

Environmental Considerations For Cos. Contemplating Ch. 11

By **Dianne Phillips and Maria de la Motte** (September 23, 2020, 2:34 PM EDT)

With economic downturn comes bankruptcy. It is often observed that the intersections between the U.S. Bankruptcy Code and environmental law can create conflict, because while many federal and state environmental statutes seek to hold parties responsible for contamination, in some cases, many years after a release has occurred, the Bankruptcy Code seeks to offer debtors a fresh start.

Debtors reorganizing under Chapter 11 of the Bankruptcy Code, and their creditors, should be aware that environmental obligations may be exempt from the automatic stay and that some environmental obligations will not be dischargeable in bankruptcy. This article provides an overview of common issues arising at the intersection of bankruptcy and environmental law.

Not all environmental obligations are subject to the automatic stay.

One important consideration is whether an environmental claim or obligation will be subject to the automatic stay. Section 362(a) of the Bankruptcy Code mandates that prepetition claims of creditors are automatically stayed, triggered by the filing of the bankruptcy petition.[1]

There is an exception to the automatic stay for a governmental entity's commencement or continuation of an action within its police or regulatory power.[2] An action to collect a monetary judgment, however, will be stayed.[3]

A Chapter 11 debtor must comply with environmental laws prior to filing its plan of reorganization — and afterwards, if it remains in possession.[4] Analysis of the police and regulatory power exception to the automatic stay is not only highly fact-dependent, but similar facts are sometimes analyzed differently by courts in counterintuitive ways.[5]

Generally, the automatic stay will not be effective against proceedings to fix penalty amounts, natural resource damage amounts or involving the share of costs to be allocated to a potentially responsible party under the Comprehensive Environmental Response, Compensation and Liability Act, or CERCLA.[6]

In considering whether such claims fall within the police and regulatory power exception to the automatic stay, most courts will employ either or both of two tests — the pecuniary purpose test and public policy test.[7]

Under the pecuniary purpose test, reviewing courts focus on whether the proceeding relates primarily to the government's pecuniary interest or to matters of public safety, with matters of public safety falling within the exception to the automatic stay.

Under the public policy test, courts except proceedings effectuating public policy from the stay, whereas those adjudicating private rights — for example, a government agency's suit



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to recover from a contractor who failed to deliver goods — will be stayed.[8]

The automatic stay will, however, be effective against the enforcement of monetary judgments, even if such enforcement is in furtherance of the government's regulatory powers, because otherwise, the government would receive unfair treatment compared with other creditors.[9] For example, efforts to collect a potentially responsible party's share of CERCLA cleanup costs will be stayed.[10]

Not all environmental claims are dischargeable.

Chapter 11 allows debtors to discharge all claims arising before the bankruptcy petition.[11] The Bankruptcy Code defines a claim as a "right of payment" or "right to an equitable remedy for breach of performance if such breach gives rise to a right of payment." [12] The meaning of this definition in the context of environmental obligations has been the subject of considerable — and at times inconsistent — interpretation by courts.

Compliance With Environmental Laws and Regulations

After a Chapter 11 debtor has reorganized, the organization will still need to comply with environmental laws.[13] Accordingly, orders addressing ongoing pollution will often not be dischargeable.[14] There are cases where courts have refused to confirm a reorganization plan because the debtor did not satisfactorily demonstrate that it could comply with environmental laws if allowed to remain in possession after reorganization.[15]

Courts are sometimes skeptical, however, of attempts by government agencies to collect a monetary claim arising from a prepetition act of the debtor by characterizing the claim as a regulatory action to address ongoing pollution.[16]

Monetary claims related to prepetition releases, including natural resources damages, are generally dischargeable in bankruptcy.[17] This includes claims brought by the government[18] and those brought by private parties.[19]

Fines and Penalties

Fines or penalties payable to a government agency, however, may not be dischargeable in bankruptcy.[20] There is noteworthy variation in how different courts have treated fines and penalties.

A recent Delaware case found that prepetition penalties for air emission violations were dischargeable claims.[21] In contrast, other courts have not only refused to allow penalties to be discharged, but have granted them first priority payment as administrative expenses that are "actual, necessary costs and expenses of preserving the estate." [22]

These courts have characterized fines and penalties,[23] or even administrative and legal costs incurred by a state agency in arranging remediation efforts,[24] as part of the "cost of doing business" for the debtor, and therefore benefiting the estate, while other courts have found that penalties that seek to "punish and deter" do not benefit the estate and therefore should not receive administrative expense priority.[25]

Prepetition Monetary Claims Versus Injunctions

Another common issue is whether an environmental injunction, consent order or other such obligation related to prepetition activities of the debtor constitutes a prepetition claim

dischargeable in bankruptcy.

Factors courts examine include (1) whether the debtor is capable of performing the cleanup, (2) whether the pollution is ongoing, and (3) whether the environmental agency has an option under the applicable environmental statute and regulations to remedy the problem itself and seek reimbursement from the debtor.[26]

In considering whether the debtor is capable of performing the cleanup, some courts focus on whether the debtor has access to the property, with the ability of the debtor to access the property weighing towards finding a nondischargeable obligation rather than a dischargeable monetary claim.[27]

Other courts consider whether the debtor can personally complete the actions required by the injunction, reasoning that any expenditure of money makes an injunction the equivalent of a monetary claim.[28]

Most courts, however, recognize that almost all injunctions require some money to be spent,[29] and one court even found that a requirement to pay a performance bond did not constitute a monetary claim, because the purpose of the bond was to ensure the debtor's performance under the order, not to reimburse costs incurred by the state.[30]

The issue of whether pollution is ongoing can sometimes be dispositive, as courts are reluctant to allow an ongoing threat to human health or the environment.[31]

For example, where a debtor's predecessor had improperly drained wetlands and a state agency sought to require the debtor to build new replacement wetlands in another location, the court found that the agency was, in essence, seeking "compensation for past misconduct," not seeking an order ameliorating ongoing pollution.[32]

The court distinguished these facts from cases where hazardous waste is continuing to migrate into waterways unabated.[33] In another case, an injunction requiring a debtor to remove asbestos from buildings was dischargeable because the asbestos would create a hazard only if removed or disturbed, and therefore, its presence did not qualify as ongoing pollution.[34]

Cases discussing whether the U.S. Environmental Protection Agency or a state agency could opt to complete the desired action itself and seek reimbursement highlight the importance of understanding the underlying environmental statutes.

For example, under CERCLA, the EPA has the option to remediate a contaminated site and then sue potentially responsible parties for response costs, so an order to clean up a site, to the extent that it imposes obligations beyond any obligation to stop ongoing pollution, will be a dischargeable claim.[35]

In contrast, under other statutes, such as the Clean Water Act or the Resource Conservation and Recovery Act, where the government has no such option to seek payment, an injunction will not likely be found to be a dischargeable claim.[36] Courts conduct a similar analysis of state statutes.[37]

Determining When a Claim Arises

A further wrinkle is that the threshold question of whether a claim arose prepetition, and is therefore even potentially dischargeable, can be complicated for environmental claims,

especially for contingent claims, such as claims seeking future response costs and future natural resource damage costs.

Different jurisdictions apply different tests to determine when a claim arose, with many endorsing the "fair contemplation" approach.[38] In *In re: Jensen*, decided in 1993, the U.S. Court of Appeals for the Ninth Circuit held that all future response and natural resource damage costs based on prepetition conduct that can be "fairly contemplated by the parties" at the time of the debtors' bankruptcy are dischargeable claims under the Bankruptcy Code.[39]

Relevant factors include "knowledge by the parties of a site in which there may be liability, notification by the creditor to the debtor of potential liability, commencement of investigation and cleanup activities, and the incurrence of response costs." [40]

Other courts hold that an environmental claim arises "when a potential claimant can tie the bankruptcy debtor to a known release of a hazardous substance," [41] look to when the acts giving rise to the liability occurred [42] or consider when there was a relationship in which liability could arise. [43]

The ability to abandon property may be limited.

Another issue that can arise at the intersection of bankruptcy and environmental law is whether contaminated property can be abandoned. Under Section 544(a) of the Bankruptcy Code, a trustee can abandon property which is burdensome or of inconsequential value to the estate. [44]

However, in 1986, in *Midlantic National Bank v. New Jersey Department of Environmental Protection*, the U.S. Supreme Court held that "a trustee may not abandon property in contravention of a state statute or regulation that is reasonably designed to protect the public or safety from identified hazards." [45]

Cases following *Midlantic* have interpreted this holding with varying degrees of breadth. On the narrow end of the spectrum, the U.S. Bankruptcy Court for the Western District of Oklahoma court allowed abandonment where it "will not aggravate the existing situation, create a genuine emergency nor increase the likelihood of disaster or intensification of polluting agents." [46]

The U.S. Bankruptcy Court for the District of Minnesota, taking a more moderate approach, laid out a balancing test considering "(1) the imminence of danger to the public health and safety, (2) the extent of probable harm, (3) the amount and type of hazardous waste, (4) the cost to bring the property into compliance with environmental laws, and (5) the amount and type of funds available for cleanup." [47]

Some courts have taken a still-broader reading, holding that a property cannot be abandoned without full compliance with all applicable environmental law. [48]

Purchasers in Section 363 sales should still conduct all appropriate inquiries.

Section 363(f) of the Bankruptcy Code allows a debtor, upon notice to all creditors and with bankruptcy court approval, to sell assets free and clear of claims and interests. [49]

Potential purchasers of such a property should be cautioned that real property is not really "free and clear" with respect to contamination, because while a purchaser in a Section

363(f) sale is not liable for claims and interests as a successor of the debtor, it can still be held liable as a current owner or operator under CERCLA.

Therefore, purchasers at a Section 363(f) sale will still want to establish an available landowner liability defense, such as qualifying as a bona fide prospective purchaser.

Conclusion

In light of the economic downturn caused by the COVID-19 pandemic, bankruptcy and restructuring considerations are a reality for many organizations. While this article highlights some key topics at the intersection of bankruptcy and environmental law, it by no means represents an exhaustive summary of the challenges that can arise.

There is little U.S. Supreme Court case law to guide courts in this area and these matters are often highly fact-dependent, leading to variation in how different jurisdictions will treat similar issues. Depending on the concerns facing your organization, it may be important to consider potential environmental issues early in the Chapter 11 process.

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[1] 11 U.S.C. § 362(a).

[2] 11 U.S.C. § 362(b)(4).

[3] Id.

[4] See *In re Commonwealth Oil Refining Co.*, 805 F.2d 1175 (5th Cir. 1986) (U.S. EPA's RCRA enforcement action not stayed; before filing its plan of reorganization, debtor was required to cease treating, storing and disposing of waste without EPA permit and submit closure and post-closure plans for its disposal facilities).

[5] Compare *In re Goodwin*, 163 B.R. 825 (Bankr. D. Idaho 1993) (Idaho Department of Health and Welfare's suit seeking injunction stayed as a pre-petition claim because under the applicable statute, the state could have sought money damages instead) and *City of New York v. Exxon Corp.*, 932 F.2d 1020 (2d Cir. 1991) (New York City's suit for CERCLA recovery not stayed, which sought reimbursement of waste removal costs, natural resource damages, and a declaratory judgment that debtor was liable for future costs).

[6] See *U.S. v. Jones & Laughlin Steel Corp.*, 804 F.2d 348 (6th Cir. 1986) (Judicial proceeding to fix the amounts debtor owed to various government entities not stayed, as resolution represented a regulatory action and would not affect the assets available to other creditors). See also *City of New York v. Exxon Corp.*, 932 F.2d 1020 (2d Cir. 1991); *U.S. v. Nicolet, Inc.*, 857 F.2d 202 (3d Cir. 1988); *In re Commerce Oil Co.*, 847 F.2d 291 (6th Cir. 1988); *U.S. v. Sugarhouse Realty*, 162 B.R. 113 (E.D. Pa. 1993); *U.S. v. Alsol Corp.*, 2014 WL 46775 (D.N.J. Jan. 2, 2014).

[7] See *In re Commerce Oil Co.*, 847 F.2d 291, 295 (6th Cir. 1988).

[8] *Id.*

[9] See *U.S. v. Nicolet, Inc.*, 857 F.2d 202 (3d Cir. 1988); *In re Commonwealth Oil Refining Co.*, 805 F.2d 1175, 1183 (5th Cir. 1986); *Penn Terra Ltd. v. Dep't of Env'tl. Res.*, 733 F.2d 267, 272 (3d Cir. 1984); *U.S. v. Sugarhouse Realty*, 162 B.R. 113, 117 (E.D. Pa. 1993).

[10] See *U.S. v. Nicolet, Inc.*, 857 F.2d 202 (3d Cir. 1988); *U.S. v. Alsol Corp.*, 2014 WL 46775 (D.N.J. Jan. 2, 2014).

[11] 11 U.S.C. § 1141(d).

[12] 11 U.S.C. § 101(5)(A-B).

[13] See *Ohio v. Kovacs*, 469 U.S. 274, 285 (1985); *In re CMC Heartland Partners*, 966 F.2d 1143, 1146 (7th Cir. 1992); *In re Industrial Salvage, Inc.*, 196 B.R. 784, 790 (Bankr. S.D. Ill. 1996).

[14] See generally *U.S. v. Apex Oil Co.*, 579 F.3d 734 (7th Cir. 2009); *In re Torwico Electronics, Inc. v. N.J. Dep't of Env'tl. Prot.*, 8 F.3d 146 (3d Cir. 1993); *In re Chateaugay Corp.*, 944 F.2d 997 (2d Cir. 1991); *In re Taylor*, 572 B.R. 592 (Bankr. E.D.N.C. 2017); *Mark IV Industries Inc. v. N.M. Env't Dep't*, 438 B.R. 460 (Bankr. S.D.N.Y. 2010); *In re Industrial Salvage, Inc.*, 196 B.R. 784 (Bankr. S.D. Ill. 1996).

[15] See, e.g., *In re Jager*, 609 B.R. 156 (Bankr. W.D. Penn. 2019); *In re Lewis*, 215 B.R. 880 (Bankr. D. Alaska 1997).

[16] See, e.g., *In re Peabody Energy Corp.*, 958 F.3d 717 (8th Cir. 2020) (state statutory and common law tort claims discharged in bankruptcy as claims to recover money, not claims brought under the police or regulatory power of the state); *In re G-I Holdings Inc.*, 654 Fed. Appx. 571, 574 (3d Cir. 2016) (*New York City Housing Authority's* claims seeking asbestos removal discharged in bankruptcy as a monetary claim for property damage, not a regulatory action to abate ongoing pollution). For further discussion of the Eighth Circuit's recent decision in *In re Peabody Energy Corp.*, see Holland & Knight's Energy and Natural Resources Blog: "U.S. Court of Appeals Holds That Climate Change Tort Claims Are Dischargeable in Bankruptcy," Aug. 21, 2020.

[17] See generally *Ohio v. Kovacs*, 469 U.S. 274 (1985); *In re Nat. Gypsum Co.*, 139 B.R. 397 (Bankr. N.D. Tex. 1992).

[18] See, e.g., *Ohio v. Kovacs*, 469 U.S. 274, 283-85 (1985); *In re Peabody Energy Corporation*, 958 F.3d 717, 724 (8th Cir. 2020); *In re Chateaugay Corp.*, 944 F.2d 997, 1008 (2d Cir. 1991); *In re G-I Holdings Inc.*, 654 Fed. Appx. 571, 572 (3d Cir. 2016); *In re Jimmo*, 204 B.R. 655, 660 (Bankr. D. Conn. 1997).

[19] See, e.g., *In re Chemtura Corp.*, 439 B.R. 561, 570 (Bankr. S.D.N.Y. 2010); *In re Texaco Inc.*, 182 B.R. 937, 953-54 (Bankr. S.D.N.Y. 1995).

[20] See, e.g., *Cumberland Farms v. Fla. Dep't of Env'tl. Prot.*, 116 F.3d 16, 20 (1st Cir. 1997); *In re Jimmo*, 204 B.R. 655, 659 (Bankr. D. Conn. 1997).

[21] See *In re Exide Technologies*, 613 B.R. 79, 81 (Bankr. D. Del. 2020), appeal docketed,

No. 20-8023 (3d Cir. April 23, 2020).

[22] 11 U.S.C. §§ 507(a), 503(b)(1)(A); see *In re Chateaugay Corp.*, 944 F.2d 997, 1009-10 (2d Cir. 1991).

[23] See *Cumberland Farms v. Fla. Dep't of Env'tl. Prot.*, 116 F.3d 16, 22 (1st Cir. 1997) ("The payment of a fine for failing, during bankruptcy, to meet the requirements of Florida environmental protection laws is a cost 'ordinarily incident to operation of a business' in light of today's extensive environmental regulations.").

[24] See *Com. of Pa. Dep't of Env. Res. v. Conroy*, 24 F.3d 568, 569-71 (3d Cir. 1994).

[25] See *In re Exide Technologies*, 613 B.R. 79, 89 (Bankr. D. Del. 2020), appeal docketed, No. 20-8023 (3d Cir. April 23, 2020).

[26] *Mark IV Industries Inc. v. N.M. Env. Dep't*, 438 B.R. 460, 467-68 (Bankr. S.D.N.Y. 2010).

[27] See, e.g., *Ohio v. Kovacs*, 469 U.S. 274, 283 (1985); *In re Torwico Electronics, Inc. v. N.J. Dep't of Env'tl. Prot.*, 8 F.3d 146, 151 (3rd Cir. 1993); *In re Taylor*, 572 B.R. 592, 603 (Bankr. E.D.N.C. 2017); *Mark IV Industries Inc. v. N.M. Env. Dep't*, 438 B.R. 460, 469 (Bankr. S.D.N.Y. 2010).

[28] See, e.g., *U.S. v. Whizco, Inc.*, 841 F.2d 147, 151 (6th Cir. 1988); *Gable v. Borges Const., Inc.*, 792 F. Supp. 2d 117, 123 (D. Mass. 2011).

[29] See, e.g., *U.S. v. Apex Oil Co.*, 579 F.3d 734 (7th Cir. 2009); *In re Torwico Electronics, Inc. v. N.J. Dep't of Env'tl. Prot.*, 8 F.3d 146 (3d Cir. 1993); *In re Commonwealth Oil Refining Co.*, 805 F.2d 1175, 1186 (5th Cir. 1986); *Mark IV Industries Inc. v. N.M. Env. Dep't*, 438 B.R. 460, 467 (Bankr. S.D.N.Y. 2010); *In re Industrial Salvage, Inc.*, 196 B.R. 784, 789 (Bankr. S.D. Ill. 1996).

[30] See *U.S. v. Hubler*, 117 B.R. 160, 164-65 (W.D. Pa. 1990).

[31] See generally *In re Torwico Electronics, Inc. v. N.J. Dep't of Env'tl. Prot.*, 8 F.3d 146, 151 (3rd Cir. 1993).

[32] See *In re IT Group, Inc., Co.* 339 B.R. 338, 342-43 (D. Del. 2006).

[33] *Id.*

[34] *In re G-I Holdings Inc.*, 654 Fed. Appx. 571, 574 (3d Cir. 2016).

[35] *In re Chateaugay Corp.*, 944 F.2d 997, 1008 (2d Cir. 1991).

[36] *U.S. v. Apex Oil Co.*, 579 F.3d 734, 736-37 (7th Cir. 2009); *In re Taylor*, 572 B.R. 592, 603 (Bankr. E.D.N.C. 2017).

[37] See, e.g., *Mark IV Industries Inc. v. N.M. Env. Dep't*, 438 B.R. 460, 469 (Bankr. S.D.N.Y. 2010) (where New Mexico Water Quality Act did not allow the state to conduct the cleanup itself and recover costs, injunction was not a dischargeable claim).

[38] See, e.g., *In re Crystal Oil Co.*, 158 F.3d 291, 298 (5th Cir. 1998); *In re Jensen*, 995

F.2d 925, 930 (9th Cir. 1993); In re Nat. Gypsum Co., 139 B.R. 397, 409 (N.D. Tex. 1992); In re Motors Liquidation Co., 598 B.R. 744, 756 (S.D.N.Y. 2019).

[39] In re Jensen, 995 F.2d 925, 930 (9th Cir. 1993) (internal citation omitted).

[40] United Artists Theatre Circuit, Inc. v. Cal. Regional Water Quality Control Bd., 255 Cal. Rptr. 3d 796, 831 (2019).

[41] In re Crystal Oil Co., 158 F.3d 291, 298 (5th Cir. 1998).

[42] See, e.g., In re Parker, 313 F.3d 1267, 1269-70 (10th Cir. 2002); Grady v. A.H. Robins Co., 839 F.2d 198, 203 (4th Cir. 1988).

[43] See In re Motors Liquidation Co., 598 B.R. 744, 755 (S.D.N.Y. 2019).

[44] 11 U.S.C. § 554(a).

[45] Midlantic Nat. Bank v. N.J. Dep't of Env'tl. Prot., 474 U.S. 494, 507 (1986).

[46] In re Oklahoma Refining Co., 63 B.R. 562, 565 (Bankr. W.D. Okla. 1986). See also In re Smith-Douglass, Inc., 856 F.2d 12, 16 (4th Cir. 1988); In re Brio Refining, Inc., 86 B.R. 487, 489 (N.D. Tex. 1988).

[47] In re Franklin Signal Corp., 65 B.R. 268, 272 (Bankr. D. Minn. 1986).

[48] See, e.g., In re Peerless Plating Co., 70 B.R. 943, 946-47 (Bankr. W.D. Mich. 1987).

[49] 11 U.S.C. § 363(f).