INSIDE THE MINDS

Managing Environmental Liabilities in Bankruptcy

Leading Lawyers on Identifying Environmental Risks, Implementing Emerging Risk Transfer Strategies, and Navigating Current Trends in U.S. Environmental Liability

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Conflicting Goals of Environmental Law and Bankruptcy Demand Innovative Business Strategies

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***"It is said that the world is in a state of bankruptcy, that the world owes the world more than the world can pay."* — Ralph Waldo Emerson**

Introduction

The economic downturn beginning in late 2007 certainly brought to life the essence of this apt quote for many companies and their creditors globally. In the United States, there is a fundamental tension between the goals of bankruptcy law and environmental law. The former is focused on allowing the rehabilitation of distressed entities, providing a structure through which such entities can obtain a fresh start free from their past financial problems. The latter seeks to impose the costs of environmental cleanup (and other environmental liabilities) on businesses that caused or are otherwise responsible for pollution, including holding companies accountable for their past actions (or for their mere ownership/operational status). This tension, between those statutes imposing long-term environmental obligations and those fostering financial restructuring and a fresh start, is difficult to reconcile. Neither statutory scheme expressly acknowledges the other. Moreover, there is a limited body of case law and precedent upon which practitioners may rely to guide their clients.

For practitioners in environmental and bankruptcy law, however, the recent economic downturn (and consequent rise in bankruptcy filings) marks a time of opportunity. The increase in bankruptcy filings has provided a rapidly growing body of law in a contracted timeframe, offering guidance and structure to the formerly ill-defined legal crossroad between environmental and bankruptcy law.

In addition, on the practical side, the high volume of bankruptcies occurring in this period also has resulted in the need for efficiency and creativity. Both bankruptcy and environmental attorneys have had to develop time-efficient and novel strategies to navigate their clients through the reorganization process. What once would have required many months or a year or more to resolve, now can be completed in certain circumstances in half that time or less. With regard to environmental liabilities, a handful of transactional environmental practitioners nationwide have been successfully adapting certain liability resolution strategies developed in the "fast lane" of the mergers and acquisitions markets of the last two decades to provide time-efficient resolution of, and financial certainty with respect to, environmental liabilities in the bankruptcy context.

Finally, there is greater clarity regarding the applicability of the discharge of environmental liabilities in bankruptcy now than there ever has been. And the law in this area continues to evolve. Recent decisions have clarified the relative long-term risk of environmental liability to be absorbed by all stakeholders, and transactional strategies have been adapted from the mergers and acquisitions arena to efficiently accomplish the business goals of those stakeholders. By tapping into a small group of legal, technical, and financial professionals practicing in this rapidly evolving area of alternative environmental liability disposition, clients can efficiently and fully resolve environmental obligations/liabilities in bankruptcy and truly emerge with a fresh start (at least with respect to environmental issues). This is particularly critical as, despite some signs of recovery, the ongoing uncertain economic climate will continue to challenge the cash flow and balance sheets of many previously financially sound companies, and will place a spotlight on the risks posed by legacy environmental liabilities to creditors and potential successors.

The Legal Landscape: Environmental Law and Bankruptcy Law

As noted above, there is an inherent conflict between environmental law and bankruptcy law. The underlying policy goals of Chapter 11 bankruptcy law are to provide a company (or an individual) a fresh start and to promote financial rehabilitation by discharging a debtor's past obligations. Environmental law, however, seeks to ensure that the government (through its "police powers") can order a responsible party to, among other things, clean up pollution, including historic contamination caused by business predecessors. This conflict represents a dynamic area of the law in which new precedent is being created with great frequency. Thus, counseling clients about environmental liabilities and bankruptcy requires an up-to-date understanding of the state of law in both areas.

As discussed in greater detail below, many environmental obligations/liabilities, including certain administrative orders or injunctions requiring cleanup of pollution conditions (historic and/or ongoing), may not be discharged through bankruptcy. As a result, businesses seeking bankruptcy protection (and companies seeking to purchase assets through bankruptcy) may not be able to avoid all environmental cleanup obligations and liabilities. Often, the extent to which ongoing cleanup obligations and/or other environmental liabilities are or are not discharged through a bankruptcy proceeding will directly affect whether a company can successfully emerge from bankruptcy.

Underneath all the legal jargon, there is one fundamental question to be resolved: can environmental liabilities be discharged in bankruptcy, and if so, which ones? Like all legal analyses, the answer to this question requires assessment of a number of factors, including:

1. **Operating obligations.** To the extent that a debtor engages in business while in bankruptcy, it is generally held that it must comply with its legal obligations, including operational obligations under environmental law. See 11 U.S.C. § 959(b). Environmental permits and the obligations they impose must be complied with, and a company cannot evade or avoid its environmental compliance obligations. Emergency actions to protect public health, safety, or welfare must continue to be undertaken. See, e.g., *Penn Terra Ltd. v. Dept. of Envtl. Res.*, 733 F.2d 267 (3d Cir. 1984). Generally, courts have treated enforcement actions under environmental law as invoking the government's police powers, thus exempting the action from discharge in bankruptcy as well. See, e.g., *Midlantic Nat'l. Bank v. New Jersey Dept. of Envtl. Protection*, 474 U.S. 494 (1986).

2. **Claims.** In general, a Chapter 11 bankruptcy will discharge a debtor from any "claims" that arose before the date of the confirmation of the plan of reorganization. Under the Bankruptcy Code, a claim is broadly defined to include: (a) "right to payment" or (b) "right to an equitable remedy for breach of performance if such breach gives rise to a right to payment, regardless, in either case, whether such rights are reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured." See 11 U.S.C. § 101(5). Thus, one issue to be addressed in determining whether an environmental liability may be discharged in bankruptcy is whether the liability is considered a claim.

Not all environmental liabilities are claims. Where a debtor has an obligation of payment that arises under environmental law, such as to pay a penalty for non-compliance or a historic permit fee (i.e., related to operations pre-bankruptcy), such obligation likely would be considered a claim as noted in Subsection (a) of the definition of claim above, and it would be generally dischargeable.[1] The more complex situation involves a debtor's obligation that arises under environmental law that requires performance rather than payment (e.g., a government-issued cleanup order or obtaining an injunction for performance of cleanup activities); is such an obligation a claim and/or a dischargeable claim under bankruptcy law? The controlling Supreme Court case addressing the issue of whether a cleanup obligation is a claim in a bankruptcy proceeding is *Ohio v. Kovacs*, 469 U.S. 274 (1985). The holding in *Kovacs*, however, is narrow, and has required interpretation in recent cases to clarify the broader issue of the definition of claim. This is one area of active legal interpretation being developed in the current economic climate, as noted above. The facts in *Kovacs* are straightforward. The defendant/debtor failed to clean up an industrial and hazardous waste disposal site pursuant to an order by the state of Ohio under the Comprehensive Environmental Response, Compensation, and Liability Act, 42 U.S.C. §§ 9607, *et seq*. As a result, the state gave control over the defendant's assets to a receiver in order to effectuate cleanup of the site. The defendant/debtor then filed for bankruptcy. After the bankruptcy, the state attempted to enforce the cleanup order. The court held that because a receiver was appointed to execute the cleanup of the site, no action by the debtor was necessary and the Comprehensive Environmental Response, Compensation, and Liability Act order, therefore, was dischargeable because it was effectively an order for payment of cleanup costs and not an exercise of the state's police powers.[2] Thus, the injunction to clean up a

[1] While an historic permit fee generally would be a dischargeable claim, a key issue in an asset sale or reorganization would be whether the buyer or reorganized debtor requires the permit going forward, in which case the buyer/reorganized debtor would need to assume and cure the non-payment to secure the permit and satisfy environmental compliance obligations going forward.

[2] The Court did note, however, "that anyone in possession of the [hazardous waste] site…[including] the bankruptcy trustee must comply with the environmental laws of the State of Ohio. Plainly that person or firm may not maintain a nuisance, pollute the waters of the State or refuse to remove the source of such conditions." *Kovacs*, 469 U.S. at 285.

hazardous waste site in *Kovacs* was a claim in bankruptcy and, therefore, dischargeable. The decision of the Supreme Court in *Kovacs*, however, rested primarily on the underlying state control of the site and the fact that the government essentially converted its cleanup order into a payment obligation when it sought to enforce the injunction by appointing a receiver.

Subsequent cases have limited *Kovacs* to its unusual facts involving the receivership. Currently, the key analysis to determine whether a remedial injunction under environmental law is a claim, and therefore dischargeable in bankruptcy, requires an evaluation of the nature of the specific environmental law at issue. Some environmental statutes impose injunctive obligations in the alternative; the responsible party performs under the statute, or where the responsible party fails to respond, the federal or state environmental agency performs the necessary cleanup activity and charges the responsible party for the cost of that performance. The current body of law generally holds that injunctive obligations to protect the public from ongoing environmental threats are not claims and therefore not dischargeable, where the underlying environmental statutory scheme provides *only* for performance and not for an alternative payment for performance. See, e.g., *United States v. Apex Oil Co.*, 579 F.3d 734 (7th Cir. 2009) (ruling that a company, long since emerged from Chapter 11, was required to undertake an approximately $150 million cleanup ordered by the U.S. Environmental Protection Agency under the Resource Conservation and Recovery Act, as the cleanup obligation of its pre-bankruptcy predecessor was not a claim discharged in the bankruptcy proceeding); *In re Chateaugay Corp.* (LTV), 944 F.2d 997 (2d Cir. 1991) (holding that an order by the U.S. Environmental Protection Agency against a debtor, that to any extent ends or ameliorates continued pollution, is not a dischargeable claim); *In re Torwico Electronics Inc.*, 8 F.3d 146 (3d Cir. 1993) (holding that a state's attempt to force a debtor to clean up hazardous waste was not a claim within the meaning of the Bankruptcy Code). As of the date of this publication, where an injunction is made pursuant to an environmental statutory scheme, and where such injunction does not provide a responsible party an alternative form of monetary relief for an injunctive obligation, courts have held that such an injunction is not a claim and therefore not dischargeable. Thus, these injunctive obligations survive bankruptcy.

3. **Not all assets sold during bankruptcy are sold "free and clear."** One of the benefits of bankruptcy is that the purchaser of a debtor's assets during the bankruptcy case may generally take title to the assets "free and clear" of claims, liens, and other encumbrances against the debtor that arose before the bankruptcy filing (i.e., pre-petition). An important exception to this general rule, however, can be claims with respect to environmental cleanup obligations.

   First, as noted above, operational obligations under environmental law (e.g., complying with environmental permits) must be satisfied. Therefore, where a purchaser is buying an ongoing operational business, such purchaser must anticipate performing all necessary operational obligations in the context of environmental laws (e.g., compliance with and renewal of permits, as well as compliance with environmental regulations).

   Second, where a purchaser has expressly agreed to assume a debtor's obligations as part of the sale consideration, such environmental obligations must be performed after the consummation of the sale.

   Third is the interesting legal issue of whether any of the debtor's legacy environmental obligations survive bankruptcy. In the context of successor liability, some such obligations undoubtedly do survive bankruptcy. Pursuant to the Comprehensive Environmental Response, Compensation, and Liability Act, the Resource Conservation and Recovery Act, and their state analogs (which authorize the U.S. Environmental Protection Agency, various state environmental agencies, and/or private parties to seek to: (1) compel owners and operators of contaminated properties to remediate contamination; (2) obtain the recovery of remediation costs they have incurred; or both (1) and (2)), the owner of an environmentally contaminated asset purchased through bankruptcy may face successor environmental liability through its status as an "owner" or "operator." The extent to which a purchaser may face successor environmental liability, however, can depend on the jurisdiction in which the bankruptcy case is filed. The government generally will take the position that ongoing responsibility springs anew or revests based on the debtor's or buyer's post-bankruptcy ownership or operation. See generally, *Reconciliation of Bankruptcy and Environmental Law, A Legal Survey*, Alan S. Tenenbaum, U.S. Department of Justice, 39th Annual Conference on Environmental Law, March 2010. Moreover, the case law on the subject generally takes a similar position. See generally, *In the Matter of CMC Heartland Partners*, 966 F.2d 1143 (7th Cir. 1992) (finding that an order requiring a successor to a debtor railroad to clean up the site it owned was not mere repackaging of a claim for damages that was forfeited by failure to file a proof of claim in railroad reorganization, but, rather, the U.S. Environmental Protection Agency established that its order depended on the successor's current ownership). Currently, however, the Second, Third, and Fourth Circuits have permitted sales free and clear of successor environmental liability claims, while the Sixth and Seventh Circuits and the Bankruptcy Court in the Western District of Texas have held that there is no basis for releasing the purchaser from successor environmental liability. It is important not to take comfort or place undue reliance on case law that may be favorable to debtors or purchasers in avoiding successor liability post-bankruptcy, however, as the Department of Justice typically reinforces its position that imposes successor liability on the debtor or buyer post-bankruptcy in the language of the final bankruptcy plan or sale approval order, requiring the inclusion of the following language (or some variation thereof):[3]

"Nothing in this Order or the Asset Purchase Agreement releases, nullifies, precludes, or enjoins the enforcement of any liability to a governmental unit under police or regulatory statutes or regulations

[3] Alternatively, the government also may enter into a settlement with a prospective purchaser that limits its remedial liability in exchange for an assumption of defined cleanup work. In this manner, the government assures remediation of the material environmental impacts, and the asset sale can advance.

> that any entity would be subject to as the owner or operator of property after the date of entry of this Order."

Thus, successor environmental liabilities post-bankruptcy can be an ongoing concern for new owners purchasing assets through bankruptcy and/or could hinder the reorganization of bankrupt entities. As a result, as discussed below, innovative business strategies have been developed to mitigate these concerns and limit potential environmental liabilities.

Efficient Bankruptcy Strategies

As noted above, given the significant volume of filings since late 2007, bankruptcy practitioners are pursuing strategies to make the proceedings more efficient. There are clear benefits to a client, as well as the other stakeholders, in pursuing these efficient bankruptcy practices, including:

- **Speed.** Efficient practices offer the potential for a faster reorganization and a quick exit from bankruptcy.
- **Cost.** An obvious benefit to a speedy reorganization is the potential for significant cost savings.
- **Control.** Once a bankruptcy filing occurs, the matter is subject to a great deal of oversight and scrutiny from many different stakeholders. Efficient practices tend to limit control of the process to those stakeholders with the greatest interest in the outcome.

The good news is that with regard to environmental liabilities, valuable tools have been developed in bankruptcy proceedings as well as in the private sector over the last two decades that provide efficient and timely methodologies for liability resolution. In terms of bankruptcy practice, processes have emerged that enhance the efficiency of asset sales of environmentally impacted sites through bankruptcy. Similarly, the merger and acquisition markets of the 1990s and 2000s also required the development of transactional strategies that could offer fast, efficient resolution of key deal issues, including environmental risks and liabilities. Specifically, where an asset sale is a necessary element of a bankruptcy, Section 363 of the Bankruptcy Code is employed. 11 U.S.C. § 363. The sale of assets in bankruptcy through the 363 process (a "363 sale") can be more efficient and faster than a sale through a plan of reorganization. Similarly, to ensure a quick exit from Chapter 11, debtors are filing their cases with the plan already approved by the requisite creditors (i.e., pre-packaged) or fully negotiated with, but not voted on by, their creditors. Either option makes the overall process more timely and efficient.

Selling Assets through Bankruptcy: Section 363 Sales

Several recent high-profile bankruptcies (e.g., General Motors, Chrysler) anticipate 363 sales of a significant number of environmentally contaminated assets.

Section 363 of the Bankruptcy Code permits the trustee/debtor to sell assets, with court approval, outside of the ordinary course of its business and independent of the plan of reorganization. Section 363 also permits the sale to the buyer free and clear of any interest in the property (including claims, liens, and other encumbrances against the property), so long as one of the following applies: (1) applicable non-bankruptcy law permits sale of such property free and clear of such interest; (2) such entity consents; (3) such interest is a lien, and the price at which such property is to be sold is greater than the aggregate value of all liens on such property; (4) such interest is in bona fide dispute; or (5) such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.

The sale of assets in bankruptcy can be accomplished through either a plan of reorganization or a 363 sale. The value of the 363 sale lies in its efficiency. The 363 sale process is more efficient and does not require explicit creditor approval (although creditors have a right to be heard and object to the 363 sale). Meanwhile, a plan of reorganization is a comprehensive plan, addressing the overall financial situation of the debtor, all the interests of all levels of creditors, and the effect of the planned bankruptcy on all stakeholders. A 363 sale is simply a sale of some or all of an estate's assets. To be approved, a 363 sale requires only that the bankruptcy court find the asset sale be appropriate, as assessed against the following criteria: (1) whether the terms of the sale constitute the highest and best offer for the assets to be sold; (2) whether the negotiations for the sale were conducted at arm's length; (3) whether the sale is in the best interest of the bankruptcy estate and its creditors; and (4) whether the sale is being made in good faith. If these criteria are satisfied, and the purchase price for the assets exceeds the obligations to creditors holding collateral against such assets, the sale likely will be approved.[4]

For trustees/debtors, especially those involved in high-profile bankruptcy proceedings, the 363 sale is well suited to current markets. The first benefit lies in the ability to maintain asset value. Once bankruptcy is filed, the value of the assets to be sold may depreciate rapidly. The faster a sale can be achieved, the greater the likelihood that the value of the assets can be maintained. Moreover, where the sale includes ongoing business concerns, public confidence in the products/services of the debtor is best maintained if the sale proceeds quickly and business can continue/resume under the new structure. The second benefit is the relative simplicity of the sale. As noted, unlike confirmation of a plan of reorganization, which requires the voting approval of at least one impaired class of creditors, a 363 sale only requires approval of the bankruptcy court without the need to seek the affirmative approval of any stakeholders (although parties in interest have the ability to object to the sale). As a result, a 363 sale is typically completed in thirty to forty-five days, while the plan voting and confirmation process, including the filing and approval of a disclosure statement under Section 1125 of the Bankruptcy Code (11 U.S.C. § 1125), can take more than ninety days to complete.

Approval of a 363 sale requires an auction process to generate the "highest and best offer" for the asset. Typically, the assets will be marketed by the debtor, with the assistance of its advisers, in a private sale context. The debtor will then negotiate with each party interested in the asset to determine which offer is highest and best. Once the debtor, in its business judgment, makes that determination, it negotiates the asset purchase agreement with the prospective buyer. This stage of the sale process can occur inside or outside of bankruptcy. Either way, the debtor then presents

[4] Where the purchase price is not enough to pay all creditors holding such assets as collateral in full, the sale cannot be approved over the objection of such creditors unless applicable bankruptcy law could force the creditor to accept the sale. See generally, *363 Bankruptcy Sale FAQ: What You Need to Know to Understand What's Going on with Chrysler and GM*, Ohio Practice Business Law, 2009, available at: http://www.ohiopracticalbusinesslaw.com/2009/05/articles/bankruptcy/363-bankruptcy-sale-faq-what-you-need-to-know-to-understand-whats-going-on-with-chrysler-and-gm/ (last visited July 28, 2010).

the winning bid to the bankruptcy court as the "stalking horse," which essentially sets the floor for the price and asset purchase agreement terms for the public phase of the auction process. The assets are then marketed in a public auction process to attract other prospective buyers and ensure the debtor has obtained the highest and best offer for the assets.

Companies considering a 363 sale should be aware that state and federal environmental agencies likely would object to any proposed sale that could have the net effect of abandoning, underfunding, or otherwise avoiding the environmental liabilities and obligations of the debtor. Accordingly, entities considering selling assets through a 363 sale should have a strategy in place to address potential environmental liabilities and obligations.[5]

Pre-Packaged and Pre-Negotiated Bankruptcy Plans

A debtor that seeks to minimize its time in Chapter 11 may, in addition to considering a quick sale of its assets, consider negotiating a plan of reorganization with its creditors prior to filing for bankruptcy protection. The result of the negotiations can take one of two forms. First, the debtor can file a pre-packaged plan, which is simply a plan of reorganization that has been accepted by the requisite number of creditors (one-half in number and two-thirds in amount) under applicable non-bankruptcy law (i.e., securities laws) prior to commencement of the Chapter 11 case. The second is a pre-negotiated plan, which is one in which the debtor has reached agreement with its creditors on the terms of a plan of reorganization but has not actually solicited their votes (the voting process will take place in Chapter 11). The legal requirements are the same, and the criteria for approval are unchanged; the only difference between a pre-packaged bankruptcy and a traditional Chapter 11 proceeding lies in the sequence of events. There are a number of clear benefits to a pre-packaged or pre-

[5] To approve a 363 sale, the bankruptcy court must find that the sale is in the debtor's best interest. If approved, the sale order is automatically stayed for fourteen days to allow any objecting party time to seek a further stay to appeal the sale order. See Fed. R. Bankr. P. 6004(h). The transaction is generally closed either immediately after entry of the sale order (in the event the court waives the fourteen-day stay period) or after the sale order has become final and non-appealable (i.e., after expiration of the ten-day appeal period). While the timing depends on a number of factors, including the jurisdiction in which the bankruptcy case is filed and the nature and extent of the assets being sold, the 363 sale process generally takes about two months.

negotiated plan approach, however. Importantly, the debtor minimizes the amount of time it must remain in bankruptcy. The time-consuming negotiations occur before the filing occurs. As noted above, where the underlying value of a business and its assets could diminish with time and/or where the public confidence in a business concern could quickly erode in the event of bankruptcy proceedings delay, a pre-packaged or pre-negotiated bankruptcy is well suited to quick resolution. Similarly, a debtor retains the greatest control over the proceedings where a plan is negotiated and approved before filing.

Innovative Tools and Strategies Developed to Address Environmental Liabilities

While tools such as pre-packaged plans, pre-negotiated plans, and 363 sales have been developed to quickly and efficiently resolve general liabilities in bankruptcy, there are certain considerations that are unique to environmental liabilities. Certainly, any time-efficient resolution of bankruptcy requires a coordinated effort by two interrelated disciplines—business and legal. First, the debtor, in its business judgment, must assess the long-term goals to be accomplished and the structure of the reorganized business. Similarly, the legal team develops the bankruptcy strategy to resolve legally those liabilities in the jurisdiction at issue in light of the business goals. Where environmental liabilities must be resolved in bankruptcy, however, a significant third consideration must be included in the assessment—the technical discipline. The environmental/technical team must engage in focused and strategic due diligence to identify and define the scope of those environmental liabilities that are to be resolved. The idea is not to be exhaustive and lengthy. Rather, the due diligence must be carried out by experienced professionals with the skill to focus only on the truly material issues. Without such technical definition, the analysis is incomplete. For example, absent the ability to quantify or otherwise "box in" the financial impact of the known (and unknown) environmental liabilities, the debtor (and therefore, its creditors) will be unable to maximize a return on the sale of the debtor's assets. Therefore, while the tendency of debtors and their bankruptcy counsel is to be cost-conscious in the early stages of pre-petition planning and not involve environmental counsel and environmental consultants, early involvement of environmental legal and technical experts is critical, as the key strategic framework for the bankruptcy often is set at this time, and it is at this stage that environmental experts can offer creative risk management strategies that add value to the deal structuring. Engaging environmental experts too late in the process limits their role to reactive risk management and damage control. Especially for bankruptcies involving material environmental risks, consultation with environmental counsel and consultants should be like voting—"early and often"—so environmental issues can be cost-effectively and creatively managed as opposed to "dragging down" the transaction.

Having so defined the goals of the bankruptcy as well as the underlying scope of the cleanup liabilities/obligations to be resolved, the next hurdle involves developing the strategies to resolve them. One powerful tool is use of an environmental risk/liability transfer. A risk/liability transfer is a method to contractually transfer to an environmental contractor the obligation and associated remedial liability to clean up all pre-existing pollution conditions at or related to a site (or portfolio of sites). Literally, a risk/liability transfer allows the deal team to separate the environmental remedial liabilities from the sites/assets and resolve such liabilities. In the bankruptcy context, an environmental risk/liability transfer allows the debtor to separate an otherwise non-dischargeable environmental liability from an asset.[6]

In recent years, a growing number of consulting and brownfield redevelopment companies have evolved from solely conducting remediation (typically on a "time and materials" basis) to contractually assuming certain environmental liabilities, often under a guaranteed fixed price program. That is, not only will these companies perform the environmental remediation necessary to clean up the property, but they also will assess and value a company's environmental liabilities and contractually assume the remediation and regulatory obligations. This type of

[6] Note that an environmental risk/liability transfer is distinct from the creation of an environmental trust established to address environmental cleanup obligations, which also has become increasingly prevalent in recent bankruptcy proceedings. See, e.g., *In re Lyondell Chemical Co.,* 09-10023, 2010 WL 1544411 (U.S. Bankr. Ct. S.D.N.Y. April 19, 2010) (in which twenty-three sites and facilities were transferred to a custodial trust funded with $108 million for clean operations); *In re Tronox Inc., et al.*, 09-10156, 2010 WL 2835545 (U.S. Bankr. Ct. S.D.N.Y. June 28, 2010) (in which the debtor agreed to pay $115 million into custodial trusts as part of a deal to resolve its environmental liabilities rather than sell off its assets). Nevertheless, use of an environmental trust can be incorporated into a risk/liability transfer strategy to achieve the desired resolution of environmental risks and liabilities.

environmental risk/liability transfer is a risk allocation strategy that allows for the contractual resolution of environmental liabilities associated with the condition of a property. In this manner, a transaction involving the transfer of assets can take place as if the sites were not environmentally impacted, and result in appreciating "clean" value for such assets.

A risk/liability transfer (or buyout) generally involves the contractual transfer of remedial liabilities associated with preexisting environmental conditions (e.g., cleanup obligations) at a site to a third-party environmental contractor (or liability buyout firm). The transfer is typically pre-funded and supported with a guaranteed-fixed-price remediation contract/scope of work backed by a parent-level indemnity from the liability buyout firm. Financial assurance to support such transfer contracts has been achieved most often with long-term (e.g., ten years), site-specific environmental insurance policies (discussed below) from a financially secure insurer. Alternatively, financial security can be achieved with the establishment of trusts (especially beneficial for Superfund sites) or escrow agreements. In some instances, as part of the liability transfer, the liability buyout firm will execute a cleanup consent order or enter into a voluntary cleanup program with the environmental regulatory agency with jurisdiction on behalf of all stakeholders to accomplish the risk/liability transfer at the regulatory level.

These types of environmental risk/liability buyouts are useful tools in the context of both 363 sales as well as pre-packaged and pre-negotiated bankruptcies. In both cases, a risk/liability transfer affixes a single fixed cost to the resolution of environmental remedial liabilities. Moreover, it separates the remedial obligation post-bankruptcy from the underlying, restructured business or assets. For pre-packaged bankruptcies, a risk/liability transfer provides the creditor committees, and ultimately the bankruptcy judge, comfort that environmental cleanup obligations are fully funded and allocated. In a 363 sale, a risk/liability transfer allows the debtor to gain maximum value for its assets by separating the environmental cleanup obligation/liability from the underlying assets, making them more attractive to buyers, thereby expanding the pool of potential buyers, as well as facilitating a far less complex sale agreement once a buyer is identified. A properly executed environmental risk/liability buyout will facilitate the rehabilitative goals of bankruptcy (by allowing a debtor to more easily and expeditiously recoup value for contaminated property) while simultaneously satisfying environmental regulatory obligations.

Environmental insurance can be an integral tool to help manage risks and bridge the gap in risk allocation. While traditional insurance programs may not be adequate, tailored, deal-specific environmental insurance is typically (although not always) used to wrap around the contractual environmental risk/liability buyout obligation. While environmental insurance is not necessary or even available (nor cost-effective) for every situation (such as when the expected cleanup cost is small and/or well defined, or the cost of the premium for environmental insurance is disproportionate to the value of the deal), the key is to identify environmental risks at the earliest stage possible, and then craft financial solutions tailored specifically to the client's business priorities.

The types of policies relevant in the bankruptcy context include cleanup cost cap/stop loss policies, pollution legal liability policies, or a combination of both. It is important to note that environmental insurance policies, if properly structured, can be written to cover a broad spectrum of potential exposures beyond cost overruns associated with remedial obligations, including traditional pollution legal liability coverages (some or all of which the liability buyout firm likely will not take contractual responsibility for) such as property damage and bodily injury ("toxic tort" coverages); natural resource damages; liability associated with transportation and disposal of hazardous wastes/substances; project delays and business interruption; loss of collateral value; contract liability; and legal defense costs. It is stressed that an environmental insurance policy is, in its essence, a contract and needs to be negotiated and tailored (manuscripted) to the specifics of the transaction and the underlying cleanup or other environmental risks, just like any other deal document. Off-the-shelf, template, or specimen environmental insurance policies are not acceptable in this context, and should be avoided.

Regulatory approval must be considered. In the end, approval from the relevant state and/or federal environmental agency will be required for the liability buyout firm's participation. In pre-packaged bankruptcies, the debtor and other stakeholders likely will engage in discussions with the environmental agency with jurisdiction prior to filing in order to gain buy-in.

In a 363 sale, the liability/risk transfer will be a fundamental aspect of the assets to be sold, and therefore will require similar agency acceptance. While it is possible that the relevant regulatory agency may refuse to sign off on the liability transfer, such a result is not likely. With experienced environmental counsel and an established liability buyout firm involved, the relevant regulatory agency should quickly realize that an environmental risk/liability buyout in the face of bankruptcy would not only benefit the debtor and its creditors, but also would facilitate the remediation of the contaminated sites and prevent the possibility of "orphaned" environmental liability. With the regulatory agency on board and all interests aligned, the focus should shift to ensuring that the regulatory agency issues an attractive consent decree/order for the liability buyout firm with predefined cleanup standards/endpoints.

Multiple interests will be aligned through a properly structured environmental risk/liability buyout. The benefits of a properly structured liability buyout include, but are not limited to, defining the cost to resolve cleanup obligations of a debtor, resolution of cleanup liabilities, and avoidance of long-term, undefined costs for management of the cleanup by the new/reorganized owner of the asset. In the event the assets are sold to an "arm's-length" third party, the transfer of liability to the liability buyout firm will reduce/eliminate the environmental stigma of the assets, increase the overall value of the properties, and result in higher and better bids than if the cleanup obligations were still tied to the asset.

Conclusion

It is an unfortunate fact that in the current economy, corporate bankruptcy is big business. Business bankruptcy filings rose significantly since late 2007 and are expected to continue throughout 2010. The collapse of the real estate market, tight credit markets, and decreases in consumer demand for products fueled the recent recession and resulted in significant bankruptcy activity. In 2010, and likely for the next few years, bankruptcy has become an important vehicle for restructuring good companies with bad balance sheets.

The resolution of environmental liabilities in bankruptcy represents a particular challenge. There is a basic tension between the goals of environmental law and bankruptcy law and, until recently, there was a dearth of legal precedent upon which counsel could rely in developing a bankruptcy strategy for the resolution of environmental liabilities. However, the high volume of recent bankruptcy activity has resulted in increased precedent and therefore greater guidance in this area. In addition, this volume of work has resulted in the development of more efficient resolution strategies for corporations with environmental liabilities facing Chapter 11 bankruptcy.

Companies considering bankruptcy must fully evaluate their potential environmental liabilities prior to filing for bankruptcy and critically analyze which liabilities may be discharged and which may survive. Similarly, companies considering bankruptcy also should be aware that once a bankruptcy filing is initiated, state and federal environmental agencies might be spurred into action to address known environmental pollution conditions that may otherwise have been a lower priority to try to prevent potential cleanup obligations of the debtor from being discharged by the bankruptcy court. Therefore, a company considering filing for bankruptcy should have an up-front strategy in place for dealing with its environmental liabilities.

As this area of practice is so dynamic, businesses are cautioned to seek experience in their counselors. While the tools and strategies for the efficient resolution of environmental liabilities are advancing, there is a relatively small and defined list of legal, technical, insurance, and environmental professionals with significant experience in this trade.

Quantification and management of legacy environmental risks represents a significant challenge in the bankruptcy arena. Ultimately, a well thought out bankruptcy plan, whether it be a pre-packaged or pre-negotiated structure, a 363 sale, a risk/liability transfer, or any combination thereof, that addresses and boxes in the environmental liabilities, will facilitate the beneficial reuse of a company's contaminated assets while simultaneously benefitting the creditors and expediting the sale of the company's assets or the reorganization of the company itself.

Key Takeaways

- The recent economic downturn has resulted in an increase in bankruptcy filings and, in many cases, has highlighted the conflicting goals of environmental law (i.e., to impose the costs of environmental cleanup on responsible parties) and bankruptcy law (i.e., to allow distressed entities to obtain a fresh start free from their past financial problems).

- In light of the increase in bankruptcy filings and rapidly growing body of case law, there is greater clarity regarding the treatment of environmental liabilities in bankruptcy now than there ever has been.
- Despite this increased clarity, the continuing conflict between the goals of environmental law and bankruptcy demand innovative strategies to expeditiously and cost-effectively manage environmental risks and liabilities.
- For example, a comprehensive risk/liability transfer strategy (utilizing experienced environmental counsel and an established liability buyout firm) will not only benefit a debtor and its creditors, but the relevant regulatory agency should quickly realize that the risk/liability transfer also will facilitate the remediation of the contaminated sites and prevent the possibility of orphaned environmental liability.
- Ultimately, a well thought out bankruptcy plan, whether it be a pre-packaged or pre-negotiated plan, a 363 sale, a risk/liability transfer, or any combination thereof, that addresses and boxes in the environmental liabilities, will facilitate the beneficial reuse of a company's contaminated assets while simultaneously benefiting the creditors and expediting the sale of the company's assets or the reorganization of the company itself.

Related Resources

Cases

- *Penn Terra Ltd. v. Dept. of Envtl. Res.*, 733 F.2d 267 (3d Cir. 1984)
- *Midlantic Nat'l. Bank v. New Jersey Dept. of Envtl. Protection*, 474 U.S. 494 (1986)
- *Ohio v. Kovacs*, 469 U.S. 274 (1985)
- *United States v. Apex Oil Co.*, 579 F.3d 734 (7th Cir. 2009)
- *In re Chateaugay Corp. (LTV)*, 944 F.2d 997 (2d Cir. 1991)
- *In re Torwico Electronics Inc.*, 8 F.3d 146 (3d Cir. 1993)

- *In the Matter of CMC Heartland Partners*, 966 F.2d 1143 (7th Cir. 1992)
- *In re Lyondell Chemical Co.*, 09-10023, 2010 WL 1544411 (U.S. Bankr. Ct. S.D.N.Y. April 19, 2010)
- *In re Tronox Inc., et al.*, 09-10156, 2010 WL 2835545 (U.S. Bankr. Ct. S.D.N.Y. June 28, 2010)

Statutes

- United States Code: Title 11, Chapter 11
- Comprehensive Environmental Response, Compensation, and Liability Act, 42 U.S.C. §§ 9670, *et seq.*
- Resource Conservation and Recovery Act, 42 U.S.C. §§ 6901, *et seq.*
- 11 U.S.C. § 959(b)
- 11 U.S.C. § 101(5)
- 11 U.S.C. § 363
- 11 U.S.C. § 1125

Regulations

- Fed. R. Bankr. P. 6004(h)

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