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US V. Apex Oil: Will High Court Revisit Ohio V. Kovacs?

Law360, New York (June 30, 2010) -- While U.S. Supreme Court watchers digest the court's recent opinions in its high-profile gun rights and method patents cases, bankruptcy practitioners should have their eye on the appeal of a Seventh Circuit decision that could have a significant impact on bankruptcy cases.

A petition for review of United States v. Apex Oil Co. Inc., filed in February, asks the Supreme Court to determine whether an injunction requiring a debtor to clean up contaminated property at an estimated cost of $150 million creates a “right to payment” and thus a “claim” subject to discharge under 11 U.S.C. § 101(5)(B).

This would be the first time since its 1985 opinion in Ohio v. Kovacs that the Court has addressed the treatment of equitable claims under the Bankruptcy Code. Here’s hoping the Court grants certiorari and provides more guidance in a sometimes uncertain area of bankruptcy practice.

What Is a “Claim”?

Congress assigned two definitions to the term “claim” in the Bankruptcy Code. A claim can be a “right to payment,” whether or not the right is “reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured.” 11 U.S.C. § 101(5)(A). It can also be a “right to an equitable remedy for breach of performance” — such as the right to compel the debtor to do (or not do) something other than pay money — “if such breach gives rise to a right to payment.” 11 U.S.C. § 101(5)(B).

Claims under § 101(5)(A) are, relatively speaking, easily explained: if the creditor has any right to payment at all, it has a “claim” subject to discharge. The analysis under § 101(5)(B) is less straightforward. On its face, the statute excludes certain equitable obligations, but because neither “equitable remedy” nor “gives rise to a right to payment” is defined, there is uncertainty as to where the line should be drawn. Indeed, as we discuss below, the courts of appeals have struggled since Kovacs to consistently identify the appropriate boundary.

Ohio v. Kovacs

In Kovacs, the debtor’s corporation caused environmental damage. The state of Ohio sued CEO Kovacs and the corporation and obtained a judgment enjoining further pollution, requiring site cleanup, and ordering Kovacs to pay $75,000 for injury to wildlife.

When Kovacs failed to comply with the judgment, a receiver was appointed to take over the corporation and his personal assets and to conduct the cleanup. Kovacs subsequently filed bankruptcy, prompting Ohio to seek a declaration that the clean-up injunction was not a dischargeable “claim” under the Bankruptcy Code.

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The bankruptcy court ruled for Kovacs, reasoning that Ohio was attempting to collect money from Kovacs as a means of satisfying the injunction, and that Kovacs, having been displaced by the receiver, had no ability to render performance of the injunction other than by the payment of money. The district court and the Sixth Circuit affirmed this holding.

In argument to the Supreme Court, everyone agreed that the $75,000 damages award was dischargeable, even though it appeared to arise from the same "breach of performance" as the injunctions: violations of environmental laws. Yet the Supreme Court affirmed, holding that Ohio had a "claim" because "the cleanup order had been converted into an obligation to pay money."

The court relied principally on a statement from the House floor that "a judgment for specific performance may be satisfied by an alternative right to payment in the event performance is refused; in that event, the creditor entitled to specific performance would have a "claim" for purposes of a proceeding under title 11."

This reasoning suggests strongly that § 101(5)(B) does not incorporate every "breach of performance" that gives rise to both monetary and equitable remedies (an argument made repeatedly since Kovacs), but rather only those breaches for which the right to money damages is derivative of (that is, derived from) the equitable remedy.

Stated differently, a right to an equitable remedy becomes a "claim" only when money damages are an alternative to (or substitute for) the equitable remedy itself, notwithstanding other money damages that may flow directly from the breach.

Most federal appellate courts have bought into the "derivative damages" analysis in one way or another, but the unique facts of Kovacs — namely, that a receiver was appointed to control the corporation and conduct the cleanup — left unclear how to apply the rule in other circumstances. The Court did not decide whether Ohio would have had a "claim" if the receiver had not seized Kovacs' personal and corporate assets.

Interpreting Kovacs

In In re: Udell, the Seventh Circuit followed the Kovacs analysis, concluding that a right to an injunction for violations of a covenant not to compete was not a dischargeable "claim." A § 101(5)(B) claim exists, the Seventh Circuit explained, only "if the right to payment is an "alternative" to the right to an equitable remedy ... [such that] the two remedies would be substitutes for one another." In other words, the right to payment must arise "with respect to" the equitable remedy, and because Indiana law did not permit the payment of liquidated damages as a substitute for performance of the restrictive covenant, the injunction was not a claim.

This decision filled at least one of the gaps left by the unique facts in Kovacs: The court looked to state law to determine whether the right to an injunction gave rise to an alternative right to payment. Other circuits have reached similar conclusions.

But Judge Flaum, concurring in Udell, rejected the derivative damages analysis. Although he believed the result was "sensible," because applying the statute as written would lead to "patently absurd consequences," he read the statute to compel the conclusion that the injunction was a "claim" because the contract's breach also gave rise to $25,000 in liquidated damages. This "cumulative" remedy approach seems hard to reconcile with the decision in Kovacs.

The desire to reach a result deemed sensible also played a role in In re: Chateaugay Corp., another environmental case. The Second Circuit adopted the derivative damages analysis, but decided that all CERCLA injunctions halting or ameliorating ongoing pollution are nondischargeable, even though CERCLA allows the EPA to undertake the actions necessary to stop ongoing pollution and recover the costs of such actions from the responsible parties.

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The court expressed concern that a different outcome would encourage bankrupt parties to refuse, with impunity, to stop ongoing pollution. Thus, the court held that if a CERCLA decree compels both removal of accumulated wastes (a potentially dischargeable claim) and stopping ongoing pollution (a nondischargeable obligation under the court's reasoning), then the entire order is not a dischargeable claim. The court recognized that this approach would result in most environmental injunctions being nondischargeable, which was precisely the result the Second Circuit intended.

The result in Kovacs might be explained as a similar effort to be sensible. The Supreme Court viewed discharge of the obligations to be fair because Ohio had turned a cleanup order into a collection action. Stripped by the receiver of any ability or authority to personally clean up the site, the poor debtor was let off the hook.

And if the Supreme Court had any concern that the environmental pollution would not be remedied by the state of Ohio or the receiver, the court did not express it.

The Equitable Remedy Issue Reaches its Apex

In Apex, the United States played its hand more carefully than the state of Ohio did in Kovacs. The federal government chose the Resource Conservation and Recovery Act of 1976 to compel Apex to clean up a former oil refinery site in Illinois. RCRA does not entitle a plaintiff to demand payment of clean-p costs in lieu of specific performance, so, whether or not one accepts the derivative damages rationale (Judge Posner called it the "natural reading" of § 101(5)(B)), this put Apex in the difficult position of arguing that RCRA gives the EPA a "right to payment" even though RCRA does not authorize any form of monetary relief.

Apex argued instead that it lacked the ability to clean up the site itself, and would have to hire a third party to do the job at a cost of $150 million. Apex's cost of complying with the equitable decree, it contended, was the EPA's "right to payment."

The Seventh Circuit rejected this argument, saying that "[a]lmost every equitable decree imposes a cost on the defendant, whether the decree requires him to do something, as in this case, or, as is more common, to refrain from doing something."

The Seventh Circuit's reasoning is consistent with the Third Circuit's decision in In re: Torwico Electronics, Inc., but contradicts the Sixth Circuit's decision in United States v. Whizco, Inc., where it was held that to the extent compliance with a cleanup ordered under the Surface Mining Control Act of 1977 "would force the defendant to spend money, the obligation [is] a liability on a claim." The Sixth Circuit reaffirmed this principle in Kennedy v. Medicap Pharmacies Inc., although the court found the noncompete obligation non-dischargeable because compliance would not cause the defendant to expend money.

The Seventh Circuit flatly rejected that application of Whizco in the RCRA context, and in general, by explaining that Whizco "cannot be squared" with controlling precedent that "costs incurred is not equivalent to 'right to payment.'"

What Now?

Given RCRA's exclusive remedy, it seems unlikely that the Supreme Court will reverse Apex. But the Apex/Torwico — Whizco/Kennedy circuit conflict should prompt the court to at least take the case, and the court could use that opportunity to clarify the apparently limited holding in Kovacs. Recall that, in Kovacs, the Supreme Court called an injunction a claim because it was "converted into an obligation to pay money"—a statement that was perceived, by the Sixth Circuit at least, to justify the decisions in Whizco and Kennedy.

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The Supreme Court might also explain the reliance in Kovacs, as a basis for the decision, on the form of relief sought by the state of Ohio (pursuit of payment as an alternative to personal performance), in lieu of a more exclusive focus on whether damages are an alternative to an equitable remedy. That reasoning, it appears, is being tested in litigation.

And it may be practical for the court to confirm the alternative remedy analysis once and for all. Though it is widely accepted by the courts of appeals, there are dissenters.

In the end, for bankruptcy practitioners Apex may not be the best case for Supreme Court review. Ideally, the court would address a statute authorizing both equitable relief and money damages, as in Chateaugay. Such a case (particularly an environmental one) might also give practitioners a better sense of how much these cases will be guided by the sensibility of results, as sometimes opposed to strict statutory construction.

But even a case like Apex would help clarify a decision that is now 25 years old, and which has led to sometimes inconsistent results in the years since.

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