
North Carolina Bar Association

ENVIRONMENTAL ISSUES IN BANKRUPTCY AND FAILED DEVELOPMENT PROJECTS

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January 12, 2017



TROUTMAN SANDERS

Topics

- Background on Bankruptcy
- Background on Environmental Law
- Environmental Obligations in Bankruptcy
- Environmental Obligations in Distressed Developments
- Case Study

Background on Bankruptcy

- Chapter 7 versus Chapter 11 Bankruptcy
 - Chapter 7 – A trustee takes control of the debtor's property and liquidates its assets to pay creditors.
 - Goal is to give a debtor a "fresh start" but it doesn't always turn out that way.
 - Amount paid to creditors depends on their priority versus others under the bankruptcy code.

Background on Bankruptcy

- Chapter 7 versus Chapter 11 Bankruptcy
 - Chapter 11 – Debts are reorganized according to a court-approved plan.
 - Typically known as “debtor in possession”
 - Debtor typically retains possession of assets and continues operating under court supervision.
 - Primary goal is to develop a plan of reorganization of debts, which is then confirmed by the court.

Background on Bankruptcy

- Definitions

- Debtor's Estate – all of the debtor's assets that are available for payment of creditors.
- Abandonment – procedure that allows a trustee or a debtor in possession to remove certain property or assets from the estate and avoid related costs.
 - This can be a controversial issue in the environmental arena.

Background on Bankruptcy

- Definitions

- Discharge in Bankruptcy – debts are repaid and forgiven.
 - Commonly, this is seen as the purpose of bankruptcy, to give the debtor a fresh start.
 - Not exactly, if you're a corporation in Chapter 7.
 - Not all debts are dischargeable in bankruptcy. For example:
 - Secured Creditors.
 - Fines and penalties.
 - Fraudulent transactions.

Background on Bankruptcy

- Definitions

- Discharge in Bankruptcy

- Chapter 7 – only individuals

- Individuals get a discharge, corporations do not.

- Chapter 7 just provides an easy way for a corporation to wind up its affairs prior to dissolution.

- Chapter 11 – discharges for all!

- Secured loans are restructured and typically paid in full.

- Unsecured creditors typically receive less than the full value of the debt.

Background on Bankruptcy

- Definitions
 - Administrative Expenses – Amounts paid during pendency of bankruptcy case to keep business operating or to preserve the value of its assets.
 - Technically would be an unsecured creditor with little chance of getting paid, but bankruptcy code puts these expenses second in line for payment.
 - Goal is to encourage business to keep dealing with a bankrupt entity while the case is pending.

Background on Bankruptcy

- Automatic Stay in Bankruptcy
 - Once petition is filed, creditors cannot commence actions against debtor outside of bankruptcy proceeding.
 - Preserve debtor's estate for all creditors.

Topics

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Background on Environmental Law

- Two Basic Types of Environmental Liabilities
 - Compliance
 - Financial Liability for Cleanups
- Compliance With What?
 - Regulations
 - Permits
 - Administrative Orders / Agreements
 - Consent Decrees
 - Injunctions

Background on Environmental Law

- Examples of Compliance Obligations
 - Regulations – Store all hazardous waste in an accumulation area using suitable drums or containers.
 - Permit – Provide mitigation for wetlands filled in as part of a development project.
 - Administrative Order – EPA or state orders a facility owner to abate a release.
 - Agreement – requirements in a NC Brownfields Agreement.
 - Consent decree – Judicially enforceable settlement of previous Clean Air Act violations obligates facility to implement leak detection program above and beyond what the regulations require.
 - Injunction (rare) – Court order to complete closure of a coal ash impoundment by a certain date.

Background on Environmental Law

- Examples of Financial Liabilities for Cleanups
 - Cost recovery actions by EPA, a state or private parties for costs incurred to cleanup a contaminated site.
 - Contribution actions brought by defendants in a cost recovery action against other liable parties.
 - Common law claims for damages arising out of contamination.
 - Contractual indemnity agreements.

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Environmental Obligations in Bankruptcy

- Costs of Compliance During Bankruptcy are Administrative Expenses
 - Theory – if a debtor remains in operation during bankruptcy, it does so for the benefit of its creditors.
 - Thus, the creditors must share in the cost of preserving the value of the assets.

Environmental Obligations in Bankruptcy

- Costs of Compliance During Bankruptcy are Administrative Expenses
 - Only post-petition expenses are given higher priority.
 - Pre-petition expenses (and related debts) do not get special treatment.

Environmental Obligations in Bankruptcy

- Administrative Expenses
 - *Ohio v. Kovacs*, 469 U.S. 274, 284-85 (1985).
 - “We do not question that anyone in possession of the site ... must comply with the environmental laws Plainly, [no one may] maintain a nuisance, pollute waters of the State, or refuse to remove the source of such a condition.”

Environmental Obligations in Bankruptcy

- Administrative Expenses
 - Examples of Environmental Expenses
 - Cost to operate pollution control equipment at manufacturing facility post-petition – administrative expense;
 - Contractual indemnity obligation to parties who performed remediation before petition was filed – not an administrative expense.

Environmental Obligations in Bankruptcy

- Administrative Expenses
 - Examples of Environmental Expenses
 - Cost for the government to perform removal action at debtor's property post-petition – if the property is an imminent threat, government's costs are administrative expenses.
 - Costs incurred by foreclosing lender to address contamination (pre- and post-petition) – administrative expenses.

Environmental Obligations in Bankruptcy

- Effect of the Automatic Stay
 - Actions to require compliance post-petition are not stayed.
 - Actions to enforce pre-petition judgments requiring compliance are not stayed.
 - Actions to recover pre-petition response costs are stayed.

Environmental Obligations in Bankruptcy

- The Line Between Compliance Obligations and Liability for Pre-Petition Contamination
 - Scenario: A hazardous waste generator illegally disposes of hazardous waste at its facility without a permit and subsequently files for bankruptcy protection.
 - Question: Is this a pre-petition liability that can be discharged in bankruptcy or is it an ongoing compliance obligation that is an administrative expense?

Environmental Obligations in Bankruptcy

- The Line Between Compliance Obligations and Liability for Pre-Petition Contamination
 - Three Judicial Decisions of Note:
 - *United States v. Apex Oil Co.*, 579 F.3d 734 (7th Cir. 2009) – bankruptcy court cannot discharge a debtor's obligation to comply with the law, therefore, it cannot discharge debtor's obligation to perform corrective action under RCRA regarding improper disposal of hazardous waste.

Environmental Obligations in Bankruptcy

- The Line Between Compliance Obligations and Liability for Pre-Petition Contamination
 - Three Judicial Decisions of Note:
 - *In re Towico Electronics, Inc.*, 8 F.3d 146 (3d Cir. 1993) – NJDEP order to abate source of ongoing releases of contaminants from illegal disposal of hazardous waste is not dischargeable in bankruptcy.

Environmental Obligations in Bankruptcy

- The Line Between Compliance Obligations and Liability for Pre-Petition Contamination
 - Three Judicial Decisions of Note:
 - *In re Chateaugay Corp.*, 944 F.2d 997 (2d Cir. 1991) – claim by EPA for its pre-petition costs to perform CERCLA removal action is dischargeable in bankruptcy.

Environmental Obligations in Bankruptcy

- The Line Between Compliance Obligations and Liability for Pre-Petition Contamination
 - Emerging Rule – appears to be that dischargeability depends upon the authority under which the government is acting.
 - Apex Oil and Towico Electronics focused on the fact that government cannot take money in lieu of compliance with the law.

Environmental Obligations in Bankruptcy

- The Line Between Compliance Obligations and Liability for Pre-Petition Contamination
 - Chateaugay focused on fact that CERCLA Section 107 allows EPA to sue for its costs.
 - If pre-petition obligations can be reduced to a money judgment, they are dischargeable.
 - Unanswered question: Is the distinction between an agency asserting its RCRA authority versus its “CERCLA” authority a distinction without a difference?

Environmental Obligations in Bankruptcy

- The Line Between Compliance Obligations and Liability for Pre-Petition Contamination
 - So What?
 - If an obligation is not dischargeable in bankruptcy, the debtor is not relieved of it at the conclusion of the case.
 - The obligation may not be subject to the automatic stay, and governmental agencies can still take enforcement action against the debtor.
 - Bottom line – less money for creditors.

Environmental Obligations in Bankruptcy

- N.C.G.S. 130A-20 – if DENR enters a property to abate an imminent hazard, it has a lien for its costs on the property.
 - Treated as a mechanic's lien.
 - Lien is a security interest, so it's not discharged in bankruptcy.
 - But, DENR's claim is subject to prior recorded interests.

Environmental Obligations in Bankruptcy

- Abandonment
 - Scenario: The debtor's estate contains a property that requires significant environmental expenditures and is unlikely to increase the amount of money ultimately available to pay creditors.
 - Solution: the debtor in possession or the trustee abandons the property from the debtor's estate.

Environmental Obligations in Bankruptcy

- Abandonment
 - Consequence: If the court agrees to permit abandonment, the debtor's estate avoids further liability for the property during the bankruptcy proceeding.
 - Example – if a debtor owns a RCRA site that is not likely to be saleable, but which involves significant ongoing costs, abandonment is a way to avoid those costs and preserve the remaining value of the debtor's estate.

Environmental Obligations in Bankruptcy

- Limitations on Abandonment
 - *Midlantic Nat'l Bank v. NJDEP*, 474 U.S. 494 (1986).
 - Courts may not permit abandonment in a way that violates environmental laws or if the property presents an imminent and identifiable threat to the public.
 - *In re Smith-Douglass, Inc.*, 856 F.2d 12 (4th Cir. 1988).
 - If the violations of environmental law do not cause imminent public health or safety risk, abandonment may still be permissible.
 - Regulators are likely to oppose abandonment.

Environmental Obligations in Bankruptcy

- Paradoxical Effect of Abandonment
 - Once a property is abandoned, it leaves the debtor's estate and reverts to the party with right to possess it.
 - Could be the owner or a party with a security interest.
 - But, the environmental issues are still there and the debtor is saddled with them all over again.

Environmental Obligations in Bankruptcy

- Criminal Liability

- If a facility is still operating – Given that compliance is still required during bankruptcy, criminal liability is likely still available as an enforcement tool.
- If a facility is not operating – Arguably, the assets of the debtor's estate should not be used to satisfy compliance obligations that have no hope of benefiting creditors.
 - Even if court does not permit abandonment, if the facility shuts down at direction of the court or trustee, the argument against criminal liability seems stronger.

Environmental Obligations in Bankruptcy

- Criminal Liability

- *United States v. Hansen*, 262 F.3d 1217 (11th Cir. 2001).
 - Parent corporation of the owner of the facility at issue was in Chapter 11 bankruptcy.
 - CEO argued he could not be liable for criminal violations of RCRA because bankruptcy court denied a request for money “to shutdown” plant and for new equipment.
 - Eleventh Circuit rejected the argument and held that debtor in possession can borrow funds to run the business without court approval.
 - CEO should have borrowed money to bring facility into compliance.

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Environmental Obligations in Distressed Developments

- Two Major Issues
 - Contamination
 - Compliance
- Lots of Perspectives
 - Seller
 - Seller's Creditors
 - Buyer
 - Buyer's Lender
 - Regulators

Environmental Obligations in Distressed Developments

- Defenses regarding Contamination Existing before Acquisition
 - CERCLA
 - Lender Liability Defense – 42 U.S.C. § 9601(20)(A)
 - Lender must hold indicia of ownership to protect value of its security interest.
 - Lender may not participate in management of facility.
 - Guidance – 57 Fed. Reg. 18,344 (Apr. 29, 1992) (reversed by DC Circuit but subsequently re-affirmed by Congress).

Environmental Obligations in Distressed Developments

- Defenses regarding Contamination Existing before Acquisition
 - CERCLA
 - Purchasers after Initial Release
 - 2002 Superfund Defense (bona fide prospective purchaser, innocent landowner)
 - Guidance: Interim Guidance Regarding Criteria Landowners Must Meet in Order to Qualify for Bona Fide Prospective Purchaser, Contiguous Property Owner, or Innocent Landowner Limitations on CERCLA Liability (Mar. 6, 2003).

Environmental Obligations in Distressed Developments

- Defenses regarding Contamination Existing before Acquisition
 - IHSA /OPHSCA - Lenders
 - IHSA contains a lender liability defense similar to CERCLA – N.C.G.S. § 130A-310.7(a)(1).
 - OPHSCA does not contain a codified lender liability defense.
 - Subsequent owners would need to rely on “responsible party concept” and *Lancaster* decision.
 - Not clear that *Lancaster* holding is as broad as we would like for it to be.
 - Third party defense?

Environmental Obligations in Distressed Developments

- Defenses regarding Contamination Existing before Acquisition
 - IHSA / OPHSCA – Purchasers after Initial Release
 - Defenses for Subsequent Owners
 - No BFPP or Innocent Landowner Defense
 - IHSA contain a defense for purchasers who acquire title without knowledge, or reason to know, of the contamination.
 - OPHSCA contains a third party defense.

Environmental Obligations in Distressed Developments

- Liability for Compliance Issues Existing at the Time of Acquisition
 - Transactional Considerations
 - Asset Purchase versus Stock Purchase
 - EPA's Interim Audit Policy for New Owners
 - Purchasers who disclose violations to EPA discovered during due diligence can avoid gravity-based penalties and economic benefit penalties.
 - 73 Fed. Reg. 44,991 (Aug. 1, 2008).
 - EPA explicitly reserved the right to take action against previous owners.
 - » How do you build that possibility into a transaction?

Environmental Obligations in Distressed Developments

- Liability for Compliance Issues Existing at the Time of Acquisition
 - Issue has not been thoroughly addressed in the case law.
 - Federal environmental regulatory statutes do not contain lender liability defenses similar to CERCLA (except for USTs).
 - Legal limits of liability may extend further than we think.

Environmental Obligations in Distressed Developments

- *United States v. Norris*, 937 F.2d 286 (6th Cir. 1991).
 - Never been cited by another court.
 - Facts: Bank took security interest in real property after owner filled wetlands without a permit. Bank subsequently foreclosed on security interest and took title to property.
 - Issue: Enforceability of trial court order requiring lender to allow previous owner to re-flood the illegally filled wetlands.

Environmental Obligations in Distressed Developments

- *United States v. Norris*, 937 F.2d 286 (6th Cir. 1991).
 - Result: Court says the order is enforceable, even though this is agricultural land and will reduce the value of the bank's collateral to nothing. No discussion of civil penalties.
 - Implication: The Corps likely approached the lender and asked them to apply for a permit and provide mitigation. The lender should have agreed.

Environmental Obligations in Distressed Developments

- *U.S. v. Norris* appears to be the only case that has addressed this issue directly.
- Implications:
 - Do a compliance audit before you acquire distressed developments.
 - Possible that unsatisfied permit conditions could become subsequent purchaser's (or a lender's) problem.

Environmental Obligations in Distressed Developments

- Be Clear about What You are Acquiring
 - USTs are a great example.
 - Fixture law governs whether a deed to real property conveys title to USTs.
 - *Lee-Moore Oil Co. v. Cleary*, 245 S.E.2d 720, 722 (N.C. 1978).
 - Leading case on fixtures is *Little v. Goforth Industries, Inc.* 340 S.E.2d 510 (N.C. Ct. App. 1986).
 - Courts look to intent of parties at time of UST installation to determine if they become fixtures.

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Case Study

- Hypo:
 - Developer has owned the site for a long time and does not qualify as a BFPP. No brownfields agreement.
 - Active construction going on at the site without stormwater and wetlands permits.
 - During the construction work, EPA becomes aware of a significant source of contamination at the property and does a removal action because the developer is in financial distress.
 - Developer goes into bankruptcy after removal action complete.
 - Subsequent purchaser interested in buying the property.

Case Study

- Perspectives
 - Seller
 - Seller's Creditors
 - Buyer
 - Buyer's Lender
 - Regulator

Case Study

- From the Seller's Perspective
 - Effect of bankruptcy on liability for removal action – arguably it can be discharged.
 - Were all removal action costs pre-petition?
 - If removal action continues post-petition, EPA may be entitled to priority for those expenses.
 - Plus there is at least one case where a lender got priority for pre-petition and post-petition removal action expenses.
 - Compare to situation where EPA exercises authority under RCRA to require excavation of illegally disposed hazardous waste.

Case Study

- From the Seller's Perspective
 - Stormwater and Wetlands Compliance
 - Bankruptcy cannot discharge obligation to comply with the law.
 - Pre-petition civil penalties cannot be discharged.
 - Requirement to purchase wetland credits
 - Arguably, the value of the required credits can be reduced to a monetary judgment and is therefore dischargeable.

Case Study

- From the Creditor's Perspective
 - Every dime that is used for cleanup, buys wetland credits, or pays a civil penalty reduces my recovery.
 - Abandonment – depending upon market conditions, and inherent value of property, creditors may see asset as impaired and as threat to value of the debtor's estate.
 - Align with Seller regarding dischargeability of removal action costs and cost of wetlands credits.

Case Study

- From the Buyer's Perspective
 - U.S. v. Norris suggests the sins of the seller may run with the land.
 - Legal distinction may be unfulfilled obligations to agencies that benefit the land.
 - Example – Absence of wetlands makes the property more valuable, and that value accrues to the buyer, so the buyer should be liable for un-purchased wetland credits.
 - But, as a buyer, would you really want to find out in court? Better to negotiate.

Case Study

- From the Buyer's Perspective
 - Threat of a CERCLA Windfall lien is a real problem for a developer.
 - CERCLA Section 107(r)(2).
 - If the government can't recover its costs from the Seller in the bankruptcy proceeding, a windfall lien would make a lot of sense.

Case Study

- From the Buyer's Lender's Perspective
 - No money for the buyer unless the Lender can quantify the costs the buyer faces and how they will affect buyer's ability to repay the loan.
 - The more negotiated the agreement between regulators and the buyer, the easier it is to eliminate variables and judge risk of default.
 - Norris suggests that loan should be conditioned on correcting the violations immediately after closing.
 - Priority of its security interest versus potential windfall lien.

Case Study

- From the Regulator's Perspective
 - Goal is compliance and correcting adverse environmental impact.
 - Two Options if there's an Interested Buyer
 - Take a hard line with Seller in bankruptcy proceeding
 - Oppose abandonment and push for treatment of all costs as administrative expenses.
 - Negotiate with buyer regarding contamination and non-compliance.
 - Combination of voluntary cleanup and negotiated after-the-fact permit.
 - Threat of CERCLA Windfall lien under 107(r)(2).

Case Study

- From the Regulator's Perspective
 - Without a buyer – combination of a hard line in bankruptcy with potential of civil and criminal enforcement against individuals involved.
 - Policy Perspective
 - Enforcement against bankrupt entity has low probability of improving conditions at property, especially in Chapter 7.
 - State or EPA will have to spend its own money.
 - Negotiation with prospective buyer improves chances of environmental benefits.
 - Other people's money.

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