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Alert

Fourth Circuit Affirms Priority of Tax Lien over Failed Chapter 11 Professional Fees

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A federal "secured tax claim takes priority over [a professional's] claim to fees" in an aborted Chapter 11 case, held the U.S. Court of Appeals for the Fourth Circuit on Jan. 26, 2016. *In re Anderson*, 2016 WL 308590, at *1 (4th Cir. Jan. 26, 2016). Affirming the bankruptcy and district courts, the Fourth Circuit explained that the professional's claim for Chapter 11 "administrative expenses was" *not* "among the unsecured claims covered by [Bankruptcy ("Code")] § 724 (b)(2)," which permits only certain "holders of administrative expense claims … the right to subordinate secured tax creditors in [a later] Chapter 7 liquidation[ ]." *Id.* at *2. The amendments to Code Section 724(b)(2) in 2005 and 2010 evidenced Congress' intent to "exclud[e] claims for the expenses incurred during [a] prior [failed] Chapter 11" case. According to the Fourth Circuit, Congress wanted "to provide greater protection for holders of tax liens … from erosion of their claims' status by expenses incurred" in Chapter 11 cases. *Id.*, citing H.R. Rep. No. 109-31 [I], at 100 (2005). The only administrative expenses that prime a tax lien, therefore, are the burial expenses of a Chapter 7 liquidation.

Relevance

Professionals in reorganization cases — financial advisers, accountants and lawyers — have a keen interest in getting paid for their services. Similarly, other creditors (e.g., secured lenders, unsecured creditors) are often eager to subordinate asserted priority claims such as professional fees that would reduce their recovery. *Anderson* underscores the risk of non-payment to Chapter 11 professionals when: (1) the Chapter 11 case fails; *and* (2) a taxing authority has a lien on the debtor's assets.

Statutory Context

"The general rule in bankruptcy is that secured claims are satisfied from the collateral securing those claims prior to any distributions to unsecured claims." *Id.*, citing Code §§ 506, 725; *In re Midway Airlines, Inc.*, 383 F.3d 663, 669 (7th Cir. 2004). Thus, secured claims prime all other administrative and unsecured claims in a bankruptcy case. Applying that general rule in *Anderson*, the IRS tax claim would ordinarily have been "paid first," with "nothing … left for payment" to unsecured administrative and other claims. *Id.*

But Chapter 7 of the Code provides a limited exception to the general rule, in Section 724(b)(2): Property of the estate "that secures an allowed claim for a tax … shall be distributed … to any holder of a claim … [for administrative] expenses incurred under this chapter *and shall not include [administrative] expenses incurred under Chapter 11*." (emphasis added). This limited exception enables administrative priority creditors in a Chapter 7 case to "'step into the shoes' of secured tax creditors … so that when the collateral securing the tax claims are sold, the unsecured [administrative priority] creditors are paid

first." Administrative expense claims in Chapter 7 liquidations thus have "the right to subordinate secured tax creditors." In 2005, because Congress was concerned that Chapter 11 debtors would be incurring administrative expenses "when there was no real hope for a successful reorganization, to the detriment of secured tax creditors when Chapter 7 liquidation ultimately proved necessary," it excluded expenses incurred during the prior unsuccessful Chapter 11 reorganization case from the administrative expenses "covered by § 724(b)(2)." *Id.*

Facts

The debtor filed its Chapter 11 petition on Feb. 3, 2010, with the professional ("P") approved as debtor's counsel. The IRS filed a claim against the estate for $1 million, most of which was secured by all of the debtor's property. P received bankruptcy court approval for compensation of $200,000. That claim was entitled to an administrative priority in the Chapter 11 case under Code Section 507(a)(2) as an expense of the Chapter 11 estate.

The bankruptcy court later converted the case to Chapter 7 on Nov. 17, 2011, and a trustee was appointed. The total amount of funds available in the debtor's estate was $720,000. The Chapter 7 administrative expenses alone amounted to roughly $300,000, leaving the estate with approximately $420,000 for distribution, an amount substantially below the $1 million needed to satisfy the IRS secured tax claim. The $200,000 owed to P was also unpaid. "So unless [P's] unsecured administrative claim took priority over the secured claim of the IRS, [P] would not collect its fees." *Id.* at *1. The legal issue, therefore, was whether P "could 'subordinate' the IRS … claim" under Code Section 724(b)(2). *Id.*

The trustee sought an order from the bankruptcy court excluding P's claim as an administrative expense. The United States and the trustee stressed that P was "not entitled to subordinate the IRS's secured tax claim" *Id.* at *3. In response, P argued that an earlier version of Section 724(b)(2) governed and that the current version of the statutory section "would have an impermissible retroactive effect, cutting off its right to recover for Chapter 11 administrative expenses incurred before Congress" amended the Code in 2010. The bankruptcy court dismissed P's objection, however, reasoning that the current version of Section 724(b)(2) governed "under the normal rule that 'a court is to apply the law in effect at the time it renders its decision.'" *Id.*, citing *Bradley v. Sch. Bd. of Richmond*, 416 U.S. 696, 711 (1974). In its view, the current version of Section 724(b)(2) was "already … in effect when the case converted to Chapter 7, so application of current law would have no retroactive effect on P's right to subordinate tax liens in a Chapter 7" case. *Id.* The district court affirmed for essentially the same reason.

The Fourth Circuit

Affirming, the Fourth Circuit agreed "that courts should apply the law in effect when they render their decisions ... unless that law would operate retroactively without clear congressional authorization." *Id.* at *4. Finding that P's claim "is governed and foreclosed by" the current version of Section 724(b)(2), the court reasoned that its ruling would have the "advantage of being clear and easy to administer." *Id.* at *5.

Rejecting P's argument that the lower courts had retroactively impaired its rights, the court of appeals stressed that before Congress amended the Code in 2005 and 2010, "§ 724(b)(2) had no application to the Debtor's case at all. It afforded [P] no entitlement to subordinate the IRS's secured tax claim for the threshold reason that it simply did not apply in the Chapter 11 [case] that began [here] in early 2010 and did not end until November 2011, eleven months *after*" the last relevant Congressional amendment.

Thus, by "the time the case converted to Chapter 7 in November 2011," the earlier "version of § 724(b)(2) had been superseded already by the current corrected … version." *Id.*

Comment
Anderson serves to remind professionals in a Chapter 11 case to evaluate: (1) the chance of a failed reorganization; and (2) the existence and amount of any federal or state tax liens against the debtor's property. Even when there is a large tax lien, though, the parties can avoid the application of Code Section 724(b)(2) by using a Chapter 11 liquidation if reorganization is not feasible.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or the author.

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