Practical guidance at Lexis Practice Advisor®

Lexis Practice Advisor® offers beginning-to-end practical guidance to support attorneys' work in specific legal practice areas. Grounded in the real-world experience of expert practitioner-authors, our guidance ranges from practice notes and legal analysis to checklists and annotated forms. In addition, Lexis Practice Advisor provides everything you need to advise clients and draft your work product in 16 different practice areas.

Paul H. Zumbro

George E. Zobitz

Understanding Certain Priority and Significant Liabilities in Bankruptcy

by Paul H. Zumbro, George E. Zobitz, Matthew M. Kelly, and Stephanie A. Marshak, Cravath, Swaine & Moore LLP

Introduction

First, although a primary goal of the Bankruptcy Code is to treat all unsecured creditors equally, the Bankruptcy Code provides certain unsecured creditors with prioritized distributions. Priority unsecured claims may be satisfied only from unencumbered assets but are senior in right of payment to general unsecured claims. Secured creditors come ahead of both general and priority unsecured creditors in the bankruptcy waterfall up to the value of their collateral.

Second, unsecured lenders should be aware that certain large liabilities may be of such a significant magnitude that they overwhelm the unsecured creditors' claims pool by diluting other general unsecured creditor's pro rata claim to the unencumbered assets available to distribute after distributions are made to the priority unsecured creditors.

Third, although a second primary goal of the Bankruptcy Code is to give the debtor a "fresh start" by discharging indebtedness, bankruptcy law and practice may result in certain potentially significant liabilities remaining outstanding post-bankruptcy. Debtors may find it desirable to settle or satisfy large liabilities that will remain outstanding post-bankruptcy using the debtors' unencumbered assets during a bankruptcy case in order to avoid being saddled with significant liabilities post-bankruptcy and to avoid the need to file for bankruptcy protection a second time (pursuant to 11 U.S.C. § 1129(a)(11), one of the requirements to confirm a plan of reorganization is that confirmation of the plan "is not likely to be followed by the liquidation, or the need for further financial reorganization, of the debtor"). Such settlements and satisfactions of liabilities diminish the unencumbered assets available to satisfy general unsecured claims.

Thus, unsecured lenders should be aware that certain special types of unsecured liabilities may have priority over general unsecured creditors' claims and that certain categories of liabilities, while not entitled to priority treatment, may be of such a significant magnitude that they overwhelm the unsecured creditors' claims pool (e.g., massive environmental liabilities) or may diminish the unencumbered assets available to satisfy the general unsecured claims if satisfied during the course of the case (e.g., pension obligations).

Unsecured liabilities that may receive priority treatment, make up a significant portion of the unsecured creditors' claims pool, or that may not be dischargeable in whole or in part at the conclusion of a chapter 11 case include: (1) tax liabilities, (2) liabilities pursuant to the Comprehensive Environmental Response, Compensation, and Liability Act ("CERCLA"), 42 U.S.C. §§ 9601 et seq. and other environmental protection laws, (3) liabilities stemming from pension and employee benefits, and (4) liabilities derived from collective bargaining agreements.

Priority Unsecured Claims

In a chapter 7 liquidation case, unsecured claims are paid pro rata in the order in which they are listed under section 507(a) of the Bankruptcy Code. 11 U.S.C. §§ 507(a), 726. Under a chapter 11 plan, most holders of priority unsecured claims must receive payment in full in cash, unless the holder of a particular priority unsecured claim agrees to different treatment or the class accepts a chapter 11 plan that provides for deferred cash payments equal to the allowed amount of such claim. See 11 U.S.C. § 1129(a)(9)(B). General unsecured claims in a chapter 11 plan are distributed pro rata from the unencumbered assets available after distributions

are made to the priority unsecured claims. See 11 U.S.C. § 1129(a)(7) (requiring in a chapter 11 reorganization that general unsecured creditors may not receive less than the amount they would receive in a chapter 7 liquidation). Finally, given that fluctuations in valuation and other matters can impact the position of secured creditors vis-à-vis general unsecured creditors (including the possibility that the secured creditor will end up with an unsecured "deficiency" claim or that a secured lender has not properly perfected its claim), secured lenders should also be aware of bankruptcy priority rules.

Tax Liability

Underlying the Bankruptcy Code is the public policy that a bankruptcy case cannot be used as a means of avoiding tax liabilities incurred by a debtor. Section 1129(d) of the Bankruptcy Code reflects this public policy by providing that, upon request of a party-in -interest that is a governmental unit, the court may not confirm a chapter 11 plan if the "principal purpose of the plan is the avoidance of taxes." 11 U.S.C. § 1129(d). More generally, the Bankruptcy Code promotes this public policy by granting tax claims certain priority rights to distribution. The Bankruptcy Code prioritizes distribution of unencumbered assets to unsecured tax claims before distribution of unencumbered assets to general unsecured claims. In a chapter 7 liquidation case, unsecured claims are paid in the order in which they are listed under section 507(a) of the Bankruptcy Code. 11 U.S.C. §§ 507(a), 726(a)(1) (property of the estate is to be distributed "first, in payment of claims of the kind specified in, *and in the order specified in*, section 507..." (emphasis added)). Eighth priority under section 507 is granted to claims for (1) income taxes for which a tax return was due within three years before the bankruptcy, provided the tax year ended before the bankruptcy; (2) income taxes assessed within 240 days before the bankruptcy; (3) taxes withheld or collected from others before the bankruptcy, such as social security or income taxes withheld from employees' wages; (4) employment taxes on wages paid before the bankruptcy where the return was due within three years before the bankruptcy; (5) excise taxes where the transaction giving rise to the excise tax occurred, or any applicable return was due, within three years before bankruptcy; and (6) property taxes and customs duties if incurred, or related to a transaction that occurred, within one year before bankruptcy. 11 U.S.C. § 507(a)(8)(A)-(a)(8)(F).

Under a chapter 11 plan, all holders of priority unsecured claims of governmental units pursuant to section 507(a)(8) must receive regular installment payments in cash of (i) a total value, as of the effective date of the plan, equal to the allowed amount of such claim (ii) over a period ending not later than five years after bankruptcy filing date and (iii) in a manner not less favorable than the most favored non-priority unsecured claim provided for by the plan. 11 U.S.C. § 1129(a)(9)(B),(C). Section 1129(a)(9)(C)(iii) of the Bankruptcy Code allows governmental entities to examine a plan and require the plan proponent to offer them the best set of repayment terms offered any other class of unsecured creditors. For example, if general unsecured creditors are proposed to be paid in full within three years from filing, section 1129(a)(9)(C) of the Bankruptcy Code will require that priority tax claims also be paid within three years, and not the maximum five years otherwise applicable.

Additionally, certain claims for taxes incurred by the estate after the petition date are entitled to priority as administrative expenses. 11 U.S.C. § 507(a)(2) (administrative expenses are typically first priority unsecured claims in corporate chapter 11 cases, as they come behind only domestic support obligations in the section 507 priority list and those claims are not typically relevant in a corporate case); 11 U.S.C. § 503(b)(1)(B) (specifying which tax claims constitute administrative expenses). These include property taxes, whether secured or unsecured, and any tax attributable to an excessive allowance of a tentative carryback adjustment that the estate received. 11 U.S.C. § 503(b)(1)(B). In an involuntary case, tax claims arising in the ordinary course of the debtor's business in the "involuntary gap" between the filing of the involuntary petition and the entry of the order for relief are entitled to third priority. 11 U.S.C. §§ 507(a)(3), 502(f).

If any person liable to pay any tax neglects or refuses to pay the tax after demand, the amount shall be secured by a lien in favor of the United States upon all property and rights to property, whether real or personal, belonging to such person. 26 U.S.C. § 6321. Like all other liens, for a tax lien to be effective as against a trustee in bankruptcy it must be perfected prior to a bankruptcy filing. To perfect a tax lien, the U.S. government must file notice of the lien in the appropriate jurisdictions as prescribed by the Internal Revenue Code. 26 U.S.C. § 6323(f). Statutory lien notices are filed in recording offices depending on the type of property, its location, and applicable state law. Id.

Tax claims supported by liens are secured claims and therefore do not fall within the eighth priority class, which covers only unsecured tax claims. However, in a chapter 11 case, secured tax claims that, but for their secured status would have fallen within the eighth priority class, are entitled to receive regular installment payments in cash in the same manner as unsecured claims in the eighth priority class. 11 U.S.C. § 1129(a)(9)(D). In essence, this means that the secured tax claim must receive at least as favorable treatment in the plan as the most favored unsecured, non-priority class of claims. In a chapter 7 case, secured tax claims are treated as regular secured claims, and thus rank ahead of all priority unsecured claims to the extent of their collateral. 11 U.S.C. § 724(b).

According to the UCC's first in time, first in right rule, a prior perfected lien will trump a newly perfected lien. U.C.C. § 9-322 (2010). One interesting issue that comes up in practice is how liens securing revolving credit facilities relate to other consensual or nonconsensual liens, such as tax liens. In the case of a tax lien and a prior perfected lien securing a revolving facility, the tax lien

may prime the prior-perfected revolving lien with respect to advances made after the perfection of the tax lien. This is due to the revolving nature of the obligations under a revolving credit facility: even though the lien securing the revolving facility may have pre-dated the tax lien (and thus would be prior to the tax lien under the general rule), the obligation in respect of a revolving credit advance made after the imposition and perfection of a tax lien by definition did not exist at the time of the tax lien so may be considered to have been secured after the tax lien. However, the Internal Revenue Code states that a tax lien shall not be valid with respect to revolving advances made before the 46th day after the date of the tax lien filing (or earlier, if the revolving lender had actual notice or knowledge of the tax lien filing). 26 U.S.C. § 6323(d). Because 45 days is a relatively short safe harbor, it is important for secured revolving lenders to monitor tax lien filings to ensure that their liens do not become subordinate to a tax lien. This generally is not an issue for secured term lenders, who make only a single advance at closing and typically do searches for tax liens as a closing condition.

CERCLA and Other Environmental Protection Laws

CERCLA and numerous other federal and state environmental protection laws broadly seek to hold parties responsible for environmental cleanup. Such environmental liability can be very costly, and so companies with large environmental liabilities might seek to use the protections afforded by the Bankruptcy Code to avoid or defer environmental obligations. Environmental liabilities are not treated specially under the Bankruptcy Code. Nevertheless, environmental liabilities ought to be analyzed by creditors, both because of their potentially significant magnitude and because of certain limitations on the dischargeability of environmental cleanup obligations.

The primary issue surrounding a debtor's environmental liabilities is whether they constitute claims under section 101(5) of the Bankruptcy Code. The debtor's liability creates a claim only if it gives rise to a right to payment. 11 U.S.C. § 101(5). If a liability constitutes a claim, it can be discharged at the conclusion of the bankruptcy case. See 11 U.S.C. §§ 524, 727 and 1141(d). If a liability does not constitute a claim, it cannot be discharged, and the debtor will remain saddled with the liability after emerging from bankruptcy protection. There are two important implications of this non-dischargeability: first, when analyzing necessary postemergence capital requirements, these obligations need to be taken into account; and second, it may be desirable to satisfy or settle these claims during the bankruptcy case (which of course will diminish the amount of unencumbered assets available to satisfy general unsecured claims).

In 1985, the United States Supreme Court ruled that a cleanup injunction pursuant to a state environmental law was a dischargeable claim under the Bankruptcy Code. Ohio v. Kovacs, 469 U.S. 274 (1985). In Kovacs, although the cleanup order was injunctive, the only performance actually sought was monetary reimbursement, as the debtor was unable to participate in the cleanup due to a receiver's control over the property. Id. at 283.

Some courts have since held that a cleanup injunction constitutes a dischargeable claim only if the specific statute giving rise to the injunction provides an alternative right to seek monetary relief. See, e.g., USA v. LTV Corp. (In re Chateaugay Corp.), 944 F.2d 997, 1008 (2d Cir. 1991) ("But an order to clean up a site, to the extent that it imposes obligations distinct from any obligation to stop or ameliorate ongoing pollution, is a 'claim' if the creditor obtaining the order had the option, which CERCLA confers, to do the cleanup work itself and sue for response costs, thereby converting the injunction into a monetary obligation."); Mark IV Industries, Inc. v. New Mexico Environment Department (In re Mark IV Industries, Inc.), 459 B.R. 173, 186 (S.D.N.Y. 2011) ("the proper test for determining whether an enforcing agency has a 'right to payment' under section 101(5)(B) for an environmental injunction is to consider whether the enforcing agency has a right to cleanup and recover response costs under the statute pursuant to which the enforcing agency has obtained its injunction"). Courts have disagreed as to whether an environmental injunction that does not include an alternative right to seek monetary relief may be, in effect, a dischargeable claim where the debtor will be forced to spend money to hire a third party in order to comply with the injunction. Compare United States v. Whizo, Inc., 841 F.2d 147 (6th Cir. 1988) (holding that an injunction based on the Surface Mining Control and Reclamation Act of 1977 without an alternative right to monetary relief was a dischargeable claim where the debtor would be required to spend money to hire a third party to comply with the injunction), with U.S. v. Apex Oil Co., 579 F.3d 734 (7th Cir. 2009) (holding that an injunction based on the Resource Conservation and Recovery Act without an alternative right to monetary relief was not a dischargeable claim, even though the debtor would have to hire an outside firm to perform the work). Finally, even if the statute provides an alternative right to monetary relief, an injunction that proscribes ongoing pollution cannot be satisfied through the payment of money and therefore may not be a dischargeable claim. In re Mark IV Industries, Inc., 459 B.R. at 188.

Monetary claims for cleanup costs incurred prepetition and monetary claims for future response costs arising from prepetition bankruptcy releases of hazardous wastes are generally considered general unsecured, dischargeable claims. However, cleanup costs that are liquidated post-petition but pre-effectiveness with respect to the prepetition release of hazardous wastes are generally entitled to administrative expense priority. In re Chateaugay Corp., 944 F.2d at 1010.

Other potentially responsible parties (PRPs) may be able to assert claims to recover at least some of the future cleanup costs debtors otherwise would have been responsible for under CERCLA. The Second Circuit generally does not allow claims seeking

recovery of future remediation costs because according to Bankruptcy Code section 502(e)(1)(B), the court shall disallow contingent claims for reimbursement or contribution where the claimant is coliable with the bankrupt debtor and PRPs are generally co-liable with the debtor. See In re Lyondell Chem. Co., 442 B.R. 236 (Bankr. S.D.N.Y. 2011); In re Chemtura Corp., 443 B.R. 601 (Bankr. S.D.N.Y. 2011); Route 21 Associates of Belleville, Inc. v. MHC, Inc., 486 B.R. 75 (S.D.N.Y. 2012). However, other courts have allowed PRPs to assert claims for future costs under CERCLA section 107(a) for reimbursement when the co-liability element is unsatisfied. See In re Allegheny Int'l, Inc., 126 B.R. 919 (W.D. Pa. 1991), aff'd without opinion, 950 F.2d 721 (3d Cir. 1991) (allowing recovery of past and future response costs for a cleanup that lacked any government involvement); In re Matter of Harvard Indus., 138 B.R. 10 (Bankr. D. Del 1992); In re APCO Liquidating Trust, 370 B.R. 625 (Bankr. D. Del 2007).

Due to the resulting fine line between (dischargeable monetary) environmental claims and (non-dischargeable) environmental injunctions, creditors should be aware that, in a case involving a debtor with significant environmental liabilities, substantial estate resources may need to be dedicated to resolving difficult environmental claim issues, and that, to the extent dischargeable, environmental claims can potentially eat up a substantial portion of the unsecured creditors' claims pool. In addition, to the extent creditors are receiving as a distribution in a case the equity of a reorganized debtor, they should be aware that certain environmental liabilities (e.g., arising under a clean-up injunction) may not be dischargeable through bankruptcy.

Pension and Employee Benefits

As a matter of public policy, the Bankruptcy Code extends certain protections to current and former employees of the debtor. Specifically, certain claims against the debtor for contributions to an employee benefit plan may be granted a lien under applicable non-bankruptcy law and may be treated as priority claims under the Bankruptcy Code.

When a defined benefit plan subject to the Employee Retirement Income Security Act of 1974 (ERISA) is terminated without sufficient assets to pay all its promised benefits, the Pension Benefit Guaranty Corporation (PBGC) becomes the trustee. The PBGC typically has four types of claims in bankruptcy: (a) claims for unpaid PBGC insurance premiums ("premium claim"), pursuant to 29 U.S.C. § 1307; (b) a claim for a premium at a rate equal to $1,250 multiplied by the number of individuals who were participants in the defined benefit plan immediately before the termination date ("termination claim"), pursuant to 29 U.S.C. § 1306(a)(7); (c) a claim for unfunded benefit liabilities of the pension plan, if any, pro-rated to the date of plan termination ("unfunded benefit claim"), pursuant to 29 U.S.C. § 1362(b); and (d) a claim for any unpaid minimum funding contributions ("minimum funding claim"), pursuant to 29 U.S.C. §§ 1082(b)(2), 1342(d), 1362(c) and 26 U.S.C. § 412(b)(2). Unfunded benefit liabilities are the value of the plan's benefit liabilities minus the current value of the plan's assets. See 29 U.S.C. § 1301(a)(18). The PBGC's claims are joint and several obligations of the plan sponsor and each member of its controlled group. 29 U.S.C. §§ 1307, 1306, 1362(a) and 1082(b)(2). In bankruptcy, the PBGC typically files its entire claim separately against each debtor in the controlled group and can pursue its claim against non-debtor controlled group members as well (including non-U.S. subsidiaries which likely do not guarantee any bank or bond debt, potentially giving the PBGC a structurally senior claim against those entities). Unless the PBGC's claims are described otherwise below, such claims are generally considered general unsecured claims.

If a defined benefit plan is terminated during a bankruptcy reorganization proceeding, then the termination claims are not claims in the terminating employers' bankruptcy cases, but instead become obligations of the employers only upon their emergence from bankruptcy or case dismissal. 29 U.S.C. § 1306(a)(7)(B); see Pension Benefit Guaranty Corporation v. Oneida Ltd., 562 F.3d 154 (2d Cir. 2009). That means that these liabilities are effectively non-dischargeable. There are two important implications of this nondischargeability: first, when analyzing necessary post-emergence capital requirements, these obligations need to be taken into account, and second, it may be desirable to settle these claims with the PBGC during the bankruptcy case (which of course will diminish the amount of unencumbered assets available to satisfy general unsecured claims).

If the plan sponsor and the members of its controlled group fail or refuse to pay the full amount of the unfunded benefit liability, after demand by the PBGC, a lien arises on all property and rights to property, whether real or personal, belonging to the plan sponsor and the members of its controlled group in the amount of such unfunded benefit claim (including interest), except that such lien may not be in an amount in excess of 30% of the collective net worth of the plan sponsor and its controlled group. 29 U.S.C. § 1368(a). Additionally, if (1) a plan sponsor fails to make the minimum funding contributions before the due date for such payment and (2) the unpaid balance of such payment when added to the aggregate unpaid balance of all preceding payments exceeds $1 million, then there shall be a lien upon all property and rights to property, whether real or personal, belonging to the plan sponsor and the members of the controlled group. 26 U.S.C. § 412(n). The minimum funding automatic lien shall be equal to the aggregate unpaid balance of the required minimum funding contributions. Id. Like all other liens, for the unfunded benefit lien and the minimum funding lien to be effective as against a trustee in bankruptcy it must be perfected prior to a bankruptcy filing. To perfect the unfunded benefit lien or the minimum funding lien, the PBGC must file statutory notice of the lien in the appropriate jurisdictions as prescribed by the Internal Revenue Code, as such liens are treated as tax liens. See 29 U.S.C. § 1368(c)(4); 26 U.S.C. § 412(n)(4)(C). Statutory lien notices are filed in recording offices depending on the type of property, its location and applicable state law. See 26 U.S.C. § 6323(f). Note that as a tax lien, there are certain circumstances in which a non-tax lien will trump a prior perfected tax lien pursuant to 26 U.S.C. § 6323(b), (c) and (d). If the PBGC does not perfect before it is subject to the automatic stay

or the avoidance preference period, even if the unfunded benefit lien or the minimum funding lien was created prepetition, the PBGC's unfunded benefit claims and minimum funding claims would generally be considered general unsecured claims. Because unfunded benefit liens cannot be created until after a plan is terminated, such liens are generally not perfected in time to create secured claims in bankruptcy.

Where its claims are unsecured, the PBGC generally asserts various bases on which its claims should be afforded priority status. Payments to fund an employee benefit plan related to services rendered after the filing of the petition may constitute second priority administrative expense claims as actual and necessary costs of administering the bankruptcy estate. 11 U.S.C. §§ 507(a)(2), 503(b). In a chapter 11 case, administrative expense status is available for any payments required to be made for retiree benefits before a confirmed chapter 11 plan is effective. 11 U.S.C. § 1114(e)(2). Note that, for purposes of such priority, "retiree benefits" means payments to any entity or person for the purpose of providing or reimbursing payments for retired employees and their spouses and dependents, for medical, surgical, or hospital care benefits, or benefits in the event of sickness, accident, disability, or death under any plan, fund, or program. 11 U.S.C. § 1114(a). Fifth priority is granted to claims against the debtor for any contributions to an employee benefit plan arising from services rendered within 180 days before bankruptcy, to the extent of $12,850 per individual (less any amount paid to each such individual as a fourth priority wage claim for wages earned within 180 days before the filing of the petition up to $12,850 per individual). 11 U.S.C. §§ 507(a)(5)(A), 507(a)(4).

In short, some pension and employee benefits may be granted secured or priority status and others might be non-dischargeable, such that a debtor may ultimately be saddled after emergence from chapter 11 with significant liabilities stemming from pension and employee benefits. PBGC claims frequently make up a sizable portion of the general unsecured claims pool. Thus, the resolution of PBGC claims (including via settlements) during the course of the bankruptcy case is often an important part of the overall restructuring solution in a corporate chapter 11 case.

Collective Bargaining Agreements

Section 1113 of the Bankruptcy Code reflects Congress's intent to protect employees covered by collective bargaining agreements with the debtor. Specifically, section 1113 provides that the trustee may not seek to reject a collective bargaining agreement without first proposing modifications to the employee representative. The debtor's proposals must: (1) be based upon the most complete and reliable information available at the time; (2) include only those modifications that are "necessary to permit the reorganization"; and (3) "assure[] that all creditors, the debtor and all of the affected parties are treated fairly and equitably." 11 U.S.C. § 1113(b)(1)(A). In approving a request for rejection, the court must find that: (1) the trustee met the proposal requirements; (2) the employee representative refused the proposal without good cause; and (3) the balance of the equities clearly favors rejection of the agreement. 11 U.S.C. § 1113(c). Once rejected, the employees covered by collective bargaining agreements with the debtor can file a general unsecured claim.

During, but not in lieu of, these steps, the court may approve interim modifications to the terms, conditions, wages, benefits, or work rules of the collective bargaining agreement. 11 U.S.C. §§ 1113(e), (f). However, under the protective requirements of section 1113, the court may permit interim modifications to a collective bargaining agreement only if such modifications are essential to the continuation of the debtor's business or in order to avoid irreparable damage to the estate. 11 U.S.C. § 1113(e).

Creditors should be aware of the potential impact of this collective bargaining process in cases involving significant unionized workforces.

This excerpt from Lexis Practice Advisor®, a comprehensive practical guidance resource providing insight from leading practitioners, is reproduced with the permission of LexisNexis. Lexis Practice Advisor includes coverage of the topics critical to attorneys who handle legal matters. For more information or to sign up for a free trial visit www.lexisnexis.com/practice-advisor. Reproduction of this material, in any form, is specifically prohibited without written consent from LexisNexis.

Learn more at: lexisnexis.com/practice-advisor

LexisNexis, Lexis Practice Advisor and the Knowledge Burst logo are registered trademarks of Reed Elsevier Properties Inc., used under license.
© 2017 LexisNexis. All rights reserved.