

## Memorandum

To: Honorable Betty T. Yee, Chairwoman  
Honorable Judy Chu, Ph.D., Vice-Chair  
Honorable Bill Leonard  
Honorable Michelle Steel  
Honorable John Chiang

From: Kristine Cazadd  
Chief Counsel 

Subject: **April 24, 2007 Board Hearing**  
**Item M1 – Other Chief Counsel Matters**  
**Bankruptcy Update - Comprehensive Report**

Date: April 11, 2007

At any given time, the Board typically has over 2,700 open accounts in bankruptcy status affected by approximately 2,200 bankruptcy cases. These accounts may involve discontinued business operations, but many accounts involve taxpayers still actively engaged in business; these range from small proprietors to large national or multi-national corporations. During the 2005-2006 fiscal year, nearly \$26 million in Board accounts receivables was paid on accounts in bankruptcy status. Taxes paid with returns for businesses in bankruptcy status totaled an additional \$225 million during this same fiscal year. This demonstrates that not only are there significant Board tax liabilities at risk in bankruptcy cases, but that there is revenue to recover and protect in these cases. Please refer to the attached Exhibit A for a list of notable claims recovered in large bankruptcy cases from 2002 to the present.

### Critical Events

Recently, a sequence of critical events has affected the Board's management of accounts in bankruptcy status. The timeline below summarizes these critical events.

- In January 2005, the Attorney General's office announced a policy change to limit representation of state agencies in out-of-state litigation. In response, the Board of Equalization Legal Department requested a Finance Letter of \$1.86 million for fiscal year 2005 - 2006 to add three additional bankruptcy attorneys, one staff assistant, and funding to pay fees and costs of outside counsel in out-of-state bankruptcy litigation matters.

- In April 2005, the Department of Finance approved this Finance Letter, as part of the fiscal year 2005 – 2006 May revision; and a reorganization of the Legal Department integrated the Special Procedures Section into the Legal Affairs Division of the Legal Department. The Finance Letter was included in the 2005 Budget Act.
- In October 2005, the BAPCPA (Bankruptcy Abuse Prevention and Consumer Protection Act), the most sweeping change in the United States Bankruptcy Code since the Bankruptcy Code's enactment in 1978, took effect. Public anticipation of the Bankruptcy Code changes caused record bankruptcy filings in the days prior to the October 17, 2005 effective date of the changes, with debtors seeking to take advantage of "old law" provisions.
- In November 2005, the Field/District bankruptcy specialist positions were reassigned to the Special Procedures Section from the Sales and Use Tax Department, effectively centralizing all bankruptcy staff within the Legal Affairs Division. The bankruptcy group interacts with bankrupt tax debtors, their attorneys, bankruptcy trustees, the State Attorney General's Office, other taxing agencies, and other involved parties in various types of bankruptcy processes.

### **What is Bankruptcy and What is at Stake for the Board?**

The commencement of a bankruptcy case<sup>1</sup> imposes an "automatic stay", a form of injunction that limits the actions creditors may take while the stay is in place. Generally, collection actions must cease, but actions to determine a tax liability may continue, e.g. audits, petitions, and appeals. Later in a bankruptcy case, a "discharge" may be granted, which may permanently enjoin the Board from collection of certain liabilities. Many tax liabilities are excepted from discharge and if not paid through a bankruptcy case, may be collected from a tax debtor after the automatic stay terminates.

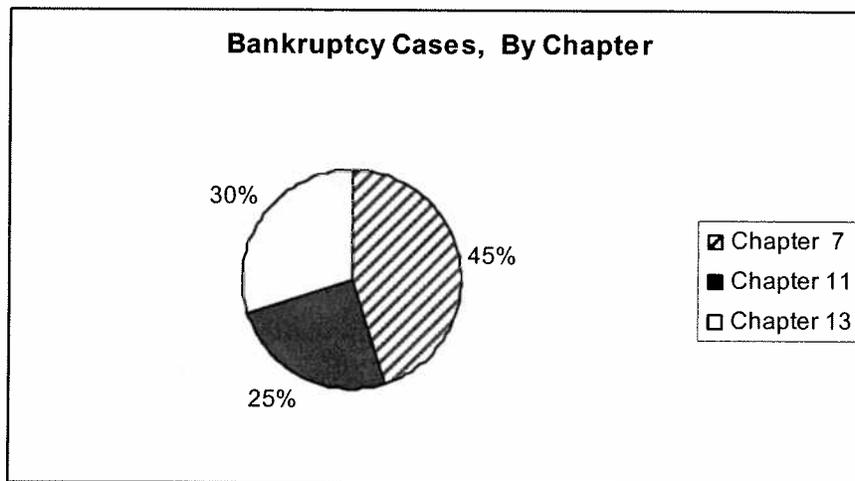
To receive payments in bankruptcy cases<sup>2</sup> the Board must file proofs of claim for unpaid tax and fee liabilities. However, simply filing proofs of claim in bankruptcy cases does not guarantee payment. Currently, over \$13 million dollars in Board claims are being challenged in bankruptcy courts across the nation. It is the Bankruptcy Group's responsibility to defend the Board's claims or the Board may lose the legal right to recover the tax revenue represented in

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<sup>1</sup>In 1978, Congress enacted the Bankruptcy Code, the federal law that controls bankruptcy cases nationwide. The Federal Rules of Bankruptcy Procedure implement bankruptcy procedures. Bankruptcy courts, subdivisions of the federal district courts, preside over most bankruptcy cases. Each district court has at least one bankruptcy court, with 90 bankruptcy courts nationwide. Each district of a bankruptcy court has its own local rules that control procedure in bankruptcy cases pending in that district. In other areas of law, there is a single set of statutory authority, procedural rules and applicable controlling case law. Bankruptcy law, however, often involves an interplay between federal and state statutes, rules and case law. That interplay makes bankruptcy law one of the most complex areas of practice.

<sup>2</sup>Many large well-known businesses in the United States have petitioned for bankruptcy relief. Many have emerged from bankruptcy after successfully reorganizing/restructuring their debt, or otherwise accomplishing their business goals. In recent years companies such as Pacific Gas and Electric, K-Mart, Polaroid, United Airlines, GST Telecom, Fleming Foods, 21<sup>st</sup> Century Oil and Calpine Energy have been or still are, debtors in bankruptcy who have unpaid tax liabilities to the Board. The trend for large enterprises to use bankruptcy as a business strategy to reorganize remains steady.

those claims. The Board also faces litigation in the form of "preference" actions in which a bankruptcy trustee or other party attempts to recover from the Board money previously paid to the Board. Also, some proposed bankruptcy plans may not provide for the proper dollar amount or payment of a Board claim as required by the Bankruptcy Code, and it is the Bankruptcy Group's responsibility to identify and react to such inadequacies. Objections to claims of the Board, objections by the Board to proposed plans, and other types of litigation involve the Board's bankruptcy attorneys and occasionally require representation by the Attorney General's office or outside counsel. This litigation always involves considerable support by Special Procedures Section staff.



The majority of the essential tasks for successful recovery by staff in the Bankruptcy Group are as follows:

- **Chapter 7 Cases.** Chapter 7 cases constitute about 45% of the Board's accounts in bankruptcy status and involve liquidation of a debtor's nonexempt assets. Chapter 7 cases are the most prevalent form of bankruptcy case and demanding in terms of immediacy of response. To protect the State's right to revenue, the Bankruptcy Group must quickly file proofs of claim in each bankruptcy case where a distribution to creditors will occur, must determine whether a Board tax liability is discharged or excepted from discharge, and must monitor cases for adversary proceedings filed against the Board. Any delay in these processes could be fatal to the Board's right to recover on the liability.
- **Chapter 13 Cases.** Chapter 13 cases constitute about 30% of the Board's accounts in bankruptcy and involve a tax debtor's repayment of all or part of a Board tax or fee liability through a chapter 13 plan over a period of three to five years. The Bankruptcy Group must scrutinize all Chapter 13 plans filed by tax debtors to determine proper dollar amounts and payments needed for satisfaction of the Board's claims. In some cases, staff must formally object to plans in court to protect the Board's right to payment of the full amount due. Once a chapter 13 plan is confirmed, Special Procedures staff must monitor plan payments and the timely reporting and paying of tax and fee liabilities to ensure that a taxpayer remains in compliance and

pays the full amount due under the chapter 13 plan and/or promptly respond to petitions for modification of a plan.

- **Chapter 11 Cases.** Chapter 11 cases constitute about 25% of the Board's accounts in bankruptcy and, although fewest in number, they are the most complex and involve the greatest dollar amounts. Chapter 11 cases usually involve the reorganization of a business entity and sometimes the orderly liquidation of the assets of the business. At a minimum, the Bankruptcy Group must review and analyze a chapter 11 debtor's disclosure statement and proposed plan of reorganization to determine if a Board tax or fee liability is properly provided for under a plan; if it is not, staff must immediately object to confirmation of a debtor's chapter 11 plan in order to avoid potential revenue loss in the case. The Bankruptcy Group must evaluate Chapter 11 plans for feasibility, including research into the business transactions of the debtor and the type of industry in which the debtor operates. In addition to this multi-disciplinary analysis of chapter 11 bankruptcy cases, the staff must often evaluate and contend with multiple corporate entities or subsidiaries jointly administered under one bankruptcy case. Board tax liabilities often run into the millions of dollars in these cases. The pay-out periods in these cases often range from three to six years, and payment may not occur evenly, or may be delayed due to litigation or other factors. It is important for Special Procedures staff to closely monitor payments under plans confirmed in chapter 11 cases, so that payments are tracked and revenue protected.

### **Timing and Location**

The Bankruptcy Code provides for priority distribution of payment on almost all Board tax claims. Unpaid taxes for returns due within three years before the bankruptcy filing, and some other unpaid taxes, are afforded "priority" status. When a claim has priority status, the Board is entitled to receive payments ahead of general unsecured claimants. This requires that the Board's claims for these liabilities are paid 100% of tax and pre-bankruptcy interest. It is essential that timely and accurate claims be filed in bankruptcy cases to participate in the distribution of assets. There are strict deadline dates, or "bar dates", that must be met for a claim to be timely, and there are usually short response times when litigation is filed.

When bankruptcy litigation arises, it is now complicated by the location of the court where the debtor filed. Since a debtor may elect to file bankruptcy either where its business is located or incorporated, Delaware and New York have become popular states for chapter 11 bankruptcy filings as the majority of businesses are incorporated there<sup>3</sup>. Currently, most large chapter 11 cases are filed in out-of-state bankruptcy courts, requiring the involvement of Board attorneys and in some cases, the hiring of outside counsel. These cases require constant vigilance.

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<sup>3</sup> Until a few years ago, most bankruptcies affecting Board accounts were filed in California.

**Benefits of the Internal Bankruptcy Reorganization**

The November 2005 reorganization of the Special Procedures Section bankruptcy group has resulted in positive benefits for the Board and the Board's taxpayers. These benefits include:

- Enhanced Taxpayer Relations
  - More accurate and consistent notification and information provided to bankrupt debtors regarding the effects of their cases on tax liabilities, and
  - Improved bankruptcy guidelines communicated to the district offices - resulting in more effective staff communications after bankruptcy cases are commenced.
- Enhanced Bankruptcy Community Relations
  - Expanded and more effective communications and personal relationships with attorneys in the Attorney General's Office;
  - Increased familiarity with bankruptcy rules and procedures, resulting in more efficient resolution of bankruptcy matters involving the Board;
  - Better relationships with bankruptcy trustees' offices and bankruptcy court personnel;
  - Improved communications with bankruptcy attorneys, resulting in more non-litigation dispute resolutions.
- Enhanced Caseload Management
  - Expanded communications between Special Procedures staff and Board legal counsel;
  - Increased staff education and knowledge of bankruptcy law and procedures;
  - Development of uniform strategic positions for similar bankruptcy issues and cases;
  - Increased supervisory oversight and timeliness in handling bankruptcy matters;
  - More assertive and proactive role regarding post-bankruptcy non-compliance issues;
  - Improved technology to handle bankruptcy claims and compliance matters including use of PDF documents;
  - Reduction in the number of errors in processing bankruptcy claims.
- Increased Collections with Reduced Costs
  - Less reliance on the Attorney General and outside Counsel to protect the Board's claims;
  - Frivolous litigation is identified and resolved faster, using fewer resources;
  - Cases outside the Attorney General's referral guidelines are now handled by Board legal counsel and staff rather than being abandoned.

### **Future Direction and Revenue Opportunities**

The Bankruptcy Group and Special Procedures will continue to adapt to environmental changes, with the goal of effective management of and tax recovery from bankruptcy caseload. The group seeks to identify and implement incremental process improvements, including opportunities to partner with other California tax and regulatory agencies to gain access to or efficiencies from their technologies or processes. Among these revenue opportunities are:

- **Electronic Database Matching.** The Franchise Tax Board (FTB) currently implements electronic database matching of bankruptcy case information, using common identifying numbers. The Employment Development Department Payroll Tax Department (EDD) has contracted with FTB for a "value-added" electronic copy of this data stream. Participation in this process would improve the Board's ability to identify and address tax issues of bankrupt debtors at the earliest possible opportunity, maximizing the ability to file timely claims and address special issues.
- **Electronic Recordation of Tax Liens.** The FTB currently electronically transmits notices of state tax liens to participating county recorders' offices for recordation. Using this technology, recordation is nearly simultaneous with an electronic transmission. Using existing paper-based mailing processes, it often takes weeks or months from the date of mailing to the date of recordation for a Board notice of state tax lien to record in a county recorder's office and for an endorsed-stamped copy to be returned to the Board. This can result in a Board tax lien losing priority to other liens or not being found when a title report is made in connection with a sale or refinance of a tax debtor's real property. A small but growing number of counties are accepting electronic recordation of liens. It may be possible to use the already established FTB process, with some enhancements, to extend the electronic lien filing process benefits to the Board. Interagency cooperation and possible partnering with FTB on this matter, as feasible, could benefit both agencies' efforts.

Additionally, opportunities may exist with other agencies for process or communications improvements that can improve work products, and aid in identifying and addressing issues for tax debtors who are not in compliance with all essential legal requirements.

Other future endeavors to support legal processes include:

- **Electronic filing of proofs of claims with the bankruptcy courts.** Bankruptcy courts are already accepting, and may soon require, taxing agencies and other creditors to file claims electronically. Bankruptcy courts have undergone a significant transformation in their filing and docketing systems. Most filings are performed electronically on-line. Most pleadings are stored electronically in electronic data banks. In effect, the bankruptcy courts have gone paperless.
- **Electronic storage of records for accounts that are the subject of legal proceedings or have been written off but have a tax lien in place.** Electronic records storage for these accounts would permit the Board to retain and produce supporting documentation for tax liens and legal issues when the underlying tax liability supporting a lien is challenged in court or in some other venue.

There may also be other opportunities for such records imaging measures, which would benefit workflow.

If you have any questions or would like additional information, please contact Assistant Chief Counsel Janice L. Thurston at (916) 324-2588, Supervising Tax Counsel (Acting) Bruce A. Emard at (916) 323-2481, or Supervisor of the Special Procedures Section, Roberta Cornell, at (916) 445-9197.

Approved:



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Ramon J. Hirsig  
Executive Director

KC: bb

cc:	Mr. Ramon Hirsig	(MIC:73)
	Ms. Anita Gore	(MIC:86)
	Ms. Randie Henry	(MIC:43)
	Mr. David Gau	(MIC:63)
	Ms. Janice Thurston	(MIC:82)
	Ms. Roberta Cornell	(MIC:55)
	Mr. Bruce Emard	(MIC:82)

## Exhibit A

<b>Notable Claims Recoveries in Large Bankruptcy Cases for California State Board of Equalization Selected Cases, 2002 - present</b>		
<b>Fiscal Years *</b>	<b>Debtor</b>	<b>Amount</b>
2003/2005	Fleming Foods, Coremark, & subsidiaries	\$ 28,030,405
2002/2003	Pacific Gas and Electric	\$ 21,973,176
2003/2004	GST Telecom	\$ 9,195,000
2003/2004	Wherehouse Entertainment	\$ 3,250,000
2004/2005	K-mart	\$ 2,249,507
2002/2003	Comdisco Inc	\$ 1,940,000
2004/2005	Polaroid Corp. & Polaroid ID Corp	\$ 1,705,150
2005/2006	Northpoint Communications	\$ 1,675,483
2005/2006	Impath Inc.	\$ 1,500,000
2005/2006	Heilig-Meyers Furniture	\$ 794,945
2003/2004	Wareforce Inc.	\$ 772,625
2006/2007	DVI Financial Services Inc.	\$ 700,000
2002/2006	Paragon Steakhouse Restaurants	\$ 660,000
2002/2003	Bugle Boy Industries	\$ 599,569
2005/2006	Kent Investors Inc.	\$ 539,908
2004/2005	House2Home Inc.	\$ 456,706

\* Payment installments may span multiple years.