AIRA Association of Insolvency & Restructuring Advisors

Journal

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Hall v. United States

What a Chapter 12 Tax Case Can Teach Us About The Supreme Court and the Bankruptcy Code – Part I

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The study of bankruptcy taxation is a humbling endeavor. Two tradition-rich codes often conflict with no clear consistent winner. In the past, the Supreme Court often would embrace a textual approach to the conflict between bankruptcy and tax policy; on other occasions, the Court would look past the textual facade and focus on the purpose behind the relevant section in divining meaning.

In the Supreme Court's recent decision in *Hall v. United States*, No. 10-875, the Court addressed a relatively uninteresting (at least to most of us) provision found only in chapter 12 of the Bankruptcy Code – section 1222(a)(2)(A) – by embracing an approach expounded on in two earlier chapter 13 cases, thereby exposing an elegant algorithm that the Court will use in unlocking meaning from the Bankruptcy Code. To see how one chapter 12 case and two chapter 13 cases have changed the intellectual bankruptcy landscape, we are going to have to undertake a short but robust route through four of my academic interests – farming bankruptcy, cryptography, archaeology, and chapter 13 cases. In Part I of this two-part article, we are going to take a closer look at *Hall v. United States*; this discussion will set the table for our cross-disciplinary approach.

Hall v. United States

In *Hall v. United States*, No. 10-875, the Supreme Court in a 5-4 decision ruled that a chapter 12 family farmer's sale of their farm generated a federal income tax liability owed by the debtors and that was not incurred by the chapter 12 bankruptcy estate for purposes of the protections embodied in Bankruptcy Code section 1222(a)(2)(A). Enacted in 2005 to provide a more robust discharge to chapter 12 debtors and further chapter 12 reorganizations, this section saves family farms. Acknowledging that the commencement of a chapter 12 bankruptcy estate does not create a separate taxable entity, the Majority held that any postpetition tax liability resulting from a family farmer's postpetition sale of assets is not incurred by the bankruptcy estate. Rather, the family farmer must account for, recognize, and pay the tax. Thus, a chapter 12 family farmer may not use Bankruptcy Code section 1222(a)(2)(A) to strip the priority status of administrative expenses, easing the burden to confirm a chapter 12 plan.

Section 1222(a)(2)(A) was part of the 2005 Amendments to the Bankruptcy Code. That section provides:

> The plan shall –
>
> (2) provide for the full payment, in deferred cash payments, of all claims entitled to priority under section 507, unless –
>
> (A) the claim is a claim owed to a governmental unit that arises as a result of the sale, transfer, exchange, or other disposition of any farm asset used in the debtor's farming operations in which case the claim shall be treated as an unsecured claim that is not entitled to priority under section 507, but the debt shall be treated in such a manner only if the debtor receives a discharge…[1]

Section 1222(a)(2)(A) is a priority-stripping provision. It is not designed to reduce a governmental claim; rather, its purpose is to remove priority status from what may otherwise be a priority claim under section 507 of the Bankruptcy Code. This amendment

Scholar in Residence continues on p. 20

1 11 U.S.C. §1222(a)(2)(A).

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AIRA Journal is published six times a year by the Association of Insolvency and Restructuring Advisors, 221 Stewart Avenue, Suite 207, Medford, OR 97501.

Letter from the President

Stephen Darr, CIRA, CDBV
Mesirow Financial Consulting LLC

Dear Members and AIRA Staff:

This is my last letter as your President. For the next two years, I will be able to "coast" as Chairman of the Board. My time as your President has gone by very quickly and I truly enjoyed the experience

Before I get promoted to Chairman, I need to make many acknowledgements to everyone who made these past two years so rewarding.

My heartfelt thanks go to –

- The members of AIRA for their continued support and understanding
- The other members of the Board of Directors for listening to my thoughts and validating the soundness of some of my ideas
- Grant Newton and all of the other people who run AIRA on a day-to-day basis and make the job of President so easy and rewarding
- Mesirow Financial for permitting me the time and support to accept this position.

I know everyone will give the same level of support to our incoming President, Tony Sasso.

AIRA has long been the leader in providing thought-leadership, training and certification programs for financial advisors in the fields of restructuring and reorganization. The CIRA certificate is recognized by every group dealing in troubled company matters, including the Courts, attorneys, lenders, investment bankers, investors and creditors. The CDBV certificate is well on its way to similar widespread acceptance and the consistent attendance at our conferences, seminars and other meetings underscores their value to the bankruptcy community.

Of course, I have been active in AIRA before my term as President and will continue to be active. If you are interested in advancing your own knowledge, your reputation in the industry and working with a wonderful group of people, please become active in the Association.

I look forward to seeing you in San Francisco.

Steve Darr

Executive Director's Column

Grant Newton, CIRA
AIRA Executive Director

AIRA Journal is completing its 25th year of publishing articles and information pertaining to the financial, legal, business, academic and other perspectives of the bankruptcy and restructuring field. At its 27th Annual Conference in San Francisco, June 6-10, 2012, AIRA will recognize two *AIRA Journal* section editors, Professor Baxter Dunaway and Forrest Lewis, for significant contribution to the *Journal*.

Professor Emeritus of Pepperdine University's School of Law, **Baxter Dunaway** was instrumental in initiating *Distressed Business & Real Estate Newsletter (DB & RE Newsletter)*, *AIRA Journal's* predecessor. During the real estate crisis of the 1980s, Baxter provided direction and vision as we worked together to bring about a publication that would specifically address troubled business and real estate. In April of 1986, the first *DB & RE Newsletter* was printed by Westlake Publishing Company. A few years later, AIRA arranged for all members to receive the *Newsletter* as a wrap-around with *AIRA News*.* AIRA purchased the *Newsletter* from Westlake Publishing in 2001, and the two original newsletters were combined to create a single journal, subsequently renamed *AIRA Journal* in April 2005 (Vol. 19, No. 1). Baxter has written articles every issue of the *Journal* and its predecessors for 25 years.

Forrest Lewis, CPA, serves as tax editor for *AIRA Journal* after offering at the beginning of 2006 to write a regular tax section for the *Journal*. His tax section first appeared in the February/March 2006 edition and he has consistently provided excellent tax articles and case summaries for six years. A retired Partner with Plante Moran, Forrest received his bachelor's degree in Economics from the University of Michigan. He has been associated Plant Moran since joining the tax department of a predecessor of Plante Moran, CPAs, in 1974. Forrest has served a variety of corporate and partnership clients and his bankruptcy assignments have included Enron and General Motors. Since retiring in 2005 he continues to work part time.

I congratulate and look forward to working with **Tony Sasso** (Deloitte.) as he begins his term as AIRA's President for 2012-2014. Many thanks to **Steve Darr** (Mesirow Financial Consulting) for doing an excellent job as President the last two years; it has been a real pleasure to work together. Finally, I extend the Association's gratitude to **Grant Stein** (Alston+Bird) for his input and leadership as Chairman the past two years.

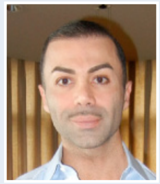
I look forward to seeing you in San Francisco,

Grant

*The title was AIA News under the earlier association name, Association of Insolvency Accountants.

Corporate Carve-Out Due Diligence Checklist

Matt Thompson, CIRA
VP of Portfolio Operations, Skyview Capital



Alex Soltani
CEO & Chairman, Skyview Capital

Many corporations are seeking to enhance shareholder value by divesting struggling or non-core divisions. This process is called a "carve-out" (see the last edition of AIRA Journal (Vol. 25 No. 5.) for a previous article on this topic). Buying carved-out business units is more challenging than buying existing standalone businesses and there are a number of unique challenges. Strategic buyers usually have an existing business infrastructure that can be used to run the business. Private equity buyers, on the other hand, need to develop this infrastructure so that the carved-out entity can operate independently. There are a number of carve-out specific due diligence issues which should be evaluated to help ensure a successful acquisition, transition, and exit.

The first step in a carve-out transaction is to perform due diligence on the carved-out unit. The key elements of carve-out acquisition due diligence include the following:

1. **Financial Diligence—**This is similar to the diligence performed in any M&A transaction. Oftentimes it is useful to engage a third-party to perform a financial quality of earnings (QoE) report to understand the run-rate EBITDA, historical performance, and debt and debt-like obligations. This is very useful to get comfort around the earnings generation capability of the target. A frequently faced challenge is the lack of separate, full financial statements for the carved-out business. Sometimes there are high-level divisional financial statements, but they include corporate allocations which are not appropriate for the carved-out business. Sometimes, the seller will conduct a carve-out audit to provide a better look at what the business would look like as a standalone entity. Even these carve-out audits require a number of assumptions and allocations. It is also important to understand what financial back office staff are remaining with the business (e.g. controllers, payroll, purchasing, forecasting) so that there is adequate expertise to keep the accounting function operational. A review of working capital and capital expenditure requirements is also necessary to understand the projected cash flows post-transaction.
2. **Legal Diligence—**Because carve-out transactions are typically asset purchases, the legal drafting of the Asset Purchase Agreement is lengthy. It is important to understand what legal entities will be required to be set up and any local taxation requirements. It is also key to understand any open litigation exposure (e.g. intellectual property, employee). It is also crucial to understand what Intellectual Property is being transferred with the business.
3. **IT Diligence—**It is crucial to understand the Information Systems requirements of the business. Oftentimes in the carve-out the business in question does not come with a full IT back-office. In order for the business to run smoothly, a clear plan must be in place for what IT systems will be used on a go-forward basis. Transferability of any IT software licenses is very important. In addition, it is crucial to know what IT staff will and will not be coming with the transaction, so those positions can be backfilled.
4. **HR Diligence—**It is crucial to understand which personnel will be transferring with the business (both HR and otherwise). Further, acquirers must understand all of the payroll obligations and any employment agreements of the carved-out company to avoid misunderstandings post-closing. Other issues to consider are any change of control provisions, equity packages, and non-standard benefits, which must be considered in financial budgeting.
5. **Supply Chain Diligence—**Acquirers should ensure that supply chain and key vendor relationships are preserved in the carved-out business entity. Sometimes the carve-out entity purchased through the parent, so it may be challenging to separate and maintain the vendor relationships. Sometimes vendors are willing to sell to the parent, but may be reluctant to sell to a smaller carve-out entity without a long financial, operating history. A disruption in the supply chain could cause major operational and financial problems.
6. **Management Due Diligence—**One of the most important areas of due diligence is to meet and get to know the most senior executives coming with the business (e.g. CEO, CFO). Oftentimes, in carve-outs the individuals coming over were divisional CFOs or divisional General Managers. These individuals are often good operators, but they may not have had experience of dealing with corporate level issues (e.g. financing's, public relations, treasury). It is imperative to understand their vision for the business and understand if they can be successful managing a standalone business. It is advisable to perform background checks on senior management before a transaction is completed.
7. **Market Diligence—**As in any acquisition it is crucial to understand the current state of the industry and the target's competitive position. Oftentimes these corporate carve-out units have been "neglected" by the parent, so they are not fulfilling their market potential. Calls with existing customers, as well as the target's sales team substantiate the sales pipeline and help identify any risks to projections. Reviewing reports and interviewing industry analysts can provide a lot of color on key industry dynamics.

This list covers some of the primary areas that strategic and financial buyers should focus on as they evaluate carve-out acquisition opportunities. ■

Alex Soltani is CEO and Chairman of Skyview Capital and Matt Thompson is VP of Portfolio Operations at Skyview Capital. Skyview Capital is a Los Angeles-based technology and telecom-focused buyout firm that has completed several carve-out transactions. You can reach Alex Soltani at asoltani@skyviewcapital.com or Matt Thompson, CIRA, at mthompson@skyviewcapital.com.

Bankruptcy Valuation

Kenji Mochizuki, CIRA
Managing Director, Akemi Capital

Municipal Distress and Chapter 9 Bankruptcy: Educational Resources and Books Review

For bankruptcy / restructuring / turnaround / workout professionals seeking to expand and deepen their knowledge of municipal distress and bankruptcy, AIRA recently hosted three webinars: "Municipal Bankruptcy, Part 1: Law; "Municipal Bankruptcy, Part 2: Finance"; and "Municipal Bankruptcy, Part 3: Accounting, Budgeting & Financial Management". For those who were unable to attend or who wish to review the presentation and save it for future reference, audio versions with supporting materials are now available at AIRA's website, www.AIRA.org.

During the past year, a number of titles were also published relevant to troubled municipalities; several of these will serve as excellent resources for advisors in this area and are discussed below with comments to help guide readers to resources that will be useful to them.

Municipalities in Peril: The ABI Guide to Chapter 9—Published by the American Bankruptcy Institute (ABI) and written by four attorneys involved with Jefferson County, Alabama, and one attorney involved with Vallejo, California.[1] The first book published on Chapter 9 that I found (the publication date is March 2010), it has about 100 pages of content, not counting the introductory pages with author bios and the Appendix listing the statutes specifically authorizing Chapter 9 filings for each of the states. The topics covered by the chapters include what Chapter 9 is, eligibility for Chapter 9, reasons to seek vs. not seek Chapter 9 protection, pre-filing planning and preparation, filing and administering a Chapter 9 case, the plan of adjustment, and life after Chapter 9.

Chapter 7, Administering a Chapter 9 Case, is a particularly useful chapter that includes dealing with trade vendors, limitation of avoiding powers, continuation of the prepetition lien, treatment of bond debt, and general obligation vs. special revenue municipal bonds. Chapter 8, on Plan of Adjustment, contains content not usually found elsewhere, including what the plan must versus what it may do, and a long discussion on cramdown in Chapter 9 filings.

Most chapters are succinct and the content layout and format easy to read. Non-lawyers and novices to Chapter 9 of the Bankruptcy Code will find this book a painless and useful read.

Chapter 9 Bankruptcy Strategies: Leading Lawyers on Navigating the Chapter 9 Filing Process, Counseling Municipalities, and Analyzing Recent Trends and Cases (Inside the Minds—Published on October 2011 and written by partners at various law firms.[2] Aside from one chapter on the less commonly discussed topic of Chapter 9 filings of healthcare entities and one chapter on the theoretical use of the prepackaged plan in Chapter 9, the ten chapters tend to be repetitive. Most chapters cover the same ground, albeit to different degrees, including the definition of a municipality, authorization and eligibility for filing Chapter 9, and the similarities and differences between Chapter 11 and Chapter 9. The non-lawyer or elected official of a municipality could benefit from reading selected chapters at their discretion, but the lawyer or bankruptcy / restructuring professional would be more likely to appreciate the thorough treatment given where nothing apparently is left undiscussed on the topic of Chapter 9.

The Appendices contribute just under a third of the total content of the book. The appendix listing the statutes specifically authorizing Chapter 9 filings for each of the states is the most detailed I have seen. In the filing checklist for Chapter 9 cases, several boilerplate examples are provided, which I have never seen provided in other publications. There are several examples of Chapter 9 related documents, e.g. a summary of terms for a hospital district financing, and an amended note modification and extension agreement. Key pleadings from the City of Vallejo, California, case are also summarized in an exhaustive list.

Because many law firms offer free publications on Chapter 9 whose content overlap with this title, readers may hesitate to purchase it. If the next edition were to expand beyond simply explaining Chapter 9 of the Bankruptcy Code— through the addition of case studies, sharing of insights on particular Chapter 9 experiences, discussion of how advisors and lawyers can still assist a local government before the relatively rare Chapter 9 filing, and/or the elimination of unnecessary repetition—this title could become a useful addition to the library.

The Fundamentals of Municipal Bonds, 6th edition—Written by Neil O'Hara for the Securities Industry and Financial Markets Association (SIFMA), published December 2011.[3] How does one rewrite the bible of the municipal market whose fifth edition was published 11 years ago? Aside from updating all of the numbers and charts in *The Fundamentals of Municipal Bonds, 5th edition*, the author of record largely left well enough alone, such

Bankruptcy Valuation *continues on p. 6*

1 H. Slayton Dabney, Jr., Patrick Darby, Daniel G. Egan, Marc A. Levinson, and George B. South III (March 2010). Municipalities in Peril: The ABI Guide to Chapter 9. Alexandria, VA: American Bankruptcy Institute.

2 Multiple Authors (October 2011). Chapter 9 Bankruptcy Strategies: Leading Lawyers on Navigating the Chapter 9 Filing Process, Counseling Municipalities, and Analyzing Recent Trends and Cases (Inside the Minds). Aspatore Books, a Thomson Reuters Business.

3 O'Hara, Neil, for the Securities Industry and Financial Markets Association (SIFMA) (December 2011). The Fundamentals of Municipal Bonds, 6th edition. Hoboken, NJ: John Wiley & Sons, Inc.

Bankruptcy Valuation *continued from p. 5*

that this title already popular in finance courses can continue to be used in the classroom.

Because the preface did not highlight the changes and new content in the sixth edition, I compared the previous edition page by page with the new edition. I discovered three new sections on tender option bonds (TOBs), electronic trading systems, and credit default swaps. I found a few new paragraphs in the interest rate swap section and some updates in the chapter on regulatory and disclosure requirements, e.g., Dodd-Frank legislation, recent changes, and a few new general rules. Otherwise, there are just a few paragraphs deleted here and there, as well as a brief new mention of the Build America Bonds program, Electronic Municipal Market Access (EMMA) information repository, and bond insurance failures. There is nothing on municipal bond defaults, high yield or distressed municipal bonds.

There is decidedly no quantitative information such as bond math, but for bankruptcy and restructuring professionals who register as municipal advisors in order to advise local governments on municipal bonds, this text remains an essential part of any library as a comprehensive introduction to the muni market.

Encyclopedia of Municipal Bonds: A Reference Guide to Market Events, Structures, Dynamics, and Investment Knowledge—Just published in January 2012 and written by Joe Mysak, former editor and publisher of the Bond Buyer, then current editor of Bloomberg Brief Municipal Market and columnist with Bloomberg News, who has been reporting on the municipal bond market since 1981.

In the introduction, the author states his desire to tell the history and stories of "MuniLand," most of which "has not been put between hard covers before in any kind of comprehensive way."[4] The author accomplishes this through the encyclopedia format with entries A to Z, which are either definitions or stories with appropriate citations of the original source materials. Even with my personal experience in municipal credit analysis and fixed income securities, I learned very much from this encyclopedia.

This title does fulfill a need among bankruptcy / restructuring professionals new to municipal distress and bankruptcy to get quickly informed of the many backstories throughout the history of "MuniLand." There is no other resource currently available that provides this useful perspective, and even municipal credit analysts working at credit rating agencies can learn a lot from reading this title.

Bloomberg Visual Guide to Municipal Bonds, just published in March 2012, is written by Robert Doty who was a member of the Board of Governors of the National Federation of Municipal Analysts (NFMA), General Counsel to the Government Finance Officers Association (GFOA), and served on various committees of the National Association of Bond Lawyers (NABL).[5] Similar to several instructional series on computers, this title makes heavy use of visual learning aids to teach a wide range of municipal bond topics. These topics include informational resources, types of municipal bonds, risks, rewards, and considerations when buying munis; municipal bond pricing and trading, tax exemption of munis, and muni market regulations.

While bond defaults and Chapter 9 bankruptcy are discussed more than most books on fixed income and municipal bonds, most of the Chapter 9 material is introductory and covered in much more detail in the February 2012[6] and March 2012[7] AIRA webinars on municipal bankruptcy by contributor James E. Spiotto, a municipal bankruptcy authority and partner at Chapman and Cutler LLP.

If your firm already owns the SIFMA book above, this visual guide would still be worth buying only for bankruptcy / restructuring professionals who are registered municipal advisors whose practice involves a significant amount of municipal bond work. Municipal credit analysts and financial advisors of municipal bond issuers will already be knowledgeable most of the content, but may still appreciate all of the information in a single, convenient source that is attractively presented, because the entire title contains the most current information, numerous useful exhibits not found elsewhere, and many topics not discussed in other fixed income or municipal bond titles. ■

Kenji Mochizuki, CIRA, Section Editor, currently works in bankruptcy / restructuring / M&A advisory as well as in distressed investing and credit analysis; he is the author of a chapter and an appendix on municipal defaults and bankruptcy in a book entitled, "Investing in the High Yield Municipal Market", to be published in June 2012 by John Wiley & Sons, Inc. / Bloomberg Press. He can be contacted at kenji@akemicapital.net

4 Mysak, Joe (January 2012). Encyclopedia of Municipal Bonds: A Reference Guide to Market Events, Structures, Dynamics, and Investment Knowledge. Hoboken, NJ: Bloomberg Press, an imprint of John Wiley & Sons, Inc.

5 Doty, Robert (March 2012). Bloomberg Visual Guide to Municipal Bonds. Hoboken, NJ: Bloomberg Press, an imprint of John Wiley & Sons, Inc.

6 https://www.aira.org/conference/webinar/021612

7 https://www.aira.org/conference/webinar/032112

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Bankruptcy Taxes

Forrest Lewis, CPA
Plante & Moran PLLC

TAX TREATMENT OF PURCHASED CLAIMS IN BANKRUPTCY

In recent years a very active secondary market has developed for claims in bankruptcy cases. This article will deal only with the tax treatment of non-interest bearing receivables by U.S. holders and further assumes a simple fact situation where cash liquidating distributions are made by the debtor corporation pursuant to a court approved plan, no liquidating trust is involved. (The liquidating trust affects the timing of the recognition but probably not the amount or character of any gain or loss.) Before getting into purchased or holder-in-due-course claims, let's review the tax treatment of unsecured and wage claims in bankruptcy by those who originally provided the goods and services to create the receivable.

Cash distributions to original claimholders

Cash distributions received by original claimholders who provided goods or services to the debtor will yield ordinary income or loss to the extent of any difference between the tax basis of the receivable (claim) and the amount of cash received. Internal Revenue Code Section 1221 says that the following asset yields ordinary income: "(a)(4) accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of [stock in trade of the taxpayer or other property of a kind which would properly be included in inventory or held for sale to customers]."

> **Example 1—**An office supply store, an accrual basis taxpayer, sold goods to the debtor for $10,000 but only receives $4,000 upon a Chapter 7 liquidation of the debtor. Being an accrual taxpayer, the office supply store has a $10,000 basis in its receivable (claim) resulting in a $6,000 ordinary loss (bad debt).
>
> **Example 2—**A wholesale distributor provided $10,000 of merchandise to the same debtor but wrote the entire receivable off as a bad debt when the debtor filed the Chapter 7 petition. The wholesaler receives a similar $4,000 liquidating distribution from the debtor but now has $4,000 of ordinary income.
>
> **Example 3—**An employee filed a claim for priority unpaid wages of $3,000 in the same case. The employee receives $3,000 less the appropriate withholding taxes and receives a W-2 form for gross wages of $3,000.

Purchased or secondary market claims

Claims acquired by unrelated purchasers take a purchased basis in the claim and, in some cases, the claim may qualify for capital asset treatment, but for reasons that will be explained many will result in ordinary income. Technically, such a claim does qualify for capital asset treatment. If you review the language of the Internal Revenue Code cited above, even an account receivable from the sale of inventory does not have the "ordinary" taint in the hands of the new holder who was not the one that provided the goods or services to the debtor. A capital asset held for more than a year will qualify for long term capital gain treatment which is only subject to a 15% income tax rate to individuals currently. However, any one of the following circumstances can convert some or all of the capital gain to ordinary income:

Wage claims—A person buying a wage claim walks into a real hornets' nest. The IRS takes the position that no matter whom a wage claim is assigned to, it is wages subject to withholding and payroll taxes at the time it is paid, credited to the original employee. This is true even if the wages are paid by a subsequent operator of the business or a liquidating trustee (court cases Otte and Armadillo). Worse yet, a W-2 form should now be issued to the employee who sold the claim, even though the net cash distribution may be going to an assignee.

Dealer in claims—If a taxpayer has a volume of purchased claims on which distributions are ultimately collected, at some point if the volume and level of activity are large enough, it passes from the category of an investment into that of a business, especially if the taxpayer both buys and sells. Gain on an investment can be a capital gain; gain from a business dealing in claims is ordinary income.

Sale or exchange requirement—Sometimes the IRS challenges capital gain treatment where there is no "sale or exchange" of the asset. While there is no authority on the sale or exchange treatment of purchased claims, one would think that the receipt of cash liquidating distributions in satisfaction of the claimholder's rights would constitute a sale or exchange.

Market discount—This little known rule is the most complex barrier to capital gain treatment for purchased claims. IRC Section 1276 essentially converts some or all of the realized gain on sale of an obligation which had been purchased on the secondary market at a discount from face as ordinary (interest) income, called market discount. It technically only applies to obligations with a maturity of one year or more; however, there is little specific authority on its application to purchased claims in bankruptcy. One would normally think that most accounts receivable (open accounts) have a short term maturity like 30 days, but in bankruptcy those receivables will have gone unpaid for months or years. Indeed, the taxpayer claiming long term capital gain treatment would have to walk the tightrope of demonstrating ownership of the claim for more than a year but that it is a short term obligation in order to avoid the market discount regime. Further, what is the effect of the conversion of an account receivable to an allowed claim in bankruptcy?

Conclusion

While a purchased claim, other than a wage claim, held for more than a year can be a long term capital asset, a complex maze of ordinary income traps must be navigated. Many of the rules on this are currently unsettled, but with the explosion of volume in the secondary claims market, all of these issues are likely to be resolved in the coming years.

***Bankruptcy Taxes** continues on p. 16*

Bankruptcy Taxes *continued from p. 15*

SURVEY OF RECENT TAX CASES

Trustee's interest extended to S Corp termination which increased the tax burden of the estate

The recent decision in *Majestic Star Casino* has extended the Prudential Lines doctrine which states that a trustee may demonstrate that certain tax actions and elections of the debtor can have an adverse effect on the bankruptcy estate and the courts may act to preserve the estate by affecting those actions and elections. In this case, Barden Development, Inc. had previously made an S corporation election in which corporate income passes through to its shareholders who then pay the federal and Indiana income tax. As permitted to S corporations, an election was made to treat its subsidiary, Majestic Star Casino, II, as liquidated and a "disregarded tax entity" (qualified S subsidiary) of Barden, meaning Majestic's income was combined with Barden's and all tax was paid by the Barden shareholders. On November 23, 2009, Majestic filed a petition in bankruptcy. In early 2010, Barden filed with the Internal Revenue Service an election to revoke its S corporation status. One impact of this was to terminate the qualified subsidiary status of Majestic and make it a C corporation again as of January 1, 2010, liable for its own income tax for federal and Indiana purposes. This resulted in the State of Indiana seeking $2.26 million in income tax from Majestic. In order to reinstate the qualified subsidiary status of Majestic, the trustee had to overcome objections from Barden and its owners, the IRS, and the State of Indiana—which it did successfully. The U.S. Bankruptcy Court for the district of Delaware held that the revocation of S corporation status was a violation of the automatic stay and an avoidable transfer and reinstated S corporation status. *In re The Majestic Star Casino, LLC, et al., Debtors*, U.S. Bankruptcy Court, D. Delaware; 09-14136(KG), January 24, 2012.

Court upholds strategy where Chapter 13 debtor filed tax claim on behalf of State of Michigan

The Sixth Circuit recently upheld a taxpayer against the State of Michigan where the taxpayer filed a tax claim on behalf of the State of Michigan for her 2008 state income tax in order to make 2008 a prepetition liability. The debtor, Dianette Hight, filed a petition in Chapter 13 on January 28, 2009, then on February 4, 2009, she filed her Chapter 13 plan with the bankruptcy court. On April 8, 2009, Hight filed her Michigan state income tax return, which indicated that she owed $4,900 in income taxes for the 2008 tax year. She did not make payment when she filed her return nor when the taxes became due on April 15, 2009. On July 17, 2009, Hight filed a proof-of-claim on behalf of the Michigan Department of Treasury ("Treasury"), which meant that Hight's tax debt would be paid through her Chapter 13 plan. (Presumably any taxes not covered by the formula payments would be discharged. On the other hand, if it were a postpetition liability, it would not be eligible for discharge through this petition.) Treasury, which had not filed any claims in Hight's bankruptcy case, objected to the claim filed by Hight on its behalf. Treasury argued that this was a postpetition claim falling under Bankruptcy Code §1305, which gives only to a creditor the option of filing a claim, and that Hight, as a debtor, could not file such a claim on its behalf. Hight responded to Treasury's objection by arguing that her protective claim was permitted under B.C. §501(c). The Court held that the language of §1305 was "permissive" and did not exclude the debtor from filing a proof-of-claim for a tax year that ended before the petition date. The court ruled the 2008 tax liability was treated as a prepetition tax for purposes of the debtor's plan. *Michigan Department of Treasury v. Hight*, 6th Circuit, March 5, 2012.

Sixth Circuit rebuffs IRS attempt to stop interception of refunds by Michigan trustees

In a very unusual case, the Sixth Circuit refused to uphold a blanket order to stop the practice of a group of Michigan bankruptcy trustees from obtaining orders for IRS to turn over the income tax refunds of debtors to the trustees in order to assure those refunds would be available to the estates to pay creditors. Because the Eastern District of Michigan had an abnormally low success rate in capturing income tax refunds of debtors to be included in bankruptcy estate funds, the trustees convinced bankruptcy judges to order IRS to pay the refunds directly to the trustees starting in 2008. IRS complied for awhile but when it realized that it involved manually processing almost 5,000 returns for the 2009 tax year, it looked for a way to put an end to the redirection of refund orders. Apparently this is a recurring issue in that district because the same problem surfaced in 2001 and required IRS to file consolidated appeals to each redirection order. In 2009, IRS sued the trustees in U.S. District Court to get a declaratory order to stop the process of redirection orders arguing they were a violation of federal sovereign immunity. The District Court ruled in favor of the IRS. However, the trustees appealed and on January 30, 2012 the Sixth Circuit ruled that the United States did not have proper standing. It vacated the District Court decision because the United States had sued the trustees whereas its fight was really with the bankruptcy courts themselves. The Court of Appeals noted that the proper way for the IRS to combat this was to appeal the specific bankruptcy court redirection orders as it had done earlier when the issue arose. United States Court of Appeals for The Sixth Circuit, case No. 10-1400.

IRS EXPANDS "FRESH START" PROGRAM: SOFTENS LATE PAYMENT, OFFER IN COMPROMISE

Over the last 15 months, the Internal Revenue Service has implemented its own version of "fresh start" for taxpayers struggling to meet their tax obligations, including the following changes made in February 2011 (IR-2011-20, Feb. 24, 2011):

- Increasing the dollar threshold when liens are generally applied from $5,000 to $10,000, resulting in fewer tax liens
- Making it easier for taxpayers to obtain lien withdrawals after paying a tax bill
- Withdrawing liens in most cases where a taxpayer enters into a Direct Debit Installment Agreement
- Allowing small businesses with $25,000 or less in unpaid tax to participate in the installment agreement program (previously, only small businesses with under $10,000 in liabilities could participate); they will have 24 months to pay
- Expanding the streamlined Offer in Compromise (OIC) program to cover taxpayers with annual incomes up to $100,000; also the limit on tax liability has been raised to $50,000, doubling the current limit of $25,000

IRS announced an expansion of the "Fresh Start" initiative in March 2012 (IR-2012-31, March 7, 2012):

- Extension of time to pay taxes: Certain taxpayers who have been unemployed for 30 days or longer or subject to certain hardships will be able to extend the time for paying their income tax (or certain other taxes) for six months. Though interest will accrue, no failure-to-pay penalties will apply. Form 1127-A or Form 1127 must be filed by the original due date of the tax return.
- Taxpayers who owe up to $50,000 (increased from $25,000) in back taxes will now be able to enter into a streamlined agreement with the IRS that stretches the payment out over a series of months or years.
- The maximum term for streamlined installment agreements has been raised to 72 months, from the current 60-month maximum.
- Taxpayers seeking installment agreements exceeding $50,000 will still need to supply the IRS with a Collection Information Statement (Form 433-A or Form 433-F).
- Taxpayers may pay down their balance due to $50,000 or less to take advantage of the streamlined agreement option. ■

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Bankruptcy Cases

Professor Baxter Dunaway

SUPREME COURT

Supreme Court to Examine Credit-Bidding Case

The U.S. Supreme Court will decide an important bankruptcy question: whether lenders have the right to use debt as currency in bankruptcy auctions, the *Wall Street Journal* reported. An airport hotel bankruptcy case *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, --- S.Ct. ----, 2011 WL 3499633, 80 BNA USLW 3090, 80 BNA USLW 3112 (U.S. Dec 12, 2011) (NO. 11-166) resulted in an appeals-court split over the credit-bidding issue. In that case, a three-judge panel with the U.S. Court of Appeals for the Seventh Circuit sided with the hotel's lenders, who had insisted they should be able to use debt to purchase their collateral. The year before in the Third Circuit, however, the publisher of Philadelphia's two daily newspapers succeeded in the company's quest to bar lenders from bidding debt at auction. Arguments were heard on April 23, 2012. A decision is expected in June or later in the summer.

Court Will Address Lender Acceptance of Unearned Fees

Granting certiorari in *Freeman v. Quicken Loans, Inc.* (Docket No. 10-1042), 2011 WL 578903, the United States Supreme Court has agreed to address whether § 8(b) of the Real Estate Settlement Procedures Act (RESPA), 12 U.S.C.A. § 2607(b), prohibits the acceptance by lenders and others of unearned fees only when those fees are divided between two or more parties, as in a kickback arrangement, or whether the provision also applies to unearned fees retained by a single defendant. Arguments were heard on February 21, 2012.

The statute provides that "[n]o person shall give and no person shall accept any portion, split, or percentage of any charge made or received for the rendering of a real estate settlement service in connection with a transaction involving a federally related mortgage loan other than for services actually performed." In the case below, *Freeman v. Quicken Loans, Inc.*, 626 F.3d 799 (C.A.5-La. 2010), a panel of the Fifth Circuit Court of Appeals ruled that the language of § 8(b) was unambiguous and did not cover unearned fees by a sole provider of settlement services. The Fifth Circuit noted that all of the circuit courts that have addressed the issue agreed that the statute plainly prohibits fee-splitting, which occurs when two or more persons split a fee, any portion of which is unearned. The Fourth, Seventh, and Eighth Circuits have held that RESPA is exclusively an anti-kickback provision and so requires two culpable parties. The Second, Third, and Eleventh Circuits have rejected the two-party requirement and have held that RESPA prohibits mark-ups, which occur when a service provider charges the borrower for services performed by a third party in excess of the cost of the services to the service provider, but keeps the excess itself. Previously, only the Second Circuit had explicitly addressed whether the RESPA provision prohibits a sole provider's "undivided unearned fees," which occur when a service provider charges the borrower a fee for which no correlative service is performed. In *Cohen v. JP Morgan Chase &*

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Co., 498 F.3d 111 (C.A.2-N.Y. 2007), the Second Circuit Court of Appeals found that § 8 prohibited undivided unearned fees.

One circuit judge dissented from the Fifth Circuit's decision and would have held that unearned undivided loan discount fees violated § 8(b) of RESPA. With the exception of its decision to give *Chevron* deference to the interpretation of § 8(b) articulated by the Department of Housing and Urban Development (HUD) in a policy statement, the dissent agreed with the Second Circuit's decision in *Cohen*. The dissent found the statutory phrase "any portion, split, or percentage of any charge...other than for services actually performed" to be ambiguous with respect to Congress's intent to prohibit unearned undivided fees, and reasoned that prohibiting such fees would strike at a core objective of RESPA, namely, that of promoting the transparency of costs associated with settlement.

The petitioner's brief for this case is available on WESTLAW in the SCT.BRIEF database at 2011 WL 3706112. The respondent's brief for this case is available on WESTLAW in the SCT.BRIEF database at 2011 WL 4352236. The reply brief for this case is available on WESTLAW in the SCT.BRIEF database at 2011 WL 4957383.

Eleventh Circuit

Is an oversecured creditor only entitled to the contract rate of interest from the date of filing until confirmation of the bankruptcy plan in a Chapter 13 case where the debtor invokes the "cram down" power of 11 U.S.C. § 1325(a)(5)(B)?

The Eleventh Circuit held that an oversecured creditor is only entitled to the contract rate of interest from the date of filing until confirmation of the bankruptcy plan in a Chapter 13 case where the debtor invokes the "cram down" power of 11 U.S.C. § 1325(a)(5)(B). *In re Garner*, --- F.3d ----, 2011 WL 5979019, 23 Fla. L. Weekly Fed. C 604 (11th Cir.(Ala.) Nov 30, 2011) (NO. 11-10465).

Section 506(b) of the Bankruptcy Code is an exception to the general rule that a creditor cannot claim interest accruing on debts during bankruptcy:

To the extent that an allowed secured claim is secured by property the value of which, after any recovery under subsection (c) of this section, is greater than the amount of such claim, there shall be allowed to the holder of such claim, interest on such claim, and any reasonable fees, costs, or charges provided for under the agreement or State statute under which such claim arose.

The issue on appeal is whether Section 506(b) applies following confirmation. In this appeal the decisions of the bankruptcy and district courts, which held that Section 506(b) is inapplicable following confirmation, are consistent with Supreme Court and circuit court decisions interpreting the scope of Section 506(b).

In *Rake v. Wade*, the Supreme Court noted that an oversecured creditor's claim for interest accrues under Section 506(b) "as part of the allowed claim from the petition date until the confirmation or effective date of the plan." 508 U.S. 464, 471, 113 S.Ct. 2187, 2191, 124 L.Ed.2d 424 (1993), *superseded on other grounds by statute* 11 U.S.C. § 1322(e). The oversecured creditor FUSB argued that *Rake* is not applicable to this case because the parties in *Rake* agreed that Section 506(b) only applied to the post-petition, pre-confirmation period.

The Court noted that interpreting Section 506(b) to only apply post-petition, pre-confirmation is also consistent with decisions of sister circuits that address the temporal scope of Section 506(b) in relation to Section 1325(a)(5)(B)(ii). Section 1325(a)(5)(B)(ii) allows confirmation of a debtor's plan if the value of property under the plan is not less than the allowed amount of the claim on the effective date of the plan. 11 U.S.C. § 1325(a)(5)(B)(ii) (2004). The Ninth and Second Circuits read Sections 506(b) and 1325 together to mean that interest accrues under 506(b) only until confirmation of the plan even though that section lacks an explicit temporal limitation. *In re Hoopai*, 581 F.3d at 1099–1100; *In re Milham*, 141 F.3d at 423, 425. The Court rejected FUSB's argument that because there is no "cutoff" provision in Section 506(b), an oversecured creditor can accrue interest post-confirmation until the equity cushion is exhausted.

Supreme Court, New York County, New York

To prove fraud does an insurer of mortgage securities need only show that the insured had misled it about the securities that it insured, not that the misrepresentations caused its losses?

Justice Eileen Bransten of the New York State Supreme Court held that to show fraud, the insurer MBIA need only show that the insured Countrywide had misled it about the $20 billion of securities that it insured, not that the misrepresentations caused its losses. *MBIA Ins. Corp. v. Countrywide Home Loans, Inc.,* --- N.Y.S.2d ----, 2012 WL 10899, 2012 N.Y. Slip Op. 22002 (N.Y.Sup. Jan 03, 2012) (NO. 602825/08).

MBIA posits common law claims for fraud and breach of warranty. The court finds that in this insurance context, with MBIA as an insurance company and Countrywide as an applicant for insurance, the claims are informed by New York common law and Insurance Law Sections 3105 and 3106. Both New York common law and Insurance Law are clear that a material misrepresentation made at the time an insurance policy is being procured may lead to a policy being rescinded and/or avoided. This corresponds to a standard claim for fraud, in which fraud is complete when a misrepresentation is made that induces a party to take action and that party suffers damages as a result. The court therefore finds that no basis in law exists to mandate that MBIA establish a direct causal link between the misrepresentations allegedly made by Countrywide and claims made under the policy. In order to prove its claims for fraud and breach of warranty, MBIA must prove all elements of its claims.

First Circuit

Has a bank, by presenting executed mortgage deeds to a registrar for recording years before the mortgagors' bankruptcy filing, attained a prepetition "interest in property" within the meaning of the Bankruptcy Code exceptions to the automatic stay and the trustee's strong arm power, and thus bank has interest in the real property superior to a later-in-time bona fide purchaser or judicial lien holder which could not be avoided as a preferential transfer?

The First Circuit affirmed a ruling that a bank, by presenting executed mortgage deeds to a Puerto Rico registrar for recording years before the mortgagors' bankruptcy filing, attained a prepetition "interest in property" within the meaning of the Bankruptcy Code exceptions to the automatic stay and the trustee's strong arm power, and thus had interest in the real property superior to a later-in-time bona fide purchaser or judicial lien holder.

Under Puerto Rico relation back provision, debtors' transfers of mortgage deeds to bank were "perfected" for purposes of preferential transfer provision of Bankruptcy Code as of the dates of presentment, which were outside the ninety day window for preferential transfers, because only a bona fide purchaser presenting documents earlier than bank could have acquired a superior interest; thus, mortgage deeds could not be avoided as preferential transfers. 11 U.S.C.A. § 547(e)(2); 546(b)(1)(A); 30 L.P.R.A. § 2256. *Soto-Rios v. Banco Popular de Puerto Rico*, 2011 WL 5865656 (C.A. 1-Puerto Rico)(2011).

First Circuit

In a bankruptcy can the right to pursue a commercial tort claim be passed to secured creditors as proceeds of original collateral?

In a bankruptcy the right to pursue a commercial tort claim cannot be passed to secured creditors as proceeds of the original collateral. *City Sanitation, LLC v. Allied Waste Servs. of Mass., LLC* (*In re American Cartage, Inc.*), 656 F.3d 82, 55 Bankr.Ct.Dec. 89 (1st Cir. (Mass.) Aug 31, 2011) (NO. 10-2284).

The United States Bankruptcy Court approved settlement of claims between Chapter 7 trustee and individual whom he had hired as controller and office manager to assist trustee with day-to-day business operations of debtor while it was in Chapter 11, and downstream purchaser of debtor's assets appealed. The United States District Court for the District of Massachusetts affirmed, and debtor's alleged successor in interest, which filed commercial tort claims against downstream purchaser, appealed. In resolving a questions of first impression, the Court of Appeals, held that: 1) right to pursue commercial tort claims could not be passed to a secured creditor as proceeds of original collateral, 2) bankruptcy trustee was the proper party to assert commercial tort claims; and 3) failure to comply with bankruptcy rule requiring that a first-tier appeal include a statement of the issues to be presented waived the omitted issue on appeal. *Affirmed.*

Third Circuit

To avoid sanctions, to what extent must attorneys make reasonable inquiry to verify information about debtor prior to making misleading statements regarding debtor to bankruptcy court in their motion for relief from stay?

Third Circuit affirmed bankruptcy court imposing sanctions under Bankruptcy Rule 9011 on mortgage lender and its attorneys based on inaccurate and misleading statements in motion for relief from stay and in response to claim objection. This case arises from the bankruptcy proceeding of a Chapter 13 bankruptcy. In the debtors' bankruptcy petition, they listed the bank HSBC, which held the mortgage on their house, as a creditor. In turn, HSBC filed a proof of claim with the bankruptcy court. Attorneys for creditors failed to adequately investigate accuracy of electronic information received through an automated third-party provider on creditor's behalf. *In re Taylor*, 655 F.3d 274, 66 Collier Bankr. Cas.2d 147, Bankr. L. Rep. P 82,062 (3rd Cir.(Pa.) Aug 24, 2011) (NO. 10-2154).

This case is an unfortunate example of the ways in which over reliance on computerized processes in a high-volume practice, as well as a failure on the part of clients and lawyers alike to take responsibility for accurate knowledge of a case, can lead to attorney misconduct before a court.

The Court is primarily concerned with two pleadings that HSBC's attorneys filed in the bankruptcy court—(1) the request for relief from the automatic stay which would have permitted HSBC to pursue foreclosure proceedings despite the Debtors' bankruptcy filing and (2) the response to the Debtors' objection to HSBC's proof of claim. The Court is also concerned with the attorneys' conduct in court in connection with those pleadings. ■

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Members in the News

Stephen J. Scherf, CIRA, CDBV, CPA/ABV, CFE (Asterion Consulting) recently appeared on NBC's 5 o'clock news broadcast to discuss the American Airlines Bankruptcy and to provide commentary on the bankruptcy process and the potential merger of the airline.

Scholar in Residence *continued from p. 1*

addresses, among others, a major problem faced by many family farmers filing under chapter 12: the sale of farm assets to make the farming operation economically viable, triggering a taxable gain which, as a priority claim or administrative expense, had to be treated more favorably than general unsecured claims or, if an administrative expense, had to be paid in full to confirm a chapter 12 plan. Even though the priority tax claims (other than administrative expense) could be paid in full in deferred payments under prior law, in many instances the debtor still could not meet this requirement, thus giving the government a virtual veto of the debtor's plan. Section 1222(a)(2)(A) seeks to limit this veto power.

Initially, one should note that chapter 12 is a remedial and substantive chapter for relief under the Bankruptcy Code. As such, to understand its proper role, one must recognize that a chapter for bankruptcy relief, such as chapter 12, is procedurally akin to a collective federal interpleader action. The debtor commences a case under the relevant chapter for relief (chapter 12 in this case) and then provides notice to all his creditors (stakeholders) of the filing. Upon the filing of the petition, the debtor's property is automatically transferred to the bankruptcy estate where it is protected by the automatic stay (like the res in a receivership case that is protected by the doctrine of *in custodia legis*) and used and administered in accordance with the Bankruptcy Code. Like any collective remedy, such as an interpleader action or receivership, the forum is inhabited by multiple parties making competing claims to assets. Like its federal receivership or interpleader counterpart, the bankruptcy forum cannot and does not limit its focus to a bilateral dispute; rather, the court must entertain simultaneous assertions of claims against the property of the estate in accordance with carefully crafted distributional schemes under the Bankruptcy Code.

Consistent with the Bankruptcy Code in general, chapter 12 bankruptcy policies include:

- the preservation of the family farm and farm operations;
- the equal distribution of estate property in accordance with the bankruptcy distributional scheme;
- an inclusive definition of "claim" to ensure the participation in a bankruptcy case of a greater universe of those with an interest in the debtor or the debtor's assets;
- the fresh start embodied in the chapter 12 discharge; and
- family farmer debtor responsibility, by delaying the chapter 12 discharge until full performance under the chapter 12 plan.

The Bankruptcy Code strikes a delicate balance between debtors and creditors: all creditors. Thus, one must be cautious in rushing to the Internal Revenue Code ("IRC"), including sections 1398 and 1399, a body of law that seeks bilateral determinations between the government and a taxpayer, in order to understand provisions in the Bankruptcy Code, a body of law that seeks to resolve multilateral claims and rights in a context far different with far different policies than one would find under the IRC.

Hall introduced that concern. A fundamental tenet of bankruptcy law is that claims of equal dignity are to be treated equally. The definition of "claim" is found in §101(5) and includes "any right to payment . . . ."[2] Although the definition is a federal question, courts regularly consult applicable nonbankruptcy law in an effort to understand better the existence of a claim.

In *Hall*, had the taxable transfer occurred *prepetition in a tax year that closed before the commencement of the case*, the federal tax law provides that the IRS has a right to payment, that is, a claim, in the chapter 12 case. That IRS claim is presumptively a general unsecured claim, treated like any other unsecured claim under the chapter 12 plan, unless the IRS can prove that it is entitled to priority treatment under the Bankruptcy Code. Priority is a bankruptcy term of art; its meaning cannot be gleaned from any other source of law.

Here, the federal income tax claim that arose from our *hypothetical sale* is arguably a priority tax claim under §507(a) and would have been entitled to special priority treatment under the Bankruptcy Code prior to the 2005 Act. Under old chapter 12, that priority tax claim would have to have been paid in full over time with interest or the chapter 12 plan would not have been confirmed absent IRS consent. This was the case even though the general unsecured creditors were paid little and certainly less than the full value of their claims. In fact, that is the very nature of the priority claim: the priority claim is ensured full payment before any general unsecured creditors are paid at all. Essentially, for every dollar increase in a priority claim, we witness a corresponding dollar decrease in funds left for the general unsecured creditors. Thus, the priority tax claim diverts distributions from other general unsecured creditors, disturbing the fundamental policy of equal treatment, and because it must be paid in full (although over time), it renders many chapter 12 plans no longer feasible, frustrating the policy of family farm preservation and family farmer discharge. But that was precisely the nature of chapter 12 as constructed by Congress prior to the 2005 Amendments to the Bankruptcy Code. It was this set of circumstances that Congress addressed in 2005 in enacting §1222(a)(2)(A).

Hall, however, is different than our hypothetical case above because, in *Hall*, the taxable transfer occurred postpetition, that is, while the debtors were in bankruptcy administering estate property. Thus, the taxable transfer did not create a claim but an administrative expense for a tax. Under section 503(b), postpetition taxes are generally administrative expenses and administrative expenses are priority claims under section 507(a); however, section 1399 of the IRC states that the commencement of a chapter 12 case does not create a separate taxable entity so that the bankruptcy estate could not actually incur a tax. That was the tension that the Court had to address in *Hall*.

When a debtor files for relief under chapter 12, a bankruptcy estate is created under section 541. The estate may incur its own

2 12 U.S.C. §101(5).

obligations that are generally treated as administrative expenses under §§503 and 507(a)(2) and paid out of property of the estate, including postpetition income under §1207(a)(2). Generally, administrative expenses are obligations of the estate and not necessarily obligations of the debtor. What clouded the issues in *Hall* is that the chapter 12 bankruptcy estate is treated under the IRC as a disregarded entity. See 26 U.S.C. §1399. In other words, unlike the bankruptcy case where an individual debtor files for relief under chapter 7 or 11, the filing of a chapter 12 petition does not create a separate taxable entity. The chapter 12 bankruptcy estate, unlike its chapter 7 or 11 counterpart, receives no new taxpayer identification number and has no duty to file returns.

In *Hall*, the government asserted that postpetition sale fails to qualify for nonpriority treatment under §1222(a)(2)(A) because of the language in section 1399, among other provisions. The government's position would essentially eviscerate §1222(a)(2)(A) in that it would deny the priority-stripping power of that Section when it would be needed most, in the actual administration of the bankruptcy case after a chapter 12 petition in bankruptcy has been filed. Relying on the text and context of the relevant statutes, the Majority of the Court agreed with the government notwithstanding the debilitating effect of such a holding on family farmer reorganizations, and held that the federal income tax is not incurred by the bankruptcy estate but by the individual debtor. It is clear, however, that the Court did not allow the unequivocal purpose of section 1222(a)(2)(A) to cloud its vision in interpreting the text and context of that provision, sections 503, 507, and IRC sections 1398 and 1399.

As an example, the legislative history to §1222(a)(2)(A) is sparse but illuminating. One of the principal sponsors of the law was Senator Charles Grassley, the only United States Senator who is also a family farmer. In support of the bill, Senator Grassley observed:

> But Chapter 12 can be made even better. "Safety 2000" will make Chapter 12 better. The bill expands the definition of family farmer so that more farmers can use Chapter 12. Under current law, family farmers can't use Chapter 12 to save their farms if a farmer has more than $1.5 million in debt. This is too restrictive, and my bill would let farmers who have up to $3 million in debt use Chapter 12. "Safety 2000" also helps farmers to reorganize by keeping the tax collectors at bay. Under current law, farmers often face a crushing tax liability if they need to sell livestock or land in order to reorganize their business affairs. According to Joe Peiffer a bankruptcy lawyer from Hiawatha, Iowa, who represents many family farmers, high taxes have caused farmers to lose their farms. Under the Bankruptcy Code, the I.R.S. must be paid in full for any tax liabilities generated during a bankruptcy reorganization. If the farmer can't pay the I.R.S. in full, then he can't keep his farm. This isn't sound policy. Why should the I.R.S. be allowed to veto a farmer's reorganization plan? "Safety 2000" takes this power away from the I.R.S. by reducing the priority of taxes during proceedings. This will free up capital for investment in the farm, and help farmers stay in the business of farming.[3]

Thus, the legislative history and the stated purpose of the new chapter 12 to save family farms that may be lost because of relatively large governmental claims, strongly supported a reading of section 1222(a)(2)(A) that would allow the priority-stripping provisions to be applied to postpetition transfers. New chapter 12 policy and Senator Grassley's vision as embodied in §1222(a)(2)(A) are greatly frustrated by the Majority's holding. The Majority's holding has resurrected priority treatment for claims that arise from the transfer of farm assets used in a debtor's farming operations if those transfers took place ***in bankruptcy but not to those transfers that took place during tax years that closed prior to a bankruptcy filing***.

Strange indeed. The immediate consequence of the opinion is that chapter 12 debtors may no longer mitigate the effect of tax liabilities generated from postpetition sales of farming assets. Thus, the primary thrust of the 2005 amendments to chapter 12 and section 1222(a)(2)(A) has been largely eviscerated by the opinion. This will result in more failed chapter 12 plans because the debtors are unable to meet the cash hurdle imposed by the confirmation standards and the treatment of administrative expenses, which are entitled to be paid in full in cash as of the effective date of the plan.

In Part II of this article, I plan to show how an understanding of cryptography and its focus on converting crypto-text into plain-text through the use of crypto-variables, the importance of context to archaeological praxis, and chapter 13 of the Bankruptcy Code shed light on the holding in *Hall* to teach us important lessons on how the Supreme Court will continue to resolve those difficult cases in the margins of the Bankruptcy Code. ■

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3 145 Cong. Rec. S750-02.

KB Toys Ruling: Trade Claims Purchases Subject to Disallowance

On May 4, 2012, a decision was made in *In re KB Toys, Inc.,*[1] that impacts the treatment in chapter 11 of trade claims related to transfers of debt of bankrupt companies. Judge Kevin Carey, of the U.S. Bankruptcy Court of the District of Delaware, ruled that if a trade claim is subject to disallowance in the seller's hands based on its failure to return an avoidable transfer, then the disability will travel with the claim from the seller to the buyer. An immediate impact of the decision will be the disallowance of $650,000 in claims asserted against the bankrupt debtor, *KB Toys*, by traders that have bought such claims.[2]

Section 547 of the Bankruptcy Code gives the debtor-in-possession broad powers to recover transfers made within 90 days prior to the filing of the petition.[3] In the case of insiders, the time period is extended to one year. The legislative history of this section indicates the primary concern of the drafters was to eliminate motivation on the part of creditors to "race to the courthouse to dismember the debtor" when the debtor appears to be sliding into bankruptcy.[4] Rather, the creditors should share equally in the available assets of the debtor and not be punished for attempting to work with the debtor by not asserting all available rights.

Section 502 of the Bankruptcy Code covering the allowance (or disallowance) of claims or interests provides, in subsection (d), *for the disallowance of any claim of any entity that is a transferee of a preferential or fraudulent transfer unless it has repaid the transferred amount to the bankruptcy estate* (emphasis added). Thus, section 502(d) of the Bankruptcy Code provides that the purchaser of a trade claim may have the claim dismissed if the seller of the claim fails to repay a liability that arose from a preference payment. Section 502(d) derived from Section 57g of the Bankruptcy Act of 1898 (repealed 1978), which has been interpreted as establishing the basis for allowance or disallowance of particular claims.

In *KB Toys,* Judge Carey disallowed trade claims that were purchased on the secondary market because the sellers of the claims had not repaid their preference liability. The court rejected the decision of the District Court in *Enron* (SDNY), which reversed the bankruptcy court ruling and held that disallowance pursuant to Section 502(d) created a "personal disability" that did not transfer with claims when they are sold to good faith purchasers on the open market.[5] The issue was framed as whether the purchaser of a trade claim holds the purchased claim subject to the same rights and disabilities, and is subject to the § 502(d) challenge, as is the original holder of the claim. Because previous court decisions were not in accord as to the plain meaning of this section, the court in *KB Toys* closely considered legislative history and the rationale of previous cases—i.e., *In re Metiom* and the bankruptcy court's opinion (subsequently reversed) in *Enron*. These were used to come to the conclusion that a transfer of a claim does not change the character of the claim itself but merely replaces one party with another.[6]

The *KB Toys* bankruptcy court in particular rejected the *Enron* district court's "assignment" versus "sale" analysis, noting that these concepts are not easily distinguishable and that neither is defined in the Bankruptcy Code. The court cited multiple sources for the view that the assignment-versus-sale analysis introduced a novel distinction that ignored the interchangeability of those terms and did not provide clear guidance for market participants going forward.[7] The court further considered concerns of potential disruption of the distressed debt markets, and noted that claims traders are sophisticated players capable of performing due diligence and accounting for the risk that avoidance actions could give rise to a defense to a claim.[8]

The court acknowledged its analysis applied only to *trade claims* purchased from the original holders noting that the Bankruptcy Code often gives special protection to transfers in "public markets." Moreover, the court considered the constructive or imputed notice to the buyer of the trade claims given the information that was made available in the schedules. Thus the Delaware bankruptcy court's ruling leaves room for a different conclusion with respect to (i) transfers of notes, bonds, bank debt and other instruments, and (ii) prepetition transfers or other transactions where information concerning the potential disallowance was unavailable.[9]

1 *In re KB Toys, Inc.*, 2012 WL 1570755 (Bankr. D. Del. May 4, 2012)

2 Brickley, Peg. (May 7, 2012). Claims ruling sets stage for final payout in KB Toys case. Dow Jones Daily Bankruptcy Review: DBR Small Cap. Online at http://bankruptcynews.dowjones.com/Article?an=DJFDBS0020120507e857mhvsb

3 Specifically, section 547 covers payments made on account of antecedent debt made within 90 days of filing (or within one year if made to an insider).

4 H.R. Rep. No.95-595, at 177-8 (1977). U.S. Code Cong. & Admin. News 1978, at 6137-8.

5 *In re KB Toys, Inc.,* at *9-11(analyzing *Enron Corp. v. Springfield Assocs., LLC (In re Enron Corp.),* 379 B.R. 425 (SDNY 2007).

6 *Id.* at *7-8. (analyzing *In re Enron*, 340 B.R. at 198-99).

7 *Id.* at *9.

8 *Id.* at *10.

9 WilmerHale Bankruptcy & Financial Restructuring Alert. May 18, 2012. Purchaser of trade claims takes subject to disallowance based on sellers; failure to repay preference liability. Online at http://wilmerhaleupdates.com/ve/ZZILuPjgLokYw93

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