Imperfect Solutions

Bankruptcy and Contaminated Property

By Diane W. Whitney

Courts painstakingly work to reconcile competing goals, as CERCLA's are better served if claims against a debtor are not discharged.

What happens when an owner of environmentally contaminated property files for bankruptcy? What happens to the property, the liability, the cost of remediation? The answers to these questions are contained in a handful of cases and are fairly well-defined—but not easily understood. Understanding the treatment of contamination issues in bankruptcy can help a financially troubled owner plan if he or she has sufficient time to do so before filing. This article will discuss how contaminated property is treated in the context of bankruptcy and how courts, particularly the Supreme Court, have worked their way through the analysis of this issue.

Conflicting Goals

Perhaps the most basic issue involved in bankruptcies that include contaminated property is whether liability for remediation constitutes a debt that can be discharged in bankruptcy. Historically, the largest such debts arise under the Comprehensive Environmental Response, Compensation and Liability Act, 42 U.S.C. §9601 *et seq.* ("CERCLA," also known as "Superfund"), so much of this discussion will deal with CERCLA liability.

There is a basic tension between the goals of the bankruptcy code and those of CERCLA. Bankruptcy's goal is to maximize claims that can be discharged in order to provide the debtor with a fresh start. CERCLA's goal is the remediation of contaminated property with funds from those who caused the contamination. *Chateaugay Corp. v. LTV Corp. LTV Steel Co.*, 944 F.2d 997, 1002 (2d Cir. 1991). CERCLA's goal is better served if claims against the debtor are not discharged and so remain the debtor's obligation, while the debtor would get a more complete "fresh start" if those obligations were discharged.

Courts painstakingly work their way through this issue by focusing on definitions in the Bankruptcy Code—*i.e.*, what is a "debt" and what is a "claim"—to determine how remediation costs should be treated. The analysis therefore starts with those definitions.

Definitions in the Bankruptcy Code

The term "claim" means

(A) right to payment, whether or not such right is reduced to judgment,

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liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal equitable secured or unsecured; or

(B) right to an equitable remedy for breach of performance if such breach gives rise to a right to payment, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured or unsecured.

The term "debt" means liability on a claim.

11 U.S.C.A. §101(5) and (12)

§727 of the Code contains requirements for discharges and §523 contains exceptions which are debts that are not discharged. Exceptions relevant to environmental matters include that in §523(a)—debts that are for a "fine, penalty, or forfeiture payable to and for the benefit of a governmental unit…"

Major Bankruptcy Decisions Governing Contaminated Property

There are five major decisions that explain how contaminated property will be dealt with in bankruptcy. They are, in chronological order:

- *Ohio v. Kovacs*, 469 U.S. 274, 105 S. Ct. 705 (1985);
- *Midlantic National Bank v. N.J. Dept. of Environmental Protection*, 474 U.S. 494, 106 S. Ct. 755 (1986);
- *In Re Chateaugay Corp. v. LTV Corp. v. LTV Steel Co.*, 944 F.2d 997 (2d Cir. 1991);
- *Torwico Electronics, et al v. N. J. Dept. of Environmental Protection*, 8 F.3d 146 (3d Cir., 1993); and
- *In re McCrory Corporation*, 188 B.R. 763 (S.D.N.Y. 1995)

Though there are numerous other cases that refine these decisions, these five provide the framework for understanding the issues of contaminated real property in bankruptcy proceedings.

When Is a Clean-Up Obligation a Dischargeable Debt and When Can Contaminated Property Be Abandoned?

Are remediation costs dischargeable in bankruptcy? Typically the debtor wants the answer to be yes and a governmental agency wants the answer to be no. And depending on the facts and procedural status of the situation, both answers may be correct.

In *Ohio v. Kovacs*, the issue was a hazardous waste site. The state got an injunction in state court to force Kovacs to clean up the site, and then had a receiver appointed when he failed to do so. The receiver's job was to take the Kovacs' property and assets as needed to comply with the injunction, but he had not completed that task when the debtor filed for bankruptcy. The issue of whether the debt asserted by the state was dischargeable worked its way to the U.S. Supreme Court, which found that the debtor's obligation under the injunction was a debt that was dischargeable. The Court reasoned that it was clear that the receiver's goal was to get enough of the debtor's money to pay clean-up costs, therefore the order under the injunction had been converted into an obligation to pay money that was appropriately discharged in bankruptcy.

Ohio's argument was that the injunction had three parts: (1) an order to stop polluting; (2) an order to clean-up the site; and (3) an order to pay money to compensate the state for damage to fish. It conceded that the order to pay money was dischargeable, but that the requirement to clean-up the site was not. The Court's response was that the only way the debtor could perform the clean-up obligation was to pay for the clean-up, which was confirmed when the receiver sought payment rather than personal performance. Therefore the obligation had been converted to a monetary debt that was dischargeable. *Kovacs* at 282. The same result would be found if the debt was to a private party that made a claim for contribution from the debtor.

The Court went on to consider that if the state had prosecuted Kovacs under civil or criminal environmental laws when he failed to clean-up the site, it might not have been a dischargeable debt, but by going after his assets, the receiver both made it a dischargeable debt and made it impossible for the debtor to perform the clean-up. *Kovacs* at 282–83. If a fine or penalty had been imposed prior to bankruptcy, that would not have been discharged. *Kovacs* at 284; 11 U.S.C.A. §523(a)(7).

And what happens to the property? Whoever is left in control of it must comply with Ohio environmental laws. *Kovacs* at 285. In a footnote, the Court suggests that if the value of the property is more than the cost to clean it up, the trustee would sell it and the buyer would have to clean it up. Section 363 of the Bankruptcy Code permits the sale of assets, including real estate, free and clear of all liens and claims, but not free of environmental liabilities. If the cost of clean-up exceeds the value of the property, the trustee would abandon the property to the debtor and he or she would still bear the remediation liability. *Kovacs*, FN 12.

An order that ends 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."

And the very next year, the Supreme Court opined on the issue of abandonment. In *Midlantic National Bank v. N. J. Department of Environmental Protection*, the issue was whether a bankruptcy trustee could abandon contaminated property in contravention of laws and regulations designed to protect the public's health or safety.

The Bankruptcy Code Does Not Preempt Public Health and Safety

Section 554(a) of the Bankruptcy Code reads: "After notice and hearing, the trustee may abandon any property of the estate that is burdensome to the estate or that is of inconsequential value and benefit to the estate."

The trustee in *Midlantic* wanted to abandon two properties, one in New York and one in New Jersey, both contaminated with waste oil containing PCBs, where the cost of remediation exceeded the value of the property. Though agreeing that the properties were of no value to the estate, New York argued that abandoning them would threaten public health and safety and violate New York environmental laws. New York also relied on 28 U.S.C. §959(b), which states that a trustee must manage and operate property according to the laws of the state where the property is located. The

bankruptcy court agreed with the trustee, the property was abandoned, and the state of New York spent $2.5 million to clean up the New York site.

Again the case worked its way up to the Supreme Court, and that court reached a very different decision. Referring to a number of laws passed by Congress that evidenced the goals of environmental protection, such as CERCLA and RCRA, the Court ruled that the Bankruptcy Code does not pre-empt all other laws. *Midlantic* at 505. The interest of the bankrupt estate must give way to the government's interest in the public's health and safety. *Midlantic* at 504.

To the extent you have the ability to plan ahead… the possibility of some party filing for bankruptcy should be part of your thinking.

The Court found that bankruptcy court does not have the power to allow contaminated property to be abandoned without imposing conditions necessary to protect the public. *Midlantic* at 507. This is to be a narrow exception, only applied when the condition of the property presents an imminent and identifiable harm to the public.

The dissent by four members of the Court suggests that the finding by the majority was based on very thin precedent and that it actually elevates the status of remediation claims over claims by other creditors, which was never intended by the Bankruptcy Code.

If property cannot be abandoned, the trustee can create a trust to own, remediate and sell the property, with proceeds to go back into the bankrupt's estate. Some trustees make use of environmental insurance products for protection in this process.

Most Injunctions to Remedy Ongoing Pollution Are Not Claims

Timing and the nature of a "claim" were at issue in *In Re Chateaugay Corp. v. LTV Corp. v. LTV Steel Co.* LTV was a Potentially Responsible Party (PRP) under CERCLA at 14 sites, but was implicated at a great many more nationwide. The company's schedule of liabilities included 24 pages of "contingent claims" held by EPA and various state environmental agencies. Based on only the 14 CERCLA sites, EPA's proof of claim was for $22 million.

EPA's position was that they did not hold claims dischargeable in bankruptcy because the response costs had not yet been incurred, even through the releases occurred pre-petition. This case dramatizes the conflicting goals of CERCLA and the Bankruptcy Code.

In complex analysis, the Second Circuit determined that EPA can seek payment if it elects to incur clean-up costs itself, but it cannot accept payment as an alternative to continued pollution. Therefore a clean-up order that both removes accumulated waste and stops ongoing pollution is not a dischargeable claim because it is not a claim that is reduced to payment. An order that ends 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." Most environmental injunctions to remedy on-going pollution will not, therefore, give rise to claims in bankruptcy. *Chateaugay* at 1008.

However, under CERCLA, if a creditor received an order, performed the clean-up and sued others for response costs, thereby converting the injunction into a monetary obligation, it could constitute a dischargeable claim.

This decision suggests that all injunctions that are to remedy on-going pollution are not claims. It also makes it clear that a trustee may not abandon contaminated property in violation of an environmental regulation reasonably designed to protect the public from identified hazards. If property has contamination that endangers public safety, the costs that must be incurred to remove the danger are considered necessary to preserve the estate, and therefore qualify as administrative costs. Decisions as to priority require specific consideration of each cost.

Next in the line-up of significant environmental bankruptcy decisions is a Third Circuit case, *Torwico Electronics, et al v. N.J. Dept. of Environmental Protection*, 8 F.3d 146 (1993), in which a Chapter 11 debtor sought to avoid liability for environmental remediation by making the state's efforts to enforce clean-up obligations into dischargeable claims under 11 U.S.C. §101(5).

Torwico listed NJ DEP as a creditor with a disputed and unliquidated claim based on three Notices of Violation issued by the agency, but the agency filed no claim with the bankruptcy court. The court defined the issue as whether Torwico's environmental obligations constituted a "debt" under the Bankruptcy Code. The state's position was that it did not make a demand for money, it demanded that Torwico rectify an ongoing situation that constituted a hazard. Siding with the state, the court found that Torwico's obligation was not a debt that gave rise to a dischargeable claim and the company could not avoid the remediation obligation.

The last helpful decision in this line of cases is *In Re McCrory Corporation*, 188 B.R. 763 (U.S. Bank. Ct. SDNY, 1995), another Chapter 11 case, where the issue was whether environmental costs incurred in New Jersey post-petition resulting from pre-petition actions were entitled to priority as administrative expenses. The debtor, the lessee of the property, rejected the lease in the bankruptcy proceedings. The landlord wanted clean-up costs to receive administrative priority under 11 U.S.C. §§503 and 507.

Resolution of the issues in this case depended on the court's interpretation of *Midlantic* and whether that decision prevented the trustee from abandoning the property. If the court found that the trustee could not abandon the property, clean-up costs would be an administrative expense. *McCrory* at 767. The analysis then hinged on whether the violation of environmental law at the site posed an imminent risk of harm. In *McCrory* there was no imminent risk that prevented abandonment. Thus, the property could be abandoned, and having been abandoned, the property was no longer in the estate, so its remediation did not benefit the estate and clean-up costs did not receive administrative priority.

Lessons Learned from These Cases

Very often, the knowledge that you have a problem with contaminated property

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occurs in such a manner that advance planning is not possible. It is difficult to plan for contingencies you had no reason to foresee. But to the extent you have the ability to plan ahead, and in the midst of the many complex technical and legal issues you must deal with, the possibility of some party filing for bankruptcy should be part of your thinking.

Simplifying the findings of these decisions is difficult, but the following seem to be possible outcomes when contaminated property is addressed in bankruptcy:

- If the remediation obligation is reduced to a monetary amount, it will be discharged as a debt. Though this relieves the debtor of the immediate financial obligation, it leaves the property contaminated and future liability for remediation obligations still possible.
- If the value of the property exceeds its clean-up costs, the trustee can sell the property and the buyer, who presumably bought it at a discount, is responsible for its remediation.
- If the cost of remediation exceeds the property's value, and the condition of the property does not threaten public health or the environment, the trustee can abandon the property and the debtor is left with the property and the remediation obligation post-bankruptcy.
- If the property presents a hazard, the trustee may not abandon it without taking some action to render it safe. Presumably the costs of that action are administrative expenses, which may or may not receive priority.
- If the state cleans up the property, as is likely to be the situation in many cases, it will probably put a lien on the property to recover its costs, and that recovery could depend on whether the property can be sold for more than the cost of the remediation.

The best a debtor who owns contaminated property probably can do is to have the cost of remediation become a debt that is discharged by the bankruptcy court. The debtor most likely will lose the property, but also lose the debt. The worst the debtor can do is to be left post-bankruptcy with both the property and a remediation cost obligation that exceeds the value of the property. A middle ground would be where concern that an environmental debt could be discharged if bankruptcy is filed leads to settlement discussions among PRPs, allowing the debtor to resolve its obligation for a negotiated figure. If the debtor PRP pays a reduced share, the shares of other PRPs would increase, but that would also be the result if the decision was made in the context of bankruptcy.

Bankruptcy cannot solve all problems—the case of contaminated property is just one example where none of the possible solutions satisfies all participants. FD