Client Alert.

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Mark IV Ruling: District Court Affirms Bankruptcy Court's Denial of Discharge of Environmental Obligations

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Last month, District Court Judge Shira A. Scheindlin of the Southern District of New York affirmed a bankruptcy court ruling which held that the environmental cleanup obligations of debtor Mark IV Industries, Inc. were not discharged in bankruptcy.[2] Given the current legal landscape, *Mark IV* may make the likelihood of discharging environmental claims even more difficult, potentially undermining chapter 11 as an optimal alternative for companies saddled with environmental liabilities. In light of the importance of the issues involved, Mark IV will likely appeal Judge Scheindlin's decision to the Second Circuit.

BACKGROUND

When automotive parts manufacturer Mark IV Industries, Inc. and its affiliates (collectively, "Mark IV") filed chapter 11 bankruptcy proceedings in 2009, the company had been engaged in environmental cleanup efforts at a former manufacturing site in New Mexico for over 13 years. Despite years of cleanup efforts, Mark IV had been told by the New Mexico Environmental Department ("NMED") that a plume of contamination was still spreading at the site, requiring continuing cleanup obligations. Mark IV brought an adversary proceeding seeking a declaratory judgment that its obligation to clean up the site was discharged in bankruptcy. Bankruptcy Judge Stuart M. Bernstein denied Mark IV's request, holding that the debtor's environmental obligation regarding the New Mexico cleanup site did not constitute a "claim" in bankruptcy and was therefore not dischargeable.

APPLICABLE LAW

Confirmation of a chapter 11 plan of reorganization "discharges the debtor from any debt that arose before the date of such confirmation."[3] While confirmation of a plan for a reorganizing debtor discharges all liability on claims arising prior to confirmation (versus a liquidating plan, which does not effectuate a discharge), bankruptcy has no effect on obligations that do not qualify as claims. The salient question in the *Mark IV* cases, therefore, was: which environmental obligations are considered "claims" in bankruptcy?

Under the Bankruptcy Code, a claim includes "a right to an equitable remedy for breach of performance *if such breach also gives rise to a right to payment*."[4] In the environmental context, the issue typically arises where an entity is required to conduct a contaminated site investigation, cleanup, and/or pay a fine. Thus the issue is whether the breach of such cleanup obligation "gives rise to a right to payment," and thus constitutes a "claim."

In its analysis, the District Court reviewed both the text of the Bankruptcy Code and legal precedent addressing the extent to which an environmental cleanup obligation constitutes a "claim" in bankruptcy, including the 1985 Supreme Court decision *Ohio v. Kovacs*[5] and the Second Circuit *Chateaugay* ruling.[6]

In *Kovacs*, the state of Ohio obtained an injunction enjoining a polluter from bringing additional industrial waste to the landfill he owned, and requiring him to conduct cleanup of the waste already on the property. When Kovacs failed to comply, the state appointed a receiver took possession of the site and began conducting the cleanup itself. Before the cleanup was complete, Kovacs filed bankruptcy, and Ohio sought a declaratory judgment that the debtor's cleanup obligation was not dischargeable in bankruptcy. In holding that the cleanup obligation was a dischargeable claim, the Supreme Court noted that by dispossessing the debtor and removing his control over the site, the state prevented the debtor from conducting the cleanup himself. The Court therefore held that the state was effectively seeking a money judgment, which is a "claim" under the Bankruptcy Code. Because *Kovacs* largely turned on the fact that the debtor had been dispossessed of its property, it left many questions unanswered, and its applicability has generally been limited by later case law.

In *Chateaugay*, the Second Circuit found that when an order requires cleanup of contamination and the applicable government agency has the option of conducting the cleanup itself and seeking reimbursement, the obligation is a claim because its breach "gives rise to a right to payment." On the other hand, in the case of an order to stop polluting, because the enforcing agency may not accept payment and allow the party to continue polluting, such order does not create a bankruptcy claim. Therefore, the court placed "on the non-'claim' side all injunctions that seek to remedy on-going pollution…"[7]

ANALYSIS ON APPEAL

Availability of Monetary Relief Under a Separate Statute Is Irrelevant.

In view of applicable precedent and the plain text of the Bankruptcy Code's definition of "claim," the District Court, largely following the reasoning of the Bankruptcy Court, rejected Mark IV's argument that the polluter's conduct—not the statute under which the agency elected to proceed—should determine whether a payment obligation (and therefore claim) exists. In this case, NMED had chosen to sue Mark IV under a New Mexico statute (New Mexico Water Quality Act), which permitted only equitable remedies and did not authorize NMED to clean up the site itself and recover costs from the polluter. According to Mark IV, its failure to clean up the site gave NMED a right to payment under statutes it did not choose to utilize, including the Hazardous Waste Act and the Comprehensive Environmental Response, Compensation and Liability Act ("CERCLA") and other New Mexico state statutes that would have provided NMED with a monetary remedy.

Judge Scheindlin agreed with the Bankruptcy Court in rejecting this position because "such an interpretation could potentially render all environmental injunctions dischargeable,"[8] which would squarely contradict the Second Circuit's observation that "most environmental injunctions will fall on the non-'claim' side of the line."[9] Therefore, the District Court held that availability of monetary relief under a separate statute is irrelevant.[10] Instead, the court described the "proper test" to determine whether an enforcing agency has a "right to payment" for an environmental injunction as "whether the enforcing agency has a right to cleanup and recover response costs *under the statute pursuant to which the enforcing agency has obtained its injunction*."[11]

Ongoing Pollution Is Basis for Nondischargeability of Environmental Injunctions.

The District Court also agreed with the Bankruptcy Court's analysis regarding ongoing pollution. If an injunction addresses ongoing pollution, such injunction is not a claim, even if the statute allows a right to payment because "a polluter does not have the right to pay to continue to pollute."[12] Therefore, Judge Scheindlin held that the Bankruptcy

Court did not err in applying an "ongoing pollution" test as a separate prong of its analysis.[13] In *Mark IV*, however, the question of whether pollution was ongoing at the site was the subject of a factual dispute. The court determined that it was not necessary to resolve this question on appeal because the "right to payment" analysis was dispositive in determining that Mark IV's obligations with respect to NMED were not dischargeable.

CONSIDERATIONS WITH DISTRICT COURT'S RULING IN *MARK IV*

While it may be too early to understand the full impact of this decision, it is likely that some governmental agencies will begin acting more strategically relative to bankruptcy considerations, electing to proceed under environmental statutes that provide only injunctive relief, especially when enforcing against polluters in financial distress. For example, in some circumstances, the Environmental Protection Agency may have the option of seeking to require that a responsible party remediate contamination under either CERCLA or the Resource Conservation and Recovery Act ("RCRA"). Unlike under CERCLA, RCRA does not give the Environmental Protection Agency the authority to conduct the cleanup itself and seek reimbursement. Thus, the Environmental Protection Agency could choose to bring an enforcement action under RCRA, thereby preventing the obligation from being considered a "claim," even if the Environmental Protection Agency could have elected to enforce under CERCLA.

Another interesting question: how might a court view the issue if the Environmental Protection Agency brought claims under the both CERCLA and RCRA in a bankruptcy case? Would the CERCLA claim be dischargeable and obligations imposed under RCRA survive?

A further consideration involves the potential impact on recoveries by general unsecured creditors. To the extent that environmental liabilities may be less likely to be discharged following *Mark IV*, recoveries by general unsecured creditors may correspondingly decrease. Ironically, the very tort claimants injured by the debtor's environmental actions could recover less as a result of the debtor's nondischargeable cleanup obligations.

CONCLUSION

Entities considering bankruptcy as a means of addressing environmental liabilities should examine closely whether their environmental liabilities will be considered claims not only in light of *Mark IV*, but also additional recent case law. Debtors grappling with this issue may consider the potential advantages of pursuing a sale of assets through section 363 of the Bankruptcy Code, which can be used to sell assets "free and clear." Since a debtor that has sold all of its assets would obviously not be able to comply with a non-dischargeable cleanup decree following the sale, the equitable remedies available to governmental agencies may be largely meaningless in liquidating cases to the extent such remedies do not attach to the purchaser.

However, to the extent there is ongoing pollution, there can be little doubt that governmental agencies would seek to impose the cleanup obligations on the purchaser of the assets. Further, to the extent that the governmental agency proceeds under a statute where only equitable remedies are available and the debtor's liability to the government is not "in bona fide dispute," then it may not be possible to obtain a "free and clear" order and any cleanup obligations would attach to the purchaser. The extent the purchaser is required to undertake cleanup obligations would undoubtedly have an adverse impact on the purchase price, thereby further reducing creditor recoveries.

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Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.

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[1] For previous discussion on the *Mark IV* cases by Larren Nashelsky, Kristin Hiensch, and colleagues, please see "Contemplating Chapter 11 as a 'Fresh Start'? Consider Recent Developments in Environmental Claims Liability," published in the BNA *Bankruptcy Law Reporter* and available here

[2] *In re Mark IV Industries, Inc. (Mark IV Industries, Inc. v. New Mexico Environment Dept.),* No. 11 CIV 648 (SAS) (S.D.N.Y. Sept. 28, 2011) ("*Mark IV*"), affirming *Mark IV Indus. v. N.M. Env't Dep't (In re Mark IV Indus.)*, 438 B.R. 460 (Bankr. S.D.N.Y. 2010).

[3] 11 U.S.C. § 1141(d)(1)(A).

[4] 11 U.S.C. § 101(5)(B) (emphasis added).

[5] 469 U.S. 274 (1985).

[6] *United States v. LTV Corp. (In re Chateaugay Corp.)*, 944 F.2d 997 (2d Cir. 1991).

[7] *Chateaugay*, 944 F.2d at 1009.

[8] *Mark IV* at *25.

[9] *Chateaugay*, 944 F.2d at 1008.

[10] *Mark IV* at *31 ("Second-guessing an agency's choice of which authority to proceed under could often force an agency to accept a 'suboptimal remedy,' which is inconsistent with the requirements of the Bankruptcy Code.").

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

[12] *Id.* at 36.

[13] The Bankruptcy Court articulated a three-factor test for determining whether an environmental obligation is a claim: *(1) Is the debtor capable of executing the equitable decree, or can it comply only by paying someone else to do it?; (2) Is the pollution "ongoing"?; (3) Does the statute imposing the equitable obligation permit the environmental agency the option of cleaning up the pollution on the debtor's behalf and seeking reimbursement? In re Mark IV*, 438 B.R. at 467-68.