UNITED STATES BANKRUPTCY COURT

IN AND FOR THE DISTRICT OF ARIZONA

In Re **RFI REALTY, INC.,** **Debtor.**	**Chapter 11 Proceedings** **Case No. 04-10486-PHX-CGC** **UNDER ADVISEMENT DECISION RE APPLICATION OF CALIFORNIA DEPARTMENT OF TOXIC SUBSTANCES CONTROL FOR PAYMENT OF AN ADMINISTRATIVE EXPENSE**

I. Introduction

Nominally at issue is whether the California Department of Toxic Substances Control ("DTSC") is entitled to an administrative expense claim for costs incurred in supervising the environmental cleanup of the estate's contaminated property in Santa Clarita, California ("Property"). But the real dispute is different. Whittaker Corporation ("Whittaker") is the prior owner of the Property and remains liable, along with the Debtors, under applicable environmental laws to clean up the site. American Insurance Specialty Lines Insurance Company ("AISLIC") issued a policy to Whittaker insuring such a loss. DTSC made demand upon Whittaker for payment of its supervisory costs relating to abating the contamination on the site. As the result of a settlement, DTSC has been paid all but $180,000 of its claim. Because of Whittaker's continuing liability, and the existence of the AISLIC policy, the issue becomes who will bear the burden of DTSC's accruing claim in the longer term: the Debtors, on the one hand, or Whittaker and its insurer AISLIC on the other (together the "Whittaker Parties") —and whether the Whittaker Parties can recover from the Debtors the amounts they have already paid? For the Whittaker Parties to prevail, they will have to step into the shoes of DTSC under principles of equitable subrogation.

Determining the allowable amount of an administrative claim for environmental cleanup costs is a fact intensive matter involving the review and consideration of voluminous records of monitoring and supervision. For that reason, it is important to keep in mind the fundamental question of how, if at all, such a claim will be paid if successfully asserted against the estate.

While DTSC does have a lien on the estate's property for at least a part of its claim, the Court has previously determined that this lien is junior to three other liens; at the present time, there is no sale on the horizon that would produce proceeds sufficient to reach to that level of priority, much less the level of an unsecured priority claim.

Therefore, to be paid on any allowed administrative claims, the claimants have to find a source other than a sale of the property. The parties agreed at the hearing that the only current avenue for such payment is a carve out established under a prior settlement with one of the secured creditors, Porta Bella Lender ("PBL"), approved by the court June 15, 2007 (Dkt. 1074) ("PBL Settlement"). That settlement authorized payment of certain identified claims, including some administrative expenses, and reaffirmed a stipulation with PBL dated July 26, 2006 for use of $125,000 a month[1] in cash collateral for payment of certain agreed upon administrative expenses. This raises the question whether payment of a DTSC administrative claim is within the scope of the PBL Settlement.

Taking everything together, therefore, for DTSC to establish and be paid on an administrative priority basis, it must demonstrate that its costs may appropriately be asserted against the estate on that basis under applicable law and that any such claim is payable under the PBL Settlement. For Whittaker, and derivatively AISLIC, to prevail, they must show both of the above plus that they are entitled to be subrogated to the rights of DTSC against the estate.

At this time, the Court cannot, and will not, make a factual determination regarding the extent of an administrative claim, if any. Due to the time and expense required to try the issue, the Court will not require the parties to undertake that issue until it is economically feasible to do so and that determination cannot be made unless and until a source of payment reveals itself. However, the Court will examine whether the claim asserted is of the type allowable as an administrative expense.

[1] The agreed upon amount was to be reduced to $111,000 with an outside termination date of August, 2009.

Further, the Court will examine whether the record is sufficient to make a determination on whether such a DTSC claim, if it exists, is payable under the PBL Settlement.

Finally, subrogation has been raised by the Whittaker Parties; however this issue, and it is a complicated one, has not been briefed by either party. Nevertheless, while a definitive ruling is not possible, the Court will sketch out the issues of concern based on its own research and analysis. As more fully developed below, after that review, the Court is of the view that the application of the subrogation doctrine to these facts is highly problematic.

II. Background

On March 27, 2008, the DTSC filed its application for allowance and payment of administrative expenses against the debtor Santa Clarita, LLC's ("SCLLC") bankruptcy estate ("Application"). The genesis of the matter is rooted in Adversary 07-520-CGC brought by RFI Realty, Inc., Remediation Financial, Inc., SCLLC and Bermite Recovery, LLC's (collectively "Debtors") regarding the priority and payment of liens. The issue first arose in Whittaker's opening brief in the adversary filed on March 12, 2008. The matter was subsequently addressed in filings in the adversary as well as filings in the administrative case. After briefing and oral arguments were completed in the adversary, the Court issued an Under Advisement Decision on June 25, 2008 ("June Decision") establishing the priority of the Kennedy secured claim, the KPCO lien, the PBL lien and the DTSC lien.

The history of the case is summarized in the June Decision and is incorporated by reference. Some key events have occurred since the June Decision. First the proposed sale of the real property in Santa Clarita, California to SunCal Santa Clarita, LLC fell through. At this point, to the Court's knowledge, there is no buyer for the Property.

Second, the Court clarified its June Decision regarding availability of sale proceeds for DTSC's oversight work. In the June Decision, the Court stated that DTSC's claim for oversight and supervision is to be paid from SF Escrow 2 without recourse to sale proceeds. Debtors interpreted this statement as meaning SF Escrow 2 could never be replenished from sale proceeds. However, the Court's decision was made in light of the pending sale to SunCal and was made assuming a lack of funds available to reach DTSC's claim. Accordingly, during the August 14, 2008 hearing on the

matter, the Court clarified that SF Escrow 2 can be replenished from a sale as allowed by California law and the November 2005 Coverage And Claims Settlement Agreement ("CCSA").

Third, a settlement has been reached between DTSC and the Whittaker Parties. Under terms of the settlement, DTSC has been paid a total of $3 million for its past oversight and supervision costs from SF Escrow 2 ("DTSC Settlement"). The payment covers costs billed by DTSC through December 2007 and interest through March 2008. Further, the DTSC Settlement states that DTSC was owed $3.18 million through March 2008 and there is $180,000 still outstanding to DTSC after the DTSC Settlement. According to the DTSC Settlement, the remaining outstanding balance of $180,000 was incurred for post-petition work. Finally, the DTSC Settlement purports to subrogate the Whittaker Parties to DTSC's rights against the estate.

III. Parties Arguments

A. DTSC

DTSC claims that it incurred $957,908.95 in post petition costs associated with supervision and cleanup performed between July 7, 2004 and December 31, 2007. Under the 2001 enforceable agreement, "[SCLLC] is liable for all of DTSC's costs that have been incurred or will be incurred in the future in taking response actions at the Site, including costs of overseeing response actions performed by Respondent pursuant to this Agreement." When SCLLC failed to perform, DTSC ordered Whittaker to perform. DTSC asserts that this action did not relieve SCLLC of its responsibility to clean up the site.

In addition, DTSC claims that Debtors are responsible for cleanup under California and Federal law, relying on Cal. Health & Saf. Code § 25356 *et seq.* Specifically, Health & Saf. Code § 25355.7 provides that DTSC:

> shall establish policies and procedures consistent with this chapter that the [DTSC]'s representatives shall follow in overseeing and supervising the activities of responsible parties who are carrying out the investigation of, and taking removal or remedial actions at, hazardous substance release sites;

Section 25360(a) further states:

> Any costs incurred by the department or regional board in carrying out this chapter shall be recoverable pursuant to state or federal law by the Attorney General, upon the request of the department or regional board, from the liable person or persons.

DTSC therefore argues that its costs incurred for supervision and cleanup are allowable administrative expenses because they were incurred to preserve estate property citing *In re Dant & Russell, Inc.*, 853 F.2d 700, 709 (9th Cir. 1988). *Dant & Russell* held that cleanup costs are "warranted when the cleanup costs result from monies expended for the preservation of the bankruptcy estate." *Id.* at 709. DTSC says that its costs meet the statutory requirements of Section 503 because they are: 1) "actual" (DTSC is requesting unpaid post-petition costs at its standard rate); and 2) "necessary" (any cleanup requires the approval of DTSC).

Because SCLLC is obligated to perform cleanup along with Whittaker, DTSC argues that it is irrelevant which party actually performed the work so long as the estate benefits. Further, if Whittaker did not do the work, SCLLC would have had to under the mandate of 28 USC § 959(b).[2]

According to DTSC, the Court's June Decision did not moot the application because; 1) it only determined lien priorities; 2) there is still approximately over $180,000 in unpaid postpetition oversight and supervision costs; and 3) the Whittaker Parties assert subrogation rights against the debtors for all payments.

Finally, according to DTSC, there is no *res judicata* or claims waiver because no set bar date exists and DTSC was not a party to the CCSA or the PBL Settlement.

B. Whittaker & AISLIC

The Whittaker Parties also argue DTSC is entitled to payment of its claim as an administrative expense under *Dant & Russell* and Section 503. Further, the Whittaker Parties argue that SCLLC has a continuous obligation to DTSC, despite the fact that DTSC is only billing and supervising Whittaker. The Whittaker Parties argue that both current and former owners, such as SCLLC, of contaminated property are potentially responsible parties under California law. This continuing obligation is referenced in an Imminent Action Order which states, "[n]othing in this Order relieves SCLLC from any obligation or liability that is subject to under [the Enforceable Agreement] or any other provision of law." Under the Whittaker Parties's theory, SCLLC is equally required to pay DTSC's claim and therefore an administrative claim is appropriate under

[2] This section requires a trustee to "'manage and operate' the property of the estate 'according to the requirements of the valid laws of the State in which such property is situated.'" *Midlantic Nat. Bank v. New Jersey Dept. of Environmental Protection*, 474 U.S. 494, 507 (1986).

Dant & Russell.

Critically, the Whittaker Parties argue that payment of **this** administrative claim is contemplated under the PBL Settlement. The basis for this position is: 1) the order approving the PBL Settlement states that nothing in the Spreadsheet attached to the PBL Settlement shall "be relied upon by any party to assert waiver or defenses to a claim;" 2) Section C(1) of the PBL Settlement allows payment of pre-sale closing operating expenses in accordance with the attached spreadsheet; 3) there are line items on the attached spreadsheet for "Admin Claim Payments (other than monthly)" for $900,000 and "Current and anticipated Admin Claims (est.)" for $1,509,746; and 4) and DTSC's claim is *pari passu* with the other administrative claims identified in the PBL Settlement. According to The Whittaker Parties, combining these prongs entitles DTSC to recovery under terms of the PBL Settlement.

Further, the Whittaker Parties argue that the CCSA is not a bar to DTSC's claim because DTSC is not a party to the CCSA. Finally, while the Whittaker Parties have asserted a right to subrogation, it is unclear whether the basis is state law, Federal law or both.

C. Debtors

The Debtors dispute DTSC's entitlement to an administrative claim, arguing that because Whittaker is the respondent to an Imminent Action Order dated November 22, 2002, it is therefore the responsible party for cleanup. Further, according to the Debtors, SCLLC has not been billed for oversight expenses since April 2003. Therefore, the Debtors claim that they are not responsible for the supervision and cleanup costs associated with the Property.

The Debtors also argue that the effort to re-litigate the source of payment is barred by *res judicata* via the CCSA, which provides a funding mechanism for cleanup, and by the PBL Settlement. According to the Debtors, no party claimed that the DTSC oversight costs were administrative claims during the CCSA negotiations and no party sought an administrative claim for the costs in the context of the PBL Settlement. The Debtors argue that parties to the CCSA, including the Whittaker Parties, knew of DTSC's cleanup while negotiating the CCSA.

The Debtors urge that under the CCSA, the Whittaker Parties agreed that all DTSC claims for supervision shall be paid from SF Escrow 2, citing CCSA Paragraph IV(F)(6)(iv):

> Provided not otherwise paid under Section III.A.2., payment of (A) the amounts which are owed by Whittaker to the DTSC incurred for regulatory oversight and supervision after December 30, 1998 and prior to Closing, including any interest on said amounts, and any fines or penalties for late payment of said amounts; and (B) any amounts which are owed by Whittaker to the DTSC incurred for regulatory oversight and supervision after Closing, but excluding any interest on said amounts and also excluding any fines or penalties, unless and such interest, fines or penalties are attributable to improper delay in the administration of SF Escrow 2 (in which event such interest, fines or penalties are payable out of SF Escrow 2), (however, this provision shall not be deemed a waiver of defenses of any Party as to the amount or validity of any DTSC claim.)

In the Debtors' view, the Whittaker Parties expressly agreed that the DTSC oversight and supervision claims would be satisfied from SF Escrow 2, thereby releasing Debtors from any responsibility for such claims to Whittaker. To bolster this point, the Debtors point out that the SF Escrows were funded by **SCLLC's** PLC Policy which provided coverage of environmental cleanup costs. Further, according to the Debtors, under CCSA Paragraph VI(A)(3), AISLIC released the Debtors from any and all claims including the DTSC Claim:

> The AISLIC Parties/RFI Release includes any and all claims and causes of action relating to the following . . . : a) the Property; . . . r) the DTSC Claim . . ..

Further, the Debtors argue that there is no right to recovery under the PBL Settlement. According to the Debtors references to administrative claims in the PBL Settlement are not generic administrative claims, but instead refer to specific budgetary items.

Finally, the Debtors argue that DTSC's claim, if it ever existed, no longer exists because DTSC has been paid $3 million and the DTSC Claim is only for $950,000.

IV. Analysis

A. Is DTSC entitled to an administrative claim for its environmental cleanup costs?

i. Standards for administrative expense

Pursuant to 11 U.S.C. § 503(b)(1)(A), an administrative claim shall be allowed when it is for "the actual, necessary costs and expenses of preserving the estate . . . for services rendered after the commencement of the case." Actual and necessary are terms that are construed narrowly. "[T]he terms 'actual' and 'necessary' are construed narrowly so as 'to keep fees and administrative costs at a minimum.'" *Dant & Russell, Inc.* at 706 (quoting *In re O.P.M. Leasing Services, Inc.*, 23 B.R. 104, 121 (Bankr.S.D.N.Y. 1982); *See also In re Hanna*, 168 B.R. 386 (9th Cir. BAP 1994). DTSC, as the

administrative claimant, bears the burden of proof and "must show that the claim was incurred post-petition, that it directly and substantially benefitted the estate, and that it is an 'actual and necessary' expense, a test which includes necessary costs of administering or operating the estate's business." *In re First Magnus Financial Corp.*, 390 B.R. 667, 674 (Bankr.D.Ariz. 2008); *In re Hanna*, 168 B.R. 386, 388 (9th Cir. BAP 1994); *Metro Fulfillment*, 294 B.R. 306, 309 (9th Cir. BAP 2003).

ii. Ninth Circuit Case Law

There are several cases in the Ninth Circuit that have addressed the question of whether or not environmental cleanup is entitled to an administrative expense. All parties cite *Dant & Russell* in which the Ninth Circuit ultimately concluded that the requested administrative expense claim was not allowable. *Id.* at 709. One key factor was that the debtor was not the owner of the real property. However, the Circuit went on to state, "[q]uite a different result, however, is warranted when the cleanup costs result from monies expended for the preservation of the bankruptcy estate. *See, e.g., Lancaster v. Tennessee (In re Wall Tube & Metal Prod. Co.*, 831 F.2d 118, 124 (6th Cir.1987))." *Dant & Russell* at 709. Despite denying the administrative expense claim, the Circuit suggested that under the proper factual circumstances, post-petition environmental cleanup costs could warrant an administrative expense claim.

In *In re Hanna,* the debtor owned a filling station that leaked into the groundwater and caused damages to the adjacent property. The adjacent land owner performed remediation. The environmental damage occurred pre-petition, but continued passively post-petition. The Panel ultimately concluded "environmental damage caused to the [debtor's] site occurred prepetition, including the continuing effects of prepetition damages, and that cleanup costs relating to prepetition damages were not entitled to administrative expense priority." *Id.* at 390.

In *In re Jensen*, 995 F.2d 925 (9th Cir.1993), the issue was whether post-petition cleanup charges were dischargeable. The state of California performed environmental cleanup after the debtor refused to do so. Importantly, the state discovered the environmental damage prepetition. The Court determined "that the state had sufficient knowledge of the [debtors'] potential liability to give rise to a contingent claim for cleanup costs before the [debtors] filed their personal bankruptcy

petition....The claim filed by California DHS against the [debtors] therefore was discharged in the [debtors'] bankruptcy." *Id.* at 931. However, the dischargeability context of *Jensen* is considerably different from the administrative expense claim at issue here.

In *In re Lazar*, 207 B.R. 668 (Bankr.C.D.Cal 1997), the state of California imposed postpetition criminal fines against debtors for failure to remediate contamination. In that context, the court reached several conclusions regarding an administrative expense claim. First, it concluded that the contamination must present "an imminent and identifiable harm to the public health or safety." *Id.* at 675 (citing to *Midlantic* at 507 n. 9). Additionally, claims for administrative priority arising from the postpetition costs of cleaning up contamination have a better case for administrative expense priority. *Lazar* at 676. In the end, the court denied the administrative claim ruling that:

> New, postpetition contamination must be shown, under the Ninth Circuit standards set forth in *Dant & Russell*, *Jensen and Hanna*, to support a claim for the costs of environmental remediation. The requirement that an administrative expense be postpetition cannot be met absent such new contamination. A continued postpetition deterioration or postpetition failure to remediate prior contamination does not satisfy this requirement.

Lazar at 680.

iii. The DTSC Claim in this Case

A. Allowability

The task now is to fit the claim asserted by DTSC within the guidance of the cases cited. First, there is no directly controlling Ninth Circuit precedent. *Dant & Russell* is instructive but not conclusive on the points presented here. In *Dant & Russell*, a lessor sought to recover costs it incurred post-petition to clean up pre-petition damage on land it had leased to the debtor. As the owner of the property, the lessor was under a direct obligation to the environmental authorities to respond. But, because the damage had been caused by its lessee (the debtor), the lessor sought reimbursement from the estate. The Court disallowed that claim largely on the basis that the contamination resulted from pre-petition activities of the debtor.[3] The Court declined to extend priority status to the lessor's claim on public policy grounds, holding that to do so would invade the

[3] Interestingly, the facts stated in the opinion indicate that the debtor continued to operate for a short time post-petition.

province of Congress.

Even though *Dant & Russell* itself is not on point, it cites with approval cases that are. Key among them is *In re Wall Tube & Metal Prod. Co*., 831 F.2d 118, 124 (6th Cir.1987). Through its fabrication of metal products on leased premises, Wall Tube generated hazardous materials. Operations shut down in October 1983; in December of that year, a state inspector discovered leaking toxic substances and demanded that the company remediate. The company failed to do so and filed for Chapter 7 bankruptcy in February 1984. The state thereafter incurred "response costs" to clean up the problem and filed an administrative expense claim against the estate. The bankruptcy court disallowed the claim on the grounds that the costs were not actual and necessary costs of preserving the estate and that the trustee was not obligated to comply with 28 U.S.C. § 959(b). The Sixth Circuit reversed, stating:

> The State of Tennessee, in the absence of compliance by the debtor's estate, was entitled by its own law to expend funds to assess the gravity of the environmental hazard. We thus find those expenses to be actual and necessary, both to preserve the estate in required compliance with state law and to protect the health and safety of a potentially endangered public.

Wall Tube at 124.

The present case, while not identical, is strikingly similar. DTSC is entitled under California law to mandate the compliance of responsible parties with their remediation obligations and to supervise and monitor the activities undertaken. In order for the property to be legally remediated, DTSC must "sign off" on the work done and to do so, is entitled and required to engage in its monitoring activities. In *Wall Tube*, as here, all of the contamination occurred pre-petition; notwithstanding the lack of post-petition conduct by the debtor, the court found that the costs incurred by the state post-petition were entitled to administrative priority.

Does it matter that Whittaker is doing the work and not the Debtors? The answer is no. The fact is that Whittaker is equally responsible for clean up and has the financial capacity to do the work, be it through the AISLIC policy or on its own. The Debtors, while equally responsible for cleanup, lack the financial capability to do it but benefit directly from having it done. The Debtors acknowledge that a successful cleanup is essential to their reorganization—without the cleanup of

the contamination, no sale of the property (at least at a price that would yield substantial returns to creditors as contemplated by the Debtors) is possible. That point has been made numerous times throughout this proceeding. Viewed in this way, the cleanup costs should be allowable as an administrative claim.

This conclusion is not inconsistent with the other cases in this circuit. On its face, *Jensen* appears contrary, standing for the proposition that post-petition cleanup costs by the state of pre-petition damage were dischargeable because the state had knowledge of the damage prior to the filing of the case. But the rationale in a dischargeability case involving an individual's fresh start is quite different and not transferrable to this situation. Likewise, in *Hanna*, unlike this case, there was not even an arguable benefit to the estate that would derive from allowing an administrative priority claim for damages to adjoining property caused by petroleum leaks on the estate's property. Finally, *Lazar* viewed the issue through the lens of an individual's liability for criminal fines. Like the discharge context, this point of view has little relevance to whether a Chapter 11 estate has received a tangible benefit.

Therefore, the Court finds and concludes that to the extent DTSC can prove its actual reasonable costs incurred during the post-petition period in supervision and monitoring of Whittaker's cleanup of the environmental damage on the estate's property, that claim would be entitled to administrative priority under Section 503(b)(1)

B. Amount

The fact that some amount may be allowable does not finish the inquiry. First, to the extent that DTSC has been paid from a third party, in this case either the Whittaker Parties or SF Escrow 2, such payment would be an offset against the allowed claim. Second, the components of the claim would be subject to objection and justification to demonstrate that they meet the statutory standard.

B. Is there a source of payment for an administrative claim?

As noted above, the actual prove-up of an administrative claim would be fruitless in the absence of an identified source of payment. The Whittaker Parties, in anticipation of being subrogated to the rights of DTSC, argue that payment of this claim was contemplated under the PBL Settlement and should be paid, at the least, *pari passu* with other administrative claims allowed

thereunder. A close review of the record indicates no factual basis for this position and the Court rejects it.

Without the PBL Settlement, there is no source for payment of any administrative expenses as there are no unencumbered assets in the estate. In that agreement, PBL, as the secured creditor "on the bubble", agreed to the use of its cash collateral for very specific purposes. There is no rational construction of the language of the PBL Settlement, its attachments or the court documents related to it that would permit use of that "carve out" to pay a DTSC administrative claim.

The first applicable principle is that a secured creditor cannot be forced to allow the use of its cash collateral for a purpose to which it does not consent, in the absence of a court order based upon a finding that the secured creditor's interest in the collateral would be adequately protected. 11 U.S.C. § 363(c)(2). No such request has been made by DTSC and no such finding has been made by the Court. Therefore, as of today, payment would be available on this claim only if there is a basis to conclude that PBL consented to such use. The record is sufficiently clear on this point that the Court does not require further evidence but may base its decision upon judicial notice of documents in the court file.

On June 1, 2007, Debtors filed their motion to approve the Porta Bella Settlement. (Dkt 1045.) That filing consisted of the body of the Motion together with a "Term Sheet" attached as Exhibit A. The motion recites that throughout the case

> the Court and major secured creditors have agreed to allow Debtors a monthly expense budget of $125,000. Under the settlement, PBL and Debtors have agreed to continuation of the $125,000 monthly amount until September 1, 2007, at which point, the budget will be reduced from its current level to $111,000 through the earlier of the closing of the sale under the SunCal PSA or August, 2009. Authorized items under the budget are: general operating expenses consistent with the current budget, and payment to approved professionals, including Avion's monthly compensation at the current level of $42,000 per month (subject to a credit against future success fee as set forth herein), and $40,000 per month beginning as of February, 2007, to pay allowed administrative fees and expenses of Debtors' bankruptcy counsel . . . .

There is no mention of payment of monitoring costs unless they can be characterized as "general operating expenses consistent with the current budget." That budget, per the stipulation for use of cash collateral among the Debtors and PBL (dkt 859), is a creature of agreement among those same parties. As the Debtors' papers in this dispute make abundantly clear, the Debtors have not sought

PBL's consent for the use of cash collateral for that purpose and PBL has not granted it.

So, if the $125,000 line item in the PBL Settlement is not a source of payment, what else might be? The Whittaker Parties' papers point to the lines named "Admin Claim Payments (other than monthly) 900,000" and "Current and anticipated Admin Claims 1,509,746." Neither is remotely applicable.

The Notes to the spreadsheet make clear that the $900,000 relates to a payment for professional fees **previously made**, not a set aside for future payments.[4] While the $1,509,746 is for future payments, the components of that number are clearly set forth in the Notes - and none of those components is payment of DTSC monitoring costs.[5] In short, there is no currently available method for payment of a DTSC administrative claim, even if one were allowed. Although the Court agrees with DTSC that the costs incurred are "necessary" and "actual" and benefit the estate, there is no point in establishing the scope of that claim at this time in the absence of a source of payment.

C. Subrogation

Subrogation is an equitable remedy that allows a party that pays the obligation of another to step into the creditor's shoes and assert the claim against the party primarily liable. Thus, for example, a guarantor who pays its principal's obligation to a third party may, in appropriate circumstances, assert the rights of the paid creditor against its principal, the debtor. In this case, the Whittaker Parties have claimed they are entitled to be subrogated to DTSC's rights against the estate, therefore effectively enabling them to pursue DTSC's administrative claim because of the payment made under the settlement. However, the issue first arose in Whittaker's and DTSC's memoranda in response to Debtors' objection to the claim and has not been fully briefed. For that reason, and because of the lack of a payment source, the issue is not currently ripe for determination. Nonetheless, the Court will address a number of concerns in inherent in the Whittaker Parties' claim, if and when it does become ripe.

Although AISLIC, Whittaker and DTSC agreed in the DTSC Settlement that the Whittaker

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[4] "The $900,000 was paid from the Initial Payment."

[5] Avion's success fee of $500,000, $509,746 in then outstanding payments to Debtors' counsel, and an estimated $500,000 for future legal fees over the monthly payments from the $125,000 budgeted amount. The total of these three numbers is $1,509,746.

Parties are entitled to subrogation, subrogation is an equitable remedy subject to determination by the Court, not merely agreement of the parties. *See Memphis & L.R.R. Co. v. Dow*, 120 U.S. 287, 302, 7 S.Ct. 482, 30 L.Ed. 595 (1887) (stating that subrogation "is enforced solely for the purpose of accomplishing the ends of substantial justice.") The equities of subrogation have not been determined by this Court. Moreover, it is unclear under what law, Federal, state or otherwise, AISLIC and Whittaker are seeking subrogation.

i. California

In California, the burden of proof is on the party seeking subrogation. *In re Flamingo 55, Inc.*, 378 B.R. 893, 917 (Bankr.D.Nev. 2007). Subrogation arises under the following basic circumstances:

> (1) The obligor (defendant) owes a debt or duty of some kind to the creditor (subrogor).
> (2) The subrogee (plaintiff), pursuant to his own obligation to the creditor, pays that debt or discharges that duty.
> (3) The circumstances make it inequitable that the subrogee should bear the loss while the obligor is unjustly enriched.

Bush v. Superior Court, 10 Cal. App. 4th 1374, 1381, 13 Cal. Rptr. 2d 382, 386 (3d Dist. 1992).

Here, how do AISLIC and Whittaker meet the third requirement? They both entered into the CCSA. Under terms of the CCSA, AISLIC agreed to pay DTSC for the cost of cleanup and released the Debtors from the DTSC claim. In what sense is it inequitable that they should bear a loss they agreed to bear? How is it equitable to circumvent an explicit release through the back door of subrogation? How does this satisfy the underlying purpose of subrogation as stated in the Restatement(Third) of Suretyship and Guar. § 27, cmt a (1996): "[I]t is a rule that the law adopts to compel the eventual satisfaction of an obligation **by the one who ought to pay it**." (emphasis supplied).

Further, to obtain subrogation, the following prerequisites must be met:

(1) Payment must have been made by the subrogee to protect his own interest.

(2) The subrogee must not have acted as a volunteer.
(3) The debt paid must be one for which the subrogee was not primarily liable.
(4) The entire debt must have been paid.
(5) Subrogation must not work any injustice to the rights of others.

Flamingo 55 at 911. Here, AISLIC and Whittaker appear not to meet prerequisites (2) through (5). They voluntarily agreed to the CCSA. Whittaker was primarily liable to DTSC for cleanup costs, caused the contamination itself, and did not pay the entire debt. Passing that primary obligation on to the Debtors appears, on the face of it, "to work an injustice on the rights" of the Debtors.

ii. Section 509

Section 509 of the Bankruptcy Code addresses the rights among co-debtors. "Courts are split as to whether Section 509 preempts or supplements the common law of subrogation." *Flamingo 55* at 919. Under Section 509 a creditor must show:

(1) that it is an entity that is liable with the debtor on, or that has secured [] a claim of a creditor against a debtor [];
(2) that it had paid the claim secured; and
(3) that it has not received the consideration for the claim held by such creditor.

Flamingo 55 at 919 (internal quotations omitted). Here, it appears clear that the Whittaker Parties received consideration because the DTSC Settlement releases the Whittaker Parties from any past oversight claims. Section 509 "does not apply when the liability of the person seeking subrogation is direct and of equal status with the debtor's." *Flamingo 55* at 920. Further, Section 509(b)(2) "excludes those who are primarily liable for the debt from subrogation because they received consideration for paying the debt." *In re Celotex*, 472 F.3d 1318, 1321 (11th Cir. 2006). Here, Whittaker was and is directly liable for paying the cleanup costs.

There is some authority to the contrary. "A co-liable creditor who has actually paid environmental cleanup costs, of course, is subrogated to the rights of the governmental unit asserting the environmental claim." *Collier on Bankruptcy* ¶ 509.09[4][a] (citing to *Coal Stripping, Inc.*, 222 B.R. 78 (Bankr.W.D.Pa. 1998)). However, as noted by *Colliers*, the language in *Coal Stripping*

regarding subrogation is dictum. The focus of *Coal Stripping* was whether or not an administrative claim existed, not on whether or not the insurance company was entitled to subrogation.

Additionally, at least one court in denying an administrative expense claim, has limited the application of *Coal Stripping* to situations where two factors exist: A1) a state agency actually performed the cleanup of hazardous materials on the property; and 2) the party seeking administrative expense priority for costs expended on the cleanup of the property was a surety of the debtor subrogated to the government agency's administrative expense claim under § 509 of the Code. *In re G-I Holdings, Inc.*, 308 B.R. 196, 207 (Bankr.D.N.J. 2004). Here, neither factor exists. First, Whittaker performed clean up under supervision of the DTSC. Second, AISLIC is not a surety of the Debtors, instead it is an insurer of a creditor.

One final point. The Court has mentioned in passing the release of the DTSC claims under the CCSA. This abbreviated discussion is not intended to understate the importance of the issue. Any future claim for subrogation by the Whittaker Parties, if and when ripe, would necessarily be viewed through the prism of Rule 9011 given the terms of the CCSA to which both AISLIC and Whittaker are parties.

iii. Conclusion

Based on the brief review above, even if an administrative claim exists, subrogation would be highly problematic. A final determination on the issue will be made if and when the issue is ripe.

V. Conclusion

Therefore, the Court rules as follows:

1. To the extent DTSC could prove its actual reasonable costs incurred during the post-petition period in supervision and monitoring of Whittaker's cleanup of the environmental damage

on the estate's property, that claim would be entitled to administrative priority under Section 503(b)(1) for those portions not paid from another source;

2. There is no currently identifiable source for payment of a DTSC administrative claim because there are no free assets in the estate and such a claim is not payable under the PBL Settlement;

3. As a result, the Court will not entertain further proceedings on establishing the amount and extent of such a claim unless all parties so agree;

4. Although the matter is not ripe for immediate determination, any claim by AISLIC or Whittaker to be subrogated to the rights of DTSC is highly problematic.

So ordered.

DATED: March 20, 2009

Charles G. Case II
UNITED STATES BANKRUPTCY JUDGE

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