

May 2020

Follow @Paul_Hastings



Seven Things to Keep in Mind about Treatment of Environmental Liabilities in Bankruptcy

By [Tom Munteer](#)

For debtors seeking to reorganize under Chapter 11 of the Bankruptcy Code, creditors with claims against reorganizing debtors, and purchasers of assets in bankruptcy court-administered sales, this alert flags seven things to keep in mind about the treatment of environmental liabilities in bankruptcy.

I. Bankruptcy Doesn't Excuse Compliance with Environmental Rules

While a Chapter 11 debtor remains in possession of its assets, the debtor must comply with all environmental rules that govern its assets' operations. Debtors must abide by all the conditions in their air emissions and water discharge permits and all hazardous waste management rules.

Bankruptcy Code Section 362's automatic stay of administrative and judicial proceedings provides a reorganizing debtor breathing room.¹ The automatic stay is not effective, however, against government agencies' enforcement of their police powers.² In the case of environmental rules, the Supreme Court held that the automatic stay does not excuse compliance with environmental rules if the debtor operates after filing a Chapter 11 petition.³ As a result, the government can secure injunctive relief against a debtor under the Clean Air or Clean Water Acts or federal hazardous waste management law.⁴

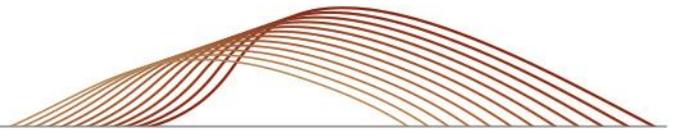
The situation is a little more complicated when it comes to government agencies' pursuit of penalties for noncompliance. Administrative or judicial proceedings to *fix* penalty amounts are not subject to the automatic stay.⁵ Efforts to *collect* money judgments once the penalties are fixed, however, are stayed.⁶

The same principles govern efforts to collect a potentially responsible party's share of Superfund site cleanup costs. The government's action against a debtor to *fix* its share of costs can proceed but an effort to *collect* a money judgment is stayed.⁷

II. Cleanup Cost and Environmental Damage Claims Are Dischargeable as General, Unsecured Claims

Chapter 11 reorganizations provide debtors with a fresh start by extinguishing—"discharging" in bankruptcy terms—"claims" that arose before the debtor filed bankruptcy.⁸ The Bankruptcy Code defines a "claim" as either a "right to payment"⁹ or a "right to an equitable remedy for breach of performance if such breach gives rise to a right to payment."¹⁰

Environmental liabilities treated as "claims" will be discharged by plan confirmation.



Environmental liabilities can include such things as cleanup costs (either at the debtor's own site or at disposal sites the debtor sent waste to) or environmental damage the debtor's operations caused to adjoining property. Bankruptcy courts typically treat such liabilities as general, unsecured claims.

Even unknown and uncertain hazardous substance release response costs are dischargeable claims. The bankruptcy of a major industrial company illustrates the impact of this rule. EPA may file a proof of claim for tens of millions of dollars in response costs at the many Superfund sites to which EPA *knows* an industrial debtor sent its waste. EPA may believe those sites represent only a fraction of the sites at which the debtor *might* have sent its waste. Despite the uncertainty, plan confirmation discharges the debtor's cleanup liability for unknown response costs at unknown sites.¹¹

The rule holds for environmental damages sought in tort actions as well. Tort claims for property damages that adjoining landowners brought in state court after confirmation of an oil and gas producer's reorganization plan were discharged, even where the property owners did not know the debtors' operations had had impacts on their properties.¹²

III. Cleanup Cost Claims Arise When the Spill Occurred

In order for cleanup liabilities to be discharged by confirmation of a plan of reorganization, the claim must have arisen before the debtor filed bankruptcy. This rule makes determining when the claim arose critical.

Bankruptcy courts generally hold that cleanup liability arose when a spill occurred. Environmental liability will have arisen—and thus be a dischargeable claim—if the release or threatened release occurred prior to bankruptcy.¹³

The effect of this rule is to protect reorganized entities that receive claims years after a court confirmed their bankruptcy plan. The rule does not depend on whether, for example, adjoining property owners had knowledge of the damage the release did to their property¹⁴ or whether EPA knew about the release before bankruptcy.¹⁵

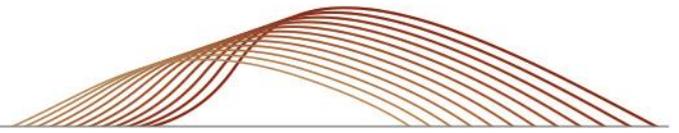
IV. Injunctive Obligations Endure for Reorganizing (and Reorganized) Debtors

The specific type of environmental relief sought affects whether an environmental liability is considered a "claim." Unlike cleanup cost claims or claims for compensation for environmental damages just discussed, demands for injunctive relief are not "claims" and are not dischargeable.

There is substantial authority establishing that cleanup orders (i.e., injunctions) are not claims and, therefore, will not be discharged. These can be either orders issued by government agencies or judicial injunctions obtained by private parties to address on-going hazardous substance releases.¹⁶

This rule is particularly important for leaking underground petroleum storage tanks. The federal statute governing leaking tanks (and the many state statutes patterned after it) provides private parties only injunctive relief to compel a cleanup. The statute does not allow the harmed party to incur the cleanup costs itself and then sue for reimbursement. Reorganization will not discharge a debtor's obligation to perform a cleanup where the claimant obtains an injunction.¹⁷

Reorganizations in which a debtor emerges from Chapter 11 in possession of its assets are less frequent than other outcomes, for example, asset sales under Bankruptcy Code Section 363 discussed below. In rare situations in which the debtor emerges in possession of its assets, the reorganized debtor will retain environmental liability for the pre-petition environmental condition to which an injunction applies.¹⁸



V. Where Multiple Remedies Exist, Government Agencies Can Choose Their Remedies

Government agencies can choose the form of relief they pursue and, thus, determine whether the debtor's environmental liability is a dischargeable claim. The federal Superfund statute as well as state "mini-Superfund" statutes typically provide the government two forms of relief: (1) actions for recovery of response costs or (2) for injunctions to compel the responsible party to perform the cleanup. (Private parties can only seek to recover response costs under the Superfund statute.)

Take the example of a former gravel pit in which paint sludge waste was disposed. Under the Superfund statute, the federal government had two alternatives for cleaning up the pit. The government could have cleaned up the gravel pit first and then sued the debtor to recover its costs. Or, the government could have issued an order to the debtor to perform the cleanup.

Where the gravel pit continued to constitute a hazard and the government issued an order, the order was not a claim, and thus could not be discharged. In the gravel pit example, the court was unsympathetic to debtor's argument that the government could have used its alternative cost-recovery authority. The court declined the debtor's request to convert the order into a claim. As long as the cleanup order was valid, the debtor remained liable.¹⁹

Courts have reached similar results where state agencies avail themselves of injunctive remedies under state laws that provide alternative cost-recovery remedies.²⁰

VI. To Earn Priority as "Administrative Expenses" Environmental Costs Need to Benefit the Debtor's Estate

Creditors have an interest in seeing their environmental claims categorized as "administrative expenses." The Bankruptcy Code grants priority to the payment of administrative expenses, which it defines as the "actual, necessary costs and expenses of preserving the estate."²¹ Costs of cleaning up a debtor's site or bringing debtor's operations into compliance with environmental law benefit the debtor's estate. They are entitled to administrative priority.

If, for example, after the debtor's bankruptcy filing, the government incurs cleanup costs at property the debtor held during its reorganization, the government's costs would be entitled to administrative priority.²² On the other hand, a landlord's costs of removing underground storage tanks on its debtor tenant's leasehold—where there was no evidence the tanks had leaked and no government agency ordered the tanks' removal—were not entitled to administrative expense priority.²³ The landlord's tank removal did not benefit the debtor tenant's estate.

VII. For Contaminated Property They Acquire in Section 363 Asset Sales, Purchasers Should Seek to Qualify as Bona Fide Prospective Purchasers

Purchasers of assets from a debtor in bankruptcy rely on the protection of Bankruptcy Code Section 363, which allows debtors to sell assets "free and clear" of their attendant liabilities.²⁴ As to environmental liability, the value of this protection is apparent with respect to off-site waste disposal. The 363 purchaser of an industrial facility does not assume liability for cleaning up all the off-site waste management sites the facility used in the past.

What if the acquired asset is itself contaminated? That is, what if releases of hazardous substances occurred not as a result of waste shipments to an off-site disposal facility but occurred on the industrial property the purchaser is buying? Does a 363 asset purchaser avoid liability for the environmental condition of the asset it acquires?



To protect itself from liability for environmental contamination at an industrial facility it acquires, a 363 purchaser needs more protection than the Bankruptcy Code provides. To avoid liability, a purchaser of contaminated property in a Section 363 asset sale needs to qualify as a “bona fide prospective purchaser” under the Superfund statute.²⁵

While there are nuances to qualifying as a bona fide prospective purchaser, there are two core requirements. First, before the purchase, the buyer must conduct “all appropriate inquiry” into the property’s environmental condition.²⁶ “All appropriate inquiry” means obtaining a Phase I environmental site assessment for the property. Second, after the purchase, the buyer must exercise “appropriate care” with respect to the property’s environmental condition. “Appropriate care” means taking “reasonable steps” to stop any continuing releases, prevent any threatened future release, and prevent or limit human, environmental, or natural resource exposure to any previously released hazardous substance.²⁷

* * *

Depending on their situation, reorganizing debtors, creditors of such debtors, and purchasers of bankruptcy assets will want to keep in mind these aspects of how environmental liabilities are treated in bankruptcy.

Tom thanks his law partner James Grogan for reviewing a draft of this alert.

◇ ◇ ◇

¹ 11 U.S.C. § 362(a).

² *Id.* § 362(b)(4).

³ *State of Ohio v. Kovacs*, 469 U.S. 274, 285 (1985) (“anyone in possession of the site . . . must comply with the environmental laws”).

⁴ *In re Commonwealth Oil Refining Co.*, 805 F.2d 1175 (5th Cir. 1986) (RCRA § 3008(a) order not stayed by bankruptcy filing); *U.S. v. Jones & Laughlin Steel Corp.*, 804 F.2d 348 (6th Cir. 1986) (modifications to consent decree under Clean Water and Air Acts not stayed).

⁵ *Board of Governors of the Federal Reserve System v. Corp. Financial, Inc.*, 502 U.S. 31 (1991); *In re Commerce Oil Co.*, 847 F.2d 291 (6th Cir. 1988); *U.S. v. Nicolet, Inc.*, 857 F.2d 202 (3rd Cir. 1988).

⁶ 11 U.S.C. § 362(b)(5).

⁷ *U.S. v. Alsoi*, 2014 U.S. Dist. LEXIS 1179, at *13-15 (D.N.J. Jan. 2, 2014).

⁸ 11 U.S.C. § 1141(d).

⁹ *Id.* § 101(5)(A).

¹⁰ *Id.* § 101(5)(B).

¹¹ *LTV Corp. v. United States (In re Chateaugay Corp.)*, 944 F.2d 997, 1005 (2d Cir. 1991) (demands for Superfund response costs from bankrupt LTV Steel are dischargeable, even if “EPA does not yet know the full extent of the hazardous waste removal costs that it may one day incur and seek to impose upon LTV, and it does not yet even know the location of all the sites at which such waste may yet be found”).

¹² *In re Texaco, Inc.*, 182 B.R. 937, 952 (Bankr. S.D. N.Y. 1995).

¹³ *LTV Corp., supra*, 944 F.2d at 1005.

¹⁴ *Texaco, supra*, 182 B.R. at 952 (Bankr. S.D. N.Y. 1995) (“[T]he fact that the alleged contamination damage to Respondents’ property was not manifest at the surface does not mean that it was not capable of detection prior to confirmation. There can be no dispute that the alleged subsurface contamination was susceptible of detection by a variety of scientific testing methods which could be performed by environmental engineers. . . . Based on the evidence presented, I find as a fact that any subsurface contamination of Respondents’ property that existed prior to the Confirmation Order could have been detected and reasonably quantified or evaluated prior to the Confirmation Order either by Texaco or by the Respondents.”)

Paul Hastings LLP

PH Perspectives is published solely for the interests of friends and clients of Paul Hastings LLP and should in no way be relied upon or construed as legal advice. The views expressed in this publication reflect those of the authors and not necessarily the views of Paul Hastings. For specific information on recent developments or particular factual situations, the opinion of legal counsel should be sought. These materials may be considered ATTORNEY ADVERTISING in some jurisdictions. Paul Hastings is a limited liability partnership. Copyright © 2020 Paul Hastings LLP.



-
- ¹⁵ *LTV Corp., supra*, 944 F.2d at 1005. (“EPA does not yet know the full extent of the hazardous waste removal costs that it may one day incur and seek to impose upon LTV, and it does not yet even know the location of all the sites at which such waste may yet be found”).
- ¹⁶ *Id.*, 944 F.2d at 1008 (If the order “does no more than impose an obligation entirely as an alternative to a payment right,” then the order is dischargeable. The order must be aimed at “ameliorating on-going pollution” or “end or ameliorate continued pollution” in order to survive the re-organization plan confirmation.); *In re CMC Heartland Partners*, 966 F.2d 1143 (7th Cir. 1992) (as long as a release still occurring, the injunction order will not be discharged as a claim).
- ¹⁷ *AM International, Inc. v. Datacard Corp.*, 106 F.3d 1342 (7th Cir. 1997) (private injunctive actions under RCRA 7002 will not be discharged as claims).
- ¹⁸ *CMC Heartland Partners, supra*, 966 F.2d at 1146-47.
- ¹⁹ *Id.*
- ²⁰ See e.g., *In re Torwico Electronics, Inc. v. the New Jersey, Department of Environmental Protection and Energy*, 8 F.3d 146 (3d Cir. 1993), *cert. denied*, 114 S. Ct. 1576 (1994) (“Here, it is undisputed that the order was issued under statutory sections which do not allow the state to perform the cleanup and then sue for reimbursement of its costs. That authority may exist under other potentially relevant statutes for the state to perform the cleanup and seek reimbursement of its costs is irrelevant . . .”). See also *Mark IV Industries Inc. v. the New Mexico Environment Department*, 438 B.R. 460 (Bankr. S.D.N.Y. 2010) (Under New Mexico’s Water Quality Act, state regulators did not have the authority to clean up the pollution and then seek reimbursement from Mark IV; they could only issue compliance orders and commence civil suits to remedy the condition.).
- ²¹ 11 U.S.C. §§ 507(a), 503(b)(1)(A).
- ²² *Pennsylvania v. Conroy*, 24 F.3d 568 (3rd Cir. 1994); *In re Hemingway Transport, Inc.*, 993 F.2d 915 (1st Cir. 1993); *In re Smith Douglas, Inc.*, 856 F.2d 12 (4th Cir. 1988).
- ²³ *In re Mahoney-Troast Construction Co.*, 189 B.R. 57 (Bkrtcy. D. N.J. 1995).
- ²⁴ 11 U.S.C. § 363.
- ²⁵ 42 U.S.C. § 9607(r)(1). (A bona fide prospective purchaser is one “whose potential for liability for a release or threatened release is based solely on the purchaser’s being considered to be an owner or operator of a facility.”).
- ²⁶ *Id.* § 9601(40)(B)(i), (ii).
- ²⁷ *Id.* § 9601(40)(D).