NEW MEXICO Lawyer

November 2015 Volume 10, No. 4 www.nmbar.org

Current Issues in

Bankruptcy Law

Bankruptcy Law Section

The Grave Importance *of a Debtor's Disclosure in Bankruptcy*

By Edward A. Mazel

The United States bankruptcy system is a wonderful thing, and no, I'm not saying that because I make a living as a bankruptcy attorney and Chapter 7 panel trustee. Nor do I mean to imply that individuals' financial crises are wonderful things, as they clearly are not. Rather, a bankruptcy system offering people in difficult financial situations an opportunity for a fresh start is a wonderful thing. Our system is far from perfect, but it should not be taken for granted, as we must be mindful that in some countries, such as China, there is no similar legal mechanism to assist individuals experiencing a financial crisis.

The main goal of a Chapter 7 bankruptcy is usually to obtain a discharge of pre-petition debts under 11 U.S.C. § 524. However, in order to obtain the benefit of the discharge injunction, the system requires a full, complete, and accurate disclosure of any and all property interests. If debtors fail to make a full, complete, and accurate disclosure of all of their property interests, they are exposed to serious risks. Such risks include losing the ability to claim an asset or cause of action exempt[1], losing the right to pursue a claim against third party, having the discharge denied or revoked, and even potential criminal charges for intentional nondisclosure.

... a bankruptcy system offering people in difficult financial situations an opportunity for a fresh start is a wonderful thing.

Given the numerous and very serious consequences for failing to disclose assets, debtors' attorneys must be vigilant in ensuring their clients make a full, complete, and accurate disclosure of property interests. Commencement of a bankruptcy case creates a bankruptcy estate. This estate is vast and is comprised of all legal or equitable interests of the debtor in property as of the date of filing. These interests include claims against third parties, contract rights, life estates, remainder interests, and even contingent, unliquidated, or disputed interests. Property of the estate also includes any interests in certain property that the debtor acquires or becomes entitled to acquire within 180 days after filing a bankruptcy, such as a bequest, devise, or inheritance, or as a beneficiary of a life insurance policy or death benefit plan. Most, but not all of the time, debtors successfully disclose the full extent of their interests in real property, vehicles, bank accounts, and tangible personal property. These items are generally foremost in one's mind, and are usually the first things debtors think of when disclosing assets.

The more common omissions from debtors' disclosures are typically some type of claim against a third party, such as breach of contract or personal injury claim, or a partial interest in real property or an inheritance. Failing to disclose a claim against a third party in a bankruptcy can result in the loss of the debtors' right to pursue such claim at a later date or their right to claim an exemption in such claim. For example, in 2013, I was the assigned trustee in a Chapter 7 bankruptcy case[2] where the debtors had entered into a pre-petition contract for services, paid $5,000 for the services, and subsequently filed for Chapter 7 bankruptcy protection prior to the services being rendered. Pursuant to the terms of the contract, the services were to have been provided to the debtors a couple months before the bankruptcy was filed. When they were not, the parties entered into a settlement agreement extending the time for the services to be provided. Under the settlement, the services were to be provided a few months after the bankruptcy was filed.

In the bankruptcy case, the debtors did not list the contract right in their schedules or disclose any claim or reason to sue anyone when asked under oath at the first meeting of creditors. At the time of the meeting of creditors, the services were due to be provided in approximately three weeks, pursuant to the terms of the settlement agreement. However, I was not made aware of this contract, the settlement agreement, or the debtor's interest in the contract. After the creditors' meeting, I determined there were no known assets to administer and filed a "no asset" report in the case. Shortly thereafter, the case was closed by the clerk.

Approximately three weeks after the creditors meeting, and only two days after the services were due under the settlement agreement, the debtors commenced a lawsuit against the other contracting party for failing to provide the services. The lawsuit resulted in a judgment in the debtors' favor. Subsequently, I received a call from an attorney for the judgment debtor, who had learned of the debtors' bankruptcy, and who inquired as to whether the debtors had disclosed the claim in their bankruptcy. After reviewing the case and the creditors' meeting transcript, and determining the debtors had failed to disclose their interest in the contract, I moved to reopen the bankruptcy case so I could seek to enforce the estate's contract rights. Since the debtors' rights in the contract were not disclosed, those rights remained property of the bankruptcy estate even after the case was closed, because the general rule is that only disclosed assets not pursued by the trustee are abandoned back to a debtor upon the closing of a case. As a result of the debtors' failure to disclose this interest, they did not have standing to bring their lawsuit and the judgment they obtained was void.

Once the case was reopened, I was able to reach a settlement with the party on the other end of the contract, and sought court approval of the settlement. In response, the debtors objected to the settlement, filed amended schedules listing their interest in the contract and/or claim against the other party, and asserted an exemption for the full amount of the claim. I objected to the debtors' newly-claimed exemption and the Bankruptcy Court held a final evidentiary hearing on the settlement motion and objection to the debtors' exemption. The Court found that a debtor's ability to amend its exemptions as a matter of right ends at case closure, but that a court may allow an amendment in a reopened case if the debtor can show excusable neglect. The Court determined the debtors' failure to disclose their interest in the contract, or potential claim, was a result of neglect. The Court then analyzed whether the neglect was excusable, and considered the following factors: (i) the danger of prejudice to the nonmoving party, (ii) the length of the delay and its potential impact on judicial proceedings, (iii) the reason for the delay, including whether it was within the reasonable control of the movants, and (iv) whether the movant acted in good faith. The Court determined that these factors did not carry equal weight, and put the most weight on the reason for the delay and whether the movant was at fault. The Court determined the debtors' neglect was not excusable, finding three of the four factors weighed against the debtors, and the fourth factor, good faith, to be neutral. In sum, the debtors lost their right to pursue the claim, simply because they failed to disclose their interest in the contract and/or claim against the contracting party. Unfortunately, in my short three-year tenure as a Chapter 7 trustee, I have come across this situation quite often.

The consequences of failing to disclose a property interest also extend well beyond the potential loss of a debtor's ability to pursue a claim or claim an exemption…

The consequences of failing to disclose a property interest also extend well beyond the potential loss of a debtor's ability to pursue a claim or claim an exemption, and in some instances can give rise to a denial or revocation of a debtor's discharge under 11 U.S.C. § 727. In the case mentioned above, I did not believe the debtors' failure to disclose the contract was intentional, and based on the testimony given by the debtors, was satisfied that sufficient grounds did not exist to attempt to revoke the debtors' discharge. However, if I had believed the debtor had intentionally failed to disclose a property interest, I likely would have pursued a denial or revocation of the discharge.

In order to ensure that debtors make a full, complete, and accurate disclosure, I encourage attorneys to personally review their client's schedules and statement of financial affairs one question at a time with their client prior to filing. Additionally, I have found it very helpful in my own practice to develop a set of questions or checklists that may elicit disclosure of some of the more abstract or intangible property rights. The schedules and statement of financial affairs are lengthy, and in my experience most debtors don't fully understand what is being asked of them. Debtors need the assistance of counsel to carefully review their schedules and make a full, complete, and accurate disclosure.

Lastly, defense attorneys may also benefit in investigating whether a plaintiff has filed a bankruptcy, and if so, determining whether the claim the debtor is pursuing arose prior to, or after, the bankruptcy was filed. If the claim or property interest arose prior to the petition, and the debtor failed to disclose such property interest or claim, the debtor may lack standing to pursue the claim, giving the defendant a strong defense to the debtor's pursuit of that claim. ■

Endnotes

[1] Exemptions allow debtors to retain a certain amount of equity in real and personal property regardless of the extent or amount of creditors' claims. In New Mexico, bankruptcy debtors may elect either the (i) New Mexico exemption scheme found in NMSA 1978, § 42-10-1 et seq., or (ii) Bankruptcy Code exemption scheme found in 11 U.S.C. § 522(d).

[2] *In re Smith,* 2014 WL 7358808 (Bankr. D.N.M. Dec. 24, 2014)

Edward A. Mazel's practice is concentrated on Chapter 11 bankruptcies, creditor's rights, landlord/tenant disputes, and commercial litigation. In 2012, Mazel was appointed to the Chapter 7 Bankruptcy Trustee Panel for the District of New Mexico and continues to serve in such capacity. Mazel serves on the Board of Directors and as president-elect of the State Bar of New Mexico Bankruptcy Law Section.

Chapter 11:
A Lifeline for Distressed Companies

By Thomas D. Walker and Leslie D. Maxwell

Although he's never filed a personal bankruptcy, Donald Trump is no stranger to Chapter 11 and the opportunities it offers over-leveraged and struggling companies to get back on their feet. Bankruptcy does not necessarily mean the death of a company. Rather, it's a tool that can offer breathing room—protections that allow all the players in a company's financial life to come into a single forum to be treated fairly and appropriately. Under the protection of the Bankruptcy Code, businesses can sell assets free and clear of liens, assume or reject leases, and restructure or discharge debts. Chapter 11 isn't just for the too-big-to-fail crowd. It can help enterprises of modest size survive downturns and thrive into the future.

Learning from Trump

Donald Trump is a successful real estate developer who transformed a modest inheritance into a much greater fortune by using all the financial and political tools available to build and maintain his wealth—including four significant business bankruptcies.[1] While Trump's political opponents have used perceived negative attitudes about bankruptcy against him, he argues that he has simply taken advantage of laws available to all businesses.[2] But, whatever one thinks of Trump the politician or Trump the entertainer, lawyers should resist the urge to paint him with a scarlet "B." Why? Because Chapter 11 bankruptcy provides some of the most effective and powerful tools supporting entrepreneurs in America today.[3]

While no private New Mexico businesses may operate on the level of Trump's casinos, the available bankruptcy tools are identical. As New Mexico's economy regains footing, businesses that want to survive into better times should heed the lessons bigger companies have long known—Chapter 11 bankruptcy offers an effective set of tools for bridging the path to a profitable future. For example, Trump's New Jersey casinos used Chapter 11 to stop foreclosures and other collection actions, restructure high-interest debt, eliminate unsecured debt, and to pressure organized labor into more favorable terms. Although he lost most if not all of his personal investment, each bankruptcy provided Trump's companies with valuable relief available only in bankruptcy.

Many Business Problems can be Resolved in Chapter 11

In Chapter 11, businesses can continue operating despite significant financial problems, such as unsecured debt that the business cannot continue to pay as agreed; secured debts that exceed the value of the collateral and cannot be paid under current circumstances; unproductive or unnecessary real or personal property, including excessive equipment, unprofitable locations and expensive or over-market leases; and, other financial obligations that inhibit continued profitable operations.

Good Candidates for Chapter 11

Generally, businesses that have a reasonable chance of a successful reorganization require positive cash flow sufficient to pay post-petition operating expenses. These costs can include payroll, payroll taxes, costs of goods, supplies and maintenance, utilities, rent, and insurance. Secured creditors' interests must be protected, which often requires post-petition payments. Ultimately, a business must generate sufficient cash flow to pay for its operations and make payments on pre-petition debts great enough to get the support of its creditors or meet criteria for imposing a judicially-ordered repayment plan on its creditors.

Sometimes lack of cash can be overcome. Businesses that do not have sufficient cash flow may be able to borrow money to continue basic operations through a reorganization if circumstances are right and a willing lender is available. Lenders may negotiate favorable terms and controls that would be unlikely outside of bankruptcy. Carefully structured post-petition loans often include regular access to and close scrutiny of books and records, specific financial and performance reporting requirements, enhanced collateral positions and protections, advanced priority for repayment, and other creative loan terms, so long as they are arguably beneficial to the business and other creditors. Post-petition financing is often part of a package of reforms available only in bankruptcy that give the company a chance to survive, and in the process, enhance the prospects for paying some portion of pre-petition debts.

Other Companies That May Benefit

Single-purpose entities formed to own and operate commercial real estate can benefit from bankruptcy reorganization. Many have negative net-worth or face negative cash flows due to the depressed commercial real estate market. Such entities can reduce the principal balance on commercial real estate loans and revise repayment terms to better fit the economic reality. This is particularly true of income-producing properties.

Individual persons and married couples are often candidates for Chapter 11 reorganizations, particularly in New Mexico where so many businesses are sole proprietorships. Sometimes this is because the individuals have debts or assets that make them ineligible or poor candidates for bankruptcies under Chapter 7 or Chapter 13, while on other occasions prospective petitioners are attracted to Chapter 11 because of the useful tools it offers.

Bankruptcy Tools to Consider

The planning and reorganization provisions available in Chapter 11 are made possible in many instances by the general protections and tools bankruptcy provides. They include:

- **Automatic Stay**. One of the most important and powerful tools is the automatic stay upon filing of a bankruptcy petition. The automatic stay is a statutory injunction that temporarily stops most collection and enforcement actions and gives the filer a "breathing spell" to stay in business while moving forward with a reorganization plan. The stay applies to most lawsuits, foreclosures, repossessions, garnishments, contract enforcement and collection actions. The stay permits a business to defer payment on some obligations while it continues to use its assets, remain in business, and attempt to reorganize. This allows a company the opportunity to preserve going concern value for a reorganization or an organized sale of the going concern. Bankruptcy can preserve the basic business operation, name and goodwill, and retain customers that are often lost in a foreclosure, lock-out, or piecemeal liquidation.
- **Sell property free and clear of liens and interests.** Chapter 11 debtors can sell assets free of claims, liens and interests of all kinds. This tool is arguably the most powerful of those available to the Chapter 11 debtor. These so-called "363 Sales" (named after the governing Bankruptcy Code section) can be accomplished through a Chapter 11 plan or, with increasing approval, absent a confirmed plan. Buyers get clean title to property, while the liens and interests attach to the proceeds, under the protection of a federal court order.
- **Subordinate debt and adjust interest rates.** In some cases, Chapter 11 debtors can recharacterize undersecured debt and eliminate or subordinate the unsecured portion. Secured creditors may agree or be compelled to reduce secured debt to an amount equal to the value of their collateral. Other creditors may support the reorganization because they may get more than they would get in a liquidation. Sometimes unsecured debt is converted into an equity interest with a chance of having future value. Also, excessive or over-market interest rates on debts secured by personal and real property can be restated to better reflect market conditions and generally make the success of reorganization more likely.
- **Cure defaults and accelerated debts.** Chapter 11 debtors can cure defaults on contracts, including mortgages and leases. This permits debtors to return to pre-default terms, reverse default penalties, and get back in good standing with creditors. Similarly, in some instances, Chapter 11 debtors can negotiate extended payment terms on past due, unsecured tax debts.
- **Assume or reject executory contracts and unexpired leases.** Chapter 11 debtors may be able to reject certain equipment leases, real estate leases, or other unfulfilled contracts, and assume the obligations on others. Unprofitable locations and unproductive equipment may be returned to the lessors in order to improve cash flow and restore profitability. Multi-location businesses can consolidate operations into the most efficient structure; retail businesses can close unproductive locations and focus on those that generate profits.
- **Avoidance and recovery actions.** The Chapter 11 debtor has the power to avoid and recover certain pre-petition, preferential or fraudulent transfers. Avoidance actions can recover assets transferred or undo liens to free up assets for sale or use as additional loan collateral.

Conclusion

No business, large or small, wants to find itself looking to the "last resort" of the bankruptcy laws for help. In these hard economic times, a company of any size need not find itself without recourse for survival. The tools of the Bankruptcy Code, if wielded early and appropriately, can set many companies on the road to recovery. ■

Endnotes

[1] Mr. Trump's inheritance and current fortune are subjects of debate beyond the scope of this article.

[2] Under his watch, Trump's New Jersey casinos filed four bankruptcies, in 1991, 1992, 2004 and 2009. On the first three filings, Trump was not despondent. "I don't think it's a failure, it's a success," Trump reportedly said at the time. (Associated Press 11/22/04.) Trump discussed the bankruptcy filings in positives terms: "We have one of the most powerful gaming companies the day it comes out (of bankruptcy). There's no way we could have done that without the 'B' word," he said. "The future looks very good." Trump did not describe the 2009 filing as a success, however.

[3] Bankruptcy is typically not a positive event in the life of a company or in the community it occupies. It is complicated, expensive, detail intensive and arduous for those charged with making it happen. It can be very hard on employees, suppliers and investors. It is often the "last resort," and for good reason. People lose jobs and suppliers go unpaid. But oftentimes such consequences would have happened anyway. If considered carefully and early enough (before too much damage is done), Chapter 11 bankruptcy can point in the direction of business survival, job preservation and one less empty local building. This article is not about the complicated "mechanics" of a Chapter 11. It is about the possibilities United States Code Title 11 offers to the struggling or failing business and for the lawyers who are asked, "What can we do?"

Thomas D. Walker is a partner at Walker & Associates PC where he practices in the areas of bankruptcy, business transactions, commercial law and litigation, real estate law and foreclosure. He attended Tulane University and the University of New Mexico School of Law. He is a current board member and past chair of the State Bar of New Mexico Bankruptcy Law Section.

Leslie D. Maxwell practices primarily in bankruptcy and commercial law at Walker & Associates PC. She received a Bachelor of Arts in Anthropology from Emory University in 2003 and her Juris Doctor from the University of New Mexico School of Law in 2006. Maxwell is on the Board of Directors of the State Bar of New Mexico Bankruptcy Law Section.

Second Mortgage Lien Stripping in Chapters 7 and 13

after *Bank of America, N.A. v. Caulkett*

By Karen H. Bradley and Gerald R. Velarde

The Effect of *Caulkett*

Prior to June 1, 2015, at least one circuit court allowed homeowners who were underwater on their mortgages to void a junior mortgage on a primary residence in a Chapter 7 case, relying on 11 U.S.C. Section 506 (a) and (d). *See Folendore v. United States Small Business Administration*, 862 F.2d 1537 (11th Cir. 1989). The Court noted that section 506 (a) provides that a creditor is secured to the extent of the value of the creditor's interest in the property, and is unsecured to the extent that the value of creditor's interest is less than the amount of the allowed claim. Since Section 506(d) provides that to the extent that a lien secures a claim against the debtor that is not an allowed secured claim, such lien is void, the Court concluded that since the amount owed on the senior mortgage exceeded the value of the residence, the junior lien holder did not have an allowed "secured claim."

The homeowner's ability to void a junior mortgage in a Chapter 7 case was squelched on June 1, 2015, when the U.S. Supreme Court decided the case of *Bank of America, N.A. v. Caulkett* and *Bank of America, N.A. v. Toledo-Cardona*, 575 U.S. ___, 2015 WL 2464049, 2015 U.S. Lexis 3579 (Nos. 13-1421 and 14-163, June 1, 2015). In *Caulkett*, the Court held that a debtor homeowner in a Chapter 7 bankruptcy case could not "strip-off" or void a junior mortgage on a primary residence under Section 506(d) when the debtor was underwater on his/her mortgage. The Court upheld its prior decision in *Dewsnup v. Timm*, 502 U.S. 410 (1992), wherein it defined the term "secured claim" in Section 506(d) to mean a claim supported by a security interest

Before the 2007 financial crisis, second mortgages, and even third mortgages, were common, as many homeowners realized they could tap into their often substantial home equity to acquire loans to pay off unsecured debt, take vacations, and fund other projects. However, the significant decline in home values over the last several years has often erased the equity homeowners had in their homes. Coupled with the decline in the economy, which has caused many to lose their jobs, the result is that many homeowners are unable to sell their homes and are unable to pay the first mortgage, let alone a second or third mortgage. These unfortunate circumstances have forced a number of homeowners to seek help from various resources, including requesting bankruptcy relief. This article will examine what, after *Caulkett*, a homeowner may do or not do under Chapter 7 and Chapter 13 of the Bankruptcy Code to void a second lien on a primary residence, when the homeowner is "underwater" on his/her mortgage. That is, when the amount owed on the first lien exceeds the value of primary residence. Reference to the homeowner as being "underwater" on the mortgage will be used throughout this article.

> ***… many homeowners are unable to sell their homes and are unable to pay the first mortgage, let alone a second or third mortgage.***

Chapter 7 or Chapter 13?

Homeowners who are underwater on their homes generally seek relief under either Chapter 7 or Chapter 13 of the Bankruptcy Code. When the debtor wants to "save the house," Chapter 13 is selected. Under Chapter 13, the debtor can keep the residence by "curing" any pre-petition arrearages by paying the arrearages over time through a Chapter 13 Plan, and by resuming making regular payments to the mortgage holder. The Chapter 13 filing will also stop any foreclosure action that may have been initiated by the mortgage holder.

In a Chapter 7 case, the debtor generally receives a discharge of debts that exist at the time the case is filed. Therefore, if homeowners do not want to keep their primary residence, they can walk away from the mortgages and not be held personally liable on the notes associated with the mortgages in any subsequent foreclosure action. If the homeowners want to keep the primary residence but had judgment or other non-consensual liens which impair their homestead exemption in the property, they can file a motion in the Chapter 7 to avoid those liens.

... today's practitioners should be armed to with answers to homeowners' questions as to how to best proceed with a bankruptcy when they have multiple mortgages.

in property, and found that a "secured claim" does not depend on whether a lien is partially or wholly underwater. The Court declined to accept the homeowner's argument that Section 506(d) could be construed as any claim that is backed by collateral with some value.

Although *Caulkett* makes it clear that a debtor homeowner in a Chapter 7 case cannot avoid a junior mortgage on a primary residence when the debtor is underwater on his/her mortgage, it appears the ability to do so in Chapter 13 remains unaffected. In *Caulkett*, the Court did not address avoidance of a junior mortgage on a primary residence in a Chapter 13 bankruptcy case under 11 U.S.C. Section 1322(b)(2). Thus, whereas it is clear after *Caulkett* that a debtor who is underwater on his/her mortgage cannot avoid the junior mortgage based on Section 506(d), the issue remains whether the debtor can avoid the junior mortgage in a Chapter 13 case under Section 1322(b)(2).

Some guidance as to whether, in a Chapter 13 case, a junior mortgage on a primary residence can be avoided under Section 1322(b)(2), may be gleaned from cases decided before *Caulkett*. In a case decided before *Caulkett,* the Tenth Circuit considered the issue of whether Section 506(d) allows a Chapter 13 debtor to strip a second mortgage from the homestead when the debtors are underwater on their mortgage. *Woolsey v. CitiBank, N.A.*, 696 F.3d 1266 (10th Cir. 2012). In *Woolsey,* the debtor homeowner made substantially the same argument as that made by the debtor in *Caulkett,* i.e. that §506(d) allowed a strip of a second lien. Although the Tenth Circuit invited debtors to argue the applicability of Section 1322(b)(2) to strip a second lien, the debtors refused to do so. The Tenth Circuit stated that "in deference to their wishes, we opt today against forcing a Section 1322(b)(2) argument onto the unwilling debtors and leave that statute and its meaning for another day when a bankruptcy petitioner actually wants to pursue the question." *Id.* at 279.

Although the Tenth Circuit has not specifically ruled on the issue, decisions from various other circuits indicate that debtors in Chapter 13 cases can avoid a junior mortgage on a primary residence when the debtors are underwater on their mortgage, **not** pursuant to Section 506(d) as vetoed by *Caulkett*, but under the provision specifically applicable to Chapter 13; namely, 11 U.S.C. Section 1322(b)(2). *See Lane v. W. Interstate Bancorp (In re Lane)*, 280 F.3d 663 (6th Cir. 2002); *Zimmer v. PSB Lending Corp. (In re Zimmer)*, 313 F.3d 1220 (9th Cir. 2002); *Pond v. Farm Specialist Realty (In re Pond)*, 252 F.3d 122 (2d Cir. 2001); *McDonald v. Master Financial, Inc. (In re McDonald)*, 205 F.3d 606 (3rd Cir. 2000); *Bartee v. Tara Colony Homeowners Association (In re Bartee)*, 212 F.3d 277 (5th Cir. 2000); *Tanner v. FirstPlus Fin., Inc. (In re Tanner)*, 217 F.3d 1357 (11th Cir. 2000). Based on dicta in *Woolsey* and the rulings by other circuits, it is possible that the Tenth Circuit (and ultimately the U.S. Supreme Court) will authorize the use of Section 1322(b)(2) to strip off a junior mortgage on a primary residence when homeowners are underwater on their mortgages.

What the Court in *Caulkett* makes clear is that a debtor homeowner in a Chapter 7 case can no longer void a wholly unsecured junior mortgage under Section 506(d) of the Bankruptcy Code. Since the Court in *Caulkett* did not address Section 1322(b)(2), however, junior mortgages can probably still be avoided in Chapter 13, although not under Section 506(d). A homeowner who is seeking advice on dealing with junior mortgages on his/her residence should be made aware that Chapter 7 now offers limited relief, but that Chapter 13 continues to be a viable (albeit expensive, if litigated) option. Homeowners should be advised that they should obtain a market analysis or appraisal of the home, so that a reasonable value can be assigned. Next, homeowners should determine the exact amount owed on the primary mortgage. If the amount owed on the primary mortgage exceeds the value of the residence, homeowners can be advised that a Chapter 13 bankruptcy **may** allow the homeowner to avoid the junior mortgage, and that a motion to avoid the junior mortgage may be attempted. However, homeowners should also be warned that the holder of the junior mortgage may oppose the avoidance and may obtain a competing appraisal. At trial, the issue will be the value of the residence, which may involve the testimony of (often expensive) valuation experts.

No longer exist the days when homeowners are seeking to tap into financial resources available by means of their mortgages. Rather, today's practitioners should be armed to with answers to homeowners' questions as to how to best proceed with a bankruptcy when they have multiple mortgages. Knowing the difference in protections currently provided under Chapter 7 versus Chapter 13 bankruptcy proceedings, following the Court's decision in *Caulkett,* is key to best advising one's potential clients. ■

Karen H. Bradley is a Managing Partner of Little, Bradley & Nesbitt PA. Her practice is primarily limited to representing lenders in real estate foreclosure, bankruptcy and related actions.

Gerald R. Velarde is a sole practitioner in Albuquerque. His practice mainly involves consumer and small business bankruptcy or workouts. Velarde serves on the Local Rules Amendments and Advisory Committee for the U.S. Bankruptcy Court, District of New Mexico.

In re Mallo: Dischargeability of Late-Filed Taxes

By Daniel A. White

On Dec. 29, 2014, the Tenth Circuit issued its opinion in two consolidated cases, *Mallo v. IRS* and *Martin v. United States*, announcing a result which would strike most laypeople as unusual: because the debtors' income tax returns were not timely filed, they did not constitute tax returns under 11 U.S.C. § 523(a). *In re Mallo,* 774 F.3d 1313 (10th Cir. 2014). The Tenth Circuit came to this conclusion due to the so-called "hanging paragraph" of section 523, that is, the last unnumbered paragraph of section 523(a), appearing after section 523(a)(19). The hanging paragraph, sometimes referred to as section 523(a)(*), states in part: "For purposes of this subsection, the term 'return' means a return that satisfies the requirements of applicable nonbankruptcy law (including applicable filing requirements)." Relying on decisions in the context of habeas petitions, bankruptcy appeals, and a criminal prosecution for willful failure to file corporate tax returns, the Tenth Circuit held that the timeliness of a tax return is a "requirement of applicable nonbankruptcy law" under the hanging paragraph. *Id.* at 1321.

... in the Tenth Circuit, any tax debt for a tax year with a late-filed tax return is nondischargeable ...

The Tenth Circuit went on to explain that, as a result, tax debts associated with late returns were not dischargeable under the bankruptcy code by operation of 11 U.S.C. § 523(a)(1)(B)(i), which provides that individual debtors may not discharge debts "for a tax or a customs duty—with respect to which a return, or equivalent report or notice, if required—was not filed or given." The impact of this holding should not be understated: in the Tenth Circuit, any tax debt for a tax year with a late-filed tax return is nondischargeable, unless the return was filed under a safe harbor provision. The Tenth Circuit's conclusion was based on the Fifth Circuit's similar holding in *In re McCoy* where the Fifth Circuit held that "[u]nless it is filed under a 'safe harbor' provision similar to [26 U.S.C.] § 6020(a), a state income tax return that is filed late under the applicable nonbankruptcy state law is not a 'return' for bankruptcy dischargeability purposes under § 523(a)." *In re Mallo*, 774 F.3d 1313, 1321-22 (10th Cir. 2014); *In re McCoy*, 666 F.3d 924 (5th Cir. 2012).

What is interesting in *Mallo* is that, not only did the *Mallo* taxpayers not want *McCoy* to be adopted, but "[t]he United States agree[d] that the interpretation in *McCoy* should not be followed or applied, and specifically indicate[d] that it 'does not advocate adoption of *McCoy* as it leads to harsh results that would penalize taxpayers who file even a day late and without requiring government intervention to assess the tax.'" *In re Mallo,* 498 B.R. 268, 277 (D. Colo. 2013) *aff'd* 774 F.3d 1313 (10th Cir. 2014). In the underlying case, the District of Colorado declined to adopt *McCoy*, and instead held that the timeliness of a tax return was relevant to whether the taxpayers made "an honest and reasonable attempt to comply with tax law" under the *Beard* test. *Id.* at 281. The *Beard* test is a four part test assessing, "whether the filings: '1) purported to be returns; 2) were executed under penalty of perjury; 3) contained sufficient data to allow computation of tax; and 4) represented an honest and reasonable attempt to satisfy the requirements of the tax law.'" *Id.* at 272 (quoting *Wogoman v. IRS (In re Wogoman)*, 475 B.R. 239 (10th Cir. BAP 2012). *See also Beard v. C.I.R.*, 793 F.2d 139 (6th Cir. 1986). The District of Colorado found that because there was no "claim of circumstances beyond a taxpayer's control that prevented him or her from filing a timely return," the taxpayer's return did not qualify as a tax return for dischargeability purposes. However, on appeal, the Tenth Circuit overruled the District of Colorado and adopted the *McCoy* rule.

The *McCoy* rule provides that an untimely tax return is not a "return." This appears to be contradicted by the language of section 523(a)(1)(B)(ii), which refers to tax debts "with respect to which a return, or equivalent report or notice was filed or

given after the date on which such report or such return, report or notice was last due, under applicable law or under any extension." Under the *McCoy* rule, there can be no such thing, except for returns prepared by the taxing authority and signed by the taxpayer under 26 U.S.C. § 6020(a), or similar state or local law, because in any other instance, a return that is not timely filed is not a 'return' at all. However, this contradicts the plain language of section 523(a)(1)(B)(ii), which contemplates late-filed tax returns in broader circumstances than returns prepared by the taxing authority and signed by the taxpayer under 26 U.S.C. § 6020(a), or similar state or local law.

In *Mallo,* the taxpayers argued that the *McCoy* rule renders section 523(a)(1)(B)(ii) meaningless because section 523(a)(1)(B)(ii) renders debts for taxes with respect to which the debtor filed a late-filed tax return nondischargeable "after two years before the date of the filing of the petition." *In re Mallo*, 774 F.3d 1313, 1323 (10th Cir. 2014). If all late-filed tax returns are nondischargeable under section 523(a)(1)(B)(i), then this section is surplusage. The Tenth Circuit considered this argument but rejected it. The Tenth Circuit explained that returns filed late under section 523(a)(1)(B)(ii) but not the hanging paragraph would include returns prepared by the IRS under 26 U.S.C. § 6020(b). These returns are prepared and signed by the IRS, and specifically excluded from the hanging paragraph's definition of a return which "satisfies the requirements of applicable nonbankruptcy law". *Id.* at 1323-1325.

This disagreement shows signs of becoming a circuit split, and presents a potential pitfall for debtors' counsel.

The end result of the Tenth Circuit's adoption of the *McCoy* rule is that taxpayers who do not file a return and then have their returns prepared for them under 26 U.S.C. § 6020(a) by the IRS may potentially be eligible to receive a discharge of the debt in bankruptcy, while a taxpayer who filed a tax return a day late would not receive the same treatment. This creates an incentive for taxpayers contemplating bankruptcy who have not filed tax returns for certain years to petition the IRS for returns prepared under 26 U.S.C. § 6020(a), rather than simply filing their own returns. However, the IRS currently does not have sufficient resources with which to prepare returns under 26 U.S.C. § 6020(a).

The IRS's official position has been that the key point is whether the taxpayer filed a return before or after the tax was assessed, because in the IRS's view, it is the assessment of the tax that creates a debt. *In re Wogoman*, 475 B.R. 239, 250-251 (BAP 10th Cir. 2012). This view predates the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, and has not been widely accepted. *See, e.g., Id.* (citing *Savage v. IRS (In re Savage)*, 218 B.R. 126 (10th Cir. BAP 1998)); *In re Briggs*, 511 B.R. 707, 712 (Bankr. N.D. Ga. 2014). However, certain courts have been receptive to this line of reasoning, including the First Circuit's Bankruptcy Appellate Panel and the Bankruptcy Court for the Central District of California. Those courts adopted the IRS's position in recent cases, and held that taxes for which the taxpayer filed a late return prior to assessment could be discharged under section 523(a)(1)(B). *In re Gonzales,* 506 B.R. 317, 326-328 (1st Cir. BAP 2014)*; In re Pitts,* 497 B.R. 73 (Bankr. C.D. Cal. 2013).

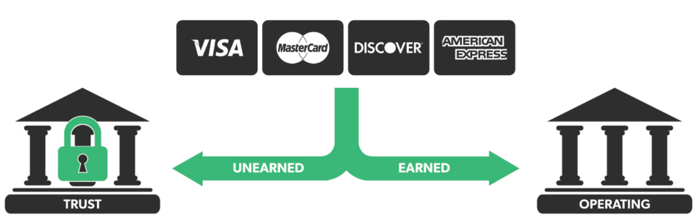
In conclusion, whether a "late-filed tax return" can even exist outside of the narrow confines of 26 U.S.C. § 6020(a) or similar state or local law, and the precise rules regarding dischargeability of tax debt for which a return was filed late, are presently the subject of a nascent disagreement among courts nationwide. This disagreement shows signs of becoming a circuit split, and presents a potential pitfall for debtors' counsel. ■

Daniel White is a bankruptcy attorney with Askew & Mazel LLC in Albuquerque. He is newsletter editor of the American Bankruptcy Institute's young and new members committee and on the Board of Directors of the State Bar of New Mexico Bankruptcy Law Section.

1.95% & 20¢ per transaction | No swipe required | No equipment needed

Helping law firms get paid.

IOLTA guidelines and the ABA Rules of Professional Conduct require attorneys to accept credit cards correctly. We guarantee complete separation of earned and unearned fees, giving you the confidence and peace of mind that your transactions are handled the right way.



www.LawPay.com/nmbar | 866.376.0950

LAWPAY®
CREDIT CARD PROCESSING

AffiniPay is a registered ISO/MSP of BMO Harris Bank, N.A., Chicago, IL