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Fresh Start, Not So Fresh: Courts Hold That Environmental Liabilities Survive Chapter 11 Reorganization

Introduction

For more than 30 years, the conflicting goals of U.S. bankruptcy and environmental laws have confounded investors and practitioners in their attempts to predict how a debtor's responsibility for historic contamination will be dealt with in chapter 11. Environmental statutes are in significant part designed to ensure that entities responsible for contamination pay the costs of cleanup, irrespective of fault or the passage of time. This statutory goal directly collides with a principal purpose of chapter 11, namely the achievement of a fresh start for the debtor, free from the overhang of legacy liabilities. The Supreme Court has directed that when possible, the objectives of the environmental and bankruptcy laws should be reconciled,[1] but this is far easier said than done, and the result over the years has been a potpourri of inconsistent case law. Some courts have bent logic to favor the environmental goals,[2] while others have done the same to favor chapter 11's objectives.[3] Two recent decisions – *Mark IV Industries, Inc.*[4] and *Apex Oil Co., Inc.*[5] – establish a clear trend of favoring environmental over bankruptcy goals.

What is a "Claim" in Bankruptcy?

Resolution of the conflict between bankruptcy and environmental laws turns on the question of whether a particular cleanup obligation is a "claim" as defined by the Bankruptcy Code. If the obligation is a claim, it is capable of being discharged; if it is not, the bankruptcy has no effect on it, and the debtor cannot escape responsibility for the cleanup. Lest this seem unimportant, bear in mind that environmental liabilities can be significant in many chapter 11 cases.

The Bankruptcy Code defines "claim" to include "a right to an equitable remedy for breach of performance *if such breach also gives rise to a right to payment.*"[6] Under environmental laws, state and federal governments have broad power to pursue injunctive relief to compel a

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1 *Midlantic Nat'l Bank* v. *NJDEP*, 474 U.S. 494 (1986).

2 *In re Torwico Electronics, Inc*., 8 F.3d 146 (3d Cir. 1993).

3 *United States* v. *Whizco,* 841 F.2d 147 (6th Cir. 1988).

4 *In re Mark IV Industries Inc.*, No. 09-12795, 2010 WL 4225949 (Bankr. S.D.N.Y. Oct. 21, 2010).

5 *United States* v. *Apex Oil,* 579 F.3d 734 (7th Cir. 2009), No. 09-1023, *cert. denied*, No. 09-1023, 2010 WL 752322 (Sup. Ct. Oct. 4, 2010).

6 11 U.S.C. § 101(5) (emphasis added).

potentially responsible party (a "PRP") to clean up historic contamination.[7] However, no law allows a PRP to make a payment in lieu of compliance with a cleanup injunction, although certain environmental laws authorize the government to perform the cleanup itself and bill the PRP for the cleanup costs.

Confusion in the Case Law

The only U.S. Supreme Court case to address whether a debtor's cleanup obligation is a "claim" is *Ohio* v. *Kovacs*.[8] In *Kovacs,* the U.S. Supreme Court held that a state agency's injunction ordering a debtor to clean up hazardous waste became a right to payment when the state obtained the appointment of a receiver for the site previously owned by the debtor, thus dispossessing the debtor of the property and preventing him from performing the cleanup work. The Supreme Court held that since the debtor would be forced to spend money to comply with the state injunction, the injunction was therefore a dischargeable "claim" in bankruptcy.

Because the *Kovacs* ruling turned on the appointment of a receiver, its application to traditional chapter 11 cases is somewhat limited. As a result, lower courts that have been confronted with the question of whether environmental claims are dischargeable in chapter 11 have reached varied conclusions. For instance, in *United States* v. *Whizco*, the Court of Appeals for the Sixth Circuit took the "expenditure test" articulated in *Kovacs* to the next level holding, even though the government sought to enforce an equitable remedy and did not seek to recover monetary damages from the debtors, the government's cleanup order was a "claim" merely because it required the debtors to expend money.

At the opposite end of the spectrum from *United States* v. *Whizco* is *Torwico Electronics, Inc.* v. *State of New Jersey,* where the Third Circuit Court of Appeals held that the debtor's obligations under a cleanup order relating to the debtor's previously owned, but no longer occupied property was not a "claim." The Court reasoned that the order required the debtor to act to reduce an ongoing hazard, rather than merely to pay money, and that the debtor could gain access to the land and conduct the cleanup, for which it had an ongoing responsibility under New Jersey law. Similarly, the Second Circuit Court of Appeals in *United States* v. *LTV Corp. (In re Chateaugay Corp.),*[9] held that the government's cleanup order was not a claim, regardless of whether it required the debtor to expend money, if it required the debtor to take action that would end or ameliorate *ongoing* pollution.

Deliberate Trend or Added Confusion?

The *Mark IV Industries* and *Apex Oil* decisions provide the latest guidance on this topic. The focus of these decisions is the statutory regime under which the government pursues its claim and, in particular, whether the regime authorizes the government to perform the cleanup itself

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[7] Section 7003 of Resource Conservation and Recovery Act of 1976 (RCRA), 42 U.S.C. § 6973, Section 106 of Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA), 42 U.S.C. § 9606, Section 504 of the Clean Water Act, 33 U.S.C. § 1364, Section 1431 of the Safe Drinking Water Act, 42 U.S.C. § 300.

[8] *Ohio* v. *Kovacs*, 469 U.S. 274 (1985).

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

and to seek reimbursement from the debtor. In particular, these cases hold that where the government brings an action for injunctive relief under a statute which does not authorize any form of monetary relief – whether such action is commenced pre- or post-bankruptcy, and whether the action could have been commenced under a different statute that does authorize the government to perform the cleanup and to seek reimbursement – the debtor's obligation with respect to such injunctive relief is not a "claim," and therefore is not dischargeable in chapter 11.

In *Mark IV Industries,* the Bankruptcy Court for the Southern District of New York held that because the New Mexico Water Quality Act authorizes only injunctive relief, and does not provide an alternative cost-recovery remedy, the government's cleanup order was not a "claim," and thus was not dischargeable. Significantly, the court held that, even if the government could have sought monetary relief under other statutes, it is bound in its determination by the statute under which the government elected to pursue its remedies.

In *Apex Oil*, the government proceeded under RCRA, which similarly does not provide an alternative cost-recovery remedy, and obtained a cleanup injunction well after Apex had emerged from chapter 11.[10] The Court of Appeals for the Seventh Circuit similarly held that, because RCRA does not authorize any form of monetary relief, the government's cleanup order under RCRA was not a "claim" and, therefore, was not dischargeable.[11]

These decisions arm government environmental creditors with enormous leverage in chapter 11 cases. With multiple statutory regimes at its disposal, there is little doubt that, after *Mark IV Industries* and *Apex Oil*, wherever possible, the government will pursue troubled companies, or even companies that have cleaned up their balance sheets and emerged from chapter 11, under RCRA or a similar statute that authorizes only injunctive relief.

Conclusions

The *Mark IV Industries* and *Apex Oil* decisions highlight the need for distressed investors to understand and properly account for the dischargeability (or not) of a company's environmental liabilities, and the resulting leverage (or lack thereof) of a government environmental creditor in chapter 11.

From the debtor's perspective, entities contemplating a chapter 11 filing should evaluate carefully the potential business and reorganization implications of the possibility that environmental obligations may survive chapter 11. In the light of *Mark IV Industries* and *Apex Oil*, certain debtors with substantial environmental liabilities may find it exceedingly difficult, if not impossible, to reorganize as a standalone entity. In that case, particularly where successor liability is not an issue – whether as a result of a debtor's corporate structure or otherwise – restructuring by means of a "363 sale" in bankruptcy may prove a better solution.

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[10] The government had conducted its initial investigation under CERCLA and the Clean Water Act, however, it ultimately sought relief against Apex Oil under the RCRA.

[11] On October 4, 2010, the U.S. Supreme Court denied *certiorari* in *Apex Oil*. *See United States* v. *Apex Oil,* No. 09-1023, 2010 WL 752322 (Sup. Ct. Oct. 4, 2010).

Finally, an entity considering purchasing the stock or an asset or business of a company that emerged from chapter 11 should appreciate that the debtor's environmental obligations may not have been discharged and, as the buyer, you may be held responsible for pre-bankruptcy cleanup obligations associated with the acquired entity and/or assets.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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