



HOT TOPICS IN BANKRUPTCY: BANKRUPTCY BASICS FROM CHAPTER 11 TO RETAIL FAILURES AND TREATMENT OF TAXES

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TOPICS

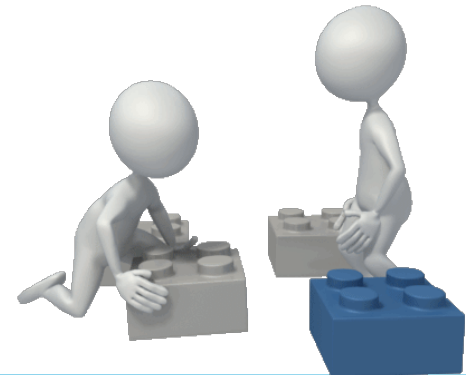
- ☐ **Doing Business with a Debtor in Bankruptcy**
- ☐ **Chapter 11 Retail Bankruptcies On The Increase**
- ☐ **Examining Corporate Insolvency in Bankruptcy Litigation in the Real World: A Complex Task**
- ☐ **When Does Personal Income Tax Debt Become Dischargeable In Bankruptcy?**

DOING BUSINESS WITH A DEBTOR IN BANKRUPTCY



BANKRUPTCY – CHAPTER 11

- In Chapter 11 cases, debtor may operate its business and use its property in the ordinary course of business, without permission from the bankruptcy court
 - “Ordinary course of business” not defined
- If lien on Debtor’s cash, then Debtor needs lender’s consent or bankruptcy court’s authority to use cash
 - Example: Sports Authority



TYPES OF BANKRUPTCY

- Chapter 7: Liquidation
- Chapter 9: Municipalities
- Chapter 11: Reorganization
- Chapter 12: Family Farmers/Family Fishermen
- Chapter 13: Individuals Meeting Certain Standards
- Chapter 15: Cross-Border/International Cases

FIRST MEETING OF CREDITORS



IMPACT OF THE BANKRUPTCY PROCESS ON BUSINESS OPERATIONS

Bankruptcy Basics from
Chapter 11 to Chapter 13 and Beyond



RULE 2004 DISCOVERY

- Discovery in a bankruptcy case is governed by Federal Rule of Bankruptcy Procedure 2004, which provides for a motion to the court seeking an order compelling the examination (a "Rule 2004 Exam") of any entity.
- There does not have to be a pending controversy for a Rule 2004 Exam to be ordered. Rule 2004 Exams are commonly used as pre-filing discovery to determine the existence of causes of action.
- The scope of a Rule 2004 Exam is broad and has been likened to a fishing expedition. The exam "must relate only to the acts, conduct or property or to the liabilities and financial condition of the debtor, or to any matter which may affect the administration of the estate . . ."
Rule 2004(b).



RULE 2004 DISCOVERY, CONT.

How To Commence

- Rule 2004 is implemented by the issuance of a subpoena under Rule 9016, which makes Rule 45 applicable.

When Can You Not Use This Tool

- Once an adversary proceeding or contested matter is commenced, Rule 2004 does not apply, and the Federal Rules of Civil Procedure, to the extent made applicable by the Bankruptcy Rules, apply. See *In re Enron Corp.*, 281 B.R. 836, 840 (Bankr. S.D. N.Y. 2004).

THE AUTOMATIC STAY (§ 362)

- The automatic stay stays litigation against a debtor that was or could have been commenced prior to the commencement of the case, whether by way of administrative, judicial or similar proceedings or any attempt to collect or recover a prepetition claim against the debtor, the debtor's property or property of the estate.
- However, the automatic stay does not apply to claims that arise after the commencement of the case.



BENEFICIARIES OF THE AUTOMATIC STAY

WHEN/TO WHOM IT APPLIES

- The Debtor
- Property of the Estate
- Property of the Debtor

WHEN IT DOESN'T APPLY

- Third Parties (i.e. principals, officers, directors, or affiliate non-debtors of a debtor)
- Co-defendants in litigation in which Debtor is also a party.

VIOLATING THE AUTOMATIC STAY

If a creditor violates the automatic stay with knowledge of the pending bankruptcy case, the court can and will impose sanctions against the creditor for violating the stay. 11 U.S.C. § 362(k).



RELIEF FROM THE AUTOMATIC STAY

CHALLENGE ACCEPTED



- Relief may be obtained from the automatic stay by filing a motion.
- There are various grounds that exist upon which relief may be granted:
 1. "cause"; and/or
 2. where the debtor does not have any equity in the property at issue and the property is not necessary for an effective reorganization of the debtor.

TERMINATION OF THE AUTOMATIC STAY

The automatic stay terminates when:

- The case is dismissed or the debtor receives a discharge;
- Property is no longer property of the Estate;
- If the debtor filed a bankruptcy that was dismissed within one (1) year of the filing then the automatic stay terminates 30 days from the filing unless the debtor can show that the second case was filed in good faith; or
- If the debtor had two (2) or more bankruptcy cases dismissed within the past year.

CHAPTER 11 PROCESS



CHAPTER 11 PLAN

- In a chapter 11 bankruptcy case, the payment of pre-petition claims await the judicial approval (called “confirmation”) and implementation of a Chapter 11 Plan.
- The Chapter 11 Plan may be a reorganization or a liquidation of the Debtor’s assets.
- The Chapter 11 Plan is essentially a court-approved modification of the relationships between the Debtor, its creditors, and other stake holders.



CHAPTER 11 PLAN, CONT.

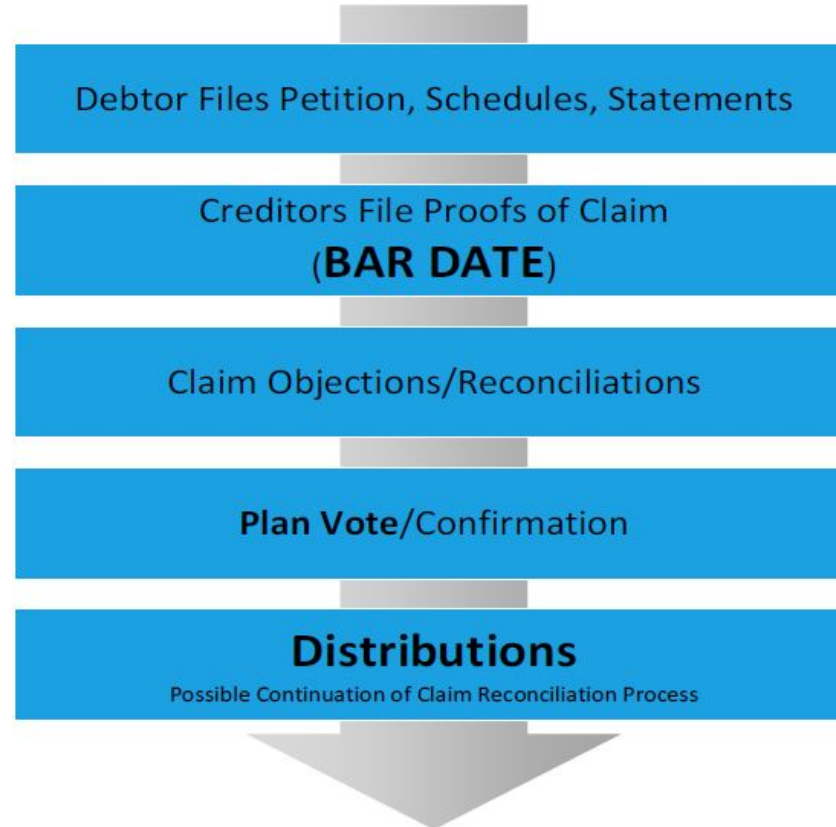
- The Chapter 11 Plan may provide for the classification and treatment of creditors and interest holders.
- Chapter 11 Plans can use a variety of transactions, such as payments from the Debtor's continuing business operations or proceeds of asset sales, the issuance of shares or rights offerings, or the distribution of litigation proceeds or beneficial interests in trusts.
- Depending on the terms of the Chapter 11 Plan, a creditor may receive any amount between nothing and 100 percent of the amount of its pre-petition claim.

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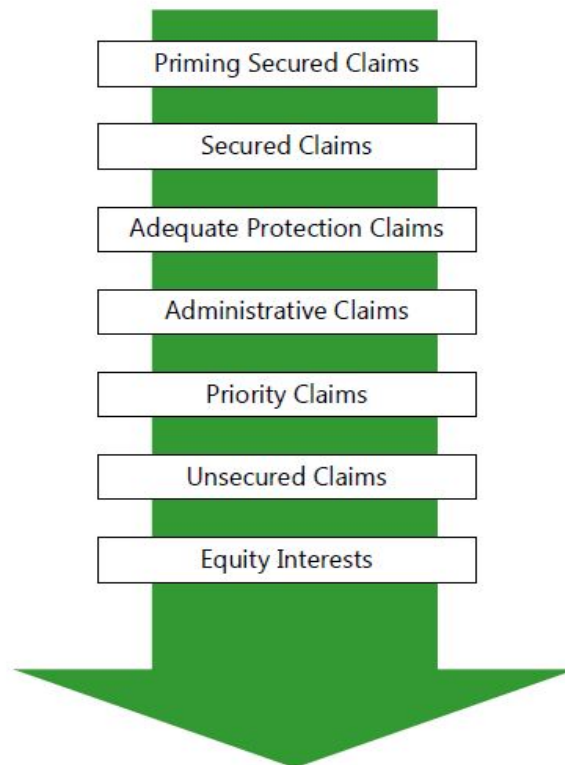
"OK, now that we all agree, let's all go back to our desks and discuss why this won't work."

CHAPTER 11 CREDITOR MILESTONES



PRIORITY OF CLAIMS (WATERFALL)

- **Secured Claims** include contractual and statutory rights on the Debtor's assets and setoff claims
- **Adequate Protection Claims** are claims to compensate a secured claim holder for a decrease in the value of its collateral during the bankruptcy case; adequate protection requires the party to seek affirmative relief from the Bankruptcy Court
- **Administrative Expense Claims** include obligations incurred by Debtor during the bankruptcy case (the actual, necessary costs and expenses of preserving the estate)
- **Unsecured Claims** generally comprise the largest number of claims against Debtor and generally receive nothing or a fraction of the claim



SPORTS AUTHORITY'S DEMISE

- March 2016, Sports Authority limps into chapter 11 in Delaware
- In the inventory are \$8.5 million in consignment goods from 170-vendors
- The Company also owed Wilmington Savings Fund Society FSB \$276.7 million under a first-priority lien
- The initial plan was to slim down and survive as a more nimble purveyor of bats, balls, and running shoes
- But, who owned the inventory and who got the sales proceeds?



CONSIGNMENT SALES AND TIGHTER CREDIT

- As goods were sold at discount prices, where would the money go - to the secured lender or the consignment seller?
- Vendors have rights under the Uniform Commercial Code but they have to affirmatively assert these rights and file/record under state law
- The Judge in Delaware has yet to decide who wins if the paperwork proves to be inadequate



CHAPTER 11 RETAIL BANKRUPTCIES ON THE INCREASE

Actual Case Discussion: Maximizing Cash Flow
and Recovery for Vendor Clients, Related Issues,
and Recent Retailer Updates



In re: Florida Shoes, Inc.*

(“FS” or the “Company”)



- A case discussion on a currently pending Chapter 11 case in Florida
- Hinds & Shankman, LLP (“H&S”) represents the largest unsecured creditor as the Chair of the Official Committee of General Unsecured Creditors (“Shoe Co.”)

*The real names of the parties have been changed to maintain confidentiality.

SUMMARY OF FACTS AND LEGAL ISSUES

- H&S is Counsel for Shoe Co., the largest General Unsecured Creditor in the FS Retail Chapter 11.
- FS business is closely held by a single owner with no independent bookkeeping or accounting department. Committee acted quickly to employ financial advisor and counsel to get immediate handle on financial information and cash flow.
- FS business is thinly capitalized = time is of essence to establish repayment plan to avoid liquidation.
- Current Plan terms on the table to allow FS to survive in business.
- Failure of FS to confirm a Plan would be disastrous for Shoe Co. and all creditors.



CONCLUSION

"No matter the number of times you fail you must be determined to succeed. You must not lose hope. Don't stop in your storm. Don't give up so easily."

- Tony Narams, Top Secret: You Can Fly Like An Eagle



RECENT BANKRUPTCY FILINGS BY RETAILERS AND THOSE WHICH AFFECT RETAILERS



Hanjin Shipping

Korean receivership and companion New Jersey filing of a Chapter 15 case of Hanjin, the seventh largest shipping company in the world, is having a dramatic negative impact on retailers.

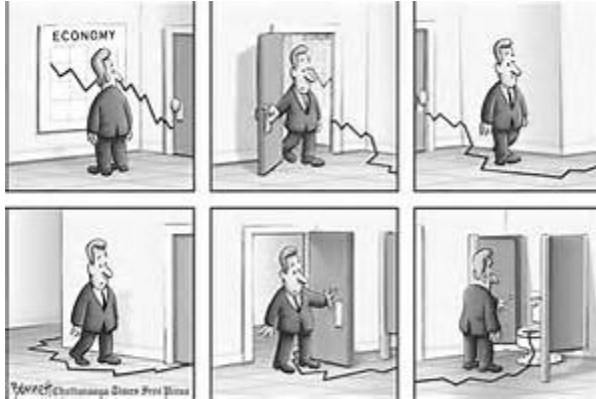


U.S. RETAILERS WHO'VE FILED FOR CHAPTER 11 BANKRUPTCY OR ARE CLOSING STORES

- **Store Closings**
 - Macy's
- **Bankruptcy Filings**
 - Wet Seal
 - RadioShack
 - Columbia House
 - Quiksilver
 - American Apparel
 - Pacific Sunwear



MALLS ARE DETERIORATING



THE EFFECT OF 2005 BANKRUPTCY CODE CHANGES

Why it's now much harder for retailers to survive:

1. Leases have only 210 days to decide whether to close stores.
2. Vendors that recently shipped goods 20 days before filing given right to demand payment in full, instead of pennies on the dollar.
3. Lenders can demand harsh terms for emergency loans.

SPORTING GOODS RETAIL BUSINESS TAKING A BIG DIVE

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- The number of sporting goods stores that are set to close after two retail companies file for bankruptcy in recent months.



SURVIVAL OF THE FITTEST

- “The American household is still in the process of tightening its belt, the cross-currents of Internet competition are formidable, and we haven’t yet begun to see all of the consequences,” says James Tancredi, a partner at Day Pitney LLP.
- Scores of retailers are undergoing turnarounds, and as they’re forced to compete with the quickly-produced and inexpensive offerings of H&M, Zara, and others, only the fittest will survive.

EXAMINING CORPORATE INSOLVENCY IN BANKRUPTCY LITIGATION IN THE REAL WORLD: A COMPLEX TASK



In re: El Segundo Post-Production Studios, Inc.* **(“ES” or the “Company”)**



- Case discussion of a currently pending lawsuit co-defended by Hinds & Shankman, LLP (“HS”)

**The real names of the Parties have been changed to maintain confidentiality*

INTRODUCTION TO ES



- H&S is defense counsel to KG, a former corporate director and officer to ES in a lawsuit pending before the US Bankruptcy Court in Los Angeles.
- Plaintiff is asking for an award of a minimum of \$70 million in damages against KG and his six co-defendant former officers and directors of ES.
- KG is being falsely accused by the Plaintiff of “looting” ES and rendering ES insolvent by his conduct while a director and officer of ES involving several corporate transactions.
- Plaintiff can’t prove three things: (1) KG “looted” ES, (2) ES was insolvent, and (3) ES was rendered insolvent as a result of KG’s conduct;
- Based on the above, Plaintiff isn’t entitled to recover damages against KG.

THREE ALTERNATIVE TESTS FOR CORPORATE INSOLVENCY RELEVANT TO ES IMPOSED BY BANKRUPTCY COURT

1. Balance sheet inventory
2. Inadequate Capitalization
3. Cash Flow, or Equitable Insolvency



Examination of Relevant Evidence Regarding Corporate Solvency and Report Under All Three Tests Is A Complex Test

The relevant financial documents of a liquidated corporation are:

- Disorganized;
- Possessed by multiple parties;
- Often in multiple drafts and versions;
- Highly voluminous, and;
- Contain confidential/privileged information required by the forensic CPA to perform a complete competent job.

OUTLINE OF CASE FACTS

- A. ES was a profitable, successful entertainment post-production business for over 26 years.
- B. ES always operated as a successful independent business.
- C. ES and the Defendants were properly advised as appropriate professionals and made informed decisions regarding the corporate transactions alleged in the Complaint.
- D. Evidence obtained thus far supports that ES was solvent by virtue of operating at a profit and paid its debts as they came due through 2011 during the times of the alleged transactions in Plaintiff's Complaint.



The “bad conduct” falsely alleged by Plaintiff in complaint didn’t cause ES to become insolvent and cease business operations.



WHY?

- PTO salary policy of ES for key employees didn't make company insolvent.
- ES commercial real property acquisition to house its business operations didn't render ES insolvent, nor was it implemented while ES was insolvent, nor did same profit KG, nor defendants.
- ES's foreign operations reduced operating costs to increase profitability and didn't render ES Insolvent, nor "push" ES into shutting down and filing bankruptcy.
- ES's transfer of software rights: a non-issue.
- ES's investment loans into a medical research company was not a cause of insolvency, nor the demise of ES.
- ES's carry forward of its net operating loss ("NOL") was based upon sound evaluation and advice of ES's CPA's and benefitted ES enormously.

THE REAL REASONS FOR THE CLOSURE OF ES



1. ES reasonably expected the three major film features to monetize operations in 2012 and continue its 26 year ongoing legacy of largely successful operations.
2. Chapter 11 filing, confirmed Liquidation Plan, and sale of ES by a Liquidating Trustee.
3. The Complaint and procedural status of same.

CONCLUSION



WHEN DOES PERSONAL INCOME TAX DEBT BECOME DISCHARGEABLE IN BANKRUPTCY?



THE 3-2-240 RULE

“There is absolutely nothing to be said in favour of growing old. There ought to be legislation against it.” – Patrick Moore

- Tax return was due at least 3 years ago
- Tax return was filed at least 2 years ago
- Tax return was assessed at least 240 days ago



11 U.S.C. § 507

“(a) The following expenses and claims have priority in the following order: [...] (8) Eighth, allowed unsecured claims of governmental units, only to the extent that such claims are for – (A) a tax on or measured by income or gross receipts for a taxable year ending on or before the date of the filing of the petition – (i) for which a return, if required, is last due, including extensions, after three years before the date of the filing of the petition.”

11 U.S.C. § 507(a)(8)(A)(i).

TAX RETURN DUE THREE (3) YEARS AGO



- Tax return due April 15, 2013.
- Tax return shows IRS owed \$5,000.
- \$5,000 to IRS dischargeable in bankruptcy AFTER April 15, 2016.

- Tax return due April 15, 2013.
- Taxpayer needed an extension. IRS grants a six-month extension. Tax return now due October 15, 2013.
- After filing, IRS owed 5,000.
- \$5,000 to IRS now dischargeable AFTER October 15, 2016.

11 U.S.C. § 523

“(a) A discharge under section 727, 1141, 1228(a), or 1328(b) of this title does not discharge an individual debtor from any debt – (1) for a tax or a customs duty – (A) of the kind and for the periods specified in section 507(a)(3) or 507(a)(8) of this title, whether or not a claim for such tax was filed or allowed; (B) with respect to which a return, or equivalent report or notice, if required – ... (ii) was filed or given after the date on which such return, report, or notice was last due, under applicable law or under any extension, and after two years before the date of the filing of the petition...”

11 U.S.C. § 523(a)(1)(A) and (a)(1)(B)(ii).

TAX RETURN FILED TWO (2) YEARS AGO



- 2012 tax return is due on April 15, 2013.
- Taxpayer finally files 2012 tax return on June 1, 2014.
- Taxpayer did not receive an extension to late file.
- Taxpayer owes IRS \$5,000.
- \$5,000 owed to IRS is dischargeable after June 1, 2016 (2 years + 3 years*).

**Tax return must have been filed at least 2 years before filing for bankruptcy, and return must come due, at least, 3 years prior to filing for bankruptcy.*

11 U.S.C. § 507



“(a)(8) Eighth, allowed unsecured claims of governmental units, only to the extent that such claims are for – (A) a tax on or measured by income or gross receipts for a taxable year ending on or before the date of the filing of the petition - ... (ii) assessed within 240 days before the date of the filing of the petition, exclusive of – (I) any time during which an offer in compromise with respect to that tax was pending or in effect during that 240-day period, plus 30 days; and (II) any time during which a stay of proceedings against collections was in effect in a prior case under this title during that 240-day period, plus 90 days...”

TAXES ASSESSED WITHIN 240 DAYS

- Taxpayer's 2010 tax return was due on April 15, 2011.
- Taxpayer files 2010 tax return on April 15, 2011.
- IRS assesses the taxes on March 1, 2012. Assessment shows taxpayer owes more in taxes.
- Taxpayer files an amended tax return on February 1, 2013.
- IRS assesses the amended tax return on July 1, 2014.
- Taxpayer will be eligible to discharge outstanding tax debt starting March 1, 2015. (July 1, 2014 + 240 days)



"It's relatively simple. We only want what's ours,
plus 30% of what you think is yours."

RESTRICTIONS, LIMITATIONS, EXCEPTIONS

- Tax Liens
- Property Taxes
- Chapter 7 vs. Chapter 13
- Fraudulent or willful evasion



