

# Pratt's Journal of Bankruptcy Law

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# Seventh Circuit Holds That the Illinois Department of Revenue Must Present Evidence to Support the Value of Its Claim for Adequate Protection in a Section 363 Sale

*By Michael T. Benz, Bryan E. Jacobson, and James P. Sullivan\**

*The U.S. Court of Appeals for the Seventh Circuit recently held that the Illinois Department of Revenue could not collect delinquent retail and sales taxes from the proceeds of assets sold pursuant to Section 363 of the Bankruptcy Code because it failed to present evidence to the bankruptcy courts of the losses it suffered as a result of the assets being sold free and clear of its right to pursue the purchasers of the assets pursuant to the Bulk Sales provisions of Illinois law. The authors of this article discuss the decision.*

Recently, in *Illinois Department of Revenue v. Hanmi Bank* (“Hanmi”) and *Illinois Department of Revenue v. First Community Financial Bank* (“First Community”),<sup>1</sup> the U.S. Court of Appeals for the Seventh Circuit held that the Illinois Department of Revenue (“IDOR”) could not collect delinquent retail and sales taxes from the proceeds of assets sold pursuant to Section 363 of the Bankruptcy Code because IDOR failed to present evidence to the bankruptcy courts of the losses it suffered as a result of the assets being sold free and clear of IDOR’s right to pursue the purchasers of the assets pursuant to the Bulk Sales provisions of Illinois law.<sup>2</sup>

## BACKGROUND

The *First Community* case involved a cinema and café located in Naperville, Illinois, while *Hanmi* concerned a group of five gas stations in several Illinois

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<sup>1</sup> 895 F.3d 465 (7th Cir. 2018). The cases were consolidated on appeal to the Seventh Circuit.

<sup>2</sup> 35 ILCS 5/902(d) and 35 ILCS 129/5j (together, the “Illinois Bulk Sales Acts”). The Illinois Bulk Sale Acts give IDOR the right to pursue the purchaser in a bulk sale for state taxes owed by the seller.

towns.<sup>3</sup> In the respective bankruptcy cases, Hanmi Bank and First Community Financial Bank were the senior creditors of the debtors, and IDOR had junior claims for unpaid taxes. In both cases, the debtors sought bankruptcy court approval to sell substantially all of their assets pursuant to Section 363.

Citing Section 363(e), IDOR requested that the bankruptcy courts set aside a portion of the sale proceeds as a form of adequate protection, given that the sales would eliminate IDOR's interest in the debtors' assets and its right under the Illinois Bulk Sales Acts to recover the outstanding taxes from the purchasers.<sup>4</sup> While the bankruptcy courts in both cases either agreed or assumed that IDOR was entitled to adequate protection for its interest under Section 363, the bankruptcy courts held that because the sale proceeds were insufficient to satisfy the claims of First Community Bank and Hanmi Bank, IDOR was not entitled to any of the sale proceeds.<sup>5</sup>

## THE APPEAL

On appeal, IDOR argued that the bankruptcy courts failed to account for its right under the Illinois Bulk Sales Acts not only to pursue a bankruptcy debtor for unpaid taxes but also to recover unpaid taxes from the *purchaser* of a debtor's assets. IDOR's primary contention was that because the debtors' assets were sold free and clear of IDOR's interest, the value of the assets to prospective purchasers was higher than it otherwise would have been, such that the final sale price for the assets necessarily included a premium for the removal of IDOR's interest, entitling IDOR to a share of the sale proceeds.

The Seventh Circuit agreed in principle that IDOR was entitled to adequate protection under Section 363(e) because the removal of IDOR's interest, particularly IDOR's statutory right to recover unpaid taxes from the purchasers,

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<sup>3</sup> Both bankruptcy cases were initially filed under Chapter 11 of the Bankruptcy Code but were later converted to Chapter 7.

<sup>4</sup> Section 363(e) of the Bankruptcy Code allows a party whose interest has been removed from sold assets to obtain "adequate protection," which typically takes the form of a payment from the sale proceeds to compensate the party for the decrease in the value of its interest extinguished pursuant to Section 363(f). That decrease is calculated by comparing what the creditor will recover in bankruptcy where its interest in property has been extinguished pursuant to Section 363(f) with what its recovery would have been had its interest remained intact.

<sup>5</sup> The bankruptcy courts found that because IDOR was a junior creditor, and the sales proceeds were insufficient to repay Hanmi Bank and First Community Financial Bank in full, there was no need to consider adequate protection for IDOR. The bankruptcy courts held that affording IDOR a share of the sales proceeds in these circumstances would be tantamount to allowing IDOR to "jump the queue" of priority established by the Bankruptcy Code.



likely increased the sales prices. Nevertheless, the Seventh Circuit held that IDOR failed to provide the bankruptcy courts with evidence upon which the bankruptcy courts might assign a reasonable value to its interest.

The Seventh Circuit disagreed with IDOR's position that it was entitled to sales proceeds equal to 100 percent of the taxes it was authorized to collect from the purchasers, describing as unrealistic the idea that IDOR would necessarily have recovered 100 percent of the tax delinquency from an "informed purchaser." Any premium a purchaser might pay for the removal of IDOR's interest, the court explained, would have been discounted by the likelihood of IDOR actually collecting the delinquent taxes from the purchaser. The court found it more likely that a purchaser would negotiate with IDOR to settle IDOR's claim for delinquent taxes at "something less than 100 percent that the Bulk Sales Provisions would allow it to collect." More importantly, because IDOR presented no evidence regarding how much it would have collected from the purchasers, there was no way to determine what decrease in value the Section 363 orders caused or what consideration the purchasers paid specifically to buy the assets free and clear of IDOR's interest under the Illinois Bulk Sales Acts. Accordingly, the Seventh Circuit concluded that the bankruptcy courts did not err in valuing IDOR's adequate protection interest at \$0.

## CONCLUSION

Although IDOR was unsuccessful in the *Hanmi* and *First Community* cases, bankruptcy practitioners in Illinois and other jurisdictions<sup>6</sup> should review whether prospective bankruptcy sales under Section 363 will trigger the application of state specific statutory schemes governing bulk sales, and whether negotiations should take into account possible adequate protection claims by state taxation authorities for delinquent taxes owed by the debtor. Lenders' counsel should also review the availability of state law foreclosure relief as an alternative remedy, since as the Seventh Circuit recognized in the *Hanmi* and

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<sup>6</sup> Most states maintain successor liability provisions in their tax statutes governing the payment of delinquent taxes by purchasers of business assets in bulk sales. *See, e.g.*, Cal. Rev. & Tax. Code § 6811 *et seq.* (requiring a purchaser of a business or stock of goods to withhold sufficient of the purchase price to cover payment of delinquent state taxes until the former owner produces a receipt from the California State Board of Equalization showing the taxes have been paid or a certificate stating that no amount is due); N.Y. Comp. Codes R. & Regs. tit. 20, § 537.0 *et seq.* (requiring a purchaser of bulk assets to notify the New York State Department of Taxation and Finance at least 10 days prior to closing. Within five days of receipt of the notice, the Department must advise the purchaser whether it is possible the seller has unpaid sales taxes, and within 90 days thereafter, must notify the purchaser of the actual amount of sales taxes due from the seller).

*First Community* cases, foreclosure does not trigger the application of the Illinois Bulk Sales Acts.