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BANKRUPTCY FOR THE ENVIRONMENTAL LAWYER: A SHORT PRIMER, PART II

By

Karen Cordry*

[Editor's note: Part I of this article may be found in the April 2004 issue of the *National Environmental Enforcement Journal* at <http://www.naag.org>.]

B. *Chapter 13*

Only individuals (including sole proprietorships) are eligible to file a Chapter 13 petition. Unlike Chapter 7 cases, a Chapter 13 bankruptcy is income-based, not asset-based. Indeed, the general focus in Chapter 13 is allowing debtors to use the Chapter 13 plan process to get back on their feet and get caught up on their arrearages on the loans on their house or car. While a typical Chapter 7 debtor has a very low income and limited assets, Chapter 13 debtors usually have substantially greater income and a car and a home they are trying to save. A typical Chapter 13 debtor has lost his job and been out of work for several months, fallen behind on house payments, and is now facing foreclosure. In the meantime, though, he has secured a new job and is making enough to allow him to resume making regular payments and get caught up on the back payments if he can discharge some or all of his unsecured debts. The debtor remains in possession of his assets and earnings and commits to making payments from his disposable income (after making provision for reasonable living expenses) to a Chapter 13 trustee who, in turn, distributes the payments to the various creditors.

This is, in effect, a government-sponsored form of credit counseling and, when done well, can be beneficial to debtors and creditors alike by providing substantially greater returns than would a Chapter 7 proceeding. As a further encouragement to debtors to take this route and subject themselves to the financial discipline of Chapter 13 for several years, they are given what is usually referred to as the "super discharge." Unlike the expansive (and expanding) list of exceptions in Chapter 7, under Section 1328, the only debts that are excepted in Chapter 13 are those for domestic support obligations, student loans, and fines and restitution imposed in criminal cases. Thus, debts for taxes, civil fines and penalties, fraud, defalcation by a fiduciary, and willful and malicious injury are all subject to being discharged in Chapter 13.

In order to avoid having the super discharge make Chapter 13 a haven for major miscreants, the Code puts dollar limits on the debt owed by a Chapter 13 filer. Section 109(3) provides that the debtor must have less than $307,675 in liquidated, noncontingent unsecured debt and $922,975 in secured debt. The general idea is that this will limit the size of the debts that will be protected by the super discharge. Unfortunately, the requirement that only unsecured *liquidated* debts are counted towards the limit opens up a very big loophole. A debtor that files while a case is still in litigation can argue that he or she is eligible, no matter what the size of the judgment being sought. If a matter is still unliquidated at the time of the filing, the debtor can agree, shortly after the bankruptcy filing, to a judgment vastly in excess of the limit without losing the original eligibility. For instance, in *In re Solomon,* 67 F.3d 1128 (4th Cir. 1995), the court held that the debtor-doctor's stipulation, after the filing of his Chapter 13 petition, to owing $4 million to victims of his sexual misconduct did not make him an ineligible Chapter 13 debtor (although it also noted that it might be possible to contest the filing as not having been made in good faith).

The problem is mitigated somewhat, though, by the fact that the courts generally find that a debt is "liquidated" if it can be readily determined, on the basis of objective criteria; they do not require that it has been

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reduced to a money judgment. *See In re Mazzeo*, 131 F.3d 295, 304–05 (2nd Cir. 1997). In that case, for instance, the tax withholding amounts owed could be readily determined, based on the statute and the wages paid. On the other hand, a claim for "pain and suffering" would be a classic example of an amount that would not be liquidated prior to an actual decision being made on the damages. Thus, any state that has a claim that could be excepted from discharge in Chapter 7 (or 11, as will be seen below), but that would be discharged in Chapter 13, should always first check the eligibility standards to see if the debtor is properly in that chapter. In addition, the "good faith" argument alluded to in *Solomon* is a possible alternative line of attack, but it is far more difficult to make, and many courts will not allow a case to be denied on that basis, so long as the debtor has literally met the statutory qualifications.

Because of the low eligibility limits, and the limitation to individual debtors, most environmental cases of any consequence will likely not be filed in Chapter 13. However, if a debtor does file under this Chapter, the Code and the Rules must be read carefully. While there are many similarities to a Chapter 11 case, Chapter 13 cases move much more rapidly and with far less forgiveness for any party that misses the deadlines. In addition, it is critical to read the local rules (and perhaps consult with the Chapter 13 trustee). Despite the requirement that Congress enact uniform laws of bankruptcy, different bankruptcy courts have come up with very different ways of actually structuring and administering their Chapter 13 plan processes. This ranges from the time limits for creditors to take actions, to how soon the plan must be filed, to when objections to claims must be filed, to whether a form plan will be used in the district. Each particular court's version of Chapter 13 has much to recommend itself — but the version used in a different state may bear very little resemblance to that in your locale, so it is vital to learn how the forum court chooses to function.

Unsecured creditors do not vote in Chapter 13 cases; their only option is to object to the plan if it does not meet the statutory criteria. The plan must pay secured claims in full (with interest) and priority claims in full (without interest) and must ensure that other unsecured creditors receive as much as they would in a Chapter 7 case. Since virtually all Chapter 7 cases are "no asset" cases in which unsecured creditors receive nothing, this latter criteria provides almost no limitation on plan terms. The other requirement is that, if any creditor objects to the plan, the debtor must devote all of his disposable income to plan payments for three years. Plans can run from three to five years, but creditors cannot force a payment term for more than three years (except to the practical extent that the court often looks at the term of the plan in assessing whether the debtor is acting in good faith). See Sections 1322 and 1325 for the plan and confirmation requirements.

Because the statutory requirements are so limited, it is possible for a Chapter 13 plan to provide nothing for unsecured creditors, while still providing the debtor with the super discharge. On the other hand, in some districts, most cases are filed in Chapter 13 and most plans propose high percentage payments to creditors. Interestingly, while many Chapter 13 cases never result in a confirmed plan and many confirmed plans do not result in full payment, the failure rate does not necessarily correlate with the amounts to be paid under the plans. Some of the districts where the plans propose the highest payments also experience the highest success rates. Whether this is due to some local "bankruptcy culture" or whether it is a function of the model used to operate Chapter 13 in those districts is less than clear, but it is just another example of the disparities in the process. In any case, if you are in a district that confirms low percentage plans, the high failure rate of Chapter 13 cases may be your protection. The super discharge only applies if the debtor confirms and completes a plan. If the debtor cannot complete its plan, it can either receive a standard Chapter 7-type discharge in Chapter 13 (see Section 1328(b)) or it can simply convert its case to Chapter 7 and receive that discharge. In either scenario, the creditors will be entitled to keep whatever payments they received before there was a default under the plan and will also be able to resume collection efforts against the debtor for their debts that are excepted

from the discharge.

C. *Chapter 11*

1. General Issues

The eligibility standards are the same in Chapter 11 as in Chapter 7 (except that railroads can file under Chapter 11); the property of the estate and exemptions are also the same. The primary goal in Chapter 11 is to reorganize the company, but liquidations can also be carried out in Chapter 11, and this is, in fact, becoming increasingly more common. Such liquidations are often carried out in the form of "pre-packs," *i.e.,* pre-packaged bankruptcies in which the debtor has managed to convince most, but not all, of the requisite creditors to accept a write-down of their claims. In the face of a few holdouts, a case is filed with a fully structured plan already agreed to by the majority of the constituencies. The bankruptcy process is then used to force the agreement into place over the objections of a minority of the creditors. These cases usually move very fast, thus making it difficult for creditors that have not been part of the pre-filing negotiations to participate in a meaningful fashion.

In any event, whether the case is proceeding as a reorganization or a liquidation, the primary difference from a Chapter 7 case is that, except in cases of misconduct or gross incompetence (beyond the general managerial incompetence that presumably led to the bankruptcy filing in the first place, in most cases), the debtor's existing management remains in control and the bankrupt entity is referred to as the "debtor-in-possession" or "DIP." Operating as a DIP is of great importance to management because it usually believes that it can do a better and cheaper job of bringing the company out of bankruptcy than could a newly installed trustee and because staying in control lets the people in management keep their jobs. Indeed, in many cases, debtors successfully persuade the court that they must institute a "Key Employee Retention Program" (KERP) to pay bonuses to upper management (and sometimes, but rarely, lower levels of employees) to convince them to stay and work for the bankrupt entity.[1]

Unlike a Chapter 7 proceeding, where a company is usually operated (if at all) for only a short time to carry out an orderly shutdown and liquidate inventory and where the trustee must receive specific permission to keep operating the business, Chapter 11 companies are automatically authorized, by Section 1107, to continue to operate in the ordinary course of business. Section 341 meetings are held in these cases as well, and, again, it is important to be aware of any relevant dates that are calculated from the date of that meeting.

The discharge provisions in Chapter 11 have a number of key differences from Chapter 7 cases. To begin with, Section 1141(c) provides that the discharge occurs upon the confirmation of a plan of reorganization and covers all debts incurred to the date of confirmation, not just to the date of the petition. However, under Section 1141(d)(3), a liquidation plan for a non-individual debtor does not provide any discharge of debts, just as it would not in Chapter 7. In short, for businesses, discharge is an all or nothing proposition — a full discharge for a reorganized debtor and no discharge for a liquidated debtor. Thus, while the management may be able to exert greater control over a liquidation in Chapter 11, the debtor cannot obtain a broader discharge than in Chapter 7 merely by changing chapters. For individuals, on the other hand, Section 1141(d)(2) imposes the same discharge exceptions as in Chapter 7, but the "objections to discharge" process does not apply in Chapter 11. Instead, Section 1112 provides that much the same litany of misconduct issues that constitute discharge objections will be the bases for dismissing the case or converting it to Chapter 7. Once in Chapter 7, a discharge objection can then be raised, if warranted. The time limits on repeat discharges, however, do not apply in Chapter 11, so the fact that a case is a repeat filing after a Chapter 11 case would not be a basis for converting or dismissing the case. (This is presumably because the debtor would likely end up paying considerably more in a Chapter 11 case than in a Chapter 7 so there is less need to bar a repeat discharge.)

Perhaps the most important practice tip to take away

is that the concept of discharge exceptions is wholly irrelevant for corporate debtors — one's reputation for bankruptcy expertise will suffer markedly if one is drawn into an analysis of whether Enron's fraudulent conduct, for instance, will result in its debts being excepted from discharge. Whether a corporate debtor will be able to discharge debts will be decided on a global basis, not on a debt-by-debt basis.

2. Priorities

Unlike Chapter 7, there are no explicit priorities set for Chapter 11 payments, although Section 1129(a)(7)(A)(ii) does require that, for a plan to be confirmed, each creditor must receive at least as much as it would in a Chapter 7 liquidation (the "best interest of creditors" test). Moreover, if a class of claims does not approve the plan, Section 1129(b)(2)(B)(ii) provides that each member of the class may contest the plan if any claimant or equity holder that is "junior to the claims of such class" receives any property on account of that junior interest (the "absolute priority" rule). In addition, Section 1129(a)(9)(A) provides that administrative claims must normally be paid in full on the confirmation date for the plan to be approved, unless each claimant individually agrees to accept less than full payment or payment at a different time. Priority claims can be paid over time with the approval of the class but, again, must, at a minimum, be paid in full, unless the individual claimant agrees otherwise (Section 1129(a)(9)(B)). (There is yet another rule in Section 1129(a)(9)(C) for payment of tax claims but that is not relevant to environmental claims.)

A debtor that turns out to be unable to pay all administrative claims (much less all lower priority claims) is termed "administratively insolvent" and, as soon as it appears that this may be the case, the Chapter 11 case is usually converted to a Chapter 7. (This is a primary reason why many cases initially filed in Chapter 11 do not confirm a plan.) In the case of a conversion to Chapter 7, Section 726(b) provides that the fees incurred by Chapter 7 professionals (*i.e.,* those working for the Chapter 7 trustee) and other Chapter 7 expenses of administration receive priority over the administrative expenses incurred in the Chapter 11 case, proving once again that, among equivalent expenses, some are more equal than others.

Because of the two confirmation requirements — the "best interests of creditors" test and the "absolute priority rule" — plans generally are set up largely in accordance with the same series of priorities as in Chapter 7. It is relatively easy to apply the best interests of creditors test because the Chapter 7 priorities are clear, and it can readily be determined if the amount of money being proposed in Chapter 11 is as much as it would be in Chapter 7. The absolute priority rule is less easy to follow because the Code does not define what it means to say that a claim is "junior" to other claims, particularly since, as noted above, Chapter 11 does not, in fact, include any specific priority scheme. Nor does the Code have any definition of what is a "junior" claim — thus, this could either mean junior only to the extent that the Code defines one claim as being subordinate to another or it could use the term as it is applied in nonbankruptcy law or in contracts that might explicitly subordinate one debt to another. To be sure then, in a simple case, with secured debt, priority claims, and general unsecured debt, there is little doubt of the order of these three sets of claims or that all of them come before the equity interests of the share holders.

The primary context, however, in which this issue arises for governmental units is with respect to penalty claims, which debtors almost inevitably seek to subordinate in their Chapter 11 plan. The attempt to do so is generally linked to these confirmation requirements, particularly the absolute priority rule. And, up until 1996, such motions were usually granted with little question. Courts started with the Chapter 7 subordination provisions, added in a dollop of legislative history about the value of giving compensatory claims preference over penalties, uncritically noted the need to ensure that creditors received liquidation value, and readily concluded that penalties could be subordinated in Chapter 11 as readily as in Chapter 7. In doing so, those courts were, of course, using the notion of a Code-dictated sense of what is a "junior" claim since, in nonbankruptcy law, penalty or punitive damages claims are equally as collectible as compensatory

claims.

This trend reached its apogee in *In re First Truck Lines, Inc.*, 8 F.3d. 210 (6th Cir. 1995), in which the court held that, despite the express statement in Section 503(b)(1) that postpetition tax penalties were entitled to administrative status, the court could use the general provisions in Section 510 to "equitably subordinate" such penalty claims because it would be unfair to treat them equally with compensatory claims. The Supreme Court firmly and unanimously rejected that view, on appeal at *United States v. Noland*, 517 U.S. 535 (1996), noting that subordination on the grounds of equity normally was thought to require some showing of inequitable conduct by the creditor. At a minimum, then, application of Section 510(c) had to be based on something unique to a particular claim. A court could not use that section to engage in a categorical reordering of the priorities that Congress had already set. And, since the lower court had relied on nothing more than the fact that the claims were for a penalty to justify the subordination, its reasoning would have applied to *any* tax penalty claim. That result, which would have automatically subordinated all tax penalty claims, would then be in direct contradiction of the congressional decision to *elevate* such claims. That result, the Court held, was not a proper use of Section 510(c). *Noland,* 517 U.S. at 541.

Perhaps, even more significantly, the Court quickly applied the *Noland* analysis to a lower court's approval of a plan that subordinated a prepetition tax penalty claim (where the argument about congressional intent to elevate such penalties relevant to postpetition taxes did not apply). In *United States. v. Reorganized CF & I Fabricators of Utah, Inc.*, 518 U.S. 213, 229 (1996), the Court held that equitable subordination under Section 510(c) could not be used as a basis to subordinate that penalty claim. Since equitable subordination was the only basis on which the lower court had ruled, the Court did not decide the question of whether either of the Chapter 11 confirmation tests could force subordination of penalties.

The courts have not yet come to a consensus on what *Noland* and *CF & I* mean with respect to arguments that the confirmation requirements can be used to force subordination. One of those tests — the best interest test — can be fairly readily dispensed with. At first glance, the argument may seem unassailable — if penalty claims are paid behind compensatory claims in Chapter 7, but given parity in Chapter 11, how could the other creditors receive as much as in the Chapter 7 case? The argument falls apart quickly, though, as soon as one returns to the first principle of bankruptcy law; namely, that a reorganization almost certainly provides more value — a bigger pie — than does a liquidation. Debtors are required to provide a liquidation analysis in their Chapter 11 plan and to prove that the proposed reorganization is a good thing; such analyses *always* show that the reorganization will provide more value than a liquidation — often by a substantial multiple of liquidation projections. Thus, the liquidation comparison will doom penalties only when they are so huge that they would outweigh the effect of the much larger pot of assets that all creditors will be drawing from. The test for confirmation is an absolute recovery, not a relative amount. As an example: unsecured creditors might receive $40,000 of their $100,000 worth of claims in a liquidation where there was only $160,000 to distribute and a penalty claim might receive nothing. On the other hand, in a reorganization, where the total pot might increase to $480,000, those same creditors might receive their entire $100,000, even if the entire $50,000 penalty is paid. Because the pot is bigger, more claims can be paid from it, while still increasing the amount paid to the prior claimants. While their $40,000 might have been twenty-five percent of the smaller pot and the $100,000 is only sixteen percent of the larger pot, that is irrelevant because people are interested in dollars, not percentage shares.

This leaves only the claim of whether penalty claims are somehow inherently "junior" to other claims. This would seem to be the same sort of categorical treatment that *Noland* and *CF & I* reject, particularly in that neither the Code nor nonbankruptcy law explicitly require treatment of such claims as being lesser in stature than other unsecured claims. The bottom line is that government counsel must carefully read plan terms to see if they propose to subordinate penalty

claims automatically. At a minimum, the government should object to having such an issue determined as part of the plan, since this is a legal issue, not one on which other creditors should be voting. Instead, the government should argue that the matter needs to be decided separately in a proceeding between the debtor and the government and that the plan should confine itself to stating the debtor's position that it intends to try to subordinate the claims. This was the course that was taken in both the Worldcom and Enron bankruptcies. Proceeding in this way allows the court to look at the issue in a more neutral atmosphere instead of in a plan confirmation proceeding where there is strong pressure to confirm the plan. In addition, once the debtor becomes aware of the actual size of the penalties vis-à-vis the other claims (and if other creditor constituencies vote in favor of the plan without any guarantee that the penalty claims will be subordinated), it may well choose to drop the threat to litigate unless the penalties are quite large.

3. Automatic Stay Issues

As most practitioners know, Section 362(a) of the Code automatically imposes a stay on litigation against the debtor or its estate once the case is filed. This has several purposes — to give the debtor some breathing room to sort out its situation, to make sure that one creditor does not gain advantages over another, and to allow the bankruptcy court to centralize and control litigation in one forum. Notwithstanding those purposes, Congress has also created a substantial number of exceptions to the stay (and, like the discharge exceptions, their numbers continue to grow as well). The primary ones for governmental purposes are Section 362(b)(1) — the criminal exception; Section 362(b)(4) — the civil police and regulatory exception; and Section 362(b)(3) — a more obscure exception that, with the right state laws in place, can allow the state to litigate and impose a superpriority lien. Describing the scope of the latter is beyond the introductory scope of this article. *In re 229 Main Street Ltd. Partnership*, 262 F.3d 1 (1st Cir. 2001), describes the scope of the exception and its incredible power to protect the state's ability to impose a lien for its clean-up costs *even during the course of the case* in certain circumstances. The criminal exception is extremely broad (and likely encompasses even attempts to collect upon monetary judgments — see *In re Simonini*, 69 Fed. Appx. 169 (4th Cir. 2003), and cases cited therein)), but it is rare to seek criminal sanctions, so the primary exception that governmental prosecutors will use is the civil police and regulatory exception in Section 362(b)(4).

That exception covers litigation, enforcement of judgments (other than money judgments), actions to control or affect property of the estate, and "acts" to collect on a claim. The first two points have been excepted from the stay since the Code was enacted in 1978; the latter two were added in 1998 to clarify whether police and regulatory actions that might have an impact on estate property — such as the denial or revocation of a license or permit, for instance — might still be covered. The "acts" provision of the stay was added to the Code to cover non-judicial sorts of pressure and harassment that could coerce someone to pay a claim. It was added to the exception to deal with the possibility that someone would claim that even activities that were covered by the other parts of the exception would still be barred because they were part of some long chain of events that could eventually result in collecting on a claim.

While initially there were some disputes, it is now relatively well settled (at least everywhere but in the Sixth Circuit) that actions to obtain injunctive orders directing the debtor to do remediation work or to liquidate the amount of the government's cost recovery claims are excepted from the stay under this exception. Indeed (again other than in the Sixth Circuit), virtually all courts agree that injunctive clean-up orders are not monetary claims, do not fall within the scope of the automatic stay to begin with, and are generally not subject to discharge. The primary cases dealing with these issues are actually relatively old — after a flurry of decisions in the early to mid-1990s, it appears that the parties have been doing more negotiating and less litigating. Every environmental counsel dealing with bankruptcy issues needs to be familiar with the following cases, but due to space considerations, they will only be listed for your reading plea-

sure, without further detailed discussion: *Board of Governors of Fedral Reserve System v. MCorp Financial, Inc.*, 502 U.S. 32 (1991) (stay exception does not turn on court's assessment of validity of administrative actions); *Penn Terra Ltd. v. Department of Environmental Resources, Com. of Pa*., 733 F.2d 267 (3rd Cir. 1984) (injunction that requires expenditure of funds is not a "money judgment" and stay exception still applies); *City of New York v. Exxon Corp.*, 932 F.2d 1020 (2nd Cir. 1991) (cost recovery liquidation actions excepted from stay (but not collection of amounts determined)); *U.S. v. LTV Corp. (In re Chateaugay Corp.)*, 944 F.2d 997 (2nd Cir. 1991) (actions to remediate existing contamination not claims and not barred by the stay); *Matter of CMC Heartland Partners*, 966 F.2d 1143 (7th Cir. 1992) (where liability for cleanup is based on ownership or operations, bankruptcy discharge does not eliminate ongoing liability on debtor that continues to own contaminated land); *In re Torwico Electronics, Inc.*, 8 F.3d 146 (3rd Cir. 1993) (order to do cleanup is not a claim and not barred by the stay even if it requires expenditure of funds — disagreeing with *U.S. v. Whizco, Inc.*, 841 F.2d 147 (6th Cir. 1988)); *Safety-Kleen, Inc. (Pinewood) v. Wyche*, 274 F.3d 846 (4th Cir. 2001) (state enforcement of surety bond requirement not barred by the stay).

The main point to remember is that one may determine liability and liquidate damages but, once the actual determination has been made that the government is owed a specific sum of money for its expenditures, the actual collection of such amounts must be made through the bankruptcy court claims process. Even though the determination is not subject to the stay, the actual enforcement (i.e., collection) of the amount is.

4. Operations During the Case

As discussed earlier, Chapter 11 cases, unlike Chapter 7 cases, do not work from a statutory set of priorities that are applied to a static set of assets to be distributed. Instead, debtors are given wide authority to restructure their operations so that they will begin to run a profitable business rather than continuing on their money-losing ways. This process starts on the very first day of the case when most large debtors walk in the courthouse door with an armload of "first day motions." (Not a particularly imaginative name, but fully accurate as to what they are.) These are a mass of pleadings meant to accomplish everything from setting up new bank accounts to obtaining approval to incur up to hundreds of millions of dollars of new, postpetition financing under Section 364.

Most of these motions are relatively innocuous, but some can be distinctly problematic. The two most likely to raise issues are the "critical vendors" motion and the "DIP financing order." The Code does not contain any general provision authorizing prepetition claimants to be paid prior to confirmation of a plan, much less in the first weeks of the case. Even priority claims are not necessarily paid before the end of the case. Yet, critical vendor orders are typically entered at the beginning of the case and allow the debtor to make quick payments on claims that do not even have a priority, much less a super-administrative status.[2] These orders (and similar orders in which debtors seek to clean up any prepetition wages and benefits and to pay any outstanding priority taxes) are all justified under the rubric of "necessity" payments. The idea is that it is "necessary" to make the payments in order to convince the vendors to continue to deal with the debtor (in the absence of an executory contract), or to have the workers continue to show up each day (in a productive mood), or to make the government happy.

At least with the employees and the government, the argument could be that 1) these are priority payments, 2) they will need to be paid in full to confirm a plan, 3) the debtor has no doubt that it will confirm a plan, and 4) the payments are, therefore, only a little prema-

ture. This may sound reasonable for those payments (although it ignores the unpleasant reality that a great many expected reorganizations turn into administratively insolvent liquidations). Critical vendors, on the other hand, rarely, if ever, will have priority status for their payments so paying them in full at the beginning of the case will almost inevitably result in their receiving more (sometimes far more) for their general unsecured claims than will other, less-favored creditors.

Indeed, the most interesting thing about critical vendor payments is the close resemblance of such payments to avoidable, preferential transfers. Under Section 547 of the Code, any party that receives more during the ninety days prior to the filing of the petition than it would receive for that claim in a Chapter 7 liquidation is subject to an action to "avoid" (*i.e.,* vacate) the transfer and require that the funds received be paid into the estate. A primary aim of preferential transfer law is to ensure that there is equality of treatment of prepetition creditors by barring some from being paid in full while others receive nothing. The beneficiaries of critical vendor motions, however, receive exactly the same preferential payments and do so with the court's blessings! This appears to occur because most lower courts seem somewhat mesmerized by the conclusory assertions of the debtor that it *must* deal with these vendors, that it *couldn't* find anyone else to deal with in a timely fashion, and that the vendors will *refuse* to deal with it absent these payments. (And, to be sure, after this sort of genteel blackmail turned out to work in the first few cases, it undoubtedly did become true that vendors became increasingly demanding.)

The issue recently came to a head in the Kmart bankruptcy. In that case, as the Seventh Circuit recited in its opinion in *In re Kmart Corp.*, 359 F.3d 866 (2004), the debtor, based only on the sketchy and conclusory statements of its own officials, was allowed to name over *half* of its vendors (over 2,300) as being "critical" and to quickly and fully pay in cash their prepetition claims, totaling over $300 million. The other some 2,000 vendors eventually only received about ten cents on the dollar, which was paid in stock in the new company (which is not quite as reassuring as cold hard cash), and distributed well over a year after the case was filed. Not surprisingly, some of the disfavored creditors appealed; the district court reversed the order and the Seventh Circuit affirmed the reversal.

It noted that it might be possible for the debtor to rely on Section 363(b)(1) (which allows for the court to approve the use of property out of the ordinary course of business) as a basis for allowing some vendors to be paid out of order, but, to do so, the debtor would have to *prove* two things: first, that the vendors really *would* refuse to do business with it, absent the advance payment and, second, that providing the added payments to them and allowing the debtor to continue in business would result in a better overall result than creditors would otherwise receive. That is, if the payment of the $300 million *really* was critical to keeping the business going and creating a viable reorganization that would pay unsecured creditors ten cents on the dollar, this might be better than a quick liquidation that could provide only enough to pay off the secured creditors and leave nothing for the unsecureds. The court did not flatly decide that, even with such proof, it would allow the payments to be made, but concluded that the evidence in this case did not come close to proving those facts. The reverberations from the decision will be felt for some time — and, while limiting such payments to a few vendors is likely to be helpful, there may also be some fallout for governments and employees seeking to have their own version of such "necessity" orders entered.

Another first day motion of critical interest is the so-called "DIP financing" order. In order to stay in business, debtors often need new financing when the case is filed. They have exhausted their current lines of credit and resources and, until their finances are stabilized, need immediate help to provide cash flow for salaries, to buy goods to replenish their depleted shelves, and the like. To encourage such loans (and, thereby to encourage the reorganizations), Section 364 of the Code does allow the court to extend priority and even superpriority liens to such entities. As a price of providing the financing, lenders often seek to extract additional concessions, ranging from barring

any attacks on their prepetition loans and the perfection thereof to determining litigated issues involving third parties.

In at least one set of cases, for instance, bankruptcy courts in Delaware agreed to include in the loan orders between Debtor A and Bank B language providing that state agency C would not receive recoupment for its Medicaid payments. The oddity of A and B deciding that C should lose was only exacerbated by the fact that the order was entered *ex parte* without service on the state. The reality is that the types of provisions that lenders may seek to include are limited only by their ingenuity in thinking of ways to write protections for themselves. Any agency that has a substantial claim against a debtor would be well advised to quickly obtain and review any DIP financing orders to make sure that they do not contain any such mischievous provisions. In most cases, although the order may be entered *ex parte* initially, it usually only has a limited duration and, during that initial period, parties are allowed to try to convince the court to change its mind. If no objections are raised, though, one can certainly expect that the order will become final and unassailable. If the financing includes language, for instance, barring the government from taking certain actions that might be seen as interfering with the reorganization, that order may govern despite what the automatic stay says.

5. Plan Confirmation

Once the debtor has stabilized its operations and decided how it plans to make changes to return to profitability, it must produce a plan of reorganization upon which creditors may vote.[3] In addition, the debtor is required under Section 1125 to produce a disclosure statement to accompany the plan. The disclosure statement is an explanatory document, akin to a prospectus for a stock offering. Like a prospectus, it is meant to give adequate information to creditors to allow them to make a reasoned determination on whether to support the plan. It generally includes a section on the circumstances surrounding the debtor's fall into bankruptcy, what precipitated the filing, and what happened during the case. It should then provide an accounting of the debtor's assets, the claims against the debtor, how those claims will be divided up into various classes, and what will be paid to each class of claims. Section 1122 describes the classification process — while dissimilar claims cannot be classified together, all similar claims need not be placed in the same class. In practice, debtors frequently divide up the unsecured claimants to a degree, with traditional trade creditors generally being grouped together, and other creditors, such as personal injury claimants or governmental claims being placed in other classes. This can be done as long as it is not a pretext for discriminating against one or more such classes or for carving out a group solely to help the debtor obtain confirmation of its plan.

In the first situation, the debtor might separate out personal injury claimants because they will utilize a different claims resolution process and might have access to certain resources (like insurance policies) that are not applicable to the creditor body as a whole. *Cf In re Allied Products Corp. (Allied Products Corp. v. ITT Industries, Inc.)*, 2004 WL 635212 (N.D. Ill. Mar. 31, 2004) (debtor could not "cash out" insurance policies and use proceeds to apply to all claims rather than using them for parties who would be beneficiaries under the policies). Doing so, to the extent that such persons receive at least as much as other creditors, would not violate the Code.

The second situation is a result of the requirements for plan confirmation. Under Section 1126(c), a class of claims accepts the plan if more than one-half of the voting creditors, holding more than two-thirds of the dollar amount of the claims, vote in favor of the plan. In turn, under Section 1129, there are different confirmation requirements if all impaired classes vote in favor of the plan versus if one or more such classes votes against the plan. If all classes vote in favor of the plan, the debtor need only show under Section 1129(a)(7) and (8) that all creditors will receive as much as in a Chapter 7 case (which usually is not overly difficult). However, if any class votes against the plan, then the debtor must satisfy additional requirements in Section 1129(b) (including the absolute priority rule and certain other payment requirements).

To invoke the Section 1129(b) provisions to "cram down" the plan over the opposition of some of the classes, the debtor must be able to show that at least *one* class does support the plan. If all unsecured creditors are put in the same class, this may be an all or nothing proposition for the debtor — if it cannot secure the support of that class, it will not be able to even try to confirm its plan. Thus, it is not uncommon for the debtor to attempt to come up with some rationale to either carve out the dissenters from a large group that is expected to support the plan, or to pull a small group out that will support the plan, even though the bulk of creditors is expected to oppose the plan. In either case, the court will look closely at the rationale for the establishment of the separate class to see if it has any appropriate basis, apart from trying to gerrymander the final vote. If there is no such rationale, the court will not allow the separate classification.

If the debtor does try to separate out governmental claims of one sort or another, it is important to read the disclosure statement to determine the stated rationale for the distinction and the treatment to be accorded. If the reasoning seems reasonable, if the treatment is fair, and if it does not appear that the separation is designed solely to allow the debtor to disadvantage other creditors, there is no reason to oppose the treatment. If not, then the government must consider objecting to the disclosure statement and/or the plan.

In view of the informational function of disclosure statements, technically the proper objection is that they do not adequately describe the plan or give creditors sufficient information on which to base a vote. If a disclosure statement fully and accurately describes a plan, courts often say that it is premature to object to it on the basis that the plan is substantively objectionable. A great many disclosure objections are denied on the basis that they are really "confirmation issues." That said, most creditors still file such substantive objections for a variety of reasons — to begin the dialogue process with the debtor and, hopefully, obtain a modification of the plan before it is sent out for a vote; to start to educate the court before the confirmation; and, occasionally, to get the court to bar the plan. Notwithstanding the "confirmation issue" standard, it is still true that a substantial number of decisions have allowed creditors to raise issues that would make the plan "unconfirmable on its face." In such situations, many courts have held that it would make no sense to incur the time and expense of sending a plan out for a vote, where it could not be confirmed even with favorable votes by the classes. To be sure, many courts also deny such objections, but it is difficult in advance to know which courts will decide which way, so most creditors file the objections regardless.

In any event, it is typical for the original disclosure statement to undergo one or two rounds of adjustments before it goes out to creditors. After the original statement is served, though, the later versions will be taken up much more quickly and often will only be served on those who previously objected to the statement. Moreover, it is standard procedure for the updated version to be completed in the early hours of the morning prior to the date on which the hearing resumes and for creditors to see a heavily red-lined version only upon walking into the court room. As disconcerting as this is to those accustomed to the normal pace and manner of litigation and service, it seems to be a fact of life in big bankruptcy cases and one must simply adjust to it. What it does mean is that most of the work on disclosure statements (after the original filing of objections) will take place in phone conversations before the hearing date and meetings in the corridor on the hearing date. If the government has serious issues, therefore, it needs to have the classic "boots on the ground" at the courthouse.

After the disclosure statement is approved, it is sent with the plan to the creditors. They are given a period of time (usually four to six weeks) to vote on the plan and a date is set for objections to be filed to confirmation. To vote, one must have an "allowed" claim; *i.e.,* one that is correctly listed by the debtor in its schedules, or one where a proof of claim has been filed and not objected to, or where the court has resolved a disputed claim in favor of the creditor. If the claim is not allowed, there is a process under Rule 3018(a) for the court to "temporarily allow" a claim, solely for the purpose of voting on the plan. How-

ever, whether one votes or not, every creditor may still file objections to the plan. This is usually the more important step, since it is actually relatively rare for classes to vote against plans. (Creditors are usually so doubtful that they will get anything from the case that most are unlikely to vote against any plausible plan.)

And, as with the disclosure statement, the plan objections usually set off a flurry of efforts to resolve such issues with the creditors. So long as the revisions to the plan do not materially disadvantage other creditors, or make the plan unconfirmable for other reasons, the debtor can modify the plan without sending it out for a re-vote, pursuant to Section 1127. Thus, again, it is not enough to simply file an objection and wait for the hearing; to the contrary; most matters are wrapped up before the confirmation hearing, on the agreement of the parties. Waiting until the actual hearing date puts the remaining creditor in the position of being the obstruction that is holding up the plan for everyone. Squeaky wheels do get attention — but sometimes they just get cast aside and the juggernaut rolls on. It's a delicate process — judging how long to hold out — and one that makes bankruptcy so much fun !?

For environmental claimants, the main goal in most bankruptcies is to have the debtor agree that its cleanup obligations ride through the bankruptcy and will be dealt with on the other side. While this is usually the best outcome, it does mean that the government must be heavily involved in the question of whether the debtor's plan will meet the feasibility requirement for confirmation under Section 1129(a)(11). If the debtor will only have free cash flow from its operations of $500,000 a year, the government will not be able to insist that the debtor spend $1,000,000 a year on pumping and soil removal, at least if it expects to have the plan confirmed. Thus, these practical realities may require that the government adjust its sights on what it will demand be done by the debtor. In turn, this may be your best argument to the court to make it understand why treating environmental obligations as nondischargeable injunctive obligations, rather than claims, is in the best interests of the debtor *and* the other creditors. To enforce injunctive relief, the first requirement is that the government must have a viable operating debtor, which is what all the creditors want. In short, "we're the government, we're your friend, and we're here to help you." Honestly.

III. Conclusion

These two articles have presented a mere sliver of all of the information that is relevant to environmental regulators when their regulated entity/defendant files bankruptcy. A full understanding would take a several hundred page book — or attendance at the three-day bankruptcy conference to be held this fall in Washington, D.C., entitled "Bankruptcy Issues from a Government Perspective." To learn more, contact Karen Cordry at <kcordry@naag.org>. If you can't come, just remember, you've only been given enough information here to make you truly dangerous.

ENDNOTES

1. From the arguments often made in support of the KERPs, it appears that there is a strong and thriving market in hiring high management officials of companies that have been unable to operate at a profit. Thus, those management officials often have successfully argued to bankruptcy courts that they must pay themselves more money to agree to stay with the debtor for some or all of the reorganization process. While it may be clear that it would take an added bonus to convince an outsider to join a bankrupt entity, it is less clear why higher payments are needed to keep the existing management in place, but these KERP agreements are entered on a fairly routine basis.

2. Even in the case of executory contracts and leases that the debtor is allowed to "assume" and thereby demand the right to retain the benefit of its bargain, the debtor must only agree to "cure" prepetition defaults. The assumption and the "cure" payment, though, rarely come until a plan is actually confirmed. The critical vendor orders, on the other hand, are typically entered and paid within weeks after the case is filed.

3. As noted above, debtors may also propose liquidating plans, but the requirements are the same in either case.

DECISIONS

Air

"Standard" in CAA Includes Regulations Concerning Purchase of Vehicles: *Eastern Manufacturers Association and Western States Petroleum Association v. South Coast Air Quality Management District et al.,* No. 02-1343 (U.S. Apr. 28, 2004)

Background

Section 209(a) of the Clean Air Act (CAA) states:

> No State or any political subdivision thereof shall adopt or attempt to enforce any standard relating to the control of emissions from new motor vehicles or new motor vehicle engines subject to this part. No State shall require certification, inspection, or any other approval relating to the control of emissions . . . as condition precedent to the initial retail sale, motor vehicle engine, or equipment.

42 U.S.C. § 7543(a).

Between June and October 2000, the South Coast Air Quality Management District (SCAQMD) adopted six Fleet Rules. The rules cover operators of fleet sweepers, passenger cars, light-duty trucks, medium-duty vehicles, public transit vehicles and urban buses, solid waste collection vehicles, airport passenger transportation vehicles, and heavy-duty on-road vehicles. All the rules apply to public operators; three apply to private operators as well. These rules prescribe the types of vehicles that operators must purchase or lease when adding or replacing vehicles. Four require the purchase or lease of alternative-fuel vehicles and two require the acquisition of either alternative-fueled vehicles or vehicles that meet certain emission specifications established by the California Air Resources Board. Violations subject operators to fines and other sanctions.

In August 2000, the petitioners filed suit, claiming that the Fleet Rules are preempted by section 209 of the CAA. The district court held that the rules were not "standards" under that section of the CAA because they regulate purchase of vehicles already certified for sale in California. The court recognized that both the First and Second Circuit Courts of Appeals had previously held that section 209(a) of the CAA preempted state laws mandating that a specified percentage of a manufacturer's in-state sales be of zero-emission vehicles. *See Association of International Automobile Manufacturers, Inc. v. Commissioner,* 308 F.3d 1, 6–7 (1st Cir. 2000); *American Automobile Manufacturers Association v. Cahill,* 152 F.3d 196, 200 (2d Cir. 1998). It distinguished these cases by noting that they involved a restriction on vehicle *sales,* not on vehicle *purchases.* The Ninth Circuit affirmed and the Supreme Court granted certiorari.

Holding

The district court's determination that the CAA's preemption provision did not invalidate the Fleet Rules was based on its interpretation that the word "standard" includes only regulations that compel manufacturers to meet specified emission limits. According to the Court, neither this interpretation nor the distinction between purchase and sale restrictions finds support in the statute itself nor in its structure.

"Standard" is defined as that which "is established by authority, custom, or general consent, as a model or example; criterion; test." Webster's Second New International Dictionary 2455 (1945). The criterion referred to in section 209(a) relates to the emission characteristics of an automobile or its engine. According to the Court, this interpretation is consistent with the use of "standard" throughout Title II of the CAA The respondents' interpretation, adopted by the courts below, would engraft onto the meaning of "standard" a limiting component, defining it as only "[a] production mandat[e] that require[s] manufacturers to ensure that the vehicles they produce have particular emissions characteristics, whether individually or

in the aggregate." Brief for Respondent South Coast Air Quality Management District 13. Such an interpretation confuses *standards* with the *means* of enforcing standards. Standards do target vehicles or engines; section 209 proscribes standard-enforcement *efforts* that can be directed to manufacturers or purchasers.

This distinction can be seen by studying the provisions immediately following section 202. Section 202 sets standards. Sections 203 through 206 detail the means to enforce those standards. A standard is a standard even when not enforced through manufacturer-directed regulation. For instance, section 246 requires certain "restrictions on the purchase of fleet vehicles to meet clean-air standards." The respondent did not attempt to defend their rules under this provision. Nonetheless, section 246 demonstrates that Congress clearly contemplated the enforcement of emission standards through purchase requirements.

Furthermore, the Court noted that treating sales restrictions and purchase restrictions differently for preemption purposes would make no sense. A manufacturer's right to produce a vehicle would be meaningless without a purchaser's right to buy it. The Court stated:

> It is true that the Fleet Rules at issue here cover only certain purchasers and certain federally certified vehicles, and thus do not eliminate all demand for covered vehicles. But if one State or political subdivision may enact such rules, then so may any other; and the end result would undo Congress's carefully calibrated regulatory scheme.
>
> . . . .
>
> A command, accompanied by sanctions, that certain purchasers may buy only vehicles with particular emission characteristics is as much an "attempt to enforce" a "standard" as a command, accompanied by sanctions, that a certain percentage of a manufacturer's sales volume must consist of such vehicles.

Slip op. at 8.

In light of these principles, the Court stated that it would seem that at least certain aspects of the Fleet Rules are preempted, but they may not be preempted *in toto.* There are issues that would affect the ultimate disposition of the petitioners' suit, such as the scope of the petitioners' challenge, whether some of the rules, or their application, can be characterized as internal state purchase decisions (and, if so, whether a different standard for preemption would apply), and whether section 209(a) preempts the Fleet Rules even as applied beyond the purchase of new vehicles (such as lease arrangements or the purchase of used vehicles). Since these questions were not passed on below nor presented in the petition for certiorari, they are best addressed in the lower courts.

Environmental Justice

Plaintiffs' Fourteenth Amendment Suit Survives Summary Judgment: *Harold Cox et al. v. City of Dallas et al.,* No. 3:98-CV-1763-BH (N.D. Tex. Feb. 24, 2004)

Background

The plaintiffs own homes in a residential neighborhood that is located adjacent to a landfill in Dallas, Texas. The area of the landfill was used for sand and gravel mining. No permit for a landfill was ever issued, although the application of the mining permit indicated that the pits were to be filled with solid waste. At the time the original permit was issued, the residents of the area were predominately white, non-Hispanic. By 1980, the residents of the neighborhood were predominately African-American.

As early as 1976, officials were aware that there was open dumping of solid waste at the site. Beginning in 1982, some of the plaintiff homeowners began com-

plaining about massive illegal dumping. The city attempted to address the issue by fining the owner, but the residents' complaints continued. In 1983, when the Dallas Board of Adjustment was going to consider revoking the mining permit and made a site visit, the owner moved the trash and covered it with dirt. At the subsequent hearing, although many of the homeowners wrote letters expressing their opposition to continuing their permit, none of them appeared. The Board voted to take no action.

Illegal dumping continued at the site. It was even used by two city demolition contractors to dump debris. In 1987, the city sued and, in 1989, it obtained a judgment for operating an illegal municipal solid waste disposal site. The judgment ordered the defendants to cease the disposal of municipal solid waste and to implement a plan to close the site. However, illegal dumping continued. In November 1991, the City moved for contempt for failure to comply with the terms of the judgment but, because service was not obtained on one of the defendants, no hearing was held.

In 1992, the site was acquired by First State Bank as a result of a loan default. The bank then sold the site to Herman Nethery who submitted a construction permit application to the city. The proposed project was described as "fill & mine property." Despite numerous new citations for illegal dumping and continued citizens' complaints, the city issued a permit without first conducting a required inspection. Through November 1996, the city continued to issue citations for illegal dumping. During September 1996, a subcontractor on a city demolition project was observed disposing of debris at the site. Another city subcontractor, Herman Gibbons, operated the site for Mr. Nethery.

In November 1997, the city obtained a judgment against Nethery for operating a solid waste facility without a permit. Additionally, Nethery and Gibbons were both found guilty of organized criminal activity in connection with their operation of the site and were sentenced to prison. Nethery's conviction was reversed on appeal.

This lawsuit was first filed in February 1998. In their fourth amended complained, filed in October 2003, the plaintiffs alleged violations of the Fourteenth Amendment to the U.S. Constitution and of the Fair Housing Act. The city moved for summary judgment.

Holding

The court first addressed the Fair Housing Act (FHA) claims. Section 3604(a) of the FHA makes it unlawful to "refuse to sell or rent after the making of a bona fide offer, or to refuse to negotiate for the sale or rental of, or otherwise make unavailable or deny, a dwelling to any person because of race, color, religion, sex, familial status, or national origin." 42 U.S.C. § 3604(a) Courts have held that there must have been a direct impact on plaintiffs' ability, as potential home buyers or renters, to locate in a particular area or to secure housing. In this case, the plaintiffs have not alleged that the city violated section 3604(a) of the FHA by refusing to sell or rent to them or refusing to negotiate for any discriminatory reasons. They simply claim that the illegal dumping decreased the habitability of their homes and made their homes harder to sell. The city was, therefore, entitled to summary judgment with respect to the section 3604(a) claim.

Section 3604(b) of the FHA makes it unlawful "[t]o discriminate against any person in the terms, conditions, or privileges of sale or rental of a dwelling, or in the provision of services or facilities in connection therewith, because of race, color, religion, sex, familial status, or national origin." 42 U.S.C. § 3604(b). Most courts have interpreted the "in connection with" language as applying only to discrimination which precludes ownership of a dwelling. *See, e.g., Clifton Terrace Association Limited v. United Technologies Corporation,* 929 F.2d 714, 720 (D.C. Cir. 1991). This court adopted that reading of the statute. Since the plaintiffs did not allege discrimination related to the acquisition of their homes, the court awarded summary judgment to the city on this issue.

The plaintiffs also asserted a cause of action under 42 U.S.C. § 1983 for violation of federal housing regulations, 24 C.F.R. § 100.70(b),(d)(4). The court dis-

cussed whether there was a private right to enforce the housing regulations but determined that the city was entitled to summary judgment on this action because the statute and its implementing regulations are aimed at prohibiting discriminatory provision of housing. Since the court had already determined that no reasonable trier of fact could find that the city made unavailable or denied a dwelling to the plaintiffs within the meaning of the FHA, this claim must fall as a matter of law as well.

The court then turned to a discussion of the plaintiffs' allegation of intentional discrimination under section 1983 and section 1981, grounded on a violation of the Equal Protection Clause of the Fourteenth Amendment. To establish such a claim, the plaintiffs must first prove a prima facie case of discrimination. To determine such intent, a court may consider both circumstantial and direct evidence of intent. In *Village of Arlington Heights v. Metropolitan Housing Development Corporation,* 429 U.S. 252, 265–68 (1977), the Court indicated that at least five factors should be considered: (1) Whether the official action "bears more heavily on one race than another," (2) the historical background of the decision; (3) the sequence of events leading to the challenged decision; (4) any departures from normal procedural sequence; and (5) the legislative or administrative history. A violation of the Fourteenth Amendment occurs "only if a state decisionmaker selects or continues in a particular course of action at least in part because of, not merely in spite of, its adverse effects upon an identifiable group." *United States v. LULAC,* 793 F.2d 636, 645 (5th Cir. 1986).

If the plaintiffs provide proof of racially discriminatory intent or purpose, the burden then shifts to the defendant to provide a legitimate, nondiscriminatory reason for the actions taken. If the city can provide such a reason, then the presumption of intentional discrimination evaporates.

The city argued that the illegal dumping was not condoned by the city nor was the result of city action. However, the plaintiffs noted that the application for the permit indicated that the owners intended to fill the site with solid waste, that city contractors used the site to dump waste, and that the city's efforts to halt the illegal dumping were ineffective. Thus, the court held that there was sufficient evidence to establish there is a genuine issue of material fact for trial on whether official actions of the city permitted the continued illegal dumping.

The plaintiffs also presented evidence that the city did remedy illegal dumping and/or illegal mining at two sites located in predominantly white neighborhoods. According to the court, this is sufficient evidence to create a genuine issue of material fact regarding whether the three sites were similarly situated in order to show disparate treatment.

Applying the *Arlington Heights* factors to the evidence adduced, the court concluded that the plaintiffs had provided sufficient facts to make the issue of a discriminatory intent triable. After the neighborhood had changed from predominately white to predominately African-American, the city issued a permit in which the applicant noted its intent to dump solid waste. The city determined not to terminate the use at the site after the owner was fined for operating a sanitary landfill and after receiving numerous citizen complaints. The city failed to enforce the judgment it received. It issued a new permit without inspecting the premises. This sequence of events could permit a reasonable trier of fact to find racially discriminatory intent. The city's assertion of its attempt to remedy the illegal dumping in order to prove it had a legitimate nondiscriminatory reason for its actions was not sufficient for it to receive summary judgment on this issue.

Finally, the court discussed the possibility of the city's liability under section 1983. Liability does not attach merely because a city employed a tortfeasor; the city's actions must be officially sanctioned or ordered. The court, having reviewed the plaintiffs' evidence, concluded that there was a genuine issue of material fact whether the city's failure to terminate the illegal dumping was a result of execution of one of its customs or policies.

In denying the city's summary judgment motion, the court also determined that the issue of whether damages would be available against the city should the plaintiffs win their case should be left to a later state of the lawsuit.

Takings

Nuisance Exception Applies to Physical Takings: *John R. Sand & Gravel Company v. United States,* No. 02-509L (Fed. Cl. Apr. 2, 2004)

Background

In 1969, the plaintiff, John R. Sand & Gravel Company, leased a 158-acre parcel of land in Metamora, Michigan, for a term of fifty years. The lease contains a covenant of quiet enjoyment and includes the right to remove the marketable stone and sand on the property. A landfill is located on the northern portion of the tract of land. The landfill was placed on the National Priorities List of hazardous waste sites in 1984 and U.S. EPA began removing contaminated material from the site in 1992. In December 1986, EPA issued an Administrative Order (AO) to the plaintiff requiring it to grant access to all portions of the leased property to complete activities pursuant to a consent decree entered into with potentially responsible parties to EPA and its agents. The plaintiff was not a party to the consent decree. The AO also ordered the plaintiff to cease all mining activity in the area of Institutional Controls. Under the threat of a $25,000 a day penalty for noncompliance, the plaintiff complied with the AO.

In May 2002, the plaintiff filed a takings claim with the U.S. Court of Federal Claims, alleging that EPA physically took portions of the plaintiff's leased property because it forced the company to cease its mining activities. The parties filed cross-motions for summary judgment.

Two principle issues were involved in the summary judgment motions: whether the Supreme Court's holding in *Lucas v. South Carolina Coastal Council,* 505 U.S. 1003 (1992), regarding the nuisance exception to takings liability applies to physical takings as well as regulatory takings and, if it does apply, whether it applies to this case.

Holding

In *Lucas,* the Supreme Court held that, if background principles of a state's nuisance and property law bar a property owner from using property in a certain way, then the Takings Clause does not require compensation for an alleged taking to abate that use. A close reading of the *Lucas* decision convinced this court that this exception applies to a physical takings case as well.

In a takings case, the first inquiry is to determine the nature of the property interest claimed. The *Lucas* Court began its discussion of the owner's property interest by stating:

> Where the State seeks to sustain regulation that deprives land of all economically beneficial use, we think it may resist compensation only if the logically antecedent inquiry in the nature of the owner's estate shows that the proscribed use interests were not part of his title to begin with. This accords, we think, with our "takings" jurisprudence, which has traditionally been guided by the understandings of our citizens regarding the content of, and the State's power over, the "bundle of rights" that they acquire when they obtain title to property.

Id. at 1027. Although the first sentence speaks of "regulation," the second sentence speaks to the Court's view that takings law has recognized the state's power over the property. The Court continued its discussion by addressing physical takings:

> Where "permanent physical occupation" of land is concerned, we have refused to allow the government to decree it anew "without compensa-

> tion", no matter how weighty the asserted "public interests" involved — though we assuredly would permit the government to assert a permanent easement that was a pre-existing limitation upon the landowner's title.

Id. at 1028–29.

The defendant argued, and the court agreed, that the first part of that sentence should be read to state the general rule with the second part being the exception to that rule. Thus, a physical takings claim may be defeated where the owner intends a use that is prohibited as a nuisance and the state has the authority to abate that nuisance use. The Supreme Court in *Lucas* took the general rule and exception from physical takings cases and applied it to confiscatory regulatory takings cases.

Property rights have often been described as a "bundle of sticks." State law determines which sticks are in a person's "bundle" and the background principles of state nuisance and property law "inhere in the title itself." *Id.* at 1029. Thus, the inquiry into the nature of a plaintiff's property interest — the first step in any takings analysis — requires a consideration of "background principles of state property and nuisance law that inhere in title and restrict the uses to which an owner can put his property." Slip op. at 10. This is true in physical takings cases as well as in regulatory takings cases.

Under this analysis, the defendant in a takings case must identify the background principles which would be applicable. The federal government argued that various aspects of Michigan's property and nuisance law inhere in the plaintiff's title. The potential nuisances identified were groundwater pollution, production of odors from the excavation of rotting garbage, violation of a public health, safety, or welfare statute; and failure to obtain the necessary permits.

The court examined each of these potential nuisance issues thoroughly. It found that Michigan law also requires that a party claiming a nuisance must show that the injury or harm is reasonably certain to occur. The court concluded that there was insufficient evidence that the plaintiff's mining would have caused a nuisance regarding both odor and groundwater pollution. As to the claim of the violation of a public health, safety, or welfare statute, the government claimed that the plaintiff's mining in the area of institutional controls would have violated the Michigan Natural Resources and Environmental Protection Act. However, the government failed to explain whether that act is a health, safety or welfare statute or whether the landfill site is a "facility" under the statute and whether mining is a measure that is "necessary to prevent exacerbation of the existing contamination," one of the standards under the act.

The government also argued that mining within the institutional control area would have violated the Michigan Water Resources Commission Act. The court noted that the parties had not adequately addressed whether the act is a "sufficiently strong background principle of state nuisance law to ground a nuisance defense." Slip op. at 26. Furthermore, the defendant had not developed evidence to support its allegation that plaintiff's continued mining would have "directly or indirectly discharge[d] into the waters of the state" any hazardous substances.

The plaintiff argued that it was not required to obtain a soil removal permit nor a soil erosion and sedimentation control permit. Since the applicability of those permits to the plaintiff's business was being contested at the time of the taking, the court did not decide this issue. As to the groundwater discharge permit, the plaintiff argued that it would apply, if it were to apply at all, only to an area outside of the area of institutional controls. The court noted that it would be difficult to see how the government could effectively abate a nuisance occurring outside the area of institutional controls by preventing plaintiff from mining inside that area.

Even if there were such evidence, one remaining issue would have to be decided. May the government physically occupy another's property to abate a nuisance? The court held that the scope of the abate-

ment available under state law is appropriate to examine because the government can "do no more than duplicate the result that could have been achieved in the courts." *Id.* at 1029. Under Michigan law, the state has broad police power to abate public nuisances, but this power is not without limit. The Michigan Supreme Court has held that, if a nuisance arises out of the operation of a legitimate business, the nuisance should be abated in a way that does not completely destroy the business. *See, e.g., Rohan v. Detroit Racing Association,* 22 N.W.2d 433, 466 (Mich. 1946).

The court concluded that the legal arguments and factual evidence regarding background principles of Michigan property and nuisance law must be further developed. Furthermore, there are still disputed issues of material fact. Thus, the court denied the government's cross-motion for summary judgment with respect to its defense.

Finally, the federal government argued that the plaintiff's remedy should be a lawsuit against its lessor for the breach of the covenant of quiet enjoyment. However, the defendant cited no caselaw suggesting that, in this type of situation, the only cause of action available to the plaintiff would be against its lessors.

The court, thus, granted the defendant's motion for summary judgment with respect to the defense regarding background principles of state property and nuisance exception to takings liability but denied the other motions for summary judgment.

Water

Rule 6(a) Applicable to Notice Requirement of CWA: *American Canoe Association, Inc., et al. v. City of Attalla,* No. 03-12777 (11th Cir. Mar. 23, 2004)

Background

Section 505(b)(1) of the Clean Water Act (CWA), 33 U.S.C. § 1365(b)(1), requires a sixty-day period after notice of a violation of the statute during which a private citizen must wait before filing suit. During this time, only the state or federal government may initiate suit. The question in this appeal is whether Federal Rule of Civil Procedure 6(a) is applicable to this section of the CWA.

The plaintiffs in this lawsuit filed suit on the sixty-first day. The district court dismissed their action because the sixtieth day fell on Sunday, which would not count in the sixty-day wait period if Rule 6(a) were to apply. The state filed an enforcement action on the same day the plaintiffs filed their suit. The plaintiffs appealed the dismissal of their lawsuit.

Holding

Section 505(b) of the CWA provides that no citizen suit lawsuit may be commenced:

> (A) prior to sixty days after the plaintiff has given notice of the alleged violation (i) to the Administrator, (ii) to the State in which the alleged violation occurs, and (iii) to any alleged violator of the standard, limitation, or order, or
> (B) if the Administrator or State has commenced and is diligently prosecuting a civil or criminal action in a court of the United States, or a State to require compliance with the standard, limitation . . . .

The plaintiffs' suit was filed on the sixty-first day; on the same day the state initiated an enforcement action

Rule 6(a) reads:

> (a) Computation. In computing any period of time prescribed or allowed by these rules, by the local rules of any district court, by order of court, or by an applicable statute, the day of the act, event, or default from which the designated period of time

> begins to run shall not be included. The last day of the period so computed shall be included, unless it is a Saturday, a Sunday, or a legal holiday, or, when the act to be done is the filing of a paper in court, a day on which weather or other conditions have made the office of the clerk of the district court inaccessible, in which event the period runs until the end of the next day which is not one of the aforementioned days.

The court noted that the Eleventh Circuit has recognized that there is a general legislative intent to apply Rule 6(a) to all federal statutes enacted or amended after its adoption unless a statute reflects a contrary intent. The CWA is silent on this issue.

The plaintiffs argued that Rule 6(a) should not be applied for several reasons. First, they pointed out the rule applies only when a paper must be filed or some other act taken within a prescribed time. However, the court could find no such limitation in the rule. It applies "in computing *any* period of time" (emphasis added) and contains the disjunctive "or" when it speaks of the "act to be done is the filing of a paper in court."

The plaintiffs also argued that the rule should not be applied because, at the end of the sixtieth day, it would have been impossible for the plaintiffs to file a citizen suit. The court pointed out, however, that the purpose of the sixty-day wait period is to allow governmental entities and the potential violators a full sixty days to consider and to take action. It was impossible for the government to file suit on Sunday so, without the application of Rule 6(a), the government would not have the full sixty days to file suit.

The plaintiffs also argued that the court's applications of Rule 6(a) to other statutes are distinguishable because the sixty-day period in section 505 is not a statute of limitation. The court pointed out that it had applied Rule 6(a) to other actions that did not involve a statue of limitations and could see no reason why Rule 6(a) should apply only to time measurements which are statutes of limitation. Further, according to the court, the sixty-day notice period in the CWA acts much like a statute of limitation by mandating a period during which only the government can bring an enforcement action.

The plaintiffs also argued, for the first time on appeal, that Rule 82 bars application of Rule 6(a) to jurisdictional periods because it provides that the Federal Rules of Civil Procedure are not to be "construed to extend or limit the jurisdiction" of the district court. Because the notice period is a mandatory condition precedent to commencing suit, the plaintiffs argued that it is jurisdictional in nature. In *Sierra Club v. Yeutter,* 926 F.2d 429 (5th Cir. 1991), the Fifth Circuit, in discussing a counterpart of the notice and delay requirement in the Endangered Species Act, concluded that it was not jurisdiction "in the strict sense of the term" and, thus, could not be raised for the first time on appeal. *See also Lockett v. EPA,* 319 F.3d 678, 682– 83 (5th Cir. 2003). The court concluded that the computation rules of Rule 6(a) have no impact on the court's jurisdiction.

The court, thus, affirmed the district court's holding.

Discharge of Muddy Water From Supply Pond May Be Actionable Under CWA: *Greenfield Mills, Inc., et al. v. Larry Macklin et al.,* No. 01-1863 (7th Cir. Mar. 19, 2004)

Background

The plaintiffs in this lawsuit are riparian landowners along a five-mile portion of the Fawn River, beginning at Orland Dam and ending at Greenfield Millpond in Indiana. The defendants are an official and employees with the Indiana Department of Natural Resources (DNR) who work at a state fish hatchery. The Fawn River runs through the hatchery property at Orland. The dam forms a supply pond that feeds the hatchery's fish rearing grounds. When the main flow control gates of the dam are lifted, the pond water flows from the supply pond down the Fawn River to Greenfield Millpond.

In March 1998, it was discovered that there was a problem with the river intake plumbing. In order to fix the problem, officials felt it necessary to expose the river inlet structure by drawing down the water in the supply pond. Time was critical. The repairs were needed before the walleye harvesting season which was to begin the first of June. The decision was made to draw down the water in the supply pond to make the plumbing repairs and to allow visual inspection of the gates which also needed repair. The intention was to only draw down enough water to expose the piping.

The top gates of the main flow control structure were opened at 8:30 on the morning of May 18, 1998. By 11:00, the supply pond was drained enough that the pipes and plumbing work were exposed. The gates were then left open while employees went to lunch, inspected water levels at other areas of the fishery, and purchased supplies to repair the plumbing. At two o'clock, when one of the employees returned, a DNR fisheries biologist observed that the supply pond had been reduced so that the silt-covered bottom was exposed. Water flowing through was picking up the silt and depositing it into the river.

One of the plaintiffs, Gene Lewis, arrived and demanded the gates be closed immediately. Instead, concerned about the effect of the silt entering the river on downstream fish populations, employees decided to go to the water control structure of the upstream bypass channel and divert as much clean water into the river below the dam as possible, bypassing the hatchery supply pond.

Meanwhile, Lewis' son, attorney Neal Lewis, arrived at the hatchery and again demanded the gates be closed. Employees first wanted to repair the plumbing but decided to, instead, close the gates. By 4:00 p.m., the supply pond was again full. Several weeks later, the repairs were made by a DNR diver without drawing down the water of the supply pond. The only repair work done after the water was lowered on May 18 was that a chain was attached to two of the lower gates because of the difficulty that had been encountered in trying to raise them.

The plaintiffs brought this lawsuit against the defendants, alleging that they had violated the Clean Water Act by failing to obtain a permit prior to draining the supply pond. At trial, testimony was offered showing that the mud deposited into the river came from the supply pond and that, as a result, several hundred fish were killed, a small lake at Greenfield Mills was transformed to an environment dominated by marshy conditions, and the bottom of Fawn River had been elevated and certain once freely-flowing areas have become stagnant.

The district court granted summary judgment to the defendants, finding that the dredging fell within a maintenance exception to the permit requirement of section 404(f)(1)(B) of the Clean Water Act (CWA), 33 U.S.C. § 1344(f)(1)(B). The plaintiffs appealed.

Holding

Under the CWA, one who wishes to discharge a pollutant must generally obtain a permit under section 404 (for dredged or fill material) or under section 402 for other pollutants. The plaintiffs alleged that the defendants discharged dredged materials into Fawn River; therefore, the court looked at section 404 to determine whether a permit was required. The court commented in a footnote that it affirmed the district court's holding that the discharge did not require a section 402 permit, but disagreed with the district court's conclusion that the defendants' purpose and intent were relevant in determining whether section 402 had been violated. Liability under section 402 is strict unless an exemption applies to the discharge.

The CWA generally prohibits "the discharge of any pollutant by any person" absent compliance with one of the permitting schemes incorporated in the act. "Discharge of a pollutant" means "any addition of any pollutant to navigable waters from any point source." The defendants argued that there was no "addition" of dredged spoil because the supply pond and the Fawn River are essentially the same body of water. They noted that the decisions in *National Wildlife Federation v. Gorsuch,* 693 F.2d 156, 174–75 (D.C. Cir. 1982), and *National Wildlife Federation v. Consum-*

ers Power Company, 862 F.2d 580, 584 (6th Cir. 1988), which hold that the discharge of pollutants from one body of water to a contiguous one is not an "addition."

The court noted, however, that more recent decisions have undercut these holdings. The Fourth Circuit in *United States v. Deaton,* 209 F.3d 331 (2000), held that sidecasting was still an addition of a pollutant even though nothing was added from the outside world. The court stated:

> Once it was removed, that material became "dredged spoil," a statutory pollutant and a type of material that up until then was not present on the Deaton property. It is of no consequence that what is not dredged spoil was previously present on the same property in the less threatening form of dirt and vegetation in an undisturbed state. What is important is that once that material was excavated from the wetland, its redeposit in the same wetland added a pollutant where none had been before.

Id. at 335. Similarly, in *Avoyelles Sportsmen's League, Inc. v. Marsh,* 715 F.2d 897, 923–24 & n.43 (5th Cir. 1983), the court stated that the term "addition" may reasonably be understood to include "redeposit."

The court in *Catskill Mountains Chapter of Trout Unlimited, Inc. v. City of New York,* 273 F.3d 481, 489–94 (2d Cir. 2001), noted that the decisions in *Gorsuch* and *Consumers Power* were based on deference to the EPA's interpretation of "addition." However, the Second Circuit commented that EPA's interpretation was not adopted in a rulemaking or other formal procedure and, in accordance with recent Supreme Court cases, is not entitled to the broad deference accorded to it by the D.C. and Sixth Circuits. In this case, U.S. EPA has urged that the court apply the broader definition of "addition" employed in more recent cases.

The court noted that EPA's position was persuasive for several reasons. First, it is in keeping with the CWA's purpose, "to restore and maintain the chemical, physical, and biological integrity of the Nation's waters." 33 U.S.C. § 1251(a). Second, soil and vegetation removed from one part of a wetland and deposited in another may disturb the ecological balance of both areas — both the area in which the material is deposited and the area from which it was removed. Finally, the court noted its agreement with the Fifth Circuit that the more restrictive definition "would effectively remove the dredge-and-fill provision from the statute." *Avoyelles* at 924 n.43. Therefore, the court held that the discharge of dredged material into a contiguous body of water constitutes an "addition" of dredged spoil.

The question then posed by the court was whether the discharge fell into one of the exemptions. Under section 404(f)(1), the discharge of dredged or fill material "for the purpose of maintenance, including emergency reconstruction of recently damaged parts, of currently serviceable structures such as dikes, dams, levees, groins, riprap, breakwaters, causeways, and bridge abutments or approaches, and transportation structures" is exempt from permitting requirements. However, this exemption is construed narrowly and the regulations provide that "[m]aintenance does not include any modification that changes the character, scope, or size of the original fill design." 33 C.F.R. § 323.4(a)(2).

The plaintiffs contended that the defendants were not protected by the exemption for three reasons: (1) There is a genuine issue of material fact whether the defendants' real purpose was for dredging the pond instead of for maintenance; (2) the exemption does not include activity that was not required for maintenance or not proportional to the maintenance performed; (3) the dredging was not maintenance because it modified "the character, scope, or size of the original fill design." 33 C.F.R. § 323.4(a)(2).

In determining the purpose for the defendants' actions, courts have "looked beyond the stated or subjective intentions and determined the effect of 'objec-

tive' purpose of the activity conducted. *United States v. Sargent County Water Resource District,* 876 F. Supp. 1090, 1101 (D.N.D. 1994). Based on the record, the court concluded that a reasonable trier of fact could conclude that the defendants' purpose was *not* to perform maintenance. There was evidence that the DNR had been interested in dredging the supply pond and had been told that a permit would be required. The defendants were slow to conduct the repairs and allowed the pond to drain much longer than was needed to do the repairs. Furthermore, the defendants did not show why a draw down was necessary for the repair of the gates.

Both EPA and the Army Corps of Engineers argued as *amici* that the exemption includes dredging *only* if the dredging is reasonably necessary for the proposed maintenance. The court agreed. A requirement of reasonable necessity or proportionality comports with the CWA's legislative history. Congress repeatedly stressed that the exemptions were intended to cover only a very narrow range of activities "that cause little or no adverse effects either individually or cumulatively." 3 *Legislative History* 420. Further, several courts have interpreted the exemptions as containing a reasonableness requirement. *See, e.g., United States v. Sargent County Water Resource District,* 876 F. Supp. at 1098, and *United States v. Zanger,* 767 F. Supp. 1030, 1035 (N.D. Cal. 1991). Applying such a standard to this case, the court determined that the plaintiffs had brought forth sufficient evidence to permit the trier of fact to conclude that the dredging was not reasonably necessary to perform the maintenance on the pump or to inspect the gates.

The regulations provide that "[m]aintenance does not include any modification that changes the character, scope, or size of the original fill design." 33 C.F.R. § 323.4(a)(2). The district court determined that the dredging here did not change the original fill design of the supply pond and that, thus, the regulation was not implicated. The plaintiffs argued that "original fill design" refers to Fawn River, the area where the dredged material was deposited. The defendants argued, and the district court agreed, that original fill design is comprised of the dam and the supply pond behind the dam. The amici argued that original fill design is the man-made structures that are the subject of the exemption, such as dikes, dams, levees, not a natural watercourse such as the Fawn River.

One of the few decisions to address this issue is *United States v. Sargent County,* 876 F. Supp. 1081, 1087 (D.N.D. 1992). This case concerned an analogous maintenance exemption for draining ditches in 33 U.S.C. § 1344(f)(1)(C). In that case, the court defined original fill design as "1) the depth and width of the ditch as it was originally constructed, plus 2) any improvements made to any segments of the ditch prior to the CWA's jurisdiction over wetlands in 1975." *Id.* The court focused on changes in the man-made ditch, not on changes on natural watercourses affected by the drainage ditch. Applying that definition to the case at bar, the court held that the defendants did not change the "character, scope, or size of the original fill design" since there is no evidence to suggest that the draw down of water affected the character, scope, or size of the dam.

In order to escape the permit requirement, defendants must not only establish that their activities fell within one of the exemptions, but they also must establish that their actions are not "recaptured" by section 404(f)(2). This section states:

> Any discharge of dredged or fill material into the navigable waters incidental to any activity having as its purpose bringing an area of the navigable waters into a use to which it was not previously subject, where the flow or circulation of navigable waters may be impaired or the reach of such waters be reduced, shall be required to have a permit under this section.

33 U.S.C. § 1344(f)(2).

It is clear from the language of the statute that two things must have occurred in order for the recapture provision to apply: the discharge is "incidental to any activity having as its purpose bringing an area of the

navigable waters into a use to which it was not previously subject" *and* "the flow or circulation of navigable waters may be impaired or the reach of such waters be reduced" by the discharge. This interpretation is bolstered by both caselaw and by the judgment of the interpreting agencies. Consequently, the defendants need only prove that one of these conditions did not exist to avoid the application of the recapture provision.

There is evidence in the record showing that the defendants had expressed interest in dredging the supply pond prior to the draw down incident. Furthermore, many of the defendants' actions were inconsistent with their stated purpose of performing maintenance: they did not perform the maintenance immediately, took a lunch break, purchased supplies and, in fact, did not perform the maintenance at all on that day. Based on this evidence, the court could not conclude that, as a matter of law, the defendants established that they escaped the first prong of the recapture provision.

The evidence could also permit the trier of fact to conclude that the defendants' actions impaired the flow and circulation of the Fawn River. One of the plaintiffs' studies showed, for instance, that the bottom of Fawn River was elevated after the release of mud and silt and that certain areas that had been flowing freely were now stagnant. Therefore, the court concluded that the trier of fact could conclude that the recapture provision of the statute was applicable to the defendants' activities.

The court, thus, reversed and remanded the case to the trial court.

[Editor's note: The plaintiffs also brought a takings and due process claim. The appellate court concluded that Indiana law recognizes that takings characterized by a physical invasion need not lose all economically beneficial use of their property in order to bring an inverse condemnation action. Since state law would recognize a physical invasion taking, the plaintiffs must exhaust their state remedies as required by the holding in *Williamson County Regional Planning Commission v. Hamilton Bank of Johnson City,* 473 U.S. 172, 186–87 (1985). Seventh Circuit caselaw since *Williamson County* holds that the exhaustion requirement applies to due process claims as well when based on the same facts as a takings case. *See, e.g., Hager v. City of West Peoria,* 84 F.3d 865, 869 (7th Cir. 1996).]

Court Discusses Sentencing Enhancement: *United States v. Emilio A. Perez,* No. 02-16627 (11th Cir. Apr. 20, 2004)

Background

Emilio Perez was the owner, operator, president, and director of Emi-Sar, a trash hauling business. He was also president of Panokee Investments, which owned two federally protected wetland sites in Palm Beach County, Florida. Environmental officials from various agencies investigated unlawful dumping by Emi-Sar trucks at those sites from September 1999 through May 2001. Agents observed that the illegally discharged materials had raised the elevation of the wetlands resulting in the loss of habitat and wetland function. Authorities informed Perez of the illegal dumping and the U.S. Army Corps of Engineers issued cease-and-desist orders, but the dumping continued.

In August 2001, a federal grand jury indicted both Perez and Emi-Sar on two counts of knowingly and unlawfully discharging pollutants into wetlands of the United States without a permit and on one count of knowingly and willfully injuring property of the Department of the Army Corps of Engineers, resulting in damages exceeding $1,000. The jury returned guilty verdicts on both counts for both defendants.

At the sentencing hearing, the district court enhanced the sentence for "ongoing, continuous, or repetitive discharge," but enhanced it only four levels instead of six because the materials discharged were not the "worst type of pollutants." On appeal, Perez complained that the enhancement was not warranted.

Holding

The district court gave Perez a four-level enhancement under U.S.S.G. § 2Q1.3(b)(1). Perez argued that the enhancement was unjustified because the court did not require the government to prove that the dumping resulted in actual environmental contamination.

Guideline 2Q1.3(b)(1) reads: "(a) If the offense resulted in an ongoing, continuous, or repetitive discharge, release, or emission of a pollutant into the environment, increase by 6 levels; or (b) if the offense otherwise involved a discharge, release, or emission of a pollutant, increase by 4 levels." Application Note 4 of the Commentary reads:

> Subsection (b)(1) assumes a discharge or emission into the environment resulting in actual environmental contamination. A wide range of conduct, involving the handling of different quantities of materials with widely differing propensities, potentially is covered. Depending upon the harm resulting from the emission, release or discharge, the quantity and nature of the substance or pollutant, the duration of the offense and the risk associated with the violation, a departure of up to two levels in either direction from that prescribed in these specific offense characteristics may be appropriate.

Id. § 2Q1.3, Application Note 4.

According to the government's reading of the guideline, it need only prove that the defendant's conduct fit within the language of the guideline. Perez argued, however, that an assumption of actual contamination is inappropriate because section 2Q1.3(b)(1)(A) pertains to dumped materials that are not "hazardous or toxic." If this guideline is to be applied, he contended, the government has the burden to prove actual contamination.

The interpretation of section 2Q1.3 was an issue of first impression in the Eleventh Circuit. However, the court had earlier addressed the interpretation of section 2Q1.2, which exactly parallels section 2Q1.3. In *United States v. Cunningham,* 194 F.3d 1186 (11th Cir. 1999), the court held that there were not additional requirements in the application of the section 2Q1.2(b)(1) enhancement beyond those actually contained in the guideline. The court reached the same conclusion in this case: "[W]here two sentencing guidelines are worded identically, absent any distinctions or clarifying words noted in the Commentary, they should be interpreted and applied in the same manner." Slip op. at 8–9. Section 2Q1.3 parallels section 2Q1.2 exactly, but applies to pollutants that are not hazardous, toxic, or pesticides. In this case, the district court applied the enhancement properly because the government proved that Perez engaged in repeated, unlawful dumping in federally protected wetlands without a permit.

Point Source Discharges From Lumbering Operation Requires Permit: *Environmental Protection Information Center v. Pacific Lumber Company et al.,* No. C01-2821 MHP (N.D. Cal. Jan. 23, 2004)

Background

Pacific Lumber Company and its wholly owned subsidiary, Scotia Pacific Lumber Company, own approximately ninety-five percent of the land that encompasses the Bear Creek watershed in Humboldt County, California. It is used for logging. According to the complaint, the logging activity has created a substantial increase in the amount of sediment deposited into Bear Creek. Pollutant-laden water flows through 156 hillside culverts and 5.5 miles of roadside ditches, all of which drain directly into stream-crossing culverts.

This lawsuit alleges that Pacific Lumber neither holds nor has applied for the relevant National Pollutant Discharge Elimination System (NPDES) permits under the Clean Water Act (CWA). The lumber company argued that its activities were exempt from the permit requirements of the CWA and filed a motion to dismiss.

Holding

A "point source" under the CWA is defined as:

> [A]ny discernible, confined and discrete conveyance, including but not limited to any pipe, ditch, channel, tunnel, conduit, well, discrete fissure, container, rolling stock, concentrated animal feeding operation, or vessel or other floating craft, from which pollutants are or may be discharged. This term does not include agricultural stormwater discharges and return flows from irrigated agriculture.

33 U.S.C. § 1362(14).

In response to a court decision that invalidated its first round of regulations detailing exemption for some discharges from agricultural and silvicultural activities from NPDES permitting requirements, U.S. EPA promulgated a new silvicultural-source regulation in 1976 and repromulgated it in 1980. *See* 45 Fed. Reg. 33,290. The current regulation defines a silvicultural point source as:

> [A]ny discernible, confined, and discrete conveyance related to rock crushing, gravel washing, log sorting, or log storage facilities which are operated in connection with silvicultural activities and from which pollutants are discharged into waters of the United States. The term does not include non-point source silvicultural activities such as nursery operations, site preparation, reforestation, and subsequent cultural treatment, thinning, prescribed burning, pest and fire control, harvesting operations, surface drainage, or road construction and maintenance from which there is natural runoff.

40 C.F.R. § 122.27(b)(1).

In 1987, Congress amended the CWA to include a section on municipal and industrial stormwater discharges. In section 402(p), the statute reads:

> (1) General rule
>
> Prior to October 1, 1994, the Administrator or the State (in the case of a permit program approved under this section) shall not require a permit under this section for discharges composed entirely of stormwater.
>
> (2) Exceptions
>
> Paragraph (1) shall not apply with respect to the following stormwater discharges: (A) A discharge with respect to which a permit has been issued under this section before February 4, 1987. (B) A discharge associated with industrial activity. (C) A discharge from a municipal separate storm sewer system serving a population of 250,000 or more.

33 U.S.C. § 1342(p). The lumber company reads this section as requiring permits only for particular kinds of stormwater discharge sources, those related to "industrial" or some "municipal" activity, none of which apply in this case.

However, section 402(p) does not purport to deal with *all* types of discharges. Both caselaw and the language of the statute make clear there are two threshold inquiries that govern the applicability of section 402(p). One is whether the relevant discharges are composed entirely of stormwater. The second is whether the relevant discharges are "currently and properly unregulated." *See Environmental Defense Center, Inc. v. United States Environmental Protection Agency,* 345 F.3d 840 (9th Cir. 2003).

The court opined that Pacific Lumber erred when it alleged that the plaintiff's complaint targets discharges composed entirely of stormwater. Its complaint al-

leges that the company's drainage system utilizes a number of point sources to redirect stormwater *and pollutants* into Bear Creek. There is nothing in the complaint which alleges that the discharges are entirely and exclusively stormwater. Nor is the second threshold met. EPA's Phase II stormwater provisions deal with unregulated discharges, not those already regulated, such as point source discharges. For section 402(p) to apply to the discharges here, the sources must have been "unregulated" at the time of the 1987 amendments. This is not the case here. The complaint alleges that the lumber company is discharging through point sources. These were regulated at the time of the 1987 amendments.

The complaint thus states a claim for which relief may be granted. Thus, the court denied the motion to dismiss.

CIVIL/ADMINISTRATIVE PROCEEDINGS

New Filings

Nuisance

***Michigan Department of Natural Resources v. King of the Wind Farms, Inc.,* No. 04-461-CE (Cir. Ct. Ingham County Mar. 29, 2004)**

The Michigan Attorney General's Office has filed a lawsuit against the 300-acre King of the Wind Farms, Inc., for allegedly violating state statutes related to air pollution control, water resources protection, and solid waste management requirements. The complaint asks the court to order the farm owners to operate their compost facility in a manner that doesn't cause a nuisance and to pay civil fines for the violations.

The farm consists of an equestrian barn and horse raising activity, several crop fields used to grow food for the horses, and a composting operation. Michigan environmental officials have received more than 400 complaints of odors emanating from the facility. Officials have also sampled stormwater discharges from the facility that have demonstrated contaminants at levels potentially injurious to the water.

[For further information, contact Michigan AAG Pam Stevenson at (517) 335-4483.]

Settlements

Air

***United States v. True Manufacturing Company,* No. 4:04-CV-00495-JCH (E.D. Mo. Apr. 28, 2004)**

The federal government has announced a settlement that resolves federal Clean Air Act and other environmental claims against True Manufacturing Company, a maker of commercial refrigeration equipment in O'Fallon, Missouri. The company failed to get proper permits for a silk-screen printing operation. Under the settlement, True will reduce its emissions of volatile organic compounds by more than ninety-four tons per year, including more than forty-four tons of hazardous air pollutants. The company has also agreed to pay a $1.5 million fine and spend some $1.9 million on supplemental environmental projects designed to reduce VOC emissions more than required by law and regulations.

True self-disclosed violations of the Resource Conservation and Recovery Act and the federal Clean Water Act. This settlement also resolves those violations by requiring the company to include a stormwater pollution prevention plan and a spill prevention control and countermeasure plan under the Clean Water Act and complete an integrated contingency plan that includes a hazardous waste contingency plan and an occupational Safety and Health plan.

[For further information, contact AUSA Suzanne Gah at (314) 539-2200.]

USTs

***New Hampshire v. Charles Alward and Joan Alward,* No. 03-E-0012 (Super. Ct. Belknap County Jan. 27, 2004)**

Charles and Joan Alward, the owners of Gus's Country Store on Route 106 in New Hampshire, have agreed to settle a lawsuit brought against them by the state alleging that they had been operating unregistered underground storage tanks. This problem had persisted although state officials had warned the Alwards since 1997 to correct the problems. The Alwards agreed to pay a $60,000 fine, $35,000 of which will be suspended for two years so long as the couple doesn't break any environmental laws during that period. The settlement also states that the Alwards cannot own another underground storage tank in the state.

Gus's Country Store has since been sold and is now called D&D Country Market and Deli. New pumps and a new concrete pad have now been installed.

[For further information, contact New Hampshire AAG Jennifer Patterson at (603) 271-3679.]

Water

***New Jersey v. AmerGen Energy Company,* OAL No. EWR 0871 38-2003S (Apr. 8, 2004)**

In a New Jersey administrative procedure, AmerGen Energy Company, the operator of the Oyster Creek Nuclear Generation Station, has agreed to pay a fine of $1 million for a violation of its discharge permit. The illegal discharge occurred when workers shut down a transformer for maintenance. This led to the shutdown of three pumps that are used to cool water before it is released into Oyster Creek. Three hours after the discharge occurred, state officials measured a water temperature of 101 degrees in one part of the creek. The discharge killed over 5,800 fish.

[For further information, contact New Jersey DAG Charles Licata at (609) 984-7147. For information concerning criminal charges, contact New Jersey DAG Ed Bonano at (609) 984-4470.]

***United States v. Massachusetts Bay Transportation Authority,* No. 04CV1048l-MEL (D. Mass. Mar. 20, 2004)**

A consent decree has been lodged that settles allegations that the Massachusetts Bay Transportation Authority violated the Clean Water Act (CWA) and Clean Air Act (CAA) at several facilities owned and operated by the defendant. The allegations included discharges of process wastewater without a permit, violations of U.S. EPA stormwater permitting requirements, and federal bus idling regulations.

Under the decree, the defendant will pay a civil penalty of $328,274, achieve compliance with applicable provisions of the CWA and CAA, and expend at least $1 million on supplemental environmental projects.

[For further information, contact Ronald Gluck, DOJ, at (202) 514-4414.)

CRIMINAL PROSECUTIONS

Informations/Indictments

Water

***United States v. PQ Corporation,* No. 04-0175 (D. Md. Mar. 30, 2004)**

The PQ Corporation of Valley Forge, Pennsylvania has been charged with violating the Clean Water Act at its plant in Baltimore, Maryland. Additional criminal charges have been filed in Missouri and Pennsylvania concerning PQ's plants in St. Louis and Chester.

PQ's facilities use high heat to manufacture sodium silicate from soda ash and sand. The company allegedly discharged improperly treated wastewater from its Maryland facility between 1995 and 2000 without a CWA permit.

[For further information, contact AUSA Michael Cunningham at (410) 209-4800.]

Pleas/Verdicts

Asbestos

***United States v. Alexander Salvagno, Raul Salvagno, and AAR Contractor, Inc.,* No. 02-CR-51 (N.D.N.Y. Mar. 31, 2004)**

After a five-month trial, a federal jury has convicted Alexander Salvagno, Raul Salvagno, and AAR Contractor, Inc., on fourteen felony counts in connection with their asbestos abating activities. The defendants were convicted of conspiracy to violate the Racketeer Influenced and Corrupt Organization Act (RICO), conspiracy to violate the Clean Air Act (CAA) and Toxic Substances Control Act, violations of the CAA, and, as to Alex Alvagno, three tax fraud counts.

AAR Contractor, Inc., was one of the largest asbestos abatement companies in New York State. The evidence established that, for ten years, the defendants engaged in grossly illegal asbestos abatement activities. From 1990 to 1999, Alex Alvagno secretly co-owned a purportedly independent laboratory, Analytical Laboratories of Albany, Inc. The defendants used the lab to defraud victims by creating fraudulent laboratory analysis results which purported to show that all asbestos had been properly removed as promised by the defendants.

The evidence at trial established that illegal collusion between AAR and the lab occurred at more than 1,555 facilities throughout the state, including elementary schools, churches, hospitals, state police barracks, and the New York Legislative Office Building. Witnesses, including many former lab and AAR employees, testified to "rip and run" activities that included indoor "snow storms" resulting from the release of large amount of visible asbestos into the air during the removal process. Evidence also established that workers were knowingly sent into asbestos "hot zones" while being encouraged to work illegally without respirators or without sufficient replacement filters for the respirators. Investigators found high levels of asbestos remaining at various locations where AAR at conducted asbestos removal activities.
Sentencing is scheduled for September 10. The jury determined that each defendant must forfeit approximately $2 million for their racketeering violations.

[For further information, contact AUSA Craig A Benedict at (315) 448-0672.]

Water

***United States v. Bouchard Transportation Company,* No. 04-10087 (D. Mass. Mar. 29, 2004)**

Bouchard Transportation Company officials recently pled guilty to violating environmental laws when an oil barge went off course and hit rocks under the waterline in Buzzards Bay in April 2003. The resulting spill killed at least 450 seabirds and contaminated nearly ninety miles of shoreline in the bay. Officials admitted that neither the captain nor the first mate of its tugboat *Evening Tide* were at the controls when the incident occurred. The rocks tore a twelve-foot-wide

gash in the barge, causing the bay's worst oil spill since 1969.

The company will pay a $9 million fine, of which $7 will go to a national fund for improving wildlife habitat and $2 million to a trust fund to clean up oil spills. Bouchard will also pay the $40 million spent so far for cleanup, make payments for private property damage, and face a future bill for environmental damage.

[For further information, contact AUSA Josh Levy at (617) 748-3154.]

Sentences

Ocean Dumping

***United States v. MMS Company, Ltd.,* No. CR04-37 (D. Ore. Apr. 5, 2004)**

A Japanese company that manages the vessel *Spring Drake* has been sentenced after it pled guilty to four felony charges connected to dumping oily wastewater at sea. The case had been simultaneously filed in courts in Portland, Oregon, San Francisco, California, and Los Angeles, California. The plea was entered in Portland where the ship was boarded by U.S. Coast Guard officials.

The company was sentenced to pay a $1 million fine in the Oregon case and $500 thousand for each of the California cases. Half of the fines were suspended with that portion of the money going to fund environmental projects through the Fish and Wildlife Foundation and the National Parks Foundation.

In a separate proceeding, Shashank Pendse, the *Spring Drake's* chief engineer, pled guilty to knowingly failing to accurately record the ship's oil cischarges in the ship's oil record book. He was sentenced to serve thirty days in federal prison.

The *Spring Drake* dumped oil and oily sludge at sea through a pipe that bypassed the ship's pollution control equipment.

[For further information, contact AUSA Robert Ross at (503) 727-1000.]

RCRA

***United States v. Rhodia, Inc.,* No. 03-29BU (D. Mont. Apr. 29, 2004)**

Judge Donald W. Molloy of the District Court of Montana has sentenced Rhodia Inc., to pay $18 million in criminal fines and restitution as a result of its pleading guilty to two knowing violations of the Resource Conservation and Recovery Act. He also ordered Rhodia to perform 1,000 hours of community service. The violations — illegally storing hazardous waste containing elemental phosphorus — took place at Rhodia's manufacturing plant in Silver Bow County, Montana. Rhodia will be required to clean up the site pursuant to orders by U.S. EPA. Rhodia was also placed on five years' probation, which could be extended if the cleanup should take longer than five years.

The Silver Bow Plant previously manufactured elemental phosphorus used to produce feretilizer, pesticides, and food grade phosphoric acid.

The criminal fine is the largest paid for criminal environmental violations in Montana and one of the largest paid for prosecution of hazardous waste crimes in the country. Of the total fine, $1.8 million will be paid to Montana's Department of Envrionmental Quality.

[For further information, contact AUSA Kris McLean at (406) 542-8851.]

UPDATE

***Leavitt v. Tennessee Valley Authority,* No. 03-1162, 72 U.S.L.W. 3685 (May 4, 2004):** The Court has denied certiorari to this Clean Air Act (CAA) case. The Eleventh Circuit held that the CAA violates Due Process in that it allows U.S. EPA to issue administrative compliance order based upon "any information available," with the possibility of imposition of civil and criminal penalties for noncompliance, absent an adjudication.