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United States Bankruptcy Court
Albuquerque, New Mexico

UNITED STATES BANKRUPTCY COURT
DISTRICT OF NEW MEXICO

In re:

Furr's Supermarkets, Inc.

Case No: 11-01-10779 SA

Memorandum in Support of Motion
To Pay Taxes from Aggregate Proceeds

Now Comes the New Mexico Taxation and Revenue Department ("Department"), offering this memorandum in support of its motion to compel payment of taxes, states:

The Department recently filed a Second Amended Motion to Require Payment of Taxes from Aggregate Proceeds. The reason for the recent amendment is that the Department learned that it had substantial grounds to assert a claim under Code § 510(c) (equitable subordination) when, on June 13, 2002 at a deposition of Terry Wallock in Los Angeles, the Department learned that the lenders specifically instructed the Debtor to remove gross receipts taxes from any post-closing budget because those taxes were not trust fund taxes and that the lenders would only support paying debts that were tied to generating revenue or that were superior in priority.

In connection with obtaining the September 18 First Post-Closing Order, the Lenders assured the court that anyone would merely have to file a motion for any priority dispute with regard to the Aggregate Proceeds. The order permitted a motion practice to be used if "for any reason" the Court determined that the Lenders were not entitled to "any portion" of the proceeds. Accordingly, the Court can subordinate the proceeds under § 510(c) via a contested matter or utilize § 552(b) or 105 to reorder priorities according to equitable principles.

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Nothing in Any Prior Order Prohibits the Relief Requested

Unlike § 506(c), sections 552(b) and 510(c) do not limit standing to the Trustee or any other representative of the "estate." The Department is not requesting the relief of paying taxes in any representative capacity.

The Final Financing Order purported to "waive" rights under 552 and 510(c) "*on behalf of [the debtor] and its estate.*" ¶ 19 (emphasis added). Putting aside, for the moment, the concern about waiving rights with regard to things that have not happened yet and with regard to events over which the entity protected by the waiver has total control, none of the parties who signed off on the Final Financing Order had any authority to waive anything on behalf of the New Mexico Taxation and Revenue Department. The Department was not a party to "the agreements set forth in this paragraph." Sections 510(c), in particular, and 552(b) do not limit standing under those sections to trustees.

In fact, the Lenders' counsel used the exclusive standing of the estate's representative to bring § 506(c) actions as the justification to support the argument that the estate can "waive" those rights: "And the result [as ruled by the U.S. Supreme Court] was that the debtor or the Trustee has the sole right under 506(c) if they have those rights. And there is nothing in the Bankruptcy Code that says they can't waive those rights. They can waive those rights." TR. March 14, 2001 at 33 (argument of Mr. Athanas).

The order by its terms does not preclude any other party (who was not a party to the agreement or who had rights that the debtor could not waive) from asserting its own claims under § 510(c) or § 552(b). To the extent the order could arguably be construed otherwise, that only establishes an ambiguity in the order. "Collateral Estoppel is inappropriate where a prior judgment is ambivalent." *Hardy v. Johns-Manville Sales Corp.*, 681 F.2d 334, 343 (5th Cir. 1983) (construing Restatement (2d) Judgments § 29, comment g). The Department was not a party to the First Financing Order, so *res judicata* is inapplicable.

Finally, § 510(c) is based on common law cases such as *Pepper v. Litton*, 308 U.S. 295 (1939), which involved a bankruptcy court unwinding priorities established in an earlier court order. The Department asserts that a party can never insulate itself in a court order from its own subsequent inequitable conduct which can be remedied under § 510(c). *See* March 14, 2001 Transcript at p. 41 (The Court appearing to concur that an advance waiver of misconduct is against public policy).

Even if the Department's motions imply or necessitate a modification of the Financing Order, it is a modification that is implicitly authorized by the Financing Order's own terms. Paragraphs 6 and 19 provided for waivers of various Code sections with respect to both the prepetition loans and the DIP loans and their respective collateral. By comparison, paragraph 21 limited the power to modify the order only in a way that would affect "the validity of any DIP Indebtedness . . . or the enforceability of any lien, priority or right authorized hereby with respect to any such DIP Indebtedness." The DIP loan has been paid.

For reasons stated above, affording the Department relief under §§ 510(c) or 552(b) with respect to the Aggregate Proceeds does not conflict with or necessitate a modification of the Financing Order. If such a modification is necessary, it is appropriate under Rule 60(b)(5) or 60(b)(6) because a court may limit the effect of decrees as they relate to unilateral future conduct of one of the parties and because the Financing Order itself appears to contemplate such a modification.

The Requested Relief is Appropriate Under the Circumstances

A. The Successor In Business Statutes Created an Interest in Furr's Business

New Mexico Statutes create a in interest in the assets of the business for payment of the tax "due on account of that business." NMSA § 7-1-61(B). Taxes are "due" whether or not a return has been filed. Federal law precludes the Department from fully exercising the full remedies of the section due to the automatic stay and the Code § 363 sale order. That does not mean that the state does not have a property interest in the fund that was created by the sale order.

The interest protected does not depend on assessments against the debtor/taxpayer. Otherwise, the statutes would not apply to businesses that did not file tax returns, for instance. The parties agreed that the Department's rights would attach to the proceeds.

The buyer is only assessed if it does not comply by putting sufficient money in trust, as required by NMSA § 7-1-61(C). The sale order specifically referred to that statute. The Court order specifically contemplated that the Department would utilize the bankruptcy court's authority to look to the proceeds rather than assessing Fleming. The order of this Court, approved by the Lenders, specifically acknowledged the Department's potential interest in those proceeds based upon its successor in business statutes.

The sale is not a foreclosure. A foreclosure is an action by the creditor to seize or control the assets of the debtor. In a receivership proceeding, for instance, the receiver is personally liable for taxes. NMSA § 7-1-71 (100 percent civil penalty for failure of person to collect and pay over taxes); NMSA § 7-1-3 (Q) (person includes a "receiver"). The entity appointing the receiver is also liable. *See also*, Tex Jur. 3d Ed. § 163 (West 2002) ("The costs and expenses of a receivership are generally adjudged against the party or parties for whose benefit, or on whose application the receivership was ordered."). The Department wishes the Lenders did foreclose. Either the business would have been shut down (and no further taxes incurred) or the Lenders would have had to pay the taxes (and indemnify its receiver) if the receivership ran the business.

The Lenders want it both ways. They want the independence of a Debtor in Possession, but, at the same time, want the bankruptcy sale to be deemed a "foreclosure." In fact the Lenders argument would write the New Mexico Successor in Business statutes out of the statute books if any sale was deemed a "foreclosure" because secured lenders were paid from the proceeds.

The notion that Fleming did not acquire Furr's "business" is nonsensical. Again the Lenders seek to narrow the statute so as to construe it out of existence. In fact, the only reported case has ruled that the statute is to be construed broadly. *See*, *Sterling Title Co. v. Commissioner of Revenue,* 85 N.M. 279, 511 P.2d 765 (Ct. App. 1973) (statute is broadly construed, and includes taking over some assets of defunct, non-operating business).

The interest in the assets of a business created by NMSA §§ 7-1-61 through 7-1-63 are alternatives to the tax lien rights. The Department's rights under the successor statutes are in addition to any rights arising under a notice of tax lien pursuant to §§ 7-1-37 and 7-1-38. *Cf.*, *First Interstate Bank v. Taxation and Revenue Dep't.*, 108 N.M. 756, 779 P.2d 133 (N.M. App. 1989) (fact that lender foreclosed on its UCC Article 9 lien did not preempt tax clearance statutes regarding taxes relating the sale of alcoholic beverages; the statutes are alternative remedies).

The Department acknowledges that its regulation precludes the Successor in Business rules from applying when their application would be "materially inconsistent with the rights of secured creditors." That is exactly the equitable analysis which the Department asks the Court to undertake. The regulation does not say that the secured creditor always wins. The regulation implies an inquiry into principles of fair play and a case-by-case analysis.

B. The Court's Equitable Powers Would Appropriately Be Exercised in the Way Requested by the Department

The Lenders attempt to defeat the Department's motion by relying on the state legislature's decisions. However, if this were a purely state law matter, the state would be protected. The state would be able to assess Fleming or would have been able to negotiate with Fleming and the Lenders regarding conditions for granting a tax clearance under NMSA § 7-1-61(C). Congress took that control from the Department, and the Department is doing what Congress requires: asking for relief from this Court.

The Lenders' reference to foreclosure law is instructive. As indicated above, a bank could not get a receiver appointed and benefit from the Receiver's failure to pay taxes. The reference to state law only helps the Lenders when they proceed half way through the analysis. The legislature has given tools to the Department to deal with this type of problem, but the intervening bankruptcy case prevents the Department from fully using those tools.

Pursuant to 28 U.S.C. §§ 959 and 960, Bankruptcy Code §§ 510(c), 552(b) and 105 and the historical power of a bankruptcy court to reorder priorities, the Court has the flexibility under circumstances where the Lenders are overreaching. The § 552(b) power to limit a post-petition lien based upon the equities of the case is most often employed to avoid a secured creditor improving its position at the estate's expense. *See generally, In re Cross Baking Company, Inc.*, 818 F.2d 1027, 1033 (1st Cir. 1987). The text of the statute allows for the relief the Department requests here.

Section 510(c) relates to a bankruptcy court's historic "equitable powers in passing on a wide range of problems arising out of the administration of bankrupt estates. They have been invoked to the end that fraud will not prevail, that substance will not give way to form, that technical considerations will not prevent substantial justice from being done." *Pepper v. Litton*, 308 U.S. 295, 304-05 (1939). The requirements for equitable subordination are that (1) a claim holder engaged in inequitable conduct, (2) misconduct caused injury to a creditor or conferred an unfair advantage to the claim holder, and (3) equitable subordination of the claim is consistent with the bankruptcy code. *In re Baker & Getty Fin. Servs.*, 974 F.2d 712 (6th Cir. 1992).

Attached to this memorandum is Ruling 100-96-1 under the statute prior to its amendment. Nevertheless it reveals the negotiated process and the types of conditions that the Department may place on tax clearances. If Fleming and the Lenders approached the Department about acquiring a tax clearance, and the Department were concerned about insuring that current taxes were paid as a condition of granting the clearance, that could have been a negotiated resolution. The bankruptcy laws have reduced the ability of the Department to protect itself in that regard.

The Department is not seeking to acquire in bankruptcy court a remedy that is precluded by its own statutes, as the Lenders suggest. In fact, it is the Department that is seeking to acquire a remedy which is equivalent to the non-bankruptcy alternative. The lenders are using the bankruptcy court to obtain an unfair advantage over the Department. That is the issue before the Court.

The Department consented to look to the proceeds of the Fleming sale on the reasonable assumption that the Lenders would allow its debtor to comply with state and federal law. The lenders were dealing with a debtor in possession which is required to pay taxes pursuant to a separate federal statute addressing the issue. 28 U.S.C. § 960. The Fleming Asset Purchase agreement, § 8.6 required that Furr's business be conducted in its ordinary course, and that the leases be kept current and the goodwill maintained. Section 8.8(b)(iii) required Furr's to satisfy any addition conditions "imposed by Governmental Authorities with respect to the acquisition of Seller." The DIP loan, § 5.4, required Furr's to "comply with the requirements of all applicable laws, rules, regulations and orders of any governmental authority as now in effect and which may be imposed in the future . . . ."

The Lenders, not the debtor, controlled whether Furr's complied with New Mexico tax law under the circumstances complained of here, and it was unreasonable and inequitable for the Lender's to prohibit the debtor from complying with state law, federal law and its own loan agreements. The Lenders received monies that were charged to Furr's customers and separately designated on the sales receipts as taxes. According to recent deposition testimony of Mr. Mortensen, Furr's former Chief Financial Officer, the gross receipts taxes were not factored into the determination of what price Furr's would charge for the product it sold.

The Fleming sale proceeds would not exist if it were not for the unique powers of the bankruptcy code and, in particular, the manner in which this Court accommodated the debtor and Lenders to bring the sale to fruition. The sale proceeds would not exist if Furr's breached the sale agreement by not operating—which would be the only way to have avoided incurring the gross receipts taxes. The Code contemplates that the Court can equitably address issues raised by the Department in this context.

WHEREFORE, the Court should order that the Lenders pay over to the Department from the Aggregate Proceeds sufficient funds to cover the taxes, penalties and interest relating to gross receipts tax returns that were filed by the debtor post-petition but with respect to which the Lenders would not authorize payment.

Respectfully submitted,

Donald F. Harris
Special Assistant Attorney General
New Mexico Taxation and Revenue Department
PO BOX 8485
Albuquerque, NM 87108
505-841-6583
e-mail dharris@state.nm.us

I certify that a copy of the foregoing was mailed to the following parties contemporaneously with the filing of this document.

Robert Jacobvitz
500 Marquette N.W., Suite 650
Albuquerque, NM 87102

Bill Davis
PO Box 6
Albuquerque, NM 87103

Ron Andazola
PO Box 608
Albuquerque, NM 87102

Paul Fish
PO Box 2168
Albuquerque, NM 87103

Jennie Behles
PO Box 849
Albuquerque, NM 87103

Ronald Silverman
Bingham Dana
399 Park Ave
New York, NY 10022

Donald F. Harris

Ruling 100-96-1
Issued: March 7, 1996
Effective: March 7, 1996

A ruling has been requested concerning the applicability of certain provisions of the Tax Administration Act to the following facts:

> X, an entrepreneur, wants to purchase business Y. However, business Y has tax and other loan obligations which exceed the value of the business several-fold. X wants to purchase the business at the fair value of the business and pay off all of Y's debts with the proceeds of the sale, including the tax delinquencies to the Department. Y will receive no cash money, and X and Y are not, and never have been, affiliates or related entities in any way. The loan obligations have priority over the tax delinquencies. No corporate officers or upper-level management of Y will become employed by X. The sale is a true "arms-*length" transaction.*

X first contacted the Department prior to purchasing Y and asks for a tax clearance pursuant to Tax Administration Act, Sections 7-1-61 and 7-1-62. X has been notified that the Department cannot give Y a tax clearance upon payment of the value of the assets, because Sections 7-1-61(C) and 7-1-62(A) NMSA 1978 only authorize two types of documents: (1) a certificate indicating that Y owes no taxes, or (2) a notice of the amount of tax for which the vendor is liable.

X then asks how Section 7-1-64(B) NMSA 1978 applies in a situation where the department will not issue a tax clearance under the conditions proposed.
Section 7-1-64(B) NMSA 1978 states that the "purchaser hereunder may completely discharge his responsibility under the provision of this section by surrendering and assigning all his interest in the tangible and intangible property acquired, <u>or the proceeds thereof</u>, to the director or his delegate . . . ." (emphasis added). The meaning of this section is open to more than one interpretation. One obvious principle contained in the language is that the liability can be limited to either the assets or the value of the assets, if the purchaser assigns to the Department either the assets or the proceeds of the assets.

In the case of an "arm's length transaction", and in circumstances where no monies have been paid to the seller, the Department has the discretion to accept the remaining "proceeds thereof" after payment of the other loan obligations of the business, in lieu of the assets of the business, when the Department is satisfied that no other consideration is changing hands and the proceeds of the sale represent a fair price for the business.

Because of the language in Section 7-1-64(B), the Department accepts X's offer of the proceeds of the sale and X, as the purchaser "completely discharge[s] his responsibility . . ." under the successor liability statutes upon remittance of the proceeds. Sections 7-1-61 through 7-1-64 NMSA 1978. The proceeds shall be remitted to the Department within 30 days of the issuance of this ruling.

[This ruling expires on December 31, 2006, unless previously withdrawn by the Secretary or superseded or rendered invalid by a change in law or regulation.]