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The Nondischargeability of Government Cleanup Orders

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Introduction

One of the primary purposes of title 11 of the United States Code (the "Bankruptcy Code") is to provide debtors with a financial fresh start. Upon the filing of a bankruptcy petition by or against the debtor, section 362(a) of the Bankruptcy Code provides that all entities are barred from actions to collect, assess, or recover any pre-petition claims against the debtor.[1] In general, the automatic stay serves to halt any pending legal proceedings against the debtor so that the pre-petition claims can be managed and discharged by the bankruptcy court.[2] There are, however, exceptions to the automatic stay. One of those exceptions is known as the "police and regulatory exception."[3] Under this exception, the automatic stay does not preclude the government from enforcing its police or regulatory powers, nor does it bar the enforcement of any non-monetary judgement obtained by the government.[4]

When addressing the dischargeability of environmental obligations, such as cleanup, courts must determine whether the obligations constitute a claim under the Bankruptcy Code. Section 101(5)(A) of the Bankruptcy Code states that a "claim" includes a "right to payment,

[1] 11 U.S. C. § 362(a).
[2] *In re Linear Elec. Co., Inc.*, 852 F.3d 313 (3d Cir. 2017).
[3] 11 U.S.C. § 362(b)(4).
[4] *Id.*

whether or not such right is reduced to judgement, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured or unsecured."[5] While the automatic stay does not bar the enforcement of any non-monetary judgment obtained by the government, any right to payment by a government agency constitutes a "claim." This prompts the question, can the government force a debtor to "clean up" a contaminated site, even if it costs the debtor money to comply? If cleanup orders by the government are considered "monetary judgements" or "claims," this poses a substantial obstacle to successful reorganization.

There is no agreed upon settled law to answer the present question. This memorandum explores whether a cleanup order is a dischargeable monetary claim by exploring the various ways different circuits have dealt with the issue. Part I discusses *Ohio v. Kovacs,* the only Supreme Court decision that has addressed the issue. Part II analyzes how the Third and Seven Circuits have approached government cleanup orders. Part III concludes by examining the emerging rule and exploring recent lower court decisions using that rule.

I. The Supreme Court Holds That Cleanup Orders are Dischargeable When the Obligation is Reduced to a Monetary Judgement

In 1985, the Supreme Court addressed whether the State of Ohio's environmental cleanup order against a debtor constitutes a claim under the Bankruptcy Code.[6] In that case, the State of Ohio ordered the debtor, William Lee Kovacs, to remediate a hazardous waste site.[7] The State of Ohio's Environmental Protection Agency and Department of Natural Resources sued Kovacs for violating state environmental laws by polluting public waters with pesticides and industrial waste.[8] Kovacs stipulated that his company, Chem-Dyne Corp., would remove environmental

[5] 11 U.S.C. § 101(5)(A).
[6] Ohio v. Kovacs, 469 U.S. 274 (1985).
[7] *Id.* at 275.
[8] *In re Kovacs*, 717 F.2d 984, 984-85 (6th Cir. 1983), *aff'd sub nom.*, *Kovacs*, 469 U.S. 274 (1985).

hazards from the industrial waste disposal site, but ultimately failed to comply.[9] The court then granted Ohio's motion to appoint a receiver to force Kovacs to comply.[10] The receiver was authorized to collect reimbursement from Kovacs's assets for the remediation work.[11] However, before the receiver had fully remediated the site, Kovacs filed for bankruptcy.[12] Therefore, if the receiver's power "[gave] rise to a right of payment," then it could be discharged as a claim.[13]

The Supreme Court held that the debtor's cleanup obligation was subject to the automatic stay because the obligation had been reduced to a monetary judgement.[14] The appointment of the receiver was determinative because Kovacs no longer had possession of the hazardous waste sites.[15] In addition, after the receiver was appointed, the only performance sought from Kovacs was payment of money to offset costs of remediation.[16] Therefore, Kovacs could not comply with the injunction to clean up, and its obligation to the government agency could only be accomplished by money judgment.[17] Thus, the Court held that Ohio was merely trying to obtain money payments from Kovacs, and that the cleanup order was dischargeable in bankruptcy.[18]

The *Kovacs* decision provides little guidance to whether a cleanup order is a claim under the Bankruptcy Code. After *Kovacs*, though it is clear that an injunction to clean up is treated as a dischargeable claim when it is reduced to a monetary payment, it remains unclear under what circumstances cleanup orders are reduced to dischargeable claims.

II. Cleanup Orders May Be Nondischargeable, Regardless of Cost to Comply

[9] *Kovacs*, 469 U.S. at 277-78.
[10] *Id.* at 276.
[11] *Id.* at *283*.
[12] *Id.* at 276 n. 1.
[13] 11 U.S.C. § 101(5)(B).
[14] *Id.* at 279.
[15] *Id.* at 283.
[16] *Id.*
[17] *Id.*
[18] *Id.*

A. Third Circuit Holds That Cleanup Orders Are Nondischargeable When Government Does Not Seek Monetary Payment

In 1993, the Third Circuit of the United States Court of Appeals addressed whether the State of New Jersey was trying to compel a debtor to clean up contaminants or merely seeking money from the debtor.[19] In that case, Torwico Electronics conducted a manufacturing business at a leased location.[20] After Torwico moved its business to a new location and filed for bankruptcy, a hidden illegal seepage pit, containing hazardous wastes that were continuously migrating into local waters, was found at the formerly leased location.[21] The New Jersey Department of Environmental Protection and Energy issued an Administrative Order compelling Torwico to submit a written closure plan for the seepage pit.[22] Torwico claimed to have no knowledge of the contamination found at the site, and sought to avoid its cleanup obligation.[23]

The Third Circuit analyzed whether Torwico's obligations constituted a "claim" under the Bankruptcy Code.[24] The court held that the environmental obligations owed by the debtor were not claims, but instead "an exercise of the state's inherent regulatory and police powers," which makes the obligation nondischargeable.[25] Furthermore, the State of New Jersey was seeking cleanup, not a monetary payment.[26] The court reasoned that the debtor had an ongoing responsibility to remediate its environmental waste, and could not "maintain an ongoing nuisance in direct violation of state environmental laws."[27] Therefore, the obligation could not be

[19] *In re Torwico Elecs., Inc*., 8 F.3d 146 (3d Cir. 1993).
[20] *Id.* at 147.
[21] *Id.*
[22] *Id.*
[23] *Id.* at 147-48.
[24] *Id.* at 147.
[25] *Id.* at 151.
[26] *Id.*
[27] *Id.* at 150.

discharged, and "the state can exercise its regulatory powers and force compliance with its laws, even if the debtor must expend money to comply."[28]

The Torwico court distinguished *Kovacs* because, unlike the debtor in *Kovacs*, Torwico could conduct the cleanup because it still had access to the site, and the state had not performed any cleanup on its own or through a receiver.[29] In addition, the court noted that "[u]nlike *Kovacs,* the state in this case neither seeks money nor has a right to payment under the statutory authority asserted or the Order imposed; the state seeks compliance with its laws through a cleanup of a current hazardous situation."[30] Torwico is still good law, as the Third Circuit decision has not been overruled. Consequently, it is likely that cleanup orders would be enforced in the Third Circuit, even for debtors who do not continue to own the contaminated property.

B. Seventh Circuit Holds That Cleanup Orders Are Nondischargeable When Government Has No Alternative Right to Payment

In 2009, the Seventh Circuit of the United States Court of Appeals held that the government could order the cleanup of a contaminated oil refinery by the debtor who no longer owned the cite.[31] In that case, Apex Oil's predecessor, Clark Oil and Refining Corporation, owned an oil refinery in Illinois.[32] Clark Oil filed for bankruptcy, reorganized, and merged with Apex Oil when it emerged from bankruptcy.[33] Fifteen years later, under the Resource Conservation and Recovery Act, the Environmental Protection Agency ("EPA") filed for injunctive relief against Apex Oil for environmental contamination that occurred before Clark Oil filed for bankruptcy.[34] At the Illinois oil refinery, millions of gallons of oil were trapped

[28] *Id.*
[29] *Id.* at 151.
[30] *Id.*
[31] United States v. Apex Oil Co., 579 F.3d 734 (7th Cir. 2009).
[32] United States v. Apex Oil Co., 438 F. Supp. 2d 948, 949 (S.D. Ill. 2006).
[33] *Id.*
[34] *Id.*

underground and were contaminating groundwater and emitting fumes.[35] The contamination continuously created a hazard to health and the environment.[36] Apex Oil argued that cleanup would lead to expensive cleanup costs because it no longer acted as an oil refinery, so it would have to hire a third party to complete the cleanup.[37] The court analyzed "whether the government's claim to an injunction was discharged in bankruptcy."[38]

The court reasoned that the "natural reading" of the definition of a "claim" is when the holder of a right to equitable relief has the right to obtain payment if for some reason the equitable remedy is unobtainable.[39] A cleanup injunction, which is a court order to remediate a contaminated site, "gives rise to a right to payment" only when the government files for such injunctive relief under a statute that authorizes it to collect money from the debtor.[40] In this case, the EPA had no alternative right to payment if cleanup was unobtainable, because the Resource Conservation and Recovery Act "[did] not authorize any form of monetary relief."[41] In addition, the court claimed that if the cleanup injunction could be discharged, the government could not "effectively enforce its laws… [because] virtually all enforcement actions impose some cost."[42] Thus, the court held that the EPA's cause of action was not a claim, and therefore nondischargeable by bankruptcy.[43]

Much like the Third Circuit in *Torwico*, the Seventh Circuit distinguished *Kovacs* mainly because of the appointed receiver in that case. In *Kovacs*, the debtor failed to comply with the

[35] *Apex Oil*, 579 F.3d at 735.
[36] *Id.*
[37] *Id.* at 736.
[38] *Id.* at 735.
[39] *Id* at 736.
[40] *Id* at 737.
[41] *Id.*
[42] *Id.*
[43] *Id.*

cleanup injunction, so the receiver was appointed to take possession of his assets.[44] There, the receiver was seeking money to offset remediation, rather than seeking cleanup by the debtor.[45] Conversely, in *Apex Oil* the government was not seeking money payment, nor did its injunction entitle it to any form of payment.[46]

III. Lower Courts Create New Tests for Nondischargeability

A. The Emerging Three-Factor Test

In 2010, in *Mark IV Industries*, the Bankruptcy Court for the Southern District of New York held that a debtor's duty to clean up the site was not discharged pursuant to the plan confirmation order or subject to the automatic stay.[47] In that case, Mark IV Industries, contaminated groundwater from its work site, and the water continued to remain at levels that exceeded acceptable federal and state water quality standards.[48] The New Mexico Environmental Department ("NMED") sought to enforce a cleanup under the New Mexico Water Quality Act.[49] However, Mark IV had already filed for bankruptcy, leaving the issue of whether Mark IV's obligation to remediate the contaminated groundwater was a "claim" under the Bankruptcy Code.[50]

The court, citing *Kovaks*, *Torwico*, and *Apex Oil,* adopted a three-factor test to determine whether a cleanup injunction is a claim.[51] First, a court should analyze whether the debtor can fulfill its injunctive cleanup obligation, or if it must do so by paying someone else to clean up.[52]

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[44] *Id.*
[45] *Id.*
[46] *Id.*
[47] *In re Mark IV Indus., Inc*., 438 B.R. 460 (Bankr. S.D.N.Y. 2010), *aff'd,* 459 B.R. 173 (S.D.N.Y. 2011).
[48] *Id.* at 469.
[49] *Id.* at 462.
[50] *Id.* at 464.
[51] *Id.* at 467-69.
[52] *Id.* at 469.

Second, the court should determine whether the pollution by the debtor is ongoing.[53] Third, a court should analyze whether the government agency has the option under a statute to perform the cleanup itself, and then seek contribution from the debtor.[54]

Applying the three-factor test to the facts in *Mark IV*, the court held that Mark IV's environmental obligations were nondischargeable.[55] First, the court found that Mark IV could comply with the cleanup order because the government was prepared to give Mark IV access to the site, rather than do the remediation itself.[56] Second, the court found that although Mark IV had not conducted operations at the site for over twenty years, the contaminants nevertheless remained in the groundwater.[57] Finally, the New Mexico Quality Act did not provide for an alternative monetary remedy if Mark IV did not comply with the cleanup order.[58] The court focused on the fact that the state could not perform the cleanup itself and then recover the costs.[59] It was non-determinative that the government could have proceeded under other state statutes that provide an alternative right to recover costs of the remediation.[60]

B. Third Circuit Holds That Government May Not Repackage Monetary Claims as Nondischargeable Cleanup Injunctions

In 2016, the Third Circuit of the United States Court of Appeals held that the New York City Housing Authority ("NYCHA") could not repackage a claim for damages against G-I Holdings as a nondischargeable cleanup injunction in the hopes of circumventing federal bankruptcy laws.[61] In that case, G-I Holdings was the manufacturer of housing products

[53] *Id.*
[54] *Id.*
[55] *Id.*
[56] *Id.*
[57] *Id.*
[58] *Id.*
[59] *Id.*
[60] *Id.*
[61] *In re G-I Holdings Inc.*, No. 15-2164, 2016 WL 3878160, at *1 (3d Cir. July 18, 2016).

containing asbestos.[62] Seeking to address its asbestos related lawsuits, it filed for relief under chapter 11 of the Bankruptcy Code.[63] Meanwhile, NYCHA submitted a half-billion dollar claim against G-I Holdings for property damage to its buildings, claiming it had to take expensive measures to remove asbestos containing material from its buildings.[64] Subsequently, a plan of reorganization was approved, which disposed of all covered claims against G-I Holdings.[65]

Three years later, NYCHA sought an injunction to compel G-I Holdings to remove any asbestos containing material contained in NYCHA buildings.[66] NYCHA argued that it held inherent regulatory power as a governmental agency to compel G-I Holdings to "remediate the ongoing environmental harm resulting from the asbestos containing material it produced."[67] The Third Circuit rejected NYCHA's argument because the asbestos contained in the apartments only became a health hazard when it was removed or disturbed during renovations.[68] According to the Third Circuit, NYCHA was not confronted with ongoing pollution that had to be remediated, but instead was faced with additional costs to remove the asbestos containing material.[69] The Third Circuit described these costs as "property damage," and held that NYCHA was merely attempting to "foot the bill for remediation of a past harm."[70] Such claims were discharged in G-I Holding's bankruptcy, and NYCHA could not repackage its forfeited claim for damages.[71]

Conclusion

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[62] *Id.*
[63] *Id.*
[64] *Id.*
[65] *Id.*
[66] *Id.*
[67] *Id.* at *2.
[68] *Id.*
[69] *Id.*
[70] *Id.*
[71] *Id.*

In general, the automatic stay does not preclude the government from enforcing its police or regulatory powers, nor does it bar the enforcement of any non-monetary judgement obtained by the government.[72] Although a debtor must expend money to comply with cleanup orders for contaminated sites, the mere fact that cleanups cost money "does not convert an equitable obligation into a dischargeable claim."[73] Consequently, a debtor may be required to cleanup despite the terms of the automatic stay and the pendency of a bankruptcy case. However, the courts seem to agree that when the government is trying to offset remediation costs or disguise a monetary claim as injunctive relief, the debtor will not be obligated to pay and the government's "claim" may be discharged.

[72] 11 U.S.C. §362(b)(4).
[73] *Apex Oil*, 579 F.3d at 738 ("[The] discharge must indeed be limited to cases in which the claim gives rise to a right to payment because the equitable decree cannot be executed, rather than merely imposing a cost on the defendant, as virtually all equitable decrees do."); *Torwico*, 8 F.3d at 150 n. 4 ("Were we to adopt the bankruptcy court's position that any order requiring the debtor to expend money creates a dischargeable claim, it is unlikely that the state could effectively enforce its laws: virtually all enforcement actions impose some costs on the violator.")