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Client Alert

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# Federal Circuit Vacates Seminal Ruling Allowing Government Contractors to Recover CERCLA Costs Under Long-Expired Production Contracts

"The courts are increasingly supportive of reimbursement under expired contracts for today's liabilities where such costs are incurred for purposes of addressing past defense programs. Consequently, notwithstanding the temporary setback of the Federal Circuit's *Shell Oil* decision, cases such as ExxonMobil live on and offer a pathway for contractor recovery."

Government contractors are increasingly looking to their long-expired government contracts to recover today's CERCLA liabilities from the US government. On March 7, 2012, however, the Federal Circuit in *Shell Oil Co. v. United States*, Case No. 2010-5161 (Fed. Cir. 2012) upended an important $69 million trial court ruling in favor of government contractors for reasons best described as a significant (though perhaps temporary) setback. The Federal Circuit concluded that, notwithstanding six years of prior litigation, the trial judge should have recused himself from the case because his wife had inherited, years earlier, less than 100 shares of stock in the parent of two of the four companies seeking CERCLA recovery from the government.

At first glance, the Federal Circuit decision appears to be a disappointing blow to those government contractors seeking recovery from the federal government for CERCLA environmental cleanup costs arising from defense-related programs. Yet it would be premature to read too much into the Federal Circuit's reversal, which was based upon none of the contractual merits and therefore does not signal a dramatic shift away from the contractors' hard-fought gains of the last several years.

Federal case law continues to fashion a rule that, to the extent defense contractors become liable today under CERCLA for environmental cleanup costs under the theory that the contractor is an "owner," "operator," or "arranger," those CERCLA costs may be recoverable from the United States though the government contracts in effect many decades ago. Even the Federal Circuit has unequivocally recognized, just seven years earlier, that a World War II-era government contract obligates the government to reimburse its former contractor fully for any "later-arising" CERCLA environmental costs, even if those liabilities accrued 50 years after the government contract was terminated.[1] A growing number of cases continue to support the evolving principle that expired government contracts still possess value and respond to today's CERCLA liabilities. An important ruling in this area is *ExxonMobil Corporation v. United States*,[2] which was authored in October 2011 by the same trial judge who issued the now-vacated 2010 *Shell Oil* opinion discussed below.

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## Background: *Shell Oil Co. v. United States*

The *Shell Oil* case was first filed in 2006 by two oil companies that were required under the threat of a government takeover to produce aviation gas (avgas) for the military during World War II.[3] Instead of taking over the two refineries, the government entered into 10 separate contracts between 1942-43 with the two companies. The acidic byproducts of the avgas production were sent to the McColl waste disposal site in California. Decades after the 10 contracts expired, the oil companies were sued by the State of California and EPA under CERCLA for recovery of the McColl site's cleanup costs. In 1994, the oil companies agreed to pay $18 million in CERCLA costs to the federal and state governments, after which the former defense contractors sought recovery of its assigned percentage share of "today's" CERCLA liabilities for the McColl site through its long-expired 1942-43 avgas contracts.

In a seminal 2010 ruling, the companies successfully revived their 1940s government contracts six decades after all work had been performed under the theory that the CERCLA liabilities of the 1990s amounted to a type of recoverable "charge" or "tax" contemplated by the 1940s "Taxes Clause" of the avgas contracts (and which can be found in standard government contracts at various points in time).[4]

Until 2010, no other court had found that the Taxes Clause of a standard government contract provides a platform for reimbursement of legacy cleanup costs. The trial court in *Shell Oil* pointed to earlier cases from the Federal and Ninth Circuits that had found for the contractors on other contractual theories and essentially adopted their philosophy that "the cleanup costs are properly seen as part of the war effort for which the American public as a whole should pay."[5] The *Shell Oil* trial court actually admonished the government: "To now refuse to pay costs imposed by supporting the war effort on behalf of the United States does not befit the honor of our Nation."[6]

The government challenged the *Shell Oil* ruling not upon the contractual merits but upon the grounds that the judge had an incurable conflict of interest, and the matter needed to be decided by a different judge. In a strange twist, the trial judge's wife's modest inheritance of less than 100 shares of stock in the parent of two litigants set back the development of this important area of law, at least for the time being. The good news is that the same trial judge issued a substantively similar ruling a year later in the October 2011 *ExxonMobil* case that remains good law for contractors.

## Disqualification Issue in *Shell Oil*

The judge's wife had inherited less than 100 shares of stock in 2004, two years before the *Shell Oil* government contract case was filed. The stock was issued by the parent corporation of two of the four companies in the *Shell Oil* matter seeking recovery of its CERCLA costs from the government under expired contracts. However, the trial judge did not recognize the relationship between these companies at the outset of the case.

In 2009, the judge finally raised the stock ownership issue with the parties after he apparently discovered the parent company's relationship to two of the four litigants seeking recovery of its CERCLA liabilities at the McColl site. Upon consulting numerous sources and conducting extensive research, the judge decided to sever the two companies from the case and have that aspect of the case reassigned to a different judge. The trial judge concluded, however, that he did not need to recuse himself from the entire

case because his wife owned no stock in the remaining companies. The court then proceeded to author the seminal opinion in favor of the remaining contractors, holding the government responsible under long-expired contracts for the "public's liability" as created in 1980 by CERCLA.

Notwithstanding six years of litigation and judicial efforts to cure any conflict by severing the two subsidiary companies, the Federal Circuit vacated the *Shell Oil* judgment in its entirety and remanded the case to be reassigned to a new judge. In the appellate court's view, the trial judge had no choice but to recuse himself from the entire case. Under the applicable rules set forth in 28 U.S.C. Section 455, recusal was deemed mandatory because the judge did not divest the financial interest of his spouse. In reaching this decision, the court relied heavily on several provisions of Section 445.[7]

Although there was not a scintilla of evidence of bias or impropriety on behalf of the trial judge, the mere fact that his wife never divested her shares before the ruling rendered the opportunity to cure inapplicable. In short, instead of severing the case, the trial judge should have either (1) recused himself from the entire case or (2) divested his spouse's stock ownership interest before issuing any opinions in the case. Because the trial judge did neither, the Federal Circuit held it was necessary to vacate the order and reassign the case to a new judge, to be litigated anew.

## *ExxonMobil Corporation v. United States*: The 2010 *Shell Oil* Principles Live On

Although disappointing, the Federal Circuit's *Shell Oil* ruling does not signal any substantive departure from the increasingly influential case law holding the United States *contractually* responsible for present-day CERCLA liabilities (or comparable state law cost-recovery statutes). Other decisions continue to provide strong support for imposing contractual liability on the US government through a variety of standard contract provisions for cleanup costs resulting from defense production.[8]

Coincidentally, one of the most influential and forceful opinions on this topic belongs to the same federal judge who had authored the now-vacated 2010 *Shell Oil* decision.[9] *ExxonMobil Corporation v. United States*[10] remains good law in support of defense contractors and their recovery of costs incurred under either federal or state cleanup programs. In *ExxonMobil*, two oil refineries in Texas and Louisiana produced critically needed aviation gas for the US government pursuant to three 1942-43 "avgas" contracts. Decades later, the by-products of that avgas production were discovered at the refineries and required remediation. In 1987 and 1995, state regulators in Louisiana and Texas ordered the cleanup *under state laws*.

The Taxes Clause in the three 1940s *ExxonMobil* government contracts contained language identical to the 10 California avgas contracts at issue in the now-vacated *Shell Oil* decision and required the government to reimburse the Texas and Louisiana refinery owners for the following "charges" or "taxes":[11]

> [A]ny new or additional taxes, fees or **charges**, other than income, excess profits, or corporate franchise taxes, which [Contractor] may be required by any municipal, state, or federal law in the United States or any foreign country to collect or pay by reason of the production, manufacture, sale or delivery of [avgas].

Applying the same principles forged in the 2010 *Shell Oil* decision, the *ExxonMobil* court held only five months ago that the 1940s Taxes Clause provided a suitable platform decades later for the government contractor to seek today's CERCLA cleanup costs as a recoverable "charge."[12]

In so doing, the *ExxonMobil* court noted that war-related risks should be borne by the government. It labeled the government's attempts to escape liability "disingenuous because the government has acknowledged that [wartime] production creates waste," a consequence of which the government was aware when it had signed the underlying contracts.[13] In reaching this decision, the *ExxonMobil* court pointed to its nearly identical *Shell Oil* decision from 2010, criticizing the government (again) in the process:

> ExxonMobil entered into the Avgas Contracts with the Government to facilitate the war effort, and the Government's need for excessive amounts of avgas prompted the Government to insure ExxonMobil's production costs. . . . *the very purpose of the [government] contract clauses at issue was to remove the potential risks any reasonable producer would be reluctant to take on*. To now argue that the guarantee was very limited in time while the risks are now doing damage is inconsistent with the whole purpose of the clause.[14]

## Conclusion

In recent years, government contractors have successfully recovered from the United States up to 100 percent of their assigned percentages of present and future CERCLA (or state law) liabilities for the past performance of fuel or weapons manufacturing under long-expired contracts. These cases may vary on the precise theory of contract recovery and may depend on whether the specific contract provides for "reimbursement" of losses, expenses, "charges," or damages. Nonetheless, the courts are increasingly supportive of reimbursement under expired contracts for today's liabilities where such costs are incurred for purposes of addressing past defense programs. Consequently, notwithstanding the temporary setback of the Federal Circuit's *Shell Oil* decision, cases such as *ExxonMobil* live on and offer a pathway for contractor recovery.

**Endnotes**

[1] *See Ford v. United States*, 378 F.3d 1314, 1319-20 (Fed. Cir. 2004).

[2] *ExxonMobil Corporation v. United States*, 101 Fed. Cl. 576 (2011).

[3] *Shell Oil Co. v. United States*, 93 Fed. Cl. 439 (2010).

[4] The Taxes Clause in *Shell*, as in many government contracts from the World War II era, state: "[A]ny new or additional taxes or fees, or charges, other than income, excess profits, or corporate franchise taxes, which [contractor] may be required to pay any municipal, state or federal law in the United States or any foreign country to collect or pay by reason of the production, manufacture, sale or delivery of the [avgas]." *Shell Oil Co. v. United States*, 93 Fed. Cl. 439, 443 (2010).

[5] *Id.* at 446.

[6] *Id.*

[7] Specifically, Section 455(a) requires "[a]ny justice, judge, or magistrate judge of the United States [to] disqualify himself in any proceedings in which his impartiality might reasonably be questioned." Section 455(b) further described a number of scenarios where recusal is required, including where the judge "knows that . . . his spouse . . . has a financial interest in the subject matter in controversy or in a party to the proceeding." The Federal Circuit court emphasized that it "is well-established that the ownership of stock constitutes a 'financial interest.'" Finally, Section 455(f)'s statutory exception would allow the judge to keep the case if, upon discovering the conflict, he had divested himself "of the interest that provide[d] the grounds for *disqualification*." *See Shell Oil Co. v. United States*, Case No. 2010-5161 (Fed. Cir. 2012) (citing 28 U.S.C. § 455).

[8] Other important cases include, to name just a few: *ExxonMobil Corporation v. United States*, 101 Fed. Cl. 576 (2011) (concluding that war-*related* risks should be borne by the government); *Ford v. United States*, 378 F.3d 1314 (Fed. Cir. 2004) (holding that the World War II-era government contract obligated the government to reimburse its former contractor fully for any "later-arising" CERCLA environmental costs); *E.I. Du Pont de Nemourts & Co. v. United States*, 365 F.3d 1367 (Fed. Cir. 2004) (holding that that all CERCLA costs are reimbursable, notwithstanding a long-expired government contract).

[9] *See ExxonMobil Corp.*, 101 Fed. Cl. at 579-81.

[10] *Id.*

[11] *Id.* (emphasis added).

[12] *Id.* at *580*.

[13] *See id.*

[14] *Id.* at 581 (emphasis added).

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