Definition of Property Limited Under Bankruptcy Code

By Barry M. Klayman and Mark E. Felger

Delaware Business Court Insider
June 12, 2013

Barry M. Klayman

Mark E. Felger

On March 28, 2012, we wrote about a bankruptcy court decision voiding a nondebtor parent company's revocation of its own S corporation status, which had the effect of terminating its debtor subsidiary's "qualified Subchapter S subsidiary" (QSub) status, as an unlawful transfer of the debtor subsidiary's property in violation of Sections 362 and 549 of the Bankruptcy Code. The decision in *The Majestic Star Casino LLC v. Barden Development* (*In re The Majestic Star Casino LLC*), Adv. No. 10-56238 (Bankr. D. Del. Jan. 24, 2012), was noteworthy for its expansive view of what constituted property of the debtor's estate and its holding that the debtor's QSub status was a property interest of the estate since it afforded the debtor the right to be free of a tax burden that would diminish estate funds. The effect of the ruling was to cause the sole shareholder of the debtor's parent company to be responsible for any federal or state income taxes payable by the debtor. As we wrote then, the case had been appealed to the district court and the appeals were still pending. Since then, the district court certified the appeals to the U.S. Court of Appeals for the Third Circuit, which, on May 21, vacated the bankruptcy court's order and remanded the case with directions to dismiss the complaint. In so doing, the Third Circuit took direct aim at the bankruptcy court's expansive view of what constitutes property of the estate in *The Majestic Star Casino LLC v. Barden Development* (*In re The Majestic Star Casino LLC*), Nos. 12-3200/3201 (3d Cir. May 21, 2013).

The facts of the case were discussed in our earlier article. The debtor, Majestic Star Casino II (MSC II), was a wholly owned subsidiary of Barden Development Inc. (BDI), which along with its sole shareholder, Don Barden, elected to treat BDI as an S corporation. BDI, in turn, elected to treat MSC II as a QSub. The S corp election resulted in BDI becoming a "pass-through" entity for tax purposes, with all items of income, loss, deduction and credit flowing through the corporation to be reported on the personal tax returns of the corporation's sole shareholder. A QSub is also a "pass-through" entity, and all of its income and losses flow up to the parent S corp (and then out to the S corp's shareholders). MSC II filed for bankruptcy and, after the petition date, BDI filed with the Internal Revenue Service to revoke its Subchapter S election, which automatically terminated MSC II's QSub status. Neither BDI nor Barden sought authorization from the bankruptcy court to change BDI's tax status. The debtor brought an adversary action against BDI and Barden challenging their action as an unlawful post-petition transfer of the estate's property. The complaint sought recovery of that "property" through an order directing the IRS to restore retroactively BDI's status as an S corp and MSC II's status as a QSub. The bankruptcy court agreed with the debtor and ordered the defendants, including the IRS, to restore the status of MSC II as a QSub of BDI.

As the Third Circuit noted, the order had significant practical implications for the parties. The debtor's emergence from bankruptcy resulted in the cancellation of a substantial amount of indebtedness, which, in turn, generated cancellation of debt (COD) income equal to the debt that was reduced in bankruptcy. The IRS estimated the amount of the COD income to be $170 million. If BDI were restored to S corp status, then it, and ultimately its sole shareholder, Barden, would be liable for taxes on the COD income. Also, the bankruptcy court's order caused the IRS to lose the benefit of MSC II's tax liabilities being treated as an administrative expense of the estate, which would have allowed the government to be paid before most other creditors.

The Third Circuit identified a preliminary question regarding the debtor's standing that the parties did not raise and the bankruptcy court did not consider. If the subsidiary's tax status is "property," but the court holds that QSub status belongs to the parent and not the subsidiary, then the right to challenge the revocation of QSub status belongs solely to the parent, and the bankruptcy estate of the QSub did not succeed to that right under Section 541 of the Bankruptcy Code, which provides that the estate succeeds only to legal or equitable interests of the debtor as of the commencement of the case. If that were so, then the debtor subsidiary challenging revocation of its QSub status is actually asserting the rights of a third party, namely its S corp parent, which is contrary to general principles of standing. The court concluded, however, that in order to determine whether the debtor subsidiary had standing, the court first had to decide whether MSC II's tax status was "property" and, if so, whether it belongs to MSC II. Thus, the question of standing was inextricably bound up with the merits of the case, and the court had to address the latter before it could decide the former.

The court noted that Congress generally left the determination of property rights in the assets of a bankrupt's estate to state law. However, if some federal interest requires a different result, then property interests may be defined by federal law. The court concluded that in this case, the Internal Revenue Code, rather than state law, governed the characterization of entity tax status as a property interest for purposes of the Bankruptcy Code.

The bankruptcy court had reasoned that QSub status is analogous to S corp status and, based on cases holding that the latter is "property" for purposes of the Bankruptcy Code, concluded that the former is also "property." Those cases, in turn, based their conclusion that S corp status is property on a series of precedents holding net operating losses (NOLs) to be property. Notably, the court said it had yet to address the question of whether NOL carrybacks or carryforwards constitute "property," but distinguished the ability to elect to carry forward or carry back NOLs from the ability to make an S corp election. A debtor in possession of NOLs has a defined amount of them at the time of the bankruptcy filing: They are a function of the debtor's operations prior to bankruptcy and are not subject either to revocation by the shareholders or termination by the IRS. In contrast, the shareholders of an S corp can terminate its pass-through status at will, regardless of how long it has been an S corp and whatever its pre-bankruptcy operating history.

The court found that other courts, recognizing the logical flaws in the comparison between NOLs and S corp status as "property," argued that S corp status must be "property" because it has value to the estate. This was the primary rationale of the bankruptcy court in this case. However, although the "right" of a debtor to place its tax liabilities on a nondebtor may have value, that does not mean that such a right, if it exists, is property. "Capacious as the definition of 'property' may be in the bankruptcy context, we are convinced that it does not extend so far as to override rights statutorily granted to shareholders to control the tax status of the entity they own," the court said. A tax classification over which the debtor has no control is not a "legal or equitable interest of the debtor in property" for purposes of Section 541 of the Bankruptcy Code.

Finally, the court noted a substantial inequity in the cases treating S corp status as "property" of the debtor's estate. Normally, taxes are borne and paid by those who derive some benefit from the income being taxed. If a bankruptcy trustee is permitted to avoid the termination of a debtor's S corp or QSub status, then any income generated during the reorganization process is likely to remain in the corporation, and ultimately in the hands of creditors, but the resulting tax liability will be borne by the S corp shareholders. This inequity, the court said, calls into question the soundness of any holding that an entity's tax status is "property" in the first place.

In the end, the court declined to follow the cases holding that S corp status is "property" within the meaning of the Bankruptcy Code. The court then argued that a debtor subsidiary's QSub status has an even weaker claim to be "property." The subsidiary's use and enjoyment of QSub status is not only dependent on the parent's continuing to own all of its stock, but also on the parent's decision not to revoke the QSub election as well as the parent's continuing status as an S corp. Nor can the subsidiary transfer or otherwise dispose of its QSub status. A tax classification over which the debtor has no control and that is not alienable or assignable is not a "legal or equitable interest of the debtor in property" within the meaning of Section 541.

Finally, the court concluded that even if QSub status were "property," it is not property of the subsidiary but of the S corp parent. Allowing the QSub status to be treated as "property" of the debtor subsidiary rather than the nondebtor parent, as the bankruptcy court did, places restrictions on the rights of the parent that have no foundation in the Internal Revenue Code or the Bankruptcy Code. Under the bankruptcy court's holding, a QSub in bankruptcy can stymie legitimate transactions of its parent as unauthorized transfers of property of the estate, even though the QSub had no right to interfere with those transactions prior to filing for bankruptcy.

Having determined that a debtor's QSub status is not property of the estate, the court returned to the question of standing and held that the debtor lacked standing to initiate an adversary proceeding to seek avoidance of the alleged "transfer" of its QSub status. It vacated the bankruptcy court's order and remanded with directions to dismiss the complaint for lack of jurisdiction.

As we suggested earlier, the bankruptcy court opinion was noteworthy for its expansive definition of what constitutes the "property" of the debtor. The Third Circuit's opinion puts some limitations on that definition. Not everything that is a benefit to the estate is "property," particularly where the debtor has no control over the alleged "property" and no ability to transfer or otherwise dispose of it. Whether the holding in the case will apply to other interests or be extended in other ways to cabin the "capacious" definition of "property" under the Bankruptcy Code remains to be seen.

Barry M. Klayman *is a member in the commercial litigation group and the bankruptcy, insolvency and restructuring practice group at* ***Cozen O'Connor****. He regularly appears in Chancery Court.*

Mark E. Felger *is co-chair of the bankruptcy, insolvency and restructuring practice group at the firm.*