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# Environmental Regulation and the Bankruptcy Act

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## INTRODUCTION

Environmental agencies have recently begun to grapple with the growing problem of individuals and corporations seeking refuge under the Federal Bankruptcy Act.[1] The question of whether a bankruptcy court can and should act to enjoin a state from enforcing its environmental laws is far from settled. While it may be true that a court appointed trustee must comply with the laws of the state,[2] the role of the bankruptcy court in restraining a state enforcement action is less certain. Support can be found for the alternative propositions that (a) the bankruptcy court lacks jurisdiction to interfere with state enforcement actions,[3] (b) the bankruptcy court may possess jurisdiction but should not interfere,[4] and (c) the bankruptcy court possesses jurisdiction and should interfere.[5] The purpose of this article is to consider the potential conflicts involving the Bankruptcy Act and state regulatory programs designed to protect the environment. We will consider the ways in which the courts perceive the interface of the state regulatory authority and the Bankruptcy Act, and how this could be changed by pending legislation.

## THE BANKRUPTCY FRAMEWORK

The Bankruptcy Act arises from a specific grant of authority in the federal constitution, empowering the Congress "To establish . . . uniform laws on the subject of Bankruptcies."[6] The Act is set up under two major areas: (1) the liquidation provisions, also known

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1. The Bankruptcy Act of 1898, 30 Stat. 544-66, *as amended*, 11 U.S.C. § 1 (1970) [hereinafter referred to as the Bankruptcy Act].

2. *See* 28 U.S.C. § 959(b) (1970); Gillis v. California, 293 U.S. 62 (1934).

3. *See* In re Dolly Madison Industries, Inc., 504 F.2d 499 (3d Cir. 1974).

4. *See* In re Diversa-Graphics, 2 Bankr. Ct. Dec. 194 (S.D.N.Y. Jan. 22, 1976).

5. *See* In re Hillsdale Foundry Co., 2 Collier Bankr. Cases 546, 1 Bankr. Ct. Dec. 195 (W.D. Mich. 1974).

6. U.S. CONST. art. I, § 8, cl. 4.

as straight bankruptcy; and (2) the rehabilitation and reorganization provisions which seek to prevent outright liquidation of assets.[7]

Courts of bankruptcy, created by the Bankruptcy Act,[8] are vested with jurisdiction in law and in equity to take steps necessary to enforce the provisions of the Act.[9] In *Katchen v. Landy,*[10] the United States Supreme Court affirmed the principal that bankruptcy courts possess original jurisdiction to conduct proceedings under the Bankruptcy Act, and can exercise summary jurisdiction to adjudicate controversies relating to property over which they have actual or constructive possession.[11] Despite the clear language of *Katchen,* however, there has arisen a question as to the bankruptcy court's power under circumstances relating to the police power of a state or municipality.

## The Framework of Environmental Protection

### A. *The Police Power as a Source of the State's Authority*

Police power is the authority by which a state legislates for the public good. It is derived from the sovereignty of the state, has been held to be one of the least limitable of the governmental powers,[12] and has been upheld in a wide variety of circumstances.[13] The Supreme Court, speaking about police power, promulgated the classic test of the propriety of a legislative action: "It must appear—first, that the interests of the public require such interference; and second that the means are reasonably necessary for the accomplishment of the purpose and not unduly oppressive upon individuals."[14] The Court went on to say:

> The extent and limits of what is known as the police power have been a fruitful subject of discussion . . . . It is universally conceded to include everything essential to the public safety,

7. 1 Collier on Bankruptcy ¶ 0.01 (14th ed. 1973).
8. 11 U.S.C. § 11(a).
9. 11 U.S.C. §§ 11(a)(1); (a)(2); (a)(5); (a)(9); (a)(15); 61 and 66.
10. 382 U.S. 323 (1966).
11. *Id.* at 327.
12. *See* Queenside Hills Realty v. Saxl, 328 U.S. 80 (1946).
13. *See, e.g.,* Goldblatt v. Town of Hempstead, 369 U.S. 590 (1962); Berman v. Parker, 348 U.S. 26 (1954); Miller v. Schoene, 276 U.S. 272 (1928); Lawton v. Steele, 152 U.S. 133 (1899); Northwestern Fertilizing Co. v. Hyde Park, 97 U.S. 659 (1878); Phalen v. Virginia, 49 U.S. (14 How.) 163 (1850).
14. Lawton v. Steele, 152 U.S. 133, 137 (1894).

> health, and morals, and to justify the destruction or abatement, by summary proceedings, of whatever may be regarded as a public nuisance. Under this power . . . the State may interfere wherever the public interests demand it, and in this particular a large discretion is necessarily vested in the legislature to determine, not only what interests of the public require, but what measures are necessary for the protection of such interests.[15]

The Supreme Court has consistently upheld state and municipal regulatory programs as a valid exercise of the police power,[16] and it is this broadly applied power that forms the foundation of a state's environmental laws.[17]

### *B. The State's Exercise of the Police Power to Protect the Environment*

Pennsylvania, like most other states, possesses a comprehensive legislative scheme for protection of the environment. The keystone of this scheme can be found in a recent amendment to the Pennsylvania Constitution which charges the Commonwealth with the responsibility for preserving and maintaining the state's natural resources.[18]

In 1970, the Pennsylvania legislature created the Department of Environmental Resources to enforce the various state environmental protection statutes.[19] These environmental laws establish a com-

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15. *Id.* at 136.

16. *See* cases cited in note 13 *supra.*

17. The following cases indicate activities which have been held to be a reasonable exercise of the police power: Penn Central Transportation Co. v. City of New York, 98 S. Ct. 2646 (1978) (New York City's Landmark Commission can designate the Grand Central Terminal an historic landmark and thereafter prohibit the construction of a multi story tower above it); Goldblatt v. Town of Hempstead, 369 U.S. 590 (1962) (municipality can prohibit sand and gravel operations beneath the water table within its borders); Huron Portland Cement Co. v. Detroit, 362 U.S. 440 (1960) (city can regulate air pollution emanating from federally licensed vessels); Miller v. Schoene, 276 U.S. 272 (1928) (state entomologist can order the cutting of red cedar trees to protect apple orchards from cedar rust disease); Hadacheck v. Sebastian, 239 U.S. 394 (1915) (municipality can ban brickyards within its boundaries); Lawton v. Steele, 152 U.S. 133 (1894) (state official can destroy fish nets to enforce a New York fish and game statute); Mugler v. Kansas, 123 U.S. 623 (1887) (state can ban the manufacture and sale of intoxicating liquors and a municipality can ban all pool halls); Northwestern Fertilizing Co. v. Hyde Park, 97 U.S. 659 (1878) (municipality can prohibit fertilizer production or transportation within its boundaries).

18. PA. CONST. art. I, § 27 [also known as the Environmental Amendment].

19. *See* the Administrative Code, Act of April 9, 1929, Pub. L. No. 177, *as amended* by

prehensive regulatory program designed to protect the environment of Pennsylvania.[20] The environmental protection statutes are not to be viewed in isolation, however, the federal government has created a body of law called environmental law[21] and for each of the Pennsylvania statutes there exists a federal law[22] which protects similar environmental interests and relies upon the state to assume the primary role in regulating those interests,[23] thereby buttressing the state's role in environmental protection.

## JURISDICTION—THE BANKRUPTCY COURT OR STATE COURT

One of the sensitive issues facing a state environmental attorney involves the spectre of the summary jurisdiction of the bankruptcy court[24] as compared to the jurisdiction of state courts to enforce state laws. The question that initially arises is whether the existence of the bankruptcy proceeding insulates a debtor before the bankruptcy court from a state action, or in the alternative, either forces the state to institute the state action in the bankruptcy court or requires that a state request that the bankruptcy court permit the state to file an action in state court. This dilemma arises both in the context of criminal and civil enforcement proceedings.

### *A. Criminal Offenses—The Supreme Court*

It is universally recognized that the state's police power allows the classification of certain offenses as crimes,[25] and it would appear to

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the Act of December 3, 1970, Pub. L. No. 834, No. 275, PA. STAT. ANN. tit. 71, § 510-1 (Purdon Supp. 1977-78).

20. The various statutes include, inter alia, The Act of June 22, 1937, Pub. L. No. 1987, *as amended*, PA. STAT. ANN. tit. 35, § 691.1 (Purdon 1977) (Clean Streams Law); The Act of January 8, 1960, Pub. L. No. 2119, *as amended*, PA. STAT. ANN. tit. 35, § 4001 (Purdon 1977) (Air Pollution Control Act); The Act of July 31, 1968, Pub. L. No. 788, No. 241, *as amended*, PA. STAT. ANN. tit. 35, § 6001 (Purdon 1977) (The Solid Waste Management Act); The Act of May 31, 1945, Pub. L. No. 1198, *as amended*, PA. STAT. ANN. tit. 52, § 1396.1 (Purdon Supp. 1977-78) (The Surface Mining Conservation and Reclamation Act).

21. *See generally* Soper, *The Constitutional Framework of Environmental Law*, in FEDERAL ENVIRONMENTAL LAW 20 (1974).

22. The Clean Air Act, 42 U.S.C.A. § 7401 (Supp. 1978); the Clean Water Act, 33 U.S.C.A. § 1251 (Supp. 1978); Federal Surface Mining Control and Reclamation Act, 30 U.S.C.A. § 1201 (Supp. 1978); Resource Conservation and Recovery Act, 42 U.S.C.A. § 6901 (1977).

23. *See, e.g.*, 33 U.S.C.A. § 1251(b) and 42 U.S.C.A. §§ 6901(a)(4), 7401(a)(3) (Supp. 1978); 30 U.S.C.A. § 1201 (Supp. 1978).

24. Katchen v. Landy, 382 U.S. 323 (1966).

25. *See* Moore v. People of the State of Illinois, 55 U.S. (14 How.) 13 (1852), where the

be folly to suggest that a particular debtor's status in a bankruptcy proceeding could excuse the debtor from prosecution for the violation of a state's criminal statutes. But Pennsylvania's environmental laws, like those in most other states, also declare certain conduct to be unlawful, subjecting the offender to, *inter alia,* criminal proceedings.[26] Is it proper then for a federal court, such as a bankruptcy court, to enjoin a state proceeding for violation of environmental laws?

In *Fenner v. Boykin*[27] the United States Supreme Court held that a federal court could enjoin state officers from instituting criminal actions *only* when absolutely necessary for the protection of constitutional rights, and only under "[e]xtraordinary circumstances where the danger of irreparable loss is both great and immediate. Ordinarily there should be no interference with such officers,"[28] and the court refused to grant the injunction. The next term the Supreme Court reiterated that principal in *Massachusetts State Grange v. Benton*[29] when it affirmed the refusal of a lower court to issue an injunction against Massachusetts state officials to stop them from enforcing a state daylight-savings time statute. In *Fenner* and *Massachusetts State Grange* the injunction sought was against a state official or agency. This principal, however, has been extended to the refusal to enjoin state criminal nuisance proceedings.

Then, in *Younger v. Harris,*[30] the Supreme Court held that federal courts could not enjoin a state criminal proceeding unless at least one of three specific requirements were met,[31] or "where a person about to be prosecuted can show that he will, if the proceeding in the state court is not enjoined, suffer irreparable damages."[32] The

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Court said that "[t]he power to make municipal regulations for the restraint and punishment of crime, for the preservation of the health and morals of her citizens, and of the public peace, has never been surrendered by the States, or restrained by the Constitution of the United States." *Id.* at 18.

26. PA. STAT. ANN. tit. 35, §§ 691.301, 691.307 (Purdon 1977).

27. 271 U.S. 240 (1926).

28. *Id.* at 243-44.

29. 272 U.S. 525 (1926).

30. 401 U.S. 37 (1971).

31. 28 U.S.C. § 2283 (1970) provides, "A court of the United States may not grant an injunction to stay proceedings in a state court except as expressly authorized by Act of Congress, or where necessary in aid of its jurisdiction, or to protect or effectuate its judgments.

32. 401 U.S. at 43.

*Younger* court explained that the "irreparable" injury must be "both great and immediate" and the cost, anxiety, and inconvenience of having to defend against a single criminal prosecution could not by themselves be considered "irreparable."[33] In *Huffman v. Pursue, Ltd.*[34] the irreparable injury requirement was extended by the Court beyond criminal actions when it refused to enjoin a state court proceeding founded upon a violation of an Ohio nuisance statute. The Court said the state's interest in nuisance litigation is likely to be every bit as great as it would be in a criminal proceeding.[35]

### *B. Criminal Offenses—The Bankruptcy Court*

Against this backdrop, the Bankruptcy Court in the Southern District of New York refused a request by a debtor in a Chapter XI proceeding[36] to enjoin the Attorney General of New York from prosecuting a criminal action in *In re Diversa-Graphics.*[37] At the time the Chapter XI proceeding was filed by Diversa-Graphics, the district court issued an order, consistent with the language of section 314 of the Bankruptcy Act, which enjoined the commencement or continuation of any proceeding wherein the debtor was a defendant or respondent until further decree by the bankruptcy court.[38] The issues raised in this case were whether the stay provisions incident to a Chapter XI proceeding enable a bankruptcy court to issue an injunction, and, if so, whether the stay provisions require the bankruptcy court to intervene and grant injunctive relief with respect to an existing criminal prosecution brought by the Attorney General

33. *Id.* at 46.

34. 420 U.S. 592 (1975).

35. *Id.* at 604.

36. A proceeding commenced under Chapter XI of the Bankruptcy Act, 11 U.S.C. § 701, will often involve the continued operation of a business while an arrangement is worked out to pay off the creditors. This is one of the rehabilitative chapters of the Bankruptcy Act. *See* note 7 and accompanying text *supra.*

37. 2 Bankr. Ct. Dec. 194 (S.D.N.Y. January 22, 1976).

38. Section 314 of the Bankruptcy Act, 11 U.S.C. § 714 (1970), states:

> The court may, in addition to the relief provided by section 29 of this title and elsewhere under this chapter, enjoin or stay until final decree the commencement or continuation of suits other than suits to enforce liens upon the property of a debtor, and may, upon notice and for cause shown, enjoin or stay until final decree any act or the commencement or continuation of any proceeding to enforce any lien upon the property of the debtor.

This language comports with the language of section 114 of a Chapter X proceeding, 11 U.S.C. § 514 (1970).

after the Chapter XI petition was filed.

As to the first question, it was concluded that section 314 authorized the court to stay the proceedings,[39] but reference was made to *Younger's* requirement of "special circumstances"[40] to deny the issuance of an injunction, even though the debtor argued that the automatic stay provisions of Rule 11-44(a)[41] brought it within one of the specific exceptions. The *Diversa-Graphics* court held that Rule 11-44(a) should not operate to stay criminal proceedings. It further concluded that the fourth exception of *Younger,* where the injury to a federal right could be shown to be great and immediate, did not exist in this case.[43]

In *In re Albert Glenn Huffman,*[44] a bankrupt sought the protection

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39. The court did not go into any detail in support of its conclusion. *But see* In re Dolly Madison Industries, Inc., 504 F.2d 499 (3d Cir. 1974) and notes 58-64 and accompanying text *infra.* In *Dolly Madison,* the Third Circuit held a court lacked jurisdiction to enjoin a state in the exercise of its regulatory powers.

40. 401 U.S. at 37.

41. Rule 11-44(a) provides in relevant part:

> (a) Stay of Actions and Lien Enforcement. A petition filed under Rule 11-6 or 11-7 shall operate as a stay of the commencement or the continuation of any court or other proceeding against the debtor, or the enforcement of any judgment against him, or of any act or the commencement or continuation of any court proceeding to enforce any lien against his property, or of any court proceeding, except a case pending under Chapter 10 of this title, for the purpose of the rehabilitation of the debtor or the liquidation of his estate.

42. The *Diversa-Graphics* court addressed the argument that the automatic stay provisions of Rule 11-44 broadened the statutory authority in § 314, 11 U.S.C. § 714 (1970). The court said:

> I must construe the apparently broader language of Rule 11-44(a) in accordance with the substantive limitations of the relevant provisions of the Bankruptcy Act itself. So while Section 311, 11 U.S.C. § 711 confers broad jurisdiction on the Bankruptcy Court over the assets of the debtor, wherever located, it has been consistently held that that Section and Section 314 gave the Court no jurisdiction to stay State Court proceedings effectively, unless such proceedings would in such interference with or dimunition of the debtor's property that the rehabilitative purpose of Chapter XI would be chilled. *See* In Re Laufer, 230 F.2d 866, 868 (2d Cir. 1956), Teledyne Industries, Inc. v. Eon Corp., 371 F. Supp. 191 (S.D.N.Y. 1974). Since Rule 11-44(a) was meant not to expand but merely to implement Sections 311 and 314 it cannot be considered an express Congressional grant bringing it within 28 U.S.C. Section 2283.

2 Bankr. Ct. Dec. at 196.

43. The court, in strongly worded language, expressed its opinion of the relationship between the police power and Chapter XI:

> Chapter XI, granted its rehabilitative purpose, is not to be construed as insulating a debtor from the exercise of the state's police power expressed in its penal enactments. Public policy insists that transgressions of the criminal law be dealt with, and I find no reason to protect this debtor merely because it seeks the benefit of Chapter XI relief.

*Id.* at 197.

44. 4 Bankr. Ct. Dec. 34 (E.D. Va. March 7, 1978).

of the bankruptcy court to prevent extradition by use of a discharge in bankruptcy. The bankrupt purchased a car in Tennessee and completely destroyed it in an accident in Virginia. The Tennessee bank holding security interest in the car caused a felony warrant to be issued, alleging that the bankrupt had removed the car from the state contrary to state law. The bankrupt, facing extradition from Virginia, attempted to seek a declaratory judgment in order to dissolve the basis of the criminal action, but the bankruptcy court said that it lacked jurisdiction to prevent the extradition and further ruled that the dischargeability of a debt through bankruptcy had nothing to do with alleged criminal acts.[45] This line of cases suggests that an injunction should not issue where criminal offenses, such as violations of environmental statutes, lie and a bankrupt debtor should not be able to find refuge in the shroud of the Bankruptcy Act.

### C. *Other Unlawful Acts*

Often the unlawful or illegal acts may occur while the debtor continues in business.[46] For example, a Chapter XI proceeding contemplates rehabilitation rather than liquidation of all assets. Continued operation of an enterprise may be essential to generate the necessary income to set up a satisfactory arrangement with creditors. However, if the continued operation could create a violation of law, some protection should be afforded to the public to insure that violations of law do not occur. The purposes of sections 311 and 314 of Chapter XI[47] are to prevent a creditor from defeating jurisdiction of the bankruptcy court over the debtor's property by instituting another action in a different forum.[48] This objective should not entitle a debtor-in-possession or a trustee to violate a valid state law.[49]

45. *Id.* at 35.

46. Rule 11-23 states, "The court may authorize the trustee, receiver, or debtor in possession to conduct the business and manage the property of the debtor for such time and on such conditions as may be in the best interest of the estate."

47. 11 U.S.C. § 711, 714 (1970). These sections are essentially the same as §§ 111 and 114 of Chapter XI proceedings, 11 U.S.C. §§ 511, 514 (1970).

48. *See* Teledyne Industries v. Eon Corp., 373 F. Supp. 191, 203 (S.D.N.Y. 1974), In re Bargain City, 212 F. Supp. 111, 115 (E.D. Pa. 1962).

49. 28 U.S.C. § 959(b) (1970) provides in relevant part, "A trustee . . . appointed in any cause pending in any court of the United States, including a debtor in possession, shall manage and operate the property in his possession . . . according to the requirements of the valid laws of the State in which the property is situated."

In *Gillis v. California*[50] a trustee sought to have a reorganization court enjoin a state licensing agency from requiring the debtor to file a bond required by state law in order to carry on the business of distributing fuel. The Supreme Court interpreted the predecessor of the present 28 U.S.C. § 959 as requiring the trustee to file the bond and obtain the license. Specifically, *Gillis* held that Congress was empowered to require receivers in a conservation proceeding to transact local business in accordance with state law.[51] *Gillis* clearly indicated that Congress, in enacting the Bankruptcy Act, did not intend to vest bankruptcy courts with authority to frustrate the state's ability to exercise its police powers.

The promulgation and enforcement of criminal statutes represents one method by which a state can exercise its police power. If a state regulates an activity by requiring a license or permit for lawful operation, the failure to operate in accordance with that license could subject the regulatee to suspension or revocation of its operating license, possibly causing the closing of a facility. Additionally, an activity may have to make an expenditure to comply with the laws. If that regulatee happens to be subject to a bankruptcy proceeding, does that fact offer it any protection?

In *In re Bay Ridge Inn, Inc. v. New York State Liquor Authority,*[52] the New York State Liquor Authority cancelled the liquor license of a bankrupt corporation because a custodian of the receiver offered liquor for sale in violation of state law. Judge Augustus Hand, writing for the court, found the liquor license to be a privilege granted by the State Liquor Agency and anything to which the trustee succeeded by way of permission to continue the liquor business was regulated exclusively by the state liquor control laws.[53] The *Bay Ridge* court, in reversing the decision of the bankruptcy court which had annulled the liquor license revocation, reasoned that "[a]ny rights or privileges of the trustee were created by the New York legislature and were subject to such conditions as it might impose."[54]

In *In re Colonial Tavern v. Charles L. Byrne,*[55] an almost identical

50. 293 U.S. 62 (1934).
51. *Id.* at 66.
52. 94 F.2d 555 (2d Cir. 1938).
53. *Id.* at 557.
54. *Id.*
55. 420 F. Supp. 44 (D. Mass. 1976).

case, the district court cited *Bay Ridge*[56] when it affirmed the bankruptcy court's decision that it lacked the authority to enjoin a licensing board from enforcing its laws. The court concluded by saying:

> The force of Judge Hand's opinion is even more apparent in the context of a Chapter XI proceeding, which is voluntary . . . . If the debtor's position were to be adopted, Chapter XI would provide an instantly available, cheap and easy sanctuary from all state regulatory enforcement proceedings.
>
> Nothing in the prior case law of § 314 . . . suggests that the Bankruptcy Act was ever intended by Congress to subvert the valid police power of the states in this matter.[57]

The Third Circuit has also adopted the view espoused by the *Bay Ridge* court and asserted by the *Colonial Tavern* court. In *In re Dolly Madison*[58] the court had to decide whether a reorganization court had summary jurisdictional power pursuant to Chapter X of the Bankruptcy Act[59] to order a state corporation commission to reinstate a debtor's certificate of authority to do business in Virginia. The court analyzed the power of summary jurisdiction as that of a court of equity which is derived from section 2(a)(15) of the Act.[60] This jurisdiction, according to the court, "is generally limited to the adjudication of questions concerning (1) the administration of the debtor's estate, and (2) the property in the court's actual or constructive possession."[61] The state commission had made no claim against property of the debtor corporation. The mere fact that the debtor's property may be effected by state law did not constitute a claim against that property, and absent such a claim, summary jurisdiction was unavailable.[62]

*Dolly Madison* was recently cited by the Bankruptcy Court in the Western District of Pennsylvania.[63] The debtor filed a complaint

56. "The basic holding of the [*Bay Ridge*] case, however, is that the powers of a Bankruptcy Court do not extend to interference in the comprehensive regulatory laws of a state." *Id.* at 45.

57. *Id.* at 45-46.

58. 504 F.2d 499 (3d Cir. 1974).

59. 11 U.S.C. § 511 (1970).

60. 11 U.S.C. § 11(a)(15) (1970).

61. 504 F.2d at 503.

62. *Id.* at 503-04.

63. In re A.H.-R.S. Coal Corp., No. 77-88 (W.D. Pa., May 9, 1978).

seeking an injunction against the Pennsylvania Department of Environmental Resources to force the Department to reissue a mining license that it had failed to renew, and to enjoin the Department from enforcing its laws. Upon the filing of the complaint, the court issued a temporary restraining order. The Department filed a motion to dismiss alleging, *inter alia,* that the court lacked jurisdiction. The court, in citing *Dolly Madison,* conceded that failure to renew the license effectively denied the use of the property, but it found no claim against the property to exist, and therefore it held that it lacked jurisdiction.[64]

*Bay Ridge, Colonial Tavern,* and *Dolly Madison* stand for the proposition that a bankruptcy court should not interfere with a state's regulatory program, and the *Diversa-Graphics* decision suggests that a court could interfere but choose not to. In *In re Hillsdale Foundry Co.,*[65] we find a decision which indicates that a bankruptcy court could and should interfere. The debtor in *Hillsdale* initiated a Chapter XI proceeding and filed a complaint for a temporary order against the State of Michigan and the Michigan attorney general to restrain them from the commencement or continuation of any action against the debtor, or from doing any act which might interfere with the operation of the debtor's cupola foundry. In 1969, tests performed by the State Department of Natural Resources indicated excessive particulate levels at the foundry. In 1973 Hillsdale Foundry agreed to cease operations by the end of the year. Then, after two extensions were granted allowing operations until well into 1974, the matter was referred to the state attorney general who filed a complaint for an injunction.

The bankruptcy court found Rule 11-44 so persuasive that it determined that it lacked jurisdiction to overrule the blanket stay issued at the commencement of the Chapter XI proceedings by the bankruptcy court.[66] The court felt that it would be difficult for one of its officers to operate a business pursuant to a federal bankruptcy court order, while being sued in state court for complying with an order to operate the business as usual. The court recognized the responsibilities involved,[67] but felt that since the state's officials knew of the problem for seven years, it should not now shut down

64. *Id.*
65. 2 Collier Bankruptcy Cases 546, 1 Bankr. Ct. Dec. 195 (W.D. Mich. 1974).
66. *Id.* at 198.
67. *See* 28 U.S.C.A. § 959(b) (1970).

the debtor and deprive it of the "rights granted to it by Congress under the Bankruptcy Act."[68]

This decision has been criticized in both the *Colonial Tavern* and *Diversa-Graphics* opinions.[69] In an unreported bench opinion, the district court recognized the importance of a state's right to enforce its valid laws, and held that the parties would not be further stayed from litigating the questions in state court.[70] The bankruptcy judge's order upholding its original stay was temporarily set aside to decide the state issues.[71]

A bankruptcy court in the Southern District of New York recently addressed this issue in *In re Parkchester General Hospital.*[72] The State Commissioner of Health in New York initiated a hearing to revoke the hospital's operating certificate when a Chapter XI proceeding was commenced by the hospital. Consistent with *Hillsdale Foundry Co.* and *Diversa-Graphics,* the court concluded that Rule II-44 properly stayed the state administrative proceeding. This decision was based, contrary to *Colonial Tavern* and *Dolly Madison,* on the premise that a license revocation clearly affects the debtor and the debtor's property, and, under section 311 of the Act, is within the exclusive jurisdiction of the bankruptcy court. Moreover, "high quality health service was a matter of vital public concern"[73] and although sufficient cause existed to vacate the stay order as provided by Rule II-44, the court chose not to immediately do so.[74]

The foregoing cases reflect the ambiguous situation due to the uncertainty that exists in the lower federal courts regarding state regulation and the bankruptcy's court's jurisdiction.

## The Impact of *Perez v. Campbell*

*Perez v. Campbell*[75] represents the Supreme Court's analysis of a state's regulatory power in relation to the Bankruptcy Act. In *Perez* the Court was called upon to pass on the constitutionality of a

68. 1 Bankr. Ct. Dec. at 198.
69. 420 F. Supp. at 45; 2 Bankr. Ct. Dec. at 6.
70. Hillsdale Foundry Co. v. People of the State of Michigan *ex rel.* Frank J. Kelley, Bankruptcy No. NK-1462-B9 (W.D. Mich. Nov. 22, 1974).
71. *Id.*
72. 4 Bankr. Ct. Dec. 292 (S.D.N.Y. May 3, 1978).
73. *Id.* at 293.
74. *Id.*
75. 402 U.S. 637 (1971).

section of an Arizona Financial Responsibility Statute as tested by the supremacy clause. The disputed section of the Financial Responsibility Statute involved the consequences of an unsatisfied judgment arising from an automobile accident to a driver. If the judgment against a motorist remained unsatisfied for sixty days or more, the motorist's license and registration were subject to suspension, notwithstanding a discharge in bankruptcy following such judgment. The Court concluded that the sole emphasis of the statute was to provide leverage for the collection of damages from drivers who were either at fault or adjudged negligent.[76] However, the Court found that one of the primary purposes of the Bankruptcy Act was to give debtors a new opportunity in life, unhampered by the pressures of pre-existing debt.[77]

The *Perez* court went to great lengths to demonstrate that the statute contained no provisions suspending driving privileges of careless drivers, nor did it require such drivers to attend a driver improvement course.[78] The contested section of the statute in *Perez* clearly acted as a means to force one who otherwise would be discharged by the Bankruptcy Act to pay for the damage to the other party in the accident. The Court implied that had the purpose of the state statute been to deter irresponsible driving, the statute would have withstood such a constitutional attack.[79] However, the *Perez* court saw the statute as merely a powerful weapon for creditors to use in circumvention of the Bankruptcy Act.

The invalid statute in *Perez* might be distinguished from state environmental laws in that those laws protect the natural resources for all citizens, much more akin to a highway safety act that would have met the criterion in *Perez* and not a class of creditors that the invalid *Perez* statute was designed to protect. Further, the protection of natural resources has also been declared by Congress to be a matter of national priority.[80] The federal environmental laws, inso-

76. 402 U.S. at 646-47. In looking at the purpose of the statute, the Court felt bound by the interpretation of the Arizona Supreme Court. "The Financial Responsibility Act has for its principal purpose the protection of the public using the highways from financial hardship which may result from the use of automobiles by financially irresponsible persons." Schecter v. Killingsworth, 93 Ariz. 273, 280, 380 P.2d 136, 140 (1963).

77. 402 U.S. at 648.

78. *Id.*

79. *Id.* at 651.

80. *See* § 101(a) and (b) of the Federal Clean Air Act, 42 U.S.C.A. § 7401 (Supp. 1978); Federal Clean Water Act, 33 U.S.C.A. § 1251 (Supp. 1978); § 1002(a) and (b) of the Resource

far as they recognize the state's responsibility for protecting the environment should, in any evaluation, be considered as part of the full purpose of Congress and should provide additional impetus to accept the right of a state to enforce those laws.

## A Question of Claims—*In re Marcus*

A state environmental statute may include a civil penalty provision as part of a state's enforcement options.[81] Thus, the question of penalties may also arise in the context of a bankruptcy proceeding whereupon first blush the state in collecting these penalties may appear to be a creditor that the Bankruptcy Act is designed to protect.

In straight bankruptcy, section 63(a) of the Act[82] sets forth those debts which may be provable against a bankrupt's estate, and as stated in Collier, "only a provable debt, with certain exceptions stated in the statute, subject to discharge."[83] Section 57(j),[84] however, defines those debts which shall not be allowed:

> (j) Debts owing to the United States or to any State or any subdivision thereof as a penalty of forfeiture shall not be allowed, except for the amount of the pecuniary loss sustained by the act, transaction, or proceeding out of which the penalty or forfeiture arose, with reasonable and actual costs occasioned thereby and such interest as may have accrued on the amount of such loss according to law.

The interaction of these two sections and the possible impact upon a civil penalty claim can be understood by analyzing *In Re Marcus*[85] and the authority for its decision. Prior to bankruptcy, the State of California obtained a civil penalty judgment against Marcus for violating state water pollution laws. The court first ad-

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Conservation and Recovery Act, 42 U.S.C.A. § 6902 (Supp. 1978); §§ 101 and 102 of the Surface Mining Act, 30 U.S.C.A. §§ 1201 and 1202 (1977).

81. *See* § 605 of the Clean Streams Law, Pa. Stat. Ann. tit. 35, § 691.605 (Purdon 1977) or § 9.1 of the Air Pollution Control Act, Pa. Stat. Ann. tit. 35, § 4009.1 (Purdon 1977).

82. 11 U.S.C. § 103 (1970).

83. 3A Collier on Bankruptcy ¶ 63.02 (14th ed. 1975).

84. 11 U.S.C. § 93. Section 57 entitled Proof and Allowance of Claims sets forth, *inter alia*, the procedure for filing a claim. Subsection (j), however, sets forth those claims that are not allowable.

85. 9 ERC 1957 (N.D. Calif. 1977).

dressed the issue of dischargeability of a debt. Section 17(a)[86] of the Bankruptcy Act states that a discharge in bankruptcy releases a bankrupt from all his provable debts, whether allowable in full or in part, subject to the exceptions found in section 17. If, however, a penalty is not dischargeable since it is not provable then the debtor, subsequent to the discharge, would still have to pay the penalty.

The *Marcus* court cited *Matter of Abramson*[87] as authority. In *Abramson,* New York State recovered a judgment against Shavertown Creamery Company for violation of a state law in selling skim milk without identifying it as such on the label. Later, the state brought another action seeking similar monetary penalties. The copartners were adjudicated bankrupt individually and as copartners. Thereafter, the debtors petitioned the federal district court to stay New York from collecting the judgment or prosecuting the section action. The *Abramson* court, upon which *Marcus* relied, said:

> It must be admitted that on the face of things this argument [that the judgment for penalty is provable and therefore dischargeable] is logical. However, the provisions under consideration are not wholly harmonious and we would not come to a conclusion so against public policy as that Congress intended bankrupts to be released from all liability for violating laws passed to protect the health of the community unless absolutely compelled to do so.

The *Abramson* Court continued:

> Reading the two sections together, we think that judgments for penalties are not debts which can be proved or allowed as such because they are not for a fixed liability, but that any pecuniary loss the lawmaker has sustained by the act out of which the penalty arose, together with actual and reasonable costs and interests, may be proved because of the provision in section 57j. So construed the act is perfectly reasonable. The lawmaker who has suffered no pecuniary loss is not permitted to share in the assets of the estate with creditors who have. On the other

86. 11 U.S.C. § 35(a). This section is made applicable to Chapter XI proceedings by the express language of 11 U.S.C. § 771.

87. 210 F. 878 (2d Cir. 1914).

> hand, bankrupts who have violated laws passed for the public good cannot escape punishment by going into bankruptcy.[88]

On that basis, the *Marcus* court concluded *Abramson* controlled on the issue of provability. "Provable" judgments in proceedings involving environmental actions will thus consist of those judgments which compensate for *actual* damages and reasonable costs and interests.

The next issue in *Marcus* thus logically became the allowability of the judgment involved, which under section 57(j) required a determination by the court as to whether the statute involved was punitive or compensatory in nature. The court concluded that the penalty label itself was not determinative and it was not easy to tell whether a liability came within the statute;[89] but if the statutory basis for the penalty has a punitive or deterrent purpose, then section 57(j) would apply. The court concluded that since no part of the judgment represented pecuniary loss sustained, it was not allowable.

*Marcus* stands for two propositions: (1) criminal penalties are penal in nature and therefore should not be dischargeable in a bankruptcy proceeding, and (2) insofar as a civil penalty is punitive, it too will not be dischargeable. The controversy involving the punitive versus the compensatory nature of a civil penalty may necessitate a filing of a complaint pursuant to the provisions of the Bankruptcy Act in order to determine the dischargeability of the debt.

## The Future—The Bankruptcy Reform Act[89.1]

As of this writing, the existing Bankruptcy Act is being substantially rewritten by Congress. The United States Senate has recently passed S. 2266, a bill originally introduced by Senator DeConcini of Arizona on October 31, 1977. The U.S. House of Representatives presently has before it a compromised bill, H.R. 8200, introduced on February 8, 1978. Major sections of the bill are worthy of discussion. These include the broadened definition of claims, automatic

88. *Id.* at 879-80.

89. 9 ERC at 1959 (citing 3 Collier on Bankruptcy ¶ 57.22 (14th ed. 1975)).

89.1. The Bankruptcy Reform Act was enacted into law subsequent to the preparation of this article. Pub. L. No. 95-598, 47 U.S.L.W. 1. However, the following analysis is not affected by the enactment.

stays, and the status of penalties, all of which could impact environmental regulation.

The first change reflects the issue of claims. Both bills have broadened the definition of claims to include right to payment and the right to an equitable remedy.[90] The House Judiciary Committee recognized that the definition represented a significant departure from the existing law.[91] The Committee Report said, "[T]he bill contemplates that all legal obligations of the debtor, no matter how remote or contingent, will be able to be dealt with in the bankruptcy case. It permits the broadest possible relief in the bankruptcy court."[92] This broadened definition of claims may force the environmental lawyer to both monitor the bankruptcy court and to file a claim as to the existence of any statutory obligation when a bankruptcy proceeding is commenced by a regulatee.[93]

While the broadened definition of claim may cause concern for the state and federal environmental lawyer, another significant provision regarding the automatic stay may not necessarily inhibit environmental enforcement efforts. Section 362(b) of both bills created exceptions from the rule that the filing of a petition operates as a stay of judicial and administrative proceedings. The filing of a petition would not operate as a stay from the "commencement or continuation of a criminal action or proceeding against the debtor,[94] . . . the commencement or continuation of an action or proceeding by a governmental unit to enforce such governmental unit's police or regulatory power,[95] . . . [and] the enforcement of a judgment or . . . a money judgment, obtained in an action or proceeding by a governmental unit to enforce such governmental unit's police or

90. H.R. 8200, 95th Cong., 2d Sess. (1978); S. 2266, 95th Cong., 1st Sess. § 101(4) defines claim as:

(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 does not give 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 . . .

91. HOUSE JUDICIARY REPORT, JUDICIARY REPORT NO. 95-959, 95TH CONG., 1ST SESS., (Sept. 8, 1977) at 309.

92. *Id.*

93. At any time during a bankruptcy proceeding, a regulatee while conducting its operation, may cause its operation to violate the environmental laws.

94. Section 362(b)(1).

95. Section 362(b)(4).

regulatory power." While section 362(b) would not preclude the issuance of a stay in one of the above situations, it forces the trustee to move the court into action rather than requiring the stayed party to request relief from the stay.[96] The conditions upon which a stay could be granted should be clarified to permit a stay only after notice and adversary hearing, and only if the petitioner can demonstrate that "irreparable" injury is both "immediate and great" in accordance with the Supreme Court's language in *Younger v. Harris.*

This philosophy of permitting a governmental unit to proceed also recognized the priority accorded to the government in collecting a money judgment.[97] Congress has apparently recognized that a bankruptcy proceeding should not be utilized to thwart a government's enforcement efforts.

Section 523(a)(7) of the proposed act also contemplates the continuation of the practice not to allow discharge of fines, penalties and forfeitures payable to or for the benefit of a governmental unit that does not represent compensation for actual loss.[98]

## Conclusion

While the Bankruptcy Act may, as one of its purposes, give debtors a new opportunity in life unhampered by the pressures of preexisting debt,[99] it should not be interpreted to sanction its utilization as a mechanism to avoid compliance with the laws passed by state legislatures and given the blessing of Congress to prevent environmental degradation.

The question of whether a bankruptcy court has jurisdiction to act and should act to enjoin a state from enforcing its environmental laws is far from settled. The proposed act, while not specifically addressing the question of jurisdiction, provides a mechanism to exempt a governmental unit from the automatic stay which arises upon the filing of a bankruptcy petition, thus permitting a govern-

96. Section 362(b)(5).

97. *Id.* Since the assets of the debtor are in the possession and control of the bankruptcy court, and since they constitute a fund out of which all creditors are entitled to share, enforcement by a governmental unit of a money judgment would give it preferential treatment to the detriment of all other creditors.

98. H.R. 8200, 95th Cong., 2d Sess. § 523(a)(7) (1978); S. 2266, 95th Cong., 1st Sess. (1977).

99. Perez v. Campbell, 402 U.S. 637 (1971).

mental unit to commence or continue the prosecution of actions to enforce its police and regulatory powers.

If a state statute merely provides a mechanism to protect an individual creditor against a discharged bankrupt, it would be declared invalid when construed with the Bankruptcy Act; but, if the statute's purpose is to protect the public health or safety, then the statute would not fall. Under the proposed act, the concept of claim would be drastically broadened. However, if the civil or criminal judgment represents a punitive fine the proposed act, as the existing case law illustrates, would not permit the discharge of the fine, if that fine is not wholly compensatory.

The government environmental lawyer, recognizing the rising incidents of bankruptcy proceedings, must become more aware of the Bankruptcy Act and its potential ramficiations on environmental enforcement.