How Energy Co. Buyers Can Limit Environmental Liability Risk

By **Jacob Hollinger and Darren Azman** (May 29, 2020, 3:30 PM EDT)

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Many energy companies may be driven into bankruptcy because of the COVID-19 pandemic. Third parties seeking to purchase those companies' assets may be concerned about potential successor liability for the seller's environmental obligations. This article highlights some steps that asset purchasers in bankruptcy can take to reduce the risk of such liability.

Successor liability exists under each of the major federal environmental laws. Four especially important statutes for energy companies are the Comprehensive Environmental Response, Compensation and Liability Act, or CERCLA, the Resource Conservation and Recovery Act, the Clean Water Act and the Clean Air Act.

CERCLA, also known as the Superfund statute, governs the remediation of contaminated properties, imposing strict, joint and several liability on entities that have owned and operated those properties and/or the hazardous substances found at the properties. The other statutes impose various waste management, pollution control, permitting, monitoring, record-keeping and reporting requirements.

Remediation costs under CERCLA can run into the tens of millions of dollars, depending on the property at issue. Compliance costs under the other statutes can also be quite expensive. And civil penalties under each of the statutes can be draconian, in some cases exceeding $40,000 or more per day of violation.

For asset purchasers, the general rule is that they will not be liable for a seller's federal environmental liabilities unless one of the following four situations applies: (1) the purchaser assumes the liabilities, either expressly or impliedly; (2) the transaction amounts to a de facto merger; (2) the transaction is fraudulent and intended to provide an escape from liability; or (4) the purchaser is a mere continuation of the seller.[1]

Prior to 1998, some federal courts had held that federal law also allowed successor liability to be imposed under CERCLA where there was "substantial continuity" between the asset purchaser and the asset seller.[2]

The viability of that substantial continuity test was severely undermined in 1998 when the U.S. Supreme Court held, in U.S. v. Bestfoods Inc., that nothing in CERCLA did away with fundamental principles of corporate law and that for a federal statute to abrogate fundamental common law principles the statute must speak directly to the question addressed by common law.[3]

Indeed, in the wake of the Bestfoods decision, no federal circuit court has endorsed the substantial continuity test in the environmental context and at least three circuit courts have refused to apply the test.[4] The modern trend clearly is to reject the test for federal environmental matters.[5]

Asset purchase agreements can often be drafted to avoid each of the situations described

above. In addition, bankruptcy proceedings provide an opportunity to seek additional protections for asset purchasers.

Most importantly, the bankruptcy process provides an opportunity for the parties to request that the court enter certain successor liability-related factual findings and legal conclusions. Such findings can be entered in the context of sales pursuant to Bankruptcy Code Section 363 and sales pursuant to a confirmed Chapter 11 liquidation plan.

Specific bankruptcy court findings that purchasers may want to request include, among others, that: (1) the purchaser is not a successor to the debtor; (2) that the sale is not a de facto merger or consolidation of the debtor and the purchaser; (3) the purchaser's business is not a mere continuation or substantial continuation of the debtor's businesses; and (4) the purchaser is entering into the sale in good faith and not for the purpose of avoiding the debtor's liabilities.

Purchasers can support each finding by negotiating with the seller at arm's-length and/or by participating in an auction sale; by ensuring that they are distinct entities from the seller — in terms of incorporators, owners and managers; and by not presenting themselves as a continuation of the seller's business. Purchasers may also seek additional protections, such as language indicating that the purchaser is relying on the court's determination that it is not a successor.

But perhaps the most important thing to understand about environmental liabilities in asset transactions is that even where the purchaser is not the seller's successor, the purchaser will still be responsible for environmental compliance going forward.

Thus, even where there is no risk at all of being deemed a successor entity, purchasers need to understand and address any potential environmental issues at the properties or facilities they are acquiring.

With certain limited exceptions, CERCLA imposes strict liability on the current owners and operators of contaminated property, even if they did not cause the contamination. Likewise, while the new owner of a drilling operation, a pipeline or an energy storage facility may not be liable for a prior owner's past environmental violations, the new owner will be responsible for ensuring compliance going forward.

Thus, purchasers need to understand what environmental issues exist with respect to the assets they are acquiring. Purchasers can do that by conducting thorough environmental diligence prior to the acquisition, including retaining an environmental consultant to perform phase one environmental site assessments for all properties, and regulatory compliance evaluations for any facilities being acquired.

Where a purchaser is acquiring contaminated property, one other step a purchaser can take to is to request a finding by the bankruptcy court that the purchaser has conducted "all appropriate inquiries" under CERCLA prior to the acquisition and is not affiliated with any party that is potentially responsible for contamination at the site.

Such findings will not excuse the purchaser from its own environmental compliance obligations going forward — including the obligation to properly manage any existing contamination — but they can help the purchaser secure certain legal protections under CERCLA, mitigating the risk that the purchaser will be held financially responsible for past contamination.

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[1] See United States v. General Battery Corp., Inc., 423 F.3d 294, 298-305 (3d Cir. 2005) (explaining that the general rule in most states and under federal law is that there is no successor liability for the asset purchaser unless one of those situations applies).

[2] See United States v. Carolina Transformer Co., 978 F.2d 832, 838 (4th Cir. 1992); United States v. Mexico Feed & Seed Co., 980 F.2d 478, 490 (8th Cir. 1992); B.F. Goodrich v. Betkoski, 99 F.3d 505, 519 (2d Cir. 1996).

[3] United States v. Bestfoods, Inc., 524 U.S. 51 (1998)

[4] See United States v. Davis, 201 F.3d 1, 53-54 (1st Cir. 2001) (holding that Connecticut's "mere continuation" test was the proper test to apply in the CERCLA context, not the federal "substantial continuity" test adopted by some pre-Bestfoods federal courts); New York v. National Serv. Indus., Inc., 352 F.3d 682, 683-87 (2d Cir. 2003) ("We agree that, after Bestfoods, the substantial continuity test cannot be applied to determine successor liability under CERCLA."); United States v. General Battery Corp., Inc., 423 F.3d at 309 (3d Cir. 2005) (holding that the "substantial continuity" test is not available under CERCLA because CERCLA does not abrogate fundamental common law principles).

[5] See, e.g., Dixon Lumber Co., Inc. v. Austinville Limestone Co., Inc., 256 F. Supp. 3d 658, 677 (W.D.Va. June 9, 2017) (predicting that the Fourth Circuit would no longer apply the test after Bestfoods).