Gaining the Government's Support in Bankruptcy Cases

by

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The objectives of non-tax government agencies in bankruptcy cases are usually different from those of any other party-in-interest in the case. Unlike most parties-in-interest who want to maximize their share of what are generally the insufficient resources of the bankruptcy estate, the non-tax government agency is typically concerned with enforcement of state law, protection of consumers and the environment, implementation of agency policy and, from time-to-time, politics.

Because the government agency's priorities differ from those of typical creditors and the non-tax government agency often does not have a claim to vote in the case, debtor and committee counsel frequently do not focus on the government's interests in a case -- sometimes until the government has objected to relief the debtor has sought. They view the government as a monolithic impediment to reorganization rather than a variegated constituency whose concerns, like those of parties-in-interest in the case generally, should be anticipated and addressed.

While many debtors would argue that the government has, in pursuit of the above objectives, impeded reorganizations or helped reduce the amount available for distribution to creditors, the authors would note that (a) the government often has discretion when and how to enforce certain laws; and (b) because different government agencies may have different objectives in a particular case, a savvy debtor's counsel may be able to work with the government to the debtor's benefit. Indeed, the government has taken steps to help reorganization cases succeed by taking steps that no other party would, or perhaps could, take.

Regardless of whether a particular debtor views the government as friend or foe, debtors need to think in appropriate cases about the government's interests and address them proactively. Step one is to seek to understand the government's agency(ies) objectives in a particular case. This article endeavors to provide some insight into the government's priorities by examining the government actions in cases involving public health (hospitals and nursing homes), the environment, and consumers.

I. Health Care Bankruptcies

At least two types of agencies are typically involved in a health care bankruptcy: the agency that makes payments to the provider for the benefit of Medicaid recipients; and the agency that licenses providers and oversees patient care, and also seeks to ensure the availability

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of public health resources. In Massachusetts, for example, the former is the Division of Medical Assistance while the latter is the Department of Public Health ("DPH"). The former agency's objective is usually like that of the typical creditor. If it made a Medicaid overpayments to a hospital or nursing home prepetition, it wants to be repaid that money. The Department of Public Health, however, as suggested above, has broader concerns. If a hospital or nursing home files for bankruptcy, it will examine whether there will be a shortage of nursing home or hospital beds in or around the debtor's community if the debtor's facility closes. If there are sufficient beds in the area, the DPH may not take any position on the hospital's or nursing home's reorganization as long as patients are receiving proper care during the reorganization process or any closure.

If, however, there are insufficient health care resources in a particular area, the DPH – which as a matter of public policy would therefore not want the facility to close – might take steps to facilitate reorganization, perhaps going so far as to ask the Legislature to pass legislation to help the provider even though the Medicaid agency simply wants to be repaid. This is exactly what happened in 1997 when Martha's Vineyard Hospital filed for bankruptcy. The hospital owed significant amounts to the Commonwealth's uncompensated care pool trust.[3] At that time, no court had yet determined the amounts due that trust were entitled to tax priority under the Bankruptcy Code. Presumably, however, the hospital knew that a court might make such a determination, a determination that would impair or even prevent the hospital from reorganizing.[4] The DPH decided as a matter of public policy that it wanted a hospital to be located on Martha's Vineyard. It then supported an effort to pass legislation that would relieve the hospital of its obligation to the trust fund. In July, 1997, the Massachusetts Legislature passed 1997, c. 47, § 35, which provided: "Notwithstanding the provisions of any general or special law or regulations to the contrary, the Martha's Vineyard Hospital, Inc. shall have all liability to and from the uncompensated care pool trust fund permanently extinguished and of no further force and effect." Thus, the DPH's desire to keep a hospital on Martha's Vineyard took priority over the uncompensated care pool trust's desire to be paid the monies due it.

The foregoing example illustrates that (a) different government agencies may have different priorities in a given case; (b) the interests of one agency may prevail over those of another for any one of a number of reasons; and (c) the government can facilitate reorganization. The key for debtor's is knowing what buttons to push to help the reorganization process.

II. <u>Enforcement of Environmental Laws.</u>

Environmental issues are often the "elephant in the room" in chapter 11. That is, they are the issue whose resolution will decide the success or failure of a reorganization. That is because (a) the state may have a superlien on the debtor's real estate that it may have perfected

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[3] The trust reimbursed acute care hospitals and community health centers for care provided to patients without insurance or to those who were underinsured. The trust was funded in part by assessments on hospitals who provided less free care than the "norm."

[4] In December, 1997, Judge Boroff held that amounts due the pool were entitled to priority in *In re Ludlow Hospital Society, Inc.*, 216 B.R. 312, 320 (Bankr. D. Mass. 1997). Subsequently, the First Circuit concurred. *Boston Regional Medical Center v. Commonwealth of Massachusetts Division of Health Care Finance and Policy*, 365 F.3d 51 (1st Cir. 2004).

prepetition or can create and perfect postpetition,[5] and/or (b) the cost of cleaning up the real estate exceeds the property's value and perhaps the value of the entire bankruptcy estate. In these cases, few buyers will want to purchase the contaminated property. Thus, it is generally important to address the environmental issues as early as possible in the case to avoid going way down the reorganization road only to find out that an environmental problem cannot be solved in chapter 11.

The debtor, a potential purchaser of the debtor's assets, and the state of New Hampshire, found a creative solution to an environmental problem in *In re American Tissue-New Hampshire Electric, Inc.* There, the owners of several mills in New Hampshire in chapter 11 identified a buyer who would keep the mills open and save hundreds of jobs. The problem was that the bed of the river into which the mills had released contaminants for decades was subject to expensive environmental remediation. The debtor did not have the financial resources to clean-up the riverbed and the buyer did not want to purchase the property subject to the environmental liability.

In steps the state. While the state wanted the riverbed cleaned up, it also wanted the mills to be kept open to preserve jobs in the area. In other words, there were competing government interests: cleanup v. job retention. These were resolved in favor of job retention.

The solution, once all the constituents got behind it, was relatively straightforward. The state, with the consent of the debtor, the buyer, and the Bankruptcy Court, took the riverbed by eminent domain. This avoided the debtor having to convert the case to chapter 7 because it did not have the resources to clean-up the riverbed or a buyer who wanted to purchase the mills; it also avoided the buyer refusing to purchase the property because it did not want the responsibility for the clean-up.

The lesson of *American Tissue*, like that of *Martha's Vineyard Hospital*, is that there are often competing state interests involved. The key is for the debtor to identify those state interests that are aligned with those of the bankruptcy estate, and seek to cause political and/or economic pressure to prevail over those of those state interests that would impede the debtor's reorganization.

III. <u>Government Actions To Enforce State Laws Designed to Protect Consumers</u>

Government actions to enforce state laws protecting consumers sometimes leave less room for creative solutions, perhaps because the government does not want to be perceived as being anti-consumer. Further, a debtor's obligation to comply with state consumer protection (as well as other state) laws emanates from *federal* law. Section 959(b) of Title 28 requires "a debtor in possession, shall manage and operate the property in his possession as such trustee, receiver or manager according to the requirements of the *valid laws of the State in which such property is situated*, in the same manner that the owner or possessor thereof would be bound to do if in possession thereof." (emphasis added). Many debtors have sought to circumvent state

[5] *In re 229 Main Street Limited Partnership*, 262 F.3d 1 (1st Cir. 2001).

law going so far as to seek a Bankruptcy Court order exempting them from compliance with state law. While some courts have granted such exemptions under section 105 of the Code, these exemptions are not well-grounded in law.

At least three types of consumer protection statutes have reared their heads in bankruptcy cases: laws involving going-out-of-business sales; laws protecting privacy interests of individuals; and laws regarding gift cards purchased by consumers.

The debtor in *In re Willis Furniture* sought authority to conduct a "cash raising sale" under a contract with a liquidator.[6] Under its contract with the debtor, the liquidator was to receive an 8% commission on each sale plus 50% of the gross profit on the sales and would be allowed to advertise the sale as a "bankruptcy sale or other such similarly designed event." Specifically, the liquidator would have been "permitted to use the names, phrases, and concepts on all advertising at all Sale Locations including, but not limited to, 'Bankruptcy Sale', 'Chapter 11 Bankruptcy Sale', 'Final Sale Days', and [if the case were converted to a Chapter 7 liquidation] "Going out of Business'." Interestingly, the debtor's contract with the liquidator, which embodied the foregoing terms, was not attached to the debtor's motion seeking authority or presented to the Court. Rather, the debtor "summarized" the contract and offered to make a copy available upon request.

At the hearing on the debtor's motion to approve that contract and authorize the sale, the debtor revealed that the liquidator would be bringing in substantial new (non-debtor) merchandise to the debtor's location for sale. The Court denied the motion. A few days later, the debtor refilled an amended motion requesting that the Court exercise its equitable powers under section 105(a) "to prevent state or local interference with this type of sale." The Court then granted the debtor's amended motion but did so subject to the debtor (1) not using bankruptcy or going out of business phrases or concepts if any merchandise being sold was not part of the debtor's inventory (i.e., brought in by the liquidator); and (2) "complying with all state and federal laws and regulations applicable to persons doing business in" Massachusetts. The debtor moved to amend the Court's order, claiming that the liquidator would not proceed with the transaction if it could not advertise the event as a "Bankruptcy Sale". The Court denied the debtor's request and the First Circuit upheld the decision.

After the debtor returned to the Bankruptcy Court seeking to amend the order in accordance with some guidance provided by the First Circuit in its decision, the Bankruptcy Court went on the offensive finding that the debtor's proposed modifications, and the advertisements and item tags that were filed with it, were designed to (a) confuse or mislead the purchasing public, (b) avoid the record keeping requirement as to advertising claims contained in the Massachusetts' Attorney General Regulations, and (c) "the totality [of which] amounts to something very close to fraud on the public. The lesson from *Willis Furniture* is that bankruptcy courts will sometimes state law even where government agencies are not involved in the case.

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[6] 148 B.R. 691 (Bankr. D. Mass.), *aff'd* , 980 F.2d 721 (1992).

The government's vigilance in protecting consumers and enforcing the law, even if it is at the expense of the bankruptcy estate and creditors, is evident from a pair of cases filed by online toy retailers during the dot.com bust. Unlike the assets owned by typical companies, the core assets of these companies were intangible—customer lists and information.

Toysmart.com was an internet retailer that sold educational toys. To reassure customers shopping on its web site, the company had a privacy policy that read in part:

> Personal information voluntarily submitted by visitors to our site, such as name, address, billing information and shopping preferences, is never shared with a third party. All information obtained by toysmart.com is used only to personalize your experience online . . . . When you register with toysmart.com, you can rest assured that your information will never be shared with a third party.

Lackluster sales in 2000 led Toysmart to cease operations and auction off its assets outside of bankruptcy. In an effort to maximize value, in one of its auctions, which was advertised in the *Wall Street Journal* and the *Boston Globe*, it offered detailed customer information that it maintained including, name, address, billing information, shopping preferences, family profiles—even the names, birthdates, and wish lists of children (obtained through a dinosaur trivia contest directed to children). After an involuntary petition was filed by its creditors, Toysmart continued the auction process by filing a motion for authority to sell its assets, including its customer information.

In response, the Federal Trade Commission ("FTC") sued Toysmart in federal district court for, among other things, violating Section 5 of the FTC Act by misrepresenting to consumers that personal information would never be shared with third parties and then disclosing and selling that information in violation of the company's own privacy statement.

Under a subsequent stipulation/settlement proposed jointly with the FTC in the bankruptcy case, Toysmart agreed not to sell the customer list as a stand-alone asset. Under the settlement, the debtor was allowed to sell the lists only if it was sold as part of a package that included the sale of the entire web site to a "Qualified Buyer"—i.e., in a related market and that expressly agreed to be bound by the terms of Toysmart's privacy statement. The settlement further provided that (1) Toysmart was obligated to abide by its own privacy statement until any such sale, and (2) if no sale occurred, and the debtor was not otherwise reorganized, within a year, Toysmart had to destroy all of the customer information.

Led by Massachusetts, 47 states objected to Toysmart's motion to approve the proposed settlement with the FTC arguing that the proposed settlement did not protect the rights of consumers and stating that the sale would "satisfy the States only if customers are first given notice of the proposed sale and each consumer consents to the sale of information relating to him or her." Ironically, the committee also objected to the proposed settlement arguing that the onerous conditions placed upon the sale under the settlement had soured the market for the list such that potential bidders were no longer willing to bid. After hearing the objections, the Court rejected the proposed settlement and ordered that the customer information be destroyed, concluding that, without any realistic offers from qualified buyers it would not be in the best

interests of creditors to condition the sale. In an interview conducted at the time, the Massachusetts Assistant Attorney General responsible for the matter said "I think our objections chilled the sale" and that the stipulation "would have sent a terrible message. The main point is, here's a company who could not have sold this list outside of the bankruptcy court. It's unfair to sell private information customers think will be kept private."[7] In Toysmart, the government's effort to protect consumer privacy prevailed over monies that would otherwise have been realized by the bankruptcy estate for the benefit of creditors.

Less than a year later, eToys, another online toy retailer, filed for bankruptcy in Delaware. Like Toysmart, eToys had a strongly-worded privacy policy that read in part:

> eToys respects your privacy. We do not sell, rent, loan or transfer any personal information regarding our customers or their kids to any unrelated third parties. Any information you give us about yourself or your kids is held with the utmost care and security and will not be used in ways to which you have not consented.

Unable to sell its business as a going-concern, eToys began selling its assets piecemeal. When it proposed selling its over three million person customer list to KB Consolidated, Inc., Attorneys General in Texas, Delaware, and Maryland opposed, arguing that under the proposed deal no the buyer was under no obligation to honor a strongly-worded privacy policy that customers had relied on in deciding to shop that site. In response to the Attorneys' General objections, eToys proposed sending e-mail messages to customers regarding the sale of personal information, giving them the choice to opt-out of their information being included in the sale. This proposal was also opposed by the Attorneys' General. Eventually, KB bought the domain name, intellectual property, and toy inventory, but not eToys' customer list.

The *Sharper Image* bankruptcy provides a recent example of the government protecting purchasers of gift certificates and gift cards.[8] Upon filing, the gadget-retailer announced that it was suspending the acceptance of gift certificates and gift cards purchased pre-petition by customers, claiming that its liquidity "crisis" prevented it from doing so. Following pressure from various Attorneys' General offices as well as the National Association of Attorneys General, the company announced it would honor gift certificates pursuant to modified terms. The Attorney General of the State of California, "with full knowledge" of the *Sharper Image* bankruptcy filing and the automatic stay, filed an action against the company alleging a violation of California's Gift Certificate Statute. For reasons not apparent on the record, *Sharper Image* recently withdrew its motion to honor gift certificates on modified terms.

When confronted with state consumer protection laws with which a debtor would prefer not to comply, debtors should consider whether there are public interests that could be better satisfied by non-compliance with that law. While increasing distributions to creditors will almost certainly not suffice as a reason, there may, individual cases, be reasons that would

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[7] Jill Morneau, Judge Blocks Toysmart's Plan to Sell Customer List, http://www.techweb.com/wire/story/TWB20000818S0011 (Aug 18, 2000).

[8] *In re Sharper Image Corporation*, Case No. 08-10322 (KG).

suffice that would cause the Attorney General's office, in concert with other agencies, to decide not to enforce state law in a particular case.

CONCLUSION

Many years ago, Justice Oliver Wendell Holmes warned that those who deal with the government must turn square corners.[9] While chapter 11 debtors may generally believe that the government is a foe rather than a friend, and that "turning square corners" is not in the estate's best interests, debtors would be well-advised to think about how their interests and those of the government might be aligned before assuming that the government is the enemy. Alternatively, ignoring the government, or assuming that the debtor can run rough-shod over the government, is asking for trouble. The interests of the government, like those of any party-in-interest in the case, should be respected and considered.

[9] *Rock Island, Ark. & La. R.R. Co. v. United States*, 254 U.S. 141, 143 (1920).