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Code to Code

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The Transfer of Unemployment Insurance Experience Rates

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Section 363 sales are becoming an increasingly common alternative or precursor to reorganization. When these sales involve substantially all of a debtor's assets, the potential imposition of successor liability upon a purchaser could doom the contemplated sale and markedly diminish the value of the bankruptcy estate. A string of recent decisions plot a trend toward an interpretation of § 363(f) that would protect asset-purchasers from at least one type of successor liability: unemployment tax experience rates. However, given the disparities among state laws concerning the transfer of unemployment tax experience rates, and state and federal efforts to curb unemployment tax avoidance schemes, asset-purchasers should not assume that the risk inherent in transferring unemployment tax experience rates in § 363 sales has been resolved.

Unemployment Tax Experience Rates

An unemployment tax experience rate is a projection of the anticipated cost of future unemployment claims, generally based on historical data concerning each employer. The experience rate is expressed as a percentage of an employer's taxable-wage base, which when applied to that base, yields the amount of state unemployment tax due. The factors that are used to calculate an experience rate differ among jurisdictions, but generally include the length of an employer's employment history, its past history of layoffs, its tax payment history and the general unemployment claims experience in an employer's industry.[1] Predictably, debtors' financial difficulties and descent into bankruptcy may result in an increase in layoffs and extraordinarily high experience rates.

Since 2004, federal law has required states to provide for the transfer of experience rates "if an employer transfers its business to another employer, and both employers are (at the time of transfer) under substantially common ownership, management, or control."[2] This requirement was imposed as part of the SUTA Dumping Prevention Act of 2004[3] in order to curb employers' efforts to evade unfavorable experience rates through a practice colloquially referred to as "dumping." Dumping schemes take many forms, including the transfer of employees from an employer with a high experience rate to an affiliated shell company with a more favorable rate, or the purchase of a company with a favorable experience rate for the sole purpose of reducing an unfavorable rate.

Most states have opted to implement broader provisions that mandate the transfer of experience rates, irrespective of commonality of ownership, management or control, whenever substantially all of an employer's assets are purchased by a successor.[4] The distinction between state laws that mandate experience rate transfers based solely on the sale of assets and those laws that condition a transfer upon continuity of control and business operations may have important implications for determining whether § 363(f) prevents the imposition of a debtor's experience rate upon an asset-purchaser.

Section 363(f) and the Meaning of "Any Interest"

Section 363(f) authorizes a trustee or debtor in possession to sell estate property "free and clear of *any interest in such property* of an entity other than the estate, only if —

1 A direct comparison of experience rates is complicated by the fact that the taxable compensation cap varies from state to state. A chart of experience rates and the compensation to which they are applicable is available at www.taxpolicycenter.org/taxfacts/displayafact.cfm?Docid=541 (last visited Aug. 6, 2013).

2 42 U.S.C. § 503.

3 Pub. L. 108-295, 118 Stat. 1090. SUTA stands for "State Unemployment Tax Acts."

4 *See* Employment and Training Admin., U.S. Dep't of Labor, Comparison of State Unemployment Laws, 2-28, available at www.unemploymentinsurance.doleta.gov/unemploy/pdf/uilawcompar/2013/financing.pdf (last visited Aug. 6, 2013).

(1) applicable nonbankruptcy law permits [the] sale of such property free and clear of such interest;
(2) such entity consents;
(3) such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property;
(4) such interest is in bona fide dispute; or
(5) such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest."[5]

The Bankruptcy Code does not define the term "interest," and because it is employed differently throughout the Code, it is not susceptible to a single definition.[6] Courts have logically concluded that "interest," as used in § 363(f), must encompass more than liens because Congress chose not to employ the defined term "lien" and because § 363(f)(3) itself implies that a lien is only one type of interest of which assets may be sold free and clear.[7] By negative implication, it appears that "interest" means less than an ownership interest, as the sale of estate property free and clear of the "interest of any co-owner" is dealt with separately within § 363(h). Courts have generally declined to limit the scope of the phrase "any interest in such property" to "*in rem* interests, strictly defined."[8] The recent trend of decisions suggests that "an interest in such property" encompasses any "obligations that flow from ownership of the property" being sold.[9] Ultimately, given the imprecision of § 363(f), courts have addressed whether particular interests fall within the statute's ambit on a case-by-case basis.[10]

The Application of § 363(f) to the Transfer of Experience Rates

Four cases have addressed the issue of whether a debtor's unemployment tax experience rate may be imposed upon a purchaser of assets through a bankruptcy sale. In the first case to address the issue, *Michigan Empl. Sec. Comm'n v. Wolverine Radio Co. (In re Wolverine Radio Co.)*,[11] the Sixth Circuit held that an "experience rating is not an 'interest' within the meaning of section 363(f)."[12] The *Wolverine* court explained that Michigan's experience rating system was part of the "comprehensive federal-state system" established under the Federal Unemployment Tax Act[13] for the protection of the unemployed and that no Bankruptcy Code provisions evince an intent to upset or pre-empt that system.[14] Against that backdrop, the court reasoned that an experience rate did not cloud the title to the property sold, and therefore was not included within the interests in property susceptible to being affected through a sale under § 363(f).[15] The court noted that the asset-purchaser's tax liability "arises only by virtue of the successor entity's post-petition employment of workers."[16] The court's emphasis on the asset-purchaser's post-sale conduct rather than the purchase of the assets itself may explain why *Wolverine* is the only decision that allowed a debtor's experience rate to be imposed upon a purchaser through a § 363(f) sale.[17]

In *Massachusetts Dep't of Unemployment Assistance v. OPK Biotech LLC (In re PBBPC Inc.)*, the First Circuit Bankruptcy Appellate Panel (BAP) concluded that the debtor's experience rate of 12.27 percent could not be imposed upon the purchaser of substantially all of the debtors' assets through a § 363(f) sale because the debtor's experience rate was an "interest" from which the debtor's assets had been sold free and clear.[18] After canvassing existing case law on the definition of "any interest," the BAP concluded that the phrase "'any interest' as used in § 363(f) is sufficiently elastic to include the Debtor's experience rate," based on the fact that under Massachusetts law, "[t]he transfer of [the debtor's] assets alone, not the continuation of the Debtor's business, is sufficient to trigger the imposition of successor liability on a purchaser."[19] The *PBBPC* court expressly rejected the reasoning employed in *Wolverine*. Nonetheless, the *PBBPC* court specifically referenced the fact that Massachusetts's experience rate transfer statute[20] required the transfer of the debtor's experience rate to the asset-purchaser irrespective of any post-sale conduct of the purchaser.[21] The court did not indicate whether its decision would have been different if the identity of post-transfer management or continuity of operations affected the determination of whether an experience rate should be transferred as a matter of state law.

Subsequently, two New York bankruptcy courts reached the same conclusion and employed the same reasoning as the *PBBPC* court. In *In re Tougher Industries Inc.*, affiliated asset-purchasers sought, and the court provided, confirmation that a sale order entered pursuant to § 363(f) relieved the asset-purchasers of the debtors' experience ratings.[22] New York's Department of Labor (DOL) sought reconsideration of the court's determination that the purchasers were not subject to the debtors' experience rating pursuant to N.Y. Lab. Law § 581(4).[23] The *Tougher Industries* court acknowledged its disagreement with *Wolverine* but held that *Wolverine*'s narrow construction of the phrase "any interest" was inconsistent with the more expansive interpretation adopted in *PBBPC* and in prior decisions of the Second Circuit.[24] The court adopted *PBBPC*'s holding that "§ 363(f) should be read broadly and encompasses all obligations that may flow from ownership of the property."[25]

Most recently, in *In re USA United Fleet Inc.*, the court again adopted a broad interpretation of the phrase "any interest" in determining that the debtor's unemployment experience rate could not be imposed upon the purchaser

5 11 U.S.C. § 363 (emphasis added).
6 *See, e.g.*, 11 U.S.C. §§ 101(14)(C) (indicating that "disinterested person" cannot have "*interest* materially adverse to the estate"); § 305(a)(1) (authorizing dismissal if "*interests* of creditors and the debtor would be better served by such dismissal"); § 506(b) (allowing oversecured creditor to recover "*interest* on [its] claim") (emphases added).
7 *See* 11 U.S.C. § 363(f)(3); *In re USA United Fleet Inc.*, No. 1-11-45867-jf, 2013 Bankr. LEXIS 1744, at *13 (Bankr. S.D.N.Y. April 29, 2013); *In re GMC Inc.*, 407 B.R. 463, 501 (Bankr. S.D.N.Y. 2009) (citing 3 *Collier on Bankruptcy* ¶ 363.06[1] (15th ed. rev. 2009)).
8 *See United Mine Workers of Am. 1992 Benefit Plan v. Leckie Smokeless Coal Co. (In re Leckie Smokeless Coal Co.)*, 99 F.3d 573, 581-82 (4th Cir. 1996); *see also In re TWA*, 322 F.3d 283, 290 (3d Cir. 2003).
9 *Folger Adam Security Inc. v. DeMatteis/MacGregor JV*, 209 F.3d 252, 258 (3d Cir. 2000).
10 *See Leckie*, 99 F.3d at 582; *Massachusetts Dep't of Unempl. Assistance v. OPK Biotech LLC (In re PBBPC Inc.)*, 484 B.R. 860, 867 (B.A.P. 1st Cir. 2013).
11 930 F.2d 1132.
12 *Id.* at 1146.
13 26 U.S.C. §§ 3301, *et seq.*
14 930 F.2d at 1147.
15 *Id.*
16 *Id.* at 1149.
17 Without having to reach the issue, the court also indicated in a footnote that the conditions of § 363(f)(1)-(5) had not been met. *Id.* at 1147 n.24.
18 484 B.R. 860, 869. (B.A.P. 1st Cir. 2013).
19 *Id.*
20 M.G.L. c. 151A, § 14(n).
21 484 B.R. at 869.
22 *In re Tougher Indus. Inc.*, No. 07-10022, 2013 Bankr. LEXIS 1228, at *1 (Bankr. N.D.N.Y. March 27, 2013).
23 *Id.* at *11.
24 *Id.* at *21-22 (citing *In re Chrysler LLC*, 576 F.3d 108 (2d Cir. 2009).
25 *Id.*

of the debtor's assets in a sale pursuant to § 363(f).[26] The court rejected the DOL's argument that the experience rating imposed pursuant to N.Y. Lab. Law § 581 was simply a computational device and not an interest in property subject to extinguishment in a sale pursuant to § 363(f).[27] In rejecting the DOL's argument, the court noted that the imposition of the debtor's experience rating on the asset-purchaser was not a computation at all, but rather an imposition of an otherwise arbitrary figure based solely on the fact that the purchaser had purchased assets from the debtor.[28] The court failed to address what was perhaps the DOL's most potent argument: The debtor's experience rating was "not imposed because the [debtor's assets] were purchased, but because [the purchaser] continued the business and paid substantially the same employees."[29]

The Potential Effect of Indicia of Dumping on the Experience Rate Transfer Analysis

PBBPC, *Tougher Industries* and *USA United Fleet* each expressly rejected the Sixth Circuit's analysis in *Wolverine* based on the fact that § 363(f) has been consistently read to encompass more than "*in rem* interests, strictly defined."[30] However, a rejection of *Wolverine* focused solely on its relatively narrow interpretation of § 363(f) ignores its consideration of the asset-purchaser's post-sale conduct as a central factor in deciding whether to transfer the debtor's experience rate to the asset-purchaser.[31] A rejection of *Wolverine* also ignores the generally accepted nature of successor liability at common law. "[S]uccessor liability is generally imposed due to the conduct of the purchaser, and not from the assets being sold."[32] None of the courts considering the imposition of experience rates upon asset-purchasers in § 363 sales were confronted with those facts upon which successor liability is generally founded: common control of the debtor and purchaser, the continuity of business operations or any other post-sale indicia of inequitable conduct that would justify the imposition of successor liability at common law.[33] The factors that form the core of the traditional successor-liability analysis also lie at the core of the states' federally mandated efforts to prevent dumping of experience rates.[34]

The *PBBPC* court acknowledged that the determination of whether a right is extinguished in a § 363(f) sale must be made on a case-by-case basis.[35] Furthermore, the court intimated that the result might have been different had the statutory transfer of the debtor's experience rate resulted from some fact other than (or perhaps in addition to) the purchase of the debtor's assets.[36] Similarly, by statute, Maine and North Carolina have generally prohibited the transfer of experience rates through § 363 sales.[37] However, in apparent recognition that bankruptcy sales may become a refuge for experience rate dumping, each state has made an exception to this prohibition where there is common ownership between the debtor and asset-purchaser.[38]

Conclusion

Whether courts will continue to prevent the transfer of experience rates to purchasers in § 363(f) sales will undoubtedly depend on the facts presented in particular cases. To date, courts have not confronted facts that would traditionally justify the imposition of successor liability or would indicate an effort to "dump" an unfavorable experience rate. If such facts are presented, courts may have to pay greater account to federal and state efforts to curb dumping and reconsider the currently prevailing view that experience rate transfers should be prevented because they are sought solely on account of the purchase of a debtor's property. abi

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26 2013 Bankr. LEXIS 1744, at *19.
27 *Id.* at *21-22.
28 *Id.* at *23.
29 *Id.* at *19.
30 *In re Leckie Smokeless Coal Co.*, 99 F.3d at 581-82 (4th Cir. 1996); *see In re PBBPC Inc.*, 484 B.R. at 869; *In re Tougher Indus. Inc.*, 2013 Bankr. LEXIS at *20-21; *In re USA United Fleet Inc.*, 2013 Bankr. LEXIS at *19.
31 *In re Wolverine Radio Co.*, 930 F.2d at 1149.
32 Patrick M. Birney, "Section 363 Sale Orders: May Sales Be Made Free and Clear of Successor Liability Claims?," *Norton J. Bankr. Law & Prac.*, Vol. 22, No. 4 (August 2013).
33 *See id.*
34 *See* 42 U.S.C. § 503.
35 *In re PBBPC Inc.*, 484 B.R. at 867.
36 *See id.* at 869.
37 Me. Rev. Stat. Ann. Tit. 26, § 1221; N.C. Gen. Stat. § 96-9(c)(4).
38 *See id.*