NEW MEXICO
Lawyer
February 2019 Volume 14, No. 1 www.nmbar.org

Bankruptcy Law

Bankruptcy Law Section

A DOOMSDAY PREPPER'S GUIDE
to the Treatment of Commercial Leases in a Tenant's Bankruptcy

By Shay Elizabeth Meagle

Dozens of bankruptcy filings by giant retailers over the past several years have been dubbed the "Retail Apocalypse" by one financial research site.[1] New Mexico commercial landlords have been greatly affected. A tenant's bankruptcy filing has always been an issue facing commercial landlords, but in today's financial climate, it is becoming more frequent. The process can be daunting to landlords and also to attorneys who do not regularly practice in Bankruptcy Court, especially as these national retailers file bankruptcy cases in districts across the country. If any of your clients own or manage commercial rental property, you have or will soon be approached with a tenant's notice of bankruptcy. Special rules govern leases and executory contracts in a bankruptcy case. For purposes of this article, I am going to focus narrowly on commercial real estate leases that had not expired before the tenant filed the bankruptcy case (the "Petition Date"). This article is also limited to Chapter 11 bankruptcy cases, as it is the most likely chapter in which these issues will arise.

It is tempting for a landlord to simply ignore or accept that a tenant has filed bankruptcy, and ignore the flurry of notices that will be sent regarding the case. It is important to encourage your clients not to do this. First, the landlord cannot proceed as if nothing has changed, because once a bankruptcy is filed, the landlord is prohibited from taking certain actions. Second, the landlord can miss important deadlines and the opportunity to protect its rights and ability to collect amounts due for rent owed both before and after the Petition Date. You should advise any commercial landlord clients that in the event they receive notice of a tenant's bankruptcy filing, they should seek competent advice from an attorney quickly.

The Petition Date

You and your client should be mindful of the date the bankruptcy was filed—the Petition Date. Application of many of the rules and statutes concerning commercial leases in bankruptcy will hinge on whether something occurred before the Petition Date or on/after that date.

The Automatic Stay

Most of you know about the automatic stay that kicks in upon the filing of a bankruptcy. 11 U.S.C. § 362 (2018) lists the types of actions the automatic stay prohibits. A landlord cannot simply evict a tenant for breach of lease while the tenant is in bankruptcy. A landlord also cannot contact the tenant seeking rent that was due before the Petition Date. If the tenant is in default after the Petition Date, the landlord may be able to obtain an order granting the landlord "relief" from the automatic stay, allowing the landlord to proceed with eviction, or the landlord may have other options. However, before taking any action, the landlord should seek competent legal advice. Violation of the automatic stay when the landlord knows of the filing of the bankruptcy can lead to serious consequences for the landlord, whether or not the landlord received formal notice of the bankruptcy.

Assumption and Rejection of Lease

11 U.S.C. § 365 (2018) provides that the trustee (or a debtor-in-possession—i.e., a "DIP"—in a Chapter 11 case) may assume or reject a lease upon motion and a hearing. A commercial real property lease must be assumed within 120 days of the order for relief (which is usually the Petition Date) or by the date a plan is confirmed, or it will automatically be deemed rejected and the tenant must immediately surrender the property. The court can extend it (prior to the 120-day deadline) up to an additional 90 days upon motion by the landlord or trustee/DIP and a hearing.

Assumption and Assignment

11 U.S.C. § 365(b) requires that in order to assume a lease, all defaults (including any prepetition defaults) must be cured and the trustee/DIP must provide the landlord with adequate assurance of future performance. The tenant or trustee cannot unilaterally change the terms of the lease then assume it; the lease cannot be changed unless the landlord agrees.

11 U.S.C. § 365(f) permits the tenant to assign an assumed commercial lease. This allows a tenant to sell its business, binding various landlords to rent to the successor/

purchaser under the same lease terms. There are some situations under which assignments are not permitted, but those rarely apply to a commercial lease.

When a tenant moves to assume a lease, it will usually assert a proposed "cure amount," which is the amount of total rent the tenant believes must be paid to bring the rent current. The landlord should make sure this amount is accurate, as once an order is entered, it will be difficult, if not impossible, to obtain additional pre-assumption rent payments.

Rejection

If the commercial lease is rejected, the tenant is required to surrender the leased premises to the landlord by a certain date (depending on the manner of rejection). If the tenant has continued operating its business out of the leased premises until then, the landlord likely will have a valid administrative priority expense claim against the bankruptcy estate under 11 U.S.C. § 503 (2018) for the amount of any unpaid rent that came due between the Petition Date and the effective date of the rejection. A court order must be entered, upon application and hearing, before the landlord's claim is approved and paid. However, pursuing such a claim is frequently worthwhile, as the landlord's priority dictates that it be paid before most other claims and are on the same level as the tenant's attorneys.

Any rent owed prior to the Petition Date is usually a nonpriority unsecured claim, and would be included in a proof of claim form filed in the case that sets forth the amount and basis of the claim and to which supporting documents are attached. There is usually a deadline, a "Claims Bar Date," by which that claim must be filed.

Rejection of the commercial lease will create a breach of the lease that did not exist on the Petition Date. However, pursuant to 11 U.S.C. § 502(g) (2018), damages arising from the breach of the lease are to be treated as a prepetition claim. Therefore, the landlord should include in a proof of claim, after rejection of its commercial lease, damages for loss of future rent and any other amounts which could be included as damages under state law. However, the amount a landlord can claim for future rent has been limited by 11 U.S.C. § 502(b)(6). There is usually a separate deadline set for filing these claims. There will usually be different deadline to file or amend claims based on lease rejection damages if the Claims Bar Date has already expired.

Security Deposits

Landlords frequently assume that they can go ahead and apply security deposits to rents due before the Petition Date or to past due rents at the time of rejection of a lease and surrender of the premises. However, this is not permitted under the Bankruptcy Code, and instead must be negotiated or ordered by the court. Rejection orders frequently state whether the landlords may or may not apply any deposits held. Indeed, it is important to remember that any amounts held by landlords as deposits of a tenant who files a bankruptcy case is property of the bankruptcy estate.

It is tempting for a landlord to simply ignore or accept that a tenant has filed bankruptcy, and ignore the flurry of notices that will be sent regarding the case.

Preferential Transfers

Your commercial landlord clients also should be mindful that they can be sued by the DIP/trustee or another entity under a plan to recover that is called a "preferential transfer" under 11 U.S.C. § 547 (2018). A landlord or its counsel, early in a tenant's bankruptcy case, should review the landlord's records to determine if there is a risk of such a suit. The deadline to file this kind of action does not expire until 2 years after what is usually the Petition Date, and frequently, more than a year passes before any such action is filed. 11 U.S.C. § 547, along with other Bankruptcy Code sections, allow a trustee/DIP to recover from creditors any amounts the tenant paid to them within 90 days before the Petition Date on account of an antecedent debt. Therefore, landlords need to determine whether, in the 90 days before the Petition Date, the tenant paid a chunk to the landlord to catch up on past due rent. This does not include funds paid by the tenant for current rent. It is prudent to determine any potential risk early so that efforts can be made to resolve any such issues through negotiation of any administrative priority claims, etc. However, in a case where the lease is assumed, there is no risk of a preference action.

Other Considerations & Conclusion

There are, of course, other issues affecting landlords when their commercial tenants file a Chapter 11 bankruptcy that cannot be covered in this limited article. But the considerations discussed above provide an overview of some of the main issues facing commercial landlords in the domain of tenant bankruptcies. Although provisions prohibiting bankruptcy that terminates the lease upon bankruptcy or prohibits assignment will be unenforceable if a tenant files, there are other lease provisions that can be helpful in the event of a tenant's later bankruptcy filing, such as specific landlord's lien language, defining "rent" broadly in a lease (defining it to include monthly base rent, CAM, utilities, etc.), requiring personal guarantees by individuals, obtaining and perfecting a security interest in other property of the tenant at the time of execution/renewal of the lease, limitation of the tenant's use of the premises, and provisions permitting termination by the landlord upon short notice in the event of default. Remember that commercial leases are more flexible as to terms than residential, as they are not subject to consumer protection legislation.

Chapter 11 bankruptcy cases present a swath of complex and technical issues arising under the Bankruptcy Code. However, in the midst of the retail apocalypse, commercial landlords need not fall victim to the misfortunes of their tenants. Early and competent legal advice is the best way for your clients to handle the bankruptcy of their commercial tenants. ■

Endnotes

[1] *Here's a List of 57 Bankruptcies in the Retail Apocalypse and Why They Failed*, CB Insights (Oct. 17, 2018), https://www.cbinsights.com/research/retail-apocalypse-timeline-infographic/.

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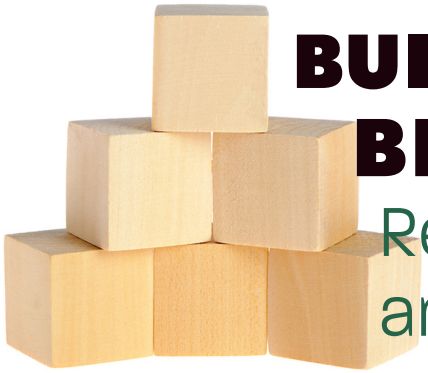

BUILDING BLOCKS: Receiverships and Bankruptcy

By Daniel A. White

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Receivership as a system for collecting rents began to mature as early as the reign of Elizabeth I (1558-1603) and was adopted by early colonial American courts as an equitable remedy. This ancient system has been undergoing a modern renaissance in much of America, and is sometimes seen as a more efficient alternative to bankruptcy in certain instances. This article will address what happens when these competing insolvency regimes collide. The typical case occurs when a receiver has been appointed in state court over a portion of a debtor's property, but the debtor then files a bankruptcy petition.[2]

The Default Position: Turnover and Accounting by Receiver

Under 11 U.S.C. § 543(a), a "custodian with knowledge" of a bankruptcy case cannot use, disburse, or otherwise administer the property he or she holds, other than "as is necessary to preserve such property." Under 11 U.S.C. § 101(11)(A), the term "custodian" includes any "receiver or trustee of any of the property of the debtor, appointed in a case or proceeding not under this title." As a result, a receiver who is aware of a bankruptcy proceeding is required to take no action other than preserve what he or she holds. Section 543(b) covers what comes next. It requires a receiver to take two actions.

First, the receiver must "deliver to the trustee any property of the debtor held by or transferred to such custodian, or proceeds, product offspring, rents or profits of such property that is in such custodian's possession, custody or control on the date that such custodian acquires knowledge of the commencement of the case." Therefore, a receiver with knowledge of a bankruptcy proceeding cannot administer property of the receivership estate and is under an affirmative duty to surrender it.

Second, the receiver must file an accounting of the assets which came into his or her possession at any time. The statute does not specify what form such an accounting must take or any deadline for filing the accounting. Federal Rules of Banking Procedure 6002(a) provides a few more details, adding that the accounting must be "prompt," and that in addition to being filed, it must also be transmitted to the United States trustee. Rule 6002(b) provides that after the report has been filed and transmitted, the court shall "determine the propriety of the administration, including the reasonableness of all disbursements." The advisory committee notes explain that this examination "may be initiated on the motion of, or the filing of an objection to the custodian's account by, the trustee or any other party in interest." Case law is scant on what constitutes an adequate, promptly-filed report.

Judicial review of the receiver's report cuts both ways. Under 11 U.S.C. § 543(c)(2), a bankruptcy court shall, after notice and a hearing "provide for the payment of reasonable compensation for services rendered and costs and expenses incurred by such custodian." These expenses are allowable administrative expenses under §

503(b)(3)(E). Accountants and attorneys employed by receivers have corresponding administrative claims under § 503(b)(4). However, under § 543(c)(3), a receiver may be surcharged, if the receiver took possession more than 120 days before the petition, for "any improper or excessive disbursement" unless the disbursement was "made in accordance with applicable law" or been approved pre-petition, after notice and hearing, by a court of competent jurisdiction. As one court has noted "it would be impossible to perform the tasks of determining reasonable compensation if a bankruptcy judge could not review the quality of a receiver's performance."[3] However, state law will ultimately control whether or not a receiver can be surcharged even if the reviewing bankruptcy court identifies an "improper or excessive disbursement."[4] This result follows from the statutory language excepting from surcharge "disbursement[s]…made in accordance with applicable law."

Excuse me! Excusing Compliance With § 543

Under § 543(d), a receiver may be excused from compliance with § 543 after notice and hearing. The test for excusal is a best interest of creditors test: A receiver may be excused from compliance if "interests of creditors and, if the debtor is not insolvent, of equity security holders, would be better served by permitted a custodian to continue in possession, custody or control of such property." While § 543(d) is often described in terms of excusing turnover by the receiver, it excuses the receiver from turnover, accounting, and judicial review of their administration by the bankruptcy court under § 543(c), including surcharge under § 543(c)(3).

In determining whether to excuse a receiver's compliance under § 543(d)(1), courts often consider the following factors:

(1) "The likelihood of reorganization, and whether the funds held by the receiver are required for reorganization;

This ancient system has been undergoing a modern renaissance in much of America, and is sometimes seen as a more efficient alternative to bankruptcy in certain instances.

(2) Whether the debtor mismanaged the property;
(3) Whether the turnover would injure the creditors;
(4) Whether the debtor would use the property for the creditors' benefit;
(5) Whether there are avoidance issues raised with respect to property retained by a receiver, because a receiver does not possess avoiding powers for the benefit of the estate; and
(6) The fact that the automatic stay has deactivated the state court [r]eceiver [a]ction."[5]

The sixth element, effect of the automatic stay, may be addressed by requesting modification or relief from the automatic stay simultaneously with the request to excuse compliance with § 543(a)-(c). Savvy practitioners may head off potential stay issues at the outset by including a stay relief request with their motion under § 543(d).

As an additional note, since § 543(d) is silent on approval of fees for an excused receiver and his or her professionals, cautious receivers and professionals may wish to include language in their excusal pleadings that they not be required to submit their fees to the bankruptcy court for approval under §§ 503(b)(3)(E) and (4).

"The party requesting turnover must show by a preponderance of the evidence that the best interests of the creditors are served by permitting a custodian to retain control of the estate."[6] Since § 543(d)(1) says "may" rather than "shall," excusal of a receiver from his or her obligations under § 543(a)-(c) is discretionary, even if the movant establishes all of the required elements.

Maybe Later? Picacho Hills: Abstention Until Liquidation

Even if a receiver's obligations under § 543(a)-(c) have been excused, the assets which they administer are still property of the estate. Likewise, even after a

receiver has been excused from complying with his or her turnover and accounting obligations, the bankruptcy case does not stop automatically. By default, the two cases proceed simultaneously. As a result, to the extent there is any ambiguity about whether property is part of a receivership estate or not, it may behoove the receiver or the appointing creditor to file a motion for determination with the bankruptcy court, to clarify who has control over the property.

However, in certain cases, creditors may prefer that the cases not proceed simultaneously, even after having the receiver excused from turnover and accounting. Under § 305(a), a bankruptcy court may "dismiss a case under this title or may suspend all proceedings in a case under this title, at any time if (1) the interests of creditors and the debtor would be better served by such dismissal or suspension…" However, as noted in *Picacho Hills,* "Abstention or suspension under § 305(a)(1) is an unusual remedy… there is no agreement on what 'interests of creditors and the debtor' should be considered" and that "Case law on abstention through suspension (rather than dismissal) is sparse." In that case, the Bankruptcy Court for the District of New Mexico began its analysis with a seven-factor test developed by the Bankruptcy Court for the District of Massachusetts. The seven factors were:

(1) Economy and efficiency of administration;
(2) Whether another forum is available to protect the interests of both parties or there is already a pending proceeding in state court;
(3) Whether federal proceedings are necessary to reach a just and equitable solution;
(4) Whether there is an alternative means of achieving an equitable distribution of assets;
(5) Whether the debtor and the creditors are able to work out a less expensive out-of-court arrangement which better serves all interests in the case;
(6) Whether a non-federal insolvency has proceeded so far in those proceedings that it would costly and time consuming to start afresh with the federal bankruptcy process; and
(7) The purpose for which bankruptcy jurisdiction is sought.

Picacho Hills is instructive. In that case, the debtor filed a chapter 11 petition shortly before a hearing on the receiver's motion to sell the debtor's assets and set aside two questionable transfers. In considering abstention under § 305(a)(1), the court determined that given the pending sale motions in state court, economy and efficiency of administration, that federal proceedings were not necessary, and that the sixth factor, the progress in the state-court receivership, weighed in favor of abstention. The court also determined that the fifth factor, an-out-of-court workout, weighed in favor of abstention to permit the receiver to proceed, because the parties had previously agreed to allow the receiver to sell the debtor's assets. On the third and seventh factors, however, results were mixed. The court determined that "on balance" it was "a better place to liquidate and distribute Debtor's assets, post-sale" but that "[p]re-sale, the Receive Action is a perfectly acceptable alternative forum. On the seventh factor, the purpose for which bankruptcy jurisdiction was sought, the Court found the debtor's attempts to use the bankruptcy filing to take control of the sale process objectionable and in no one's best interests, but that the debtor's request to use bankruptcy law and procedure for the liquidation of its assets "reasonable, and consistent with the Settlement Agreement."

To these seven factors, the court added two more:

(8) Whether § 305(a)(1) relief has the substantial support of creditors; and
(9) Whether § 305(a)(1) relief is appropriate to allow a state to enforce police powers.

In *Picacho Hills,* abstention had the support of creditors and the eighth factor was not in question. The ninth factor also supported abstention because the receiver had been appointed by the New Mexico Public Regulation Commission and New Mexico Environmental Department. The court therefore reasoned that allowing the receiver to continue and pursue the proposed sale was consistent with the state's police powers.

Based on its nine-factor analysis and having already excused the receiver's obligations to the estate under § 543(d)(1), the court granted abstention. However, that abstention was not permanent. The court found that "allow[ing] Debtor to complete the liquidation of assets in this case would not deprive [creditors] of any bargained-for benefits, and would allow Debtor to exercise its right to use the federal bankruptcy process." The court's compromise ruling allowed the receiver to continue in place, and finish liquidating the debtor's assets, but allowed the debtor to use the bankruptcy process to distribute them according to the statutory priority scheme.

Conclusion

The intersection between bankruptcy and receivership is an area where specialized and uncommonly-used code-sections may come into play. Case law is still developing, and the number of receivership-related bankruptcy cases is likely to increase as the remedy of receivership continues to become more popular.

Excusal of turnover and accounting by a receiver under § 543(d)(1) and abstention under § 305(a)(1) are powerful remedies available when a bankruptcy case is filed during a receivership. However, given that these remedies are used infrequently outside of the receivership-bankruptcy intersection, practitioners should carefully review the relevant code sections, review developing case law, and consider what other relief, including stay relief and other determinations, that it may be appropriate to request at the outset of a case. ■

Endnotes

[1] Daniel A. White, "Please Excuse Me: Receiverships and Bankruptcy," XXXVII ABI Journal 11, 36-37, 54-55, November 2018, available at abi.org/abi-journal.

[2] Assignments for the benefit of creditors, although similar to receiverships, are not covered by this article.

[3] *In re Sundance Corporation*, 149 B.R. 641, 650 (Bankr.E.D.Wa. 1993).

[4] *In re 29 Brooklyn Avenue, LLC*, 535 B.R. 36, 42-43 (Bankr.E.D.N.Y. 2015).

[5] *In re Picacho Hills Utility Co., Inc.,* 2013 WL 1788298 at * 7 (Bankr. D.N.M. 2013).

[6] *Id.* (citing *In re Franklin*, 476 B.R. 545 at 551 (Bankr.N.D.Ill. 2012)).

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The DEVIL is in the DETAILS and in the DISCHARGE – *creditors beware!*

By Ron Holmes

New Mexico is one of only a handful of states and territories in the United States that follow community property law.[1] The most basic tenet of community property is a presumption of fifty-fifty split in ownership of property and debt in marriage. Under Section 40-3-12(A), all property "acquired during marriage by either husband or wife, or both, is presumed to be community property." Exceptions include property one spouse acquired prior to the marriage, by gift, or by inheritance. This distinction, between community property and so-called separate property, is an important consideration when practitioners are consulting with potential bankruptcy clients.

When a petition is filed in a joint bankruptcy case, all community property of both spouses is disclosed to the court and subject to the liquidation powers of the trustee. If only one spouse files, that spouse's property interests must be disclosed, including community and separate property. The non-filing spouse's separate property, however, is neither property of the estate nor subject to the disclosure requirements of the filing spouse. Therefore, if one spouse has already inherited or is expected to inherit separate property, then it may be strategic to leave that spouse out of the filing.

The presumption of community acquisition of property applies equally to the allocation of debt. Debts incurred during the marriage are presumptively community debts.[2] A separate debt is, among other things, one incurred by a spouse before the marriage or after entry of a divorce decree, one "contracted by a spouse during marriage which is identified by a spouse to the creditor in writing at the time of its creation as ... separate debt," or a debt determined to be separate debt by a court having jurisdiction.[3]

A bankruptcy discharge of debt is a release of the personal liability for a pre-petition debt. More accurately, a discharge is a bankruptcy court-ordered injunction against the collection of a pre-petition debt. The discharge injunction also protects property "acquired after the commencement of the case, on account of any allowable community claim."[4]

The potential pitfall for creditors occurs when the non-filing spouse receives the benefit of a practical discharge from the debtor's discharge. "Community discharge" protects community property from claims even against the non-filing spouse.[5] This includes post-petition wages of the non-filing spouse, although it does not prevent creditors from attempting to collect separate property of the non-filing spouse. This means the community property injunction forever protects the entire community from pre-petition claims not excepted from discharge. If the non-filing spouse's debt is from fraud or other non-dischargeable wrongs, then the non-filing spouse can be protected by the "practical discharge" because the community

property protections afforded under the discharge injunction protect the non-filing spouse's interest in community property.

Not so long ago, many New Mexicans fell victim to a notorious Ponzi scheme associated with the Doug Vaughn and Vaughn Company Realtors bankruptcies. The Bankruptcy court denied Doug Vaughn's petition for a discharge. Mr. Vaughn was single when he filed his case. The end result could have been drastically different had Mr. Vaughn been married at the time of his filing and his spouse filed an individual bankruptcy case instead. Enter the hypothetical Mrs. Vaughn. What if the hypothetical Mrs. Vaughn filed a bankruptcy without Doug joining the case? She would naturally give the necessary disclosures to the court, relating to property belonging to the debtor and outstanding debt. The hypothetical Mrs. Vaughn would disclose all creditors, including those victims in the Ponzi scheme since presumptively those creditors would count as community debt. She would also disclose all property interest including community property owned by herself and Mr. Vaughn. If she had no knowledge of the Ponzi scheme, then she would likely receive her own discharge.

All of the Ponzi scheme creditors would be put on notice of the Mrs. Vaughn's petition for a bankruptcy discharge. The creditors would have to know the law in order to protect their claims from the injunction favoring the community property following discharge. Time is critical. If creditors failed to timely file an adversary action against Mr. Vaughn in Mrs. Vaughn's case, then Mr. Vaughn's interest in their community property would forever receive protections under the practical discharge discussed above. Mr. Vaughn's wages, for example, could not be garnished by the victims of the Ponzi scheme following Mrs. Vaughn's discharge.

Mr. Vaughn would not receive his own discharge, so his creditors would not be left without any remedy at all, but their remedy would be severely limited. The creditors would be restricted to seek redress only against his sole and separate property (i.e. not community property). A victim creditor must pay particular attention to the bankruptcy filings of the wrongdoer's spouse so as to not fall victim a second time to the non-filing spouse's wrongdoing.

A famous quote regarding the community discharge goes like this: "the Devil himself could effectively receive a discharge in bankruptcy if he were married to Snow White."[6] Retired New Mexico Bankruptcy Judge Stewart Rose clarified that position when he added "if [the Devil] does not treat [Snow White] better than his creditors, she will, by divorcing him, deny his discharge."[7] ■

Endnotes

[1] Other community property states include Arizona, California, Idaho, Louisiana, Nevada, Puerto Rico, Texas, Washington and Wisconsin.

[2] *See* NMSA 1978, Section 40-3-9(B)

[3] *See* NMSA 1978, Section 40-3-9(A)

[4] *See* 11 U.S.C. §524(a)(3)

[5] 11 U.S.C. 524(a)(3)

[6] Alan Pedlar, *Community Property and the Bankruptcy Act of 1978*, 11 S. Mary's L.J 349, 382 (1979).

[7] *Gonzales v. Costanza (In re Constanza)*, 151 B.R. 588, 590 (Bankr.D.N.M. 1993)

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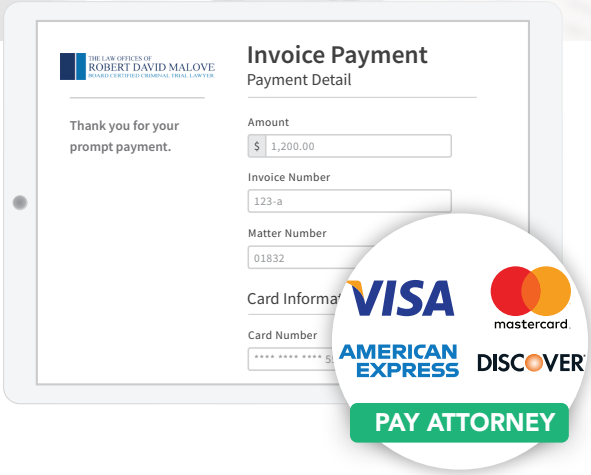

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