AMERICAN BANKRUPTCY INSTITUTE
JOURNAL
Issues and Information for Today's Busy Insolvency Professional

Chapter 11 and Environmental Law

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Bankruptcy law and environmental law have various things in common. They are both based, in large part, on federal statutes. They both deal with "discharges" of one sort or another. And they both involve color transformations. Environmental law deals with places that were once green and have become brown and addresses how to make them green again. And bankruptcy law deals with businesses that were once in the black, have gone into the red, and focuses on how to get them back into the black.

Despite these perhaps not-too-compelling similarities, the intersection of these two areas of law has engendered a great deal of uncertainty and confusion over the years, and it is difficult to articulate a unified field theory of how these two forces interact. There are several reasons for this. First, lawyers who work in one area or the other often tend to not only be unfamiliar with the other, but intimated by it. A recent study has revealed that lawyers who took bankruptcy law in law school rarely took environmental law, and vice versa.[1] Second, the key federal statutes—the Bankruptcy Code on the one hand and the federal environmental laws on the other—do not even acknowledge each other's existence. Congress has not attempted to articulate how these respective areas of the law should interact, and has left that issue to the courts. Third, the jurisprudence in this area has often raised more questions than it has answered.

Significantly, the Supreme Court has entered the fray only twice, in the *Kovacs* and *Midlantic* decisions in the mid 1980s, and has not returned to the field since. And those two cases, even with the benefit of 20 years of interpretation, remain as clear as a section of *Ulysses.*

While a great deal has been written on this issue, this installment endeavors to boil down the state of the law in this area to five basic points. But before doing that, it is a useful construct to divide environmental law into two categories.

The first is ongoing regulatory compliance. Statutes like the Clean Air Act and the Clean Water Act regulate ongoing business activities. If, for example, a factory, spews out air pollution, it has to meet specific requirements. These requirements can include the need for control equipment, like a scrubber, on what goes out of a factory's stack. These requirements only exist as long as the factory is operating. If the factory shuts down, it obviously no longer needs to run its scrubber.

The second category of environmental laws relates to clean-up of past pollution. Various environmental laws require a person or business that created contamination in the past, sometimes the distant past, to clean up that contamination. The 1980 federal Superfund statute, affectionately known as CERCLA,[2] is the leading example of such a law, and imposes clean-up liability on persons who in the past or present owned or operated contaminated sites, or arranged to dispose of their wastes at such a site. Clean-up liability is different from regulatory compliance in that even if the business stops operating, the clean-up liability still remains. And sometimes, the clean-up liability is actually triggered by the very decision to stop operating. For example, a gas station that is closing is obligated to do an environmentally sound closure that addresses any environmental contamination that the gas station may have created.

We are now ready for the five points.

Chapter 11 - "201"

Point 1: You Gotta Do What You Gotta Do: Bankruptcy Is No Excuse for Regulatory Noncompliance

As we will discuss below, there is significant uncertainty about the effect

[1] This study consisted of the author's asking for a show of hands before a number of talks he has given on this subject to different groups of lawyers.

[2] The Comprehensive Environmental Response, Compensation and Liability Act.

of bankruptcy on clean-up liabilities. But there is hardly any uncertainty about its effect on regulatory compliance. There is great consensus for the conclusion that the effect of bankruptcy on regulatory compliance is that there is none at all. This makes much sense from a policy perspective: It would be highly problematic if bankruptcy were used as an excuse for violating the law, especially laws enacted to protect public health and the environment we all share. And a number of bankruptcy-related provisions effectuate this result. Four are particularly significant.

- First, 28 U.S.C. §959(b) requires bankruptcy trustees and debtors-in-possession (DIPs) to comply with applicable state laws (and has been interpreted to include federal laws too).
- Second, the automatic stay of §362 of the Bankruptcy Code is subject to an exception for government police and regulatory powers, so that if a company is not complying with the environmental laws while in bankruptcy, the government can take enforcement action against it.
- Third, Bankruptcy Code §503, which provides for the first priority payment of administrative expense, has been interpreted to mean that if a company violates the environmental laws (or other laws) while in bankruptcy, the resulting fine or penalty the government may seek will generally be classified as an administrative expense.
- Finally, the discharge a debtor receives will not effect its continuing obligation to comply with the environmental laws because only "claims" can be discharged, and "claim" is defined in Bankruptcy Code §101(4) in terms of "rights to payment"—a definition that is generally considered to exclude regulatory compliance obligations.

Taken together, these provisions, and the cases interpreting them, mean that a company cannot effectively seek to turn itself around by cutting corners on environmental compliance. If it does, it will be subject to the same enforcement proceedings that a nondebtor can be subject to. So much for the easy part.

Point 2: You Own It, You Clean It

Not surprisingly, most of the litigation on environmental/bankruptcy issues has involved clean-up liability. And within that category, it is useful to distinguish between two situations: (1) where a debtor's liability relates to the clean-up of property it owns, and (2) where it relates to property it does not own. We start with the former.

Consider a situation where a debtor owns a steel mill that has been contaminated through decades of operation. The debtor might try to argue that the clean-up liability arises from its pre-bankruptcy activities and so should be considered a pre-petition claim. If its pre-petition activities caused tort liability, that would be a pre-petition liability, so why shouldn't a clean-up liability be the same? This argument has been generally rejected by the courts, in large part because the debtor's continuing ownership carries with it under the environmental laws a continuing obligation to clean up. The contaminated property is the "hot potato," and as long as the debtor owns it, it cannot escape responsibility for it.

Similarly, if a reorganized debtor emerges from chapter 11 with the hot potato property still in its hands, its discharge will not relieve it of clean-up liability. This was the gist of one of the Supreme Court cases, *Ohio v Kovacs,*[3] where the Court ruled that an individual who no longer owned a contaminated property after he received a bankruptcy discharge did not have to clean up that property. But the Court made clear that anyone in possession of contaminated property remains responsible to comply with the law, and presumably to clean it up.

This all creates a challenge for a reorganizing chapter 11 debtor that has the misfortune to own contaminated property that will be expensive and take a long time to clean up. If the debtor exits bankruptcy still owning the property, it will remain liable for the full clean-up. But what are the alternatives? One alternative that might be considered is abandonment under Code §554, which allows a trustee to abandon burdensome property. And contaminated property can be quite burdensome.

In the second Supreme Court decision in this area, *Midlantic National Bank v. New Jersey Department of Environmental Protection,*[4] the Court held that the authority to abandon was not absolute and could be constrained by state environmental laws, but only those intended to protect the public from "imminent and identifiable harm." In other words, before abandoning contaminated property a chapter 7 trustee may need to address certain serious environmental risks, but not all environmental risks. If some contaminated property can be abandoned, does that help a chapter 11 debtor that owns contaminated property it wishes to divest before plan confirmation?

Probably not, because of the absence of an entity to abandon the property to. A chapter 7 trustee can abandon to the debtor itself. But if a chapter 11 DIP abandons to the reorganized debtor in its nonfiduciary capacity, is anything accomplished? When the debtor emerges from bankruptcy, it will still be holding the "hot potato" and presumably still be liable for the clean-up.

An alternative approach that has been used with success in some recent cases would be for the chapter 11 debtor to, as part of its reorganization plan, transfer the contaminated property to a trust created to own, manage and clean up the property. In such a case, the debtor would need to provide the trust with funding likely to be sufficient to effectuate cleanup, or the environmental regulators would object. But if the trust were set up in good faith with funding reasonably believed at the time to be sufficient to complete the clean-up, and the clean-up costs exceeded estimates (a dynamic that happens with some frequency), the reorganized debtor would be able to assert that as it no longer owned the property, it was no longer liable for clean-up.

Point 3: If You Don't Own It, Think Twice Before Filing in Delaware

One of the most contentious issues relates to the clean-up obligation for a debtor that has legal liability for a property that it no longer owns. This liability could arise from prior ownership or operation, or from disposal of waste at a facility it never owned. This type of obligation certainly looks more like a classic pre-petition claim, but looks can be deceiving.

The main concern a debtor has here arises from the fact that the government often has two different types of approaches it can use to address contaminated property. Sometimes the government can clean up the property itself and then send liable parties a bill. The federal Environmental Protection Agency uses this procedure a great deal under CERCLA, and has a fund to perform such clean-ups. The bill it sends is clearly a monetary claim and will likely be considered a pre-petition claim. But

[3] 469 U.S. 274 (1985).

[4] 474 U.S. 494 (1986).

the government also has the authority to order liable parties to do the clean-ups themselves. Is that obligation a monetary claim? It will certainly cost money to comply—liable parties almost always hire third parties to do the clean-up—but the government wants clean-up, not money.

In Code terms, this issue manifests itself in two distinct but similar ways. Section 362(b)(4) exempts from the automatic stay government regulatory actions, but not enforcement of money judgments. Is a clean-up order a money judgment? Section 101(4) defines claim—the predicate term for a discharge—to include equitable remedies that give rise to rights to payment. Does a clean-up order give rise to a right to payment? We have now reached the heart of the environmental/bankruptcy darkness.

And this is an issue with enormous ramifications. If clean-up orders are not "money judgments" or "claims," then a debtor can be made to clean up during or after bankruptcy every site for which it has clean-up liabilities. In the pending bankruptcy of ASARCO filed in 2005, a company that had engaged in a century of metals refining and smelting (operations that left behind a great deal of contamination), it has identified about 100 sites for which it has clean-up liability.

So what is the answer? A 12-year-old Third Circuit case, *In re Torwico Electronics Inc.*,[5] held that, at least on the facts presented there, a former owner and operator of a site could be ordered to clean it up because the government was seeking clean-up, not money. The case has been much discussed and often criticized, and there are cases outside the Third Circuit that support a contrary conclusion, but it has not been overruled, and so within the Third Circuit there is a substantial likelihood that government clean-up orders can be enforced against debtors who do not own the property. A corporation planning to file a chapter 11 case, and considering Delaware as the venue, would be wise to keep this in mind if it has significant environmental liabilities.

Point 4: Timing Is Everything

A debtor seeking to address its cleanup liabilities in bankruptcy has one other concern to consider. Even if its cleanup obligation for sites it does not own could be considered pre-petition claims and discharged through confirmation of a plan, there is also the issue of when exactly the claim will be deemed to arise for bankruptcy purposes. Under §1141(d), only claims that arise pre-confirmation are discharged.

A clean-up obligation can play out over quasi-geologic time. The EPA has addressed sites under CERCLA in the 1990s arising from activities that took place in the 19th Century. As with other delayed-manifestation-type claims, this issue is presented for environmental cleanup claims: When does the claim arise? Is it when the debtors' activities took place, or when "bad stuff" (an environmental term of art) got into the environment or when the site is discovered to be a problem, or is it when the clean-up is undertaken? This "trigger" issue was much litigated in the past, but most courts have now agreed that the test is whether a particular clean-up obligation was within the "fair contemplation of the parties" during the bankruptcy. Therefore, a debtor trying to maximize its discharge will have an incentive to make sure that the EPA and state environmental agencies know as much as possible about contaminated sites for which the debtor may be liable.

This debtor goal of overloading the government with information was in some ways facilitated by the one effort to address environmental issues that appears in your Bankruptcy Code and Rules book. It appears not in the Code, but in the Forms attached to the rules, and is procedural rather than substantive. Form 7, the Statement of Financial Affairs, now requires debtors in their schedules to provide detailed information on a range of environmental matters. Item 17 requires the debtor to list every site for which it has received notice of potential liability under an environmental law, every site where the debtor has notified the government of a hazardous release, and all pending judicial or administrate environmental proceedings. Completing this form will necessitate an early review of a debtor's potential cleanup liabilities, and the process of compiling and submitting its information will facilitate an argument down the road that everything scheduled was within the fair contemplation of the government at the time.

Point 5: Even Mao Needed Six Points

Before coming to the fifth point, let's review the first four:

- Bankruptcy is not an excuse for violating environmental regulatory requirements.
- A debtor or reorganized debtor that owns contaminated property is, bankruptcy notwithstanding, responsible to clean it up.
- A debtor or reorganized debtor that has liability for clean-up of property it does not own could be ordered by the government to clean the property up, or perhaps not.
- Clean-up liability claims will likely be deemed to arise for bankruptcy purposes when they are within the fair contemplation of the parties.

The fifth point is that the remaining issues that arise in this area cannot be summed up in one final point. Sorry! But there are a hodgepodge of other issues that can arise in the bankruptcy/environmental interface. These include such things as: How are environmental contribution claims among liable parties addressed in bankruptcy? How are environmental liens addressed in bankruptcy? When are environmental issues subject to mandatory withdrawal from the bankruptcy court under 28 U.S.C. §157(d)? Plus, there are a range of others reflecting the breadth of environmental law and the intricacies of the Code. But the good news is, as stated at the outset, that a lot has been written on these issues.[6] And there may even by now be some lawyers who took both environmental law and bankruptcy in law school. ■

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5 8 F.3d 146 (3d Cir. 1993), *cert denied*, 511 U.S. 1046 (1994).

6 A leading treatise on this subject, entitled *Environmental Obligations in Bankruptcy*, was written and updated by the late Prof. Kathryn Heidt and is published by Warrant Gorham Lamont. A much shorter discussion of these issues is the author's chapter on bankruptcy (Chapter 10) in the 11-volume *Environmental Law Practice Guide*, published by LexisNexis Mathew Bender.