



Key Environmental Liability Considerations in Bankruptcy Actions

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Broadly speaking, one of the primary purposes of the United States Bankruptcy Code¹ is to allow a debtor to have a ‘fresh start.’ On the other hand, the intent of environmental laws is to require responsible parties to comply with environmental standards for the protection of human health and the environment. As a result of these competing interests, there has been extensive litigation related to the interplay between the bankruptcy and environmental regulatory regimes.

Although this is a complex area of law that requires close coordination between bankruptcy and environmental counsel, the purpose of this article is to outline some of the key issues related to environmental claims in bankruptcy: 1) from the debtor’s perspective to discharge government environ-

mental claims; and 2) from a private party claimant’s perspective to recover site remediation costs that would otherwise be owed by a debtor.

Debtor’s Protection Against Government Environmental Claims

Policy and Regulatory Exception to the Automatic Stay

The automatic stay is one of the greatest protections conferred upon debtors in bankruptcy. Once a bankruptcy petition has been filed, parties are enjoined from taking any actions to collect, assess, or recover pre-petition claims against the debtor or debtor’s property pursuant to Section 362(a) of the Bankruptcy Code.² In general, the automatic stay is designed to halt all pending legal actions against the debtor

and to require any party seeking to continue a legal proceeding to obtain leave of the bankruptcy court.

The automatic stay, however, is not absolute. Rather, there are several exceptions, including the ‘police and regulatory exception,’ which applies to the “commencement or continuation of an action or proceeding by a governmental unit...to enforce [its]...regulatory power, including the enforcement of a judgment other than a money judgment.”³ Debtors should be aware that governmental agencies are likely to assert this exception when seeking to continue any pre-petition legal actions based on alleged violations of various environmental laws, including, but not limited to, claims regarding environmental site remediation. Although this exception to the automatic stay generally does not apply where a governmental unit is seeking to enforce a monetary judgment, courts, including the Third Circuit, have usually read the exception broadly, in favor of allowing a government to continue its environmental actions against a debtor, even where the government is effectively seeking some pecuniary relief.⁴

In the Third Circuit, this exception will often allow a governmental entity to continue a pre-petition environmental action against the debtor, even one involving monetary obligations, until entry of the bankruptcy court monetary judgment. But, the government is stayed from enforcing the judgments outside of the bankruptcy proceeding.⁵

Debtors may find some relief in that some bankruptcy courts, including in the Third Circuit, will apply the ‘pecuniary interest/public policy test’ to determine whether an action by a government falls under the police and regulatory exception.⁶ If the proceeding relates principally to the protection of a pecuniary interest in the debtor’s property, rather than to its public policy interest in general safety and welfare,

the action is subject to the automatic stay.⁷

Dischargeability of Claims Pursued by the Government

One of the most significant issues relating to environmental liabilities is whether they can be discharged in bankruptcy. This issue arises in the context of both government and private party claims. Dischargeability means a legal release or elimination of debt so the debtor is no longer liable.⁸ As a general rule, only prepetition (for Chapter 7 cases) and pre-confirmation (for Chapter 11 cases) claims can be discharged in bankruptcy. Courts addressing the dischargeability of environmental obligations must first determine whether the environmental obligations constitute a ‘claim’ under the Bankruptcy Code.

Under Section 101(5)(A) of the Bankruptcy Code,⁹ a claim includes a “right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured.”

Any pre-bankruptcy right to payment of money pursued by a governmental unit constitutes a claim and is subject to discharge. With certain exceptions, governmental entity creditors asserting these claims are required to file proofs of claim in the bankruptcy case and are treated as general unsecured creditors, often receiving cents on the dollars owed.

Is a Cleanup ‘Order’ by the Government a ‘Claim’?

The more difficult and widely litigated question arises when the debtor is subject to a cleanup order directing the debtor to clean up pre-petition contamination on property owned by others, or on the debtor’s own property. The Supreme Court addressed this question in *Ohio v. Kovacs*,¹⁰ and held that the debtor’s obligation to clean up environ-

mental damage at a site the debtor did not own was a claim dischargeable in bankruptcy because the obligation had been effectively reduced to a money judgment. Relying on this case, debtors often argue that where they would be forced to spend money to comply with a cleanup order, the injunction is effectively a ‘right to payment’ and, therefore, a dischargeable claim. The Supreme Court did not address what would have happened if the debtor’s cleanup obligation was for the debtor’s own site.

In *In re Torwico Elecs., Inc.*, however, the Third Circuit addressed what would happen if it were the debtor’s own site when it declined to apply a more expansive definition of claim, and held that the environmental obligations owed by the debtor were not claims but instead “an exercise of the state’s inherent regulatory and police powers” and, therefore, not dischargeable.¹¹ At issue was the cleanup of a hidden illegal seepage pit at a site formerly leased by the debtor, discovered months after filing for Chapter 11 relief. The debtor claimed no knowledge of the seepage pit and the wastes found there.¹² The Third Circuit found the debtor had an ongoing responsibility because, allegedly, its wastes presented a continuing hazard and, as such, its obligation to remediate was not a claim and could not be discharged.

Private Party Claims for Recovery of Cleanup Costs from a Debtor

Similar to causes of action for entry of a money judgment pursued by the government, any pre-bankruptcy right to payment of money pursued by private parties will constitute a claim and be subject to discharge in bankruptcy. Like government creditors, private party creditors must file proofs of claim and are generally treated as general unsecured creditors, usually resulting in minimal recovery on their claims.

If a debtor’s cleanup obligations are

claims because they can be satisfied by the payment of money, the issue becomes whether, and in what circumstances, other potentially responsible parties (PRPs) will be able to assert claims against the debtor to recover at least some of the future cleanup costs debtors otherwise would have been responsible for under environmental remediation statutes, such as the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA).¹³

This issue implicates Section 502(e)(1)(B) of the Bankruptcy Code, which provides for the disallowance of contingent claims for reimbursement or contribution where the claimant is co-liable with the bankrupt debtor. Specifically, Section 502(e)(1) provides:

- (e)(1) Notwithstanding subsections (a), (b), and (c) of this section and paragraph (2) of this subsection, *the court shall disallow any claim for reimbursement or contribution of an entity that is liable with the debtor on or has secured the claim of a creditor, to the extent that—*
- (A) such creditor's claim against the estate is disallowed;
 - (B) *such claim for reimbursement or contribution is contingent* as of the time of allowance or disallowance of such claim for reimbursement or contribution; or
 - (C) such entity asserts a right of subrogation to the rights of such creditor under section 509 of this title.¹⁴

Elements of Section 502(e)(1)(B) and Limitations Outside the Third Circuit

Courts interpreting Section 502(e)(1)(B) have consistently applied a three-part test to determine whether a private party's claim is subject to disallowance. Each part of the test must be satisfied for a claim to be disallowed:

1. *Contingency.* The claim must be contingent at the time of allowance or disallowance.

2. *Co-liability.* The party asserting the claim must be liable with the debtor on the claim of a third party.

3. *Reimbursement or contribution.* The claim must be for reimbursement or contribution.¹⁵

Two policies underlie the application of this section: 1) preventing double recovery on the same claim and furthering equitable distribution among creditors; and 2) enabling a bankruptcy case to proceed with distribution to unsecured creditors without awaiting resolution of contingency.¹⁶

Recent decisions from the district and bankruptcy courts for the Southern District of New York (*In re Lyondell Chem. Co.*, *In re Chemtura Corp.*, and *Route 21 Associates of Belleville, Inc. v. MHC, Inc.*) have adopted broad interpretations of each of these three elements and disallowed essentially all claims seeking recovery of future remediation costs.¹⁷ In these cases, all of the PRPs' claims for future costs were disallowed,¹⁸ as the courts found that: 1) claims remain contingent until CERCLA liability has been established and amounts are actually paid; 2) the PRPs' claims were ultimately premised on co-liability to the United States Environmental Protection Agency (EPA), and multiple recoveries on the same liability are disfavored; and 3) CERCLA Section 113(f) claims were for contribution and Section 107(a) cost recovery claims were for reimbursement.¹⁹

Based on the reasoning from *Lyondell*, *Chemtura*, and *Route 21*, a creditor PRP would only be able to assert an allowable bankruptcy claim for costs already paid or incurred, because only these costs would qualify as non-contingent. With respect to past costs, it would not matter whether the claims were brought under CERCLA Section 107(a) for cost recovery or Section 113(f) for contribution. These recent decisions severely limit the types of claims a creditor PRP can assert against a bankrupt and pre-

clude claims based on future costs and expenses. However, the Third Circuit has arrived at more favorable conclusions in similar circumstances.

Future Costs under CERCLA Section 107(a) May be Allowable under Section 502(e)(1)(B)

To the extent that PRPs are able to assert a claim for future costs under CERCLA Section 107(a) (but not CERCLA Section 113(f)), they may be able to recover these costs in bankruptcy proceedings in the Third Circuit, even where the EPA has issued orders and filed its own claims.

First, in *In re Allegheny Int'l, Inc.*,²⁰ the Third Circuit affirmed without opinion a Western District of Pennsylvania case that allowed a PRP's CERCLA Section 107 claim for future response costs after finding the co-liability element to be unsatisfied.²¹ The claimant sought to recover its own past and future response costs for a cleanup that lacked any governmental involvement. The *Allegheny* court concluded that "the distinction between a cleanup performed by [a claimant] and a cleanup performed by the EPA is crucial."²²

Second, the Bankruptcy Court for the District of Delaware issued a pair of decisions²³ citing *Allegheny* and holding that a PRP's Section 107(a) claims for past and future costs were not subject to disallowance, both: 1) when the EPA had not been involved or asserted a claim against the debtor and the claim was direct,²⁴ as well as 2) when the EPA had issued an administrative order, initiated litigation, and filed its own proof of claim, but the PRP claimant still had out-of-pocket costs to incur and recover and there was no possibility of multiple payment.²⁵

Third, a decade later, the Bankruptcy Court for the District of New Jersey, in *In re G-I Holdings, Inc.*, followed *Allegheny* in allowing a direct claim for past and future cleanup costs asserted by a credi-

tor PRP group against a debtor PRP group member.²⁶ The EPA had issued a record of decision and an administrative order to the debtor and several other parties for site remediation, and the PRPs entered into a separate agreement allocating cleanup costs.²⁷ After several years of remediation, the debtor filed for bankruptcy and stopped paying its share.²⁸

While the *G-I* court rejected the PRP group's argument that its claim was entitled to administrative expense priority,²⁹ the court did allow the claim because: 1) funds had been expended and the claim was, therefore, not contingent, and 2) the claimant sought to recover sums it had and would expend, and the debtor's liability was, therefore, direct.³⁰

Thus, a PRP's ability to withstand a Section 502(e)(1)(B) challenge to its cost recovery claims for future costs appears to be better in the Third Circuit than in the Second Circuit, based on current precedent.

Conclusion

Potential debtors should be aware that the protective automatic stay provided by the Bankruptcy Code will not apply to the government's exercise of regulatory power to enforce environmental laws and pursue claims regarding related violations.

Private party claimants must be mindful of bankruptcy notices and deadlines, including the deadline to file a proof of claim, as claims not filed by the deadline will be barred. It is also important to involve bankruptcy counsel early on in the process to determine the viability of a claim and a successful strategy to pursue its recovery, an approach that may vary based upon the specific facts presented in a bankruptcy and the jurisdiction of the bankruptcy filing.

Based on current precedent, a private party claimant may have success maintaining cost recovery claims for future

costs in the Third Circuit, whereas similar claims would be disallowed in the Second Circuit. Further, although unsecured creditors may often stand to receive minimal recovery on their claims, this is not always the case, and there may be the opportunity to recover real dollars in the bankruptcy distributions. ☛

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ENDNOTES

1. United States Code Title 11.
2. 11 U.S.C. § 362(a).
3. 11 U.S.C. § 362(b)(4).
4. See, e.g., *Penn Terra, Ltd. v Pa. Dep't of Env'tl. Res.*, 733 F.2d 267 (3d Cir. 1984).
5. See, e.g., *New Jersey v. W.R. Grace & Co. (In re W.R. Grace & Co.)*, 412 B.R. 657, 663 (D. Del. 2009); *U.S. v. LTV Steel Co., Inc.*, 269 B.R. 576, 582 (W.D. Pa. 2001).
6. *Nicolet I* at 209; see also *Berg v. Good Samaritan Hospital*, 230 F.3d 1165, 1167 (9th Cir. 2000).
7. *In re W.R. Grace & Co.*, 412 B.R. at 665.
8. 11 U.S.C. § 727(b).
9. 11 U.S.C. § 101(5)(A).
10. 469 U.S. 274 (1985).
11. *In re Torwico Elecs., Inc.*, 8 F.3d 146, 151 (3d Cir. 1993), cert. denied, 511 U.S. 1046 (1994).
12. *Id.* at 147.
13. See 42 U.S.C. §1906 et seq.
14. 11 U.S.C. § 502(e)(1).
15. See, e.g., *Route 21 Associates of Belleville, Inc. v. MHC, Inc.*, 486 B.R. 75 (S.D.N.Y. 2012), aff'd, 542 Fed. Appx. 41 (2d Cir. 2013).
16. *In re Fuel Barons, Inc.*, 488 B.R. 783, 787 (Bankr. N.D. Ga. 2013) (citations omitted).
17. See *Route 21*, 486 B.R. at 93-99; *In re Lyondell*

Chem. Co., 442 B.R. 236 (Bankr. S.D.N.Y. 2011); *In re Chemtura Corp.*, 443 B.R. 601 (Bankr. S.D.N.Y. 2011).

18. See 443 B.R. at 609-610.
19. 442 B.R. at 248.
20. 126 B.R. 919 (W.D. Pa. 1991), aff'd without opinion, 950 F.2d 721 (3d Cir. 1991).
21. 442 B.R. at 253-55.
22. 126 B.R. at 923.
23. *In re Matter of Harvard Indus.*, 138 B.R. 10 (Bankr. D. Del. 1992) (*Harvard 1*); 153 B.R. 668 (Bankr. D. Del. 1993) (*Harvard 2*); see also *In re APCO Liquidating Trust*, 370 B.R. 625 (Bankr. D. Del. 2007).
24. 138 B.R. at 13-14.
25. *Id.* at 671-72.
26. *In re G-I Holdings, Inc.*, 308 B.R. 196 (Bankr. D.N.J. 2004).
27. 308 B.R. at 200-01.
28. *Id.*
29. See *id.* at 202-12. Note that amounts actually incurred post-petition to ameliorate environmental contamination may be entitled to administrative expense priority during the bankruptcy case. See, e.g., *Pa. Dep't of Env'tl. Res. v. Conroy (In re Conroy)*, 24 F.3d 568 (3d Cir. 1994).
30. *Id.* at 212.