# BIG BOX BANKRUPTCY: "THE KILLER B'S"

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## Introduction

Even if you are not a Bankruptcy lawyer, you have probably heard of at least one "Big Box" Bankruptcy case. Radio Shack, ToysRUs, Gander Mountain, Circuit City, and Gymboree are some that readily come to mind. These cases tend to move at a fast pace and, like the "smaller" Chapter 11 corporate cases, can involve pitfalls for the unwary.

## Similarities between "Big Box" Chapter 11s and Their "Smaller" Counterparts

The "Big Box" Chapter 11 cases and the "smaller" ones have a lot in common. First, no matter where the Bankruptcy Court is located state law applies. The case may be in Minnesota, New York or Delaware but if your client is in Texas, the Texas Property Tax Code still applies. Second, the sooner you find out about the case and file your notice of appearance the better because the final orders that grant "First Day Motions" can make or break your position in the case. Third, what happens in the "Big Box" cases can also happen in the "smaller" Chapter 11 cases.

## Texas Law Still Applies

Regardless of where the Debtor has chosen to file its Bankruptcy case, when it comes to property rights, state law applies. However, unless the Debtor's attorneys have encountered a Texas ad valorem tax claim in a previous case, it is highly unlikely that they will understand the basis for the claim or the law behind it. This includes attorneys who practice regularly in the Texas Bankruptcy courts. Because a large number of Bankruptcy Code provisions pertain to priority tax claims, there is a tendency to treat ad valorem tax claims as unsecured priority claims. However, the majority of Texas ad valorem property tax claims are secured claims. These claims are secured by self-perfecting liens that attach by operation of law to the property that is taxed, as provided in Section 32.01 of the Texas Property Tax Code. That section provides:

(a) On January 1 of each year, a tax lien attaches to property to secure the payment of all taxes, penalties, and interest ultimately imposed for the year on the property, whether or not the taxes are imposed in the year the lien attaches. The lien exists in favor of each taxing unit having power to tax the property.

(b) A tax lien on inventory, furniture, equipment, or other personal property is a lien in solido and attaches to all inventory, furniture, equipment and other personal property that the property owner owns on January 1 of the year the lien attaches or that the property owner subsequently acquires.

(c) If an owner's real property is described with certainty with metes and bounds in one or more instruments or conveyance and part of the property is the owner's residence homestead taxes separately and apart for the remainder of the property, each of the liens under this section that secures the taxes imposed on that homestead and on the remainder of that property extends in solido to all the real property described in the instrument or instruments of conveyance, unless the homestead is identified as a separate parcel and is separately described in the conveyance or another instrument recorded in the real property records.

(d) The lien under this section is perfected on attachment and except as provided by Section 32.03(b) [pertains to liens on manufactured homes], perfection requires no further action by the taxing unit. Tex. Prop. Tax Code § 32.01

In Texas, *ad valorem* tax liens are the highest-priority liens, senior even to purchase money or other pre-existing liens. Tex. Prop. Tax Code § 32.05. In addition, in Texas, ad valorem tax liens arise and attach along with the Debtor's personal liability for the taxes on January 1 of each tax year.

**Current Year Taxes Are Pre-Petition Claims**

It is generally understood that all amounts owed to an ad valorem property tax authority on the date of the filing of the petition constitute a prepetition claim. However, not every Debtor's attorney is aware of the fact that current year taxes, including those that are not yet due, also constitute a prepetition claim. It is common for a Debtor who has timely paid its prior year's taxes to fail to list an ad valorem tax authority as a creditor in its schedules or on the matrix because it mistakenly believes that a tax authority does not have a claim until the Debtor receives a tax bill. However, the Bankruptcy Code defines a "claim" as a right to payment whether it is liquidated, unliquidated, contingent or uncontingent. 11 U.S.C. § 101(5). Under Texas Law, a property owner's liability for ad valorem taxes for any given year arises on of January 1 of that year regardless of when the tax is ultimately assessed. Tex. Prop. Tax Code Sec. 32.01. Even if the tax authority does not know the amount of the taxes, it still has a claim for current year taxes because the right to payment incurs on January 1 when the lien and the personal liability for the tax

automatically arises. *In re Midland Industrial Service Corp.*, 35 F3d 164 (5th Cir. 1994). This also applies to postpetition taxes, which if the case is still pending, arise on January 1 of the subsequent year and constitute an administrative expense of the Bankruptcy estate.

**Texas Law Also Applies to PostPetition Taxes**

The same Texas Property Tax Code sections apply to taxes that arise on January 1 of the subsequent year. If the case is still pending without a confirmed Chapter 11 plan or a sale that has closed, the tax authority has what is known as an administrative expense claim against the Debtor. 11 U.S.C. §§ 503(b), 507(a)(8). This claim is secured by liens that have the same senior priority as the liens that secure the tax authority's prepetition claim. While other creditors are required to file and serve an administrative expense claim and request for payment, tax authorities are not required to do so as a condition of allowance of an administrative expense claim for ad valorem property taxes. 11 U.S.C. § 503(b)(1)(D).

**Ad Valorem Tax Liens Are First in Priority**

Chapter 11 Debtors may have one lender or more. They may also have property that is encumbered by mechanic's liens and/or IRS liens. Unless the Debtor filed its petition late in the year after paying that year's ad valorem property taxes, its property is also encumbered by ad valorem property tax liens. At least with regard to ad valorem ad valorem property tax liens, the answer to the question "whose lien is senior?"- is simple. Unless a very limited exception applies (which involves the IRS and business personal property) ad valorem property tax liens are senior to any other lien on the property, regardless of when the other lien attached to the property. Texas Prop. Tax Code § 32.05.

**Interest Rate for Ad Valorem Taxes Is Governed by 11 U.S.C. Section 511**

In the majority of bankruptcy cases in which the Debtor owns taxable property, the value of the collateral will exceed the amount of the tax debt. Therefore, the tax debt is oversecured and the tax authority is entitled to interest from the petition date through the effective date of the plan pursuant to 11 U.S.C. Section 506(b), as well as during the course of the plan pursuant to 11 U.S.C. Section 1129. *U.S. v. Ron Pair Enterprises, Inc. (In re Ron Pair Enter., Inc.).*, 489 U.S. 235 (1989). 11 U.S.C. Section 511 provides for payment of interest on an oversecured ad valorem property tax claim at the rate determined under applicable non-bankruptcy

law. Texas Property Tax Code Section 33.01(c) provides for interest on delinquent ad valorem property taxes at the rate of 1% per month, translating into a 12% annualized rate.

**A Bankruptcy Case Does Not Stay the Appraisal Process**

A Debtor in Bankruptcy is required to comply with state law. 28 U.S.C. §§ 959 and 960. The Texas Property Tax Code requires owners of business personal property to file a sworn rendition of the value of their property with the relevant appraisal district. Tex. Prop. Tax Code § 22.01 Failure to do so results in a penalty equal to ten percent of the base tax owed for the relevant tax year. Tex. Prop. Tax Code § 22.28(b). This penalty is secured by the statutory lien that arises on January 1 to secure all amounts ultimately owed. *Id.* Other aspects of the appraisal process that are not stayed by the Bankruptcy filing include, but are not limited to, notices of proposed value of the Debtor's real and business personal property, acceptances and rejections of rendition statements, the deadline to protest the proposed value of the Debtor's property, hearings to determine the fair market taxable value of the Debtor's property before the Appraisal Review Board and appeals of Appraisal Review Board rulings.

**A Bankruptcy Case Filing Does Not Stay the Mailing of Certain Tax Notices**

While the filing of a Bankruptcy case stays collection activity and postpetition lien filings, among other things, it does not act as a stay of the mailing of a tax bill, a notice of tax deficiency, a delinquency notice or other notice required under Texas Law. Section 362(b) of the Bankruptcy Code lists certain acts of tax authorities that are not violations of the automatic stay. Under the provisions of the Texas Tax Code, the tax authorities are statutorily required to send out certain notices to taxpayers, both on current-year and delinquent *ad valorem* property taxes. These notices, issued by the tax authority directly, fall under the exemption in section 362(b)(9)(B) and do not violate the automatic stay so long as such notices do not threaten any collection action against the debtor or the property, such as a tax lawsuit or foreclosure.

**"First Day Motions" Can Have a Lasting Impact on Ad Valorem Tax Claims**

"First Day Motions" are filed with the Bankruptcy petition or within a few days after the case is filed. Most of these motions pertain to the Debtor's operations such as the use of existing bank accounts, the payment of utility providers and payroll, the employment of professionals (including the Debtor's attorneys) and, even the honoring of gift

cards and customer reward programs. The majority of these motions tend to have little impact on the Debtor's creditors in general and are usually granted with little fanfare. However, other "First Day Motions" significantly impact the case and its creditors. These motions are for the use of cash collateral, approval of Debtor in Possession ("DIP") financing, use of the Debtor's existing cash management system, the closure of store locations and the sale of assets. These are especially common in retail cases or cases whether the Debtor needs to liquidate its business or sell it as a going concern as early as possible in order to maximize value. These motions, and the orders granting them, contain provisions that are solely for the benefit of the Debtor's prepetition lender, its postpetition lender, or both, with little or no regard for their impact on other creditors. Therefore, it is important to monitor a Chapter 11 case as early in its inception as possible in order to object to provisions in "First Day Motions" that adversely affect an ad valorem tax claim and the liens that secure it. For example, an order that allows a Debtor to use cash that is pledged as collateral to its prepetition lender (the "Cash Collateral Order") often contains findings and conclusions regarding the validity and priority of the prepetition lender's liens, provides for adequate protection in the form of replacement liens that are senior to all other liens (including liens that arise postpetition), provides for relief from the automatic stay and the right to exercise remedies under the loan documents in the event of a default under the order, and/or provides for the indefeasible application of the first proceeds from the sale of the Debtor's assets to the prepetition lender's claim before any other creditor is paid. Debtor in Possession financing orders ("DIP Orders") often contain similar provisions as those found in Cash Collateral Orders, including the indefeasible payment of all amounts owed to it from sale proceeds before they are disbursed to other creditors. It often is the case that the prepetition lender and the postpetition lender (the "DIP Lender") are one in the same. Both types of orders often provide for the payment of the prepetition lender's claim before any other creditor is paid. If the DIP lender is also the prepetition lender, often the DIP financing order provides that the prepetition debt must be paid from the DIP financing, which converts the prepetition debt to an administrative expense. It is also common for the Debtor to have a separate cash management order or a similar order regarding its bank accounts. These orders are

usually innocuous, but they should be reviewed for a provision that allows a lender to regularly sweep funds from the Debtor's bank accounts. This is very important when it comes to sale proceeds, since a DIP Lender who has authority to regularly sweep funds from the Debtor's accounts will also have the right to sweep sale proceeds from the Debtor's accounts. When the issue concerns sale proceeds that could be swept from the Debtor's account, the simplest solution is to have the sale order include a provision that requires the Debtor to pay ad valorem taxes at the sale closing or hold the funds in a segregated account that the lender cannot "sweep," such as Debtor counsel's trust account. As the senior lienholder, an ad valorem tax authority has the right to object to cash collateral and DIP financing motions that subordinate their liens to junior creditors, provide for the payment of junior creditors ahead of them in violation of the priorities set forth in the Bankruptcy Code, and propose other provisions that place payment of their claims and liens in jeopardy. As the senior lienholder, an ad valorem tax authority is entitled to adequate protection of its liens (which includes protection of its right to payment from the proceeds of the sale of its collateral prior to any creditor that is junior). 11 U.S.C. § 364(d)(1)(B). The Debtor has the burden on the issue of adequate protection. 11 U.S.C. §§ 363(p), 364(d)(2)

**Substantially All of the Debtor's Assets Can Be Sold in a Short Period of Time**

While it is more common for a "Big Box" Bankruptcy to move quickly and result in orders approving the sale of substantially all of the Debtor's assets and distribution of the majority of the sale proceeds within the first thirty days of the case, it can happen in the "smaller" Chapter 11 cases as well. It is important to monitor the cases from the beginning, not only for cash collateral and DIP financing orders, but for expedited sales of substantially all of the Debtor's assets as well. Debtors are able to obtain Bankruptcy Court approval of sales of substantially all of their assets when there is an "articulated business justification." *In re Lionel Corp.*, 722 F.2d 1063, 1070 (2nd Cir. 1983). Debtors can, and often do, have "Going Out of Business" sales where substantially all of the assets are sold to a company that conducts a liquidation sale. In cases where the value of a business is dependent on it remaining in operation, a Debtor will sell the business as a "going concern," often on short notice. Sometimes the sale motion is combined with a request for Court approval of bid procedures in an attempt to auction the assets and increase the amount of proceeds that

come in to the estate. These motions typically provide for the order approving the bid procedures to include the deadline for the submission of bids, the date of the auction, the deadline to object to the sale and the date of the sale hearing. It is important to review sale motions and motions to approve bid procedures for provisions that allow creditors to credit bid on their collateral, as well as provisions concerning the disbursement of sale proceeds. If the lender and other secured creditors, all of whom are junior to ad valorem tax authorities, have the right to credit bid (bid the amount of their claim against their collateral), the tax authority should object and request that the creditor be required to satisfy the ad valorem tax liens prior to receiving possession of the property. In the event of an asset sale that results in proceeds, rather than a credit bid which does not typically involve proceeds, there are several ways that the funds can be handled. The funds can be disbursed immediately pursuant to provisions in the sale order, held and disbursed pursuant to further order of the court, or disbursed through a plan. If the case has a Cash Collateral Order or a DIP Financing Order that provides for the immediate, indefeasible payment of the sale proceeds to the lender prior to any other creditor receiving payment, the tax authority will need to obtain language in the sale order that supersedes the provisions of all prior orders and provides for either immediate disbursement of the funds to the tax authority or for the Debtor to hold the funds, to which the tax authorities' liens attach, in a separate account as adequate protection of its liens. A sale motion that provides for a substantial disbursement of the funds to creditors with little left over for a reorganization is actually a *sub rosa* plan. *In re Braniff Airways, Inc.*, 700 F.2d 935 (5th Cir. 1983). If the motion does not provide for the tax authority to receive all amounts that it is entitled to receive, it should object to the sale motion. *Sub rosa* plans are not limited to sale motions. They have also appeared in the form of motions for authority to use cash collateral, motions for authority to provide Debtor in Possession financing and motions to approve settlement agreements.

**Ad Valorem Tax Claims Are Entitled to Specific Treatment Pursuant to the Bankruptcy Code**

Because *ad valorem* tax claims are secured, they are also entitled to certain treatment in the Chapter 11 plan. They are entitled to lien retention and the payment of interest on their claims to protect the value as of the effective date, pursuant to 11 U.S.C. Section 1129(b)(2)(A), like all other secured creditors. Property taxes are usually only a

fraction of the value of the property, so these claims are generally oversecured and entitled to interest pursuant to 11 U.S.C. Section506(b), in addition to interest that accrues from the effective date of the plan through payment in full. The interest that accrues pursuant to 11 U.S.C. Section 506(b) becomes part of the allowed secured claim to be paid pursuant to the plan. *Rake v. Wade*, 508 U.S. 464, 471 (1993). Interest that accrues pursuant to 11 U.S.C. Section 506(b) and 1129(b)(2)(A) interest is set at the state statutory rate, pursuant to 11 U.S.C. Section511. Texas Property Tax Code Section 33.01(c) provides for interest on delinquent ad valorem property taxes at the rate of 1% per month, translating into a 12% annualized rate. A plan provision that provides for interest on an *ad valorem* property tax claim at a rate less than 12% per annum is in violation of 11 U.S.C. Section 511 and will be grounds for an objection to confirmation of the plan. Moreover, in Chapter 11 cases secured tax claims are entitled to be paid in regular installments over a period of no more than five years from the petition date, and in a manner not less favorable than the most favored nonpriority unsecured claim provided for in the plan. 11 U.S.C. § 1129(a)(9)(D). If the case reaches the plan confirmation stage, the entire plan should be reviewed for provisions that negatively impact prepetition ad valorem property tax claims and administrative expense claims for postpetition taxes. These provisions can be found in the definitions and in other sections of the plan, not just in the section devoted to the treatment of claims. Examples of objectionable provisions are definitions of "penalty" that result in the nonpayment of prepetition penalties to which the tax authority is entitled, failure to provide for postpetition interest on oversecured ad valorem tax claims, a provision that states that no postpetition interest will be paid on claims, a provision that states that less than the statutory rate of interest will be paid on an ad valorem tax claim, a provision that provides for interest during a time frame that is shorter than what the Bankruptcy Code mandates, provisions that vest assets in the reorganized Debtor or a liquidating trust free and clear of liens, provisions that vest assets in the reorganized Debtor free and clear of all liens upon the payment of one secured creditor, and exit financing that is secured by liens on the Debtor's assets that are senior to all other liens.

**Omnibus Objections to Claims Cannot Be Over-looked**

A common tool of Debtor's counsel is the use of the claims objection process to eliminate

claims. When the case is large, this is often done with multiple filings of objections, called Omnibus Objections. These objections take the "shotgun approach" of listing a large number of claims that are deemed objectionable for a multitude of reasons. In "Big Box" cases, claim objections can begin before a plan is confirmed and can sometimes last for years after confirmation. These objections can be innocuous with the intention of cleaning up the list of claims by removing claims that are already paid or are duplicates. However, they can be more serious and have the effect of disallowing an ad valorem property tax claim entirely or reducing its priority, resulting in less or no payment. Common objections are that the claim does not match or appear on the Debtor's books and records, that the claim is not yet due, that the claim is filed in the wrong case or that the claim is unsecured. These objections are generally a result of the Debtor's counsel's lack of familiarity with the Texas Property Tax Code's provisions and can often be resolved if a response is filed.

**Conclusion**

While Chapter 11 cases can move quickly, a careful, proactive attorney that timely files objections can protect a tax authority's position.