

ENVIRONMENTAL ISSUES IN A BANKRUPTCY CASE

GENERAL

There are certain conflicts inherent in the mixture of the policies underlying environmental laws, i.e., protecting public health and the environment, and the policies underlying bankruptcy laws, i.e., settling a debtor's liabilities equitably and providing a debtor with a "fresh start." Some of the more noticeable areas where these conflicts collide are those affecting (i) the right of contribution; (ii) the priority of environmental claims against a bankruptcy estate; (iii) the dischargeability of environmental liabilities as debts in bankruptcy; (iv) trustee's ability to abandon contaminated property; and (v) the jurisdiction and effect of the automatic stay on government enforcement actions.

The date of the filing of a petition for bankruptcy relief is also an important time reference with respect to discharge and priority issues. The debtor will generally be discharged of all unsecured claims arising before that date or "pre-petition." If distributions are made on a debtor's pre-petition claims, the claimant may receive only a portion of its claim. If the claim, however, arises post-petition, the debtor may be liable for the entire amount as an administrative cost. Therefore, the time at which an environmental claim arises is a relevant issue whether a contribution claim will be recognized in the bankruptcy case, what priority will be given to a claim and whether the claim will be discharged by the bankruptcy.

PRIORITY OF CLAIMS

In bankruptcy, environmental claimants often attempt to establish their claim as a §503 administrative expense. Code § 503(b) provides that "actual, necessary costs and expenses of preserving the estate, including wages, salaries, or commissions for services rendered after the commencement of the case" constituted administrative expenses. 11 U.S.C. § 503(b). Pursuant to § 507 of the Code, administrative expenses allowed under § 503(b) are entitled to priority over all general unsecured claims.¹⁶

Since there is no specific provision in Section 503(b)(1) giving priority to environmental claims, the general rule has been to accord environmental claims general, unsecured status.¹⁷ Nevertheless, courts will grant an administrative priority to a claim, that (i) the right to payment arose from a post-petition transaction with the debtor's estate, rather than from a pre-petition transaction with the debtor, and (ii) the consideration supporting the right to payment was beneficial to the estate.¹⁸

Claims Based on Cleanup Cost of Post-petition Contamination.

Environmental claims arising from clean up of post-petition contamination enjoy priority as administrative expenses.¹⁹

When granting an administrative expense priority, a court will often cite to 28 U.S.C. § 959 or the Supreme Court's *Midlantic* decision, depending on the severity of the environmental contamination and the imminence of the dangers associated with it. 28 U.S.C. § 959(b) requires a bankruptcy trustee or debtor in possession to manage and operate property of the estate in accordance with applicable non-bankruptcy law. Courts have held that § 959(b) gives rise to an administrative expense.²⁰ Courts disagree whether Section 959(b) applies to debtors who have ceased operations and are liquidating their businesses.²¹ One court has held that § 959 does not necessarily apply to debtors in constructive possession of property.²²

In *Midlantic Nat'l Bank v. New Jersey Dep't of Environmental Protection (In re Quanta Resources Corp.)*,²³ the Supreme Court interpreted § 959(b) to require trustees or debtors in possession to comply with environmental laws applicable to property of the estate. The Supreme Court suggested as well that the trustee or debtor in possession could not abandon property so long as doing so would present an imminent and identifiable harm to public health or safety.²⁴ Note that *Midlantic* did not address the issue of priority of clean up expenses.

By citing § 959(b) or *Midlantic* as an analogy, cases have found that if the debtor or trustee could not abandon the property of the estate in contravention of environmental law, neither should they be able to maintain or possess the property in continuous violation of the same law; therefore, the debtor or trustee has an obligation to remedy the problem.²⁵

The Supreme Court expressly left open the question in *Midlantic* of the priority accorded to governmental costs if the trustee fails to respond to a cleanup order. *Midlantic Nat'l Bank v. New Jersey Dep't. of Env'tl. Protection*.²⁶ At least one court has concluded that cleanup obligations should be treated as a claim, not as a specific performance obligation that the trustee must carry out on an administrative expense basis.²⁷

The courts have also relied on public policy to invoke priority status for environmental claims holding that the power of the trustee "must yield to governmental interests in health and safety, which includes using assets of the estate for the necessary cleanup" and viewing the removal of the waste as an obligation of the estate as well as a "risk which the creditors must bear."²⁸

Post-petition Cleanup Costs on account of Pre-petition Contamination.

A common issue is whether a claim should be entitled to an administrative expense priority where the contamination occurred pre-petition, but continues to be a problem post-petition. In this situation, it is likely that the claim will enjoy administrative priority if there is a showing of imminent harm.³¹ However, many courts are beginning to review when the claim was incurred to determine the priority of cleanup costs. If the claim was incurred pre-petition, then post-petition cleanup costs are dischargeable unsecured claims without any priority.³²

Pre-petition Cleanup Claims.

Costs incurred pre-petition may obtain a less favored status as unsecured claims in bankruptcy.³⁵ The Security Gas court indicated in dicta that environmental cleanup orders in regard to pre-bankruptcy violations were general, unsecured claims, while post-petition hazards can have administrative expense priority.³⁶ Additionally, pre-petition fines are usually treated as dischargeable unsecured claims.

Liens Against Estate Property.

Even if environmental cleanup costs are not granted an administrative expense priority in bankruptcy, these costs may be entitled to priority as liens on property in the estate under §-506(c). This section grants a right of recovery, in effect a "superlien" on secured property for the "reasonable, common, necessary costs and expenses of preserving, or disposing of, such property to the extent of any benefit to the holder of such [secured] claim." However, this superlien applies only if the secured creditor receives some benefit such as cleaning up his collateral.⁵¹ In holding that the EPA could not obtain superlien status because the secured creditor did not receive any benefit from the cleanup action, the court in *In re T.P. Long Chem., Inc.*,⁵² specified that one type of collateral could not be used for general cleanup with no benefit to the secured creditor.⁵³

At least five states have enacted "superlien" provisions in their state Superfund statutes, namely, Connecticut, Maine, Massachusetts, New Hampshire and New Jersey. These statutes generally provide that a lien may be imposed against the real property subject to cleanup in order to assist the state in recovering state funds expended in the cleanup. The liens are referred to as "superliens" because they take priority over all other liens, including previously existing recorded liens.⁵⁴

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DISCHARGEABILITY

Discharge Generally.

A discharge in bankruptcy will most likely, with certain exceptions, release the debtor from liabilities for environmental damages arising before the bankruptcy petition was filed.⁵⁵ Section 523 of the Code provides for certain debts to survive a debtor's bankruptcy case.⁵⁶ A majority of the cases dealing with the dischargeability of environmental claims, however, are based on whether such claims constitute "claims" for purposes of the Code and not whether § 523 is applicable. For example, monetary claims by governmental agencies for response costs which have been expended pre-petition appear to be dischargeable debts; however, the courts are divided as to when claims "arise" for purposes of CERCLA liability and, therefore, whether they are dischargeable. In addition, it is not clear whether cleanup orders in the nature of injunctive relief give rise to a "right to payment" pursuant to the definition of "claim" under the Code and thus are dischargeable in bankruptcy.

Whether Injunction Claims may be Discharged.

A Third Circuit decision has held that a state's attempt to force a debtor to comply with environmental laws and to cleanup hazardous waste was not a claim discharged under the Bankruptcy Code, even though the debtor no longer was in possession of the property. In *In re Torwico Electronics, Inc.*,⁸⁰ the New Jersey Department of Environmental Protection and Energy issued a post-petition administrative order requiring Torwico to remedy certain environmental contamination. Torwico had not been in possession of the contaminated site for several years. Torwico argued that its "affirmative duty to cleanup the site and the duty to pay money to that end" was a claim under *Kovacs* and was therefore dischargeable. New Jersey responded that it did not seek a monetary judgment to be paid to the state, but rather sought to remedy on-going pollution by forcing Torwico to clean up the site.

Relying on *In re CMC Heartland Partners*⁸¹ and *In re Chateaugay*,⁸² the Third Circuit concluded that Torwico's obligations under the administrative order did not constitute a claim. New Jersey was seeking an injunction against the debtor to remedy on-going hazards. The Third Circuit went on to hold that New Jersey's injunction was not merely a "repackaging of a forfeited claim for damages," but rather was an injunction to prohibit a continuing problem and an on-going threat.

Torwico also argued that it was not liable because it was no longer in possession of the site. The court held that under New Jersey law, Torwico was the generator of the hazardous waste, and as such had an on-going responsibility for the waste it disposed. The court concluded that under New Jersey law, the debtor's obligations did not run with the land, but rather with the waste.⁸³

ABANDONMENT

The trustee in bankruptcy obtains the right to "abandon any property of the estate that is burdensome to the estate or that is of inconsequential value and benefit to the estate pursuant to § 554. A question arises, however, as to whether the Bankruptcy Code permits abandonment of property and the liabilities associated therewith as a means of avoiding obligations under environmental laws. It appears that attempts have been made by the courts to reconcile the policies of environmental law with those underlying bankruptcy law. The degree which courts will favor application of bankruptcy law over environmental concerns appear to be based on evaluation of a debtor's financial ability to comply with environmental concerns relative to the potential of a serious public health or safety risk.

Midlantic.

In *Midlantic* seems to indicate that only in situations where an imminent and serious threat to the environment exists will environmental regulations preempt the abandonment power conferred upon trustees under the Bankruptcy Code.⁹⁷

Post-Midlantic Cases.

Other cases decided subsequent to *Midlantic* which have distinguished it and allowed abandonment, indicate that abandonment would probably be allowed if no assets exist in the estate or if all of the estate's assets are encumbered.⁹⁸ In the case of *In re Smith-Douglass, Inc.*, the debtor was the owner of a fertilizer plant in Streator, Illinois, at the time it filed its Chapter 11 petition. No unencumbered assets existed in the estate, and it was eventually determined that the debtor would liquidate rather than reorganize. After liquidating all of the other assets in the estate and unsuccessfully attempting to sell the fertilizer plant, the debtor moved for leave to abandon the plant. The State of Illinois opposed abandonment on the grounds that the property violated state environmental laws although the state had not sought a "no enforcement action."

The Fourth Circuit affirmed the lower court's finding that unconditional abandonment was appropriate in light of the estate's lack of unencumbered assets coupled with the absence of serious public health and safety risks. The court therefore reversed the district court's holding that the financial condition of the debtor is irrelevant to the abandonment analysis under *Midlantic* and stated that "[w]here the estate has unencumbered assets, the bankruptcy court should require stricter compliance with state environmental law before abandonment is permitted."⁹⁹

The ambiguity surrounding footnote 9 of the *Midlantic* opinion, which appeared to limit the abandonment right only to those cases where "no imminent or identifiable harm exists", was acknowledged by the court in *Smith-Douglass*.¹⁰⁰ The court focused on the conflict between federal bankruptcy law and state environmental law in addition to the role preemption by the Supremacy Clause of Article VI of the United States Constitution plays.¹⁰¹ The Fourth Circuit concluded that preemption of state law is a matter of intent and Congress must not have intended to permit abandonment where conditions on property pose a danger of imminent death or illness.¹⁰² Therefore, a narrow exception to preemption applies where there is a serious health risk posed, and the bankruptcy court does not have the power to substitute its judgment for that of the state as to what constitutes a serious public health or safety risk.¹⁰³