

Circuits Still Split Over Enviro Fines In Bankruptcy

Law360, New York (March 06, 2014, 4:26 PM ET) -- In a typical bankruptcy case, creditors jockey for position to be paid from the assets of the bankruptcy estate. Some debts receive priority status under the Bankruptcy Code, while others fall into a pool of general creditors to be paid last. One category of debt in particular, the administrative expense, receives priority treatment ahead of the pool of general creditors. Although administrative expenses are typically fees or wages involved in managing the estate, courts have expanded the category to include other claims.

A recent decision by the First Circuit highlights the split in authority on whether penalties for environmental violations receive priority status as administrative expenses. Understanding the split in authority is critically important for debtors, creditors and creditors' committees.

In *Munce's Superior Petroleum Products Inc. v. New Hampshire Department of Environmental Services* (In re *Munce's Superior Petroleum Products Inc.*), debtor *Munce's Superior Petroleum Products* ("MSPP") had a long history of violating environmental regulations and refusing to pay the resulting environmental fines. MSPP stored fuel in above-ground oil tanks at three of its facilities in New Hampshire.

New Hampshire environmental laws require the facilities to have secondary containment systems to protect the environment in the event of leaks or tank failures. MSPP did not have a secondary containment system. On at least four occasions between 2006 and 2008, the New Hampshire Department of Environmental Services ("NHDES") notified MSPP that it was violating the secondary containment requirements and other environmental laws. MSPP did not take any action to correct the violations. In 2010 NHDES instituted a state court action seeking an injunction and civil penalties against MSPP. The state court entered an injunction requiring MSPP to comply or cease using the tanks.

When MSPP did neither and NHDES moved to hold it in contempt.

While the contempt motion was pending, MSPP filed for Chapter 11. The bankruptcy petition stayed the contempt motion. NHDES moved for relief from the stay. The bankruptcy court held that the automatic stay did not apply to NHDES' contempt action because it was an action "for the purpose of protecting public health and safety, and the environment, and to effectuate public policy."

Once the stay was lifted, the state court granted NHDES' contempt motion. The court gave MSPP 10 days to remove the tanks from service. After that, it fined MSPP \$1,000 a day for every day of noncompliance. MSPP again did not take action. NHDES moved for an assessment of contempt penalties. The court ordered MSPP to pay \$192,000 in civil penalties.

The First Circuit Prioritizes Environmental Fines Over General Creditors

NHDES moved to have the fines treated as an administrative priority claim under Section 503(b) of the Bankruptcy Code. Under 503(b), the “actual, necessary costs and expenses of preserving the estate” are entitled to priority as administrative expenses and are paid in full ahead of general creditors’ claims.

Courts have debated the concepts of “actual,” “necessary” and “preserving the estate.” The most common examples of administrative expenses are lawyers’ or accountants’ fees related to the bankruptcy or the management of the bankruptcy estate. However, in *Reading Co. v. Brown* (1968), the U.S. Supreme Court included post-petition tort damages as “actual and necessary,” regardless of whether they were beneficial to the estate.

The court in *Reading* reasoned that the decision to include tort damages protected tort victims consistent with the Bankruptcy Code’s objective of “fairness to all persons having claims against an insolvent.” MSPP argued that unlike a compensatory fine, which can be given priority, a punitive civil fine cannot. The court disagreed, citing an earlier law finding that it would be “fundamentally” unfair to allow a polluter to avoid a civil penalty simply because it had filed for bankruptcy.

Thus, at least in the First Circuit, civil penalties for environmental violations are prioritized ahead of general creditors. The *Munce* decision can have significant implications for creditors. For example, in the *Munce* case, the NHDES would receive its full \$192,000 penalty before any general creditor would be paid anything. This decision thus creates the potential that environmental fines could greatly impair or even eliminate the payments to general creditors.

The *Munce* court’s decision is consistent with many other circuits in concluding that noncompensatory environmental fines should receive administrative priority. See, for example, *In re Chateaugay Corp.*, 112 B.R. 513, 525 (S.D.N.Y. 1990) (“penalties for post-petition violations would also be entitled to be treated as administrative expenses”); *U.S. Dept of Interior v. Elliott*, 761 F.2d 168 (4th Cir. 1985) (civil penalties assessed while debtor is operating as debtor in possession had administrative priority); *Leavell v. Karnes*, 143 B.R. 212, 219 (S.D. Ill. 1990) (penalties associated with environmental violations by bankruptcy trustee are administrative expenses); *In re Bill’s Coal Co.*, 124 B.R. 827 (D. Kan. 1991) (civil penalties for environmental violations are administrative as long as they arise from post-petition misconduct); *In re N.P. Mining Co.*, 963 F.2d 1449 (11th Cir. 1992) (“when a trustee or debtor in possession operates a bankruptcy estate, compliance with state law should be considered an administrative expense”).

The *Munce* decision, however, is at odds with other courts that have addressed the treatment of prepetition violations that result in post-petition penalties. For example, in *In re NP Mining Co.*, the Eleventh Circuit found civil penalties for post-petition violations were administrative expenses, but specifically excluded as an administrative expense any expense assessed post-petition for failure to abate a prepetition violation.

Thus, penalties for violations that occur prior to the bankruptcy petition are not administrative expenses — even when the fine occurs post-petition. Similarly in *In re Lazar* (C.D. Cal. 1997) the court relied on Ninth Circuit precedent that any expenses incurred post-petition as a result of prepetition conduct are not administrative expenses. Under *In re Lazar*, there must be active post-petition wrongdoing; a mere failure to remediate is insufficient.

At least one circuit disagrees on the treatment of post-petition environmental violations. The Third

Circuit considered a case similar to *Munce* and concluded that a criminal fine imposed on a Chapter 7 debtor for post-petition environmental violations was not an administrative expense entitled to priority. *Penn Dept of Env Resources v. Tri-State Clinical Laboratories Inc.* (3d Cir. 1999).

In *Tri-State*, the court focused on whether a criminal penalty was a cost or expense that was actual and necessary to preserve the estate. As in *Munce*, the *Tri-State* court considered the difference between compensatory damages paid to tort victims and penalties paid to the government. The *Tri-State* court also noted the inherent unfairness to other creditors, reasoning that [awarding administrative priority would] allow that claim to be paid to the exclusion of, and out of the resources otherwise available for, claims of other creditors. The practical result would be that fines for committing crimes would be paid by innocent third persons — the creditors — rather than *Tri-State*, the criminal.

The debtor in *Tri-State* argued that the costs of complying with the law and paying fines were necessary costs of doing business. The court refused to accept an interpretation “based on the assumption that legitimate businesses engage in a ‘cost-benefit’ analysis to determine if they will comply with criminal laws.”

Under current Third Circuit law, a debtor’s noncompensatory fines are not administrative expenses entitled to priority. As a result, government agencies must wait in line with other general contractors to be paid.

The decision whether to grant administrative priority to environmental fines implicates conflicting public policy interests.

On the one hand, requiring companies in bankruptcy to comply with environmental laws and prioritizing environmental fines when they do not unquestionably advances the public interest in preserving the environment.

On the other hand, prioritizing environmental fines in bankruptcy can often mean that the other creditors bear the financial burden of the debtor’s noncompliance, because it limits the funds available to repay those creditors.

As illustrated above, courts weighing these interests have reached differing outcomes. These competing interests have resulted in different interpretations of “actual” or “necessary” administrative expenses in a bankruptcy, which interpretations can have very real consequences on the distribution of the debtor’s assets.

Despite the differing outcomes, courts in each jurisdiction considered common factors. When faced with a bankruptcy petition that may be affected by an environmental fine, it is important to consider:

- Was the conduct giving rise to the violation pre or post-petition?
- Was the penalty assessed pre or post-petition?
- Was the penalty monetary or an order to clean up or otherwise comply with environmental laws?
- If the penalty was monetary, was it compensatory or punitive in nature?

Although the list above is not exhaustive, it identifies the issues most likely to influence the priority given to environmental fines and penalties in bankruptcy.

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