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EPA's Bankruptcy Settlement with Philadelphia Energy Regarding the Federal Renewable Fuel Standard: One-off Deal or Harbinger of More to Come?

By Ken W. Irvin and David E. Kronenberg*

The Clean Air Act's Renewable Fuel Standard program, which is enforced by the Environmental Protection Agency (the "EPA"), requires U.S. oil refiners and importers to blend a certain quantity of renewable fuels into the fuels they produce and sell in the United States, or purchase compliance credits called Renewable Identification Numbers to otherwise satisfy their obligations under the program. This article discusses a recent EPA bankruptcy settlement with Philadelphia Energy regarding the federal Renewable Fuel Standard.

On January 21, 2018, Philadelphia Energy Solutions ("PES"), an independent oil refiner, filed for bankruptcy protection due to "unpredictable, escalating, and unintended compliance burden[s]" under the Clean Air Act's Renewable Fuel Standard ("RFS") program.[1] This program, which is enforced by the Environmental Protection Agency (the "EPA"), requires U.S. oil refiners and importers to blend a certain quantity of renewable fuels into the fuels they produce and sell in the United States, or purchase compliance credits called Renewable Identification Numbers ("RINs") to otherwise satisfy their obligations under the program.

THE BANKRUPTCY CASE

In its bankruptcy case, PES alleged that the RFS program, which was enacted in 2005 in order to support the use of renewable fuels and reduce the nation's reliance on foreign oil, disproportionally burdens independent refiners, such as itself, that do not have sufficient infrastructure to blend the quantity of renewable fuels necessary to meet their obligations under the program. Accordingly, to remain in compliance independent refiners are required to

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[1] *PES Holdings, LLC*, Case No. 18-10122, Declaration of Gregory Gatta, Chief Executive Officer of PES Holdings, LLC in Support of Chapter 11 Petitions and First Day Motions (Bankr. D. Del. Jan. 22, 2018), ¶ 20, [Docket No. 16].

purchase RINs from large integrated refiners that generate excess RINs when they blend fuel, from RINs traders, or from retail firms that are not obligated to meet the RFS program's requirements.

PES indicated that when it commenced operations in 2012 its costs to comply with the RFS program were manageable as each RIN typically cost $0.05 or less. By 2017, however, ethanol RINs soared to an average price of $0.70, a 17.5 fold increase over 2012 levels. This forced PES to purchase $832 million of RINs in the years preceding its bankruptcy case, making RFS compliance costs its second largest expense after crude oil. Further, to comply with its RFS obligations for 2016 and 2017, PES would have needed to purchase another $350 million worth of RINs by March 31, 2018.

Faced with this insurmountable burden, PES resorted to the protection of the U.S. Bankruptcy Court for the District of Delaware. Although Delaware is a common jurisdiction for large corporate bankruptcy cases, the choice was notable because a couple of months before the filing, La Paloma Generating Company, LLC, the owner of a California power plant, received approval in its own Delaware bankruptcy case to sell its assets to its senior lender free and clear of certain obligations under California's cap-and-trade program. The result in La Paloma was mostly due to certain successor liability shortfalls in the California law governing the cap-and-trade program, but it nevertheless served as an eye-opener for distressed energy companies seeking to free themselves of liability under similar market-based environmental programs.

Following this newly laid path, PES accompanied its January 2018 bankruptcy filing with a proposed Chapter 11 plan that provided for its assets to be sold free and clear of PES's RFS obligations, but in this case, to a newly formed entity owned jointly by Philadelphia Energy Solutions LLC (PES's non-debtor parent) and certain holders of PES's prepetition debt. In an admission that the sale was structured solely for the purpose of discharging its obligations under the RFS program, PES's counsel stated during a hearing in the case that the plan includes "a toggle that lets us flip" to a standard reorganization if PES and the EPA are able to resolve the RFS issues consensually.[2]

Counsel for the U.S. government noted at the outset of the case that such a sale, particularly to an insider of the debtor, may not qualify as a true sale, and that PES could not confirm a Chapter 11 plan that fails to require even minimal compliance with PES's RFS obligations.

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[2] Research Reorg, *Court Grants PES Debtors Immediate Access to $120M DIP Financing; DOJ Previews Various Plan-Related Challenges at First Day Hearing*, Feb. 27, 2018.

THE EPA SETTLEMENT

Despite the early salvos back and forth, the parties reached a settlement in a matter of weeks. It provided, among other things, that (i) 138 million RINs that PES already held would serve as full satisfaction of PES's pre-petition RFS obligations, (ii) another 64.6 million RINs that PES already held would serve as full satisfaction of PES's post-bankruptcy 2018 obligations, and (iii) PES would comply with an agreed schedule of RIN retirements on a semiannual basis through 2022. This settlement essentially absolved PES of the obligation to purchase around 400 million RINs for the 2016 through early 2018 period, but imposed strict obligations for compliance thereafter.

On March 12, 2018, the EPA notified the bankruptcy court of the settlement and stated that the settlement would be subject to a 10-day public comment process. During this period, the EPA received approximately 1,337 comments in favor of the settlement and approximately 25 comments opposed to the settlement. The 1,337 in favor were mostly submitted by employees and contractors of PES's refining facility and local government officials concerned about the effect of a shutdown on energy security and local fuel pricing. The 25 comments in opposition were mostly from biofuel companies and associations that were troubled by, among other things, the settlement's potential effect on the RFS program and the EPA's failure to vigorously enforce all avenues of attack against PES, such as by initiating enforcement actions against PES's parent company or joint venture partners, as is permitted under EPA regulations.

Following this comment period, the EPA requested that the bankruptcy court approve the settlement and justified its decision to settle by making a number of illuminating remarks in its pleadings regarding the risks of litigation on the matter.

It stated that "[c]ourts have often noted the profound tension between bankruptcy and environmental law" given that bankruptcy law seeks to provide a debtor a fresh-start through the discharge of certain prepetition obligations, whereas environmental law seeks to hold parties accountable to the full extent of their statutory violations. The EPA noted that occasionally bankruptcy law gives way to environmental law as Congress has made clear that "bankruptcy law can never be used as a safe haven from compliance with environmental laws protecting against hazards to public health and safety posed by a debtor or property of the estate." However, the EPA conceded "that although the RFS program is intended to further the goal of the Clean Air Act in reducing air pollution, . . . it is not a program designed to protect public health or safety from specific hazards posed by actions of a debtor or property of the estate as

are many other requirements of environmental law." Accordingly, the EPA acknowledged that it could not on public health and safety grounds override PES's bankruptcy protections.[3]

The EPA further acknowledged that nothing in the Bankruptcy Code or the Clean Air Act indicates how RFS obligations are to be treated in bankruptcy cases, and that based on this, it was required to follow U.S. Supreme Court guidance providing that in such instances, bankruptcy law and environmental law should be harmonized as much as possible.

In light of this, the EPA noted that on the one hand, PES's RFS obligations are legal requirements that are not subject to discharge in bankruptcy and that PES could not sell its assets free and clear by arranging a "sham sale" to insiders, but, "[o]n the other hand, to assume that the Debtors must comply in full with all compliance obligations based on pre-petition refining no matter the consequences in the bankruptcy proceeding—such as liquidation—would fail to account for bankruptcy law and would not properly harmonize the two statutory regimes." Accordingly, the EPA undertook an analysis of PES's financial position to determine the level of compliance PES was capable of satisfying. After reviewing the relevant data, the EPA's financial expert acknowledged that "PES's [Chapter 11] plan is already approaching the limit of viability" and "[a]ny requirement to retire RINs to meet past obligations, either presently or in the future, in addition to the 138 million outlined in the settlement agreement, poses a significant risk to the company remaining a viable entity."[4]

Based on this assessment, the EPA essentially waived PES's remaining prepetition RFS obligations. As to PES's postpetition obligations, however, the EPA noted that debtors-in-possession are required to manage and operate their property during a bankruptcy case in accordance with non-bankruptcy law. Accordingly, the EPA required strict compliance with the RFS program on a postpetition basis, believing that a "settlement that did not provide for full compliance by the Debtors with the CAA for their refining activities during their time in bankruptcy would flout clear statutory requirements. . . ."[5]

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[3] *PES Holdings, LLC*, Case No. 18-10122, United States' Motion and Memorandum of Law in Support of Motion to Approve Proposed Consent Decree and Environmental Settlement Agreement (Bankr. D. Del. Mar. 30, 2018), ¶¶ 39 and 44, n.6 [Docket No. 347] (citations omitted).

[4] *PES Holdings, LLC*, Case No. 18-10122, United States' Motion and Memorandum of Law in Support of Motion to Approve Proposed Consent Decree and Environmental Settlement Agreement (Bankr. D. Del. Mar. 30, 2018), ¶¶ 28, 43 and 48 [Docket No. 347].

[5] *PES Holdings, LLC*, Case No. 18-10122, United States' Motion and Memorandum of Law

THE BANKRUPTCY COURT APPROVES

The bankruptcy court ultimately approved the settlement over the opposition of Growth Energy, a biofuel association. The court found that the settlement had been negotiated in good faith, avoided the risk of litigation, and was needed to avoid a PES liquidation. In reaching this result, the bankruptcy judge was heartened by the fact that the public comments in favor of the deal vastly outnumbered the public comments opposed to the deal.

THE TAKEAWAYS

As to the takeaways from the settlement between PES and the EPA:

- First, PES's bankruptcy filing and proposal to sell its assets free and clear, achieved the intended result: relief from the vast majority of its prepetition RFS obligations. As to its postpetition RFS obligations, there was no legal mechanism by which PES could free itself of those on a prolonged basis, and thus the postpetition schedule of compliance that it agreed to in the settlement was not much of a concession compared to the relief it received.
- Second, the EPA essentially ended up settling with PES under an ability-to-pay framework, which is similar to how the EPA arrives at settlements in various environmental law enforcement contexts. PES showed that this process, which often involves months or years of jockeying outside of bankruptcy, can be significantly accelerated in bankruptcy when there is the possibility of a complete elimination of liability on the part of the debtor.
- Third, PES suffered no blowback from its proposal to sell its assets to its parent company and lenders, which, by its own admission, was solely for the purpose of eliminating its RFS obligations. The EPA referred to the proposal as a "sham" transaction, but it nevertheless served its purpose—helping force a settlement that the bankruptcy judge approved without any reservation regarding the tactics that led to its formation. This sends a signal to future debtors that such a strategy presents great upside and little downside.

In an attempt to limit similar cases in the future, the EPA asserted in the settlement that it was "based on unique facts and circumstances present in" the PES case, and shall not be treated as "having any precedential value in any other

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in Support of Motion to Approve Proposed Consent Decree and Environmental Settlement Agreement (Bankr. D. Del. Mar. 30, 2018), ¶ 44 [Docket No. 347].

non-bankruptcy or bankruptcy matter."[6] History is replete with examples of how such statements do little to dissuade similarly situated companies from seeking equivalent relief for themselves.

As to the EPA's recent actions with respect to other independent refiners, the Clean Air Act authorizes the EPA to grant temporary waivers from RFS requirements to small refineries experiencing "disproportionate economic hardship," and a recent report indicates that the EPA has been granting such waivers at a far greater rate than in the past. However, the EPA has come under attack from biofuel associations and politicians in ethanol producing states, such as Senator Chuck Grassley of Iowa, for granting such waivers in "secret" and for granting potentially "illegal" waivers to various refineries owned by Andeavor, the fifth-largest refiner in the U.S.[7]

If the EPA's use of temporary hardship waivers is curtailed or is insufficient to alleviate the market forces impacting certain independent refiners, these refiners may find that their best option to avoid liquidation is to take a page out of the PES game plan in hopes of forcing a similar deal that substantially reduces obligations under the RFS program, notwithstanding the EPA's attempt to frame the PES settlement as a one-off situation.

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[6] *PES Holdings, LLC*, Case No. 18-10122, Notice of Lodging of Proposed Settlement Agreement (Bankr. D. Del. Mar. 12, 2018), p. 5, [Docket No. 244-1].

[7] Erin Voegele, *Biofuel groups condemn EPA's decision to award waiver to Andeavor*, Biomassmagazine.com, Apr. 4, 2018.