Emory Bankruptcy Developments Journal

Volume 36
Issue 1 *A Tribute to James H.M. Sprayregen*

2020

The Decline in Value Formulation: How Courts Should Approach State Bulk Sale Provisions in Bankruptcy

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THE DECLINE IN VALUE FORMULATION: HOW COURTS SHOULD APPROACH STATE BULK SALE PROVISIONS IN BANKRUPTCY

ABSTRACT

Bulk sale provisions give state departments a unique power that distinguishes them from the traditional creditor. In light of the special nature of the interests derived from bulk sale provisions, courts should recognize such interests to be protectable by § 363(e), even if traditional bankruptcy procedures would value that interest at $0. In lieu of blindly protecting the interests of state departments or senior creditors, courts should meet somewhere closer in the middle of each party's interests. In reaching this middle ground, to assess the degree to which this protection should extend, the burden should be on the state department to prove that the stripping away of its interest resulted in that interest declining in value. To prove such a fact, a state department must show that it would have recovered value from its interest, notwithstanding the fact that the interest was stripped away. Courts should place a value on such an interest that is commensurate to the decline in value of that interest, provided the state department has proven the decline in value. The recognition of such an interest as protectable serves to avoid litigation about how courts should recognize such an interest. Furthermore, it will allow parties to approach a bulk sale without having to worry about dealing with inconsistent courts that oftentimes unduly favor state departments over individual creditors, and vice-versa. By clearing up such confusion, buyers, sellers, creditors, and state departments will be more likely to negotiate with each other before the purchase occurs, allowing all parties to ensure their interests are well represented. Accordingly, courts should adopt a "decline in value" formulation, provided in dicta of Illinois Department of Revenue v. Hanmi Bank, to determine what value to place on interests deriving from bulk sale provisions.

INTRODUCTION

The Seventh Circuit's recent decision in *Illinois Department of Revenue v. Hanmi Bank* has left many questions unanswered regarding how "bulk sale provisions" should be treated when exercised by state revenue departments.[1] For the purposes of this Comment, bulk sale provisions are state statutes requiring the purchaser in a bulk sale to follow certain procedures aimed at protecting the ability of the state to collect unpaid taxes. Following this decision, it is prescient to explore whether bulk sale provisions create an interest in state revenue departments, and, if they do, how courts should classify and treat such interests. This question is important because how we classify bulk sale provisions affects not only the debtor and creditor-revenue departments, but also the non-revenue department creditors and potential purchasers.

Historically, states instituted bulk sale provisions to protect against debtors liquidating a large portion of their inventory and absconding with the proceeds.[2] This was common in inventory transactions, in which a debtor would acquire all or most of inventory on credit.[3] After the acquisition of this inventory, a debtor could simply sell off the inventory and leave the state.[4] Typically, this occurred between small business and wholesale providers. Modern advances in credit reporting have greatly minimized this risk because wholesale providers now have much better means of assessing the credibility of an institution.[5]

To supplement or replace state law, the original UCC Article 6 was enacted. This provided that buyers who were receiving assets in a bulk sale must contact the seller's creditors and maintain a list of all creditors, as well as a schedule of property in the bulk sale.[6] If the buyers did not comply with UCC Article 6, the creditors had the ability to void the sale.[7] While only a model, the original UCC Article 6 was adopted by various states who desired to protect creditors from being spurned by duplicitous debtors who were commencing a bulk sale.[8]

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[1] *See* Ill. Dep't. of Revenue v. Hanmi Bank, 895 F.3d 465 (7th Cir. 2018).

[2] UNIFORM COMMERCIAL CODE ARTICLE 6, PREFATORY NOTE.

[3] *Id.*

[4] *Id.*

[5] *Id.*

[6] *Id.*

[7] *Id.*

[8] Currently, seven states and territories have adopted UCC Article 6: Arizona, California, District of Columbia, Indiana, Georgia, Montana, and Nebraska. The majority of states have enacted different, albeit similar bulk sale provisions. AIRSLATE LEGAL FORMS, INC., *States Adopting The UCC*, U.S. LEGAL, https://uniformcommercialcode.slegal.com/states-adopting-the-ucc/.

Because of advances in credit reporting, and a general disappearance of the original problem, the original UCC Article 6 was seen as overly burdensome on buyers.[9] Thus, the revised UCC Article 6 was set forth. The revised version allows states two options. Option A allows states to repeal UCC Article 6.[10] Option B offers a revised and updated Article 6 to those states and jurisdictions that will evaluate the positions of creditors, sellers, and buyers, and then decide whether to retain a bulk sales law.[11]

The initial aim of UCC Article 6 was to protect creditors. Many state bulk sale provisions have this aim in mind as well, but often with an emphasis on a narrower subset of creditors, i.e., creditors who owe back taxes to the state. These taxes may have resulted from a failure to pay taxes over time,[12] however, it is often the case that the unpaid taxes stem from sales taxes that accompany the bulk sale itself. Typically, these bulk sale provisions apply when an entity sells or transfers a substantial portion of its business, outside of its normal business operations—thus the reasoning behind the name "bulk sale."[13]

The bulk sale statute relied upon in *Hanmi* is typical of many states' bulk sale edicts, and dictates that a purchaser in a bulk sale must give notice of the purchase to the Illinois Department of Revenue (IDOR).[14] From there, IDOR reserves the ability to issue a "stop order" commanding the purchaser to set aside an estimated portion of the purchase monies to cover any unpaid taxes owed by the seller to IDOR.[15] IDOR then has sixty business days to determine the actual amount owed, and to issue a revised stop order compelling the purchaser to continue holding the set-aside purchase monies.[16] Should the seller fail to pay the unpaid taxes, IDOR may issue a demand to the purchaser to turn over the set-aside funds.[17] If the purchaser fails to provide notice, reserve the requisite funds, or turn over the reserved funds, IDOR has the ability to go after the purchaser personally.[18]

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9 UNIFORM LAW COMMISSION, http://www.uniformlaws.org/ActSummary (last visited Nov. 14, 2018).

10 *Id.*

11 *Id.*

12 These back taxes could be generated from property tax, income tax, etc.

13 35 ILL. COMP. STAT. ANN. 120 / 1 (LexisNexis 2019); Ill. Dep't. of Revenue v. Hanmi Bank, 895 F.3d 465, 474 (7th Cir. 2018).

14 35 ILL. COMP. STAT. ANN. 120 / 1 (LexisNexis 2019); *Hanmi Bank*, 895 F.3d at 474.

15 35 ILL. COMP. STAT. ANN. 120 / 1 (LexisNexis 2019); *Hanmi Bank*, 895 F.3d at 474.

16 35 ILL. COMP. STAT. ANN. 120 / 1 (LexisNexis 2019); *Hanmi Bank*, 895 F.3d at 474.

17 35 ILL. COMP. STAT. ANN. 120 / 1 (LexisNexis 2019); *Hanmi Bank*, 895 F.3d at 474.

18 35 ILL. COMP. STAT. ANN. 120 / 1 (LexisNexis 2019); *Hanmi Bank*, 895 F.3d at 474.

This relatively straightforward process becomes increasingly muddled when bulk sales are part of a bankruptcy proceeding. Because bulk sales carry the specter of 11 U.S.C. § 363(f) with them—providing that the bankruptcy trustee may sell property "free and clear of any interest in such property of an entity other than the estate" so long as certain factors are satisfied[19]—this strips away IDOR's interest in the property (the ability to collect unpaid taxes), and the purchaser receives the property without having to worry about any liability due to IDOR.[20] However, § 363(f) does not leave interest holders at a complete loss.[21] Entities whose interests are stripped via § 363(f) may request adequate protection pursuant to § 363(e), which provides:

> Notwithstanding any other provision of this section, at any time, on request of an entity that has an interest in property used, sold, or leased, or proposed to be used, sold, or leased, by the trustee, the court, with or without a hearing, shall prohibit or condition such use, sale, or lease as is necessary to provide adequate protection of such interest.[22]

In other words, § 363(e) provides a mechanism by which an entity whose interest has diminished in value may be recompensed to the degree that interest decreased in value.[23] Such compensation typically comes from the proceeds of the sale.[24]

The instant issue arises because of the way in which courts apply § 363(e). It is customary for courts to grant adequate protection only to protect the relevant interest from a *decline* in value.[25] The burden of showing that an interest has declined in value is on the interest holder.[26] The bankruptcy court has the discretion to determine whether the interest holder has overcome this burden by proving that the interest has declined or is declining in value.[27] The practical

[19] 11 U.S.C. § 363(f) (2019) (Factors include: "(1) applicable nonbankruptcy law permits sale of such property free and clear of such interest; (2) such entity consents; (3) such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property; (4) such interest is in bona fide dispute; or (5) such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.").

[20] 35 ILL. COMP. STAT. ANN. 120 / 1 (LexisNexis 2019); *Hanmi Bank*, 895 F.3d at 467.

[21] § 363(f); *Hanmi Bank*, 895 F.3d at 468.

[22] § 363(e).

[23] § 363(e); *Hanmi Bank*, 895 F.3d 465.

[24] *See, e.g.*, *Hanmi Bank*, 895 F.3d at 467.

[25] *See Hanmi Bank*, 895 F.3d at 470; *see also* Zink v. Vanmiddlesworth, 300 B.R. 394, 401 (N.D.N.Y 2003).

[26] *Zink*, 300 B.R. at 401.

[27] *Id.* (Adequate protection need not only follow from the use of § 363(f). Oftentimes, adequate protection is used to lift an automatic stay in a bankruptcy case in which a secured property is depreciating in value. The bankruptcy court has the discretion to lift the stay and order that the depreciating property be foreclosed on in order to liquidate the depreciating collateral).

effects of the "declining in value" formulation of § 363(e) are apparent when a creditor seeks to utilize § 363(e) in a bankruptcy proceeding in which junior creditors are set to receive nothing. For example, imagine a creditor (Creditor A) wishes to assert § 363(e) to protect its claim of $100,000 in a proceeding in which the assets of the estate amount to $500,000. Imagine further that a second creditor (Creditor B) has a secured claim of $1 million dollars. The bankruptcy trustee strips away Creditor A's interest and pays the entirety of the estate to Creditor B. Creditor A then applies for adequate protection, arguing that its interest has diminished from $100,000 to $0. The bankruptcy court would assuredly deny Creditor A's request, because its interest never actually diminished in value. Given that the estate was insolvent, and the entirety of the assets were owed to Creditor B whose claim had priority over Creditor A, Creditor A would have never received anything from the estate, regardless of whether its interest was stripped away pursuant to § 363(f). Thus, Creditor A's interest was always worth $0, and therefore could not have diminished in value.

The notion that adequate protection may only be granted when a creditor's interest has diminished in value is a crucial step in understanding why state departments such as IDOR contend that their interests stemming from bulk sales should be viewed differently than, for example, the interest held by Creditor A. The distinguishing factor, as IDOR and other state departments contend, between a creditor like Creditor A, and a state department operating pursuant to a bulk sale provision, is that a state department's interest diminishes in value the moment a state department can no longer seek payment through successor liability doctrine. Regardless of whether a state department would receive any value deriving from its claim in the bankruptcy proceeding, it would be able to seek the lost value from the purchaser, outside of bankruptcy, pursuant to the bulk sale provision. Accordingly, although the state department's interest may be valued at $0 for purposes of the bankruptcy proceeding, the ability to pursue the purchaser is valuable, notwithstanding what its value is for purposes of the bankruptcy proceeding. By stripping away that ability via § 363(f), the bankruptcy proceeding results in the state department's interest diminishing in value.

Thus, state departments will likely contend that their interest is "special" in a sense, because, despite the fact that its interest did not decline in value within the administration of the estate,[28] the ability to realize the interest outside of bankruptcy distinguishes the state department from other creditors. By taking

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[28] Their interest did not decline via the bankruptcy proceeding as they would have received $0 from the estate itself, regardless of whether the interest was stripped pursuant to § 363(f).

away the ability of a state department to pursue successor liability against a purchaser, the trustee has robbed the state of whatever value it would have derived from the purchaser. In other words, a state department will contend that its interest is "special" and thus should be afforded extra protection, because it need not rely on the assets of the bankruptcy estate to recoup the value of its claim.

Given the interplay between §§ 363 (f) and (e), it is easy to understand the importance of determining whether bulk sale provisions create "special" interests in state revenue departments. If a bulk sale provision creates a "special" interest in the state revenue department, that interest can be protected pursuant to § 363(e), and the state revenue department can be remunerated for the loss of value in that interest stemming from the bulk sale.[29] The recognition of an interest with the ability to circumvent the typical application of § 363(e), i.e., an interest that may still be adequately protected despite the fact that that interest did not diminish in value within the confines of a bankruptcy estate's asset distribution, has profound effects on the administration of a bankruptcy estate experiencing a bulk sale, the most obvious effect being a tendency to lower the sale price, and ultimately, lower the return that other creditors will receive on their claims.

This Comment intends to explore the ways in which purchasers and creditors (both regular creditors and state department creditors) should approach bulk sales, as well as provide reasons for why courts should recognize the special ability of a state department to utilize successor liability, while still adhering to an adequate protection framework that rests on a "decline in value" formulation that provides adequate protection to the extent that a state department shows that interest declined in value. In doing so, this Comment will compare two cases that grappled with how to handle bulk sale provisions—*Illinois Department of Revenue v. Hanmi Bank*, and *Schnyder v. State Board of Equalization*—to highlight the varying weights courts give to bulk sale provisions.[30] From there, a discussion of policy concerns that shape how the courts should respond to the issue is examined. And finally, an exploration about how the relevant parties should approach a bulk sale, in order to best prepare for a bulk sale taking place during a bankruptcy.

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[29] 11 U.S.C. § 363(e) (2019); *Hanmi Bank*, 895 F.3d 465.

[30] *Hanmi Bank*, 895 F.3d at 468; Schnyder v. State Bd. of Equalization, 101 Cal. App. 4th 538, 542 (Cal Ct. App. 2012).

I. BACKGROUND

At the heart of the issue of how to dealing with bulk sale provisions in a bankruptcy proceeding is the policy question of whom courts should offer more protection to—senior creditors or state departments? When it comes to this issue, the Courts in both *Hanmi* and *Schnyder* fall on opposite sides of the coin.[31] While the *Schnyder* court operated upon a strong conviction that bulk sale provisions are designed to limit bulk sales in an effort to protect the state from losing tax revenue, the *Hanmi* Court's convictions were more modest, with far less of an emphasis on protecting the state department's interest.[32] This section explores each case in more detail and lays the foundation for this Comment's argument—that courts should not afford state departments' interests deriving from bulk sale provisions the kind of protection offered in *Schnyder*, but instead should apply the "decline in value" formulation that would have been implemented in *Hanmi* if the state department had proven the amount of the decline in its interest.[33]

A. Illinois Department of Revenue v. Hanmi Bank

Hanmi was a consolidated appeal in which the Illinois Department of Revenue requested adequate protection of its interests arising from a bulk sale provision.[34] Because the bankrupt businesses were selling off all of their assets, outside their ordinary courses of business, the Illinois Bulk Sale Provision applied.[35] In facilitating the sale, the bankruptcy court allowed the sale to proceed pursuant to § 363(f) of the U.S. Bankruptcy Code (Code), resulting in IDOR's interest being stripped away, effectively leaving IDOR with no interest in the bankruptcy estate, as well as leaving IDOR without the ability to go after the purchaser under successor liability imparted by the bulk sale provision.[36] Because its interest was stripped away, and thus, in its opinion, significantly diminished, IDOR requested adequate protection pursuant to § 363(e) of the Code.[37] However, § 363(e) provides for adequate protection when an entity's interest has *diminished* in value, and in this case the Court determined, given the fact that the senior claims exceeded the amount of the debtors' assets, IDOR, as

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31 *Hanmi Bank*, 895 F.3d at 468; *Schnyder*, 101 Cal. App. 4th at 542.
32 *Id.*
33 *Id.* at 478.
34 *Hanmi Bank*, 895 F.3d 465.
35 *Id.*; 35 ILL. COMP. STAT. ANN. 120 / 1 (LexisNexis 2019).
36 *Hanmi Bank*, 895 F.3d at 467.
37 *Id.*

a junior creditor, would have received nothing regardless of whether its interest remained intact.[38] Thus, IDOR's interest did not *diminish* in value, because the value of its interest had always been $0.[39] Given this, IDOR was not entitled to adequate protection.[40] Because the value of IDOR's "interest" was $0, the Court was able to skirt the question of whether the bulk sale provisions had actually created an interest in IDOR.[41] The Court assumed the interest without holding whether bulk sale provisions create an interest in creditor-revenue departments.[42]

Despite the fact that IDOR's interest did not diminish in value, IDOR contended its interest diminished in value due to the special nature of that interest.[43] The thrust of its contention was that its ability to hold the purchaser personally liable had real value, because "the purchase price for the debtor's properties necessarily included some amount of consideration for the removal of IDOR's interest."[44] In other words, had IDOR's interest remained intact, the purchaser would have requested a lower purchase price, given the fact that bulk sale provisions require the purchaser to reserve a portion of the purchase monies to pay the state revenue department for any unpaid taxes owed by the debtor.[45] Since IDOR's interest was removed, the debtor was able to charge more for the property, and thus, the resulting difference in sale price amounted to the value of IDOR's interest.[46] The upshot of IDOR's argument was that it should not have mattered whether IDOR's status as a junior creditor would have resulted in its receiving $0 from the sale of the proceeds, because the value of its interest was inherently baked into the purchase price.[47]

Against this backdrop, we can see that IDOR considered its interest special, given the fact it could pursue the purchasers personally should it fail to comply with the bulk sale provision stop order.[48] Given the removal of that "special interest," pursuant to § 363(f), IDOR felt as though the removal of that interest

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38 *Id.* at 471.

39 *Id.* at 481.

40 *Id.*

41 *Id.*

42 *Id.* at 468. Given the lack of a holding on whether IDOR held a cognizable interest or not, this paper will explore whether bulk sale provisions create interests in state revenue departments.

43 *Id.* at 477.

44 *Id.* at 473.

45 *Id.* at 476.

46 *Id.*

47 *Id.* at 477.

48 *Id.* at 467–68.

constituted consideration that manifested itself in the adjusted (lower) purchase price.[49] The Court was responsive to this point, stating:

> [I]t is not hard to appreciate IDOR's position that it would be worth something to a bulk-sale purchaser to be able to make its purchase free and clear of IDOR's interest and thus have no worry about successor liability—and that the sale price for the debtors' properties in these cases necessarily included a premium for the removal of that interest.[50]

The senior creditors (banks) stated that recognizing IDOR's interest and providing it adequate protection would allow IDOR to jump the queue of creditors, allowing IDOR to receive monetary protection at the expense of other senior creditors. The senior creditors referred to this "as awarding IDOR a *post hoc* priming lien that permits IDOR to assume first place in the creditor queue."[51] Bankruptcy courts generally take creditor priority very seriously, and the *Hanmi* Court addressed the bank's concern by providing justification to the notion that IDOR's claim was different from a *post hoc* priming lien.[52] The Court's justification noted that IDOR's claim distinguished it from other creditors because it allowed IDOR to look past the debtor's assets and hold the purchaser personally liable for any unpaid taxes of the debtor.[53] Furthermore, because of this distinction, IDOR was not seeking to jump in line; rather, it was asking the Court to recognize its possession of a unique interest that goes "beyond the corpus of the bankruptcy estate."[54] Finally, and most interestingly, the Court stated that the removal of IDOR's interest constituted consideration that was attributable to IDOR rather than any asset of the estate.[55] These justifications led the Court to state "[w]e shall therefore assume without deciding that a court could place a value on IDOR's right and compensate IDOR accordingly from the proceeds of the § 363 sale, even if that would reduce the recovery to other, more senior creditors."[56]

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[49] *Id.* at 474.

[50] *Id.* at 476.

[51] *Id.* at 477.

[52] *Id.* (Allowing a creditor to jump the queue goes against fundamental principles of the Code, which is why the Court took this accusation so seriously).

[53] *Id.* at 467.

[54] *Id.* at 477.

[55] *Id.*

[56] *Id.* (Given the non-dispositive nature of this statement, the door is left open for normative arguments regarding the right of the court to make judgments resulting in senior creditors being "leapt over" by junior creditors, a notion that is in conflict with one of the principles of bankruptcy law.).

However, despite the Court's appreciation of IDOR's argument, the Court struggled to place a value on the removal of IDOR's interest.[57] The Court reasoned that IDOR *assumed* it would recover 100% of the unpaid tax liability from the purchaser, an assumption that IDOR did not back with meaningful evidence.[58] Moreover, the Court doubted that IDOR would have ever been able to recover 100% of its interest, citing numerous roadblocks to such a complete recovery.[59]

First, the Court noted that a sensible purchaser would take preventive measures to shield itself from any successor liability it might face from IDOR.[60] For example, a buyer is always free to contract around such liability, perhaps by placing a clause in the purchase agreement pursuant to which the seller remains liable for the delinquent taxes and providing proof that such liability is dealt with by the seller.[61] Alternatively, the buyer may structure the agreement to ensure that a portion of the purchase money was reserved to cover the delinquent taxes, at the expense of senior creditors.[62] While these measures may not affect IDOR negatively, they would affect the debtors' senior creditors negatively, and in turn, those creditors could respond with their own "weapon," the ability to foreclose on the properties.[63] In the instant case, a foreclosure on the properties would not trigger the bulk sale provisions, and thus, by virtue of the senior creditors' foreclosure authority, the senior creditors have the ability to block a sale that they believed unduly favored IDOR at their expense.[64] However, the Court pointed out that foreclosure sales come with their own impediments because they often result in a lower net recovery for senior creditors.[65]

Given that both sides have a means to block a sale that does not satisfy them, the Court recognized that a compromise between IDOR and the senior creditors is often the only approach that can work to leave both sides somewhat pleased.[66] A compromise would entail the bank agreeing to let IDOR, notwithstanding its

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57 *Id.*

58 *Id.* at 476.

59 *Id.* at 476–77.

60 *Id.* at 478.

61 *Id.*

62 *Id. See* Hoornstra v. United States, 969 F.2d 530 (7th Cir. 1992).

63 *Hanmi Bank*, 895 F.3d at 478.

64 *Id.* at 478–79.

65 *Id.* at 479.

66 *Hanmi Bank*, 895 F.3d at 479; Stephen T. Bobo, *INSIGHT: Creditors Not Required to Share Sale Proceeds to Pay Taxes*, BANKRUPTCY LAW NEWS ON BLOOMBERG LAW (Aug. 8, 2018), https://www.bloomberglaw.com/document/X2KUQ9N0000000?bna_news...-law&jcsearch=BNA%252000000164c7bbd7aaabeee7fb6f5e0000#jcite.

status as a junior creditor, take some portion of the sale proceeds in exchange for releasing the purchaser from successor liability for unpaid taxes, and IDOR agreeing to accept something less than 100 percent of the amount that the Bulk Sales Provisions would allow it to collect.[67] With this approach laid out, the Court then returned to the question of whether IDOR had sufficiently shown that the value of its interest had diminished, and if so, by what amount.[68]

The Court reasoned that IDOR's argument was unpersuasive because IDOR had failed to show any evidence indicating it would have received anything for the value of its interest.[69] For instance, IDOR failed to show that it would have received anything for the removal of its interest regarding possible negotiations/compromises with the senior lenders.[70] Additionally, IDOR failed to provide a tangible amount relating to the decrease in sale price stemming from the removal of IDOR's interest.[71] In other words, the purchaser paid less than it would have for the properties, because IDOR's successor liability-inducing interest was removed, and because IDOR failed to provide an actual amount showing the decrease in sale price.[72] The Court placed on IDOR the burden of providing evidence as to the reduction in the value of its interest for purposes of § 363(e) adequate protection.[73] Because IDOR did not quarrel with the burden factor, the Court had no problem valuing IDOR's interest at $0; however, interestingly enough, the Court noted that there is some authority suggesting that the predominant balance of the burden should be placed on the debtor.[74] In doing so the Court stated:

> [A] creditor claiming the right to adequate protection bears only the minimal threshold burden of establishing the validity, priority, or extent of its interest, whereas the debtor (or trustee) must shoulder the initial burden of establishing what constitutes adequate protection vis-

[67] *Hanmi Bank*, 895 F.3d at 479.

[68] *Id.* at 479.

[69] *Id.* at 478–79 (IDOR merely assumed that it would recover 100% of the value of its interest, a fact that the Court found implausible).

[70] *Id.* at 479.

[71] *Id.*

[72] *Id.* at 477–78 (If IDOR had shown, hypothetically, that the purchaser would have paid $100 dollars for the properties encumbered by IDOR's interest, but then paid eighty dollars for the properties unencumbered by IDOR's interest, then IDOR would have been able to contend that the value of its interest was worth twenty dollars. That twenty dollars could have been adequately protected by § 363(e) and IDOR could have received twenty dollars pursuant to that section.).

[73] *Id.* at 480.

[74] *Id.*

à-vis that interest—including the value of the creditor's interest and any decrease therein.[75]

Following the foregoing analysis, the Court, without making a definite determination as to whether the bulk sale provision created an interest in IDOR, and without determining whether the evidential burden was on IDOR itself, or rather on the debtor, the Court concluded that there was no evidence showing that IDOR's interest had diminished in value for purposes of adequate protection analysis. Thus, the Court valued IDOR's interest at $0, and IDOR was left stripped of its ability to pursue successor liability, as well as the ability to receive adequate protection for the stripping of that ability.[76]

Although the *Hanmi* Court ultimately ruled against IDOR, the opinion suggests that IDOR could have recovered on its interest, provided it was able to prove that its interest declined and by how much. The following case, *Schnyder v. State Board of Equalization*, exemplifies one court's inclination to protect the interests of the state.[77]

B. Schnyder v. State Board of Equalization

Schnyder v. State Board of Equalization is exemplary of a court favoring the interests of a state department over that of the purchaser, and indirectly, other creditors.[78] The case is instructive because California has adopted UCC Article 6. Schnyder, the purchaser, contracted to buy the grocery store business of Arbuckle Food Center, Inc. (Arbuckle), for slightly over $50,000.[79] The Schnyders proceeded under the applicable bulk sales law and placed the purchase money in an escrow account.[80] The California Bulk Sales Provision provided that a buyer who fails to comply with the notice and creditor payment requirements of the provision is liable to a claimant for damages in the amount of the claim, reduced by any amount the claimant would not have realized if the buyer had complied.[81] To address competing creditor claims, the purchaser or its escrow agent will often file an interpleader action designed to determine

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[75] 11 U.S.C. § 363(e) (2019); *Hanmi Bank*, 895 F.3d at 480 (citing *In re* AMR Corp., 490 B.R.470, 477 (S.D.N.Y. 2013)).

[76] *Hanmi Bank*, 895 F.3d at 480–81.

[77] *Compare* Schnyder v. State Bd. of Equalization, 101 Cal. App. 4th 538 (Cal Ct. App. 2012) *with* Ill. Dep't. of Revenue v. Hanmi Bank, 895 F.3d 465 (2018).

[78] *See Schnyder*, 101 Cal. App. 4th 538.

[79] *Id.* at 542.

[80] *Id.*

[81] *Id.* at 543.

which creditors will receive the set aside portion of the purchase money.[82] As is often the case, creditors laying claim to the set aside funds included the State Board of Equalization, and another senior creditor who had a higher priority than the Board.[83] Following notice of the sale, the Schnyders' escrow agent received multiple creditor claims against Arbuckle that exceeded the amount of the escrow fund, including claims from the IRS.[84] The Board then determined that the Schnyders themselves were liable for the unpaid tax liabilities, totaling approximately $30,000.[85] After the Schnyders' escrow agent informed the Board of the pending interpleader action, the Board's attorneys responded with a letter stating the "successorship issue as it relates to the Board . . . is not involved in the interpleader action. I would suggest that a Petition for Reconsideration [of the Board's successorship determination against the Schnyders]."[86] Eventually, the Board levied on the Schnyders' bank account and seized approximately $30,000.[87] The Schnyders then sued the Board for a tax refund, arguing that the interpleader action resolved any issue of successor liability the Board may have had against the Schnyders.[88]

After the trial court ruled in favor of the Board, the Schnyders appealed.[89] Their appeal alleged three claims, two of which are pertinent to this Comment: "(1) they withheld the purchase funds in compliance with section 6811 by depositing those funds initially in escrow and then in the interpleader action; (2) where multiple and conflicting creditor claims are raised, interpleader under the bulk sales law is the appropriate course of conduct . . . ."[90] In assessing these claims, the court put an emphasis on the statutory language of § 6811 (the bulk sale provision section).[91] The court relied on a sixty year-old case, *People v. Buckles*, to infer the legislative intent of the statute, stating:

> [I]t was the intention of the Legislature . . . to prevent a retailer who has failed to pay the state all of the tax due . . . from selling his business and departing with the purchase price . . . by imposing . . . a

82 *Id.* at 543–44.
83 *Id.* at 544.
84 *Id.*
85 *Id.*
86 *Id.* (internal citation omitted).
87 *See generally id.*
88 *See generally id.*
89 *See generally id.*
90 *See generally id.*
91 *See id.*

> statutory liability to pay the amount due . . . up to the amount of the purchase price.[92]

With legislative intent in mind, the court moved on to discuss the Schnyders' claims.[93] The court was not persuaded by the claim that the Schnyders successfully "withheld" the funds by placing them in an escrow account and interpleading them.[94] In refuting the claim, the court noted two points. The first was that the Schnyders' interpleader action included a claim from a creditor superior to the Board (the IRS) that exceeded the purchase amount interpleaded. Because of this, the Schnyders had not *actually* made the funds available to the Board. Instead, they had merely placed the funds in a common pool by which there was no guarantee that the Board would receive payment.[95] The second was that the Schnyders had failed to receive clearance, proof that the sellers had satisfied the unpaid taxes due to the Board.[96] The reasoning behind these two points is instructive. The first point demonstrates a strict reading of a bulk sale provision. If courts are willing to disregard interpleader actions by holding the purchaser liable regardless of how the Code's priority scheme determines interpleader actions, then purchasers will be further dissuaded from engaging in bulk sales that are accompanied by a bankruptcy proceeding. Since the legislative intent infers a desire to block sales that are only being performed in contemplation of avoiding tax liability, this consequence seems to flow naturally. The second point naturally follows, by requiring the purchaser to obtain clearance, the legislature was trying to ensure that even those sellers engaging in bulk sales would not be doing so simply to skirt their tax liability.

The court further explored the goal of the legislature was further explored by the court as it examined the Schnyders' contention that where multiple and conflicting claims are being asserted in excess of the purchase price, interpleader is the correct form of action. The Schnyders' claim was contentious because it stemmed from the fact that the bulk sales provision that was relied upon had

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[92] *Id.* at 545–46 ("We grant the Board's request to take judicial notice of certain out-of-state decisional and statutory law on the subject of successor liability. This authority confirms that successor liability statutes substantively identical to those in California abound across the country. The purpose of these statutes is generally recognized as ensuring the collection of state sales taxes by imposing liability upon the purchasing entity. They recognize that the purchaser ordinarily is in a financially better position to collect the tax than the selling entity, which is quitting the business. These successor liability statutes envision the tax debt following the business, its assets or any portion of them.").

[93] *See id.* at 546.

[94] *See id.*

[95] *Id.* at 547.

[96] *Id.*

twin aims—one concerned regular creditors, and the other with affording tax agencies the ability to assert successor liability.[97] Essentially, the Schnyders were arguing that the court should weigh the aim designed to protect regular creditors over the successor liability angle.[98] The court reasoned that this argument would deny the state the specific remedy of successor liability.[99] In doing so, the court provided two reasons. The first being that "public interest in the collection of taxes outweighs the private interest in the transfer of business assets."[100] The second being that "successor liability statutes set forth a special requirement in contrast to the more general bulk sales statutes, or provide a remedy distinct from the bulk sales remedies."[101] The demarcation between bulk sale provisions aimed at protecting regular creditors and that of the successor liability provisions aimed at protecting tax collecting agencies was central to the Schnyders' emphasis that an interpleader action was a proper response. If the court was to find the interpleader action satisfactory for discharging the Schnyders' obligation, the court would have sided with the notion that the Code's priority scheme should trump any other analysis. However, the court decided to once again return to the legislative intent of the aggregated bulk sale provision, weighing in favor of the Board. The court cited a fifty year-old California law review article that concluded that if "the seller cannot or will not provide funds to discharge the conflicting claims, the buyer's only practical alternative may well be to back out of the transaction."[102]

The article went on to claim that this backing out was an expected consequence, writing "[t]hat is the point. The buyer of a business that owes state taxes cannot hide behind the bulk sales law and avoid personal liability . . . . [S]uccessor liability statutes exist so that the transfer of business assets cannot be used to evade the payment of taxes."[103] With this, the court made known that it would defend the state's ability to impose successor liability, because the threat of that imposition was designed to inhibit bulk sales aimed at discharging tax liability. The final relevant contention made by the Schnyders—that they should not be forced to pay the tax of a third party simply because the

97 *Id.* at 546.
98 *Id.* at 545–46.
99 *Id.* at 548.
100 *Id.*
101 *Id.*
102 *Id.* at 549.
103 *Id.*

Board failed to prove its right to the purchase proceeds in the interpleader action—was also rejected by the court.[104]

Schnyder v. State Board of Equalization marks one court's willingness to defend the state's ability to impose successor liability, even in the face of an interpleader action that determined the state did not have a right to the funds.[105] Such a strong implementation of a bulk sale provision highlights certain courts' willingness to defend state agencies even when the Code does not afford the same protection to an agency.

There is a stark contrast between the *Hanmi* Court's reluctance to make a solid affirmation on how bulk sales provisions should be treated and the *Schynder* court's insistence on protecting the ability of the state department to fully utilize such provisions.[106] The varying approaches of each court highlights two competing policy approaches coloring the issues presented by bulk sale provisions. On the one hand, despite the *Hanmi* Court's reluctance to make a firm determination on how bulk sale provisions should be dealt with in a bankruptcy, the *Hanmi* Court suggests an inclination to favor the rights of other creditors instead of the rights belonging to a state department. This preferential treatment follows from the Court's recognition that by allowing a state department to assert successor liability, the purchase price will drop resulting in a smaller recovery for senior creditors. In this way, the ability to impose successor liability is seen as more of a hindrance to the administration of a bankruptcy estate, rather than a tool that may be used by states to not only collect unpaid taxes, but also as a means to dissuade purchasers from even entering into a bulk sale in the first place. The *Schnyder* court adopted a viewpoint more in line with the latter goal—by imposing successor liability in the face of an interpleader action that sought to invalidate that ability, the *Schnyder* court reinforces the idea that state department's interests in imposing successor liability should be elevated over the interests of other creditors.

These competing policy concerns are central to the issue of how bulk sales provisions should be treated in conjunction with a bankruptcy. Should the protection of state interests give way to bankruptcy distributions that follow customary bankruptcy priority rules? Or should the interests of state departments afford special privileges deriving from the way in which bulk sale provisions allow for reimbursement outside of bankruptcy, pursuant to successor liability

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104 *Id.* at 550.

105 *Id.*

106 *Compare* Ill. Dep't. of Revenue v. Hanmi Bank, 895 F.3d 465, 480–81 (7th Cir. 2018) *with* Schnyder v. State Bd. Of Equalization, 101 Cal. App. 4th 538, 548 (Cal Ct. App. 2012).

doctrine? To provide for a fair administration of a bankruptcy estate, while also recognizing the special ability that bulk sale provisions afford state departments, it seems the answer to these questions lands somewhere in the middle.

II. ANALYSIS

Bankruptcy courts would do well to mirror the *Hanmi* Court, which recognized the desires of both senior creditors and state departments by utilizing a "decline in value" approach. Such an approach will require state departments to prove their interest declined in value—a requirement that ultimately necessitates communication between a state department and all relevant parties, to help place a value on the decline of that interest. Such a requirement forces communication and encourages compromise. This Comment will further explore the questions present in *Hanmi* and *Schnyder*, ultimately arguing that the approach hinted at in *Hanmi* was sound.

A. Does a Bulk Sale Provision Create an Interest in a State Revenue Department?

The Court in *Illinois Department of Revenue v. Hanmi Bank* refrained from deciding whether a bulk sale provision creates an interest in a state revenue department.[107] Instead, the Court premised its decision on the fact that IDOR failed to provide any accurate valuation as to the amount of its interest.[108] The Seventh Circuit's avoidance of this question leaves not only the question of whether bulk sales provisions create an interest in a state department, but also, how such an "interest" should be treated. This question, along with relevant policy concerns, are discussed below.

Although the Code does not define the term "interest" for purposes of § 363(f), courts have generally applied the term broadly.[109] For instance, courts have held that employment-related claims, such as employment discrimination claims, constitute an interest, and that employee-sponsored benefit plans constitute an interest, as well as claims flowing from the ownership of property.[110] The broad interpretation of "interest" may seem to support the

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[107] *Hanmi Bank*, 895 F.3d at 468.

[108] *Id.*

[109] *See* Precision Indus. v. Qualitech Steel SBQ, LLC, 327 F.3d 537, 545 (7th Cir. 2003); *In re* Trans World Airlines, 322 F.3d 283, 289 (3rd Cir. 2003); United Mine Workers of Am. 1992 Benefit Plan v. Leckie Smokeless Coal Co. (*In re* Leckie Smokeless Coal Co.), 99 F.3d 573, 586–87 (4th Cir. 1996); *In re* Elk Grove Vill. Petroleum, 510 B.R. 594, 603 (Bankr. N.D. Ill. 2014).

[110] *See Precision Indus.*, 327 F.3d at 545; *In re* Trans World Airlines, 322 F.3d at 289; *In re* Leckie Smokeless Coal Co., 99 F.3d at 586–87; *In re* Elk Grove Vill. Petroleum, 510 B.R. at 603.

notion that courts wish to view claims as interests to maximize the number of creditors who can claim a right to payment. However, given this interpretation of § 363(f), the impetus behind this reasoning likely stems from courts' desire to administer the bankruptcy estate in an efficient manner, meaning that §363(f) is a mechanism by which "interests" are stripped during a sale—allowing that sale to proceed free and clear of any encumbrances attaching to the estate. In other words, § 363(f) allows the trustee to tinker with which interests remain viable during a bankruptcy estate sale. Moreover, removing interests that the trustee deems adverse to the efficient administration of the estate allows the estate to maximize value in a bankruptcy sale, ensuring that estate funds are used to provide the most benefit to creditors. Given the relevant policy considerations, it is easy to understand why a trustee would want to strip away a state revenue department's "interest" in delinquent taxes, especially considering such an interest allows the state department to utilize successor liability—a function that negatively affects the value of an asset in a bulk sale.[111]

The Court in *Illinois Department of Revenue v. Hanmi Bank* did not make a clear determination on whether bulk sales provisions create an interest in the state revenue department.[112] Instead, given the fact the Court planned on valuing IDOR's "interest" at $0, the Court assumed the Bulk Sales Provision created such an interest, for argument's sake. Thus, the question of whether bulk sales provisions create an interest in the state revenue department is still open to other courts in the Seventh Circuit. This inquiry does not entail whether a state department has a cognizable claim; if the state department is owed delinquent taxes by a debtor, it of course can assert a claim against that debtor. Rather, the inquiry deals with whether the means to pursue transferee liability via a bulk sale statute constitutes an interest that is protectable by § 363(e).[113]

The *Hanmi* Court's unwillingness to determine whether a state department's ability to pursue successor liability constituted an interest is puzzling. If that ability did not constitute an interest, then the trustee would have had nothing to strip away via § 363(f). But where would that leave the state department? The bulk sales provision would still be applicable, so it stands to reason that the state would be able to utilize it to go after the successor. Owing to this, it seems apparent that a trustee would hope for the recognition of a successor liability interest, because then the trustee has the ability to strip that interest. Surely

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[111] In a bulk sale, the presence of an interest that may result in successor liability is sure to drive down the purchase price, and in turn, results in the estate recovering less during the sale of such an asset.

[112] *Hanmi Bank*, 895 F.3d at 468.

[113] *See id.*; *In re* Elk Grove Vill. Petroleum, 510 B.R. 594, 602 (Bankr. N.D. Ill. 2014).

though, this could result in that interest being adequately protected by § 363(e)—leaving the question right back where it started—how to deal with that interest. Given this non sequitur, it is likely that the *Hanmi* Court was unwilling to determine not whether the bulk sales provision created an interest, but rather, what *type* of interest was created.

In passing on the issue, the *Hanmi* Court still provided a suitable framework for classifying such an interest. The *Hanmi* Court recognized that the removal of such an interest constitutes consideration inherently baked into the purchase price.[114] That is, the purchase price lowers once the interest is removed. Because of this, the interest should be recognized, and is distinguishable from other claims that normally get stripped away. Owing to the interest's special nature, it would be wise for courts to recognize such an interest and follow the framework for valuation that was hinted at in *Hanmi*, that is, the decline in value formulation.

In *Hanmi*, the state department argued that the removal of its interest resulted in a reduction of the sale price, and thus that removal constituted consideration for which IDOR should be protected.[115] However, aside from the consideration argument, IDOR also had the ability to argue whether its claim should have been given higher priority.[116]

B. Should Interests Created via Bulk Sales Provisions be Entitled Special Priority?

Given the special type of interest created by bulk sales provisions, as well as the fact the interest holder is a state government entity, it is worth discussing whether bulk sales interests should be afforded special priority, which would allow them to transcend their typical status as a junior creditor.

The court in *In Re Elk Grove Village Petroleum* laid out the Code's approach to priority of claims.[117] The court made clear that while the Code lays out the relative priorities of classes of claims, bankruptcy law will still recognize creditors' interests afforded to them by state law, unless a federal law requires a different result.[118] In IDOR's case, the question became whether or not the bulk

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114 *See Hanmi Bank*, 895 F.3d at 467–68.

115 *See id.* at 468.

116 *See In re Elk Grove Vill. Petroleum*, 510 B.R. at 600 (this is one of the arguments posited in the predecessor to the consolidation hearing that was *Illinois Dept. of Revenue v. Hanmi Bank*).

117 *See generally id.* at 599.

118 *See id.* at 600 (internal citation omitted).

sales provision created a general unsecured claim in IDOR, or something that would allow for a higher priority claim, such as a lien attaching to a piece of property of the debtor, securing the payment of the delinquent taxes.[119] The court in *In Re Elk Grove Village Petroleum* recognized that this was a question of first impression.[120] Being a question of first impression, it is worthwhile to discuss whether such a claim should receive priority, given that such a claim derives its force from state authority.

One of the principle policy considerations of bankruptcy law is allowing for creditors to receive payment in the correct priority under applicable bankruptcy law. As the Code stands today, allowed unsecured claims of governmental units receive eighth priority.[121] Among other things, this Code provision applies to the allowed claims of governmental units for taxes owed by the debtor.[122] Given that the Code only considers allowed unsecured claims of a governmental unit to warrant eighth priority, the Code is aimed at satisfying other debts before worrying about a governmental unit's ability to secure unpaid taxes. Allowing a state revenue department to hold higher priority claims pursuant to a state law that allowed for the claim would be contrary to this very principle. The majority of states delineate priority on a "first in time" basis,[123] meaning that claims recorded and secured before others will receive a higher priority.[124] Thus, a state revenue department will typically not be high priority—a debtor usually incurs debt from non-state sources such as banks and other financiers, for things like inventory, property, or other tangible items before it begins skipping out on tax payments. For example, a start-up company will likely take out loans to get its operation going, and, such loans will often be taken at the inception of the company. Once the company starts failing, it will begin to avoid tax payments to keep receiving inventory and to pay other administrative expenses, in an effort to try and get the company out of the red. Therefore, a state department's claim will arise far later than other creditors. Additionally, the other creditors are more likely to secure their loans against property of the debtor, whereas a state revenue department does not "secure" tax payments in the usual sense. For instance, a state revenue department can impose liability via other means, such as a successor liability pursuant to a bulk sale provision.

Despite the fact that state department claims will typically be placed at the

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119 *See id.* at 600–601.

120 *See id.* at 598.

121 *See* 11 U.S.C. § 507(a)(8) (2019).

122 *See* § 507(a)(8)(C).

123 *Accord In re Elk Grove Vill. Petroleum*, 510 B.R. at 602.

124 *See id.*

end of the line, there are policy concerns that weigh against placing a higher priority on the allowed unsecured claims of governmental units. One example is the promotion of a private actor's freedom to engage in lending. If the Code were to prioritize the allowed unsecured claims of a governmental unit, it may have a chilling effect on a lending organization's desire to make loans. This effect would stem from the fact that additional roadblocks to the repayment of lenders, i.e., governmental unit priority, would create more competition for the scant assets in a bankruptcy distribution. It is more harmful to de-prioritize private creditors than governmental units because of the likely negative effect that would follow from a hindrance to the free movement of capital. In other words, a private lender's knowledge that it will receive lower priority within a bankruptcy administration elevates the risk it takes when deciding to make a loan. Public policy should seek to encourage lending, rather than stagnate it. Conversely, no such discouragement occurs when the deprioritized party is a governmental unit. The unit's place in the equation is static—taxes will be levied in the same manner regardless of the priority laid out in the Code.[125] With a little planning and tinkering, the administrative expense offers an additional avenue for state departments to argue that their interest should receive higher priority.

Absent from the *Hanmi* Court's discussion of priority was the fact that tax liabilities are afforded second level priority in chapter 11 reorganization pursuant to § 503(b)(1)(B).[126] This section affords second priority for the payment of administrative expenses used to keep an entity that is proceeding through chapter 11 operational.[127] The section provides, in relevant part,

> After notice and a hearing, there shall be allowed, administrative expenses, other than claims allowed under section 502(f) of this title, including— . . . any tax— . . . (i) incurred by the estate, whether secured or unsecured, including property taxes for which liability is in rem, in personam, or both, except a tax of a kind specified in section 507(a)(8) of this title . . . .[128]

This allows for the estate to remain business operational by using credit to cover taxes and other administrative expenses. It then ensures that these administrative expense creditors will receive a higher priority—since granting credit to an

125 This is assuming that governmental units do not assess the imposition of taxes at a higher rate with the thought in mind that some citizens will fail to pay the taxes. It is unlikely that a governmental unit sets the amount of its taxes with risk management in mind.

126 11 U.S.C. § 503(b)(1)(B) (2019).

127 *Id.*

128 *Id.*

already bankrupt debtor allowed that debtor to remain a going concern in lieu of liquidation.[129]

On its face, there is a key difference between a chapter 11 reorganization aimed at keeping a business afloat and a bulk sale in which the debtor is selling off the majority of its assets outside the normal course of business. For one, the latter does not entitle the state department to any special priority protection as an administrative expense. This is sensible considering that the state department did not provide the non-payment of taxes on credit to keep the debtor's business up and running. However, the mechanism by which the non-payment of taxes occurs is likely to be very similar.

In a reorganization (scenario A), a business may forego the payment of taxes pursuant to an agreement by which the taxes are paid as credit, to be paid back later. State departments can justify lending credit to an already bankrupt debtor because they know they will receive higher priority. In the event the reorganization fails, it is still entitled to that higher priority and should receive its amount of those back taxes when the case is converted to chapter 7 and the debtor's assets are liquidated. Should the case succeed, the state department will assuredly receive 100% of the tax money, because the business will return to profitability.

This process plays out similarly in the timeline of a debtor that initiates a bulk sale (scenario B). For example, a debtor/business will forego paying its taxes to remain operational and take on credit for business related expenses such as inventory renewal, rent payments, or other costs associated with operating an ongoing business.

In each scenario, the motivation for the non-payment of taxes is the same—an attempt to keep the debtor's business a going concern. However, the treatment of the state department is drastically different in each scenario. In scenario A, the state department is entitled to a second-level administrative expense priority which virtually ensures it will receive a large portion of the unpaid taxes. In scenario B, the state department is likely a junior creditor, with no administrative expense priority, and will likely receive a much smaller portion of the unpaid

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[129] The reasoning behind this section is as follows; a business going through chapter 11 can maximize its value by maintaining its status as a going concern (an operational entity). The thinking is that by remaining operational, a business will be able to pay back more of its creditors than if the business was just liquidated and the proceeds used to pay back creditors. This is especially true for businesses in which it is likely the business will return to profitable—should a business return to being profitable, 100% of its creditors will be able to be paid back, whereas, if that business was liquidated from the start, it is unlikely that 100% of its creditors would be paid back.

taxes, if anything. The only difference between the two scenarios is the timing of the filing for bankruptcy. In scenario A, the debtor files for reorganization, and the taxes protected pursuant to the administrative expenses are those that follow post-petition, in an effort to keep operating costs of the business low to help keep the business operational. In scenario B, despite the back taxes likely stemming from the desire of the debtor to keep its business operational, since the taxes accrued before the filing of bankruptcy, they are not entitled to any administrative expense priority.

Given that the difference in treatment that befalls state departments in bulk sales follows from the timing of when a debtor files for bankruptcy, is it possible for a state department to anticipate a bankruptcy filing and respond accordingly in order to receive administrative expense priority? This would involve the state department staying on top of unpaid taxes, and once those taxes reach a threshold that the department declared suitable, intervene by contacting the debtor and requesting that it pay its taxes. Should the debtor refuse, the state department could file an involuntary bankruptcy petition. If the petition were granted, and bankruptcy commenced, the state department could then contract with the debtor to provide for the present and future tax payments on credit, thus ensuring that the state department could obtain the protection of § 503(b)(1)(B) administrative expense priority. If the petition were not granted, there would be no further harm. At the very least, the state department would stay on top of unpaid taxes owed to it by each debtor that reaches the specific threshold. Although this would not result in the prepetition unpaid taxes being covered by § 503(b)(1)(B), it would allow the state department to get a leg up on the non-payment of taxes and afford some extra protection in case the debtor planned on filing for bankruptcy, which would leave the state department at the back of the line. Of course, this would take a very proactive state department. At any given time, there are surely thousands of entities in a state who fail to stay current on tax payments. This is where the intervention threshold would come in. Once unpaid taxes reach a certain amount, the state department would intervene and effectuate a plan by which its taxes may be protected pursuant to § 503(b)(1)(B) administrative expense priority.[130] Given the resulting fact that most interests deriving from bulk sale provisions will result in a lower priority, the scenario almost always involves a struggle between a state's property rights and an individual's property rights.

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[130] Ill. Dep't. of Revenue v. Hanmi Bank, 895 F.3d 465 (7th Cir. 2018); *In re* Elk Grove Vill. Petroleum, 510 B.R. 594, 604 (Bankr. N.D. Ill. 2014). For example, in *Hanmi* and related cases, the amount owed to IDOR was $1,881,648.60. Almost $2 million in debt seems like a reasonable benchmark for a state department to go above and beyond to ensure its right to those taxes are as strongly protected as possible.

The question of whether a state government should possess priority status over private property rights has been addressed by many courts, albeit in different fashions from the instant case. In *Commonwealth, Dep't of Revenue, Bureau of Corp. Taxes v. Marros*, a Pennsylvania court determined that private property rights may sometimes be superseded by an important governmental interest.[131] In that case, a purchaser failed to comply with 72 P.S. § 1403, a Pennsylvania bulk sale provision that required a purchaser who was buying at least fifty-one percent of a company's assets to receive clearance indicating that there were no back taxes owed by the company.[132] After the sale had gone through, the Pennsylvania Department of Revenue sought payment from the purchaser.[133] The purchaser contended that there was a computational error in assessing the back taxes owed, and, it requested a revision of the owed taxes.[134] The court denied the revision, stating that had the purchaser complied with the clearance order, it would have had an opportunity to raise the computational error at a prior time.[135] The purchasers responded by arguing that its due process rights had been violated—it had been deprived of property without being granted the ability to dispute that deprivation.[136] The court, however, found that argument unpersuasive, stating "[t]here is an exception to that general rule, however. Where an important governmental interest such as collecting revenue exists, private property rights must yield to governmental needs."[137]

Despite a differing fact pattern, the *Marros* case draws some similarities with *Hanmi*.[138] The obvious similarity is that both cases deal with a state trying to recover back taxes pursuant to a bulk sale provision.[139]

Additionally, both cases question whether a state's right to taxes should

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131 *See generally* Commonwealth, Dep't of Revenue, Bureau of Corp. Taxes v. Marros, 431 A.2d 392, 393–394 (Pa. Commw. Ct. 1981).

132 *See generally id.* at 392.

133 *See generally id.* at 392–394.

134 *See id.* at 392.

135 *See id.* at 392–394.

136 *See id.*

137 *Id.* at 393–394 (referencing the ability of an individual who is deprived of property to be able to contest that deprivation in a court of law). Thirty-three years after *Marros*, the Pennsylvania Commonwealth Court would hint at a narrower reading of *Marros* in dictum of Reese's Pizza & More v. Dep't of Labor & Indus., 93 A.3d 914 (Pa. Commw. Ct. 2014) ("absent a legitimate due process challenge, equity has no jurisdiction to restrain the collection of taxes . . . [w]here an important governmental interest such as collecting revenue exists, private property rights must yield to governmental need."). This suggests that the "governmental need" schematic of *Marros* is not applicable if there is truly a deprivation of due process rights—a notion that all courts should be eager to protect.

138 *See Marros*, 431 A.2d 392; Ill. Dep't. of Revenue v. Hanmi Bank, 895 F.3d 465 (7th Cir. 2018).

139 *See Marros*, 431 A.2d 392; *Hanmi Bank*, 895 F.3d 465.

outweigh a private property right: The right to due process involving a government taking of property in *Marros* and the right to priority payment of a secured creditor in *Hanmi*.[140] Most importantly, however, both cases deal with the question of whether a state's law may ever supersede federal law.[141] In *Marros*, the court placed the interest of the state above that of constitutional due process concerns.[142] Granted, the court did not directly contradict the Constitution in favor of state law. Rather, it chose to work around the Constitution by determining that the due process rights at issue did not apply.[143] The court in *Hanmi* did not even address the constitutional question, choosing to sidestep any issues of due process by alleging that IDOR failed to give a value for the diminishment of its interest.[144]

Given the relative similarities of *Marros* and *Hanmi*, it is suitable to wonder whether the *Marros* court exceeded its boundaries. By depriving the purchasers of its right to dispute the amount in question, the *Marros* court operated dangerously close to endorsing an unconstitutional taking.[145] By taking the stance that governmental needs sometimes outweigh private property rights, the *Marros* court opened the door for the Pennsylvania government to protect its own needs over the private property rights of individuals.[146] Courts facing similar scenarios as *Hanmi* should stray far away from the *Marros* decision. Given the complexities of the scenario that *Hanmi* entails, what would such a scenario look like?

In a *Hanmi*-like case in which a state department wishes to have its interest in successor liability protected, an outright taking of property is not implicated. Instead, the taking would be framed indirectly. The state department would request adequate protection because of the decline in value of its interest.[147] The state department would have to show that it would have received a portion of the purchase money in the bulk sale, pursuant to the bulk sale provision, had that interest not been stripped away. That portion would likely be protected by § 363(e), provided the court was willing to recognize the "special interest" created by the ability to seek successor liability. This protection would be to the detriment of other creditors, in different ways, depending on the nature of the

140 *See Marros*, 431 A.2d 392; *Hanmi Bank*, 895 F.3d 465.
141 *See Marros*, 431 A.2d 392; *Hanmi Bank*, 895 F.3d 465.
142 *See Marros*, 431 A.2d at 394.
143 *See Marros*, 431 A.2d 392.
144 *Hanmi Bank*, 895 F.3d at 480.
145 *Marros*, 431 A.2d at 394.
146 *See Marros*, 431 A.2d 392.
147 As we know, the decline in value would not stem from a direct decline in value of the interest, but rather a decline in value following from the inability to seek out payment by means of successor liability.

protection. The straightforward way to afford adequate protection to a state department would simply be to allow for a distribution of assets of the estate commensurate to the amount the state department was able to prove it would have received through means of successor liability. This would involve the state department negotiating with creditors beforehand and setting the amount the creditors were willing to concede for the removal of the state's ability to seek payment through successor liability. This places a burden on the creditors—it would not receive the full amount of the claim that they are owed through normal Code application.

A second approach to affording a state department adequate protection would be to simply allow the state department to maintain its interest deriving from the bulk sales provision in order to maintain the state department's ability to utilize successor liability against the purchaser. Courts like the one in *Schnyder* would likely follow a similar approach, given their desire to protect state departments by using the threat of bulk sales provisions as a way to dissuade purchasers. In this scenario, the purchaser will undoubtedly negotiate[148] for a lower purchase price because of its knowledge that it will also have to pay for the back taxes of the seller. This negotiation would be determined by the extent to which the state department planned to enforce the bulk sales provision. Essentially, the creditors would be at the mercy of a state department that will likely be demanding 100% of the taxes owed to it. This would result in the purchase price being lowered by the full amount of the state department's claim. This would allow the state department to jump the line of creditors and receive its payment in full, to the detriment of all other creditors. Given the fact that most debtors do not have the ability to pay back all of their creditors in full, there would be creditors left without recompense, while the state department reaps its full reward.

Between the two approaches listed above, the second approach draws heavy similarities to the deprivation of property rights present in *Marros*, and echoes a hardline approach of defending state departments that is akin to *Schnyder*.[149] If a court were to adequately protect the "special interest" held by the state department by allowing the state department to retain its right to seek successor liability, that court would also be depriving the private property rights of

[148] If a state department was able to seek successor liability unfettered, then it would certainly seek to go after the entirety of the unpaid taxes. This would result in the purchaser requesting that the purchase price be the original price less the amount of unpaid taxes. In this way, the state department gets its full payment to the detriment of all other creditors.

[149] *See Marros*, 431 A.2d at 392–93.

creditors, albeit indirectly, without allowing those private creditors a chance to defend their property rights in court. Despite *Marros*'s acquiescence to this injustice,[150] the countervailing interests of protecting private property rights, as well as the ability of the trustee to make determinations that will benefit the majority of creditors, weigh heavily in favor of denying adequate protection through the above method. Regardless of whether the state department's interest is "special" or not, the consequences of affording it protection not available with a traditional application of § 363(e) are too grave.

Adequate protection coming in the form of a negotiation between a state department and the other creditors in bankruptcy administration implicates due process deprivations in a much hazier way. If the bankruptcy court required that adequate protection be granted and ordered that the trustee or other creditors negotiate with the state department for a removal of the ability to seek successor liability, the court is essentially mandating an action that will result in the deprivation of those creditor's property rights. This implicates similar notions of a private actor's inability to dispute its deprivation of privacy. However, by allowing the private actor to negotiate the amount, that actor is acquiescing to the deprivation of property. This consent would shield the action from being considered a due process violation, or at least give credence to the idea that such an action was not a deprivation of due process.

Additionally, a court need not mandate any negotiation or action. If courts were to adopt a similar framework to the decline in value formulation of *Hanmi*, which would involve a state department litigating over how much it would receive based on the decline of its interest, the mere threat of litigation would encourage both sides to settle on an agreed upon figure.

Despite the fact that the most likely scenario befalling state departments is that their interests will receive lower priority, the Code should not afford such interests special priority. Rather, courts should leave it up to state departments to litigate over the value of their interests, in an effort to promote settlement. By encouraging settlement, courts can allow the interests of all parties to be determined based on what they are willing to pay for the realization of their interests.

If we couple the notion that courts tend to implement a broad interpretation of what constitutes an interest, with the reality that state revenue departments' claims typically arise later than other secured creditors, we are left with the fact

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[150] *Marros*, 431 A.2d at 394.

that state departments will normally possess a lower-priority interest in the debtor's assets, when that debtor owes delinquent taxes and sells the majority of its assets outside of its ordinary course of business. However, given the revenue department's special power to utilize successor liability, we reach a new problem of how to value such an interest, considering that this special interest allows the state revenue department to affect a bulk sale in numerous ways.

C. What Value Should be Placed on Interests Created by Bulk Sales Provisions?

The valuation problem only arises if parties fail to reach a settlement regarding the removal of the state department interest. In lieu of an agreement, state departments should have to prove what value they would receive had their interest not been stripped.

A court analyzing the value of an interest derived from a bulk sales provision will be faced with competing viewpoints. On the one hand, a state department will be arguing that this interest is "special" because of the way in which it can be realized via successor liability outside of the normal administration of assets within a bankruptcy case. On the other hand, creditors in opposition of the state department's view will assert that the value of such an interest should stop with § 363(f), that is, once the bulk sale takes place free and clear of the state department's interest, that interest no longer exists. It has already been established that a state department requesting adequate protection of its interest carries the burden of showing that the interest has declined in value. Furthermore, a state department will contend its interest has diminished in value because of its inability to seek successor liability. This leaves a court with two options: (1) Recognizing that decline in value following the removal of successor liability rights and valuing the interest at what those successor liability rights would have amounted to if realized, or (2) stripping away the "special interest" formulation altogether and valuing that interest at $0. This section explores the practical considerations of valuing a bulk sales provision interest in light of each above option.

Given the unique power that interests created by bulk sales provisions carry, it is understandable for a state department to consider more than just the face value of the interest, when making its case during valuation. Important considerations focus on the value created for the estate by the removal of the interest, as well as the bargaining power carried by such an interest.[151]

A good starting point for how to value an interest created by a bulk sale provision is the distinction between calculable value and realizable value. This analysis is most applicable when assessing how an interest should be valued to provide adequate protection of that interest pursuant to § 363(e).[152] According to the court in *Hanmi*, calculable value refers to the value of an interest, absent the effect any payment plans will have on that interest.[153] For example, if a state revenue department has a claim for $5 million, the calculable value of that interest is $5 million. On the other hand, realizable value refers to the value that the creditor will actually realize. To use the above example, if a state department has a claim for $5 million, but it is a junior creditor in a case in which the debtor's assets amount to only $4 million, the realizable value of the state department's interest is $0, because it will not be able to realize any of the value of its interest.[154] In determining what protection should be afforded to an interest holder, the court considers realizable value, rather than calculable value.[155] Thus, a revenue department must show that its interest actually diminished in value. In other words, the state department must show that it would have at least recovered some portion of its interest, had that interest not been stripped, for it to receive any adequate protection as to the value of its interest.[156] Despite the foregoing analysis, the question remains whether a junior-creditor-state-department's interest should be valued at $0 in an above scenario, given that bulk sale interests come with special powers.

Bulk sale provisions give state revenue departments a powerful tool to use in the administration of a bankruptcy estate. However, as we saw in *Hanmi*, this interest may be stripped away pursuant to § 363(f).[157] In stripping away this interest, value is created for the estate, because it allows the estate to receive more in a bulk sale than it would if the successor tax liability interest still

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[151] This bargaining power stems from the state department's ability to go after the purchaser personally. Because of this power, the state department can influence the purchase price, and can essentially dissuade potential purchasers from moving forward with a purchase. Should the sale proceed free and clear of the state department's interest pursuant to § 363(f), the state department may threaten litigation, a situation which will further detract from the value of the estate, and, in turn, detract from the proceeds slated to go to senior creditors.

[152] 11 U.S.C. § 363(e) (2019).

[153] Ill. Dep't. of Revenue v. Hanmi Bank, 895 F.3d 465, 471 (7th Cir. 2018).

[154] This analysis is notwithstanding any special respect the court gives to the state department, given its ability to go after the purchaser via successor liability.

[155] *Hanmi Bank*, 895 F.3d at 471.

[156] *Id.* at 476–77.

[157] *Id.* at 471.

accompanied the assets. As the court in *Hanmi* recognized, the removal of this type of interest may constitute consideration, which allows placing a value on the interest itself. Thus, one way to value such an interest is by subtracting the final purchase price (sans the state department's interest) from the original purchase price (the price if the state department's interest remained attached to the assets). The problem with this approach is that it is nearly impossible to know what the original purchase price would have been. If the sale proceeds in this bimodal fashion, either the interest remains attached or the interest is stripped away.

However, there is one possible way in which this problem can be reconciled. Rather than having the trustee decide unilaterally whether an interest should be stripped away or not, the Code could provide for the trustee to offer two options to the purchaser in a bulk sale of assets encumbered by bulk sale interests. Option A would allow the buyer to purchase the assets encumbered by the bulk sale interest. From here, the buyer would negotiate a price it believes the assets should be valued, considering the fact that they are still encumbered by a successor liability inducing interest. Option B would allow the buyer to purchase the assets unencumbered. Of course, option A would result in the buyer paying less for the assets than option B. The difference in the purchase price of each option would be the price at which we could value the state department's interest. Therefore, the buyer would have to negotiate a price for both options and allow the trustee to choose whether it would be worth stripping the interest and selling at a higher price, or letting the interest remain and selling at a lower price. Although this solution would make valuing a bulk sale interest much easier, it too runs into a problem.

If the trustee chooses to sell the assets at a lower price, encumbered by the bulk sale interest, the trustee is essentially allowing the state department to jump the creditor queue—the same problem caused by the bulk sales provision in the first place. However, this may be a non-issue because a prudent trustee would likely always choose the higher purchase price to ensure senior creditors can recover the most value possible.[158] Essentially, this approach would provide the trustee with a better means of valuing a bulk sale interest, as well as the freedom to administer the estate with a better understanding of the relevant parties'

[158] One downside of this approach is that it seems a moot point to ask a purchaser what price they would be willing to pay in each scenario, especially when the purchaser has a good sense of what option the trustee will choose. It raises a question of whether such a negotiation to produce options that allow for a valuation is merely artificial, and whether or not it is an accurate way to value such an interest.

interests. However, there is authority suggesting that the burden of valuing interests for purposes of adequate protection is on the debtor.[159] Given this notion, the above approach would allow the debtor to satisfy that burden by showing the value at which a state department's interest should be valued.[160]

Of course, parties approaching a bulk sale need not let it come to a valuation of the state department's interest for purposes of adequate protection. In lieu of allowing the issue to go before the court for a valuation, such parties have ways of settling disputes of value internally.

D. How Parties Should Approach a Bulk Sale

Given the problems that a bulk sale can raise for purchasers, debtors, creditors, and sellers alike, parties approaching a bulk sale need to be aware of the nuances that such sales entail. A party can operate to best protect its interests by coming prepared with a plan of action and being knowledgeable of the different approaches each party may take in a bulk sale. This section will explore the various avenues each party in a bulk sale can take, including the ways in which parties may avoid the problems associated with a bulk sale altogether.

1. How Purchasers Should Approach a Bulk Sale

A purchaser in a bulk sale should be wary of the associated risks with purchasing a bulk sale asset. Given the ability for state revenue departments to assert successor liability against the purchaser, it is imperative for purchasers to adhere to the steps required by the state in which the sale is proceeding.[161] To better prepare for the risks associated with such a purchase, an astute purchaser should demand that the seller and debtor are transparent regarding any possible back taxes that may be owed. Transparency will provide the purchaser with the necessary information to approach the sale in the best way possible to protect against liability. This transparency should also extend to the state department itself, to keep good faith and superior information allowing for the smoothest transaction possible. The front-loading of information will ensure that the purchaser is prepared to take one of the many possible steps to avoid successor liability.

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159 *See Hanmi Bank*, 895 F.3d at 480.

160 *Id.*

161 *See Hanmi Bank*, 895 F.3d 465 (issuing notice of the purchase to the state department, reserving the requisite funds, paying out those funds to the state department).

Many jurisdictions have concluded that a bulk sales stop order requires a purchaser to not only reserve a portion of the purchase money sufficient to cover the outstanding tax liability, but also benefit the state taxing authority.[162] These courts construe bulk sale provisions to impose essentially strict liability on the purchaser for taxes left unpaid by the property's seller, such that if another creditor lays claim to the set-aside funds and the purchaser is compelled to turn over the funds to that creditor, the purchaser remains liable to the state for the outstanding tax debt.[163] One approach a purchaser may take is to set aside the requisite funds and file an interpleader action to determine which party, between the state department and other creditors, is entitled to that fund. However, should the court determine that the other creditors are entitled to that fund (as they normally would, given the senior status of those creditors arising from the nature of their claim)[164] then the purchaser would still be held personally liable to the state department for the delinquent taxes.[165] Considering the strict interpretation that accompanies many bulk sales, a sensible purchaser would look to cover its bases before agreeing to a bulk sale.

One approach a purchaser could take would be to contract tax obligations out of the initial purchase agreement. This would involve the purchase contract, including a clause that shifts any tax liability that may be placed on a purchaser via successor liability doctrines to the seller. This is best accomplished by the use of an escrow fund that accompanies the sale itself. For instance, if the sale price is $5 million, the purchase money would go into an escrow account, rather than going immediately to the seller. The administrator of the escrow account would then determine whether any risk of successor liability was apparent. If not, the sale could proceed as usual.[166] If there was an element of successor liability, the sale would be blocked until the seller could provide assurance that any outstanding liability had been taken care of. This approach best protects the purchaser; however, in the case of a bankruptcy proceeding, a trustee is unlikely to sign off on a successor liability shifting clause, especially if the debtor's assets are exceeded by its debts owed to the state department and other creditors. In

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[162] *Id.*; Schnyder v. State Bd. of Equalization, 101 Cal. App. 4th 538 (Cal. Ct. App. 2002); Red, White & Blue Transmission v. Dep't of Revenue Serv., 690 A.2d 437 (Conn. Super. Ct. 1994).

[163] *See Hanmi Bank*, 895 F.3d 465; *Schnyder*, 101 Cal. App. 4th 538; *Red, White & Blue Transmission*, 690 A.2d 437.

[164] It stands to reason that an interest arising from the nonpayment of taxes would occur later in time than interests belonging to creditors who help fund a business.

[165] *See* 35 ILL. COMP. STAT. ANN. 120 / 1 (LexisNexis 2019); *See Hanmi Bank*, 895 F.3d at 475; Bjork v. United States, 486 F.2d 934 (7th Cir. 1973).

[166] Alan Goldenberg, *Acquiring the Assets of a Business? Don't Forget About Sales Tax*, TAX MATTERS, (Mar. 6, 2014), https://www.friedmanllp.com/insights/acquiring-the-assets-of-a-business-dont-forget-about-sales-tax.

turn, a trustee is more likely to authorize a bulk sale to a purchaser who is not demanding such assurances.

Despite contracting around outstanding tax obligations in a bulk sale, there are some jurisdictions that fail to recognize the agreement of private parties for such an arrangement. These jurisdictions maintain a right to seek successor liability against the purchaser of a bulk sale, even when the purchase agreement specifies that tax liabilities will be borne by the seller. For example, in *Reese's Pizza & More v. Dep't of Labor & Indus.*, a bulk sale was undertaken pursuant to a sale agreement that provided "[g]ood and marketable title to the Sale Assets shall be sold, assigned, transferred and conveyed to Purchaser by Seller at the Closing, free and clear of all claims, liabilities, taxes, liens, security interests, encumbrances, restrictions and adverse rights of use or ownership of any kind or nature whatsoever."[167] Because of this agreement, the purchaser failed to obtain a clearance order pursuant to a Pennsylvania bulk sales provision.[168] The state department went after the purchaser for the unpaid tax liability, and the court ruled in favor of the state writing "we also reject Purchaser's contention that Section 2.3 of the Sale Agreement, wherein Predecessor agreed to transfer title to its assets to Purchaser, free and clear of all claims, taxes and liabilities, provided Purchaser with a defense to the Department's assessment against it for Predecessor's unpaid UC taxes."[169] The court went on to suggest that if the purchaser wished to insulate itself from the tax liability, it should have obtained an order of clearance pursuant to the bulk sale provision.[170] The opinion noted that the sale agreement may have followed from a misrepresentation of the seller in not disclosing unpaid tax obligations.[171] Despite this, the court took a hardline stance by imposing essentially strict liability, delivering an opinion that carried a punitive air about it.[172] In a way, the court was punishing the purchaser for refusing to adhere to the state bulk sale provision.[173] The court added that the only remedy remaining for the purchaser was to bring a separate action against the seller.[174]

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167 Reese's Pizza & More v. Dep't of Labor & Indus., 93 A.3d 914, 916 (Pa. Commw. Ct. 2014) (Furthermore, the seller misrepresented the asset sale, the opinion suggests that the seller lied about having outstanding tax obligations.).

168 *Id.* at 918.

169 *Id.*

170 *Id.* at 919.

171 *Id.* at 918–19.

172 *Id.*

173 *Id.* at 919.

174 *Id.*

In light of the *Reese's Pizza* opinion, one may wonder whether the court was acting in the interest of the state to a higher degree than was warranted, given the specter of misrepresentation that haunted the sales agreement.[175] To be sure, the court understood that the seller would not have been able to pay the outstanding tax liability. This understanding might have placed a thumb on the scale in favor of imposing successor liability.[176] This is merely one illustration of why a purchaser in a bulk sale must be increasingly wary of unscrupulous sellers. Furthermore, given some jurisdictions' unwillingness to give weight to a private agreement's attempt to remove successor liability, the safest way for a purchaser to contract out of successor liability is to couple the contract with an escrow account that makes sure the sale money will not go through until clearance of all tax liabilities is achieved.

Given the risks a purchaser faces when proceeding with a bulk sale, a purchaser's best bet is to contract out of successor liability before the sale, through use of an escrow account; otherwise, the purchaser faces the possibility of a state revenue department imposing the successor liability doctrine or proceeding to the court for a valuation of the interest created by the bulk sale provision.

2. *How Creditors Should Approach a Bulk Sale*

Creditors should also be wary when their debtor starts proceeding with a bulk sale. If the state department's interest is stripped, the creditor needs to worry about the state department requesting adequate protection; should the adequate protection be granted, the pool of money designated for paying back creditors will have one extra swimmer,[177] shrinking an often-crowded pool. Moreover, the mere presence of a bulk sale provision can be enough to scare off potential purchasers who are averse to notions of potential successor liability. This has the potential to lower the purchase price in two significant ways. For one, the purchaser will likely hold firm in negotiations, requesting to pay a smaller amount, resulting in less money available to pay back creditors.

A second way in which a bulk sale can affect a creditor is by reducing the competition in a potential bulk asset purchase. Some experienced purchasers may simply avoid a bulk sale purchase if they know that the debtor has outstanding tax liabilities. A reduction in competition during the sale will result

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[175] *Id.* at 917.

[176] *Id.* at 919.

[177] This swimmer not only takes up a lot of space but carries authority with it that most other creditors are not accustomed to having.

in a reduction of the purchase price, further resulting in less value for the estate and less money available to pay creditors. Given the foregoing risks, creditors should remain alert when the debtor that owes them money is looking to sell off assets in a bulk sale. Since creditors have a say in how a reorganization takes place, they also have the ability to block plans that may carry more risk, in favor of those that keep risk at a minimum. Thus, the creditor should consider different approaches when a possible bulk sale is on the table.

In determining the various approaches to a bulk sale, the distinction between senior and junior creditors is important. This Comment will refer to creditors that are not the state department as senior creditors. We will operate under the assumption that the state department is the junior creditor.[178] We know that the state department has the ability to go after the successor for delinquent taxes—a fact that often influences the price of the bulk sale. The senior creditors also have a strong power—the ability to force a foreclosure sale. Foreclosure sales do not implicate bulk sale provisions for two reasons. First, in a foreclosure sale, the assets go to the senior creditors, who then sell off the assets to recover on their claims.[179] Because the senior creditors have no intention of ever operating the asset business, they cannot be considered successors under a bulk sale act.[180] Second, a foreclosure sale is not considered a "sale" at all for purposes of a bulk sale act.[181] In addition:

> [R]epossession of collateral or a judicial foreclosure is not the type of "sale" to which the statute refers when it refers to the "sale of the business or stock of assets." The sale contemplates a willing purchaser and willing seller bargaining in the market price over the value of goods subsequently exchanged.[182]

This is because in a repossession, the creditor already holds an interest in the goods and is merely taking back what it essentially owns.[183] Given these two facts, a foreclosure sale blocks the state department from recovering anything under successor liability mechanisms. However, despite the ability of the senior creditors to ensure that the state department receives nothing, foreclosure sales are not always the best option. This is because foreclosure sales can ultimately

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[178] *See supra* Section II(B) (the reasons why the state department is typically the junior creditor).

[179] Raymond P. Carpenter, *Avoiding Successor Tax Liability in a Sale of Business Assets*, 18 ABA J. 49, 54 (2008).

[180] *Id.*

[181] *Id.*

[182] *Id.*

[183] *Id.*

reduce recovery when compared with bulk sales that are unencumbered by bulk sale interests.[184]

Another option a senior creditor may take is the assignment for the benefit of creditors or a general assignment.[185] This is a common law doctrine occurring outside of bankruptcy by which the debtor assigns its title to property to a third party.[186] The third party then proceeds with the sale and administers the proceeds to the creditors.[187] Such an assignment is contractual.[188] Especially savvy creditors may contract for the adoption of such as assignment at the time credit is given. The contract could provide that any bulk sale proceeds via a general assignment rather than through traditional bankruptcy law. At the very least, the contract could provide for a third party whose actions would predictably be in line with the contracting creditor's wishes. Given that the third party would control the administration of the bulk sale proceeds, the contracting creditor would not have to worry about the proceeds coming into conflict with any right the state department may have to request adequate protection. Potential pitfalls of this approach stem from the fact that there will likely be numerous creditors, and thus it is hard to draft a contract that will consider the presence of other creditors whose claims may arise far later. An effective contract may merely require that the contracting creditor receive the full amount of the money it is owed from the proceeds of any bulk sale, to be administered by a third-party trustee of the contracting creditor's choosing.[189] This approach involves plenty of foresight and may be unattractive to creditors who have strong faith in typical bankruptcy procedures.

Alternatively, a state department would not have the same ability to contract for an assignment for the benefit of creditors, because the state department's right to tax payment does not stem from an agreement to give credit, but rather from a failure to comply with state statutes. The absence of a contract between the state department and the debtor results in the inability for the state department to pursue such an approach.

Considering that senior creditors and state departments have the most skin in the game in a bulk sale, the approach that best represents each sides' interest

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[184] Ill. Dep't. of Revenue v. Hanmi Bank, 895 F.3d 465, 479 (7th Cir. 2018).

[185] Bob Eisenbach, *Assignments For The Benefit Of Creditors: Simple As ABC?*, IN THE (RED) THE BUS. BANKR. BLOG (Mar. 16, 2008), https://bankruptcy.cooley.com/2008/03/articles/business-bankruptcy-issues/assignments-for-the-benefit-of-creditors-simple-as-abc/.

[186] *Id.*

[187] *Id.*

[188] *Id.*

[189] *Id.*

is compromise. Of course, this would involve the realization by each party that the sale is unlikely to result in a realization of the full value of its claim. Once this is established, however, clever parties would do well to seek out their opposition and negotiate a settlement, rather than allowing the court to proceed in valuing all interests. Part of the impetus behind compromise stems from the fact that courts are unpredictable in how they approach interests under bulk sale provisions.

A state department approaching a possible compromise would be wise to determine the value of consideration stemming from removal of its interest. Because there is a good possibility that the value of consideration is the extent that the court will be willing to protect the state department's interest pursuant to § 363(e), a state department should be equipped with this information when it approaches settlement. However, it warrants asking whether a state department equipped with such information is better off just going to court and asking for adequate protection. Given that it has the value of its interest in mind, such a request for adequate protection is less likely to fall victim to the same valuation problem present in *Hanmi*.[190]

It would make the most sense for the trustee to negotiate with the state department on behalf of a debtor's senior creditors. Given there are typically multiple senior creditors in a bankruptcy proceeding, a single entity that can speak to the best interests of all involved would make a settlement far more efficient. Allowing the trustee to negotiate with the state department to remove the state department's interest would benefit the senior creditors in two ways. First, it would avoid the potential that a court overvalues a state department's interest or gives the state department's interest too high of a priority. By settling, the trustee can ensure that the senior creditor's interests are at least represented, rather than being completely decided by the court. Second, settlement is far cheaper than litigation and would allow the creditors to not waste valuable funds in facing off against the state department in court. Given these considerations, allowing the trustee to negotiate with the state department on behalf of the senior creditors allows for predictability and saves money.

3. How Sellers Should Approach a Bulk Sale

The seller is the party with the least to lose in a bulk sale. Given that the bulk sale provisions attach successor liability to the purchaser, the seller has a relatively easy way of getting off the hook for unpaid taxes, and oftentimes uses

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[190] *See Hanmi Bank*, 895 F.3d 465.

the bulk sale itself as a way of relieving its unpaid tax obligations. Additionally, if the seller is a debtor in a bankruptcy case, it may be the case that it is not the one conducting the sale. In situations such as those, the seller need not worry much about conducting the bulk sale. Despite this, there are still some concerns that sellers must be aware of when initiating a bulk sale.

Arguably the worst mistake a seller could make in a bulk sale is fraud. If the seller misrepresents the sale, perhaps by contending it do not owe any unpaid taxes, the seller runs the risk of the sale being voided, and even further, of being assessed punitive damages.[191]

Absent avoiding fraud, the seller's primary obligation in a bulk sale is to negotiate for the highest purchase price (provided the trustee has not taken on that responsibility). If the assets are encumbered by obligations such as unpaid taxes, the purchase price will likely be negotiated to a lower amount. Of course, the best way for a seller to achieve a favorable purchase price is to make the sale known to the public. The more bidders vying for the assets, the higher the purchase price will be driven.

Ultimately, a seller ought to comply with all relevant statutes, both state and federal, and conduct the sale with profit maximization in mind.

CONCLUSION

In conclusion, courts assessing bulk sale provisions in a bankruptcy proceeding would do well to follow the dicta provided in *Hanmi*. That is, courts should only provide adequate protection of a bulk sale interest commensurate to the amount that the state department can show its interest declined in value. This approach encourages communication and settlement to help ensure that the desires of all parties are represented. Furthermore, parties approaching a bulk sale in a bankruptcy proceeding should maintain transparency and pursue compromise in order to avoid unpredictable court decisions and costly litigation.

ANTHONY CHECK[*]

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191 *See* Kubala v. Del Don (*In re* Del Don), 2014 Bankr. LEXIS 2090 *27 (Bank. E.D. Cal. May 7. 2014).

* Notes & Comments Advisory Committee Editor, *Emory Bankruptcy Developments Journal*; J.D. Candidate, Emory University School of Law (2020); B.A., Temple University (2015). Much gratitude goes out to my faculty advisor, Professor Nancy Daspit, for her sage assistance in developing this Comment. I would also like to thank the staff members and editors of the Emory Bankruptcy Developments Journal, who have worked tirelessly to prepare my Comment and countless others for publication. Finally, a note of appreciation to those closest to me—my parents, Sharon and Glenn Check, and my girlfriend,

Maggie Hoffman. Although your assistance was not of the academic variety, the love and support I have received should not go unnoticed.