Reorganizing or Acquiring Businesses Free and Clear of Environmental Liabilities

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Introduction

Environmental and/or environmental-based tort liabilities can be a significant detraction to the current value and future prospects of a business. In some cases, those liabilities can relate to discontinued operations or assets, and in other cases, they may relate to ongoing facilities or operations. Techniques that can be considered to seek to cleanse the business from such liabilities include:

1. Chapter 11 internal reorganization of existing debtor
2. Chapter 11 sale plan
3. Bankruptcy Code Section 363 free and clear sale
4. Real property and/or Uniform Commercial Code foreclosure
5. Non-bankruptcy spinoffs, divestitures, or asset sales
6. Structured settlement with environmental authorities and claimants
7. Sale of contaminated asset to environmental remediation firm

Factors in choosing between these techniques can include:

1. Nature and extent of environmental liabilities
2. Whether contamination is or may be ongoing
3. Which environmental laws are implicated
4. Number of governmental regulatory bodies and co-potentially responsible parties (PRPs) involved
5. Willingness and ability of potential claimants to structure settlement
6. Speed of implementation needed
7. Terms and costs of proposed settlement or consent order
8. Future risk tolerance of going forward with business ownership
9. Other factors that may make bankruptcy otherwise attractive or problematic

An overview of these techniques and the factors in choosing between them is discussed below.

Key Cleansing Techniques

Chapter 11 Internal Reorganization of Existing Debtors

Environmental issues aside, true Chapter 11 reorganizations where the existing business, in close to its present form, reorganizes under existing

management with either creditor ownership or existing equity sponsor ownership through a confirmed Chapter 11 plan are increasingly infrequent. Piecemeal or business unit sales under Section 363 and liquidation of the remaining assets are much more common.

Where material environmental issues are present, a true Chapter 11 reorganization can be even more challenging. As a general matter, monetary "claims" can be discharged in a bankruptcy reorganization, while purely equitable relief may not be dischargeable. Case law has grappled with where certain environmental orders or remedies fall within that spectrum. Monetary claims for past cleanup costs are at the easier end of the dischargeability spectrum, whereas an order not to pollute going forward from a currently owned site is much harder to discharge. The fact that complying with the equitable order or directive may require the debtor to expend funds to comply does not necessarily make that obligation into a dischargeable claim.

A recent case showing this tension is *U.S. v. Apex Oil*, 579 F.3d 734 (7th Cir. 2009) petition for cert. filed, 78 U.S.L.W. 3523 (Feb 23, 2010) (No. 09-1023). In that case, the U.S. Environmental Protection Agency obtained an injunction requiring Apex Oil Company Inc. to clean up a contaminated site. Among other things, the trial court found that millions of gallons of oil were contaminating groundwater and emitting fumes effecting nearby homeowners, and that the oil plume was created by an oil refinery owned by a corporate predecessor of Apex. Apex argued that this was a claim that had been discharged in its prior bankruptcy case. Apex noted that it no longer did refining and no longer had any in-house capability of cleaning up a contaminated site, and would therefore have to hire an outside company at an estimated cost of $150 million to do so (subject to potentially pursuing other contributors to the contamination for part of that amount).

In affirming the cleanup injunction issued by the district court, the Seventh Circuit affirmed that the cleanup obligation had not been discharged by Apex's prior confirmed Chapter 11 plan, because it was an equitable remedy and not a claim. In particular, the Seventh Circuit noted that under the Resource Conversation and Recovery Act, 42 U.S.C. §§ 6901, *et seq.* (RCRA), which was the basis for the Environmental Protection Agency's suit, the government could only seek to compel cleanup and not monetary

relief. The Seventh Circuit distinguished the U.S. Supreme Court's decision in *Ohio v. Kovacs*, 469 U.S. 274, 105 S. Ct. 705, 83 L.2d 649 (1985), by noting that, in that case, the injunction order cleanup of the environmentally contaminated debtor-owned property had been issued pre-petition. The debtor in *Kovacs* failed to clean up the site, and a receiver was appointed to take possession of the assets. When the receiver sought money from the debtor in *Kovacs* to pay for the cleanup, that claim was a monetary claim seeking payment and thus dischargeable. On February 23, 2010, Apex petitioned for a writ of certiorari to the Supreme Court, and therefore there may be further guidance in the future.

Query whether the result would have been different if the injunction had been issued under the Comprehensive Environmental Response, Compensation, and Liability Act, 42 U.S.C.A. §§ 9601, *et seq.* (CERCLA), or some other statute allowing monetary damages as a form of relief, even if that is not the form of relief the plaintiff sought.

Even for claims that are dischargeable, there is the issue of whether effective notice was given to the parties to be discharged. Notice lists for bankruptcy cases sometimes focus just on current payables and pending litigation, and may not include all types of potential contingent claimants. While sometimes there is also publication notice of the bar date or the plan confirmation, there can be issues as to whether that publication notice is sufficient to bind a claimant who did not receive actual individualized notice. This depends on whether the claimant was "known" or "unknown" to the debtor.

Although a debtor must provide known creditors with actual notice of the bankruptcy filing and bar claims date in order to receive a discharge of those claims, for unknown claimants, notification by publication will generally suffice. See *City of New York v. New York, New Haven & Hartford Railroad Co.*, 344 U.S. 293 (1953); *Chemetron Corp. v. Jones*, 72 F.3d 341, 346 (3d Cir. 1995). A "known" creditor is one whose identity is either known or "reasonably ascertainable" by the debtor. *Tulsa Professional Collection Serv. Inc. v. Pope*, 485 U.S. 478, 490 (1988). An "unknown" creditor is one whose "interests are either conjectural or future or, although they could be discovered upon investigation, do not in due course of business come to knowledge [of the debtor]." *Mullane v. Central Hanover Bank & Trust Co.*, 339

U.S. 306, 317 (1950). When determining whether a creditor's identity is "reasonably ascertainable" for purposes of discharging environmental liabilities, courts examine, among other factors, the proximity of the claimant to the site and the relationship between the parties. See *Chemetron*, 72 F.3d at 347-48 (claimants who either resided at or visited addresses in proximity to nuclear waste dump maintained by debtor were "unknown creditors" where none of the parties still resided at addresses neighboring dump and identities could not reasonably be ascertained from debtor's books and records); *In re New York Trap Rock Corp.*, 153 B.R. 642, 646 (Bankr.S.D.N.Y. 1993) (holding government agency that failed to file claim to recover costs under the CERCLA to be an "unknown creditor" even where debtor had entered real estate contract with another agency of same government entity); *In re Texaco Inc.*, 182 B.R. 937, 954-55 (Bankr.S.D.N.Y. 1995) (holding claim unknown where owners of land two miles removed from the debtor's property filed action based on environmental contamination after bar date). Even where publication notice is sufficient to notify unknown claimants, if a claimant can show that a failure to file a timely claim was due to "excusable neglect," such claim may be allowed. Bankr. Rule 9006(b)(1); *Chemtron*, 72 F.3d at 349; *Jones v. Chemetron Corp.*, 212 F.3d 199, 205 (3d Cir. 2000) (claimants could not show excusable neglect where contamination was generally known in the community, some residents publicly expressed concern about the health effects of toxins due to contamination in press accounts and public meetings, and claimants introduced no evidence to show what measures they took to investigate their medical problems).

For cases where legacy or ongoing environmental liabilities are a concern, a checklist of parties you may want to consider giving notice to is included as Appendix H.

As noted by the U.S. Supreme Court in *Midlantic Nat. Bank v. New Jersey Dept. of Environmental Protection*, 474 U.S. 494, 106 S. Ct. 755, 88 L Ed. 2d 859 (1986), neither a bankruptcy filing nor the automatic stay generally immunize a bankruptcy estate from ongoing obligations to comply with laws, including environmental laws, post-petition. For owned property that has leakage or other ongoing pollution post-petition or especially post-confirmation, obligations under the CERCLA and other environmental laws generally continue, subject to perhaps a structured settlement with the

applicable environmental regulators (discussed below). One strategy that may be considered with such properties (especially if operations have been or can be discontinued at the contaminated site) is moving to abandon the property as burdensome under Section 554 of the Bankruptcy Code. For instance, Sonnenschein as debtors' counsel in *In re Philip Services Corporation, et al.*, (S.D. Tex, Jointly Administered under Case No. 03-37718-H2-11), filed a series of abandonment motions that generally resulted after litigation in the contaminated properties being abandoned to the state where the relevant property was located in. Included as Appendix I is a model of an abandonment motion and order. States often resist abandonment, and either litigation or a negotiated settlement result as a matter of abandonment motions.

Chapter 11 Sale Plan

A Chapter 11 plan may also provide for a sale to a third party. This may take the form of an actual asset sale implemented through a Chapter 11 plan or some structure where a new investor ends up owning the existing entities as a "plan sponsor." Because Section 363 asset sales (discussed below) can be quicker and cheaper, that is the prevalent way to acquire assets in bankruptcy. Two other potential drawbacks of using a Chapter 11 plan to implement a sale transaction are (i) the need to solicit creditor votes on a plan and need for an accepting impaired class of creditors, and (ii) the need to pay priority and administrative expense claims in full to meet the confirmation standards, which can be an issue if the bankruptcy estate is insolvent or illiquid.

There may be non-environmental reasons (such as unassignable but valuable intellectual property licenses) the plan route may be pursued, and plans can provide somewhat broader protections, especially against third-party tort claims, over a Section 363 format. The environmental issues are otherwise similar to those discussed above in connection with Chapter 11 internal reorganization plans or below in connection with Section 363 sales.

Bankruptcy Code Section 363 Free and Clear Sale

Section 363 of the Bankruptcy Code allows sales of assets free and clear of certain claims, interests, and liens. Some courts will include a finding that

the purchaser is not a successor to the seller for successor liability law purposes. In many jurisdictions, sales of entire business lines or even substantially all of the debtors' assets without a Chapter 11 plan are permitted if good cause can be shown to support such a sale. Where only the proceeds are insufficient to pay the secured creditor and there is no benefit to the unsecured creditors from a sale, some courts may have issues with approving what they may view as a de facto foreclosure sale. Twenty days notice of the sale is required, but can be shortened for emergencies. Where substantial assets are being sold, a longer marketing and auction period may be expected as a practical matter, especially if the assets to be sold were not thoroughly marketed on a pre-petition basis, to show a higher and better price can be obtained. While a stalking horse bidder may obtain reasonable breakup fee and bidding protections, Section 363 sales are generally open to all qualified bidders and buyer exclusivity is disfavored.

The ability to buy free and clear of environmental liabilities through a Section 363 asset purchase depends in part on the nature of the liability. For instance, absent a structured settlement (discussed below), a bankruptcy court Section 363 order will not absolve a buyer of having to comply with the CERCLA and other relevant environmental laws as to continuing pollution at a property being purchased in the sale. On the other hand, buyers will generally not be subject to liabilities related to discontinued operations or assets not being purchased.

Purchasers should keep in mind that bankruptcy cases are of limited duration, and the purchaser may need to enforce the free and clear provisions in some other federal or state court in the future. Even if the bankruptcy case is still open or could be reopened, some bankruptcy courts take the view that any judge can interpret its order and that the bankruptcy court does not need to go out of its way to protect the purchaser against subsequent claims and suits. Courts may also be concerned about whether the subsequent plaintiff received effective notice of the free and clear sale, and may be unwilling to dismiss a suit against a purchaser based on the bankruptcy court order. Whether the purchaser is liable to the claimant under applicable statutory, regulatory, or common law successor liability principles, of course, still needs to be examined. A conservative purchaser may want to give a broader notice of the free and clear nature of the sale.

The General Motors and Chrysler bankruptcy cases are recent examples of complex but swift restructurings. Given the number of jobs at stake and the political focus in those cases, we believe those cases may be an anomaly and that most bankruptcy cases seeking to address legacy liabilities such as environmental claims will be much slower and more combative.

Real Property and/or Uniform Commercial Code Foreclosure

Real property foreclosure procedures and timing vary from state to state. Foreclosure by publication or non-judicial foreclosure may be fairly quick (a month or two). Judicial foreclosures can take years, especially if heavily contested or if the applicable court is handling a large volume of foreclosure cases. Foreclosure under Article 9 of the Uniform Commercial Code is non-judicial and can be done on at least ten days notice. Where the assets are in multiple states and subject to multiple liens, pulling off a coordinated foreclosure to buy all the assets necessary to operate an entire business as a going concern can be challenging from a logistics and coordinated timing viewpoint. It is also possible that certain assets used in the business (e.g., real estate leaseholds) may not be encumbered or at least properly perfected, which makes having the secured lender deliver a complete package of operating assets without the borrower's cooperation more challenging.

Foreclosures are generally designed to deal with competing lien claims and extinguishing an existing owner's interest in the collateral. They may provide some protection against successor liability claims, but they clearly are not as protective as a bankruptcy court order in that regard. While there are some "lender liability" protections against secured lenders who act within normal parameters being held liable as an "owner" or "operator" under the CERCLA (see e.g. 40 C.F.R. 300.1100, security interest exception), buyers at (or after) foreclosure sales do not generally view those protections as immunizing them from potential liability in the future.

Non-Bankruptcy Spinoffs, Divestitures, or Asset Sales

Another technique that is sometimes evaluated is a spinoff, divestiture, or asset sale to separate good/uncontaminated assets from bad/contaminated ones. Where the "bad assets" are divested, the remaining entity is generally

not purged of at least historical liabilities up to that point absent a novation or release from the potential claimant. Where some or all of the "good assets" are divested, the transaction needs to be evaluated under state successor liability law principles, and to the extent that the remaining "bad company" is insolvent or left with unreasonably small capital or unable to pay its debts as they become due, there may be fraudulent transfer concerns as well where unpaid creditors or some future bankruptcy trustee for the transferor may try to challenge and undo the divestiture or otherwise pursue the purchaser.

Structured Settlement with Environmental Authorities and Claimants

Either within or outside of a bankruptcy case, prospective bidders or investors sometimes seek settlements with environmental authorities and other key players where the scope and nature of their cleanup obligations, if any, are agreed to so they can acquire an asset or business without the downside of potentially large and hard-to-quantify environmental liabilities. Such settlements can take a while to negotiate, and the more parties who are involved, the more difficult they can be. While various federal or state statutes can be involved, the two most common in our experience are the CERCLA and the RCRA.

Two major issues that always present some level of investment risk when owning contaminated property, whether or not bought in the bankruptcy process, are, first, the state (or Environmental Protection Agency) "changing its mind" regarding a previously approved cleanup activity, and, second, determining what entity is an "owner" (and when) for purposes of establishing CERCLA liability. Two recent cases illustrate these important points.

In *State of Minnesota ex rel. Northern Pacific Center Inc. and Northern Pacific Center Inc. v. BNSF Railway Company*, 2010 WL 2777157 (D. Minn., No. 08-6385, 7/14/10), the court denied a summary judgment motion in which BNSF argued that the earlier state approval of a 1,400 ppm lead level cleanup precluded the state from now saying a 700 ppm lead level was appropriate, thereby exposing BNSF to added costs incurred by its successor in ownership for additional costs due to excavating dirt. This case illustrates the always present, even if remote, risk of "reopener litigation."

Similarly, in *State of California Department of Toxic Substances Control, a State Agency v. Hearthside Residential Corporation*, 2010 WL 2853762 (No. 09-5538.9, Ninth Circuit, 7/22/10), the court addressed, in a case of first impression, whether "owner or operator" status under the CERCLA "is determined at the time cleanup costs are incurred or instead at the time that a recovery lawsuit seeking reimbursement is filed." With the passage of time, these can be different owners.

Finally, even if a structured settlement can be agreed to and closed, that is no guarantee against future suits. For instance, in the recent case of *City of St. Louis (Michigan) v. Velsicol Chemical Corp.*, No. 07-13683-BC, 2010 WL 1247757 (E.D. Mich. March 25, 2010), a structured settlement involving potential CERCLA liabilities was entered into between the Environmental Protection Agency, the states of Illinois, Michigan, New Jersey, and Tennessee, the debtor, its parent corporation, and a successor entity that was incorporated into a Chapter 11 plan via a plan supplement. Post-confirmation, the city of St. Louis, Michigan, who was not a party to the settlement, filed suit against the debtor and certain other parties related to alleged ongoing contamination of drinking water. The state court suit was removed to the district court, and in the recent decision cited above, the city's attempt to have the suit remanded back to state court or have the district court abstain from hearing the case (either on a mandatory or permissive basis) was denied. Subsequently, the Environmental Protection Agency filed a complaint as plaintiff-intervenor seeking a declaratory judgment that the relief sought by the city is inconsistent with the structured settlement, and defendants filed motions to dismiss certain claims as barred by the settlement agreement. A hearing on the motions to dismiss is set for August 30, 2010.

While it is unclear whether the city will succeed in its efforts to pursue the reorganized debtor, this case at a minimum shows that there is a risk of claimants who are not party to a structured settlement attempting to pursue claims that the purchaser or investor likely thought were fully addressed and resolved by the structured settlement.

Sale of Contaminated Asset to Environmental Remediation Firm

There are firms in the marketplace that will acquire or otherwise manage an environmentally contaminated asset for a fee. Those firms are of course

betting that they can clean up or otherwise address the contamination for less than the fee they charge plus the residual value of the property as remediated. The seller often either lacks the expertise to do the cleanup themselves or considers the asset to be a non-core distraction to their ongoing business.

These kinds of transactions are still uncommon and work best for a single property, not in ongoing operations of the business. Where there are material off-site pollution or tort claims, this kind of transaction is difficult. The seller generally remains liable for the contamination and is relying on the environmental firm to implement the cleanup correctly and promptly. An indemnification from the remediation firm in favor of the sellers is worthwhile only to extent that the remediation firm remains solvent.

Successor and Related Party Liability Principles

Potential liability for environmental liabilities generally arises from (i) state common law or (ii) environmental laws and regulations.

While successor liability law varies slightly from state to state, there are generally the following types of theories used to pursue successor liability: (i) express or implied assumption of the liabilities, (ii) a de facto merger with the predecessor, (iii) a mere continuation of the predecessor, or (iv) fraudulent conveyance. Where liability is based on a hazardous product, products sold into states that follow strict liability law should also be evaluated. Agency, veil piercing, and lender liability laws may also be implicated in certain situations. Where there is offsite property damage or personal injury from the contamination, doctrines of law such as nuisance, negligence, and trespass may need to be evaluated.

For federal and state environmental laws and regulations, related party liability often hinges on whether the related party was deemed an owner or operator of the contaminated facility or a contributor to landfill or other offsite pollution. Control over or active input into day-to-day operational decisions or active hands-on involvement in waste disposal or containment activities can be key facts in these kinds of cases.

Especially for out-of-court acquisitions, a purchaser should consider these doctrines and factors in structuring its transaction. For instance, does it buy the accounts receivable and marginal assets or perhaps instead consider merely providing some support to the seller or its secured lender in collecting or liquidating them? Does it want to use substantially different corporate and trade names than the business associated with the legacy liability to avoid confusion between the old business and the new one? Does it want to retain existing management, and if so, in what capacity (for instance, perhaps as a short-term transition consultant rather than as an officer of the acquiring entity)?

Conclusion

While it is certainly possible to eliminate or cap most kinds of environmental liabilities, considerable analysis and care needs to be exercised to do so effectively. As a general matter, having a detailed knowledge of the environmental issues and potential parties affected, including historical knowledge, can be very helpful. Choosing between the various techniques set forth above depends on the particular environmental issues involved and weighing the various goals of the client.

Related Resources

Statutes and Regulations—CERCLA

- Text of statute with selected cases: 42 U.S.C.A. §§ 9601- 9675
- Text of regulations: 40 C.F.R. Part 300 through Part 312

Statutes and Regulations—RCRA

- Text of statute with selected cases: 42 U.S.C.A. §§ 6901 - 7000
- Text of regulations: 40 C.F.R. Part 260 through Part 282

Selected Key Web Sites

- www.justice.gov/enrd—listing and links to recent Department of Justice suits, settlements, and, especially, proposed consent orders

- www.usa.gov—listing and links to all federal and state Web sites, plus some local government Web sites
- www.epa.gov—listing and links to various Environmental Protection Agency documents, regulations, guidance, etc.
- www.federalregister.gov—listing and links to proposed and final regulations in the Federal Register
- www.reginfo.gov—semiannual regulatory agenda and rule-makings of various agencies
- www.astm.org—general technical reference

Note: In our experience, the CERCLA and RCRA are most likely to raise environmental issues in bankruptcy or bankruptcy-related proceedings.

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Mr. Hackmann is a frequent speaker and author on a wide variety of environmental and regulatory topics. He has testified before committees of the U.S. Senate and House of Representatives on the Clean Water Act, and has served as chair or vice-chair for environmental groups and associations.

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