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A PRACTICAL GUIDE TO CONFLICTS BETWEEN STATE ENVIRONMENTAL ACTIONS AND BANKRUPTCY IN THE FOURTH CIRCUIT

MARC BERNSTEIN

Environmental law, like all other fields of law, does not operate in a vacuum. Everything from common law contract principles to constitutional issues can arise in the context of an environmental claim. The attorney in the environmental area needs to keep abreast of the influential principles from other areas of practice in order to counsel clients fully and properly.

A fine example of this commingling of specialties concerns the federal Bankruptcy Code and state environmental laws. Clashes between these two areas arise frequently. For instance, a party seeking protection under the Bankruptcy Code may possess environmentally tainted property. The debtor will wish to rid the estate of this unprofitable property, which he may do under the Code's abandonment provision. Yet, a state agency may oppose this decision by the debtor. The environmental agency, saddled with the task of protecting both human health and the health and beauty of the environment, will pursue the debtor. The agency will seek to pierce the protective barrier of the Bankruptcy Code and hold the debtor to his statutory obligation under state law to remediate the site. This simple scenario illustrates the inherent conflict between the principles underlying bankruptcy law and the goals of environmental legislation.

State environmental laws and the Bankruptcy Code make little provision for the operation of one another. Courts must resolve the conflict between the two. To the dismay of attorneys practicing in the

Fourth Circuit, the United States Court of Appeals for the Fourth Circuit has said little on these issues. In order to analyze disputes of this nature, lawyers must look elsewhere for guidance.

This Article will synthesize controlling case law with influential decisions from other circuits in order to present a coherent, comprehensive overview of the resolution of issues such as the hypothetical situation outlined above. The discussion will center on enforcement actions of state environmental agencies and how these actions are affected when a party holding title to tainted property declares bankruptcy. The Article dissects the problem by analyzing the agency's case against the various entities that the agency may pursue, i.e., the debtor, the trustee and the estate. A brief, generally applicable discussion follows regarding the state agencies' imposition of penalties.

This Article will illustrate that the law of the Fourth Circuit is by no means clear on these issues. The limited treatment that these matters have received has arguably created more questions than it has resolved. Therefore, attorneys must analyze carefully each future case which juxtaposes the Bankruptcy Code with state environmental laws in order to understand fully the current state of law in the Fourth Circuit.

5. The only decision by this court directly regarding the tensions between state environmental statutes and the Bankruptcy Code is In re Smith-Douglass, Inc., 856 F.2d 12 (4th Cir. 1988).

6. This Article will not discuss the liability of creditors of the debtor. For an introduction to the unsettled issue of lender liability, see generally United States v. Fleet Factors Corp., 901 F.2d 1550 (11th Cir. 1990) (suggesting that a secured creditor may be liable if it participated in management "to a degree indicating capacity to influence the corporation's treatment of hazardous waste"); National Oil and Hazardous Substances Pollution Contingency Plan: Lender Liability Under CERCLA, 57 Fed. Reg. 18, 344 (1992) (issuing EPA final rule regarding lender liability under CERCLA); James P. O'Brien & Jeremy A. Gibson, Final EPA Rule Allows Traditional Lender Activities Without Superfund Liabilities, 23 Current Developments, Env't Rep. (BNA) No. 2 at 326 (May 15, 1992) (discussing developments in Congress and EPA in the wake of expansive liability rule of Fleet Factors and outlining new EPA rule designed to restore lender's traditional role).
I. ACTIONS INVOLVING THE DEBTOR

The debtor cannot escape liability under compliance agreements into which the debtor entered prior to the filing of the bankruptcy petition. Furthermore, where a pre-petition agreement exists, the automatic stay will not provide temporary relief for the debtor. The automatic stay only prevents the state from enforcing monetary judgments. The stay permits the state to secure injunctive relief when such relief is in furtherance of a state's regulatory or police powers. Environmental regulation clearly falls under this exception.

The debtor may argue that injunctive relief which requires expenditure of money from the estate essentially enforces a money judgment. This argument will invariably fail. The Third Circuit was the first to reject this contention. In Penn Terra, Ltd. v. Pennsylvania Department of Environmental Resources, the Court of Appeals for the Third Circuit allowed an injunction to issue requiring the debtor to abide by a pre-petition agreement to bring the debtor's mining operation into compliance with state law. The court rested on two propositions to

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7. This discussion covers only debtors who no longer possess the bankruptcy estate. Courts treat debtors in possession in much the same way that they treat trustees. See 28 U.S.C. § 1107(a) (1992) (Subject to certain limitations, "a debtor in possession shall have all the rights . . . and powers, and shall perform all the functions and duties . . . of a [Chapter Eleven] trustee."); see also Wolf v. Weinstein, 372 U.S. 633, 649-50 (1963); RICHARD I. AARON, BANKRUPTCY LAW FUNDAMENTALS § 10.01[2], at 10-5 (1992) ("The debtor in possession . . . wear[s] the hat of the trustee . . ."). Therefore, debtors in possession will be examined along with Chapter Eleven Trustees in a later discussion. See infra notes 68 through 77 and accompanying text.

8. E.g., Penn Terra, Ltd. v. Pennsylvania Dep't of Env'tl Resources, 733 F.2d 267 (3d Cir. 1984). But see Ohio v. Kovacs, 469 U.S. 274 (1985) (duties under pre-petition clean-up order become dischargeable if state has appointed a receiver to carry out such duties) (discussed more fully infra pp. 6-7 and 16).

9. The automatic stay is an essential element of the bankruptcy process. The stay temporarily relieves the debtor from collection efforts in order to afford the debtor time to devise a repayment or reorganization plan. See generally H. Rept. No. 95-595 to accompany H.R. 8200, 95th Cong., 1st Sess. (1977), at 340-44 (explaining the basic provisions of the automatic stay) and 11 U.S.C. § 362 (1992).

10. E.g., Penn Terra, Ltd., 733 F.2d at 267.


12. Id.

13. Penn Terra, 733 F.2d at 272.


15. Id. at 279.
distinguish the injunction from a money judgment. First, the injunction
was prospective and therefore did not represent a presently liquidated
sum.\(^\text{16}\) Second, the injunction focused on future compliance and not past
damages.\(^\text{17}\)

The United States Supreme Court’s decision in \textit{Ohio v. Kovacs},\(^\text{18}\) while not directly on point, lends support to the \textit{Penn Terra} logic. In
\textit{Kovacs}, the petitioner, State of Ohio, had secured an injunction in state
court to compel respondent to clean up his corporation’s hazardous waste
disposal site.\(^\text{19}\) When respondent failed to comply with the court order,
Ohio appointed a receiver to administer the clean-up activities.\(^\text{20}\) Subsequent to the appointment of the receiver, respondent filed for
protection under Chapter Seven.\(^\text{21}\)

The United States Supreme Court held that the respondent’s
obligation under the injunction was a debt under the Bankruptcy Code and
so was dischargeable.\(^\text{22}\) The Court noted that the state could have elected
not to seek the appointment of a receiver and simply have prosecuted
respondent under the applicable environmental laws or in a civil or
criminal contempt proceeding.\(^\text{23}\) Through the appointment of a receiver,
the state effectively reduced a potentially enforceable injunction to a mere
pecuniary disbursement.\(^\text{24}\) In distinguishing \textit{Penn Terra}, the Court
implicitly recognized that situations exist in which the state’s enforcement
action will be excepted from the automatic stay.\(^\text{25}\) "The automatic stay
provision does not apply to suits to enforce the regulatory statutes of the
State, but enforcement of such a judgment by seeking money from the
bankrupt . . . is another matter."\(^\text{26}\) In this way, the Court tacitly approved
of \textit{Penn Terra}’s determination that direct enforcement of a pre-petition
agreement is acceptable under the automatic stay.

\textit{Penn Terra} and \textit{Kovacs} make clear the notion that the state may
only compel the debtor to act directly to effect the clean-up. Once the

\begin{footnotes}
\footnotetext[16]{Id. at 275-76.}
\footnotetext[17]{Id. at 276-77.}
\footnotetext[18]{469 U.S. 274 (1985).}
\footnotetext[19]{Id. at 276.}
\footnotetext[20]{Id.}
\footnotetext[21]{Id.}
\footnotetext[22]{Id. at 278-83.}
\footnotetext[23]{Id. at 282.}
\footnotetext[24]{Id. at 282-83.}
\footnotetext[25]{Id. at 283-84 n.11.}
\footnotetext[26]{Id.}
\end{footnotes}
debtor’s action involves the up-front payment of money to the state, the automatic stay likely provides protection from the state agency’s enforcement mechanisms.

II. ACTIONS INVOLVING THE TRUSTEE

A. The Midlantic Rule in the Fourth Circuit

The rules pertaining to the liabilities and obligations of bankruptcy trustees with regard to environmental remediation stem mainly from a Supreme Court holding concerning abandonment of environmentally tainted property. In Midlantic National Bank v. New Jersey Department of Environmental Protection, the Court limited the trustee’s power to abandon burdensome property to situations in which the property in question is not "in contravention of a state statute or regulation that is reasonably designed to protect the public health or safety from identified hazards." However, the now famous footnote nine provides:

This exception to the abandonment power vested in the trustee by § 554 is a narrow one. It does not encompass a speculative or indeterminate future violation of such laws that may stem from abandonment. The abandonment power

27. The Court noted in Kovacs that the appointment of a receiver may have been a wise course of action for the state to take in order to effectuate a clean-up. Id. at 283. Unfortunately, the state's strategy backfired precisely because the respondent declared bankruptcy. The result in Kovacs thus requires states that are considering dispossessing a responsible party of its assets to carefully scrutinize the party's finances before commencing any action.

In the event that a receiver has been appointed, the claim which the state has in the bankruptcy proceeding for the cost of the clean-up becomes dischargeable. Id. at 278-83. In cases where bankruptcy is imminent or likely, the state's best approach is to stand on its injunction. Conversely, the responsible party can seek the appointment of a receiver and then have the action stayed and the debt discharged.

Justice O'Connor noted in her concurring opinion that the state can set the relative priority of its claim as against other creditors by statute. Id. at 286 (O'Connor, J., concurring). Thus, the state may elect to raise its claims to the level of a statutory lien or secured claim in order to protect its interest. Id.

30. Id. at 507. In general, the Bankruptcy Code permits the trustee to "abandon any property of the estate that is burdensome to the estate or that is of inconsequential value and benefit to the estate." 11 U.S.C. § 554(a) (1992).
is not to be fettered by laws or regulations not reasonably calculated to protect the public health or safety from imminent and identifiable harm.\textsuperscript{31}

Two basic camps have developed in the interpretation of footnote nine.\textsuperscript{32} The narrow constructionists seize on the fact that the footnote is an exception to the generally permissive abandonment rule. Such courts require merely that the site at issue not be an imminent and identifiable threat to human health.\textsuperscript{33} The broad view gives more weight to the text of the \textit{Midlantic} opinion than to the footnote. This camp demands that the site be remediated to comply with all applicable state environmental laws before the court will permit abandonment by the trustee.\textsuperscript{34}

The Fourth Circuit takes the narrow view in its interpretation of the \textit{Midlantic} exception.\textsuperscript{35} Only in cases where an imminent and identifiable harm threatens the public health or safety will the court restrict the abandonment power.\textsuperscript{36}

\begin{itemize}
\item \textsuperscript{31} \textit{Midlantic}, 474 U.S. at 507 n.9.
\item \textsuperscript{32} \textit{In re Smith-Douglass}, Inc., 856 F.2d 12, 15 (4th Cir. 1988). The difficulty involved in counselling clients becomes painfully apparent when one considers that not even the courts themselves are sure which jurisdictions ascribe to which interpretation of \textit{Midlantic}. Compare \textit{In re Microfab}, Inc., 105 B.R. 161, 168 n.24 (Bankr. D. Mass. 1989), (holding that Fourth Circuit takes the position that \textit{Midlantic} requires full compliance with environmental laws), with \textit{In re Shore Co., Inc.}, 134 B.R. 572, 576-77 (Bankr. E.D. Tex. 1991) (holding that Fourth circuit will permit abandonment under \textit{Midlantic} absent demonstration of imminent harm).
\item \textsuperscript{33} See, e.g., \textit{In re Franklin Signal Corp.}, 65 B.R. 268, 271 (Bankr. D. Minn. 1986).
\item \textsuperscript{34} E.g., \textit{In re Peerless Plating Co.}, 70 B.R. 943, 946-47 (Bankr. W.D. Mich. 1987). This stringent demand is usually tempered by certain qualifications. For example, the court in \textit{Peerless Plating} required that (1) the law in question was not so onerous as to interfere with the bankruptcy adjudication itself; (2) the law in question was reasonably designed to protect the public health; and (3) the violation caused by the abandonment was not speculative. \textit{Id.} at 947. \textit{See also In re Microfab, Inc.}, 105 B.R. 161, 169 (Bankr. D. Mass. 1989) (requiring further that the trustee have the financial resources to ensure the success of the remediation).
\item \textsuperscript{35} \textit{Smith-Douglass}, 856 F.2d at 16.
\item \textsuperscript{36} \textit{Id.} at 17. Although \textit{Smith-Douglass} concerned a Chapter Eleven filing, the holding clearly will apply to Chapter Seven trustees as well. First, the debtor in \textit{Smith-Douglass} had admitted that reorganization was impossible and had begun to liquidate the estate, making the concerns of the court nearly identical to those of a Chapter Seven case. \textit{Id.} at 13-14. Second, a recent ruling in a Fourth Circuit bankruptcy court on abandonment by Chapter Seven trustees cited \textit{Smith-Douglass} with approval. \textit{See In re Doyle Lumber, Inc.}, 137 B.R. 197, 201-2 (Bankr. W.D. Va. 1992).
\end{itemize}
Two bankruptcy court decisions within the Fourth Circuit provide a factual framework of the abandonment power under *Midlantic*. In *In re Doyle Lumber, Inc.*, the debtor had ceased operations at its saw mill and wood treating facility. The trustee then failed to implement the proper closure procedures, including removal of hazardous wastes and soil sampling. A bankruptcy court in the Western District of Virginia authorized abandonment because the violation did not occur through mishandling or misuse of toxic substances and therefore created no threat of public harm.

Conversely, the debtor in *In re FCX, Inc.* did not receive unfettered license to abandon the estate’s tainted property. The court determined that the public health need not be actually impacted adversely before the court may curtail abandonment. The "imminent and identifiable harm" standard demands only that a "present and real possibility of public exposure" to the hazard on the debtor’s property exists. In *FCX* the court deemed five tons of pesticides buried in an uncontrolled condition to be such an imminent and identifiable danger. The court found that the environmental hazard could manifest itself as a present danger at any time and was therefore an imminent threat. The fact that the danger might not have been realized until five years later did

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38. *Id.* at 199-200.
39. *Id.*
40. *Id.* at 202-03.
41. 96 B.R. 49 (Bankr. E.D.N.C. 1989). The basis of the *FCX* decision was a federal statute, the Comprehensive Environmental Response, Compensation, and Liability Act, 42 U.S.C. §§ 9601-9675 (1992). The court noted that in an abandonment proceeding, the critical determination, whether there is an imminent and identifiable harm, in no way relates to the source of the law being violated. *FCX*, 96 B.R. at 54-55. Courts, therefore, should draw no distinction between violations of state and federal environmental laws when assessing the permissibility of an abandonment. *Id.* See also *In re Peerless Plating Co.*, 70 B.R. 943, 947 (Bankr. W.D. Mich. 1987) ("The EPA's administrative decision as to [whether] imminent harm [exists] is relevant but far from controlling."). *But see In re Smith-Douglass, Inc.*, 856 F.2d 12 (4th Cir. 1988).
42. *In re FCX, Inc.*, 96 B.R. at 54. The court required that the debtor set aside $250,000, the estimated cost of eradicating the imminent threat to the public, before the court would permit abandonment. *Id.*
43. *Id.* at 55.
44. *Id.*
45. *Id.* at 54.
46. *Id.* at 55.
not diminish the present threat.\textsuperscript{47}

\textit{Doyle Lumber} and \textit{FCX} demonstrate that the courts will look beyond the debtor's statutory violations to the substance of the environmental menace present on the property. The imminent and identifiable harm standard requires the court to determine whether an environmental hazard actually exists and the likelihood that the hazard will actually impact the public health at some future time.

Courts recognize that any limitation on the power to abandon necessarily translates into a limitation on the condition in which the trustee manages the property.\textsuperscript{48} The aforementioned abandonment standard therefore sets the minimum level at which any trustee must maintain environmentally impacted property while the property remains in the estate.

\subsection*{B. Chapter Seven Trustees}

A state environmental agency can pursue the Chapter Seven trustee under one of two theories. First, the agency may seek compliance with the \textit{Midlantic} imminent and identifiable harm standard. Second, the agency may elect to argue that the trustee clean up the site pursuant to the mandate of 28 U.S.C. § 959(b).\textsuperscript{49}

Chapter Seven trustees must comply with the \textit{Midlantic} standard while the property remains in the estate.\textsuperscript{50} If the property presents an imminent and identifiable danger to the public, a state agency can request action on the part of the trustee to address the condition. In response, the Chapter Seven trustee may elect to eradicate the hazard himself.\textsuperscript{51}

\begin{itemize}
\item \textsuperscript{47} Id.
\item \textsuperscript{48} \textit{E.g.}, Lancastle v. State of Tenn. (\textit{In re Wall Tube & Metal Prod. Co.}), 831 F.2d 118, 122 (6th Cir. 1987).
\item \textsuperscript{49} See, \textit{e.g.}, \textit{In re Microfab, Inc.}, 105 B.R. 161, 166 (Bankr. D. Mass. 1989). For the complete text of the relevant portions of section 959(b), see infra p. 13.
\item \textsuperscript{50} See \textit{supra} note 48 and accompanying text.
\item \textsuperscript{51} The Fourth Circuit has not ruled directly on the issue of whether the trustee may consider the expenses she incurs in the abatement of an imminent and identifiable hazard administrative costs payable by the estate. Most lower courts allow administrative status to clean-up costs if such costs are (1) reasonable and necessary to preserve the value of the estate and (2) required by \textit{Midlantic}. \textit{E.g.}, \textit{Microfab, Inc.}, 105 B.R. 161. Bankruptcy courts in the Fourth Circuit have classified as administrative those costs incurred by Chapter Eleven trustees, \textit{In re Laurinburg Oil Co., Inc.}, 49 B.R. 652, 654 (Bankr. M.D.N.C. 1984) (reasonable and necessary costs to abate violations are administrative), and by the state, \textit{FCX}, 96 B.R. 49 at 55 (costs to abate imminent and identifiable hazard
In the alternative, the trustee may simply refuse to undertake abatement actions. This option may leave the interested agency with little recourse because the law of the Fourth Circuit probably will bar the agency from obtaining an injunction against the trustee. The court in In re Doyle Lumber drew a distinction between having the estate pay for the clean-up and requiring the trustee herself to undertake such activities.\textsuperscript{52} The court stated in dictum: "Even if it were shown that the facility in its present condition was an immediate threat to the public safety, which is not the case, this court has reservations regarding the ability of a Chapter Seven trustee to perform identification and remediation procedures ... .\textsuperscript{53} The reasoning of the court reflects the generally held notion that the duties of the Chapter Seven trustee\textsuperscript{54} are wholly inconsistent with any

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\textsuperscript{52} 137 B.R. 197 (Bankr. W.D. Va. 1992). The state may also attempt to hold the trustee personally liable. This action requires that the trustee finance a clean-up with his own money, not that of the estate. Unfortunately, case law in this area is sparse. In Wisconsin v. Better Brite Plating, Inc., 466 N.W.2d 239 (Wis. Ct. App. 1991) \textit{modified}, 483 N.W.2d 574 (Wis. 1992), the Wisconsin Court of Appeals refused to hold a trustee personally liable for environmental clean-up absent a showing that the trustee personally furthered the environmental impact on the estate's property. \textit{Id.} at 247. The court found first that, for equitable reasons, exposing the trustee to potentially severe penalties and clean-up costs would be inappropriate if the trustee had not acted purposefully. \textit{Id.} at 246-47. Second, the court determined that the threat of personal liability for mere negligence would drain the pool of trustees willing to serve in bankruptcies involving toxic waste sites. \textit{Id.} at 247. These two considerations led the court to establish that trustees will not be held personally liable for their own negligence. \textit{Id.} However, when the trustee's behavior rises to the level of knowing and intentional disregard for state environmental laws, the court will hold the trustee liable for clean-up as well as any applicable penalties. \textit{Id.}

The Wisconsin Supreme Court eventually dismissed the actions against the trustees on jurisdictional grounds. Wisconsin v. Better Brite Plating, Inc., 483 N.W.2d 574 (Wis. 1992).


\textsuperscript{53} \textit{Doyle Lumber}, 137 B.R. at 203. \textit{But see Microfab, Inc.}, 105 B.R. at 169-70 (court may order Chapter Seven trustee to take abatement actions if estate possesses sufficient assets to assure success of actions).

\textsuperscript{54} The Bankruptcy Code requires the Chapter Seven trustee merely to "collect and reduce to money the property of the estate . . . and close such estate as expeditiously as is compatible with the best interests of the parties in interest . . . ." 11 \textit{U.S.C.} § 704(1) (1992).
management functions. The task of cleaning up a site is not within the mandate of the Chapter Seven trustee, and the language of Doyle Lumber strongly implies that the Fourth Circuit will not require the trustee to undertake this task.

If the state's attempts under Midlantic do indeed fail, the agency may seek compliance under 28 U.S.C. § 959(b). Section 959(b) provides:

[A] trustee, receiver or manager appointed in any cause pending in any court of the United States, including a debtor in possession, shall manage and operate the property in his possession as such trustee, receiver or manager according to the requirements of the valid laws of the State in which the property is situated, in the same manner that the owner or possessor thereof would be bound to do if in possession thereof.

The Fourth Circuit itself has not yet ruled on the applicability of section 959(b) to Chapter Seven trustees for environmental clean-up actions. Other federal courts have not adopted a uniform reading of the statute. The prevailing view maintains that the mere possession of the property by the trustee is sufficient to force the trustee to comply with applicable state law. This holds true regardless of whether the proceeding is a liquidation or a reorganization. The minority view, as espoused by the court in In re Microfab, Inc., requires the trustee to actually manage or operate the property before section 959(b) will impose any obligations on the trustee pursuant

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55. Compare 11 U.S.C. § 721 (1992) (permitting Chapter Seven trustee to operate business of debtor only if such operation is "consistent with the orderly liquidation of the estate"), with 11 U.S.C. § 1108 (1992) (permitting Chapter Eleven trustee to operate the debtor's business provided merely that a party in interest requests such action and that the court does not object).

56. The court's absolution of the trustee for clean-up duties in liquidation leads to a somewhat odd result. Smith-Douglass requires the property to be cleansed of imminent and identifiable harms prior to abandonment. Yet, Doyle Lumber suggests that a court cannot compel the trustee to perform this function. Inevitably, the state may be forced to appoint a receiver to remediate the site in order to allow the trustee to abandon it.


58. In re Wall Tube & Metal Products Co., 831 F.2d 118, 122 (6th Cir. 1987).


to state law. Although the reasoning employed in *Doyle Lumber* may appear to suggest that this minority view is the wiser course in Chapter Seven cases, the weight of authority clearly indicates otherwise. One must also consider that the court that decided *In re Microfab* expressly adopted the reasoning of *In re Scott Housing Systems, Inc.* *Scott Housing* represents an extraordinarily unpersuasive precedent in this respect, because the *Scott Housing* opinion tacitly approved of the majority view on this issue. Thus, the dicta in *Doyle Lumber* will most likely not survive a judicial challenge.

The court in *In re Wall Tube & Metal Products Co.* noted that the section 959(b) mandate does not require strict compliance with all state statutes. The *Midlantic* opinion affords the reviewing court the power to assess the law's effect on the bankruptcy proceedings and relieve the estate of compliance in certain instances.

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61. *See id.* at 168. A bankruptcy court in Virginia nearly reached the related and threshold question of whether the state law even applies in Chapter Seven cases. *See In re Doyle Lumber, Inc.*, 137 B.R. 197, 203 (Bankr. W.D. Va. 1992). Many environmental regulations define a responsible party as an "owner or operator." *See, e.g.* VA. CODE. ANN. § 62.1-44.2 et seq. (Michie 1992); Va. Regs. Reg. 680-13-02 §§ 6.1-6.8 (1992). This language parallels "manage or operate" as used in section 959. If a court is not willing to deem the trustee an owner or operator within the state statute, the court may not even have to reach the section 959 determination.

In *Doyle Lumber*, a bankruptcy court intimated that the Chapter Seven trustee may not qualify as an owner or operator under the state’s hazardous waste management regulations absent an order authorizing the trustee to operate the business. This suggests that the court order may bring the trustee under the operation of both section 959 and the state law simultaneously and that without the order, neither statute applies. However, the court later stated that the duties of the Chapter Seven trustee are "inconsistent with arranging and supervising environmental remediation." *Id.* at 203. This language implies that the court may be very reluctant to authorize the Chapter Seven trustee to manage or operate property where such activity may embroil the trustee in remediation functions.


64. *Scott Housing*, 91 B.R. at 196. The court in *Scott Housing* held § 959(b) inapplicable because the case concerned zoning issues. The court noted that the Supreme Court had excepted environmental issues in *Midlantic* and therefore any decision regarding such issues was inapplicable in the context of zoning. *Id.*

65. 831 F.2d 118 (6th Cir. 1987).

66. *Id.* at 122-23 n.13.

67. *Id.*
C. Chapter Eleven Trustees

The duty of the Chapter Eleven trustee is to maintain the activities of the estate while effectuating a financial reorganization. Section 959(b) requires that a trustee acting in such a capacity "shall manage and operate the property . . . according to the requirements of the valid laws of the State in which the property is situated." Unlike the Chapter Seven trustee, the Chapter Eleven trustee does actually manage and operate the property. Thus, there is no question that section 959(b) potentially subjects Chapter Eleven trustees to a full range of state enforcement actions.

Federal courts outside the Fourth Circuit have held that agencies may obtain injunctions to compel the Chapter Eleven trustee to bring the property into full compliance with all applicable environmental laws. This rule applies regardless of whether the debtor entered into a pre-petition agreement with the agency.

The Fourth Circuit has not yet ruled on the duties of a Chapter Eleven trustee who chooses not to abandon property. In In re Smith-Douglass, Inc., an abandonment case, the Fourth Circuit implied that it would adopt a flexible approach to remediation on properties of

68. This section applies generally to debtors in possession as well as Chapter Eleven trustees. See supra note 7. The discussion will refer to both categories as "Chapter Eleven trustee" or "trustee" where applicable.
71. E.g., In re Williston Oil Corp., 54 B.R. 10, 11-12 (Bankr. D. N.J. 1984). The Fourth Circuit has not yet ruled on the duties of Chapter Eleven trustees in regard to property retained by the estate. If the Fourth Circuit follows the decisions mentioned herein, the court will permit the Chapter Eleven trustee to retain property in the estate only if the estate finances full remediation. In the alternative, the estate may abandon the property and merely pay to abate any imminent and immediate threats. For severely impacted properties, the trustee may benefit the estate more by simply abandoning the property and not attempting to rehabilitate it. This result conflicts with the general purpose of a Chapter Eleven reorganization. See generally Ellen E. Seward, Resolving Conflicts Between Bankruptcy Law and the State Police Power, 1987 WISC. L. REV. 403, 426-33 (1987) (failure of the courts to establish a unified policy to further the goals of the Bankruptcy Code). The Fourth Circuit has noted, however, that in a Chapter Eleven abandonment the court will require stricter compliance with environmental laws if the estate possesses unencumbered assets. In re Smith-Douglass, Inc., 856 F.2d 12, 17 (4th Cir. 1988).
73. 856 F.2d 12 (4th Cir. 1988).
Chapter Eleven debtors. The court noted that "where the estate has unencumbered assets, the bankruptcy court should require stricter compliance with state environmental law before abandonment is permitted" by a Chapter Eleven trustee. Under Smith-Douglass, a state agency should be able to obtain an injunction to compel remediation of any imminent and immediate hazards. The court may also order full compliance with all applicable environmental laws provided that the estate can finance such activities. As always, the automatic stay will not hinder the state agency in its attempts to compel action on the part of the Chapter Eleven trustee.

III. ACTIONS INVOLVING THE ESTATE

If the trustee refuses or is unable to carry out the remediation, a state agency may undertake clean-up operations as its own statutory powers permit. The Supreme Court's opinion in Ohio v. Kovacs dictates that when the state incurs costs for effecting an environmental clean-up on a bankrupt's property, the state converts any clean-up obligation of the trustee or debtor into a claim against the estate. The claim is akin to an unsecured debt and is dischargeable. The Court's holding in Kovacs will not impede the state's efforts to obtain a judgment affixing a value to that claim. A court will stay any attempt to enforce this money judgment against the estate.

The Supreme Court's subsequent decision in Midlantic National Bank v. New Jersey Department of Environmental Protection has created an exception to the rather harsh Kovacs rule. In In re Wall Tube

74. Id. at 17.
75. Id.
76. Id.
77. In re Laurinburg Oil Co., Inc., 49 B.R. at 654 (citing Penn Terra, Ltd. v. Pennsylvania Dep't of Envt'l Resources, 733 F.2d 267 (3rd Cir. 1984)).
78. See, e.g., VA. CODE ANN. § 62.1-44.34:9 (10) (Michie 1992) (authorizing Virginia State Water Control Board to undertake corrective action with respect to the release of regulated substance from an underground storage tank or oil from a facility and to seek recovery for costs incurred from the owner or operator, including an individual or trust).
80. Id. at 283.
82. Id.
& Metal Products Co., the Sixth Circuit considered the abandonment rule of Midlantic and held that any response costs incurred by the state to bring the estate's property into compliance with federal environmental laws would constitute an administrative cost. Similarly, the Bankruptcy Court for the District of Massachusetts has noted that the state's expenses may properly be administrative as long as (1) the state's clean-up activities address maladies described in Midlantic and (2) the costs are actual and necessary to the preservation of the estate under 11 U.S.C. § 503(b)(1)(A).

To date, the Fourth Circuit has given this issue only cursory treatment. In In re Smith-Douglass, Inc., the court merely stated that "[c]leaning up environmental violations is properly considered an administrative expense within the meaning of 11 U.S.C. § 507(a)(1)." The court did not make clear whether it would adopt the first prong of the Microfab analysis, i.e., that administrative expense status is limited to clean-up costs incurred for imminent and identifiable hazards. In In re FCX, Inc., the Bankruptcy Court for the Eastern District of North Carolina held that the state could only recover as administrative expenses those costs incurred while ridding the property of maladies falling under the Midlantic rule. Any other expenses could be satisfied through a lien on the debtor's property. Furthermore, the Smith-Douglass opinion does not require full compliance with all applicable state laws as the Sixth Circuit opinion in Wall Tube did. This reasoning suggests that the court probably will consider any expenses the state incurs beyond what is

84. 831 F.2d 118 (6th Cir. 1987).
85. Id. at 123-24.
86. See supra notes 29-34 and accompanying text.
88. 856 F.2d 12 (4th Cir. 1988).
89. Id. at 17.
90. Id. at 16.
92. Id. at 55 ("[o]nly those costs reasonably required to remove the immediate threat will be given cost of administration status.").
93. Id. But see In re Laurinburg Oil Co., Inc., 49 B.R. 652 (Bankr. M.D.N.C. 1984). Both Laurinburg and FCX concerned debtors in possession. In Laurinburg the court permitted the debtor to recover as an administrative cost all expenses the debtor incurs during efforts to bring the site into full compliance with applicable environmental laws. However, Laurinburg was decided prior to Midlantic, that is, prior to the notion that imminent and identifiable hazards should receive special consideration. Therefore, the holding in FCX should control generally.
required by *Midlantic* administrative costs. Further disbursements will fall under the *Kovacs* rule and be converted to unsecured claims.

### IV. PENALTIES

State environmental statutes normally provide for the imposition of administrative penalties on those who violate applicable provisions.\(^{94}\) The automatic stay will permit the agency to obtain a judgment for such fines but the stay will not allow enforcement of the judgment.\(^{95}\) The Bankruptcy Code will not allow the discharge of debts incurred through the imposition of fines or penalties. Section 523(a) provides:

A discharge under section 727, 1141, 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual debtor from any debt . . . to the extent such debt is for a fine, penalty, or forfeiture payable to and for the benefit of a governmental unit, and is not compensation for actual pecuniary loss . . . .\(^{96}\)

Naturally, the agency’s arguments that any fines or penalties are collectible on an administrative basis will have no merit.\(^{97}\) These rules apply equally to Chapter Eleven and Chapter Seven debtors.\(^{98}\)

### V. SUMMARY

Under the Fourth Circuit’s limited case law, the Bankruptcy Code provides little hindrance to a state environmental agency in a Chapter Eleven case. The Code, however, may handicap severely any

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97. *See* 11 U.S.C. § 503(b)(1) (1992) (containing list of administrative expenses which does not include environmental penalties or harms).
enforcement efforts under a Chapter Seven liquidation.

In a Chapter Eleven case, the presence of a pre-petition compliance agreement is of little significance. The state most likely can obtain an injunction to compel full compliance with all applicable environmental laws, but the extent to which the property must comply with these laws may depend on the financial health of the estate.

A state may compel a Chapter Seven debtor to perform the actions prescribed by a pre-petition agreement, notwithstanding the automatic stay. Once a trustee controls the estate and if the debtor has not previously entered into any agreements with the state, the state probably will have to undertake clean-up actions itself and then seek recovery from the estate. In this case, the state may recover as administrative costs those expenditures used to abate any imminent and identifiable hazards as defined by the Fourth Circuit. Any other expenses become unsecured claims and may be discharged later in the bankruptcy proceedings.

In either case, the law of the Fourth Circuit in this field remains substantially unsettled. In order to protect their interests, the regulated community and state agencies alike should be wary of the areas which require clarification.