas lease, should not be viewed as the actions of the lessor. This characterization of the lessee's actions could change, for example, when the lessor demands the lessee to drill an offset well to protect against drainage of the leased land. However, even in this situation the lessee is technically under no obligation to drill—the lessee could release the acreage or perhaps pay compensatory royalty. As a general rule, the more control the lessor maintains over the lessee's development decisions, the more likely a court will view the lessee as the lessor's contractor.

The oil and gas lessee will most likely be deemed a CERCLA "owner." Although there are no reported decisions addressing the oil and gas lessee's CERCLA status, several cases dealing with other commercial relationships suggest that a "lessee" can be an "owner" under CERCLA. For example, in United States v. A & N Cleaners and Launderers, Inc.,340 the court was presented with the following issue:

Although it is undisputed that Marine [a lessee of a building] has never held title to the Property or any part thereof, the Government asks the court to rule that a lessee of property that maintains control over and responsibility for the property from which the lease took place is an "owner" for purposes of CERCLA.341

The court stated the issue as "what constitutes 'ownership' in the absence of title?"342 The court held Marine liable as a CERCLA owner noting Marine "exercised a degree of site control over the Property, that . . . confers ownership status upon it for purposes of CERCLA § 107(a)."343

The court in *A & N Cleaners* adopted the "site control" test articulated by the court in *United States v. South Carolina Recycling and Disposal, Inc.*,344 which provided that "the lessee/sublessor 'as lessee of the site, maintained control over and responsibility for the use of the property and, essentially, stood in the shoes of the property owners.'"345 With regard to operations associated with oil and gas development on leased land, the oil and gas lessee has the exclusive right of control over the property and would therefore be an "owner" under CERCLA § 107(a).

The oil and gas lessee would also be an "operator" under CERCLA § 107(a). In *Nurad, Inc. v. William E. Hooper & Sons Co.*,346 the court stated that a lessee of property could qualify as a CERCLA operator if it had the "authority to control the facility ... ."347 The court in *Nurad* observed that "the tenant defendants need not have exercised actual control in order to qualify as operators under ... [CERCLA] so long as the authority to control the facility was present."348 Therefore, the mere power to act is all that is required; a failure to exercise the authority to control will not insulate against CERCLA operator status.

Although the *Nurad* "authority to control" approach creates a broad definition of "operator," the court ultimately held the lessees in that case were not operators of the "facility" at issue.349 The facility included various underground storage tanks that leaked mineral spirits, a hazardous substance. Nurad was the current owner of the real estate where the tanks were located. In addition to suing previous owners of the real estate, Nurad sued previous tenants who leased buildings located on the real estate. The court found that the leases between the property owners and their tenants did not confer any express or implied right to possess or use the underground storage

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342. *Id.* at 1332.
343. *Id.* at 1333.
348. *Id.*
349. *Id.* at 843.
tanks. The court defined the “facility” as the “area” where hazardous substances have “come to be located” which in this case “is in and around the storage tanks . . . .” The court applied the “authority to control” test to the “facility” involved and held:

The fact that those tenants may have had control over a building that was adjacent to the USTs is irrelevant under the statute; a defendant operates a “facility” only if it has authority to control the area where the hazardous substances were located. Thus, . . . liability . . . extends only to those who have authority over the area where hazardous wastes are stored.

1. Lessee’s Strategy

The typical oil and gas lease gives the lessee the right to enter the land encompassed by the lease to conduct exploration, development, and production activities. So long as the lessee is pursuing oil and gas development activities, the lessee will have the “authority to control” any site on which it selects to conduct operations. This “authority” can extend to pre-existing well sites located on the leased land. Employing the Nurad analysis, the lessee need not actually exercise its authority to be considered an “operator.” However, under the oil and gas lease the lessee’s authority is limited to activities it pursues on the leased land that are consistent with the granting clause of the lease—typically activities reasonably necessary to efficiently explore for and develop the oil and gas in the leased land. Therefore, the lessee arguably must take affirmative development action, consistent with the lease terms, before its CERCLA “operator” status can be defined. It would also seem as though similar affirmative action would be required to define the lessee’s CERCLA “owner” status.

For example, assume that in 1940 Section 30 was leased to Acme Oil Company and Acme drilled four wells on the leased land. Each well had an associated drilling pit and salt water evaporation pit. In 1965 all production ceased from Section 30, Acme’s lease terminated, and Acme vacated the premises. In 1993 New Age Oil Company obtains an oil and gas lease covering Section 30. Prior to conducting any

350. Id. The court found: “Given the precise language of the lease agreements and the absence of any express authority to use the USTs, we think it would be unreasonable to assume that the tenant defendants possessed any implicit authority to exercise control over the tanks.” Id.

351. Id. at 842-43.

352. Id. at 843. The court offered the following rationale for the limitation: “The statute places accountability in the hands of those capable of abating further environmental harm, while Nurad’s proposed definition of ‘facility’ would rope in parties who were powerless to act.” Id. at 843.

353. See generally Santa Fe Minerals v. Sanford, 842 P.2d 363 (Okla. App. 1992) (while lease was being held by unit production from other lands, lessee retained rights to well bore located on the leased land that had ceased producing).

354. See supra text accompanying notes 346-52.
activities on the property, a release of hazardous substances associated with the drilling pits used by Acme becomes the focus of a CERCLA cleanup. Although Acme and its assignees would be "operators" at the time of disposal, they have long since vanished into history. The surface owner of the property is a current "owner" of the pits, and may have been an owner at the time of disposal.\textsuperscript{355}

Although New Age has the \textit{power} to use the prior well sites to conduct new development operations, it also has the ability to \textit{define} the areas on which it will, and will not, exercise its surface and subsurface easement rights. This is different from the situation contemplated by the court in \textit{Nurad}. In \textit{Nurad} the lessee's total rights were defined by the lease—nothing was left for selection or definition by the lessee. The very nature of the easement rights granted by the oil and gas lease\textsuperscript{356} are left for definition by the lessee's subsequent development activities.\textsuperscript{357} Employing such an analysis, New Age would not be an "owner" or "operator" of the Acme sites unless New Age actually exercised control over the problem areas. However, one could counter this analysis by focusing on whether the lessee had the power to exclude others from using surface locations on which it performed no activities. If the lessee does, it could be argued the lessee has a sufficient interest in the property to be classified as an "owner" or "operator."

The foregoing arguments suggest a drafting technique the lessee may want to use to limit its "ownership" and "operating" control over pre-existing contaminated surface locations. When entering into a new lease\textsuperscript{358} the lessee may want to define more precisely the nature of its surface and subsurface rights. The primary exclusive right lessees require is the right to produce oil and gas from the property. Therefore, if the lease covers all of Section 30, 640-acres, the lessee must ensure it has the exclusive right to produce oil and gas from Section 30 so nobody else, including the lessor, can claim any right to the oil and gas in the property.

The lessee also requires access to surface and subsurface areas of the leased land to explore for, develop, and produce the oil and gas. However, when lessees obtain blanket rights in the surface of the land, they risk attaining the status of a CERCLA "owner" or "operator."

\textsuperscript{355} See \textit{supra} text accompanying notes 288-303.
\textsuperscript{356} Or a mineral deed.
\textsuperscript{357} For example, the lessee possesses easement rights only to the extent necessary to support the lessee's legitimate development activities. If the lessee is not engaged in development activities at a particular location, the lessee has no right to use the location for purposes unrelated to development. The easement is inchoate, dependent upon the lessee exercising its option to conduct operations at the particular site.
\textsuperscript{358} The same techniques could be used when obtaining rights by assignment. However, the undesirable residual rights would remain with the assignor instead of the lessor. See \textit{infra} text accompanying notes 389-97.
The risk is particularly high when there are pits, wells, and other pre-existing oil and gas facilities on the property at the time the new lease is executed. In such cases the lessee, at a minimum, may want to exclude such facilities from its leasehold rights. The attorney's goal is to draft the lease so the lessee has no right to control or ownership over such facilities and the surface and subsurface area they impact. However, the lease should make it clear that pre-existing facilities, although beyond the lessee's right to control, cannot be used to interfere with the lessee's exclusive right to produce oil and gas found within Section 30.

The guiding principle is simple: take only what is needed to accomplish the client's goals while excluding interests that may have CERCLA or other environmental problems. Even under the Nurad analysis, the court recognized the benefit of the tactical acquisition: since the lease did not give the lessees any authority over the underground storage tanks, the lessees were neither owners nor operators of the tanks. Since the oil and gas lessee's surface easement rights are the main source of lessee CERCLA problems, they should be carefully crafted to give the lessee only the surface rights necessary for effective development and operation of the leased land. Consider the following "New Age" lease granting clause:

Oil & Gas Lease
("Lease")

Doc Hillard and Maude Hillard, husband and wife ("LESSOR") and New Age Oil Company ("NEW AGE"), for valuable consideration, agree to the following:

LESSOR leases and conveys to NEW AGE, subject to the terms of this Lease, the rights described in SECTION 1.

Section 1. Scope of Grant

A. The "Leased Land".

For purposes of this Lease, the land described by SECTION 1.A.1. and A.2 will be collectively referred to as the "Leased Land."

1. Surface Boundaries of Leased Land. The surface boundaries of the Leased Land are described in EXHIBIT A attached to this Lease.

The court noted that CERCLA "places accountability in the hands of those capable of abating further environmental harm" which means that CERCLA owner/operator liability should extend "only to those who have authority over the area where the hazardous substances are stored." Nurad, Inc. v. William E. Hooper & Sons Co., 966 F.2d 837, 843 (4th Cir. 1992). Applying this standard to the facts, the court stated:

Nurad contends that as lessees the tenants had a property interest that necessarily included the implicit authority to control the portion of the site that contained the USTs. We agree with the district court, however, that the terms of the tenants' lease agreements conclusively establish that their authority as tenants did not extend to the USTs.

Id. at 843.
2. Depth Limitations on Leased Land. There are no depth limitations. This lease covers all depths within the surface boundaries of the Leased Land.

B. Granted Substances in the Leased Land.

Substances in the Leased Land which are subject to the terms of this Lease include: Oil, gas, and similar hydrocarbon substances. For purposes of this Lease, the listed substances will be referred to as the "Leased Substances." The term "Leased Substance" is used to identify any one of the listed substances.

C. Purpose of the Grant.

NEW AGE is given the exclusive right to explore for, extract, and market Leased Substances from the Leased Land, pursuant to the terms of this Lease.

D. Surface Rights and Limitations.

1. LESSEE's Surface and Subsurface Rights. Subject to the terms of this SECTION, NEW AGE is given the right to use so much of the surface and subsurface of the Leased Land as is consistent with the purposes stated in Subsection C. From the Effective Date of this Lease until it is terminated, LESSOR will not construct any structure or improvement, or pursue, permit, or authorize any activity on the Leased Land that restricts, impairs, or diminishes in any manner NEW AGE's ability to use the surface or subsurface as provided for in this Lease. For purposes of this subsection, any activity which may increase NEW AGE's potential environmental liability concerning NEW AGE's surface and subsurface rights will be deemed an impermissible act that "restricts, impairs, or diminishes" NEW AGE's ability to use the surface or subsurface as contemplated by this subsection.

2. LESSEE's Surface Limitations.

a. Existing Well Bores, Drilling and Operating Pits, and Other Development Facilities. NEW AGE shall have no right, title, ownership interest, operational control, or authority whatsoever over any well, well bore, drill site, pit, aboveground or underground storage tank, or other oilfield structure or facility that is located on or in the Leased Land as of the Effective Date of this Lease.360

b. Defined Surface Right Area. NEW AGE's authority to exercise surface rights provided for in Subsection D.1. extends only to those areas in which NEW AGE declares a Surface Site pursuant to this subsection. In the event NEW AGE elects to exercise its rights under this Lease, it will notify LESSOR in writing of the proposed activity and define the surface area on the Leased Land it plans to use in conducting the activity. The surface area defined in the LESSOR notification will constitute the Surface Site for the proposed activity.

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360. Depending upon the circumstances, the lessee may want the option to use these areas or facilities by including them in a Surface Site designation provided for in subsection 2.b. However, to the extent the lessee has any option to control these areas it will make it easier for third parties to make an argument that New Age is a CERCLA owner/operator.
For areas where the lessee actually engages in exploration, development, or production activities, the lessee will be deemed an "operator" under the Nurad analysis. Therefore, the lessee should be vigilant to ensure that other parties do not conduct activities on the lessee's development areas that could result in a cleanup order directed at the lessee. Parties that might have simultaneous rights in a development area include: the lessor, surface lessees, other mineral interest owners, lessees of other minerals or depths, farmees under a farmout agreement, and owners of pipeline, utility, and other easements. Since the oil and gas lessee has "authority to control" the area, it should do so by ensuring no activity is conducted on the lessee's surface site that could give rise to CERCLA or similar environmental liability. Since the lessee has legal "control" over the areas it uses for development, the lessee is one of the CERCLA owner/operators "capable of abating further environmental harm" at the site.

The lessee also faces extensive risk as a "generator" or "arranger" of wastes associated with lease development operations. Any hazardous substance produced by the exploration, development, and production process can give rise to CERCLA liability. When the hazardous substance is taken to a "facility" for disposal, CERCLA can impose cleanup liability on the lessee as the "generator" of the substance or the party who "arranged for disposal" of the substance. In United States v. Hardage the court summarized generator/arranger liability stating:

"Generator" liability under section 107(a)(3) of CERCLA is imposed on "any person who by contract, agreement, or otherwise arranged for" disposal, treatment, or transport to a hazardous waste facility. . . . Courts have construed this CERCLA section broadly. A generator need not have selected the site. . . . Generator defendants can be liable for disposal of wastes at a particular site "even when defendants did not know the substance would be deposited at that site or in fact believed they would be deposited elsewhere." . . .

The United States need not trace the waste found at the site back to the wastes deposited by the generator. . . . However, the United States must present evidence that a "generator defendant's waste was shipped to a site and that hazardous substances similar to those contained in defendant's waste remained present at the time of the release. . . . Liability under CERCLA does not depend upon any particular quantity of the hazardous substance. Even a de minimis contributor can be held liable. . . .

"Finally, the United States need not demonstrate that the specific hazardous substances contributed to the Hardage Site by the defendants have been released from the Site. The United States
need only establish the release of 'a' hazardous substance from the Hardage Site and 'not necessarily one contained in the defendant's waste.'

To deal with its generator/arranger risk the lessee must actively manage its waste-generating activities. This may be difficult when other parties have varying control over the activity creating the waste. For example, the designated operator under a joint operating agreement or pooling order will have control over day-to-day development activities. The operator, in turn, may cede operational authority to third parties from time-to-time, such as a farmee, drilling contractor, or service contractor. However, the individual lessees included in a contract area, pooled unit, or unitized area will most likely remain liable as the generators of waste even though the act of generation was undertaken indirectly by their operating, drilling, or servicing contractors. This risk must be leveraged in the various contracts or orders that authorize such third parties to act on the lessee's behalf or to conduct activities on the lessee's oil and gas properties.

2. Lessor's Strategy
a. Lessor's Strategy in Negotiating a New Lease

The lessor's main goal is to restrict the activities its lessee can pursue on the leased land that might give rise to CERCLA and other forms of "owner" environmental liability. The lessor's position is very similar to that of a severed surface owner following conveyance of a mineral interest. Therefore, the structuring techniques discussed with regard to protecting the severed surface owner are equally applicable to the oil and gas lessor. For example, the lessor may want to re-

365. Id. at 1511.
366. See infra text accompanying notes 398-412.
367. See infra text accompanying notes 418-28.
368. In Branch v. Mobil Oil Corp., 788 F. Supp. 531, 533 (W.D. Okla. 1991), the court stated:
   The operator of the unit is merely the agent for the lessees who form the unit .
   Accordingly, to the extent an operator of the Unit created or maintained a nuisance .
   during the time that ARCO was a working interest owner in the Unit, ARCO is liable
   as a principal for the operator-agent's actions .
370. See infra text accompanying notes 389-428.
371. See supra text accompanying notes 289-316 and listing of matters that should be addressed in a mineral deed. Even the lessor must concern itself with issues such as whether to draft to provide for an automatic reversion of rights as opposed to giving the lessor the option to terminate a right. For example, consider the traditional lease provision that triggers an automatic transfer of title to fixtures and equipment left on the lease after a stated period of time. The lessor may not want title to the fixtures or equipment. One approach to restructuring the removal of equipment clause might provide as follows:
F. REMOVAL OF EQUIPMENT AND FIXTURES.
For a period of 60 days following Termination of this Lease, LESSEE is given the right to enter the Leased Land to remove any Material on the Leased Land owned by LESSEE. "Termination" means the Lease, or a relevant portion of the Lease, is no longer in effect. The cause of termination does not matter. "Material" means anything placed on the Leased Land by LESSEE, or LESSEE's contractors, to include, without
strict the granting clause of the oil and gas lease to limit the lessee's ability to place pits, ponds, processing equipment, storage tanks, injection wells, wastes, and other designated items on the leased land. At a minimum, the lessor may want to restrict the disposal of waste materials on the leased land. The lease could provide: "All substances brought onto the Leased Land, wastes generated as part of development or operation activities, and soil or other media contaminated by such substances, wastes, or activities, will be removed from the Leased Land immediately following completion of such activities."

In addition to the granting clause of the oil and gas lease, several other clauses require attention to protect the lessor's environmental interests. Beginning with the royalty clause, the lessor should consider changing the typical right-to-take-in-kind oil provision to a contractual right to share in production proceeds. Although liability for ownership of the produced product has not yet been imposed in environmental cases, a right to a share of the actual production makes it conceptually easier to try and characterize the lessee as the lessor's contractor for development purposes. Since lessors seldom actually market their share of oil, it may be better to not have the right to take oil in kind. This is one area where the potential benefits of environmental structuring may outweigh the revenue-collection benefits associated with ownership of a fractional share of the oil.

Often the lessor's best strategy for protecting its environmental interests is to select a reputable, well-qualified, and financially-sound lessee. However, the benefits of a carefully chosen lessee can be lost, under the typical form of oil and gas lease, through assignment.

limitation, such things as equipment, supplies, fixtures, tubing, casing, and other equipment in the well. LESSOR may elect to keep certain Material on the Leased Land and may do so by tendering to LESSEE the reasonable salvage value for the Material LESSOR desires to acquire. LESSEE's failure to act within the 60-day period will not in any way limit its liability associated with the presence of the Material on the Leased Land.

372. One approach might be for the owner of the fee simple absolute to convey its mineral rights to a corporate entity in which the owner holds all the stock. The deed from the fee owner to the corporation would include the environmental limitations that are desired to protect the severed surface owner. Future oil and gas leases would merely grant whatever surface rights the corporate mineral owner possesses in the property. The corporate mineral owner would need to ensure that any warranty offered in the lease expressly excepted limitations contained in the lessor's mineral deed.

373. Although there is some risk the lessee may be considered the lessor's "contractor" with regard to disposal of these wastes, this risk must be balanced against the known risk that if the material remains on the leased premises the lessor will be a CERCLA "owner" of the facility. See supra text accompanying notes 288-303.

374. See supra text accompanying notes 338-39.

375. As an additional benefit, an oil purchaser would not need a division order from the lessor since the lessee would own all the production from the property. David E. Pierce, Resolving Division Order Disputes: A Conceptual Approach, 35 ROCKY MTN. MIN. L. INST. 16-1, 16-50 to 16-52 (1990).

376. The revenue-collection benefit would include the ability to rely on conversion as a remedy when the lessor's oil is taken without the lessor's consent.
Under the typical form of assignment clause the lessee can freely assign the property and eliminate the chosen lessee’s liability to lessor for activities occurring after the date of assignment.\(^{377}\) Although the lessor could attempt to limit assignments of the lease, probably the best approach would permit assignment but attempt to keep the lessee on the hook for any liability arising after the date of assignment.\(^{378}\) For example, the lessor might negotiate for a clause similar to the following:

Limitation on Assignment and Surrender. Regardless of the other provisions contained in this lease, LESSEE can assign or surrender all or any part of this Lease. However, as to the assigned or surrendered interest, Lessee will remain obligated for the proper performance of all express and implied Lease obligations. Lessee’s liability for the non-performance of lease obligations, including the obligation to indemnify\(^{379}\) Lessor, will be in addition to the liability of any assignee obtaining an interest through the Lessee or any assignee obtaining an interest through Lessee’s assignee.

Any person or entity obtaining an assignment of rights in the Lease: (1) Is deemed to have accepted liability for the non-performance of any express or implied Lease obligations, including the obligation to indemnify Lessor, accruing prior to the date of assignment; and (2) Is liable for the proper performance of express and implied lease obligations, including the obligation to indemnify Lessor, from and after the date of assignment. The liability of Lessee and all assignees transferred an interest in the Lease is joint and several. For purposes of this section the term “assign” means a written transfer of rights in the Lease, whether classified as an assignment or sublease.

The foregoing assignment clause contemplates the lessor will negotiate a broad indemnity clause as part of the oil and gas lease.\(^{380}\) A rather simple indemnity clause might provide for the following:

B. Indemnity by LESSEE.

LESSEE will protect, indemnify, hold harmless, and defend LESSOR against any claim, demand, cost, liability, loss, or damage suffered by LESSOR, including reasonable attorney fees and litigation costs, arising out of or associated in any way with the following activities conducted by LESSEE (or those having a contractual relationship with LESSEE) on or impacting the Leased Land:

1. Any activity expressly or impliedly authorized or required by this Lease.

\(^{377}\) One of the typical forms of oil and gas lease provides: “In the event of assignment hereof in whole or in part, liability for breach of any obligation issued hereunder shall rest exclusively upon the owner of this Lease, or portion thereof, who commits such breach.” Eugene O. Kunz et al., Oil and Gas Forms Manual 21 (1987) (clause 8 of the AAPL Form 675 Oil and Gas Lease, Texas Form). The lease may also have a surrender clause that permits the lessee to release the lease and avoid subsequent liabilities.


\(^{379}\) Pursuant to a broad environmental indemnity clause added to the oil and gas lease.

\(^{380}\) See supra text accompanying notes 228-60.
2. Plugging and abandonment of producing wells, nonproducing wells, existing wellbores, or previously plugged wellbores.

3. Management, use, and disposal of produced water and wastes or substances associated with Lease activities.

4. The generation, processing, handling, transportation, storage, treatment, recycling, marketing, use, disposal, release, or threatened release, of oil, natural gas, natural gas liquids, all other petroleum substances, any waste material, or any "Hazardous Substance" or "Pollutant or Contaminant" as those terms are defined by the Comprehensive Environmental Response Compensation and Liability Act (CERCLA) at CERCLA § 101 (14) and (33), 42 U.S.C. § 9601 (14) and (33) (1988).

5. Any failure by LESSEE to comply with an express or implied obligation created by this Lease.

LESSEE's indemnity also includes any environmental problem associated with oil and gas exploration, drilling, development, production, treating, storage, transportation, marketing, processing, abandonment, and related activities at any site existing on the Leased Land as of the Effective Date of this Lease.

LESSEE's obligations created by this SECTION are continuing obligations which will continue in effect, and be enforceable by LESSOR, even after the Lease terminates or otherwise ceases to burden the Leased Land.

In conjunction with the indemnity clause, the lessor should consider a general provision addressing the lessee's environmental responsibilities, such as: "Lessee agrees to conduct its operations in strict compliance with all federal, state, and local environmental, health, and safety laws." This would then become one of the express covenants of the oil and gas lease that upon breach would trigger the lessee's indemnity obligation under subsection B.5. of the indemnity clause.

The lessor can take several affirmative precautions when entering into oil and gas leases to reduce the risk of environmental liability. The lessor's primary protection is the selection of a lessee who has both a reputation for doing things right and the financial ability to fix a problem and reimburse the lessor when things go wrong. Once such a lessee is found, the next step is to modify the standard oil and gas lease to reduce the risk of environmental problems. These modifications include adjustments to the granting clause and the addition of various restrictive and affirmative covenants.381 The lessor should also structure the lease so that if environmental problems occur, the lessor can avoid liability as a "generator" or "arranger" of the hazardous substances at issue. This may require adjustments to the standard royalty clause to avoid the lessor's right to take production in kind.382

To ensure the chosen lessee remains liable for environmental

381. See supra text accompanying notes 311-16.
382. See supra text accompanying notes 374-76.
problems, and reimburses the lessor for any loss it may suffer due to such problems, the lessor should insist the assignment clause be revised and an indemnity clause added to the lease. These adjustments to the oil and gas lease will assist the lessor in leveraging its environmental liability when entering into new lease agreements.

b. **Lessor's Strategy to Minimize Liability Under an Existing Lease**

Lessors under existing leases will typically be dealing with lease terms that were drafted without much concern for the lessor's environmental liability. The lessor can still minimize its environmental risks, however, by policing the lessor/lessee relationship in such situations. Legal tools to accomplish this include the "reasonable use" limitations, the accommodation doctrine, and implied covenant law.

The lessor could argue that any practice on the leased premises that exposes the lessor to environmental liability is per se "unreasonable" and beyond the scope of the easement rights granted by the oil and gas lease. Such "unreasonable" activity would include the lessee's disposal of hazardous wastes on the leased land.

Even if the lessee's activity falls within the scope of the granted easement, the "accommodation doctrine" might apply to restrict on-lease disposal of wastes when there are reasonable alternatives the lessee could pursue. For example, in *Hunt Oil Co. v. Kerbaugh* the court held the owner of the mineral estate must have due regard for the rights of the surface owner and consider reasonable development alternatives to minimize adverse surface impacts. However, the accommodation doctrine remains largely undeveloped and no case to date has applied it in an environmental liability context. The lessor might also argue that any lessee development practices that increase the lessor's potential environmental liability violate the lessee's implied covenant of "diligent and proper operation" or, as labeled by Texas courts, the implied covenant to "manage and administer the lease."

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383. See supra text accompanying notes 377-79.
384. This argument can be made, as a matter of contract and property law, even though the disposal is "legal" under the Resource Conservation and Recovery Act. The lessor would argue that although the wastes may be "exempt" under RCRA, they nevertheless pose an unreasonable risk of liability to the lessor under CERCLA and therefore the activity is beyond the scope of the granted easement. See supra text accompanying notes 67-72.
385. 283 N.W.2d 131 (N.D. 1979).
386. See also Rostocil v. Phillips Petroleum Co., 502 P.2d 825 (1972) (holding right to mine and right to farm cannot interfere with one another any more than necessary); Getty Oil Co. v. Jones, 470 S.W.2d 618 (Tex. 1971) (limiting obligation to accommodate surface owner's use of land).
C. Lease Assignments and Farmout Agreements

1. Reducing Environmental Risks Faced by the Assignee or Farmee

The prospective assignee or farmee of an oil and gas interest must approach the transaction with the same caution as any other property purchaser. The assignee or farmee will become an "owner" of the assigned interest. Therefore, it must assess the environmental condition of the affected leasehold interests and apply the environmental risk management techniques discussed at section III of this article. The farmee will want to include representations, warranties, assumptions of liability, and indemnities in the farmout agreement coupled with the right to avoid the transaction altogether if an assessment of the property reveals unacceptable environmental risks. The farmee should also practice the basic rule that "more" is not necessarily "better" when defining the interests it will earn under the farmout. One commentator has suggested:

Consideration should be given to limiting the interests you are earning to the smallest ownership interest possible if there are existing wells already on the leasehold. An example would be a farmout whereby farmee only earns rights to the borehole of the well drilled, leaving farmor as the owner of the balance of the leasehold estate.

2. Reducing Environmental Risks Faced by the Assignor or Farmor

If the assignor is retaining an interest in the assigned leasehold interest, the assignor's position is similar to that of a lessor who is permitting another to enter its property to conduct operations. The farmor is in a similar position under a farmout agreement. The assignor or farmor must structure each transaction to ensure each assignee or farmee does not engage in activities on the assigned interest that create new environmental liabilities or aggravate existing environmental problems. The assignor and farmor will need to employ the same techniques as surface owners or oil and gas lessors discussed in section IV of this article. These will include limitations on the rights granted, rights of re-entry, restrictive covenants, and indemnities.

The farmor must also address how its potential back-in rights will be administered. If the farmee has incurred environmental liabilities

389. See supra text accompanying notes 73-86.
390. See supra text accompanying notes 126-35.
391. If the interest is being assigned outright, the appropriate environmental provisions should be contained either in the contract or the assignment and bill of sale.
393. See supra text accompanying notes 289-316.
394. Id.
prior to pay-out, the farmer may want to avoid becoming a working interest owner and party to an operating agreement for fear a court may impose liability under joint venture, partnership, mining partnership, sublease, or agency theories. The farmer can avoid becoming a working interest owner, as with real property conveyances, by avoiding automatic conversions; this would leave the farmer in the preferred status of an overriding royalty interest owner. To further reduce risk, the farmer may not want to become a party to the joint operating agreement which would govern the parties' relations following pay-out and conversion of the farmer's overriding royalty.

D. Operating Agreements

Parties to an operating agreement must address three types of environmental liability. First, the parties to the agreement may be liable as "owners" of any contaminated leases that were contributed to the "contract area" governed by the operating agreement. Second, the parties to the agreement may be liable as "operators," "generators," and "arrangers" for the environmental practices of their operator. Third, the parties to the agreement may be liable for the operator's actions under theories of joint venture, partnership, mining partnership, or agency. Each type of liability requires attention by parties considering joint operations.

The A.A.P.L. Form 610 - Model Form Operating Agreement - 1989 provides that the parties will commit various leasehold interests to the operating agreement to form the required "contract area" for development. For example, assume A owns a lease covering the South Half of Section 30 and B owns a lease covering the North Half of Section 30. A and B combine their interests, to coordinate development of Section 30, through a joint operating agreement using the 1989 Model Form. Exhibit A to the agreement indicates each party is subjecting its respective lease to the agreement and in return each will have a 50% interest in the contract area comprising all of Section 30. Article III.B. of their agreement provides: "[A]ll costs and liabilities incurred in operations under this agreement shall be borne and paid, and all equipment and materials acquired in operations of the Con-

395. This could include off-site liabilities as a "generator" or "arranger."
396. See infra text accompanying notes 404-07.
397. See supra text accompanying notes 311-12.
tract Area shall be owned, by the parties as their interests are set forth in Exhibit ‘A.’”

According to this clause, any equipment and material acquired for operations on the contract area will be owned 50% by A and 50% by B. This would include pipe, storage tanks, compressors, dehydrators, and other “equipment” and “material” required for operations. If any of these items become a CERCLA “facility,” A and B would be the current owners.

The operating agreement also confers upon each party unspecified ownership interests in the area encompassed by the contract area. The agreement gives A certain rights in B’s lease and B rights in A’s lease. However, the 1989 Form states: “Nothing contained in this Article III.B. shall be deemed an assignment or cross-assignment of interests covered hereby . . . .” The effect of the agreement is to authorize the designated operator to enter any part of the contract area and exercise each party’s respective leasehold rights to the extent necessary to explore, develop, and produce the contract area. Even if each party’s rights are expressly enumerated, the terms of the agreement will not restrict the characterization of the parties’ relationship when addressing the rights of non-parties to the operating agreement. It is likely that for environmental purposes each party to the operating agreement will be deemed to have an ownership interest in all portions of oil and gas interests contributed to the contract area.

To address this potential ownership liability, the parties to the operating agreement must evaluate the environmental status of each lease that will be contributed to the contract area. Each contributing lessee should provide the other parties with appropriate representations, warranties, assumptions of liability, and indemnities concerning potential or known environmental risks associated with the property. If the environmental risks associated with a lease are unacceptable, the lease should be excluded from the contract area.

Although the parties to the operating agreement designate one of the parties to serve as the “operator,” each party to the agreement could be classified as an “operator” for CERCLA purposes. The operating agreement “operator” will most likely be viewed as simply the

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399. A.A.P.L. Form 610 - Model Form Operating Agreement - 1989, Art. III § B., at 10-12, [hereinafter 89 Form].
400. Often several lessees own undivided interests in processing plants and other major production or treatment facilities.
401. See generally Branch v. Mobil Oil Corp., 788 F. Supp. 531, 533 (W.D. Okla. 1991) (ownership of lease within Healdton One Unit was sufficient to impose liability on lessee for nuisance created by unit operator).
402. 89 Form, supra note 399, Art. III, § B, at 29.
403. See Curry, supra note 398, at 748, 749, 754; Bunch, supra note 392, at L-10.
404. See supra text accompanying notes 127-38.
contractor for the non-operator parties to the agreement. Since the operator is the contractor for development of the contract area, all parties to the operating agreement could be liable for the off-site disposal of hazardous substances as "generators" or "arrangers."

The operator could also be characterized as the "agent" of the non-operators. For example, in Branch v. Mobil Oil Corp. the court held that a unit operator was "merely the agent for the lessees who form the unit" and "during the time that ARCO was a working interest owner in the Unit, ARCO is liable as a principal for the operator-agent's actions . . . unless the operator was acting outside the scope of its authority." To address these potential environmental liabilities, the parties need to carefully select their operator and impose appropriate restrictions on how the operator will conduct operations. In most cases this will require substantial revision to the Model Form operating agreement to address such matters as operator development practices, operator liability for environmental problems, and operator removal for environmental misdeeds.

The general liability provisions of the Model Form operating agreement may also require attention to define the extent to which the operator can respond to environmental problems associated with the contract area. For example, assume contamination is discovered on a lease contributed to the contract area but unrelated to any operation under the operating agreement. It may be desirable to authorize the operator to enforce a cleanup obligation, provided for in the operating agreement, against the party who contributed the property to the contract area. This prevents the party contributing the contaminated property from ignoring a problem that may require attention when the contributing party is gone or insolvent.

The parties should also determine how liability associated with such problems will be allocated among parties to the agreement. For example, Article X of the 1989 Form authorizes the operator to "settle any single uninsured third party damage claim or suit arising from operations hereunder if the expenditure does not exceed ______ Dollars
Article X also provides that, regardless of the amount involved, claims and lawsuits “shall be at the joint expense of the parties participating in the operation from which the claim or suit arises.” Article VII.A. of the Model Form, read in conjunction with Article X, suggests that all other claims or lawsuits—not arising from operations—will be at the sole expense of the party responsible for the problem. Finally, the operating agreement should clearly indicate that any warranty, allocation of liability, and indemnity by the parties will survive termination of the agreement.

E. Pooling and Unitization Agreements

The primary environmental concern under pooling and unitization agreements is the prospect that a party contributing a property to the pooled or unitized area will become an “owner” of each property contributed to the area. Whether the act of pooling or unitizing the interests will be deemed a cross-conveyance should depend on the express terms of the applicable agreement or statute. For example, to avoid the problem under a lease pooling clause, the lease might provide:

C. Effect on LESSOR’s Property Rights.

The act of creating a Pool comprised of the Leased Land and other lands will not create any sort of cross-conveyance of rights between the LESSOR and other interest owners in the Pooled Unit. Instead, each party will retain sole ownership in the particular tract they contribute to the Pooled Unit.

Similar provisions could be inserted into a pooling or unitization agreement. If the unit is formed pursuant to a statutory procedure, the statute should define the effect of unitization. For example, the Kansas compulsory unitization statute provides: “Except to the extent that the parties affected so agree no order providing for unit operations shall be construed to result in a transfer of all or any part of the title of any person to the oil and gas rights in any tract in the unit area.”

However, there is always a likelihood that non-parties to the agreement, pool, or unit will argue that for purposes of CERCLA each party contributing an interest to the pool or unit has an ownership interest in the entire pool or unit. The only way to effectively deal with this risk is to assess the properties being contributed and exclude those that pose unacceptable environmental risks. The process of screening the properties, obtaining warranties, allocations of

412. Id. at 70-71.
413. See Curry, supra note 398, at 759. See supra text accompanying notes 119-22.
liability, and indemnities, will be similar to the approach taken with
the "contract area" under the operating agreement. Parties to the
unit operating agreement will also have concerns identical to those of
working interest owners to an operating agreement. The unit oper­
ating agreement should be similarly revised to address environmental
carens.

F. Drilling and Service Agreements

Any contractor that is given access to land has the potential to
acquire environmental liabilities and aggravate the liabilities of parties
that own an interest in the land. Therefore, each party must take ac­
tion to protect its respective interests. The current "owners" of the
property must ensure that contractors entering the leased land per­
form their services in an environmentally acceptable manner. For ex­
ample, the lessee must ensure the drilling contractor properly
manages materials and wastes associated with drilling operations. If
the drilling contractor disposes of hazardous substances in a drilling
pit, the surface owner, mineral owner, and leasehold interest owners
will all suffer the increased risk of environmental liability. The
lease operator who employs contractors should specify their environ­
mental obligations in the appropriate drilling or service contracts and
then monitor their activities to ensure their obligations are properly
discharged. The working interest owners should also inquire about
the contractor's off-site disposal activities since the working interest
owners may be viewed as the "generators" or "arrangers" of wastes
dealt with by their contractors.

The contractor should also structure its agreements to deal with
its potential environmental liability. Depending upon the contractor's
degree of control over an area and operation, it may be deemed an
"operator." The court's holding in Kaiser Aluminum & Chemical
Corp. v. Catellus Development Corp., demonstrates the substantial
risk facing a contractor when it enters a customer's contaminated site

415. See supra text accompanying notes 403-04.
416. See generally Branch v. Mobil Oil Corp., 788 F. Supp. 531, 533 (W.D. Okla. 1991) (own­
ership of lease within Healdton One Unit was sufficient to impose liability on lessee for nuisance
created by unit operator).
417. See supra text accompanying notes 405-12.
418. See supra text accompanying notes 288-303.
419. At a minimum, the operator must ensure that the contractors comply with limitations
contained in the underlying mineral deeds, oil and gas leases, operating agreements, and similar
agreements. For example, if a deed or lease prohibits the use of pits, or the operating agreement
restricts the use of certain types of drilling muds and other chemicals, these limitations must be
reflected in the drilling contract and related service contracts.
420. See supra text accompanying notes 86-97.
421. 976 F.2d 1338 (9th Cir. 1992).
to perform work. Catellus sold land to the City of Richmond\textsuperscript{422} and
the City hired James L. Ferry & Son to excavate and grade a portion
of the land for a proposed housing project.\textsuperscript{423} Ferry, in the process of
performing the assigned task, excavated soil containing hazardous
substances\textsuperscript{424} and spread the contaminated soil over other parts of
the property. When the contamination was discovered, the City sued Cat­
ellus to recover part of the cost of removing the contaminated soil
from the property. Catellus then filed a third-party action for contribu­
tion against Ferry, asserting Ferry was a liable party under
CERCLA.\textsuperscript{425}

Denying Ferry’s motion to dismiss, the court held that Ferry was
an “operator” under CERCLA. The court noted that Ferry “had
authority to control the cause of the contamination at the time the
hazardous substances were released into the environment.”\textsuperscript{426} The
court therefore concluded that Ferry’s activities on the land “tend to
show that Ferry had sufficient control over this phase of the develop­
ment to be an ‘operator’ under section 9607(a)(2) [CERCLA
§ 107(a)(2)].”\textsuperscript{427} The court also held that in moving and spreading the
contaminated soil Ferry “disposed” of a hazardous substance and was
therefore an “operator” “at the time of disposal” under CERCLA.
At some point, most drilling or service contractors will have “author­
ity to control” activities on the leased land that can give rise to poten­
tial disposal and release problems.

In addition to liability as an “operator” at the time of disposal,
the court held Ferry could be liable as a “transporter” since it moved
the hazardous substance to a site on the property selected by Ferry.
The court concluded:

[L]iability may be imposed under section 9607(a)(4) [CERCLA
§ 107(a)(4)] for transporting hazardous material to an uncontami­
nated area of property, regardless of whether the material was con­
voyed to a separate parcel of land. Catellus’s allegations that Ferry
excavated the contaminated soil from one area of the property and
moved it to another are sufficient to allege potential liability predi­
cated upon 42 U.S.C. § 9607(a)(4).\textsuperscript{428}

The \textit{Kaiser Aluminum} case demonstrates the need for any con­
tractor to carefully evaluate the site on which it will be operating and

\begin{itemize}
\item \textsuperscript{422} Actually it was Catellus’s predecessor, Santa Fe Land Improvement Company, that sold
the land to the City of Richmond. However, for purposes of the court’s opinion Catellus is
treated as the seller of the land. \textit{Kaiser Aluminum & Chem. Corp. v. Catellus Dev. Corp.}, 976
F.2d 1338, 1339 (9th Cir. 1992).
\item \textsuperscript{423} \textit{Id.} at 1339.
\item \textsuperscript{424} The hazardous substances were apparently placed on the property in the 1940s when the
site was used as a shipbuilding plant. \textit{Id.} at 1340 n.1.
\item \textsuperscript{425} \textit{Id.} at 1340.
\item \textsuperscript{426} \textit{Id.} at 1341.
\item \textsuperscript{427} \textit{Id.} at 1342.
\item \textsuperscript{428} \textit{Id.} at 1343.
\end{itemize}
the need to train personnel to be alert for unusual soil conditions. It also means the contractor must try to obtain contractual protection from its employer to allocate the environmental risks it will encounter every time it enters the leasehold to perform services. As with other phases of the development process, the parties to drilling and service contracts must address their respective environmental obligations and negotiate for the best position possible under the circumstances.

V. Conclusion

Every participant in the oil and gas exploration, development, and production process is exposed to potential environmental liabilities. However, each party can employ several basic techniques to avoid or minimize this liability. The goal of this article has been to explore the potential liability of different classes of participants in the oil and gas industry and suggest how future transactions might be structured to deal with environmental liability risks confronting the industry. As courts begin to focus on the unique property and contractual relationships encountered in the oil and gas industry, attorneys will be able to better define their clients' rights and structure their prospective transactions to deal more effectively with environmental risks. Until then, perhaps this article will provide a practical approach to addressing environmental liability in routine oil and gas transactions.