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Environmental Liabilities and Discharge Under a § 363 Sale



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Section 363 of the Bankruptcy Code, which allows a trustee or debtor in possession to sell its assets outside of the ordinary course of business “free and clear” of interests, only provides limited protection to the buyer with respect to certain environmental liabilities. For example, a purchaser might be held liable for any contamination based merely on its status as a current or former owner of the property, notwithstanding the language of any sale order, and notwithstanding the fact that it was uninvolved in the underlying act that resulted in liability.² Therefore, it is essential that buyers protect themselves by closely analyzing potential environmental obligations.

Section 363(b)(1) provides, in relevant part, that “[t]he trustee, after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate.” Section 363(f) provides that the trustee may sell property under subsection (b) “free and clear of any interest,” but the term “interest” is not defined in the Code. Environmental liabilities are generally dischargeable in bankruptcy.³ Courts also have concluded that “successor liability” claims are included within the scope of § 363(f),⁴ which generally applies to environmental liabilities.

Controversy stemming from bankruptcy’s effect on environmental liabilities has predominantly involved the Comprehensive Environmental Response, Compensation and Liability Act of 1980 (CERCLA),⁵ which imposes strict liability on cer-

tain categories of parties for cleanup of contaminated property. Under CERCLA, the current owner or operator of a site might be liable — even if they did not participate in the management of the site or contribute to the release of the hazardous substances, which stands at odds with § 363(f)’s “free and clear” language.⁶

It is axiomatic that § 363 asset-purchasers are generally responsible for complying with environmental obligations associated with the asset upon acquisition. If a property requires remediation at or after that time, the § 363 purchaser might be responsible for the remediation costs.⁷

CERCLA liability is status-based, meaning that strict liability is imposed on any party meeting the definition of a “covered person” under the statute. Both individuals and corporations are subject to liability under CERCLA, and all responsible parties are jointly and severally liable for indivisible cleanup costs.⁸ CERCLA defines a responsible “person” as “an individual, firm, corporation, association, partnership, consortium, joint venture, commercial entity” or government entity.⁹

Notably, CERCLA does not expressly list corporate successors as potentially responsible parties or as parties responsible for response costs under the subcategory of “person.” Section 107(a)(1)-(4) of CERCLA identifies four classes of covered persons: (1) the present owner and operator of a “facility”; (2) any “person” who owned or operated a facility at the time of the disposal of a hazardous substance at the facility; (3) any person who arranges for the disposal of a hazardous substance at the facility of

1 The authors acknowledge the contributions of Daniel Trager, a law clerk with the firm, to this article.

2 See, e.g., *New York v. Shore Realty Corp.*, 759 F.2d 1032, 1044 (2d Cir. 1985) (construing CERCLA § 9607(a)(1) to impose liability on current owner without regard to causation).

3 See generally *Ohio v. Kovacs*, 469 U.S. 274 (1985); *In re Nat'l Gypsum Co.*, 139 B.R. 397 (Bankr. N.D. Tex. 1992).

4 *Morgan Olson LLC v. Frederico (In re Grumman Olson Indus.)*, 467 B.R. 694, 703 (S.D.N.Y. 2012).

5 42 U.S.C. § 9601, *et seq.*

6 *United States v. 175 Inwood Assocs. LLP*, 330 F. Supp. 2d 213, 214 (E.D.N.Y. 2004).

7 *In re GMC*, 407 B.R. 463, 508 (S.D.N.Y. 2009).

8 42 U.S.C. § 9607(a)(4); *United States v. Monsanto Co.*, 858 F.2d 160, 163 (4th Cir. 1988).

9 42 U.S.C. § 9601(21).

another; and (4) any person who transports a hazardous substance to a disposal facility. Parties that fall into these categories are commonly referred to as “potentially responsible parties,” yet the courts of appeals that have addressed the issue are unanimous in recognizing successor liability under CERCLA.¹⁰

There is significant lack of uniformity regarding how successor liability specifically applies in the context of CERCLA liability. The primary issues concern whether: (1) state law or a uniform federal common law should govern issues of successor liability under CERCLA; (2) an asset-purchaser is entitled to assert the traditional exceptions to the rule that an asset-purchaser does not assume the liabilities of its seller unless the transaction constitutes a *de facto* merger or the “mere continuation” of the seller’s business; (3) an expanded “continuity of enterprise theory” of successor liability should be applied to an asset-purchaser who “substantially continues” the seller’s business, absent an identity of shareholders; (4) an asset-purchaser who had no knowledge of the potential CERCLA liabilities or the seller’s liability-creating activities should be the “successor” to such liabilities; and (5) successor liability can be imposed on more than one corporation.

A purchaser of assets in bankruptcy cannot be certain about its protection from future unknown environmental liability. Given the variance in the resolution of this issue across circuits and the lack of definitive guidance from the U.S. Supreme Court, there is uncertainty regarding what law should apply in cases involving corporate successor liability under CERCLA.

Section 363(f) can only discharge an “interest in such property.” Therefore, it includes only *in rem* interests, otherwise “in such property” would be superfluous.¹¹ However, state law successor liability is generally imposed due to the conduct and acts of the purchaser, and not from the assets being sold under a § 363 sale order. It is not the transferred property that gives rise to the successor-liability claim, but rather it is the purchaser’s actions subsequent to the purchase of that property that impose liability.¹² Therefore, because CERCLA liability is based on the purchaser’s status, § 363(f) would not discharge such liability.

Additional challenges confront purchasers with respect to potential future environmental liabilities. Bankruptcy courts have the power to approve sales of assets free and clear of any interest that could be brought against the bankruptcy estate during bankruptcy, either through § 363(f) or the bankruptcy court’s equitable powers.¹³ However, a sale free and clear does not preclude future claims that do not arise until after the conclusion of the bank-

ruptcy proceeding.¹⁴ A sale free and clear of claims cannot divest a claim when the claimant does not have a sustainable cause of action at the time of discharge. Furthermore, preclusion of such future claims would reward debtors and asset-purchasers who concealed claims known to them but unknown to potential claimants, thus undermining a “cornerstone” of bankruptcy law.¹⁵

In *Ninth Ave. Remedial Group v. Allis-Chalmers Corp.*, Ninth Avenue Remedial Group conducted clean-up activities of the Ninth Avenue Dump Superfund Site in Gary, Ind., under the Environmental Protection Agency’s approval. The defendant alleged that it was not liable because it was a successor-in-interest and had purchased the predecessor’s assets in a bankruptcy sale that discharged liability under § 363(f).

The court held that a successor may be found liable for claims under CERCLA if the successor knew or had notice of the potential CERCLA liability, and if there was substantial continuity in the operation of the business before and after the sale.¹⁶ It further found that “the fact that an asset sale took place in the context of bankruptcy is not determinative of the question of liability as to successors.”¹⁷

The court declined to rule on whether § 363 includes the “free and clear” protections arising under successor-liability CERCLA claims, as the bankruptcy court had the equitable power to discharge the claim against the asset-purchaser independently of § 363(f). It held that while bankruptcy courts might have the power to sell assets free and clear of any interest that could be brought against the bankruptcy estate during bankruptcy, either through § 363 or the powers of the bankruptcy court under other Code sections, a sale free and clear does not preclude future claims that did not arise until after the bankruptcy proceedings concluded.¹⁸

Courts have held that a § 363 sale will not completely discharge potential future environmental liabilities that could not have been brought during the bankruptcy. Accordingly, the buyer should not rely on “free and clear” language in the purchase agreement to ignore potential liability arising from environmental contaminants. As § 363 will not insulate a purchaser from liability that was not a viable claim during the bankruptcy, a buyer must identify and quantify all potential environmental issues in order to manage any risk of future liability. The purchaser also must conduct due diligence to assess any potential risk of environmental contamination and should consider the following mitigating measures.

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10 *United States v. Gen. Battery Corp.*, 423 F.3d 294, 298 n.3 (3d Cir. 2005).

11 *Ninth Ave. Remedial Grp. v. Allis-Chalmers Corp.*, 195 B.R. 716, 730 (N.D. Ind. 1996).

12 *DirectBuy Inc. v. Buy Direct LLC*, No. 2:15-CV-344-JPK, 2022 U.S. Dist. LEXIS 40550, at *32 (N.D. Ind. March 8, 2022).

13 *In re AutoStyle Plastics Inc.*, 227 B.R. 797, 800 (Bankr. W.D. Mich. 1998).

14 *Id.* (citing *Ninth Ave. Remedial Grp. v. Allis-Chalmers Corp.*, 195 B.R. 716, 732 (N.D. Ind. 1996)).

15 *In re GM LLC Ignition Switch Litig.*, No. 14-MD-2543 (JMF), 2017 U.S. Dist. LEXIS 123740, at *349 (S.D.N.Y. Aug. 3, 2017).

16 *Ninth Ave. Remedial Grp. v. Allis-Chalmers Corp.*, 195 B.R. 716, 726.

17 *Id.* at 729.

18 *Id.* at 732.

The *Bona Fide* Prospective-Purchaser Defense

The *bona fide* prospective-purchaser defense might shield a prospective purchaser from many aspects of CERCLA liability stemming from preexisting contamination. To avoid liability, a purchaser of contaminated property in a § 363 asset sale must, at a minimum, qualify as a “*bona fide* prospective purchaser” under CERCLA.¹⁹ In order to qualify as such, the buyer must conduct “all appropriate inquiries” into the property’s environmental condition before the purchase.²⁰ “All appropriate inquiries” is a term of art that includes obtaining a phase I environmental site assessment for the property, which must meet a number of specific requirements, including interviews of persons knowledgeable regarding the property’s history (past owners, present owner, key site manager, present tenants, neighbors, etc.); searches for recorded environmental clean-up liens; reviews of federal, tribal, state and local government records; visual inspections of the facility and adjoining properties; and the declaration by an environmental professional pursuant to § 312.21.²¹

Exercise of “Appropriate Care”

After the purchase, the buyer must exercise “appropriate care” with respect to the property’s environmental condition.²² “Appropriate care” means taking “reasonable steps” to stop any continuing releases, prevent any threatened future releases, and prevent or limit human, environmental or natural resource exposure to any previously released hazardous substance. Therefore, purchasers in § 363 sales should closely analyze their potential exposure to environmental liability as a potential successor to the debtor, and as a property owner.

Conclusion

Although certain environmental liabilities might survive a § 363 sale, by exercising proper diligence, a buyer can significantly reduce its risk of unknown liabilities that surface after closing. Equally important for asset-purchasers is to understand the potential costs of these protective measures, and to appropriately factor them into the purchase price and financial analyses. **abi**

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¹⁹ See 40 C.F.R. 312.
²⁰ 42 U.S.C. § 9601(35)(B).
²¹ 40 C.F.R. 312.21.
²² 42 U.S.C. § 9601(40)(B)(iv).