Asset Sales/Bankruptcy Taxation

Selling Unusual Assets in Bankruptcy and Their Tax Aspects (Pot, Porn and Puppies)

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Selling Unusual Assets in Bankruptcy and Their Tax Aspects: Pot, Porn and Puppies

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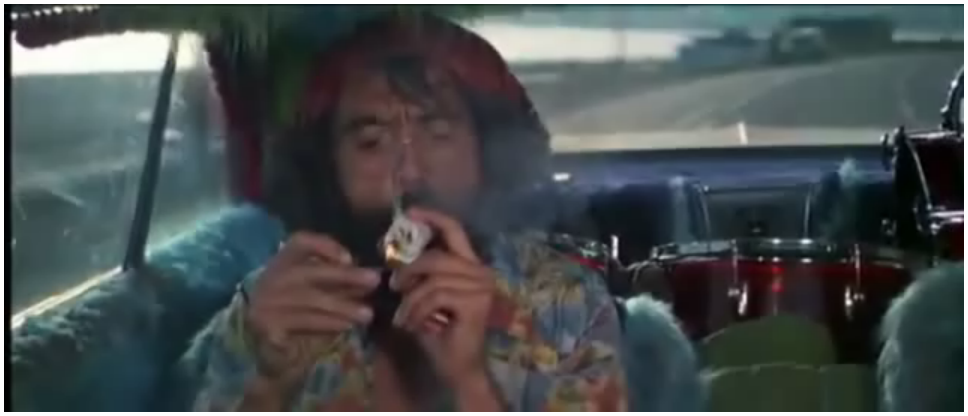
The Barrier of Bud: Hurdles in the Sale of a "Legal" Marijuana Business in Bankruptcy

Current state of marijuana laws

- State law v. federal law
- Medical use legal in 23 states and DC
- Recreational use legal in 4 states and DC
- Not legal under federal law



The Barrier of Bud: Hurdles in the Sale of a "Legal" Marijuana Business in Bankruptcy

Difficulty retaining legal assistance

- MRPC 1.2(d) prohibits a lawyer from "counsel[ing] a client to engage, or assist[ing] a client, in conduct that the lawyer knows is criminal or fraudulent, but a lawyer may discuss the legal consequences of any proposed course of conduct with a client and may counsel or assist a client to make a good faith effort to determine the validity, scope, meaning or application of the law."

The Barrier of Bud: Hurdles in the Sale of a "Legal" Marijuana Business in Bankruptcy

Difficulty obtaining licenses

- Licensing is state/local issue, not federal
- Application for business license
- Transfer of ownership form

The Barrier of Bud: Hurdles in the Sale of a "Legal" Marijuana Business in Bankruptcy

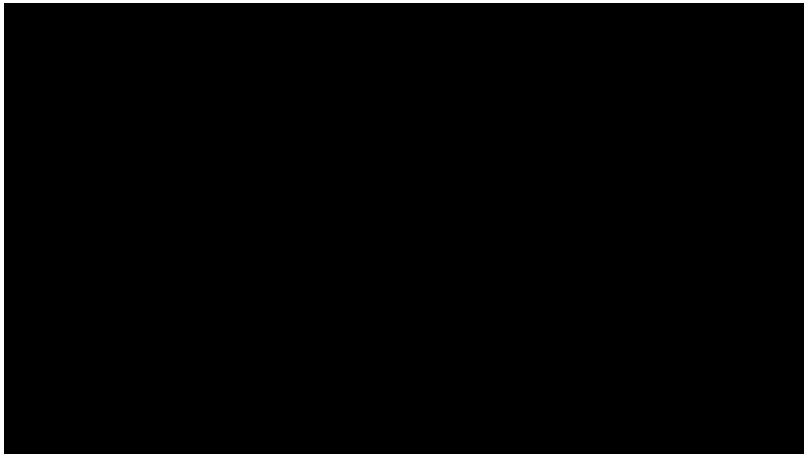
Difficulty finding willing buyers

- Securing loans and rental space
- Potential criminal liability
- Potential civil liability
- Other financial risks

The Pitfalls of Porn: Hurdles in the Sale of an Adult Entertainment Business in Bankruptcy

Including appropriate content in sale

- Objectionable and illegal content
- Content requiring consent
- Personal data
- Copyrighted material



The Pitfalls of Porn: Hurdles in the Sale of an Adult Entertainment Business in Bankruptcy

Concern about unclean hands of a debtor

- Prior management
- Compliance with state and federal laws pursuant to 28 U.S.C. § 959 while operating business prior to sale
- *Girls Gone Wild*

The Pitfalls of Porn: Hurdles in the Sale of an Adult Entertainment Business in Bankruptcy

Concern about the bottom line

- Sex sells … sometimes
- Availability of porn on Internet and difficulty of copyright enforcement
- Sex-bots, the future of porn

The Pitfalls of Porn: Hurdles in the Sale of an Adult Entertainment Business in Bankruptcy

Concern about conduct and employment issues

- Rogue employees, fights, prostitution, underage drinking, theft, drug use, and other companions of porn
- Employment status of dancers – employees v. independent contractors

The Pitfalls of Porn: Hurdles in the Sale of an Adult Entertainment Business in Bankruptcy

Concern about moral objections masquerading as regulatory compliance

- Licensing, ordinance and other other operating regulations
- Transfer restrictions

The Price of Puppies: Hurdles in the Sale of a Nonprofit Business in Bankruptcy

Unique aspects of nonprofit bankruptcies

- Not subject to involuntary bankruptcy filing under Section 303
- Not subject to conversion from Chapter 11 to Chapter 7 under Section 1112(c)
- Limitations on inclusion of assets as property of the estate under Section 541

The Price of Puppies: Hurdles in the Sale of a Nonprofit Business in Bankruptcy

Unique aspects of nonprofit bankruptcies

- Compliance with applicable non-bankruptcy law under Section 363(d)
- Transfers of assets to a for-profit entity under Section 541(f)
- Transfers of assets under a plan of reorganization under Section 1129(a)(16)

The Price of Puppies: Hurdles in the Sale of a Nonprofit Business in Bankruptcy

Realizing a sale that conforms with the nonprofit's mission

- Highest and best offer
- Purchase price v. mission
- Business judgment standard
- Good faith

The Price of Puppies: Hurdles in the Sale of a Nonprofit Business in Bankruptcy

Acknowledging the public interest and the nonprofit's mission

- Again, highest and best offer
- Promoting the nonprofit's purpose
- Role of the state

The Price of Puppies: Hurdles in the Sale of a Nonprofit Business in Bankruptcy

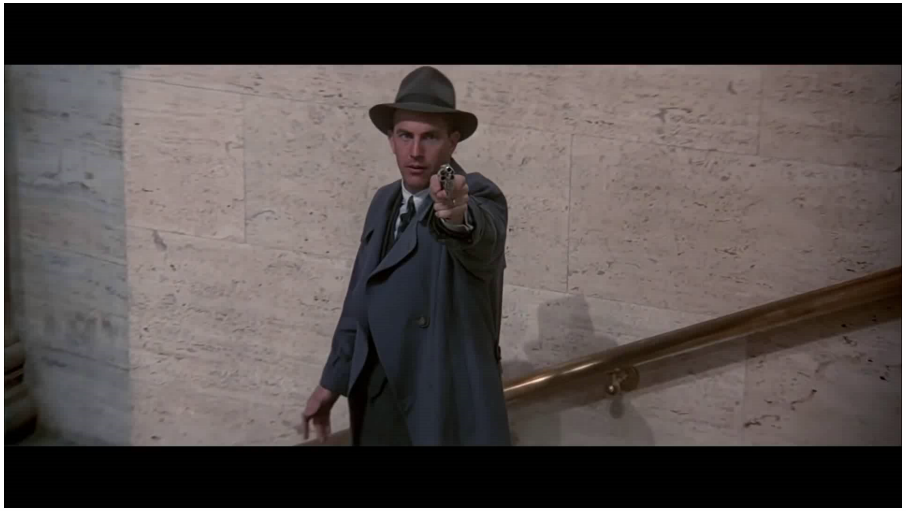
Obtaining necessary regulatory approvals

- Once again, highest and best offer
- Cooperation and support of regulators
- Continuity of mission

Tax Considerations for the Sale of Assets of a Nonprofit Business in Bankruptcy

Transfers of property in satisfacton of debt

- Cancellation of debt income, generally
- Non-recourse debt v. recourse debt
- Determination of taxable gain and COD income



Tax Considerations for the Sale of Assets of a Nonprofit Business in Bankruptcy

Cancellation of debt income

- Inclusion in gross taxable income
- Exclusion under IRC Section 108
- Extent of insolvency
- Attribute reduction and order
- Depreciable property election

Tax Considerations for the Sale of Assets of a Nonprofit Business in Bankruptcy

Debt exchange or modification

- Exchange of one debt instrument for another
- Publicy traded debt v. nonpublicly traded debt
- Stated interest rate v. adjusted federal rate
- Modifications of debt instruments
- “Significant” modifications

Tax Considerations for the Sale of Assets of a Nonprofit Business in Bankruptcy

Exchange of stock for debt

- Reduction of tax attributes for debtor in bankruptcy or insolvent debtor
- Extent to which amount of debt discharged exceeds value of stock issued plus other considerations

Tax Considerations for the Sale of Assets of a Nonprofit Business in Bankruptcy

NOL utilization

- 2-year carryback and 20-year carryforward
- Implications for entity emerging from reorganization proceedings
- Generally, value is 35% of NOL utilized
- Limitations on NOL utilization
- Bankruptcy exception
- Alternative minimum tax


Questions

SELLING UNUSUAL ASSETS IN BANKRUPTCY AND THEIR TAX ASPECTS: POT, PORN AND PUPPIES

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SELLING UNUSUAL ASSETS IN BANKRUPTCY AND THEIR TAX ASPECTS: POT, PORN AND PUPPIES

I. INTRODUCTION

Adult entertainment and nonprofit businesses have seen an increase in bankruptcy filings in recent years. Simultaneously, an entirely new industry has arisen in the wake of new laws legalizing the use of marijuana in certain jurisdictions. These materials address the challenges these unique businesses face when attempting to sell their assets in bankruptcy proceedings and the tax consequences related to the sale of their assets.

II. THE BARRIERS OF BUD: HURDLES IN THE SALE OF A "LEGAL" MARIJUANA BUSINESS IN BANKRUPTCY[1]

As marijuana advocates rejoice over marijuana's new "legality" in dozens of states across the U.S., marijuana business owners face the harsh reality that their chosen field continues to present hurdles unheard of for most businesses. These materials discuss some of the unique difficulties involved in selling a marijuana business from one owner to another.

A. Current State of Marijuana Laws

The current marijuana regulatory scheme in the U.S. has been described as "logically inconsistent"[2] and "confusing," and despite the issue's prominence in public discourse, "misunderstanding about it still abounds."[3] The confusion centers on the conflict between state and federal laws. Twenty three (23) states and the District of Columbia allow marijuana use for medical purposes.[4] "Medical use" includes such things as pain relief, nausea control, and anxiety

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[1] The panel acknowledges and appreciates the assistance of Zach Hermsen, Esquire, of Whitfield & Eddy, P.L.C., Des Moines, IA, in the preparation of the written materials in this section.

[2] *Emerald Steel Fabricators, Inc. v. Bureau of Labor & Indus.*, 230 P.3d 518, 528 (Ore. 2010).

[3] *City of Garden Grove v. Superior Court*, 157 Cal. App. 4th 355, 376 (Cal. Ct. App. 2007).

[4] These states are Alaska, Arizona, California, Colorado, Connecticut, Delaware, Hawaii, Illinois, Maine, Maryland, Massachusetts, Michigan, Minnesota, Montana, Nevada, New Hampshire, New Jersey, New Mexico, New York, Oregon, Rhode Island, Vermont, and Washington. *State Medical Marijuana Laws*, National Conference of State Legislatures (Aug. 11, 2015), http://www.ncsl.org/research/health/state-medical-marijuana-laws.aspx.

reduction.[5] Alaska, Colorado, Oregon, Washington and the District of Columbia also allow marijuana for recreational use (i.e. without regard to any medical need).[6] As new states legalize marijuana under state law, mainstream news articles frequently declare that marijuana use is now "legal" in that particular state.[7] This creates the misimpression that marijuana use is *actually* legal in the state.[8] However, despite marijuana advocates' euphoria with state-level successes, the Supremacy Clause and the federal Controlled Substances Act kill the buzz: under federal law, marijuana remains illegal in *every* state.[9]

The federal Controlled Substances Act makes it illegal to "knowingly or intentionally…manufacture, distribute, or dispense, or possess with intent to manufacture, distribute, or dispense, a controlled substance."[10] A "controlled substance" includes all drugs classified in 21 U.S.C. § 812 as either a schedule I, II, III, IV, or V substance.[11] 21 U.S.C. § 812(c)(10) lists marijuana as a schedule I drug, meaning a drug with a "high potential for abuse," "no currently accepted medical use in the United States," and "a lack of accepted safety for use…under medical supervision."[12] In short, federal law classifies marijuana as a highly

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5 *Id.*

6 *Recreational Marijuana Laws Map*, Law Atlas (July 1, 2015), http://lawatlas.org/query?dataset=recreational-marijuana-laws.

7 Dan Merica, *Oregon, Alaska and Washington, D.C. Legalize Marijuana*, CNN (Nov. 5 2014), http://www.cnn.com/2014/11/04/politics/marijuana-2014/index.html; Stuart Miller, *Marijuana Legalization in Colorado Leads to First 'Weedery,'* New York Times (Aug. 11, 2015), http://www.nytimes.com/2015/08/16/travel/weedery-marijuana-legalization-colorado-christian-hageseth.html.

8 Some citizens have fully embraced the apparent "legality" of marijuana in certain states. A wedding in Oregon featured marijuana-infused bouquets, centerpieces, and giftbags, as well as a "smoke tent" with a "budtender" serving thirteen varieties of marijuana. *Marijuana Bars, Budtender Growing Trend at Weddings*, Fox News (Aug. 30, 2015), http://www.foxnews.com/us/2015/08/30/marijuana-bars-budtender-growing-trend-at-weddings/.

9 *See* 21 U.S.C. §812(c)(10); *Gonzales v. Raich*, 545 U.S. 1, 29 (2005) (stating, "The Supremacy Clause unambiguously provides that if there is any conflict between federal and state law, federal law shall prevail.").

10 21 U.S.C. § 841(a).

11 21 U.S.C. § 802(6).

12 21 U.S.C. § 812(b)(1).

dangerous drug and prohibits it as such. Therefore, although states may choose to no longer prosecute marijuana businesses under state law, the Controlled Substances Act and the Supremacy Clause ensure that the federal prohibition on marijuana remains in effect.[13]

In the midst of this confusion over marijuana's legality, courts are finding that "[n]o clear, reliable, or lasting resolution to this conflict between state and federal law seems in view."[14] These materials focus on the unique problems this dichotomy presents for marijuana business owners and the potential issues arising in the sale of a marijuana business. These issues include (A) problems finding an attorney inclined to assist with the sale, (B) licensing issues, and (C) a seller's difficulty finding willing and able buyers.

B. Unique Issues in Selling a Marijuana Business

1. Difficulty retaining legal assistance

Model Rule of Professional Conduct 1.2(d) prohibits a lawyer from

> "counsel[ing] a client to engage, or assist[ing] a client, in conduct that the lawyer knows is criminal or fraudulent, but a lawyer may discuss the legal consequences of any proposed course of conduct with a client and may counsel or assist a client to make a good faith effort to determine the validity, scope, meaning or application of the law."

This rule may create ethical problems for lawyers with clients seeking assistance with the sale or purchase of a marijuana business. Marijuana sales are still illegal under federal law, so helping a client sell a marijuana business seems to constitute "assist[ing] a client…in conduct that the lawyer knows is criminal or fraudulent."

One commentator observed that state ethics boards have reached conflicting conclusions regarding Rule 1.2(D) in the marijuana context.[15] Arizona's board determined that lawyers

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13 21 U.S.C. §812(c)(10); *Gonzales*, 545 U.S. at 29.

14 *People v. Redden*, 799 N.W.2d 184, 208 n.16 (Mich. Ct. App. 2010).

15 A. Claire Frezza, *Counseling Clients on Medical Marijuana: Ethics Caught in Smoke*, 25 Geo. J. Legal Ethics 537, 546-47 (2012).

counseling marijuana clients do not violate 1.2(D).[16] Maine's board, on the other hand, found that lawyers generally violate Rule 1.2(D) by counseling marijuana businesses unless the lawyer's services are limited to "making good faith efforts to determine the validity, scope, meaning, or application of the law."[17] Good advice: "[g]iven the legal complexities inherent with the federal and state conflict of laws, particularly the federal stance prohibiting the use of marijuana, lawyers ought to use caution in counseling clients under state medical marijuana laws."[18] Some states have sought to clarify a lawyer's ethical boundaries in this context. The Colorado Supreme Court, for example, approved an updated ethics rule whereby lawyers may counsel clients regarding marijuana sales so long as the lawyers also advise their clients regarding the conflict with federal law.[19]

With Rule 1.2(D) looming, lawyers in states that have not clearly addressed this issue will likely hesitate before taking on a client looking to sell or buy a marijuana business, leaving the owners to face a difficult hurdle of obtaining legal counsel to assist in the frequently complex procedure of selling and buying a business.

2. Licensing

Possibly without legal assistance of counsel, owners selling marijuana businesses face extensive licensing procedures. With federal law prohibiting marijuana sales, licensing is handled at the state and local level.[20] For example, in Denver, Colorado, anyone buying a medical marijuana business (as opposed to a recreational/retail marijuana business) must apply

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16 *Id.*

17 *Id.* at 548.

18 *Id.* at 552.

19 Rule Change 2014(05), Colorado Rules of Professional Conduct, https://www.courts.state.co.us/userfiles/file/Court_Probation/Supreme_Court/Rule_Changes/2014/2014(05)%20redlined.pdf.

20 *See, e.g., Michigan Medical Marihuana Program*, Michigan Department of Licensing and Regulatory Affairs, http://michigan.gov/lara/0,4601,7-154-72600_72603_51869---,00.html.

for a marijuana business license and meet a number of strict statutory requirements, including residency in Colorado for at least two years and "good moral character."[21] Assuming the potential owner satisfies these requirements, an application, numerous complex supporting documents, and license fees must be submitted to the City of Denver Department of Excise & Licenses and to the State of Colorado's Marijuana Enforcement Division.[22] These may include a floor plan, "[a] description of products and services to be provided by the establishment," zone use permits, the state Marijuana Business License, and "[a] security plan."[23] There is a $2,000 application fee and a $3,000 licensing fee.[24] Owners are also subject to an interview with a backgrounds investigator, and each owner is fingerprinted.[25] Finally, the business is subject to several government inspections.[26] The license must be renewed annually with a renewal application and a $3,000 license fee.[27]

Further, when a marijuana business owner sells the business, the owner must first file a Transfer of Ownership form with supporting documents with the Denver Department of Excise & Licenses and with the Colorado Marijuana Enforcement Division.[28] There is a $100 fee for

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21 C.R.S. 12-43.3-307(1).

22 *Medical Marijuana Licenses*, Denver Business Licensing Center, http://www.denvergov.org/businesslicensing/DenverBusinessLicensingCenter/BusinessLicenses/MedicalMarijuanaCenters/tabid/441765/Default.aspx.

23 *Id.*

24 *Id.*

25 *Business License Application Process-Medical Marijuana*, Colorado Department of Revenue, https://www.colorado.gov/pacific/enforcement/medical-marijuana-business-license-applicant.

26 *Supra* note 22.

27 *Id.*

28 *Id.*

transferring ownership payable to the City of Denver[29] and is also a more significant state fee, ranging from $250 to $25,000 depending on the business's size and other characteristics.[30]

3. Difficulty finding willing buyers

A third issue complicating the sale of a marijuana business is the general scarcity of willing and able buyers. Several additional factors make purchasing a marijuana business an extremely risky business decision: (1) difficulty securing loans and rental space, (2) potential criminal liability, and (3) potential civil liability and financial risks.

a. Difficulty securing loans and rental space

An interested buyer trying to secure a loan to purchase a marijuana business may find that banks are unwilling to provide a loan for fear of assisting in a criminal activity.[31] Despite federal regulations meant to clear the way for bank/marijuana business relationships, banks continue to proceed cautiously.[32] One banking executive summed up the situation as follows: "[The federal regulations don't] alter the underlying challenge for banks. Possession or distribution of marijuana violates federal law, and banks that provide support for these activities face the risk of prosecution and assorted sanctions."[33]

A further business obstacle is that other businesses may be unwilling to accept payments from a marijuana businessperson. For example, one Bankruptcy Court found that simply renting

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29 *Id.*

30 *Supra* note 25.

31 Danielle Douglas, *Obama Administration Clears Banks to Accept Funds from Legal Marijuana Dealers*, The Washington Post (Feb. 14, 2014), http://www.washingtonpost.com/business/economy/obama-administration-clears-banks-to-accept-funds-from-legal-marijuana-dealers/2014/02/14/55127b04-9599-11e3-9616-d367fa6ea99b_story.html.

32 *Id.*

33 *Id.*

space to a marijuana business violates federal law.[34] These difficulties securing loans and making purchases for the business make buying a marijuana business a far less attractive proposition.

b. Criminal liability

Another factor dissuading buyers is the potential for criminal liability. Because marijuana businesses remain illegal under federal law, it is the federal government's prerogative as to whether or not it allows these marijuana businesses to operate unimpeded.[35] The current administration has made it clear that the Justice Department will not target marijuana sellers in states where marijuana sales are legal so long as the sales comply with eight federal guidelines (such as not selling to minors).[36] Nevertheless, under a new administration these policies could quickly shift, a fact that creates significant risk and uncertainty for potential buyers.

c. Civil liability and financial risks

A marijuana business buyer must also consider civil liability and other financial issues. For example, marijuana businesses face higher taxes than other businesses, making the business less financially attractive for buyers.[37] This is because marijuana businesses are taxed on their gross revenue rather than their net income.[38]

Another consideration for buyers is the potential lack of legal protections for marijuana businesses. One commentator argues that stakeholders in marijuana businesses may not be

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34 *See In re Rent-Rite Super Kegs W. Ltd.*, 4 84 B.R. 799, 809 (Bankr. D. Colo. 2012).

35 *See* Luke Scheuer, *The 'Legal' Marijuana Industry's Challenge for Business Entity Law*, 6 Wm. & Mary Bus. L. Rev. 511, 513 (2015).

36 Kevin Johnson and Raju Chebium, *Justice Dept. Won't Challenge State Marijuana Laws*, USA Today (Aug. 29, 2013), http://www.usatoday.com/story/news/nation/2013/08/29/justice-medical-marijuana-laws/2727605; *see also* Deputy Attorney James M. Cole Memorandum 8/29/2013, http://www.justice.gov/iso/opa/resources/305201382913275685746 7.pdf.

37 Benjamin M. Leff, *Tax Planning for Marijuana Dealers*, 90 Iowa L. Rev. 523, 526 (2014).

38 *Id.*

protected by traditional business entity protections such as limited liability.[39] It is possible that these protections do not apply to situations where stakeholders intentionally violate the law, and stakeholders in a marijuana business are arguably engaged in such conduct.[40]

Another traditional legal protection that may not protect marijuana businesses is federal bankruptcy law. Bankruptcy courts are courts of equity and in cases of equity, a party may not be able to invoke the court's protections if the party comes before the court with "unclean hands."[41] At least one bankruptcy court has held that a marijuana business may not invoke Chapter 13 or Chapter 7 bankruptcy protections due to the business's violation of federal law, saying, "[W]hile the debtors have not engaged in intrinsically evil conduct, the debtors cannot obtain bankruptcy relief because their marijuana business activities are federal crimes."[42]

III. THE PITFALLS OF PORN: HURDLES IN THE SALE OF AN ADULT ENTERTAINMENT BUSINESS IN BANKRUPTCY[43]

Sex has been sold in one form or another since the origination of the world's oldest profession. Although the precise size of the industry is debatable, pornography, strip clubs, and other adult entertainment businesses have flourished despite legal and social obstacles and are now a multi-billion dollar industry.[44] The industry has and will undoubtedly continue to change over the years as it adapts to changing moral views and regulations, the continuing impact of

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39 *Supra* note 35.

40 Id.

41 *See In re Rent-Rite Super Kegs W. Ltd.*, 484 B.R. at 802; Vivian Cheng, *Medical Marijuana Dispensaries in Chapter 11 Bankruptcy*, 30 Emory Bankr. Dev. J. 105, 106 (2013).

42 *In re Arenas*, 2015 Bankr. LEXIS 2821 at *9 (B.A.P. 10th Cir. 2015).

43 By S. Gregory Hays and Eric J. Silva S. Gregory Hays, the Managing Principal of Hays Financial Consulting, LLC, in Atlanta, Georgia, has served as: (1) a court-appointed Chapter 11 trustee, Chapter 7 trustee, assignee, and bankruptcy plan fiduciary in bankruptcy cases; and (2) a federal and state court receiver in numerous jurisdictions across the country. Eric J. Silva is an attorney at James C. Frenzel, P.C. in Atlanta, Georgia with experience representing receivers and creditors in receiverships and creditors, committees, and court-appointed trustees in corporate reorganization, insolvency, and commercial bankruptcy matters.

44 *See* Sam Spencer, *How Big is the Pornography Industry in the United States?,* Covenant Eyes Blog (June 1, 2012) (available at http://www.covenanteyes.com/2012/06/01/how-big-is-the-pornography-industry-in-the-united-states/).

free-online content, advancements in technology, and other industry specific issues. The shifting landscape has and will continue to cause adult entertainment businesses to fail. In instances where an adult entertainment business seeks bankruptcy protection, the sale of the debtor's unique assets presents certain challenges. An overarching concern is the duty of complying with state and federal laws pursuant to 28 U.S.C. § 959 while attempting to operate such businesses prior to a sale of assets.

A. Including Appropriate Content in the Sale

Determining the assets that may appropriately be included in a sale can be a challenge. For example, within the nebulous category of pornography, which Justice Potter Stewart famously defined stating: "[Y]ou don't really know what it is until you see it," is a subset of certain content that is so objectionable that it is illegal and/or should not ethically be included in a sale.[45] Accordingly, in a chapter 11 domain name sale, bidders agreed to carve out certain domain names that were related to child pornography, the objectionable domain names were deactivated and reported to appropriate law enforcement.[46] Additionally, content may also need to be excluded where a seller does not have appropriate rights, such as pornographic images used without appropriate consent.[47] Furthermore, the sale of certain personal data of customers maintained by adult entertainment businesses may violate privacy rights.[48]

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45 *Harbinger Capital Partners LLC v. Ergen (In re Lightsquared Inc.)*, 504 B.R. 321, 335 (Bankr. S.D.N.Y. 2013).

46 *See In re Ondova Ltd.*, 2012 Bankr. LEXIS 5429, *17-19 (Bankr. N.D. Tex. Nov. 21, 2012).

47 *See Bullard v. MRA Holding, LLC*, 890 F. Supp. 2d 1323, 1325 (N.D. Ga. 2012)(claims arising from use of videotaped image of a 14 year old plaintiff in a video and marketing campaign without consent).

48 Jason Mick, *FTC Alarmed by Bankrupt Gay Magazine's Plan to Sell Personal Data*, Daily Tech (July 19, 2010) (available at http://www.dailytech.com/updated+FTC+Alarmed+by+Bankrupt+Gay+Magazine's+Plan+to+Sell+Personal+Data/article 19019.htm).

Any bankruptcy proceeding requires analysis of all assets for potential sale including assets not currently in the possession of the estate that may be clawed back or are subject to a dispute of ownership. But in this regard, certain adult entertainment businesses involve somewhat unusual intellectual property issues that generally need to be addressed prior to a sale. Unless and until a trustee rejects a contract, upon request of a licensee, the trustee must either perform under the contract or transfer the intellectual property to the licensee.[49] In *In re PMGI Holdings, Inc.*, et al.,[50] the owner of Penthouse Magazine and thousands of adult content websites needed to first resolve a dispute over intellectual property prior to obtaining approval of a plan incident to which ownership of the company was transferred.[51] Unique copyright issues can also arise in adult entertainment bankruptcies. Copyright was effectively unavailable for pornography until 1979.[52] While it is still "unsettled in many circuits."[53] adult oriented content is now protected under the U.S. Copyright Act if the content is fixed in a tangible medium of expression and is an original work.[54]

B. Concern About the Unclean Hands of the Debtor

A significant challenge in adult entertainment bankruptcies is dealing with the prior operator and buyers concerned with becoming associated with such party. As an initial matter, concern about prior management is not just a public perception issue as the prior conduct of the debtor may serve as a defense under the unclean hands doctrine to prevent a trustee from

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49 *See* 11 USCS § 365(n)(B)(4).

50 13-bk-12404 (CSS), (B.C. Del.).

51 *See* Tom Hals and Sakthi Prasad, *Penthouse Publisher Bankruptcy: FriendFinder Networks Files For Chapter 11* (Reuters, Sept. 17, 2013)(available at http://www.huffingtonpost.com/2013/09/17/penthouse-publisher-bankruptcy_ n_3938927.html).

52 *See Mitchell Brothers Film Group v. Cinema Adult Theater*, 604 F.2d 852, 854-55, 858 (5th Cir. 1979) (holding that protection of obscene materials was neither explicitly nor implicitly prohibited under the Copyright Act).

53 *Liberty Media Holdings v. Swarm Sharing Hash File*, 821 F. Supp. 2d 444, 447 n.2 (D. Mass. 2011).

54 *See* 17 U.S.C. §§ 101-02.

recovering property to be included in a sale for the benefit of the estate.[55] In 2013, certain soft-core pornography entities of Girls Gone Wild ("GGW") filed chapter 11 to, in part, block efforts by Wynn Las Vegas, LLC ("Wynn") to recover significant gambling debts and judgments for slander and defamation obtained against the founder of GGW, Joseph Francis ("Francis").[56] Wynn obtained the appointment of a trustee due to Francis's improper conduct in the transfer of certain GGW assets.[57] In opposing the appointment of a trustee, GGW attempted to justify certain payments to Francis by indicating that the "Debtor has paid expenses related to Francis' lifestyle because Francis' image helps sell the Debtor's products and services. Francis' 'bad boy' lifestyle and image are inextricably identified with the Girls Gone Wild brand just as Hugh Hefner is identified with Playboy Magazine."[58] After the trustee was appointed, Francis was barred from GGW headquarters to avoid further disruptions. The trustee later recovered significant assets from entities related to Francis, including certain trademarks and other intellectual property, and proceeded to promote the sale of the assets of GGW.[59] However, due to

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55 *See Burkart v. Bisessar (In re Singh)*, 2015 Bankr. LEXIS 1440, *1 (Bankr. E.D. Cal. Apr. 22, 2015)("In the context of an unclean hands defense, a bankruptcy trustee stands in the shoes of the debtor and may not use his status as an innocent successor to insulate the debtor from the consequences of its wrongdoing").

56 *See In re GGW Brands, LLC ("GGW")*, Debtor in Case No. 2:13-bk-15130-SK(slander judgment resulted from Francis saying on Good Morning America that Wynn threatened to hit him over the head with a shovel and burry him in the desert and slander judgment resulted from Francis saying that Wynn sent drugs and hookers to rooms of high rollers at the casinos operated by Wynn).

57 *See* Motion for Order Directing Appointment of Chapter 11 Trustee, *In re GGW BRANDS, LLC, et al.*, Case No. 2:13-bk-15130-SK, Doc. No. 28 (March 21, 2013).

58 Response of Debtor-in-Possession in Opposition to Motion for Order Directing Appointment of Chapter 11 Trustee, *In re GGW BRANDS, LLC, et al.*, Case No. 2:13-bk-15130-SK, Doc No. 43 (March 29, 2013).

59 *See* Katy Stoch, *Joe Francis Says Bankruptcy Trustee Aims to Destroy Girls Gone Wild*, Wall Street Journal Bankruptcy Beat (May 31, 2013)(available at http://blogs.wsj.com/bankruptcy/2013/05/31/%EF%BB%BFjoe-francis-says-bankruptcy-trustee-aims-to-destroy-girls-gone-wild/); Katy Stoch, *Lawyers Prepare to Sell Girls Gone Wild Brand*, Wall Street Journal Bankruptcy Beat (Nov., 12, 2013)(available at http://blogs.wsj.com/bankruptcy /2013 /11/12/lawyers-prepare-to-sell-girls-gone-wild-brand/); Rhett Pardon, *Girls Gone Wild Auction Called Off; No Competing Overbids*, XBIZ News Report (April 15, 2014)(available at http://www.xbiz.com/news/177782).

Francis's conduct, marketing the GGW assets was difficult and "some buyers expressed reservations about buying the Debtors' assets, given its previous management."[60]

C. Concern About the Bottom Line

Although the common belief is that sex always sells, a significant concern about certain adult entertainment businesses is whether the business will be profitable in the future. For example, the China Club Cheetahs Gentlemen's Club & Restaurant closed after a significant source of key clientele was lost when down the block its neighbor, Lehman Brothers, filed for bankruptcy protection. A significant hindrance to many adult entertainment businesses is the availability of free pornography on the internet and the difficulty of online copyright enforcement.[61] Additional challenges in the industry include potential advancements in technology that may disrupt and negatively impact the market for products available and businesses operating today. According to one author, sex-bots will take over the adult entertainment by 2050.[62] In addition to competition from the internet and potential advancements in technology, some parties are concerned about the perception of a general decline in the adult entertainment industry.[63] "Revenue for the adult entertainment industry has shrunk dramatically

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60 *Motion for Order: (1) scheduling an auction and sale hearing in connection with the sale of substantially all of the Debtors' assets; (2) approving bidding procedures; (3) approving asset purchase agreement; (4) approving breakup fee; (5) approving notice of auction and sale hearing; (6) approving procedures for the assumption, assignment, and sale of contracts; and (7) approving sale of Debtors' assets free and clear of all liens, claims, and encumbrances and interests; Memorandum of Points and Authorities; and Declaration of R. Todd Neilson in support thereof, In re GGW BRANDS, LLC, et al.*, Case No. 2:13-bk-15130-SK, Doc. No, 494 (Feb. 12, 2014).

61 *See* Kate Darling, *IP Without IP? A Study on the Online Adult Entertainment Industry*, 17 STAN.TECH.L.REV. 709 (2014); Doug Walker, *Entice Files for Bankruptcy; Craton says Internet has Hurt Sale of Adult DVDs*, Rome News Tribune (Dec. 31, 2014) (available at http://www.northwestgeorgianews.com/rome/business/entice-files-for-bankruptcy-craton-says-internet-has-hurt-sale/article_45485d5a-9044-11e4-87c6-976e2e070fb6.html).

62 *See* Kaila Hale-Stern, *Don't Have Sex With Robots, Say Ethicists, GIZMODO* (Sept. 15, 2015)(available at http://gizmodo.com/dont-have-sex-with-robots-say-ethicists-1730866985).

63 *See* Motion, *supra* note 18 (citing declaration of trustee)("at least one potential buyer expressed concern that, although the Debtors were profitable in 2013, they may not be profitable in future years due to a perceived general decline in the adult entertainment industry.").

over the last decade, from a peak of roughly $13-$14 billion in 2005 to just over $5 billion now."[64] Some sources have noted stories about struggling companies suffering from declining profitability and have forecast the ultimate death of the adult entertainment production industry.[65]

D. Concerns About Conduct and Employment Issues

The operation of an adult entertainment business is commonly associated with a variety of risks such as rogue employees, fights,[66] prostitution,[67] underage drinking, theft, drug usage, underage subject matter, or employment issues resulting in losses or liability. The occurrence of such things may cause businesses to file bankruptcy or may cause further issues during bankruptcy or after a sale. Since a trustee is obligated to comply with state and federal laws,[68] a trustee who cannot operate a company without engaging in illegal activity prior to a sale should not operate the company and would be unable to sell the business as a going concern. For example, a strip club that operated prior to bankruptcy as a front to sell drugs or facilitate prostitution on the side will not be allowed to continue operations in bankruptcy unless the trustee can operate the business without the illegal activity. In many cases, a trustee will quickly

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64 Timothy Stenovec, *Free Pornography Continues To Be A Problem For The Porn Industry,* The Huffington Post (April 10, 2013). Commentators have indicated that it is now harder to make profits in porn in the digital world. *See* David Rosen, *Is Success Killing the Porn Industry?:*, AlterNet (May 27, 2013) (available at http://www.huffingtonpost.com/2013 /04/10/free-pornography_n_3052893.html).

65 *See* Darling, *supra* note 61.

66 *See* Sujeet Rajan, *Siblings Anuj Sapra, Arti Sapra Awarded Almost $9 Million in 2005 Assault Case in New York City,* The American Bazaar (March 12, 1015)(available at http://www.americanbazaaronline.com/2015/03/12/ siblings-anuj-sapra-arti-sapra-awarded-almost-9-million-in-2005-assault-case-in-new-york-city/).

67 *See* Chris Shott, *Show Me Your Assets! Busted Strip Club Bares All in Bankruptcy Filing*, Observer/Real Estate (April 20, 2008) (available at http://observer.com/2008/04/show-me-your-assets-busted-strip-club-bares-all-in-bankruptcy-filing/).

68 *See* 28 U.S.C. § 959; *State St. Bank & Trust Co. v. Park (In re Si Yeon Park, Ltd.)*, 198 B.R. 956, 965 (Bankr. C.D. Cal. 1996)("This section means that federal trustees and receivers, including bankruptcy trustees, have to comply with all applicable health and safety code, building code, business license requirements, environmental, and other regulatory obligations of business or property operations.").

terminate the operations of an adult entertainment business,[69] but several clubs have continued to operate as debtors-in-possession pending a resolution with regard to the assets of the debtor.[70]

The risks commonly associated with operating an adult entertainment business in bankruptcy are also significant concerns for potential buyers. Although the repercussions of rogue employees, fights, prostitution, underage drinking, theft, drug usage, and underage subject matter are generally well known, exposure to liability for the "employment status of dancers in adult entertainment establishments is unsettled."[71] Some courts have recognized that adult entertainment businesses can have a reasonable basis for treating dancers as independent contractors where the dancers set their own schedules and work at multiple clubs.[72] In *Cinema Art Theatre of Springfield, Inc. v. United States*,[73] the IRS assessed back employment taxes based on the allegation that the dancers were employees, but subsequently agreed that the dancers were independent contractors resulting in the nightclub receiving an award of attorney's fees. In order to try to avoid exploitative business practices encountered when dancers serve as independent contractors working for tips and paying clubs for stage time, dancers at the Lusty Lady in North Beach unionized and managed their own employment affairs.[74] In contrast, other courts

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69 *See* Lyda Longa, *Daytona Beach Strip Club Lollipops Shuts Down, Taken Over in Bankruptcy Lollipops Gentleman's Club Taken in Bankruptcy Following Feud About Who Owns Business*, The Daytona Beach News-Journal (May 9, 2015)(available at http://www.news-journalonline.com/article/20150509/NEWS/150509558?template=printart).

70 *King of Diamonds reorganization OK'd,* Pioneer Press (June 9, 2011)(available at http://www.twincities.com/dakot a/ci_18235019). Tattle Tail, Inc. in Atlanta completed a successful plan in Chapter 11 Case No. 17-61442-MHM.

71 *Redmond v. Chains, Inc.*, 996 P.2d 759 , 762 (Colo. App. 2000).

72 *See Deja Vu Entm't Enters. v. United States*, 1 F. Supp. 2d 964 (D. Minn. 1998).

73 46 F. Supp. 2d 812, 813 (C.D. Ill. 1999).

74 *See* Reyban Harmanci, *Nation's Only Strip Club May Close,* The Bay Citizen (May 8, 2012)(available at https://www.baycitizen.org/news/labor/nations-only-unionized-strip-club-may/). Reports in 2012 indicated that the only unionized strip club was facing financial distress as a result of large tax bill and competition from free online pornography on the internet. *See id.*

analyzing certain relevant factors under the Fair Labor Standards Act (FLSA) have determined that topless dancers at nightclubs are employees covered by FLSA.[75]

E. Concerns About Morality Issues and Regulatory Compliance

Adult entertainment businesses are specialized operations that are often subject to: 1) moral objections; and 2) concern about operating within the constraints imposed due to moral or other concerns.[76] The founder of GGW alleged that the appointed trustee wanted to destroy the business in conjunction with a moral crusade.[77] While the trustee asserted that such allegations were unfounded and that he was simply fulfilling the duties as trustee,[78] moral objections limit the pool of available buyers and impact constraints placed on adult entertainment businesses in the form of licensing, ordinances, and other operating regulations. Whereas a moratorium on new adult entertainment licenses would actually assist a sale by providing a protected market, a community attempting to remove all adult-orientated businesses would hinder a sale by, among other things, preventing the transfer of an operating license.[79] License transfer issues do not just arise from communities enacting regulations as demonstrated in the case of the infamous Mustang Ranch, which operated as the first licensed brothel in Nevada. After the brothel was seized in a bankruptcy proceeding in 1990, the trustee intended to operate the brothel until the brothel could be sold, but the presiding judge refused to allow the trustee to assume the licenses

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75 *See Reich v. Circle C Invs.*, 998 F.2d 324, 326 (5th Cir. 1993).

76 *See* Motion, *supra* note 60 ("Debtors are in a specialized business...potential buyers either had moral objections to the business or concerns that they did not understand how to operate an adult entertainment business.").

77 *See* Stoch, *supra* note 17.

78 *See id.*

79 *See* Kelly Johnson, *Strip Club's Owner Files for Chapter 7 Bankruptcy,* The Sacramento Business Journal (Oct. 25, 1998)(available at http://www.bizjournals.com/sacramento/stories/1998/10/26/story4.html?page=all (operating license was invalid and could not be transferred after the businesses filed bankruptcy).

of the ranch.[80] The IRS subsequently foreclosed on the brothel and auctioned the property within a few months of the foreclosure.[81] The urban legend is that the IRS operated the brothel, but available evidence indicates otherwise.[82] In addition to license issues, certain regulations are more expansive than just licensing and actually address the transfer of ownership or control of a sexually orientated business.[83]

IV. THE PRICE OF PUPPIES: HURDLES IN THE SALE OF A NONPROFIT BUSINESS IN BANKRUPTCY[84]

The tough economic conditions have not even spared puppies in recent years. Several nonprofit animal shelters have filed bankruptcy in recent years, including the Safe Haven Animal Sanctuary of Sussex County, Delaware; the Central Illinois Small Animal Rescue; the Humane Society of Cumberland County, Tennessee; and the Animal Sanctuary of the United States in San Antonio, Texas.[85] But animal shelters are not alone. Various other nonprofits have found their way to bankruptcy court, ranging from the recent filings by the San Antonio and New York City Operas to the Please Touch Museum of Philadelphia that filed on September 11, 2015.[86] Due to the fundamental differences between for-profit and nonprofit entities, the proceedings of a nonprofit entity's bankruptcy are very different than the proceedings of the average for-profit

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80 *See* David Emery, *U.S. Gov't Tried (and Failed) to Run Mustang Ranch?,* Net lore Archive (Oct. 2008) (available at http://urbanlegends.about.com/od/government/a/mustang_ranch.htm).

81 *See id.*

82 *See id.*

83 *See* the Code of Ordinances, Charter Township of Van Buren, Michigan, Sections 22-401 through 22-440.

84 The panel acknowledges and appreciates the assistance of Ryan B. White, Esquire, of Saul Ewing LLP, Philadelphia, PA, in the preparation of the written materials in this section.

85 *See In re Safe Haven Animal Sanctuary of Sussex County Inc.*, Case No. 14-10147 (Bankr. D. Del. 2014). *See also In re Central Illinois Small Animal Rescue*, Case No. 13-70855 (Bankr. C.D. Ill. 2013); *In re Humane Society of Cumberland County, Inc.*, Case No. 10-54400 (Bankr. M.D. Tenn. 2010); and *In re Animal Sanctuary of the United States* , Case No. 10-54400 (Bankr. W.D. Tex. 2010).

86 *See In re San Antonio Opera*, Case No. 12-51490 (Bankr. W.D. Tex. 2012); *In re New York City Opera, Inc.*, Case No. 13-13240 (Bankr. S.D.N.Y. 2013); *In re Please Touch Museum*, Case No. 15-16558 (Bankr. E.D. Pa. 2015).

business' bankruptcy. This section addresses some of the unique challenges nonprofits face when selling their assets through a bankruptcy proceeding.

A. Unique Issues in Nonprofit Bankruptcies

1. Special protections of Sections 303 and 1112(c)

Like for-profit entities, nonprofits are generally eligible to file petitions for relief under chapter 7 and chapter 11 of the Bankruptcy Code.[87] However, nonprofits are provided some special protections that are not available to for-profit entities. While section 303 of the Bankruptcy Code generally provides that an involuntary case may be commenced against entities that are eligible for bankruptcy under chapter 7 or 11, nonprofits are protected by an exception to the rule. Section 303 states that an involuntary case may only be commenced against an entity that is "not a moneyed, business or commercial corporation."[88]

Similarly, if a nonprofit elects to file a chapter 11 petition, it is also precluded from involuntarily becoming subject to a liquidation under chapter 7. Subject to the best interest of the estate, section 1112(b) of the Bankruptcy Code generally permits the bankruptcy court to dismiss a case under chapter 11 or convert it to a case under chapter 7. However, section 1112(c) prohibits the conversion of a chapter 11 case to a case under chapter 7 if the debtor is a "non-moneyed, non-business or non-commercial corporation."[89]

Additionally, although property of the estate is broadly defined under the Bankruptcy Code to include all legal or equitable interests of the debtor, it will not necessarily encompass

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87 *See* 11 U.S.C. § 109 "only a person that resides in or has a domicile, a place of business, or property in the United States, or a municipality, may be a debtor . . . " Under 11 U.S.C. § 101(41) a "person" is defined to include any individual, partnership, or corporation, and 11 U.S.C. § 101(9)(A)(v) further specifies that a "business trust" is included within the definition of "corporation."

88 11 U.S.C. § 303(a).

89 11 U.S.C. § 1112(c).

everything that nonprofits may view as assets.[90] Thus, where donors properly restrict access to funds, endowments or charitable trusts by retaining title or utilizing other restrictions enforceable under state law, those funds do not constitute property of the bankruptcy estate.[91]

2. Additional requirements of Sections 363(d), 541(f) and 1129(a)(16)

The special protections afforded nonprofits under the Bankruptcy Code do not come without a cost. While many entities file bankruptcy to facilitate an asset sale that may not otherwise be possible under nonbankruptcy law, certain provisions incorporated into the Bankruptcy Code that are not applicable to for-profit enterprises create unique challenges when nonprofits seek to sell their assets in bankruptcy. In the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA"), Congress made three amendments to the Bankruptcy Code that require nonprofits to comply with all nonbankruptcy laws that would be applicable to a sale of their assets outside of a bankruptcy proceeding.

The new provisions are found in sections 363(d), 541(f), and 1129(a)(16) of the Bankruptcy Code. In function, these provisions ensure that nonprofits cannot use bankruptcy to sell assets without the scrutiny that would otherwise apply under state law. Section 363(d) provides that any 363 sale "in the case of a debtor that is a corporation or trust that is not a moneyed business, commercial corporation, or trust" must be "in accordance with nonbankruptcy law applicable to the transfer of property by a debtor that is such a corporation or trust."[92] Section 541(f) similarly provides that property held by a debtor that is a nonprofit corporation "may be

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90 11 U.S.C. § 541(a).

91 11 U.S.C. § 541(b)(1), (c)(2) and (d). *See also In re Roman Catholic Archbishop of Portland in Oregon*, 345 B.R. 686, 707 (Bankr. D. Ore. 2006) and *In re Bishop College (Salisbury v. Ameritrust Texas, N.A.)*, 151 B.R. 394, 401 (Bankr. N.D. Tex. 1993).

92 11 U.S.C. § 363(d).

transferred to an entity that is not such a corporation, but only under the same conditions as would apply if the debtor had not filed a case under this title."[93]

In like manner, section 1129(a)(16) ensures that the requirements are also applicable under a plan of reorganization. It provides, "[a]ll transfers of property under the plan shall be made in accordance with any applicable provisions of nonbankruptcy law that govern the transfer of property by a corporation or trust that is not a moneyed, business, or commercial corporation or trust."[94] A bankruptcy court has explained that the purpose of these amendments was to restrict the sale of a nonprofit's property except in accordance with applicable nonbankruptcy law, so that a nonprofit entity cannot escape supervision by its state's Attorney General, who is given standing to appear and be heard on this issue.[95] Furthermore, the legislative history clarifies that the bankruptcy court has jurisdiction to apply the appropriate state laws or it may defer judgment to another forum.[96] Thus, transfer of nonprofit assets in bankruptcy proceedings are always subject to state laws and regulations, regardless of whether the nonprofit seeks a transfer through a 363 asset sale or under a chapter 11 plan of reorganization.

B. Unique Issues in Selling a Nonprofit Business

When a debtor-in-possession acting as the trustee seeks to sell its assets in bankruptcy, it must do so acting under a reasonable business judgment. Typically, the goal of any sale is to maximize the value for the benefit of a debtor's estate. Under section 363, before approving a sale of assets, bankruptcy courts are required to assess whether a debtor's proposed sale is to a buyer

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93 11 U.S.C. § 541(f).

94 11 U.S.C. § 1129(a)(16).

95 *In re Seven Counties Servs., Inc.*, 511 B.R. 431, 471 (Bankr. W.D. Ky. 2014), *leave to appeal denied* (Dec. 30, 2014), *certificate of appealability granted,* No. 13-31442(1)(11), 2014 WL 4792202 (Bankr. W.D. Ky. Sept. 24, 2014) (citing 3 Collier on Bankruptcy ¶ 363.04 (Alan N. Resnick & Henry J. Sommers eds., 16th ed; and H.R. Rep. 109–31 (BAPCA 2005) § 363(d)(1) and § 541(f)).

96 *In re Seven Counties Servs., Inc.*, 511 B.R. at 471.

that submitted the highest and best offer. While evaluating such sales, numerous factors may be considered, but the monetary consideration is generally considered the most significant factor and debtors almost always select the buyer that submitted the offer of the highest dollar amount.

In *In re United Health Care System, Inc.*, the board of the nonprofit debtor that operated the Children's Hospital of New Jersey and other health facilities evaluated multiple factors of several competing bids before accepting an offer from a buyer that did not offer the highest dollar amount.[97] At the hearing on approval of the 363 sale, another bidder objected to the sale and offered a higher bid for the assets. The bankruptcy court questioned the board's judgment and would not approve the board's selected buyer. It found that the board did not exercise sound business judgment when it selected a bid that was not the highest purchase price.

On appeal, the judgment of the board was redeemed when the district court found that the highest bid in terms of dollars may not always be the most appropriate one and overturned the decision of the bankruptcy court. In doing so, the district court rejected a mechanical application of the bankruptcy principle of "highest and best" without an examination of the totality of the circumstances. The district court held that the bankruptcy court had erred by substituting its own judgment for that of the board when it favored the offer with the higher purchase price.

Finding that the debtor's board had exercised its business judgment in good faith, the district court observed that the bankruptcy court had "failed to acknowledge that the Board of United, a non-profit organization, had a fiduciary obligation to maintain the legacy of the Children's Hospital."[98] It noted that the officers and directors of a nonprofit organization are charged with the fiduciary obligation to act in furtherance of the organization's charitable

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97 *In re United Healthcare Sys., Inc.*, Civ. No. 97-1159 (NHP), 1997 WL 176574, at *5-6 (D.N.J. 1997).

98 *Id.*

mission. Thus, "[w]hen analyzing an articulated business reason for the sale, the bankruptcy court must also take into consideration the fact that a debtor is a charitable institution.[99]

1. Realizing a sale that conforms with the nonprofit's mission

While *In re United Healthcare Sys., Inc.* was decided before the BAPCPA amendments addressing nonprofits were enacted, the principles underlying the decision are fully reinforced by the amendments that require nonprofits to adhere to all nonbankruptcy laws when selling their assets. When considering offers from prospective buyers, a nonprofit's officers, in conformance with their fiduciary duties, are required to act to fulfill the nonprofit's mission.[100] This obligation arises under the same duties of care, loyalty, and good faith required of directors and officers of traditional for-profit entities, which duties are also imposed on the officers and directors of nonprofits by statute.[101] For example, in discharging their duties under Pennsylvania law, nonprofit officers must consider the best interests of the nonprofit corporation and should also evaluate, (i) the effects of any action on all affected groups and the communities where the entity is located, (ii) the short and long term interests of the nonprofit, and (iii) "the resources, intent and conduct (past, stated and potential) of any person seeking to acquire control of the corporation." 15 Pa. Cons. Stat. Ann. § 5715 (West).

2. Acknowledging the public interest and the nonprofit's mission

A nonprofit's mission is also of significant importance and is emphasized among the factors assessed by the Attorney General in evaluating the public interest in proposed sales of

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99 *Id.*

100 *See, e.g., In re Lemington Home for the Aged*, 777 F.3d 620 (3d Cir. 2015) (addressing fiduciary duties of care and loyalty owed by director of nonprofit under Pennsylvania state statutes). *See also Torch Liquidating Trust ex rel. Bridge Associates L.L.C. v. Stockstill*, 561 F.3d 377, 385-86 (5th Cir. 2009).

101 The duties of nonprofit directors to a large extent parallel the obligations of for-profit directors. Thomas Lee Hazen & Lisa Love Hazen, *Punctilios and Nonprofit Corporate Governance-A Comprehensive Look at Nonprofit Directors' Fiduciary Duties*, 14 U. Pa. J. Bus. L. 347, 356 (2012).

nonprofit assets under state laws. For example, in New York, the Attorney General must be notified of a proposed sale of nonprofit assets and a nonprofit must obtain leave of the state court before it may be authorized to sell all or substantially all of its assets. The court must assess the adequacy of the terms and consideration and must determine whether "the purposes of the corporation or the interest of the members will be promoted."[102] In California, the Attorney General has decisional discretion over the sale of certain nonprofits. In doing so, the Attorney General must address similar factors and assess the fairness of the terms, that the value of the transaction has not been manipulated is at "fair market value," and that the transaction is in the public interest and is consistent with the purpose of the charitable trust or nonprofit.[103]

While previously seen by some as meddlesome or a less important factor, whether a sale of a nonprofit's assets conforms with its mission is now seen as one of the paramount factors for consideration in a sales approval. For example, the independent chapter 7 trustee appointed in the *Safe Haven Animal Sanctuary of Sussex County Inc.*, bankruptcy proceeding proposed a sale and realized a loss of more than $10,000 on the premise. The Trustee of the no kill animal shelter filed a motion to sell the debtor's van for $6,000 to a purchaser that also operated a no kill shelter. The Trustee estimated that the value of the debtor's 2012 Nissan NV 1500 van was $17,000. In support of the sale that was approved without objection by the Delaware Bankruptcy Court, the Trustee noted, "Importantly, the Purchaser seeks to use this Van for the transportation of dogs and cats […] In light of the intended use of the Van consistent with the mission of the Debtor, the Trustee believes that the Purchaser would be an appropriate end user of the Van.[104] More recently, the fact that proposed transactions were consistent with a nonprofit's mission has been referenced

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102 *64th Associates, L.L.C. v. Manhattan Eye, Ear & Throat Hosp.*, 2 N.Y.3d 585, 590 (2004).

103 *See* Cal. Corp. Code § 5917 (West).

104 *In re Safe Haven Animal Sanctuary of Sussex County Inc.*, Case No. 14-10147 (Bankr. D. Del. 2014) (Chapter 7 Trustee's Sale Motion, Docket Item 29; Order Approving Sale Docket Item 35).

by the Bankruptcy Court for the Eastern District of New York in its approval of transactions in the case of Federation Employment and Guidance Service, Inc. d/b/a FEGS a major social-service nonprofit.[105]

3. Obtaining necessary regulatory approvals

A nonprofit's board should also consider constraints that any regulatory approval process places on a sale when considering which offer is the "highest and best."[106] The transfer of certain types of assets of nonprofits, including health care assets, can be subject to extremely onerous state regulatory burdens. However, with some foresight, cooperation and perhaps some luck, a debtor may be able to obtain relatively quick approval of a sale that may otherwise require a lengthy process. The $38 million dollar sale of a hospital in the *In re Quincy Medical Center, Inc.*, case was subject to regulatory review by the Attorney General of the Commonwealth of Massachusetts and approval by the Massachusetts Department of Public Health. While the process of gaining regulatory approval was extensive, due to the cooperation and negotiations of the parties, the exigencies of the proposed sale, and oversight of the bankruptcy process the Massachusetts authorities and the bankruptcy court approved the sale of the hospital in slightly more than three months.[107]

However, the bankruptcy court cannot rescue a sale that lacks cooperation with and consent from state regulators. In *In re 51-53 West 129th Street HDFC*, the bankruptcy court was unable to permit the debtor, a New York City nonprofit Housing Development Finance Corporation, from proceeding with a sale proposed. New York City had moved for relief from the

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105 *See, e.g., In re Federation Employment and Guidance Service, Inc. d/b/a FEGS*, Case No. 15-71074 (Bankr. E.D. N.Y. 2015) (Debtors' Motion, Docket Item 185; Order Approving Docket Item 254).

106 *See, e.g., In re United Healthcare Sys., Inc.*, Civ. No. 97-1159 (NHP), 1997 WL 176574, at *5-6 (D.N.J. 1997).

107 2011 WL 4947208, No. 11-16394-MSH (Bankr. D. Mass. October 10, 2011).

stay in order to transfer the debtor's property to another nonprofit to oversee the rehabilitation of the property. In granting the City's motion, the bankruptcy court noted that prior to the bankruptcy proceeding, a New York state court had rejected the debtor's proposed sale as it contravened the purpose of the debtor's creation.[108]

V. TAX CONSIDERATIONS FOR THE SALE OF ASSETS IN BANKRUPTCY CASES

A. Transfers of Property in Satisfaction of Debt

When a debtor transfers or surrenders property to a creditor in exchange for debt forgiveness, a determination must be made whether the transfer results in income from debt discharge or gain on the sale of property. The characterization of the income is important due to the tax provisions allowing taxation of capital gains at a lower rate and the exclusion from tax of income resulting from debt cancellation.

General Rule. When property is surrendered in exchange for debt discharge, a disposition of property occurs and income from the disposition of property or income from the discharge of indebtedness or a combination of both will result.

Non-Recourse Debt. Generally, if the debt canceled or exchanged for the surrendered property is non-recourse debt then no cancellation of debt ("COD") income will result. Instead, the excess of the property's canceled or exchanged debt over its adjusted tax basis will be treated as taxable gain from the disposition of property.

Recourse Debt. On the other hand, if the debt canceled or exchanged for property is recourse debt both COD income and gain from the sale of property may be realized. Should the debt forgiven be greater than the fair market value ("FMV") of the property surrendered and

[108] *In re 51-53 West 129th Street HDFC,* 475 B.R. 391, 393 (Bankr. S.D.N.Y. 2012).

should the property's FMV be greater than its adjusted basis, the following two calculations would be made to determine taxable gain and COD income.

1. The excess of the property's FMV over its adjusted basis will be treated as taxable gain from the disposition of property (if the fair market value of the property is less than its basis, loss is realized), and

2. The excess of the debt exchanged or canceled over the property's FMV will be COD income.

B. Cancellation of Debt (COD) Income

Pursuant to the Internal Revenue Code ("IRC") §61(a)(12), income from the **cancellation of debt** is included in gross taxable income. However, the I.R.C. provides an exception to this general rule should the taxpayer meet requirements contained in I.R.C. § 108.

Exclusions. I.R.C. § 108 includes provisions for to determining if COD income can be excluded from taxable income. Section 108(a) provides that COD income is excluded from gross income if:

a) a debt is discharged in a bankruptcy action under Title 11 of the U.S. Code and the discharge is either granted by or is pursuant to a plan approved by the court,
b) a debt is discharged when the taxpayer is insolvent,
c) the discharge is of "qualified farm indebtedness", or
d) the discharge is of "qualified real property business indebtedness".

Insolvency. Insolvency is the excess of liabilities over the fair market value of assets immediately before the discharge. See §108(d)(3)). However,

a) The income exclusion resulting from the insolvency exception only applies to the extent of insolvency and
b) Under Revenue Ruling 92-53 1992-27 I.R.B., non-recourse debt is only included in the insolvency formula to the extent of the FMV of the property. However, the excess non-recourse debt (the amount by which the non-recourse debt exceeds the FMV of the property securing the debt) can be included in the insolvency formula to the extent the excess non-recourse debt is discharged.

Attribute Reduction and Order**.** When COD income is excluded from gross income as a result of a discharge of indebtedness under Title 11, a discharge because of insolvency or a

discharge of qualified farm indebtedness, the **amount excluded shall be applied to reduce the tax attributes of the taxpayer** (See §108(b)(1)). The reduction of tax attributes shall be made in the following order:

1) **Net Operating Losses** ("NOLs") for the year of debt discharge first and then any NOL carryover to that year reduced one dollar for each dollar of income excluded.

2) **General Business Credit carryovers** to or from the taxable year of debt discharge reduced one dollar for every three dollars of income excluded.

3) **Minimum Tax Credit** available as of the beginning of the taxable year following the year of debt discharge reduced one dollar for every three dollars of income excluded.

4) **Capital Losses** for the year of debt discharge first and then any capital loss carryovers to that year reduced one dollar for each dollar of income excluded.

5) **Basis of** taxpayer's **assets** (both depreciable and non-depreciable assets) but not below the taxpayer's aggregate liabilities remaining after the debt discharge. This applies to property held at the beginning of the tax year following the year of debt discharge.

6) **Passive Activity Loss and Credit Carryovers** from the year of discharge.

7) **Foreign Tax Credit carryover** to or from the taxable year of discharge reduced one dollar for every three dollars of COD income excluded.

Depreciable Property Election. An **election** can be made to reduce the basis of depreciable property **first**, before the attributes listed above are reduced. See §108(b)(5). However, the amount excluded under this option **cannot exceed the aggregate adjusted basis of depreciable property** measured at the beginning of the year following the year of debt discharge. This election is sensible if the taxpayer could use NOL's immediately to shelter current income, whereas the benefit of depreciation expense is only realized over a period of years. This election is also helpful inasmuch as the aggregate liabilities limitation rule (i.e. that basis cannot be reduced below the aggregate liabilities remaining after the debt discharge) does not apply.

C. Debt Exchange or Modification

General Concepts. An exchange of a debt instrument for another debt instrument is a realization event for tax purposes. For publicly traded debt, the extent to which the tax basis of the old debt exceeds the fair market value of the new debt COD income will be recognized. For nonpublicly traded debt, COD income will be recognized if the basis of the old debt exceeds the issue price of the new debt. The issue price of the new debt will be its stated principle amount if the debt bears interest at a rate that is at least equal to the adjusted federal rate. If the debt bears interest at a rate that is less than the adjusted federal rate, the exchange is subject to OID income.

Modifications. In many cases, lenders have agreed to modify the terms of the debt instrument rather than foreclose on the property or seek other types of action against the debtor. In these cases the debtor needs to carefully consider the tax impact. An insignificant modification of the debt does not have any tax impact. A significant modification is considered as an exchange of debt instruments. A debt modification is significant if, based on the facts and circumstances, the legal rights or obligations being exchanged and the degree to which they are being changed are economically significant. Special rules are provided to determine significant modification for:

1) Changes in the yield of the instrument (greater of 25 basis points or 5% of the annual yield of the unmodified instrument)
2) Changing in the timing of payment
3) Changes in the obligor or security
4) Changes in priority of the debt

D. Exchange of Stock for Debt

The Omnibus Budget Reconciliation Act of 1993 repealed the provision in I.R.C. section 108 which provided that when stock is exchanged for debt, tax attributes are not required to be reduced by the debtor that is in bankruptcy or to the extent that the debtor is insolvent. Tax

attributes will be reduced to the extent that the amount of debt discharged exceeds the value of the stock issued plus other considerations received. For example, the issue of stock with a value of $50 and debt with a value of $30 in satisfaction of a debt with a tax basis of $100 will result in $20 of COD income.

E. Net Operating Loss (NOL) Utilization

Under U.S. tax law NOLs can generally be carried back to the two years preceding the loss year and then forward up to 20 years following the loss year. The utilization of NOLs in future tax years may provide real value to a corporation that is emerging from reorganization proceedings. Generally, for federal tax purposes, the utilization of an NOL will provide value of 35% of the amount of NOL utilized.

As with most tax concepts, there are certain limitations and restrictions that may affect the benefits available to a corporation through the utilization of NOLs. IRC section 382 imposes limitations on the amount of a NOL that may be utilized in any given tax year for a corporation that has experienced a change in ownership, as defined in IRC section 382, in excess of 50 percent during a rolling 3-year period. The annual limitation on NOL utilization is established through a determination of the value of the corporation at the date of the ownership change and multiplying that value by the current federal long-term tax-exempt interest rate, established by the IRS.

There are, however, specific exceptions to the general IRC section 382 rules that may be advantageous to a corporation that experienced a change of ownership while under the jurisdiction of the court in a title 11 or similar case ("Bankruptcy Exception"). Under the Bankruptcy Exception, the limitations imposed by IRC section 382 may be completely avoided or greatly minimized if the requirements of the Bankruptcy Exception are met.

Another limitation on the utilization of NOLs that should be considered is in the computation of Alternative Minimum Tax. When computing Alternative Minimum Tax only 90 percent of the current year Alternative Minimum Taxable Income ("AMTI") may be offset by NOLs. Thus, even if sufficient NOLs exist to fully offset Regular Taxable Income in the current year, a corporation may be subject to Alternative Minimum Tax since only 90 percent of AMTI may be offset.