

1984

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### Recommended Citation

Douglas G. Baird & Thomas H. Jackson, "Kovacs and Toxic Wastes in Bankruptcy," 36 Stanford Law Review 1199 (1984).

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# COMMENT

## *Kovacs* and Toxic Wastes in Bankruptcy

Douglas G. Baird\*  
Thomas H. Jackson\*\*

During the 1970's, William Lee Kovacs operated Chem-Dyne Corporation, an industrial and hazardous waste disposal business in Hamilton, Ohio. In 1976, Ohio's Environmental Protection Agency and Department of Natural Resources charged Kovacs and Chem-Dyne with polluting Ohio waters with pesticides and industrial wastes. In 1979, a state court enjoined Kovacs from causing further pollution and also required him to remove all industrial wastes from the premises of Chem-Dyne within twelve months. Kovacs did not comply with the injunction and continued to dump wastes on the site.<sup>1</sup> In 1980, Kovacs filed a bankruptcy petition. The Sixth Circuit subsequently held that Kovacs' obligation to clean up the toxic wastes gave rise to a "claim" within the meaning of the Bankruptcy Code and could be discharged.<sup>2</sup> The Supreme Court granted certiorari, and will decide the case during the October 1984 Term.

A number of businesses that have violated state and federal anti-pollution statutes by dumping toxic wastes have filed bankruptcy petitions.<sup>3</sup> *Kovacs*, however, is unusual because the debtor is an individ-

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1. Appendix to Petitioner's Brief at A53-A54, *Ohio v. Kovacs*, 104 S. Ct. 1438 (U.S. cert. granted Mar. 5, 1984).

2. *In re Kovacs*, 717 F.2d 984 (6th Cir. 1983), cert. granted sub. nom. *Ohio v. Kovacs*, 104 S. Ct. 1438 (1984). The definition of "claim" is contained in 11 U.S.C. § 101(4) (1982).

3. See, e.g., *In re Quanta Resources Corp.*, 739 F.2d 912 (3d Cir. 1984); *Penn Terra Ltd. v. Department of Env'tl. Resources*, 733 F.2d 267 (3d Cir. 1984). These cases have usually raised the question of whether orders of state courts that required a petitioner to remedy environmental damage are stayed during the pendency of the bankruptcy proceeding because of 11 U.S.C. § 362(a) (1982), amended by Act of July 10, 1984, Pub. L. No. 98-353, § 441, 98 Stat. 333, 371 (1984). The proper analysis of these cases is quite straightforward. To the

ual, rather than a corporation. Perhaps because of that fact, the litigants have missed the issues common to both *Kovacs* and other toxic waste cases in bankruptcy. *Kovacs* presents two distinct questions, the first of which applies to every debtor in bankruptcy that has dumped toxic wastes, and the second of which applies only to individuals such as Kovacs. The first question focuses on the status in bankruptcy of any rights that the state or federal government has against a debtor's existing assets to enforce environmental clean-up orders. The second question asks whether an individual's right to a discharge of pre-bankruptcy obligations, and hence to enjoy his future earnings, includes a right to be relieved of a duty to clean up toxic wastes. No one involved in the *Kovacs* litigation has yet separated the two issues or properly identified how either should be approached.

Neither question, however, is concerned with whether Kovacs—or Chem-Dyne—must comply with the environmental laws of Ohio with respect to future operations. They, like everyone else in Ohio, must comply with those environmental laws as long as they stay in business. Debtors in bankruptcy have—and should have—no greater license to pollute in violation of a statute than they have to sell cocaine in violation of a statute. At issue in *Kovacs* is the obligation of Kovacs and Chem-Dyne to pay for the clean-up of *pre-bankruptcy* violations of Ohio's environmental laws. The case should not turn on a dispute, which has been dominating the *Kovacs* case, over whether that obligation is a "claim" or a "debt." Ohio has a right to Kovacs' existing assets in bankruptcy if, but only if, it has a "claim" against him within the meaning of the Bankruptcy Code.<sup>4</sup> Because the obligation Kovacs owes Ohio arises out of his past conduct, Ohio should be entitled to share in Kovacs' existing assets, along with other creditors, to satisfy that obligation.<sup>5</sup> The more difficult question, and one

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extent that the state court is policing a debtor's ongoing operations and forcing it to comply with existing law, nothing in the Bankruptcy Code should stay its actions. To the extent the state court order enforces a claim against the debtor for misbehavior arising before the filing of the petition, the order should be stayed. Compare 11 U.S.C. § 362(b)(4) (1982) (exception from stay for governmental actions or proceedings) with *id.* § 362(b)(5) (exception from stay for enforcement of judgments, other than monetary judgments, by governmental units).

4. 11 U.S.C. § 101(4) (1982).

5. See Jackson, *Translating Assets and Liabilities to the Bankruptcy Forum*, 14 J. LEGAL STUD. 73 (1985). For that reason, the Sixth Circuit is correct, insofar as it goes. But the Sixth Circuit's opinion does not discuss—and the parties did not seem to raise—the two crucial questions: first, the *priority* of Ohio's claim in Kovacs' assets; see notes 16–21, 33 *infra* and accompanying text; second, whether any of the exceptions to discharge in 11 U.S.C. § 523 (1982) apply. See notes 44–47 *infra* and accompanying text. The Sixth Circuit did note that

that will arise in cases involving both individuals and corporations, concerns the nature and priority of the rights associated with enforcing that obligation against the debtor's assets relative to the rights of other claimants.

To say that a claim is "dischargeable" does not mean that the associated obligation will be "wholly excused."<sup>6</sup> It only means that Ohio may not be able to reach an individual polluter's post-bankruptcy earnings. The failure of all involved in *Kovacs* to comprehend the difference between a right to existing assets and a right, in the case of individuals, to future earnings, suggests that only mischief may result from the Supreme Court's pending decision. If the Supreme Court limits its focus and conflates the issues as all the litigants, including the Solicitor General, have done,<sup>7</sup> it may throw important and previously well-understood bankruptcy doctrine into confusion.

### I. STATE LAW AND ITS RELATION TO FEDERAL BANKRUPTCY LAW

Before we even look at bankruptcy law, we should understand the state-law consequences of owing an obligation to clean up wastes. To do this, we begin with the simple case of a corporation. Assume that Debtor, a corporation, owns land on which it has dumped toxic

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the question of dischargeability under 11 U.S.C. § 523 (1982) had not been raised. *In re Kovacs*, 717 F.2d at 988.

6. See Brief for the United States as Amicus Curiae Supporting Petitioner at 7, *Ohio v. Kovacs*, 104 S. Ct. 1438 (U.S. cert. granted Mar. 5, 1984). ("The consequence [of the Sixth Circuit decision] is that a preexisting obligation to clean up a hazardous waste disposal site. . . has been wholly excused."). While this points out, correctly, that the obligation arose prebankruptcy, it badly misstates the effect of declaring something to be a "claim" cognizable in bankruptcy. See text accompanying notes 16-42 *infra*.

7. The amicus brief of the Solicitor General of the United States, for example, casts its disagreement with the Sixth Circuit as follows:

By encouraging abuse of the Bankruptcy Code to void obligations under state and federal environmental laws, the decision below flouts Congress's express intent to preserve the ability of governmental units to protect public health, safety, and the environment. Indeed, the decision effectively destroys the government's ability to enforce any statutory obligation—whether it be a regulation, permit, or clean-up injunction—against any bankrupt if compliance entails any expense by the debtor or its estate. This result finds no support in the Bankruptcy Code. The Code does not shield wrongdoers from all consequences of their actions; there is no fundamental or inalienable right to obtain a discharge in bankruptcy at the expense of the legislatively declared right of the public to be safe from environmental pollution. Brief for the United States as Amicus Curiae Supporting Petitioner, *Ohio v. Kovacs*, 104 S. Ct. 1438 (U.S. cert. granted Mar. 5, 1984). As we shall show, this approach fails to separate the question of what is a claim from the question of the priority of that claim relative to other claims. See text accompanying notes 10-47 *infra*.

wastes in violation of state law. Along with the land, which is worthless, Debtor has \$500,000 in assets. At the request of State, a court has previously enjoined Debtor from dumping any more wastes on its land and has required Debtor to file regular reports on the toxic materials that it handles each month. In addition, the court has ordered Debtor to clean up the wastes that are already there. The clean-up will cost \$400,000. Debtor also owes \$600,000 to a number of general creditors.<sup>8</sup>

#### A. *Dissolving Under State Law*

The obligation that Debtor owes to State to clean up the toxic wastes that it dumped in the past is always, in a sense, “dischargeable”—not because of anything bankruptcy law says or does, and, indeed, independent of whether the corporation ever resorts to bankruptcy—because corporations have the privilege of dissolving under state law. State law permits individuals to create corporations with limited liability. When the obligations of a corporation exceed its ability to meet them, some of those obligations will not be met. As a consequence, once the assets of Debtor are exhausted and the corporation is dissolved, if Debtor did not have enough assets to pay for its debts in full, those with rights against it, such as State, have nowhere else to turn to enforce their rights.<sup>9</sup> This result is dictated by limited liability, not bankruptcy.

#### B. *Claims in Bankruptcy*

To counter Kovacs’ argument that his obligation is a “claim” that is discharged in bankruptcy, Ohio and the United States are asserting that Kovacs’ obligation is not a “claim” within the meaning of the Bankruptcy Code at all, and hence cannot be extinguished.<sup>10</sup>

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8. Claims may arise from a variety of prebankruptcy activities of Debtor, and other claimants are not necessarily less deserving than State. The creditors might include, for example, a tort claimant who contracted cancer because of Debtor’s conduct involving the toxic waste site.

9. This would not be true if a statute imposed liability on shareholders, officers, or directors, or if the shareholders have acted in a way that would permit piercing of the corporate veil. State and federal governments are also free to impose licensing and bonding requirements on anyone who handles toxic wastes.

10. The United States, for example, criticizes the Sixth Circuit for “propounding an expansive definition of ‘money judgment’. . . [which] eviscerated the difference between a dischargeable right to payment for a breach of performance and a non-dischargeable right to enforce an injunction that entails the expenditure of money.” Brief for the United States as Amicus Curiae Supporting Petitioner at 7, *Ohio v. Kovacs*, 104 S. Ct. 1438 (U.S. cert. granted Mar. 5, 1984). In the view of the United States, a “clean-up injunction. . . . does not redress

But this argument is perverse. Neither Ohio nor the United States appears to have thought about how its interpretation of the Bankruptcy Code would apply to the more typical case of a corporate polluter. The definition of "claim" in the Bankruptcy Code does not depend on whether the debtor is an individual or a corporation. If Kovacs' obligation to clean up wastes is not a claim for purposes of bankruptcy, neither is the obligation of our Debtor corporation.

If that is so, however, then State will not share in any of Debtor's assets when they are distributed in bankruptcy. In a Chapter 7 liquidation proceeding, after the assets are sold, the proceeds are distributed first to recognized property claimants<sup>11</sup> and then as specified in section 726 of the Bankruptcy Code. Section 726, however, speaks only of payments on "claims."<sup>12</sup> If the United States is correct in asserting that Kovacs' obligation to Ohio is not a claim, then only the general creditors who are owed \$600,000 will share in the proceeds. They will receive the entire \$500,000 fetched by the sale of Debtor's assets to account for those claims and State will receive nothing in bankruptcy. Corporations receive no discharge in Chapter 7,<sup>13</sup> but it makes no difference whether they do or not. After the bankruptcy distribution, the obligation of Debtor to clean up the toxic wastes is not enforceable as a practical matter because Debtor will have no assets and, in any event, the obligation will disappear when Debtor dissolves under state law, after the bankruptcy proceeding. Because Debtor's assets will all have been paid out to holders of *claims*, if State has no "claim," it will receive none of Debtor's assets if Debtor runs through bankruptcy before dissolving. This result, we contend, is absurd. Had Debtor dissolved under state law without resorting to bankruptcy, State would have received its share of Debtor's assets on account of Debtor's obligation to clean the toxic waste site. Bankruptcy law should not be interpreted to upset such state entitlements.

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a breach of performance, nor does it operate as an alternative to a right of payment," *id.* at 17, and hence, is not a "debt" or a "claim" under 11 U.S.C. §§ 101(11) and (4) (1982), respectively.

11. 11 U.S.C. § 725 (1982) provides:

After the commencement of a case under this chapter, but before final distribution under section 726 of this title, the trustee, after notice and a hearing, shall dispose of any property in which an entity other than the estate has an interest, such as a lien, and that has not been disposed of under another section of this title.

12. The relevant portion is 11 U.S.C. § 726(a)(2) (1982). All of the categories in subsections (a)(1) through (a)(5), however, refer to "claims." Only (a)(6), providing for the excess (if any) to be returned "to the debtor," does not refer to a payment on claims.

13. *See* 11 U.S.C. § 727(a)(1) (1982).

To be sure, it is possible to read the definition of "claim" in the Bankruptcy Code to support the argument of Ohio and the United States in *Kovacs*. One can argue that an obligation to clean up toxic wastes is neither "a right to payment" nor "an equitable remedy for breach of performance," breach of which gives rise to a right to payment.<sup>14</sup> This argument, however, is mindlessly literal and, as described above, such a narrow reading of "claim" upsets the order of entitlements that existed outside of bankruptcy to the detriment of the very groups that Ohio and the United States wish to help in the ordinary cases in which the polluter is a corporation.

There is a distinction that the drafters of the Bankruptcy Code were trying to capture (albeit somewhat inartfully) in their definition of "claim." Excluding some forms of equitable relief from the definition of "claim" makes sense if one considers its role as one of distinguishing two kinds of obligations: those obligations of a debtor that result from activities engaged in before the filing of the petition and whose consequences *continue* to exist even if the debtor goes out of business or dies the moment that the bankruptcy petition is filed, and those obligations that arise because of the debtor's continued existence and that would disappear if the debtor were to cease operations or die.<sup>15</sup>

An order to clean up toxic wastes that already have been deposited is a "claim" because the equitable remedy arises out of a pre-petition action by Debtor the consequences of which do not depend upon Debtor's continued existence. By contrast, an injunction to cease polluting, such as State issued against Debtor, is not a claim within the meaning of the Bankruptcy Code because it is directed at Debtor's future operations. If Debtor ceases to exist, the injunction has no meaning because there will be no further pollution by Debtor. The order that Debtor provide monthly reports on its operations would not be a claim in bankruptcy either. Even though the order is

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14. 11 U.S.C. § 101(4) (1982) provides that:

"[C]laim" means—

(A) right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured; or (B) right to an equitable remedy for breach of performance if such breach gives rise to a right to payment, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured . . . .

15. See Jackson, *supra* note 5. Courts persistently fail to see this simple point. See *In re M. Frenville Co.*, 744 F.2d 332 (3d Cir. 1984) (although acts that led to suit for indemnification against debtor occurred pre-bankruptcy, § 362(a) did not stay indemnification suit because liability was not a claim within § 101(4), as it did not arise pre-petition).

a result of past conduct, and has a monetary value (one can calculate the costs of compliance), it is not a "claim" because it is tied to Debtor's future operations. If Debtor ceases operation, its need to file monthly reports also ends.

### C. *The Status of Obligations Within Bankruptcy Law*

The more difficult question in our example, which has been obscured in *Kovacs* by the focus on the meaning of the word "claim," is the *status* of the obligation that Debtor owes State to clean up the toxic waste site. Again, we must look first at how non-bankruptcy law would treat the right of State to use Debtor's assets to enforce that obligation relative to the rights of other claimants to use those assets to enforce obligations owed to them by Debtor. Holders of claims do not always share equally under non-bankruptcy law, and bankruptcy law, which is largely procedural, generally respects the different attributes of state law claims as long as doing so is not inconsistent with the goals of the bankruptcy process.<sup>16</sup> As the Supreme Court noted in *Butner v. United States*:

Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding. Uniform treatment of property interests by both state and federal courts within a State serves to reduce uncertainty, to discourage forum shopping, and to prevent a party from receiving "a windfall merely by reason of the happenstance of bankruptcy."<sup>17</sup>

For example, if a "claim" is secured, or is the subject of a statutory lien or a statutory trust, that claim is entitled to be paid first in bankruptcy out of the associated assets.<sup>18</sup> If such a claim is not paid in bankruptcy, the "lien" given by statute or the secured contract will "pass through" bankruptcy and be enforceable against the debtor's pre-bankruptcy property, regardless of who now owns that property

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16. See *In re M. Frenville Co.*, 744 F.2d at 337. This respect is not accorded to state laws that have effect *only* in bankruptcy, *i.e.* state-created priorities and spurious statutory liens. See 11 U.S.C. § 545 (1982). But if the property interest (whether labeled a lien or not), is effective against competing claimants both in and out of bankruptcy, no provision of the Bankruptcy Code and no bankruptcy policy invalidates the interest. See *In re Anchorage Int'l Inn, Inc.*, 718 F.2d 1446, 1452 (9th Cir. 1983); *In re Telemart Enterprises*, 524 F.2d 761, 765-66 (9th Cir. 1975); Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, 91 YALE L.J. 857, 903 (1982).

17. 440 U.S. 48, 55 (1979) (quoting *Lewis v. Manufacturers Nat'l Bank*, 364 U.S. 603, 609 (1961)).

18. 11 U.S.C. § 725 (1982). The question is one of effect, not labels. See text accompanying notes 21-33 *infra*.



and notwithstanding that the underlying debt itself was discharged. This doctrine, which was established by the Supreme Court in *Long v. Bullard*,<sup>19</sup> remains in the current Bankruptcy Code.<sup>20</sup>

Obscured in *Kovacs*, then, is the key issue: the "priority" of State's claim against Debtor's property relative to the claims of holders of other pre-petition obligations.<sup>21</sup> The priority of a claim may result not only from consensual security interests, statutory liens, or statutory trusts—all cases of which are, or should be, uncontroversial—but also from the entitlements of a particular claimant under state law. In other words, the priority of a particular claim may be inherent in restrictions placed by the state on the use of the property in dispute.

The seminal case that shows how bankruptcy law should respond to the attributes of property when evaluating rights among claimants, and not to state (or bankruptcy) labels, is *Chicago Board of Trade v. Johnson*.<sup>22</sup> In that case, the general creditors claimed the right to the proceeds from the sale of the bankrupt's seat on the Chicago Board of Trade. Notwithstanding that, under the Board's by-laws, a member could not sell his seat over the objection of another member unless and until all debts owed by the member to other members were paid in full, the District Court and the Seventh Circuit<sup>23</sup> had concluded that the seat was "property" and passed to the trustee in bankruptcy free of all claims of the members and, accordingly, could be sold for the benefit of the general creditors.

The Supreme Court reversed. Even though the other Board members did not enjoy the right "to compel sale or other disposition

19. 117 U.S. 617 (1886).

20. The language of 11 U.S.C. § 524(a)(2) (1982), as originally enacted in 1978, was not crystal-clear on this point, but the legislative history noted that *Long v. Bullard* remained good law. See H.R. REP. NO. 595, 95th Cong., 1st Sess. 361, reprinted in 1978 U.S. CODE CONG. & AD. NEWS 6317, 6317 ("The bankruptcy discharge will not prevent enforcement of valid liens. The rule of *Long v. Bullard* . . . is accepted with respect to the enforcement of valid liens on nonexempt property as well as on exempt property."). The courts have generally adopted this view. See, e.g., *In re Weathers*, 15 Bankr. 945 (Bankr. D. Kan. 1981). The technical amendments of the Bankruptcy Amendments and Federal Judgeship Act of 1984, which struck the phrase "or from property of the debtor" from 11 U.S.C. § 524(a)(2) (1982), should remove any remaining doubt about the validity of lien pass-through doctrine. See Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, § 308(a), 1984 U.S. CODE CONG. & AD. NEWS (98 Stat.) 333, 354 (to be codified at 11 U.S.C. § 524(a)(2)).

21. See *In re Quanta Resources Corp.*, 739 F.2d 912, 923 (3d Cir. 1984) (Gibbons, J., dissenting). The word "priority" is used in the text in its generic sense, not in its specific bankruptcy sense, where it refers only to priority among unsecured creditors. See 11 U.S.C. § 507 (1982).

22. 264 U.S. 1 (1924).

23. *Chicago Bd. of Trade v. Johnson*, 283 F. 374 (7th Cir. 1922), *rev'd*, 264 U.S. 1 (1924).

of memberships to pay debts,"<sup>24</sup> the Supreme Court did not think that this made "a real difference in the character of the property which the member has in his seat."<sup>25</sup> The "property" involved—the membership—was defined by the organization granting it, the Chicago Board of Trade, so as to carry with it a limitation on its value to the bankrupt (and his general creditors): Debts to other members had to be satisfied before the membership could be sold and its value could benefit the remaining claimants. This restriction on alienation had led the Illinois Supreme Court, in a prior case, to deem that such memberships were not "property" for the purposes of State law,<sup>26</sup> but the Supreme Court properly noted that the question for purposes of determining what was "property" under federal bankruptcy law was not what Illinois *called* something, but, rather, what its attributes were.<sup>27</sup> The Supreme Court concluded that so viewed, the membership had the attributes of "property" for purposes of bankruptcy.<sup>28</sup> One of those attributes, however, was that a member could not sell the property unless and until all debts to other members were paid. Noting that this right that the other members had was "in some respects similar to the typical lien of the common law,"<sup>29</sup> the Court stated that "[t]he lien, if it can be called such, is inherent in the property in its creation, and it can be asserted at any time before actual transfer . . ."<sup>30</sup> For that reason, the Court reversed the Seventh Circuit and held that the claims of the members of the Chicago Board of Trade had to be satisfied before the trustee could include the proceeds of the transfer of the seat in the general estate.<sup>31</sup>

The principle announced in *Chicago Board of Trade* is a fixed feature of bankruptcy law, and complements the admonition in *Butner v. United States* that property rights are created and defined by state law and should be followed in bankruptcy unless the bankruptcy statute clearly directs otherwise.<sup>32</sup> This principle has direct application to *Kovacs*. *If* (and the issue remains unexplored by any of the courts in

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24. 264 U.S. at 8.

25. *Id.* at 11.

26. *Barclay v. Smith*, 107 Ill. 349 (1883).

27. *See* 264 U.S. at 10-11.

28. *Id.* at 14.

29. *Id.* at 11.

30. *Id.* at 15.

31. *Id.*

32. *See, e.g., In re Anchorage Int'l Inn, Inc.*, 718 F.2d 1446 (9th Cir. 1983) (provision of state statute requiring liquor-related debts to be paid before transfer of liquor license would be approved was tantamount to a "lien" in the license, and would be recognized in bankruptcy).

*Kovacs*) the obligation that Kovacs owes to Ohio is tantamount to a restriction on the value of all (or some) of the property to its owner or to entities that assert claims through that owner, then the case is like *Chicago Board of Trade*. In that instance, the State of Ohio would be entitled to be paid first, in bankruptcy, from Kovacs' assets before Kovacs' other creditors could receive anything.<sup>33</sup> And if the assets were not used to satisfy first the obligation to Ohio, it would also follow from the analysis of *Chicago Board of Trade* that the "lien" of the state would pass through bankruptcy under the doctrine of *Long v. Bullard* and would thus be enforceable against any owner of the assets, notwithstanding that the underlying debt was discharged.

## II. ANALYSIS UNDER BANKRUPTCY AND STATE LAW

### A. *The Corporate Debtor*

Returning to the corporate example with which we began, if Debtor's obligation to clean up hazardous wastes were a general claim against assets like those of other creditors, the assets, in a Chapter 7 case, would be sold for \$500,000, free of all claims against them, and the proceeds would be distributed pro rata to all the claimants, including State.<sup>34</sup> Since there are \$1 million of such claims, State would recover one half of the cost of cleaning up the toxic wastes. Debtor, which would have no remaining assets, could then dissolve under state law. If, instead of liquidating under Chapter 7, Debtor filed a Chapter 11 petition and continued as a going concern, all of its past obligations would be discharged.<sup>35</sup> In the absence of consent to a different arrangement, ownership interests in the reorganized corporation would be divided among the creditors, including State, according to the size of their claims.<sup>36</sup> Assuming that the corporation has assets worth \$500,000 as a going concern, State would again receive assets worth 50 percent of its \$400,000 claim and the sharehold-

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33. 11 U.S.C. § 725 (1982). See note 11 *supra* and accompanying text.

34. 11 U.S.C. § 726(b) (1982).

35. *Id.* § 1141. This result is different from the case of a corporation that liquidates under Chapter 7 where discharge is not available. See note 13 *supra* and accompanying text. Under Chapter 7, the claims will be effectively "discharged" when the corporation dissolves under state law. In contrast, in a Chapter 11 reorganization, the corporation continues, so bankruptcy law provides the equivalent to the "discharge" otherwise achieved by dissolution. This discharge is sensible; it allows existing claimants (including, of course, State) to choose the path that maximizes the value of the assets, ex liabilities, to them. See Baird & Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. CHI. L. REV. 97, 110 n.45 (1984).

36. 11 U.S.C. § 1129(b) (1982).

ers would receive nothing. An injunction against Debtor to stop polluting and to file regular reports would remain effective unless, under applicable non-bankruptcy law, the change in ownership (and perhaps management) was radical enough to enable Debtor to persuade the court to lift the injunction. In its ongoing operations, Debtor would, as always, remain bound to obey all state and federal environmental laws.

If State's claim were a charge upon Debtor's assets analogous to a statutory lien or the restriction in *Chicago Board of Trade*, the analysis would be equally straightforward. If Debtor were to dissolve under state law, without resorting to bankruptcy, the assets would be sold for \$500,000. Unlike before, however, State would be entitled to payment on its \$400,000 claim first, because of its "lien," and the other creditors would share in the remaining \$100,000 of assets pro rata among their \$600,000 of unsecured claims.<sup>37</sup> As before, at the conclusion of this process, Debtor would dissolve. Because State was paid in full, it would have no remaining claim to pursue with the buyers of the assets. And the unsecured creditors, although not paid in full, again would have no one to pursue. Their claims are effectively discharged, as before, because of the state law dissolution.

There should be, as a matter of policy, no change in substantive entitlements should Debtor use bankruptcy. In a liquidation under Chapter 7, State, as a secured creditor, must be satisfied in full out of the assets before anyone else is entitled to anything.<sup>38</sup> In a Chapter 11 reorganization, State, unless it agreed to different treatment, must receive a package of rights worth the full \$400,000 before anyone else is entitled to anything. After receiving that package of rights, its claim would be discharged.<sup>39</sup>

If for some reason (such as that neither State nor anyone else filed a claim) State received nothing in Debtor's bankruptcy, the obligation of Debtor to State would remain the same as under bankruptcy law. In a Chapter 7 proceeding, State would receive nothing in bankruptcy's distribution of assets (since it did not file a claim), but the purchaser of Debtor's assets would continue to be subject to the obligation to State, because that obligation effectively was secured.<sup>40</sup>

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37. See notes 11 & 34 *supra* and accompanying text.

38. See note 11 *supra* and accompanying text.

39. 11 U.S.C. §§ 1129(a)(7), (b)(2)(A), 1141 (1982).

40. Secured claims under Article 9 of the Uniform Commercial Code continue, notwithstanding sale. U.C.C. § 9-306(2) (1978). Whether State's claim continued would actually depend on State's law regarding liens of the kind that State enjoyed; the text assumes that the treatment is tantamount to an Article 9 security interest.

For that reason, a purchaser (assuming it knew of the obligation) would pay only \$100,000 for the assets, and State could eventually collect its \$400,000 out of those assets. But it could not sue Debtor once Debtor dissolved under state law, because, again, Debtor would have ceased to exist. The effect of this is that State could pursue its collateral, but not Debtor. The same result would occur in a Chapter 11 proceeding. State's claim against Debtor would be discharged whether or not it was listed by Debtor as a creditor or had filed a proof of claim form.<sup>41</sup> But if State, for that reason, received nothing in the Chapter 11 proceeding, State could still pursue Debtor's assets, in an *in rem* action. Although *debts* are discharged in bankruptcy, *liens* are not.<sup>42</sup>

### B. *The Individual Debtor*

Up to this point, we have been looking at the issue in *Kovacs* by examining a corporate debtor. Nothing essential to this discussion changes when the debtor is an individual. While corporations enjoy limited liability under state law, individuals have a discharge right only through use of the bankruptcy process. The justification, however, for this right—the need to give individual debtors a fresh start<sup>43</sup>—is different from the justification for limited liability corporations, and the discharge right has different consequences.

A corporation must give up all of its assets to creditors when it dissolves, but an individual who receives a bankruptcy discharge is usually entitled to keep one of his most valuable assets: his future earnings. At the end of a liquidation proceeding (and subsequent dissolution), a corporation is stripped of assets and ceases to exist. Hence having an enforceable right—a nondischargeable right—against it following such procedures is meaningless. By contrast, one can talk about nondischargeable debts against an individual, because an individual is allowed to keep an asset and he continues to exist after the bankruptcy proceeding is over.

When a debtor is an individual using bankruptcy, one must ask three questions: first, whether someone has a right against the individual's existing assets; second, what priority that right has relative to others; and, finally, whether, contrary to the general rule, the person

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41. 11 U.S.C. § 1141 (1982).

42. *Id.* § 524; *Long v. Bullard*, 117 U.S. 617 (1886); see note 20 *supra*.

43. See 11 U.S.C. § 727 (1982); *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934). The principles embodied in the "fresh start" policy are discussed in Jackson, *The Fresh Start Policy in Bankruptcy Law*, 98 HARV. L. REV. — (forthcoming 1985).

with this right can look to the debtor's future earnings. The first question revolves around the question of whether someone has a "claim"; the second around what attributes the claim has under state law; and the third around whether the claim is dischargeable. The first two questions are identical to the ones we must ask in the case of a corporation using bankruptcy. The third question, however, is unique to individuals because an individual debtor retains an asset after the bankruptcy proceeding is over. Whether Kovacs' obligation to clean up toxic wastes is dischargeable is distinct from whether that obligation gives rise to a "claim" and from whether that claim gives Ohio priority over others to Kovacs' existing assets.

Under current law, whether Kovacs' obligation is dischargeable in a Chapter 7 proceeding is a narrow question of whether that obligation falls within one of the exceptions laid out in section 523 of the Bankruptcy Code. Examples of nondischargeable obligations include tax obligations, federally backed student loans, and alimony payments.<sup>44</sup> Kovacs' obligations to Ohio are not dischargeable if his actions amounted to "willful and malicious injury . . . to another entity or to the property of another entity."<sup>45</sup> The applicability of this provision to *Kovacs* is uncertain,<sup>46</sup> but this issue, not whether Ohio has a "claim," should be, but has not been, the focus of the bankruptcy litigation. If the obligation does not fall into any of the exemptions from discharge, it should not ultimately matter whether the debtor is an individual or a corporation. If the obligation does not fall within section 523 as it is presently written and if, as a matter of bankruptcy policy, it should, this section of the Bankruptcy Code ought to be amended.<sup>47</sup> Trying to reach the same result by distorting

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44. 11 U.S.C. § 523(a)(1), (5), (8) (1982). Section 523 was amended in 1984 and an exception to discharge was added for liabilities incurred from a judgment or consent decree entered against a debtor as a result of the debtor's operation of a motor vehicle while legally intoxicated. See Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, § 371, 1984 U.S. CODE CONG. & AD. NEWS (98 Stat.) 333, 364 (to be codified at 11 U.S.C. § 523(a)(9)).

45. 11 U.S.C. § 523(a)(6) (1982).

46. The state court found that Kovacs had acted "in flagrant disregard of the Stipulation and Judgment Decree." Appendix to Petitioner's Brief at A54, *Ohio v. Kovacs*, 104 S. Ct. 1438 (U.S. cert. granted Mar. 5, 1984). Even if Kovacs' actions were "willful and malicious," there is a question of whether the resulting debt to Ohio reflects harm to another entity or the property of another entity, as 11 U.S.C. § 523(a)(6) (1982) requires. Assuming that Ohio's environmental laws are designed to protect the health and welfare of its citizens, it may not be too difficult to conclude that Kovacs' actions harmed other entities or that the debt to Ohio is sufficiently related to that harm to fall within section 523(a)(6).

47. Any such amendment of 11 U.S.C. § 523 (1982) would, of course, not affect cases of debtors that are corporations.

other sections of the Bankruptcy Code will thwart the operation of bankruptcy policy in too many other cases, such as cases in which a polluter is a corporation.

### III. CONCLUSION

The threshold question in *Kovacs* should be not whether the obligation to Ohio is a nonexempt claim and thus dischargeable but, rather, what state law says about Ohio's right to pursue that obligation against Kovacs' assets relative to the rights of Kovacs' other pre-petition creditors. If, *under Ohio law*, the right is tantamount to an unsecured obligation, then the State of Ohio should share in the property of the estate pro rata with Kovacs' other unsecured creditors in the property of the estate.<sup>48</sup> But if, *under Ohio law*, the right of Ohio to enforce the clean-up order is tantamount to a security interest in Kovacs' assets, then Ohio is entitled to have that obligation satisfied *first* in any bankruptcy distribution of the estate's property. To the extent that it is not satisfied, that obligation attaches to the (nonexempt) assets, whether sold by the trustee or kept by Kovacs, because of the doctrine of lien pass-through. That is true whether state law characterizes the obligation as secured, or the subject of a statutory lien or a statutory trust.<sup>49</sup>

The failure to appreciate these issues in *Kovacs* has led to the erroneous assumption that a reversal of the Sixth Circuit is needed to ensure that a state can make polluters pay for dumping toxic wastes. To the contrary, a reversal of *Kovacs* by the Supreme Court would prevent states from reaching a debtor's assets in the more typical case in which the debtor is a corporation. Freeing Kovacs from financial responsibility for wreaking havoc on the environment may be ill-advised, but one cannot reach this conclusion without first squarely addressing the policies in the "fresh start" policy of the Bankruptcy Code.<sup>50</sup> That issue, as well as the general question of what the status

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48. Because the obligation gives rise to a "claim," Ohio would be entitled to share in the bankruptcy distribution under 11 U.S.C. § 726 (1982), regardless of whether 11 U.S.C. § 523(a)(6) (1982) exempts the claim from discharge.

49. See text accompanying notes 16-33 *supra*.

50. Nothing in the "fresh start" policy of the Bankruptcy Code, for example, seems to free an individual such as Kovacs from punishment under the criminal law. There is a line of cases that suggests that, even though not specifically listed among the exemptions to discharge, a convicted criminal's obligation to make restitution to his victim is not discharged in bankruptcy. *E.g.*, *United States v. Carson*, 669 F.2d 216 (5th Cir. 1982); *In re Magnifico*, 21 Bankr. 800 (Bankr. D. Ariz. 1982). To the extent that claims in these cases do not fit within the definition of "willful and malicious injury" to persons or property, 11 U.S.C. § 523(a)(6) (1982), or amount to "fraud or defalcation while acting in a fiduciary capacity, embezzle-

of Ohio's rights relative to competing claimants to Kovacs' assets is (or should be), are properly the subjects of debate. That the obligation to clean up toxic wastes is a "claim" in bankruptcy, however, should not be.

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ment, or larceny," *id.* § 523(a)(4), these cases may be wrongly decided. *See In re Brown*, 39 Bankr. 820 (Bankr. M.D. Tenn. 1984). In any event, they rely heavily on the notion that making restitution aids in a criminal's rehabilitation, *see, e.g., United States v. Carson*, 669 F.2d at 218, an issue that does not seem to be raised in *Kovacs*.



