

# Client Alert.

April 26, 2011

## Contemplating Chapter 11 as a “Fresh Start”? Consider Recent Developments in Environmental Claims Liability

By **Larren M. Nashelsky, Robert L. Falk, Miles H. Imwalle, and Kristin A. Hiensch**

When a company saddled with potential environmental liabilities seeks bankruptcy protection, the goals of Chapter 11—giving the reorganized debtor a “fresh start” and fairly treating similarly situated creditors—can conflict with the goals of environmental laws, such as ensuring that the “polluter pays.” Courts have long struggled to reconcile this tension. Recent bankruptcy cases from the Southern District of New York, including last year’s decision in *In re Mark IV Industries*,<sup>1</sup> and the more recent bench decisions *In re Lyondell Chemical Co.*<sup>2</sup> and *In re Chemtura Corp.*,<sup>3</sup> evidence this ongoing balancing act.

While the *Mark IV* decision suggests a trend toward favoring environmental considerations by making environmental claims harder to discharge in bankruptcy, the *Lyondell* and *Chemtura* decisions appear to cut the other way, disallowing contingent environmental contribution claims. The key considerations raised by these decisions are critical in evaluating Chapter 11 alternatives.

### WHEN IS AN ENVIRONMENTAL OBLIGATION A “CLAIM”?

Environmental obligations arise in various forms and under numerous federal and state statutes. They include obligations to stop or contain ongoing pollution, to remediate contaminated sites, to reimburse other parties for remediation costs, and to pay fines and penalties. Factors including the type of liability, the status of the contamination, and the statute under which the obligation arises all may impact whether Chapter 11 provides protection to the post-petition entity, or whether the reorganized entity remains liable.

Resolving this issue in the Chapter 11 context requires first determining whether a particular environmental obligation is a “claim” under the Bankruptcy Code. While confirmation of a plan discharges all liability on claims arising prior to confirmation, bankruptcy has no effect on obligations that do not qualify as claims.

Under the Bankruptcy Code, a claim includes “a right to an equitable remedy for breach of performance *if such breach also gives rise to a right to payment.*”<sup>4</sup> In the environmental context, the issue typically arises where an entity is required

**When a company saddled with potential environmental liabilities seeks bankruptcy protection, the goals of Chapter 11—giving the reorganized debtor a “fresh start” and fairly treating similarly situated creditors—can conflict with the goals of environmental laws, such as ensuring that the “polluter pays.”**

<sup>1</sup> *Mark IV Indus. v. N.M. Env’t Dep’t (In re Mark IV Indus.)*, 438 B.R. 460 (Bankr. S.D.N.Y. 2010).

<sup>2</sup> *In re Lyondell Chem. Co.*, No. 09-10023 (REG), 2011 WL 11413 (Bankr. S.D.N.Y. Jan. 4, 2011).

<sup>3</sup> *In re Chemtura Corp.*, No. 09-11233 (REG), 2011 WL 109081 (Bankr. S.D.N.Y. Jan. 13, 2011).

<sup>4</sup> 11 U.S.C. § 101(5)(B) (emphasis added).

# Client Alert.

to conduct a contaminated site investigation, cleanup, and/or pay a fine. Thus the fundamental question is whether the breach of such cleanup obligation “gives rise to a right to payment.” The answer, it turns out, is not straightforward.

## MUDDLED CASE LAW

The only bankruptcy case from the U.S. Supreme Court offering guidance on environmental claims is found in the 1985 *Ohio v. Kovacs* decision, 469 U.S. 274. In *Kovacs*, the state of Ohio obtained an injunction requiring a polluter to clean up a site. When the polluter failed to comply, the state appointed a receiver who took possession of the site and the polluter’s assets in order to implement the remediation. Before the cleanup was complete, the polluter filed bankruptcy. In holding that the cleanup obligation was a dischargeable claim, the Court noted that by dispossessing the debtor and removing his control over the site, the state prevented the debtor from conducting the cleanup himself. The Court held that the state was effectively seeking a money judgment, which is a “claim” under the Bankruptcy Code. Because *Kovacs* largely turned on the fact that the debtor had been dispossessed of its property, it left many questions unanswered, and its general applicability has been limited by later case law.

Another seminal case addressing environmental liability in bankruptcy is the Second Circuit’s decision in *United States v. LTV Corp. (In re Chateaugay Corp.)*, 944 F.2d 997 (2d Cir. 1991). In *Chateaugay*, the court distinguished between orders to clean up accumulated waste and orders to stop ongoing pollution. The Second Circuit held that when an order requires cleanup of contamination and the applicable government agency (in *Chateaugay*, the U.S. Environmental Protection Agency) has the option of conducting the cleanup itself and seeking reimbursement, the obligation is a claim because its breach gives rise to a right to payment. On the other hand, in the case of an order to stop polluting, because the enforcing agency may not accept payment and allow the party to continue polluting, such order does not create a bankruptcy claim. Therefore, such obligation remains enforceable against the reorganized entity.

The leading cases above have led to divergent and sometimes confusing results. For example, one recurring point of confusion is: how should entities, including courts, determine whether pollution is ongoing? While the answer may be clear for a factory emitting pollutants into the air or discharging into a waterway, the analysis can be much more complicated when, for example, groundwater contamination continues to migrate years after the original contaminant release.<sup>5</sup>

## MARK IV ADDS CLARITY . . . AND FURTHER CONFUSION TO DEFINITION OF “CLAIM”

Last year, in *In re Mark IV*, Bankruptcy Judge Stuart M. Bernstein attempted to synthesize *Kovacs* and *Chateaugay*. He articulated a three-factor test for determining whether an environmental obligation is a claim:

1. Is the debtor capable of executing the equitable decree, or can it comply only by paying someone else to do it?
2. Is the pollution “ongoing”?
3. Does the statute imposing the equitable obligation permit the environmental agency the option of cleaning up the pollution on the debtor’s behalf and seeking reimbursement?

The first two factors essentially restate the key holdings in *Kovacs* and *Chateaugay*. The third factor is new and has generated the most controversy. The *Mark IV* court found that because the New Mexico Water Quality Act authorized the New Mexico Environment Department (“NMED”) only to seek injunctive relief and not conduct the cleanup itself and seek

<sup>5</sup> See *In re Oldco M Corp.*, 438 B.R. 775 (Bankr. S.D.N.Y. 2010) (finding that debtor’s obligation to operate groundwater remediation system was not dischargeable because plume would otherwise continue to migrate).

# Client Alert.

reimbursement, the debtor's cleanup obligation was not a claim and was therefore not dischargeable. In so holding, the court rejected the debtor's argument that the obligation should nonetheless be considered a claim because NMED had the option of remediating the site and seeking reimbursement pursuant to other state and federal laws. Concerned that accepting this argument would result in all cleanup obligations becoming dischargeable claims, the bankruptcy court held that "the focus is the statute under which [the agency] elected to proceed." *Mark IV*, 438 B.R. at 470.

## LYONDELL AND CHEMTURA DISALLOW CONTRIBUTION CLAIMS FOR FUTURE CLEANUP COSTS

Earlier this year, two additional bankruptcy cases from the Southern District of New York, *In re Lyondell* and *In re Chemtura*, addressed a related question: when are claims for contribution towards environmental remediation expenses allowable claims in bankruptcy?

The relevant facts in *Lyondell* and *Chemtura*, both bench rulings issued in January 2011 by Bankruptcy Judge Robert E. Gerber, are largely identical. Both cases dealt with claims by private parties seeking contribution (as reimbursement for cleanup expenses) from debtor entities who were alleged to be "potentially responsible parties" ("PRPs") under the Comprehensive Environmental Response, Compensation and Liability Act ("CERCLA"). The debtors in each case objected to allowance of the private parties' claims, arguing that the PRP claims must be disallowed under section 502(e)(1)(B) of the Bankruptcy Code to the extent such claims sought payment for future cleanup expenses. Section 502(e)(1)(B) of the Bankruptcy Code provides that:

"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 . . . (B) such claim for reimbursement or contribution is contingent as of the time of allowance or disallowance of such claim for reimbursement or contribution."

In both cases, Judge Gerber held that claims for reimbursement of costs relating to *future* remediation of environmental damage are *not allowable* because, until such amounts are actually paid, they are "contingent" claims under section 502(e)(1)(B). In so holding, Judge Gerber noted that his rulings advance "not just bankruptcy policy, but environmental policy as well." The court explained that "[d]isallowance of reimbursement claims for amounts not yet paid by the claimant advances CERCLA's policy goal of encouraging expeditious cleanup, because claimants are encouraged to remediate promptly by the threat of disallowance of claims that have not yet been fixed." *Chemtura*, 2011 WL 109081, at \*14. At the same time, the ruling seeks to advance underlying bankruptcy goals of predictability and avoiding the uncertainty of estimating future contingent claims.

## CONSIDERATIONS FOLLOWING RECENT CASE LAW

While the *Lyondell* and *Chemtura* decisions may make bankruptcy more appealing to prospective debtors seeking a fresh start from contributions for future remediation expenses, *Mark IV*, on the other hand, may make the likelihood of discharging environmental claims more difficult, potentially undermining Chapter 11 as an optimal alternative.

It may be too early to understand the full impact of these decisions. However, in light of the *Mark IV* court's holding, it is

**Entities considering bankruptcy as a means of addressing environmental liabilities should examine closely whether their environmental liabilities will be considered claims in light of recent case law. Debtors grappling with this issue may consider the potential advantages of pursuing a sale of assets through section 363 of the Bankruptcy Code.**

# Client Alert.

possible that some governmental agencies will begin acting more strategically relative to bankruptcy considerations, electing to proceed under environmental statutes that provide only injunctive relief, especially when enforcing against polluters in financial distress. For example, in some circumstances, EPA may have the option of seeking to require that a responsible party remediate contamination under either CERCLA or the Resource Conservation and Recovery Act (“RCRA”). Unlike under CERCLA, RCRA does not give EPA the authority to conduct the cleanup itself and seek reimbursement. Thus, EPA could choose to bring an enforcement action under RCRA, thereby preventing the obligation from being considered a “claim,” even if it could have elected to enforce under CERCLA.

Another consideration is the potential impact on recoveries by general unsecured creditors. To the extent that environmental liabilities may be less likely to be discharged following *Mark IV*, recoveries by general unsecured creditors may correspondingly decrease. Ironically, the very tort claimants injured by the debtor’s environmental actions could recover less as a result of the debtor’s nondischargeable cleanup obligations. Further, as general unsecured creditors, tort claimants would be expected to fall below environmental claimants in the bankruptcy priority payment scheme because environmental cleanup costs are often awarded administrative expense status, payable in full under a Chapter 11 plan.

## CONCLUSION

Entities considering bankruptcy as a means of addressing environmental liabilities should examine closely whether their environmental liabilities will be considered claims in light of recent case law. Debtors grappling with this issue may consider the potential advantages of pursuing a sale of assets through section 363 of the Bankruptcy Code. Finally, non-debtors seeking contribution for cleanup costs from PRPs either contemplating or in bankruptcy should understand that the likelihood of receiving such contribution will likely hinge on whether the cleanup costs have actually been incurred, or whether they remain contingent future claims.

*Mark IV*, *Lyondell*, and *Chemtura* are potentially significant decisions in the ongoing efforts by courts to reconcile the competing interests of bankruptcy law and environmental law, but they will not be the last. While these decisions arose in bankruptcy court proceedings, it remains to be seen whether a circuit court will weigh in to add greater clarity.

## Contact:

**Larren Nashelsky**

(212) 506-7365

[lnashelsky@mofo.com](mailto:lnashelsky@mofo.com)**Robert Falk**

(415) 268-6294

[rfalk@mofo.com](mailto:rfalk@mofo.com)**Miles Imwalle**

(415) 268-6523

[mimwalle@mofo.com](mailto:mimwalle@mofo.com)**Kristin Hiensch**

(415) 268-6126

[khiensch@mofo.com](mailto:khiensch@mofo.com)

## About Morrison & Foerster:

We are Morrison & Foerster—a global firm of exceptional credentials in many areas. Our clients include some of the largest financial institutions, investment banks, Fortune 100, technology and life science companies. We’ve been included on *The American Lawyer’s* A-List for seven straight years, and *Fortune* named us one of the “100 Best Companies to Work For.” Our lawyers are committed to achieving innovative and business-minded results for our clients, while preserving the differences that make us stronger. This is MoFo. Visit us at [www.mofo.com](http://www.mofo.com).

*Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.*