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Carbon credits: asset and/or liability in restructuring?

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Arnold & Porter partners Brian Lohan in Chicago and Maja Zerjal Fink in New York consider the treatment of emissions credits in the financing and restructuring context and suggest unified systems for trading and dealing in them around the world.

In an effort to fight climate change, companies, countries, states and cities are undertaking efforts to reduce greenhouse gas emissions. Many have set ambitious goals to achieve net zero carbon emissions in the next 30 years. Reducing emissions is, in many cases, a costly, lengthy and/or technologically challenging process.

In certain jurisdictions, companies have the option of meeting the required or desired emissions limits by applying so-called carbon credits or emission reduction credits

(ERCs), which are certificates representing quantities of greenhouse gases that have been kept out of, or removed from, the air.

Carbon credits are usually generated by projects, such as reforestation or production or utilisation of biofuels, which are certified and reviewed by applicable agencies or institutions to ensure the quality of the credit. Once a carbon credit is claimed, it is canceled or retired.

Carbon credits have been traded for decades in both the compliance and the voluntary market. Compliance markets are governed by regional, state, national and international carbon reduction regimes.

For example, the Regional Greenhouse Gas Initiative (RGGI) is a cooperative effort among the US states of Connecticut, Delaware, Maine, Maryland, Massachusetts, New Hampshire, New Jersey, New York, Rhode Island, Vermont, and Virginia to cap and reduce power sector CO₂ emissions. RGGI allowances are offered through quarterly, regional CO₂ allowance auctions. These auctions are sealed-bid, uniform price auctions that are open to all qualified participants. They result in a single quarterly clearing price. In addition to purchasing allowances at auction, entities are also able to trade allowances on secondary markets, either directly via over-the-counter trades, or indirectly through futures contracts on exchanges such as ICE and Nodal Exchange.

Voluntary markets, which function outside of regulatory regimes, have grown significantly in recent years. There are multiple exchanges in operation, but the market is constrained by the lack of global recognition, governance and regulation of accreditation and legitimacy, varying accounting and verification methodologies, long lead time in the ramp-up of projects and quality verifications, and uncertain liquidity and financing.

In spite of these challenges, demand will likely continue to grow exponentially, potentially reaching US\$50 billion by 2030. For example, Tesla booked US\$518 million in revenue from sales of regulatory credits in the first quarter of 2021 alone, and environmental credits will likely become a more important source of revenue for a growing number of companies.

The topic of emission credits, such as RGGI, has not, generally, been a frequent issue in US bankruptcy cases, but in light of the growing demand and markets for these credits, they could become a more common issue. Emission credits or allowances (and the corresponding regulatory frameworks) are both an estate asset and liability, depending on the perspective from which you are evaluating the credits.

Generally, carbon credits held by debtors, or at least their economic value, have been treated as property of the debtor's estate. As such, they have been transferred as any other asset of the bankruptcy estate, subject to standard Bankruptcy Code limitations

– including that applicable non-bankruptcy law permits the sale free and clear of applicable interests. The Chapter 11 cases of Enron, truck stop chain Flying J, and Utah-based steel mill Geneva Steel all involved court-approved sales of the debtor’s emission reduction credits.

In the two most recent (and highly publicised) cases, Philadelphia Energy Solutions and La Paloma Generating, the emissions credits were discussed in the context of a liability.

In Philadelphia Energy, the company did not have sufficient credits, known as “RINs”, to comply with the US Renewable Fuel Standard (RFS) programme to reduce emissions. Ultimately, the company settled with the regulator and the issues were not adjudicated.

In La Paloma, the debtor’s secured lender acquired La Paloma’s assets through a credit bid. In connection with the transaction, the bankruptcy court was asked to determine whether the purchasers of the La Paloma assets assumed successor liability under California’s “cap and trade” program. The bankruptcy court concluded neither Bankruptcy Code section 363(f) nor the California regulation at issue imposed successor liability on the purchaser, and as such, the purchaser was not liable for the debtor’s pre-transfer “cap and trade” obligations (it would only become liable for “cap and trade” obligations going forward after the purchase closed).

In short, the emission surrender obligations were an “interest” under Bankruptcy Code 363(f), and the debtor’s property could be sold free and clear of such interest. While the decision was promising for debtors seeking to sell their assets, the outcome in a similar situation could be different if the relevant regulations expressly provided for successor liability.

The transactions in Philadelphia Energy and La Paloma highlight the importance of considering emission credits from a borrower/lender and seller/buyer perspective. What if the court determined the assets could not have been sold free and clear of the claims and interests? And, what if there was a question regarding whether the credits were pledged as collateral, or whether the secured creditors properly perfected their security interests in the credits?

Carbon credits are regularly included in all-asset collateral packages – for example, in renewables projects. From a secured lender’s perspective, if the borrower either generates or possesses credits/allowances, it is important to understand, among other things, how the credit/allowance is generated.

The nature of the credits and allowances, how they can be traded, the value of such credits (and its erosion when a carbon credit is claimed and canceled), the liquidity of these instruments, where and how they are evidenced, and the relevant regulatory schemes and the jurisdiction that applies to the extent a borrower generates or

possesses credits/allowances, or operates in multiple jurisdictions are all relevant questions to understand how in practice the credits/allowances can be monetised by the secured lender in the event of a borrower default.

While it is important to obtain a security interest over the credits/allowances, it is equally important to understand how they are evidenced, how they are held, and how they can be sold. The foregoing questions will also determine how to perfect such security interests properly, which should be determined jurisdiction by jurisdiction.

Moreover, to the extent a borrower or seller operates in a jurisdiction where the statute provides for successor liability, a secured lender or buyer may want to ensure sufficient monitoring over the borrower's portfolio of credits/allowances.

As climate change initiatives advance, it is more likely issues relating to carbon credits and their associated regulatory framework will increase in bankruptcy cases. This is particularly likely in situations involving successor liability, collateral-related issues and attempts to impede a debtor's ability to freely transfer and monetise such credits.

In addition, in the UK, certain liquidations have exposed the lack of transparency and resultant risk of fraud in the carbon credit markets. Several companies involved in a carbon credit scam (including Alpine Consult, Mulberry Wynford and Foxstone Carr) came under fire and were ordered into liquidation after investigations by The Insolvency Service that revealed sales of carbon credits to public investors at inflated prices and misleading information.

The European Union's Emissions Trading Scheme was likewise target of widespread tax fraud, where traders sold carbon credits with VAT added but did not remit the VAT to the relevant tax authority.

Since climate change is a global initiative, unified systems/methods for trading and recording ownership of these types of credits should be considered to ensure transparency, avoid fraud, and encourage consistency in the treatment of emissions credits in insolvency proceedings around the world.

Further reading

Unilever, Microsoft, and Brooks are among 13 additional companies to join The Climate Pledge, Amazon News, (last visited 6 Oct 2021)

Net Zero Tracker, Energy & Climate Intelligence Unit (last visited 6 Oct 2021)

United Nations Climate Action (last visited 6 Oct 2021)

C40 Cities, (last visited 6 Oct 2021)

Christopher Blaufelder et al., A blueprint for scaling voluntary carbon markets to meet the climate challenge, McKinsey Sustainability (29 Jan 2021), (last visited 6 Oct 2021)

See *In re La Paloma Generating, Co.*, No. 16-12700 (CSS), 2017 Bankr. LEXIS 3876 (Bankr. D. Del. Nov. 9, 2017)

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