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Bankruptcy Treatment of Environmental Liabilities

A Refresher and Issues to Consider

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Since taking office, President Joseph R. Biden has confirmed his commitment to addressing environmental issues. On April 9, 2021, he proposed allocating $14 billion toward initiatives to fight climate change, including large cash injections for environmental regulation and science research.[1] With an increase in funding and a renewed commitment to environmental justice, we might see a jump in environmental liability claims in bankruptcy filings. This article provides a brief overview of environmental liability and how such liability is affected by a responsible party's bankruptcy filing, touching on the dischargeability of claims, including through abandonment of assets, priority claims and successor liability in the § 363 sale context.

Obligations and Liability

In response to a growing problem of contaminated industrial sites where hazardous waste has been dumped, left out in the open or has not been properly managed, Congress enacted the Comprehensive Environmental Response, Compensation and Liability Act of 1980 (as amended, CERCLA). CERCLA established prohibitions and requirements for closed or abandoned waste sites, provided for liability of parties responsible for releases of hazardous waste at these sites, and created a trust fund to allow the Environmental Protection Agency (EPA) to clean up sites when no responsible party can be identified. Thus, it informally became known as the "Superfund."

Under CERCLA, a potentially responsible party (PRP) is strictly liable for the response costs incurred by the government or private parties to clean up the hazardous waste, and also for any resulting damage to natural resources. The following parties are PRPs: (1) the current owner or operator of the facility; (2) the party that owned or operated the facility at the time of the disposal of the hazardous substances; (3) the party that arranged for the disposal, treatment or transportation of the hazardous substances; or (4) any person or entity that accepted the hazardous substances for transport, disposal or treatment. In the bankruptcy context, environmental claimants will generally be a governmental unit, or an entity or individual PRP seeking contribution from the debtor.

Dischargeability of Claims

Whether an environmental obligation will be discharged typically comes down to three inquiries: whether the environmental liability is a "claim" under the Bankruptcy Code; whether the claim arose before or after plan confirmation (or the petition date in a chapter 7); and whether the creditor holding the claim had sufficient notice of the case and the debtor's liability. Generally, chapter 11 allows debtors to discharge all claims arising before the bankruptcy, but the 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."[2] Whether certain environmental obligations are considered to be claims for the purpose of dischargeability under the Code has been the subject of considerable, and often varying, interpretation by courts.

Courts have generally held that a debtor's obligation under a governmental cleanup order or injunction to abate pollution is not a claim within the meaning of the Code because it is not a right

1 FY 2022 Discretionary Request at 6 (April 9, 2021).

2 11 U.S.C. § 1141(d)(1)(A).

to payment.[3] In *Ohio v. Kovacs*, however, the U.S. Supreme Court held that a debtor's obligation to perform cleanup work at a contaminated site pursuant to a pre-petition order is dischargeable, but it relied on the fact that in this case, the liability had been reduced to a demand for money and limited dischargeability to only those parts of the cleanup order that involved the collection of money.[4]

In *U.S. v. The LTV Corp. (In re Chateaugay Corp.)*, the Second Circuit found that injunctive remedies might be dischargeable if the government has the option to perform the remediation and recover costs from the debtor.[5] However, the court ruled that "a cleanup order that accomplishes the dual objectives of removing accumulated wastes and stopping or ameliorating ongoing pollution emanating from such wastes is not a dischargeable claim."[6] If there is no option for the enforcing agency to accept payment in lieu of ongoing pollution, any "order that to any extent ends or ameliorates continued pollution is not an order for breach of an obligation that gives rise to a right of payment and is for that reason not a 'claim.'"[7] On the other hand, a cleanup order that imposes obligations distinct from the obligation to stop ongoing pollution is a "claim" if the agency had the option to perform the cleanup work and sue the corporation for the response costs.[8] According to the Second Circuit, most injunctions will "fall on the non-'claim' side of the line," because most cleanup orders include obligations to remove or remediate contaminated soil or other sources from which pollution continues to emanate.[9]

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When environmental liabilities do fall on the claim side of the line, determining whether an environmental claim is subject to discharge typically comes down to when the claim arose. In *Chateaugay*, the Second Circuit addressed this issue and ruled that reimbursement cost claims are dischargeable where the release or threat of release of the hazardous substance occurred pre-petition, even though the release might not have been discovered by the relevant enforcement agency or anyone else.[10] While the claimant in *Chateaugay* was a governmental entity, this analysis was applied to a private party's environmental claim after confirmation of the debtor's plan in *In re Texaco Inc*.[11]

The test described in *Chateaugay* is often referred to as the "pre-petition relationship test." It dictates that a claim arises from a debtor's pre-petition conduct that causes post-petition injury if such claim (1) arose before the filing of the petition or resulted from pre-petition conduct fairly giving rise to the claim and (2) there is some minimum contact or relationship between the debtor and claimant such that the claimant is identifiable.[12]

Some courts have rejected the *Chateaugay* analysis as having used a definition of "claim" that encompassed costs that couldn't have been contemplated by the EPA or the debtor pre-petition.[13] In *National Gypsum*, the Northern District of Texas created a test to limit the discharge of claims resulting from pre-petition conduct to situations in which response costs had been "fairly contemplated" by the debtor and creditor on or before the petition date.[14] Among the factors that might be considered under this test are knowledge by the parties of a site in which a PRP might be liable, listing the site on the National Priorities List, notification by the EPA of PRP liability, commencement of an investigation and cleanup activities, and incurrence of response costs.[15] This second test has come to be known as the "fair contemplation test," wherein a claim arises when a claimant can fairly or reasonably contemplate the claim's existence even if a cause of action has not yet accrued under nonbankruptcy law.[16]

Determining when a future claim is fairly contemplated by the parties is not always straightforward, and the case law is unclear. For example, the Seventh Circuit in *AM International* effectively validated the survival of CERCLA claims against a reorganized debtor.[17] The court affirmed the district court's finding that the claimant's predecessor had insufficient information to link the debtor to contamination at the site before plan confirmation, even though when the predecessor purchased the real estate, it was a tank farm with nine tanks in which the debtor had mixed chemicals to produce a cleaning solvent, the predecessor had leased the tank farm grounds back to the debtor pre-petition, and former employees of the debtor who knew of releases of contaminants had worked for the predecessor, which operated a related business adjacent to the site.[18]

Courts differ on which test applies and how that test is applied. Practitioners should take a close look at the governing law in their jurisdictions, as the determination of the facts in one court might differ significantly from another depending on which test is applied and how.

In addition, certain environmental claims might be entitled to administrative-expense priority if they

3 *AM Int'l v. Datacard Corp.*, 106 F.3d 1342, 1348-49 (7th Cir. 1997); *U.S. v. The LTV Corp. (In re Chateaugay Corp.)*, 944 F.2d 997 (2d Cir. 1991); *Torwico Elecs. v. State of New Jersey, Dep't of Envtl. Prot. (In re Torwico Elecs. Inc.)*, 8 F.3d 146 (3d Cir. 1993); *CMC Heartland Partners*, 966 F.2d 1143 (7th Cir. 1992).
4 469 U.S. 274 (1985).
5 *Chateaugay*, 944 F.2d 997.
6 *Id.* at 1008.
7 *Id.*
8 *Id.*
9 *Id.*
10 *Id.* at 1005.
11 *Texaco Inc. v. Bd. of Comm'rs for the LaFourche Basin Levee Dist. (In re Texaco Inc.)*, 254 B.R. 536 (S.D.N.Y. 2000).
12 *In re Tronox Inc.*, 2021 WL 653148 (S.D.N.Y. Feb. 19, 2021).
13 *In re Nat'l Gypsum Co.*, 139 B.R. 397, 407 (N.D. Tex. 1992); *Matter of Chicago, Milwaukee, St. Paul & Pacific R.R. Co.*, 974 F.2d 775 (7th Cir. 1992); *In re Jensen*, 995 F.2d 925 (9th Cir. 1993); *In re Crystal Oil*, 158, F.3d 291, 295 (5th Cir. 1998).
14 *In re Nat'l Gypsum Co.*, 139 B.R. at 407.
15 *Id.* at 407.
16 *United Artists Theatre Circuit Inc. v. California Reg'l Water Quality Control Bd.*, 42 Cal. App. 5th 851, 893 (Cal. Ct. App. 2019) (quoting *In re SNTL Corp.*, 571 F.3d 826, 839 (9th Cir. 2009)).
17 *AM Int'l v. Datacard Corp.*, 106 F.3d 1342, 1348-49 (7th Cir. 1997); *but see Boston and Maine Corp. v. Massachusetts Bay Transp. Auth.*, 587 F.3d 89, 101 (1st Cir. 2009).
18 *Id.*

arise post-petition and are the actual, necessary costs and expenses of preserving the estate.[19] Costs to bring property of the estate into compliance with environmental laws benefit the estate and might be entitled to administrative-expense priority.[20] Conversely, where there is no known threat of damage to the environment or public, or there is no governmental order to take remedial action, costs to perform cleanup might not be given administrative-expense priority.[21] Claims for contribution from the debtor by other PRPs do not stand much of a chance of being given administrative-priority status since at their root, they are simply claims for money with no corresponding benefit to the estate.

Abandonment

Another way to discharge the debtor's estate of environmental liability is through the trustee's (chapter 7) or debtor-in-possession's (chapter 11; DIP) abandonment of the hazardous property. Section 554(a) of the Bankruptcy Code allows the trustee to abandon the estate's interest in property if it is burdensome or of inconsequential value and benefit to the estate.[22] In order to find that abandonment is proper in a chapter 11, courts generally require that the trustee or the DIP made (1) a business judgment on abandonment, (2) in good faith, (3) upon some reasonable basis and (4) within the trustee's or DIP's scope of authority.[23] Once this standard has been met, the burden shifts to the objecting party.

Midatlantic Nat. Bank v. New Jersey DEP[24] is the seminal case on this topic, creating an exception to the trustee's ability to abandon property. The debtor in this case was a waste oil processor with facilities in New Jersey and New York. The trustee sought to abandon both properties, arguing that compliance with the states' cleanup demands would deplete the estate of its assets. The bankruptcy court approved the abandonment, but the states appealed through to the Supreme Court, which held that a bankruptcy court may not authorize abandonment without formulating conditions to protect public health and safety, noting that the *Midatlantic* sites had aggravated existing dangers. This judicially created exception can be derived from the *Midatlantic* holding: The trustee may not abandon property in contravention of a statute designed to protect the public health or safety from identified hazards. The Court emphasized the narrowness of its holding, noting that abandonment is not to be restricted by laws or regulations not reasonably calculated to protect the public health or safety from "imminent and identifiable harm" or by state laws "so onerous as to interfere with the bankruptcy" process.[25]

The practical implication of this holding is that courts may allow abandonment, but only if it does not pose an imminent or identifiable threat to public health or safety. The tension between a fresh start through bankruptcy and the resolution of environmental risks to public health is evident in determining whether abandonment is permitted.

Successor Liability and § 363 Issues

A sale of environmentally hazardous property in bankruptcy is not always "free and clear." It is generally understood that successor liability applies in CERCLA cases.[26] The application of successor liability often turns on the extent to which the asset-purchaser knew or should have known about the potential CERCLA liabilities.[27] The U.S. Supreme Court recently confirmed the broad statutory definition of a PRP under CERLCA.[28] The *Atlantic Richfield Co. v. Christian* decision highlights the importance of environmental due diligence, but how is this impacted by the ability of a debtor to sell its assets free and clear of liens?

Section 363 of the Bankruptcy Code provides the rules and procedures for the use, sale or lease of property of the estate inside and outside the ordinary course of business. While this Code section is helpful to prevent successor liability for claims and interests against the debtor, it does not prevent the purchaser from being held liable as a current owner or operator under CERCLA. Another way of looking at this is that environmental liabilities "run with the land" due to the strict liability under CERCLA for the category of PRPs that includes current owners and operators, for instance, when the purchased property itself is contaminated, as compared to a debtor's past acts, such as offsite waste management that is not included in the purchase. An undesirable effect of this strict liability imposed on a "current owner or operator" is that the property might fetch a significantly lower purchase price.

When purchasing potentially contaminated real property through a bankruptcy sale, the purchaser will likely need more protection than the Code provides. The purchaser might be able to establish an available landowner defense, which includes (1) the innocent landowner defense;[29] (2) the defense for contiguous property owners who can demonstrate that they did not know and had no reason to know of the contamination prior to acquiring the property;[30] and (3) the *bona fide* prospective purchaser defense, which is the most commonly applicable defense to § 363 sales.[31] There are nuances to qualifying for the landowner defense, but there are two main requirements. First, before the purchase, the buyer must conduct "all appropriate inquiry" into the property's condition.[32] This can typically be accomplished by obtaining a Phase I environmental site assessment for the property. Second, post-purchase, the buyer must exercise "appropriate care" regarding the property's environmental condition.[33] "Appropriate care" means taking reasonable steps to stop any continuing releases, prevent any threatened future releases, and prevent or limit human, environmental or natural resource exposure to any previously released hazardous substance.[34]

The purchaser should also request that the court expressly hold that the BFP defense applies, incorporating findings of fact in its order, which will shield the purchaser from applicable liability so long as it complies with the order and stat-

19 11 U.S.C. § 503(b)(1)(A). *See Amalgamated Ins. Fund v. McFarlin's Inc.*, 789 F.2nd 98, 101 (2d Cir. 1986).
20 *See, e.g., In re Munce's Superior Petroleum Prod. Inc.*, 736 F.3d 567 (1st Cir. 2013); *In re N.P. Mining Co. Inc.*, 963 F.2d 1449 (11th Cir. 1992); *In re Jones Transfer Co.*, 1996 WL 33674288, *2 (E.D. Mich. June 18, 1996).
21 *See, e.g., In re Mahoney-Troast Constr. Co.*, 189 B.R. 57 (Bankr. D.N.J. 1995).
22 11 U.S.C. § 554(a).
23 *See In re Beker Indus. Corp.*, 64 B.R. 900 (Bankr. S.D.N.Y. 1986).
24 474 U.S. 494 (1986).
25 *Id.* at 507.
26 *See Ninth Ave. Remedial Grp. v. Allis-Chambers Corp.*, 195 B.R. 716, 722-23 (N.D. Ind. 1996) (citing cases).
27 *Allis-Chalmers*, 195 B.R. at 731.
28 *Atl. Richfield Co. v. Christian*, 140 S. Ct. 1335 (2020).
29 11 U.S.C. §§ 9601(35)(A)-(B), 9607(b)(3).
30 11 U.S.C. § 9607(q)(1)(A).
31 11 U.S.C. § 9607(r).
32 11 U.S.C. § 9601(40)(B)(i), (ii).
33 11 U.S.C. § 9601(40)(B)(ii).
34 11 U.S.C. § 9601(4)(B)(iv).

ute. Once a property owner qualifies for the BFP defense, it is shielded from all CERCLA liability, including claims of the government, other PRPs and unknown claimants.

Another practical tip for asset-buyers is to obtain environmental insurance for pollution legal liability. General liability insurance policies typically have pollution exclusions, so a specific environmental policy will be necessary. The takeaway from this brief overview is that solely relying on the Bankruptcy Code's "free and clear" language and its typical application can be detrimental to an asset-purchaser in a case fraught with environmental liabilities.

Considerations

In sum, bankruptcy practitioners should be aware of whether the automatic stay will be effective against suits by governmental units, whether a claim by a governmental unit will affect the feasibility of the case, and/or whether it might be worthwhile to seek abandonment of a hazardous property to effect a "discharge" of liability associated therewith. In addition, debtor's counsel should evaluate whether it will file an exhaustive list of potential environmental claimants: While this might be advantageous for due-process purposes, doing so could introduce more claimants into the case and exhaust a debtor's resources for determining which claims are legitimate. Finally, practitioners representing asset-purchasers should consider liability and the defenses thereto in relation to a § 363 sale. It is impossible to summarize every potential issue when handling environmental liabilities in bankruptcy, but the foregoing offers a starting point and ultimately shows that practitioners cannot simply rely on the traditional application of bankruptcy principles when dealing with environmental liabilities. abi

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