Bankruptcy in Practice

The Next Generation

PRESIDENT'S AWARD

Change is afoot! Three new bankruptcy judges have been seated, and the judicial selection process is ongoing for next year. To reflect and celebrate the changes in our ranks, some up-and-coming lawyers in our section will join some veteran lawyers in this day-long session for both commercial and consumer bankruptcy attorneys. We will explore contested confirmation DIP financing and cash collateral issues, discuss bankruptcy court jurisdiction, examine hot topics in the consumer practice, debate ethical issues, highlight technological advances in the courtroom, and engage our judges, new and seasoned, in a roundtable discussion to bring the day to a close.

Sponsored by: Bankruptcy Law Section

Seminar Chair: Hilary L. Barnes, The Cavanagh Law Firm PA

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6 CLE Credit Hours

1 Ethics Hour

BIOGRAPHIES

HONORABLE JUDGE MARGARET M. MANN

Judge Margaret M. Mann was appointed a U.S. bankruptcy judge for the Southern District of California on April 2, 2010. She is currently a member of the Ninth Circuit Conference Executive Committee and chairs the Bankruptcy Clerk Liaison Committee for the National Conference of Bankruptcy Judges. Since her appointment, she has served as a faculty member for Federal Judicial Center Education programs and has participated in the Ninth Circuit New Bankruptcy Judges' Orientation program and the Ninth Circuit Bankruptcy Judges Education Committee as its chair.

Before her appointment, Judge Mann was a partner at Sheppard Mullin Richter & Hampton LLP and from 2003 to 2008 she served as chair of the Restructuring and Insolvency Practice and national hiring chair for Heller Ehrman LLP. Judge Mann received her B.A. in finance, *cum laude*, from the University of Illinois in 1978; attended the Tilburg School of Economics in The Netherlands in 1978; and received her J.D. from the University of Southern California, Gould School of Law, in 1981.

Judge Mann is a fellow with the American College of Bankruptcy and a founding member of the San Diego Bankruptcy Forum. Before becoming a judge, she was listed in Best Lawyers in America, and served leadership roles in numerous bankruptcy and civic organizations, including the State Bar Debtor Creditor Committee, Lawyers Club, Athena and the California Bankruptcy Forum. As a member of the State Bar committee, she helped draft legislation to clarify the status of the judicial foreclosure process, which was enacted into law as Cal. Civ. Pro. § 483.012 in 1997. She has also contributed as an author to several practice guides published for attorneys.

Judge Mann has been active in public service throughout her legal career. She served as a Court Appointed Special Advocate for youths in the dependency system and has been awarded the Wiley M Manuel Pro Bono Service Award on five occasions. Judge Mann is currently the chair of the Credit Abuse Resistance Education program in San Diego, providing financial literacy programs to high school students in the community and is active in community outreach programs with the Court.

HILARY L. BARNES, the Section's Committee Chair for the 2013 Convention, is a senior member of The Cavanagh Law Firm. She earned her J.D. from the Sandra Day O'Connor College of Law in 1999 and her B.A. from University of Chicago in 1986. A member of the Arizona and Oregon state bars, Hilary's experience includes a wide variety of commercial bankruptcy and restructuring matters in Chapter 11 as well as creditor representations in Chapter 7s and 13s. Her clients include Chapter 11 debtors and creditors (secured and unsecured), trustees, committees, and other parties. Her state court experience includes general commercial litigation, foreclosures, receiverships, and assignments for benefit of creditors. Hilary is an inaugural Barrister in the Arizona Bankruptcy American Inn of Court, for which she serves on the Program Committee. She has provided pro bono services for the Arizona Justice Project and volunteers her time to other non-profit organizations, usually focusing on the needs of women and their families. She gratefully thanks those in the Bankruptcy Section and at the Arizona State Bar who worked diligently to make today's CLE session a success.

EDWARD K. BERNATAVICIUS is currently a trial attorney with the Office of the United States Trustee where he concentrates on a full spectrum of bankruptcy issues concerning consumer and commercial bankruptcy law. Mr. Bernatavicius is a forming member and currently the Vice President of the Arizona Bankruptcy American Inn of Court. He is also a member of the Ninth Circuit Advisory Committee to the American Inn of Court. Mr. Bernatavicius is currently the 2013 Co-Chair of the Ethics Committee for the Bankruptcy Section Seminar for the Arizona State Bar Convention. He has twice chaired the Bankruptcy Section Seminar for the Arizona State Bar and is the former United States Trustee liaison to the Bankruptcy Executive Committee for the Arizona State Bar. Mr. Bernatavicius enjoys speaking on bankruptcy matters, volunteering his time on special projects like the Arizona District Court's *Court Works: Kids to Court*, and being a peer mentor for people with disabilities.

ALISSA A. BRICE is an associate at Ryley Carlock & Applewhite and practices in the Creditor's Rights and Bankruptcy; Lending; and Commercial Litigation groups. Alissa's practice focuses on representation of lenders and other financial institutions in loan and guaranty enforcement actions, judicial and non-judicial foreclosure, loan restructuring, receiverships and bankruptcies. Prior to joining the firm, Alissa represented debtors and creditors in Chapter 7, 11 and 13 bankruptcies, adversary proceedings, and general commercial litigation. Alissa received her undergraduate degree from the University of Southern California and J.D. from Boston College Law School. After law school, Alissa served as a law clerk to the Honorable John S. Dalis, United States Bankruptcy Court for the Southern District of Georgia. Alissa is currently admitted to practice in Arizona, California and New York. Alissa is a member of the Arizona Bankruptcy American Inn of Court, Arizona Women Lawyers Association, Maricopa County Bar Association, and is a board member of the University of Southern California Alumni Club of Phoenix.

SCOTT BROWN is a partner with Lewis and Roca LLP in Phoenix, Arizona. He graduated from Brigham Young University in 1997 with a B.A. in history and received his J.D. from Brigham Young University's J. Reuben Clark Law School in 2000. Mr. Brown served as a law clerk to the Hon. Leif M. Clark, U.S. Bankruptcy Judge, Western District of Texas. Mr. Brown has published several articles with the *Norton Bankruptcy Law Adviser*. He is Contributing Editor, Chapter 73-"Setoff," *Norton Bankruptcy Law and Practice, 3d Ed.* In addition to his Norton publications, Mr. Brown has published various other articles on bankruptcy issues with the ABI Journal and international religious human rights with BYU's Law Review. Mr. Brown is a member of the State Bar of Arizona, Maricopa County and the American Bankruptcy Institute.

JODY A. CORRALES is an associate in the Tucson office of Gust Rosenfeld, P.L.C. She is a fourth-generation Tucsonan and a 2002 graduate of The University of Arizona where she obtained her B.A., *cum laude*, in Political Science and Psychology. In 2006, she obtained her J.D. from The University of Arizona James E. Rogers College of Law. Ms. Corrales focuses her practice on bankruptcy and creditors' rights, as well as general civil litigation. She has extensive experience in bankruptcy law, including representation of creditors and debtors in all facets of bankruptcy litigation. Prior to joining Gust Rosenfeld, Ms. Corrales worked for the nation's largest consumer bankruptcy firm and was the managing attorney for all of the firm's Arizona offices. In that capacity, she enjoyed an active caseload in both the Phoenix and Tucson divisions of the bankruptcy court, having filed over 1,000 consumer bankruptcy cases. She also devotes considerable time to pro bono endeavors, frequently assisting self-represented litigants in bankruptcy court and federal district court. Ms. Corrales is an original member of the Arizona Bankruptcy American Inn of Court.

BRADLEY A. COSMAN practices in the Restructuring & Insolvency Practice Group of Squire Sanders' Phoenix office. His practice concentrates on Chapter 11 commercial bankruptcies and out-of-court restructurings. Bradley has experience representing corporate debtors and creditors, buyers of distressed assets, and estate fiduciaries, as well defending corporations in complex avoidance actions. During law school, Bradley served as a judicial extern for the Honorable Randolph J. Haines in the United States Bankruptcy Court for the District of Arizona.

TRACY ESSIG is the founder of Essig Law (fka Law Offices of Tracy S. Essig, PLC), and the Firm represents both individuals and businesses in bankruptcy, both debtor and creditor representation; tax issues/debts in bankruptcy; governmental claims in bankruptcy, mediation, collections, asset protection, tax settlements (offers-in-compromise and/or payment arrangements), tax advice regarding impact of real property deficiency issues; commercial litigation; mediation, eminent domain, real estate (transactional and litigation), business representation, property tax appeals and litigation; and representation before various state boards. Mr. Essig is a member of the: Maricopa County Bar Association, State Bar of Arizona (member: Bankruptcy, Tax, Alternative Dispute Resolution, Public Practice and Business Sections); States' Association of Bankruptcy Attorneys (Past-President and current Director); American Bankruptcy Institute; Association for Conflict Resolution; Arizona Association for Conflict Resolution; a member of the Arizona Forum for Improved Taxation; Treasurer of District 32 North Merchant Association. Former Arizona State Board of Governor Representative; Past-President of the Young Lawyer's Division for the State Bar of Arizona; Maricopa County Representative to the Public Lawyer Section Executive Counsel; Past Chair of the Solo Practitioners/Small Firm Section He lectures locally, statewide and nationally. He has authored many materials, books, articles, etc., as well as having been chapter editor for several national publications. He was also actively involved in legislation regarding the Bankruptcy Abuse Prevention and the Consumer Protection Act of 2005, including participation in drafting a number of key Bankruptcy Code provisions, as well as other legislation involving governmental rights in the tax, debtor-creditor rights and bankruptcy areas.

ELIZABETH S. FELLA is an associate in the Tucson office of Quarles & Brady, LLP. After law school, Elizabeth served as a judicial law clerk to the Honorable Sarah Sharer Curley from

August 2006-August 2008. Since that time, Elizabeth has practiced in the Q&B Restructuring, Bankruptcy, and Creditors' Rights group. Elizabeth focuses her practice on creditor representation in Chapter 11 cases. Elizabeth has also represented a limited number of debtors and trustees. Elizabeth's practice includes all types of loan restructures, from consensual workouts to contested state law enforcement actions (especially receivership actions) and bankruptcy litigation, to appeals at levels through the Ninth Circuit. Elizabeth is also actively involved in her community. She is a member of the Arizona Bankruptcy American Inn of Court, and the State Bar's Bankruptcy Section. She also serves as a board member in the State Bar's Animal Law Section and is the current Vice President of the Southern Arizona Women Lawyers' association. Elizabeth is also active in the capital campaign committee for the Humane Society of Southern Arizona. Elizabeth can be reached at (520) 770-8755 or Elizabeth.Fella@quarles.com.

S. CARY FORRESTER is a senior partner in the law firm of Forrester & Worth. He has a diverse bankruptcy practice, focusing on business cases, and has a growing mediation practice. He has represented debtors, creditors, trustees, committees, and asset purchasers in every type of bankruptcy case, and has served as both a Chapter 11 and a Chapter 7 trustee. He served on the committee that rewrote the local bankruptcy rules and is a charter member of the bankruptcy mediation panel. Since the mediation panel was formed, he has mediated many disputes in the business bankruptcy area. The issues involved include everything from routine avoidance actions and discharge litigation to complex multi-party commercial litigation, real estate disputes, escrow disputes, patent infringement and royalty disputes, partnership dissolutions, legal malpractice, Ponzi scheme litigation, mining investments, and disputes over timber royalties. Mr. Forrester has practiced law in Arizona since 1980, and has been actively involved in bankruptcy cases for most of that time. He has been included in the publication "Southwest Super Lawyers" since 2009 and in the Best Lawyers in America® since 2010. Mr. Forrester is a 1980 honors graduate of Harvard Law School and a 1985 graduate of the National Institute for Trial Advocacy.

SUSAN M. FREEMAN is a partner at Lewis and Roca LLP. She graduated from New York University School of Law in 1975 as a Root-Tilden Scholar, and holds a B.A. from Mount Holyoke College, with distinction. Ms. Freeman is a Fellow and former Vice President and Council of Regents member of the American College of Bankruptcy. She co-chairs the ABA Business Bankruptcy Committee Secured Creditor Subcommittee, and previously chaired the Chapter 11, Professional Ethics and the Programs Subcommittees. She is a frequent author and lecturer, including authoring Chapter 172 of NORTON BANKRUPTCY LAW & PRACTICE on Professional Responsibility in Bankruptcy Cases and *The Scope of Bankruptcy Ancillary Jurisdiction after* Katz *as Informed by Pre-*Katz *Ancillary Jurisdiction Cases*, 15 Amer. Bankr. Inst. L. Rev. 155 (Spring 2007). In addition to her business bankruptcy law practice, Ms. Freeman is an appellate lawyer, and has briefed over 300 civil appeals and argued approximately 100. She is a Fellow of the American Academy of Appellate Lawyers, and has taught at the National Appellate Practice Institute as well as at state counterparts, and is the co-author of the principal appellate resource in Arizona on civil appeals, the ARIZONA APPELLATE HANDBOOK. She has been included in the editions of BEST LAWYERS IN AMERICA since 1989, with listings in the categories of bankruptcy and commercial litigation/appeals. She is also listed in SOUTHWEST SUPER LAWYERS as one of the Top 50 Lawyers in Arizona. She was co-counsel for several law professors on *amicus curiae* briefs in *Tennessee Student Assistance Corp. v. Hood*, 541 U.S. 440

(2004) and *Central Virginia Community College v. Katz*, 126 S. Ct. 990, 1004 (2006), and she briefed and argued *Hall v. United States of America*, 132 S. Ct. 1882 (2012).

DANIEL FURLONG was raised on a family farm in Iowa and attended one-room country schools. He attended Iowa State University for two years. After a break from college during which he worked as a construction laborer, he transferred to Arizona State University where he obtained his undergraduate degree summa cum laude in 1978. In 1981 he graduated from the ASU College of Law and moved to Prescott where he engaged in general practice of law. Eventually his practice concentrated on bankruptcy, both creditor and debtor representation. For 10 years he was an instructor of Bankruptcy Procedure in the American Bar Association certified paralegal program at Yavapai College. He wrote an article for Consumer Bankruptcy News which provided the concepts for the first published court decision under the bankruptcy reform law of 2005. He is one of 18 attorneys selected as a founding Master of the Arizona Bankruptcy Inn of Court, an organization started by an Arizona bankruptcy judge to encourage professionalism, ethics, civility and legal skills. He is a frequent speaker at seminars for attorneys and other professionals.

CINDY L. GREENE graduated summa cum laude from Arizona State University with a B.S. degree in Justice Studies and a Minor in Communications in 2003. She received her J.D. from South Texas College of Law in 2008. She practices consumer bankruptcy law at the law firm of Carmichael & Powell, P.C. and represents individual and business debtors in Chapter 7, 11, and 13 as well as creditors in various bankruptcy related actions. She is also an adjunct faculty with Phoenix School of Law teaching Debtor/Creditor's Rights. She is a member of the National Association of Consumer Bankruptcy Attorneys, Maricopa County Bar Association, and the Arizona Bankruptcy American Inn of Court.

JOHN A. HARRIS is a partner with Quarles & Brady LLP in Phoenix and chairs the Firm's national Commercial Bankruptcy, Restructuring, and Creditors' Rights Practice Group. John has over 20 years of experience as a commercial bankruptcy/litigation attorney. John received his J.D. from the University of Texas School of Law in 1992, and he has developed a national bankruptcy practice focused on representation of commercial lenders, debtors, and other constituencies in all kinds of commercial bankruptcy, commercial litigation, and commercial workout and restructure matters. John has been listed in The Best Lawyers in America® (2009-present), selected for inclusion in the 2010-2012 Southwest Super Lawyers® list, and is Martindale-Hubbell AV® Peer Review Rated.

JUSTIN HENDERSON is an associate with Lewis and Roca LLP in Phoenix, Arizona. He received his B.S. in General Biology from the University of Arizona in 1998 and graduated *summa cum laude* from the Sandra Day O'Connor College of Law at Arizona State University in 2008. Mr. Henderson was a law clerk for Justice Scott Bales at the Arizona Supreme Court. His published articles include "Debtors in Distress: When Can You Sue for Emotional Injury?," in the 2011 edition of Norton's Annual Survey of Bankruptcy Law, and "Preferences: When Can a Trustee Claw Back Payments to Creditors," Business Law Today, March/April 2010.

MICHAEL R. HARREL is an attorney in the Phoenix field office of the Office of Chief Counsel, Internal Revenue Service. He began working for the IRS Chief Counsel after graduating from the Sandra Day O'Connor College of Law at Arizona State University. His practice focuses on litigation in the United States Tax Court and the United States Bankruptcy

Court for the District of Arizona, where he appears on behalf of the Internal Revenue Service as a Special Assistant United States Attorney.

KYLE S. HIRSCH practices in the litigation and bankruptcy areas, primarily focusing on defending and asserting creditors' rights in state and federal court. As a compliment to Mr. Hirsch's work on behalf of the firm's clients, he applies his Spanish language fluency to provide pro bono legal assistance to deserving members of the Phoenix community. Mr. Hirsch is the immediate past chair of the Bankruptcy Section of the Maricopa County Bar Association, the Secretary of the Maricopa County Bar Association, and a member of the Arizona Bankruptcy American Inn of Court.

STEVEN D. JEROME practices in bankruptcy and related state and federal court proceedings, and is a partner at the law office of Snell & Wilmer. He has significant experience in representing debtors, secured creditors and unsecured creditors in a variety of forums, including bankruptcy administrative proceedings, bankruptcy adversary proceedings, and state court receivership proceedings. In addition, Steve has significant experience in providing bankruptcy advice on transactional matters, including non-consolidation, true sale, perfection and preference bankruptcy opinion. Steve graduated from the Leavy School of Business Santa Clara University with a B.S. in 1994. He received his Doctor of Jurisprudence degree from Creighton University School of Law in 1997. Steve was listed in the *Best Lawyers in America* for 2013*, the Southwest Super Lawyers* 2010-2013*, Super Lawyers, Bankruptcy-Business Edition* for 2011*,* and the *Super Lawyers, Bankruptcy-Corporate Counsel Edition* 2010. He is a member of State Bar of Arizona, the American Bankruptcy Institute and the American Bar Association. He has been admitted to practice before the Supreme Court of Arizona, the United State District Court for the District of Arizona, the United States Court of Appeals for the 9th Circuit, and the United States Court of Appeals for the 3rd Circuit.

MICHAEL A. JONES is an associate in the bankruptcy and litigation group at Allen, Sala & Bayne. Mr. Jones received a bachelor in arts degree from Michigan State University. He received his Doctor of Jurisprudence degree from Arizona State University in 2009. In law school, Mr. Jones also served as the Business Editor for the Arizona State Law Journal. Mr. Jones is currently a member of The State Bar of Arizona Bankruptcy Section, the Arizona Bankruptcy American Inn of Court, and the Maricopa County Bar Association. Mr. Jones published an article entitled "The New Supreme Court: Its Potential Ruling on the Constitutionality of Arizona's Campaign Contribution Limits," 40 Ariz. St. L.J. 1057, 2008.

JOSH L. KAHN practices in the bankruptcy and real estate group at Ryley Carlock and Applewhite. He primarily represents creditors, with the majority of his clients being financial institutions. He has also represented Trustees and Debtors in larger Chapter 11 cases. Mr. Kahn received a Bachelor of Arts degree from the University of Texas at Austin. He received his Doctor of Jurisprudence degree, magna cum laude, from Arizona State University in Tempe, Arizona. While in law school, Mr. Kahn served as a judicial extern for the Honorable Redfield Baum, United States Bankruptcy Court. Mr. Kahn also was awarded the American Bankruptcy Law Journal prize on account of his academic performance in Chapter 7 and Chapter 11 bankruptcy courses. Mr. Kahn is active in the Arizona bankruptcy bar, and is a member of the Arizona Bankruptcy American Inn of Court.

JORDAN A. KROOP is a partner in the Restructuring & Insolvency Practice Group of Squire Sanders, resident in the Phoenix and New York offices. Jordan represents publicly traded and privately held corporate debtors and significant creditors including secured lenders, official creditor committees, commercial lessors and financial institutions in some of the largest Chapter 11 cases in the nation. He has represented clients in dozens of industries including heavy manufacturing, high-tech, real estate development, hospitality, gaming, retail and construction. The national restructuring publication Turnarounds & Workouts named Jordan as one of the nation's 12 Outstanding Young Bankruptcy Lawyers. For several years, Jordan has been awarded the designation of AV-Preeminent from Martindale-Hubbell. He has been listed in The Best Lawyers in America each year since 2009 and has been listed in Southwest Super Lawyers, a distinction honoring the top 5 percent of lawyers in the region, each year since 2007. Jordan is the co-author of "Chapter 11 Cases Involving Professional Sports Franchises" in the *Collier Guide to Chapter 11: Key Topics and Selected Industries* (LexisNexis, 2011) and the two-volume treatise *Bankruptcy Litigation and Practice: A Practitioner's Guide* (Aspen, 4th Ed., 2008), as well as the previous third edition of that treatise (Aspen, 3rd Ed., 2000), and *The Executive Guide to Corporate Bankruptcy* (Beard Books, 2nd Ed., 2010). He is the author of dozens of articles published in national bankruptcy-related periodicals and is a frequent speaker at national and regional seminars and symposia. He has served as an instructor of bankruptcy trial techniques for the American Bankruptcy Institute for the last three years and has been a professor of international commercial arbitration at the University of Salzburg (Austria) through the McGeorge School of Law. He is an adjunct professor of bankruptcy litigation and an occasional lecturer on business law topics and international commercial arbitration at the Sandra Day O'Connor College of Law at Arizona State University.

DAWN MAGUIRE-BAYNE has been practicing bankruptcy law since 2000, and is a partner at Allen, Sala and Bayne, PLC. Her practice focuses on representing Chapter 7 Trustees in the Phoenix area. Dawn is member of the State Bar of Arizona: Bankruptcy Section Committee, Arizona Bankruptcy American Inn of Court: Barrister, Arizona Women Lawyers Association, National Association of Bankruptcy Trustees and the Bankruptcy Trustee Arizona Association. In addition, she is a participant in numerous children's charities, and organizations mainly focused on finding cures for various forms of cancer. During her years of practice, she has received numerous rulings in her client's favor including *In re Palidora*, 310 B.R. 164 (Bankr. D. Ariz. 2004), *In re Sawyer*, 324 B.R. 114 (Bankr. D. Ariz. 2005), *In re Roca*, 404 B.R. 431 (Bankr. D. Ariz. 2004), and *Gaughan v. Smith (In re Smith)*, 342 B.R. 801 (B.A.P. 9th Cir. 2006).

EDWARD J. MANEY is a graduate of Hamline University School of Law, class of 1988. Before becoming Chapter 13 Trustee, Edward practiced consumer bankruptcy law for eight years. Edward left debtor practice to become staff attorney for Russell Brown, Chapter 13 Trustee. After five years as staff attorney, he was appointed Chapter 13 Trustee for the District of Arizona in October of 2002. Edward has presented at a number of bankruptcy seminars and served on the Arizona Local Rules Committee and the Uniform Chapter 13 Plan Committee.

KENN NEELEY founded the Neeley Law Firm in 2008 and quickly grew the practice to five attorneys practicing consumer bankruptcy and debt negotiation, business bankruptcy and reorganizations, tax problem resolution, and estate planning. Kenn has an entrepreneurial background, having started and sold two software development companies before founding his law firm. He focuses on providing an unmatched level of service to clients of his firm. It is this level of service that has produced the rapid growth of the Neeley Law Firm. Kenn has taught dozens of continuing education classes to real estate agents and CPAs on the topic of financial distress – including bankruptcy options, foreclosure considerations, short sale laws, and tax liability.

TRUDY A. NOWAK is the founder of Bankruptcy Law Strategists, Attorneys at Law, an Arizona law firm with a bankruptcy practice primarily focused on the representation of Chapter 7 and 11 bankruptcy trustees, adversary proceeding defendants, creditors, receivers, debtors and purchasers of bankruptcy assets and eager to handle challenging and complex cases. She has handled a large number of contested matters, adversary proceedings and appeals to the Ninth Circuit Bankruptcy Appellate Panel, the District Court of Arizona, and the Ninth Circuit Court of Appeals. Ms. Nowak has been a Chapter 7 Panel Trustee in Arizona since September 2009 and has been appointed as a Chapter 11 Trustee in several cases. From 2005 to 2009, Ms. Nowak was a partner/member in the law firm of Anderson & Nowak, PLC, and primarily represented bankruptcy trustees. From 1987 to 2005, she was an attorney and Assistant U.S. Trustee with the Office of the United States Trustee in Rochester, NY and Phoenix, AZ. Ms. Nowak has also been a contract writer and editor since 1991 for West Publishing and Lexis-Nexis in the area of bankruptcy law and federal procedure. She is a member of the Arizona State Bar Association, the Arizona Women Lawyers Association, the National Association of Bankruptcy Trustees, and the American Bankruptcy Institute, and a frequent speaker at continuing education programs on bankruptcy law. Ms. Nowak has a B.A. from the University of Rochester and a J. D., cum laude, from Syracuse University College of Law. She is licensed to practice in Arizona and New York.

FREDERICK J. PETERSON has been a partner at Mesch, Clark & Rothschild since 2005. His practice focuses on Bankruptcy, Business Reorganization, Commercial Litigation and Real Estate law. Petersen is the Managing Shareholder of the firm and serves on the firm's management committee. Petersen represents a wide variety of clients including debtors, creditors, creditors' committees and Chapter 11 Trustees in complex bankruptcy cases, and in providing financial and legal business advice. Petersen also represents individuals and companies in commercial litigation and real estate matters. He is an active volunteer for several organizations in the Tucson community and was selected in 2012 as an "Up and Comer" and in 2006 as one of the top "40 under 40" Tucson business leaders.

DALE C. SCHIAN is a long-time member of Arizona's bankruptcy community, with an emphasis in Chapter 11 reorganizations and corporate restructurings. Mr. Schian has written and lectured extensively in the areas of bankruptcy law and receiverships. Recent presentations and articles have included considerations in restructuring Single Asset Real Estate properties and the implications of *In re Loop 76,* where he served as debtor's counsel. Mr. Schian is a past chair of the Bankruptcy Section of the State Bar of Arizona and is a member of the State Bar's Business Law and Business Law Sections. He is also a member of the American Bankruptcy Institute, the Arizona Bankruptcy American Inn of Court, and the Education Bankruptcy Advisory Commission to the Arizona Board of Legal Specialization. His support of Arizona's legal community includes being a Fellow of the Arizona Foundation for Legal Services. Mr. Schian has been selected multiple times to *Super Lawyers, The Best Lawyers in America*, *Arizona's Finest Lawyers* and *Corporate Counsel*'s Top Lawyers in Bankruptcy Debtor-Creditor Rights Law. He earned his J.D. degree *cum laude* from the American University, Washington College of Law and his B.A. from Michigan State University. Mr. Schian is a co-founder and managing member of Schian Walker, P.L.C. He may be contacted at dschian@swazlaw.com or via www.schianwalker.com.

GERALD L. SHELLEY is a director in the Phoenix office of Fennemore Craig, P.C., and practices locally, nationally and internationally in matters involving commercial insolvency, business bankruptcy, business restructuring, receiverships, dissolutions, liquidations and related state and federal court litigation. His clients include banks and other creditors (secured and unsecured), committees, debtors, trustees, privacy ombudsman, purchasers, owners, board members and other parties affected by or connected to a defaulted or distressed situation. Industry experience includes real estate (raw land, hotels, retail and business centers, golf courses, timeshares, condos and apartment buildings), agriculture, restaurants, mining, transportation (trucking and airlines), retail, franchising and licensing, health care, manufacturing and e-commerce. He has handled cross border insolvency cases involving Canadian, European and Asian interests. Fluent in Spanish, he has worked on cases with assets in Mexico, Costa Rica and other Latin American countries.

CHRISTOPHER C. SIMPSON represents distressed companies in commercial workouts, turnarounds, out-of-court restructurings, and bankruptcy reorganizations. He is a partner in the firm Stinson, Morrison & Hecker, LLP. He practices in the areas of Chapter 11 reorganizations, commercial restructuring, creditors' rights, private capital, and general business. Christopher graduated from Northern Arizona University with a B.S. in 1991 and received his J.D. from the University of Arizona 1997, where he was the Executive Note Editor for the Arizona Law Review and received the First-Year Law Student Award for highest class rank. He is a member of the Arizona State Bar and is admitted to practice before the United States District Court for the District of Arizona. Additionally, Christopher is a member of the American Inns of Court for Arizona Bankruptcy, and the Maricopa County Bar Association.

KELLY SINGER is a partner at the law firm of Quarles & Brady LLP, where he practices nationally in all aspects of commercial bankruptcy and restructuring matters. He has substantial experience representing corporate debtors and creditors in Chapter 11 bankruptcies and out-of-court restructurings, creditors' committees, buyers in Section 363 bankruptcy sales, Chapter 11 trustees, and lenders in debtor-in-possession financings. He has also represented domestic and foreign corporations in the defense and prosecution of high-dollar, complex avoidance actions, including avoidance litigation involving alleged real estate Ponzi schemes. Through over a decade of practicing exclusively in bankruptcy and restructuring, Mr. Singer has acquired considerable experience representing homebuilders and other real estate developers in bankruptcy matters. He has also represented various Japanese, Chinese and European companies in U.S. and foreign bankruptcy/insolvency matters. Mr. Singer was selected for inclusion in the 2012 *Southwest Super Lawyers* list (bankruptcy and creditor/debtor rights), and a 40-under-40 nominee in the *Arizona Business Journal*. He is a contributor to *Bankruptcy Litigation and Practice: A Practitioner's Guide.*

GARY R. STICKELL is a sole practitioner who represents individuals and small businesses in the filing of bankruptcy. Gary is a member of the Bankruptcy Section of the State Bar of Arizona and chairs the Section's Consumer Debtor Committee. He is also a member of the National Association of Consumer Bankruptcy Attorneys. In the U.S. Bankruptcy Court for the District of Arizona, he serves on the Court's Education Committee and Uniform Practices Committee. In 2009, Gary initiated a brown bag lunch program, set up monthly tutoring sessions and, most recently, led a two-day program, "Bankruptcy 101," held at the Sandra Day O'Connor College of Law at Arizona State University. He also created a consumer debtors attorney list service. Gary speaks regularly on consumer bankruptcy topics, including programs sponsored by the State Bar of Arizona and the National Business Institute. He received his law degree from Boston University in 1981, after earning his Bachelor of Arts degree at George Washington University, Washington, D.C., in 1978. He has been licensed to practice in Arizona since October 1982. In the community, Gary is a past chair of the Greater Phoenix Youth at Risk Foundation and has served as the Arizona Chair of the George Washington University Alumni Admissions Program. He is currently an assistant den leader with his son's Cub Scout pack. Gary was one of two recipients of the 2010 Award of Special Merit from the State Bar of Arizona. The award, presented at the State Bar's annual convention, recognizes "significant contributions by a member of the bar to the furtherance of public understanding of the legal systems, the administration of justice, and confidence in the legal profession." Gary and his wife, Mary, are the parents of two boys.

BRYCE SUZUKI represents secured and unsecured creditors, debtors, landlords, vendors, bankruptcy investors, and equity security holders in all aspects of commercial restructuring and bankruptcy, including non-bankruptcy business workouts, asset sales, Chapter 11 bankruptcy administration and reorganization, liquidation, enforcement of creditors' rights, bankruptcy litigation and appellate work, and distressed financing issues. Mr. Suzuki is active in various bar organizations. He is a Fellow of the American Bar Foundation, a past chair of the Arizona State Bar's Committee on Minorities and Women in the Law, and the past president of the Arizona Asian American Bar Association. In 2010, he was invited to the White House as a guest of President Barack Obama for a reception honoring Asian American and Pacific Islander Heritage Month. In law school, Mr. Suzuki served as managing editor of the *Iowa Law Review* and was invited to join the University of Iowa College of Law's national appellate advocacy team.

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2013 ARIZONA STATE BAR ANNUAL CONVENTION
Friday, June 21, 2013

IN RE IRONIC AUTO RENTALS, INC.: TO CONFIRM OR NOT TO CONFIRM; THAT IS THE QUESTION.

PRESENTERS

Honorable Margaret M. Mann

Steven Jerome

Jordan Kroop

Christopher Simpson

Kelly Singer

UNITED STATES BANKRUPTCY COURT
DISTRICT OF ARIZONA

In re IRONIC AUTO RENTALS, INC., Debtor.	Chapter 11 Case No. 2:12-bk-99999-XYZ **STATEMENT OF FACTS**

Ironic Auto Rentals, Inc. (the "Debtor") is a retail automobile rental company serving a niche customer base in the Phoenix metropolitan area. The Debtor owns a fleet of restored, ironically unpopular passenger vehicles such as Buick LeSabres, Pontiac TransSport minivans, AMC Gremlins, Ford Pintos, and Volvo 240 station wagons for rental to chronically hip, ironically bearded, urban customers between the ages of 18 and 30.

First Conventional Bank ("FCB") has been the Debtor's senior secured lender since the Debtor's inception in 2005. FCB provided the Debtor with a term loan in the original principal amount of $4,000,000, which the Debtor used to purchase its fleet of ironic cars. To secure repayment of that loan, FCB took a first-priority, perfected security interest in all the Debtor's vehicles and a first-priority security interest in the Debtor's cash and accounts receivable. FCB did not have a control agreement or other mechanism to perfect its security interest in the Debtor's cash.

Owing to the opening of the light rail system and the fickle tastes of the hipster demographic, the Debtor's revenues began experiencing a marked decline in 2009; the Debtor's operations were net cash flow negative by February 2011. By May 2011, the Debtor had defaulted on its monthly debt service obligations to FCB and was out of compliance with several operating and revenue covenants under FCB's loan and security agreement with the Debtor. After FCB notified the Debtor of its material defaults under the loan agreement and began foreclosure proceedings in state court, the Debtor filed its Chapter 11 petition on April 17, 2012. As of the petition date, the Debtor owed FCB

$3,750,000 in principal and accrued interest, a debt secured by the Debtor's cash, accounts receivable, and the Debtor's 96 ironic vehicles.

As a condition to the Debtor's use of FCB's cash collateral, FCB and the Debtor agreed that the Debtor would sell 46 of its ironic vehicles under Bankruptcy Code § 363. Vulture Scrap Metals, LLC made an initial bid to purchase the 46 vehicles for $410,000, subject to higher and better offers, including FCB's potential credit bid under Bankruptcy Code § 363(k), which the Debtor did not contest and which the Debtor's sale motion expressly preserved. After bidding closed at the hearing on the Debtor's sale motion on May 23, 2012, the Court entered an order approving FCB's credit bid of $600,000 as the highest and best offer for the 46 vehicles. FCB, therefore, took possession of the 46 vehicles and credited its prepetition secured claim by $600,000, reducing that claim to $3,150,000. The Debtor continued to operate during the course of its Chapter 11 case using its remaining fleet of 50 vehicles, on which FCB retained a first-priority, perfected lien.

On March 8, 2013, the Debtor filed its plan of reorganization. The plan bifurcates FCB's claim into two classes: Class 2, containing FCB's secured claim; and Class 6, containing FCB's unsecured claim. The Court has not ruled on the value of the Debtor's fleet of 50 vehicles. All parties, however, reasonably believe that FCB is substantially under-secured in the vehicles and that FCB is strongly inclined to elect to have its claim treated as fully secured under Bankruptcy Code § 1111(b)(2). Within the plan itself and in the associated disclosure statement, the Debtor objects to FCB's potential § 1111(b) election, arguing that because FCB purchased some of the Debtor's vehicles at the beginning of the Chapter 11 case, FCB was not entitled to make a § 1111(b)(2) election under the "sale exception" found in Bankruptcy Code § 1111(b)(1)(A)(ii). The "sale exception" precludes a secured creditor with a "lien on property of the estate" from making a § 1111(b)(2) election if the secured creditor "does not have [ ] recourse [against the debtor] and such property is sold under section 363 of this title or is to be sold under the plan." The Debtor's plan does not propose to sell the Debtor's remaining fleet of 50 vehicles; instead, the Debtor would retain those vehicles and use them in its reorganized operations, with FCB retaining its lien on those vehicles to secured repayment of the restructured secured loan amount, which is amortized over 30 years at 5% interest per year. FCB and the Debtor stipulate that, for purposes of plan confirmation only, the value of the remaining 50 vehicles is $850,000.

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IN THE UNITED STATES BANKRUPTCY COURT

FOR THE DISTRICT OF ARIZONA

In Re: IRONIC AUTO RENTALS, INC., Debtor.	Proceedings Under Chapter 11 Case No. 2:12-bk-00000-ABC **DEBTOR'S BRIEF IN SUPPORT OF CONFIRMATION**

Ironic Auto Rentals, Inc., debtor and debtor-in-possession (the "Debtor"), hereby submits Debtor's Brief in Support of Confirmation of the Debtor's Plan of Reorganization, (the "Plan"), pursuant to section 1129 of title 11 of the United States Code (11 U.S.C. §§ 101 *et seq*., the "Bankruptcy Code"). In support of confirmation of the Plan, Debtor respectfully states as follows:

PRELIMINARY STATEMENT

Debtor has used the chapter 11 process to the significant advantage of its creditors and other parties-in-interest. Debtor is now ready to exit chapter 11 under a confirmable Plan which Debtor believes complies in all respects with the Bankruptcy Code.

Second Conservative Bank ("SCB"), a secured creditor, objects to Debtor's Plan contending that the Plan is neither feasible nor fair and equitable with respect to the proposed treatment of SCB's claim.

BACKGROUND

A description of the Debtor and its operations are set forth in the separate stipulated *Statement of Facts* filed contemporaneously herewith and incorporated herein. In addition to its fleet of ironic cars as described in the Statement of Facts, Debtor also owns five acres of real property and improvements housing its rental center, service facilities and parking facilities (the "Real Property"). In June of 2007, the Debtor secured a 25-year loan from SCB to finance the construction of the existing improvement on the Real Property. Due to the light rail, the demand for rental cars in the area has plummeted and the value of the Real Property as a rental car facility has diminished.

UNCONTESTED FACTS

1. On or about June 20, 2007, SCB extended credit to Debtor in the original principal amount of $6,000,000 pursuant to a 25-year term loan at 5.5% interest (the "Loan"). The Loan was evidenced by, among other things, a promissory note of the same date (the "Note").

2. The Loan is perfected and secured by a Deed of Trust and Fixture Filing (the "Deed of Trust") dated as of June 20, 2011 and recorded in the Official Records of the County.

3. The Deed of Trust grants a first priority perfected security interest in the Real Property.

4. As of the petition date the outstanding principal and interest due on the SCB loan was approximately $5,000,000.

5. For the purposes of confirmation, Debtor and SCB each agree that the value of the Real Property as a rental car facility is approximately $2,000,000.

6. However, Debtor and SCB each also agree that the Real Property would currently sell for approximately $4,000,000 if it were converted to general retail use.

7. SCB elected to have its claim treated as fully secured under Bankruptcy Code § 1111(b)(2).

8. The Plan's §1111(b)(2) treatment provides that SCB will: (i) retain its lien on the Real Property; (ii) receive equal monthly payments totaling $2,000,000 over 30 years; and (iii) receive a balloon payment of $3,000,000 in year 30 when the Debtor sells the Real Property.

9. The Debtor and SCB stipulate that the net present value of the proposed treatment of SCB's claim is over $2,000,000.

CONTESTED ISSUES OF FACT OR LAW

1. Whether the 30-year term of Debtor's proposed Plan violates the feasibility requirement under 11 U.S.C. §1129(a)(11).

2. Whether the treatment of SCB's claim is fair and equitable under 11 U.S.C. § 1129(b)(2)(A)(i).

ARGUMENT

I. THE PLAN IS FEASIBLE.

Section 1129(a)(11) of the Bankruptcy Code requires that, as a condition precedent to confirmation, a court determine that a plan is feasible. Specifically, a court must determine that:

> Confirmation of the plan is not likely to be followed by the liquidation, or the need for further financial reorganization, of the debtor or any successor to the debtor under the plan, unless such liquidation or reorganization is proposed in the plan.

11 U.S.C. § 1129(a)(11). As described below, and as will be demonstrated at the Confirmation Hearing, the Plan is feasible within the meaning of this provision.

The feasibility test set forth in section 1129(a)(11) of the Bankruptcy Code requires a court to determine whether a plan is workable and has a reasonable likelihood of success. *See In re Pikes Peak Water Co.*, 779 F.2d 1456, 1460 (10th Cir 1985).

Section 1129(a)(11) of the Bankruptcy Code does not require a guarantee of success. *See In re U.S. Truck Co*., 47 B.R. 932, 944 (E.D. Mich. 1985) ("Feasibility does not, nor can it, require the certainty that a reorganized company will succeed."), aff'd, 800 F.2d 581 (6th Cir. 1986); *In re One Times Square Assocs. Ltd. P'ship*, 159 B.R. 695, 709 (Bankr. S.D.N.Y. 1993) ("It is not necessary that the success be guaranteed, but only that the plan present a workable scheme of reorganization and operation from which there may be a reasonable expectation of success.") (quoting 5 Collier on Bankruptcy ¶ 1129.02[11], at 1129-54 (15th ed. 1992)); *In re Acequia*, 787F.2d 1352, 1364 (9^{th} Cir. 1986).

Rather, the key element of feasibility is whether there exists a reasonable probability that the provisions of the plan can be performed. The purpose of the feasibility test is to protect against visionary or speculative plans. As noted by the United States Court of Appeals for the Ninth Circuit:

> The purpose of section 1129(a)(11) is to prevent confirmation of visionary schemes which promise creditors and equity security holders more under a proposed plan than the debtor can possibly attain after confirmation.

In re Pizza of Haw., Inc., 761 F.2d 1374, 1382 (9th Cir. 1985) (quoting 5 Collier on Bankruptcy ¶ 1129.02, at 1129-36.11 (15th ed. 1984)). However, just as speculative prospects of success cannot sustain feasibility, speculative prospects of failure cannot defeat feasibility. The mere prospect of financial uncertainty cannot defeat confirmation on feasibility grounds. *See US. Truck*, 47 B.R. at 944.

Applying the foregoing standards of feasibility, courts have identified the following factors as probative:

(1) the adequacy of the capital structure;

(2) the earning power of the business;

(3) economic conditions;

(4) the ability of management;

(5) the probability of the continuation of the same management; and

(6) any other related matters which will determine the prospects of a sufficiently successful operation to enable performance of the provisions of the plan.

See In re The Leslie Fay Co.,Inc.,, 207 B.R. 764, 789 (Bankr. S.D.N.Y. 1997) (citing 7 Collier on Bankruptcy ¶ 1129 LH[2], at 1129-82 (15th ed., rev. 1996)); The foregoing list is neither exhaustive nor exclusive. *In re Drexel Burnham Lambert Group, Inc*., 138 B.R. 723, 760 (Bankr. S.D.N.Y. 1992); cf. *U.S. Truck*, 800 F.2d 581, 589 (6th Cir. 1986).

In the present case, SCB's sole argument against feasibility is that the term of Debtor's 30-year Plan renders the Plan too speculative to be confirmed. SCB's argument is undercut by the fact that its original loan to the Debtor was for a 25-year term. SCB would have us believe that while the Bank issues loans for a term of 25 years, a 30-year term suddenly disintegrates into pure speculation. SCB's argument in this regard is unsupportable.

Further, SCB is retaining its lien on the Real Property and Debtor's experts will testify that the value of the Real Property is expected to appreciate handsomely over the next 30 years. SCB's dire concerns are more speculative than the substantial probability that property values will increase over a 30-year period. SCB's speculative prospects of failure are not sufficient to defeat confirmation. *See US. Truck*, 47 B.R. at 944.

Based upon the foregoing, the Plan satisfies the feasibility standard of section 1129(a)(11) of the Bankruptcy Code.

II. THE PLAN SATISFIES THE "CRAM DOWN" REQUIREMENTS OF THE BANKRUPTCY CODE BECAUSE IT IS FAIR AND EQUITABLE WITH RESPECT TO SCB'S CLAIM.

A. The "Cram Down" Requirements Of § 1129(b)(1) Are Satisfied.

Section 1129(a)(8) of the Bankruptcy Code requires that each class of claims and interests either accept a plan or be unimpaired under the plan. 11 U.S.C. § 1129(a)(8). Here, SCB has not accepted the Plan, which otherwise prevents the Plan from complying with section 1129(a)(8).

Section 1129(b) of the Bankruptcy Code provides a mechanism for confirmation or "cram down" of a plan in circumstances where the plan is not accepted by all impaired classes of claims and equity interests. Section 1129(b) of the Bankruptcy Code provides in pertinent part:

> Notwithstanding section 510(a) of [the Bankruptcy Code], if all of the applicable requirements of [section 1129(a) of the Bankruptcy Code] other than [the requirement contained in section 1129(a)(8) that a plan must be accepted by all impaired classes] are met with respect to a plan, the court, on request of the proponent of the plan, shall confirm the plan notwithstanding the requirements of such paragraph if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan.

11 U.S.C. § 1129(b)(1). Thus, under section 1129(b) of the Bankruptcy Code, a court may "cram down" a plan over the deemed rejection by impaired classes of claims as long as the plan does not "discriminate unfairly" and is "fair and equitable" with respect to such classes. SCB does not allege that the Plan discriminates unfairly. As such, if the Plan is fair and equitable with respect to SCB's claim, then the requirements of § 1129(b)(1) have been satisfied.

B. The Plan Is Fair and Equitable Because SCB Receives Cash Payments Of A Greater Value Than The Estate's Interest In The Property.

The value of the estate's interest in the Real Property is $2,000,000. The valuation of a secured claim is governed by § 506(a) of the Bankruptcy Code, which provides in pertinent part:

> An allowed claim of a creditor secured by a lien on property in which the estate has an interest ... is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property... and is an unsecured claim to the extent that the value of such creditor's interest ... is less than the amount of such allowed claim. Such value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest.

11 U.S.C. § 506(a)(1). In *Associates Commercial Corporation v. Rash*, 520 U.S. 953 (1997), the Court determined that in the context of a "cram down" the value of property is based on the Debtor's proposed use of the property. *Id*. at 955. In other words, the value is what a willing buyer in the debtor's trade or business would pay to obtain like property from a willing seller. *Id*. at 960.

In this case the Debtor's "trade or business" is operating a rental car facility. The value of the Real Property is determined by what another rental car company would pay to acquire Debtor's Real Property. *See In re Bishop*, 339 B.R. 595, 600 (Bankr. D.S.C. 2005) (Rash requires a court to consider the proposed use, not dispositions or uses that might have been proposed). The proposed use of this property is the operation of a rental car facility. For the purposes of confirmation, Debtor and SCB each agree that the value of the Real Property as a rental car facility is approximately $2,000,000. The value of the estate's interest in the Real Property is $2,000,000. Necessarily, the value of SCB's interest in the estate's interest in the Real Property is also $2,000,000.

C. The Plan Satisfies The Fair And Equitable Requirements of § 1129(b)(2).

Section 1129(b)(2) of the Bankruptcy Code defines the phrase "fair and equitable" with respect to secured claims, unsecured claims and interests. With respect to a secured claim, section 1129(b)(2)(A) of the Bankruptcy Code provides that a plan is "fair and equitable" if:

(i) the holder of such claim retains its lien securing such claim; and

(ii) the "'holder of a claim of such class receive on account of such claim **deferred cash payments totaling at least the allowed amount of such claim**, of a value, as of the effective date of the plan, **of at least the value of such holder's interest in the estate's interest in such property**[.]'" *In re Ambanc La Mesa Ltd. Partnership*, 115 F.3d 650, 653 (9th Cir. 1997)(quoting 11 U.S.C. § 1129(b)(2)(A) emphasis added).

In the instant case, the "fair and equitable" requirement is satisfied as to SCB's Claim because: (i) SCB is retaining its lien on the Real Property; (ii) SCB is receiving deferred cash payments totaling $5 million dollars which is the amount of its allowed claim (and $1,000,000 more than SCB's valuation of the Real Property as a retail center); and (iii) the net present value of the payment stream SCB will receive under the Plan valued as of the effective date is in excess of $2,000,000 (the value of the estates interest in the Real Property). Accordingly, the Plan satisfies the requirements of section 1129(b)(2)(A) and, therefore, is fair and equitable with respect to treatment of SCB's claim.

CONCLUSION

The Plan is feasible and the Plan's proposed treatment of SCB's claim is fair and equitable. As such, the Plan complies with and satisfies all of the requirements of section 1129 of the Bankruptcy Code. Accordingly, Debtor respectfully requests entry of an order confirming the Plan.

DATED this April 11, 2013.

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IN THE UNITED STATES BANKRUPTCY COURT

FOR THE DISTRICT OF ARIZONA

In Re: IRONIC AUTO RENTALS, INC., Debtor.	Proceedings Under Chapter 11 Case No. 2:12-bk-00000-ABC **CREDITOR'S BRIEF IN OPPOSITION TO CONFIRMATION**

Second Conventional Bank ("SCB"), secured creditor of Ironic Auto Rentals, Inc. ("Debtor" or "Ironic"), hereby submits this "SCB's Brief in Opposition to Confirmation" ("Brief") to the Debtor's proposed "Chapter 11 Plan" ("Plan").

PRELIMINARY STATEMENT

The Debtor filed the Plan over eleven months ago. The Debtor bears the burden to prove by a preponderance of the evidence that SCB's treatment under the Plan satisfies all sixteen requirements of 11 U.S.C. § 1129(a). See *In re Arnold & Baker Farms*, 177 B.R. 648, 654 (BAP 9th Cir. 1994). Because the Debtor cannot satisfy its burden, the Plan is no more confirmable than it was when the Debtor filed it eleven months ago.

UNCONTESTED FACTS

1. On or about June 20, 2007, SCB extended credit to Debtor in the original principal amount of $6,000,000 pursuant to a 25-year term loan at 5.5% interest (the "Loan"). The Loan was evidenced by, among other things, a promissory note of the same date (the "Note").

2. The Loan is perfected and secured by a "Deed of Trust and Fixture Filing" (the "Deed of Trust") dated as of June 20, 2011, and recorded in the Official Records of the County.

3. The Deed of Trust grants a perfected security interest in the five acres of real property associated with Debtor's show room and sales lot (the "Real Property").

4. On April 17, 2012, the Debtor filed its petition.

5. As of the petition date, the outstanding principal and interest due on the SCB Loan was approximately $5,000,000.

6. For the purposes of confirmation, Debtor and SCB each agree that the value of the Real Property as a car lot is approximately $2,000,000.

7. However, Debtor and SCB each also agree that the Real Property would currently sell for approximately $4,000,000 if it were sold for general retail use.

8. SCB elected to have its claim treated as fully secured under Bankruptcy Code § 1111(b)(2).

9. The Plan's § 1111(b)(2) treatment provides that: (i) SCB will retain its lien on the Real Property; (ii) receive equal monthly payments totaling $2,000,000 over 30 years; and (iii) a balloon payment of $3,000,000 in year 30 when the Debtor sells the Real Property.

10. The Plan proposes that SCB receive on account of its claim an interest rate of 4.5% or such other amount as may be determined by the Court.

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CONTESTED ISSUES OF FACT OR LAW

1. The Plan's proposed 30 year term renders the Plan not feasible, and thus not confirmable under 11 U.S.C. § 1129(a)(11).

2. The Plan's proposed 30 year term renders the Plan unfair and inequitable in violation of 11 U.S.C. § 1129(b)(2)(A)(i).

ARGUMENT

I. THE PLAN IS NOT FEASIBLE BECAUSE THE PLAN IS TOO LONG AND THE BALLOON PAYMENT IN 30 YEARS IS PURE SPECULATION

As a condition of confirmation, Section 1129(a)(11) requires that the court find that confirmation "is not likely to be followed by the liquidation, or the need for further financial reorganization, of the debtor or any successor to the debtor under the plan, unless such liquidation or reorganization is proposed in the plan.'" 7 COLLIER ON BANKRUPTCY ¶ 1129.03[11], 1129-74 (15th ed. 2009). The purpose of this provision is to "prevent confirmation of visionary schemes which promise creditors and equity security holders more under a proposed plan than the debtor can possibly attain after confirmation." *In re Pizza of Hawaii, Inc.*, 761 F.2d 1374, 1382 (9th Cir. 1985) (*quoting* 5 COLLIER ON BANKRUPTCY ¶ 1129.02[11], at 1129-34 (15th ed. 1984)).

To avoid the confirmation of visionary schemes "[e]very [plan proponent] is required to present 'ample evidence to demonstrate that the Plan has a reasonable probability of success.'" *In re Seasons Partners, LLC,* 439 B.R. 505, 515 (Bankr. D. Ariz. 2010) (*citing In re Acequia, Inc*., 787 F.2d 1352, 1364 (9th Cir. 1986)). Specifically, "[s]ection 1129(a)(11) 'requires the plan proponent to show concrete evidence of a sufficient cash flow to fund and maintain both its operations and obligations under the plan.'" *Id*. (*quoting* 7 COLLIER ON BANKRUPTCY ¶ 1129.02[11], 1129-53); see also *In re SM 104 Ltd*., 160 B.R. 202, 236-39 (Bankr. S.D. Fla. 1993) (speculative financial projections and promises to obtain post-confirmation financing are insufficient to prove feasibility). The Court's role is to "scrutinize the plan to determine whether it offers a reasonable prospect of success and is workable." *Id*. (quoting *In re Sagewood Manor*

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Assocs. Ltd. P'Ship, 223 B.R. 756, 762 (Bankr. D. Nev. 1998)). Plans that are "based on speculation are not proper candidates for reorganization." *Id.*

In considering whether a particular plan is feasible, courts have considered the following factors:

(1) the adequacy of the debtor's capital structure;

(2) the earning power of its business;

(3) economic conditions;

(4) the ability of the debtor's management;

(5) the probability of the continuation of the same management; and

(6) any related matters which determine the prospects of a sufficiently successful operation to enable performance of the provisions of the plan.

In re Trans Max Tech., Inc., 349 B.R. 80, 92 (Bankr. D. Nev. 2006); *In re Wiersma*, 324 B.R. 92, 113 (9th Cir. BAP 2005), aff'd in part and rev'd in part on other grounds, 483 F.3d 933 (9th Cir. 2007). Like all requirements in section 1129(a), the plan proponent must demonstrate that its plan is "feasible" by a preponderance of the evidence. *Id.*

A. <u>The Plan's 30 Year Term is Too Long</u>

This Court "should not approve a plan if it depends on successful fulfillment of every underlying assumption of the debtor." *In re Saguaro Ranch Development Corp.*, 2011 WL 2182416, *7 (Bankr. D. Ariz. 2011). The Debtor's 30 years of projections are simply too forward looking to have any basis in fact. Under the Plan, the Debtor assumes that it can accurately predict both future intrinsic and extrinsic economic factors. Debtor's projections are the classic "visionary scheme" that bars confirmation. Debtor defies credibility by even asserting it can predict revenue, expenses and other factors 30 years into the future.

B. The Debtor's Ability to Make the Balloon Payment is Pure Speculation

A debtor must provide adequate evidence that its ability to make a balloon payment is reasonably likely to occur. *In re Linda Vista Cinemas, L.L.C.*, 442 B.R. 724, 738 (Bankr. D. Ariz. 2010) (*citing In re Made in Detroit, Inc*., 299 B.R. 170, 179-80 (Bankr. E.D. Mich. 2003); *In re Bashas' Inc*., 437 B.R. 874, 915-16 (Bankr. D. Ariz. 2010) (citations omitted).

In short, the Debtor must prove that it can predict the commercial real estate market generally, and the salability of the Real Property in particular, thirty (30) years from now. Debtor cannot predict with any degree of certainty its ability to sell the Real Property, let alone at what price 30 years from the effective date of the Plan.

II. THE PLAN FAILS TO SATISFY THE "CRAM DOWN" REQUIREMENTS OF THE BANKRUPTCY CODE BECAUSE IT IS NOT FAIR AND EQUITABLE WITH RESPECT TO SCB'S CLAIM

"To be 'fair and equitable' the plan must satisfy, with respect to secured claims, one of the following three tests:

(1) The creditor is to retain the lien securing its claim and is to receive deferred cash payments with a present value at least equal to the claim;

(2) The property securing the claim is to be sold and the lien is to attach to the proceeds of the sale; the lien on the proceeds is then to be treated as described in test (1) or (3);

(3) The creditor is to realize the indubitable equivalent of its secured claim."

In re Arnold & Baker Farms, 85 F.3d 1415, 1420 (9th Cir. 1996). However, satisfaction of the mathematical test of § 1129(b)(2)(A)(1) alone does not automatically render the plan "fair and equitable." *In re Reid Park Properties, L.L.C.*, 2012 WL 5462919, *9 (Bankr. D. Ariz. 2012). A plan that shifts too much risk to the secured lender cannot satisfy the Bankruptcy Code's "fair and equitable" requirement. *Id. citing In re DeTienne Assocs. L.P.*, 2005 Bankr.LEXIS 3122, 19-21 (Bankr. D. Mont July 29, 2005); *Aetna Realty Investors v. Monarch Beach Venture (In re Monarch Beach Venture)*, 166 B.R. 428, 436 (C.D. Cal. 1993). The "use of 'includes' in § 1129(b)(2) allows for additional considerations in analyzing whether a plan is fair and equitable." *Id. citing In re Red Mountain Mach Co*., 448 B.R. 1, 13 (Bankr. D. Ariz. 2011); *In re Bjolmes Realty Trust*, 134 B.R. 1000 (Bankr. D. Mass 1991); *In re Jones*, 32 B.R. 951 (Bankr. D. Utah 1983).

A. <u>The Court Must Value the Property at $4,000,000</u>

The Debtor concedes that the Debtor's current use of the Real Property substantially diminishes the value of the Real Property. The Debtor concedes that use of the Real Property, as a car lot, results in a value of approximately $2,000,000. However, the Debtor acknowledges that the value of the Real Property for general retail use is approximately $4,000,000. Debtor's use devalues the Real Property by $2,000,000.

Debtor contends that, for purposes of "cram down" under § 1129(b)(2)(A), this Court must value the Real Property based upon the Debtor's proposed use. Debtor's reliance on *Associates Commercial Corp. v. Rash*, 520 U.S. 953 (1997) is misplaced. In *Rash*, the Supreme Court determined that the "cram down" value of a commercial vehicle is the "the cost the debtor would incur to obtain a like asset for the same 'proposed . . . use.'" *Rash*, at 965. In the present case, the Debtor would be required to pay a market value for alternative real property. Generally, the value placed upon real property by the market assumes the "highest and best use." Not an inferior use, such as the Debtor's car lot.

If the Court adopts the Debtor's position on value for "cram down", then the Plan fails to satisfy the best interest of creditors test as to SCB. Section 1129(a)(7)(B) requires SCB to receive no less under the Plan than it would receive if the Debtor was liquidated under Chapter 7. The Debtor admits that: (i) as of the petition date, SCB is owed approximately $5,000,000; and (ii) SCB holds a valid first priority properly perfected lien on the Property. In a Chapter 7 proceeding, the Chapter 7 Trustee would not be limited to the Debtor's use of the Real Property and has an obligation to maximize the value of property of the estate. Either the Chapter 7 Trustee would sell the Real Property (and turnover the proceeds to SCB) for its highest and best use (i.e. general retail) or, more likely, allow SCB to foreclose on the Real Property, which is encumbered by SCB's

$5,000,000 lien. Regardless, in a Chapter 7 proceeding, SCB would realize the higher $4,000,000 value from the Real Property.

B. The Plan's Proposed 30 Year Term Renders the Plan Unfair and Inequitable

In the alternative, assuming the Court determines that Debtor's diminished value of $2,000,000 is present value to be utilized under § 1129(b)(2)(A)(i), SCB concedes that the Plan satisfies the mathematical requirements of § 1129(b)(2)(A)(i). However, the Plan is still not fair and equitable to SCB. As of the Petition Date, assuming the Debtor had not defaulted on the Loan prior to the present bankruptcy, the remaining term on the SCB Loan was twenty years. The Plan proposes to increase the term another ten (10) years to a new term of 30 years. Not only does the substantially increased term subject SCB to significant additional risk, the Debtor's ability to make the balloon payment is entirely dependent on the state of the real estate market 30 years from the effective date of the Plan. While some courts have held that a ten year plan term was not excessive, the Debtor's plan is for 3 times that. *In re Patrician St. Joseph Partners L.P.*, 169 B.R. 669, 680 (D.Ariz 1994). Therefore, the Debtor's Plan shifts too much risk to SCB for the benefit of the Debtor and is not confirmable. *Reid, supra*. (a plan that shifts too much risk to the secured lender cannot satisfy the Bankruptcy Code's "fair and equitable" requirement).

CONCLUSION

The Debtor's proposed Plan cannot be confirmed. The proposed Plan is not feasible and fails to satisfy the requirements for "cram down" confirmation under 11 U.S.C. § 1129(b)(2)(A).

16944637

DATED April 11, 2013.

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UNITED STATES BANKRUPTCY COURT
DISTRICT OF ARIZONA

In re IRONIC AUTO RENTALS, INC., Debtor.	Chapter 11 Case No. 2:12-bk-99999-XYZ **FIRST CONVENTIONAL BANK'S OBJECTION TO DEBTOR'S CHAPTER 11 REORGANIZATION PLAN**

First Conventional Bank ("**FCB**"), the senior secured creditor and party-in-interest in the above-captioned bankruptcy case files this Objection to the *Chapter 11 Reorganization Plan* (the "**Plan**"), filed by the debtor-in-possession (the "**Debtor**").

The Plan strips FCB of its rights under Bankruptcy Code § 1111(b) by limiting its fully secured claim under the guise of Bankruptcy Code § 1111(b)(1)(A)(ii) when the Debtor is not selling any of FCB's collateral under the Plan. Indeed, notwithstanding FCB's election to have its claim fully secured under Bankruptcy Code § 1111(b)(2), the Plan proposes to bifurcate FCB's claim into two portions: (1) a secured claim; and (2) an unsecured claim. But by virtue of FCB's § 1111(b) election, **all** the Debtor's payments of principal and interest to FCB under the Plan on account of FCB's secured claim must equal $3,150,000, and FCB should not have any unsecured deficiency claim. Put simply, the Debtor distorts the statute's language to evade the § 1111(b) protections afforded to FCB.

This Objection is supported by the entire record before the Court and by the following memorandum of points and authorities.

OBJECTION

In support of this Objection, FCB incorporates the *Statement of Facts* filed contemporaneously with this Objection.

11 U.S.C. § 1111(b)(2) permits an under-secured creditor to elect to have its entire claim amount treated as secured by the collateral and waive its unsecured claim, with the effect that all payments of principal and interest on account of the fully-secured claim over the life of the plan have to equal at least the amount of the creditor's claim.

Instead, the Debtor, relying on the following language in § 1111(b)(1) (emphasis added) argues that FCB had effectively "waived" its right to an § 1111(b) election by purchasing some of its collateral in the credit bid sale:

> (B) A class of claims may not elect application of paragraph (2) of this subsection if — … (ii) the holder of a claim of such class has recourse against the debtor on account of such claim and **such property is sold under section 363 of this title or is to be sold under the plan**.

Thus, the issue is whether the collateral sold in the credit bid sale falls within the purview of the "such property is sold…" language in § 1111(b)(1)(B).

There is no dispute that the Debtor proposes to retain the balance of FCB's collateral for use in its reorganized operations under the Plan or that the Debtor is not selling that collateral under either the Plan or 11 U.S.C. § 363. The collateral sold in the credit bid sale is longer FCB's collateral and is no longer owned by the Debtor, yet the Debtor seeks to preclude FCB's § 1111(b) election by calling that earlier collateral the "such property" in § 1111(b)(1)(B), despite that the collateral with respect to which FCB made its § 1111(b) election was different from that earlier collateral and will be retained by the Debtor under the Plan.

To arrive at its novel approach, the Debtor assets that the bankruptcy court should treat as one the two groups of collateral—one sold more than a year earlier and one still retained by the Debtor. But doing so will rewrite § 1111(b)(1)(B)(ii) to prevent a recourse creditor such as FCB from making a § 1111(b) election when **any** of the creditor's collateral is sold at any time in the case. Doing so creates an unwarranted opportunity for a cunning debtor to sell some piece of its secured creditor's collateral—anything, really—early in a Chapter 11 case so that the secured creditor is deprived of its right to make its § 1111(b) election with respect to the remaining collateral.

Section 1111(b) was enacted in 1978 as part of the Bankruptcy Code to remedy a lender's valuation risk associated with the debtor's cram down power under the former Bankruptcy Act. Enactment of § 1111(b) was a reaction to cases such as *Great Nat'l Life Ins. Co. v. Pine Gate Assocs., Ltd.*, 2 B.C.D. 1478 (Bankr. N.D. Ga. 1977). In *Pine Gate*, the court allowed the debtor to retain property subject to a secured, nonrecourse note by paying the creditor only the fair market value of the property. The *Pine Gate* decision was criticized for imposing the entire risk of undervaluation of the collateral on the secured creditor while permitting the debtor to secure the exclusive benefits of any future appreciation of the collateral. *See In re Woodridge North Apts., Ltd.*, 71 B.R. 189 (Bankr. N.D. Cal. 1987).

"[T]he reason for the inclusion of the exception contained in section 1111(b)(1)(B)(ii) is that a secured creditor who has the opportunity to protect his position by bidding his debt at a sale of his collateral and recovering his collateral, has the benefit of his bargain and requires no special protection." *In re Waterways Barge P'ship*, 104 B.R. 776, 782 (Bankr. N.D. Miss. 1989). It is the under-secured creditor's opportunity to take the collateral by credit bid that is key to the sale exception in § 1111(b)(1)(B)(ii) because without that right, the under-secured creditor still bears the risk of undervaluation. *Woodridge North Apts.*, 71 B.R. at 192-93.

The case law regarding § 1111(b) makes it clear that the sale exception in § 1111(b)(1)(B)(ii) applies only where the under-secured creditor is allowed to credit bid and recover **the collateral in question**. *Woodridge*, 71 B.R. at 192-93 ("The draftsmen of the Code clearly intended to protect the … undersecured creditor in Chapter 11 reorganizations *only* if the creditor *is not permitted* to purchase the collateral at a sale or if the debtor intends to retain the collateral after bankruptcy and not repay the debt in full") (emphasis in original; internal citation excluded). That is this case.

FCB has no opportunity to obtain the portion of its collateral being retained by the Debtor—completely different collateral from what was sold in the credit bid sale. By depriving FCB of the full benefits of its § 1111(b) election, the Debtor seeks to retain for its sole benefit any future appreciation of FCB's collateral while denying FCB the right to payment in full. This is precisely the situation that § 1111(b) was enacted to remedy. The "property" to which FCB's election pertained was the "property" retained by the Debtor under the Plan, not the old property sold in the credit bid sale a year earlier. The collateral retained under the Plan is not "such property … sold … under [Bankruptcy Code § 363] or … to be sold under the plan." 11 U.S.C. § 1111(b)(1)(B)(ii). Under the plain meaning of the text, the sale exception of § 1111(b)(1)(B)(ii) does not apply here.

Also, the "sale exception" of § 1111(b)(1)(B)(ii) is phrased in the future (or at best, present) tense. The express language of § 1111(b)(2) provides that the election cannot be made if such collateral: (a) "**is** sold"; or (b) "**is to be** sold under the plan" (emphasis added). The language and the implication are equally clear: **FCB's collateral, retained by the Debtor under the Plan, was not sold and was not going to be sold.** The Debtor's interpretation of § 1111(b)(1)(B)(ii) so as to ignore the word "such," applying the sale exception to the sale of **any** collateral **at any time**. An interpretation of a statute that renders any of its words superfluous is disfavored. *United States v. Nordic Village, Inc.*, 503 U.S. 30, 35-36 (1992) ("a statute must, if possible, be construed in such fashion that every word has some operative effect").

The approach the Debtor wants this Court to adopt severely impairs FCB's rights under the Plan and under the Bankruptcy Code. It is inconsistent with Congress' clear statutory language and incompatible with common sense.

CONCLUSION

For the reasons set forth above, FCB respectfully requests that the Court deny confirmation of the Plan.

UNITED STATES BANKRUPTCY COURT
DISTRICT OF ARIZONA

In re IRONIC AUTO RENTALS, INC., Debtor.	Chapter 11 Case No. 2:12-bk-99999-XYZ **RESPONSE TO FIRST CONVENTIONAL BANK'S OBJECTION TO DEBTOR'S CHAPTER 11 REORGANIZATION PLAN**

The above-captioned debtor-in-possession (the "**Debtor**"), files this Response to *First Conventional Bank's Objection to Debtor's Chapter 11 Reorganization Plan* (the "**Objection**"), filed by First Conventional Bank ("**FCB**"), and respectfully submits the following:

RESPONSE

In support of this Response, the Debtor incorporates the *Statement of Facts* filed with respect to the Plan.

FCB purchased a portion of its collateral through a consensual sale under Bankruptcy Code § 363. By its express terms, § 1111(b)(1)(B)(ii) precludes FCB position from electing treatment under § 1111(b)(2). Specifically, § 1111(b)(1)(B)(ii) provides that:

> A class of claims may not elect application of paragraph (2) of this subsection if – the holder of a claim of such class has recourse against the debtor on account of such claim and such property is sold under section 363 of this title or is to be sold under the plan.

Id.

If the statute's language is plain, then the Court should enforce the statute according to its terms. *See U.S. v. Ron Pair Enters.*, 489 U.S. 235, 241 (1989). The Ninth Circuit has held that bankruptcy provisions must be interpreted according to their plain meaning "except in the rare cases [in which] the literal application of a statute will produce a result demonstrably at odds with the intention of its drafters." *Arden v. Motel Partners*, 176 F.3d 1226, 1229 (9th Cir.1999); *see also In re Chamberlain*, 369 B.R. 519, (Bankr. D. Ariz. 2007).

Section 1111(b)'s language is crystal clear. If a creditor has recourse against the debtor and that creditor's collateral has been sold in accordance with § 363, the creditor "may not elect application of § 1111(b)(2)." 11 U.S.C. § 1111(b)(1)(B)(ii). Because FCB has recourse against the Debtor under its loan documents and a portion of its collateral was sold during the bankruptcy case under § 363, the Bankruptcy Code expressly prohibits FCB's right to make the election.

Section 1111(b)'s legislative history makes this point abundantly clear. The House and Senate expressly stated that:

> Sale of property under section 363 or under the plan is excluded from treatment under section 1111(b) because of the secured party's right to bid in the full amount of his allowed claim at **any** sale of collateral under section 363(k) of the House Amendment. 124 Cong. Rec. H11, 104 (daily ed., Sept. 28, 1978); 124 Cong. Rec. S17, 420 (daily ed., October 6, 1978) (emphasis added).

These statements by Congress support that a secured creditor like FCB is precluded from making the 1111(b) election where **any** portion if its collateral is sold under § 363. There is no distinction between situations in which part or all of the collateral is sold. To the extent the legislative history makes that distinction (which it does not), it is clear from the House and Senate statements that **any** credit bid sale under § 363(k) is sufficient to preclude the creditor's § 1111(b)(2) election.

Moreover, equitable principals forming the foundation of § 1111(b) and the entire Bankruptcy Code further demonstrate that FCB no longer has the right to make the election and be fully secured. "[T]here is an overriding consideration that equitable principles govern the exercise of bankruptcy jurisdiction." *Bank of Marin v. England*, 385 U.S. 99, 103 (1966). These broad equitable principles are reflected in 11 U.S.C. § 105(a), which authorizes a bankruptcy court to "issue any order, process or judgment that is necessary or appropriate to carry out the provisions of this title." The United States Supreme Court has long held that bankruptcy courts, as courts of equity, possess broad authority to modify creditor-debtor relationships. *United States v. Energy Resources Co., Inc.*, 495 U.S. 545, 549 (1990).

Congress enacted § 1111(b) in response to the decision in *Great Nat'l Life Ins. Co. v. Pine Gate Associates, Ltd.*, 2 B.C.D. 1478 (Bankr. N.D. Ga. 1977), a Bankruptcy Act case. In *Pine Gate*, the court allowed the debtor to retain property subject to a secured, nonrecourse note by paying the creditor only the fair market value of the property as determined by the court. The *Pine Gate* decision was criticized on two grounds. One, the case placed the entire risk of collateral undervaluation on the secured creditor. *See also In re Woodridge North Apts., Ltd.* 71 B.R. 189, 189-91 (Bankr. N.D. Ca. 1987) (discussing history and purpose of § 1111(b)). And two, it permitted the debtor to secure for itself the exclusive benefits of any future appreciation of the collateral. *Id.* This last point can be significant where the value of the collateral is temporarily depressed at the time of the court's determination of value. *Id.*

Section 1111(b)(1)(A) was intended to overrule *Pine Gate* and eliminate these inequities. *Id*. It allows a secured creditor to require repayment in full of its claim, notwithstanding the collateral's value on the effective date of the plan. In other words, there is no bifurcation of the claim as provided under § 506(a) when a creditor makes the elections. By virtue of the election, secured creditors now have the opportunity to protect their interests and capture future "upside" appreciation of their collateral.

When a creditor's collateral is sold under § 363, however, the collateral upon which that upside may be realized by a debtor is gone forever -- the creditor gets all the upside. Put another way, when a creditor's interest in future appreciation is protected by its ability to purchase the collateral, that creditor does not need, and is not entitled to, the protections of § 1111(b)(2). Sections 363(k) and 1111(b)(2) are, therefore, alternative and exclusive methods for protecting a creditor's interest in collateral. Allowing the election when collateral has been sold to a creditor through a credit bid, would contradict the very purposes behind §§ 363(k) and 1111(b)(2), and allow the secured creditor the benefits of both provisions at the expense of the estate. The creditor obtains a double recovery by securing the value of its collateral through direct ownership and requiring the debtor to pay it the value of such collateral, even though the creditor holds the collateral.

That is exactly what FCB want to do here. When the case was filed, the Debtor had approximately $1.45 million in vehicles securing the $3.75 million FCB debt. This equates to a $2.3 million deficiency claim. After selling nearly 48% of its highly collectible vehicle fleet to FCB, the Debtor held only $850,000 in vehicles securing FCB's $3.15 million remaining claim -- an approximately $2.3 million deficiency. But at least 48% of that remaining deficiency claim (or approximately $1,104,000) pertains to the collateral already sold to FCB. **So if FCB has the right to make the election under these circumstances, then (1) the estate is burdened with repayment of FCB's claim, including the deficiency attributable to vehicles FCB now owns, and (2) FCB gets the benefit of any appreciation for the vehicles it now owns**. This result is inequitable because it ensures FCB a double recovery at the expense of the Debtor and this estate.

CONCLUSION

FCB has chosen to purchase a portion of its collateral to reap the benefits of that property's future appreciation. FCB now wants more. The Court should overrule the Objection and bifurcate FCB's secured claim as proposed under the Plan.

2013 ARIZONA STATE BAR ANNUAL CONVENTION
Friday, June 21, 2013

NINTH CIRCUIT UPDATE ON *STERN V. MARSHALL*

PRESENTERS

Scott Brown

Justin Henderson

RECENT *STERN v. MARSHALL* DECISIONS

IN THE NINTH CIRCUIT

- *Executive Benefits Insurance Agency v. Arkison (In re Bellingham Insurance Agency, Inc.)*, 702 F.3d 553 (9th Cir. 2012). Holding that (a) the bankruptcy court lacked constitutional authority to enter final judgment on a fraudulent conveyance claim; (b) the right to an Article III judge is waivable and a litigant may impliedly consent to bankruptcy court's authority to enter final judgment in a "core" proceeding over which the bankruptcy court otherwise lacks constitutional authority; (c) appellant impliedly consented to adjudication by Article I bankruptcy judge by failing to object to bankruptcy judge's authority to enter final judgment either before the bankruptcy court or during appellant's appeal to the district court, at which point the Ninth Circuit's *Stern v. Marshall* decision had already been published, thereby alerting appellant "to the possible jurisdictional problem"; and (d) even if appellant had not impliedly consented by failing to object once it was aware of potential constitutional issues, a bankruptcy court is authorized to enter proposed findings of fact and conclusions of law for review by the district court even where the bankruptcy court lacks constitutional authority to enter final judgment.
  - While the waiver/consent issue may be settled in the Ninth Circuit (for now), the Sixth Circuit has held that a party cannot waive its objection to entry of a final judgment by an Article III court because the objection "implicates not only . . . personal rights, but also the structural principle advanced by Article III," which cannot be waived. *See Waldman v. Stone*, 698 F.3d 910 (6th Cir. 2012).
  - A petition for certiorari was filed in *Bellingham* on April 3, 2013.
- *In re Washington Coast I, L.L.C.*, 485 B.R. 393 (2012). Bankruptcy Court had constitutional authority enter a final judgment in a lien priority dispute between two competing creditors, even if lien priority depended upon interpretation of state law statute and cases. Furthermore, even if Court did not have constitutional authority to enter final judgment, appellant waived right to Art. III judge by not raising objection until it filed an appeal, and possibly by appealing to the BAP instead of the district court. (Note that the 1st Circuit BAP has also suggested that appealing to the BAP instead of the district court constitutes consent to entry of judgment by a bankruptcy judge in *In re Traverse*, 485 B.R. 815 (1st Cir. BAP 2013)).
- *In re Sunra Coffee, LLC*, 2012 WL 3590754 (9th Cir. BAP Aug. 21, 2012) (slip copy). Recognizing that *Stern* was a "narrow" holding limited to "one isolated respect" of the Bankruptcy Court's "core" jurisdiction that did not implicate a bankruptcy court's subject matter jurisdiction, and rejecting appellant's "broad" argument that *Stern* limits "the authority of Article I courts to adjudicate private rights disputes").
- *In re Deitz*, 469 B.R. 11 (9th Cir. BAP 2012) ("Even in the few cases we have located suggesting an expansive interpretation of *Stern*, the courts generally limit their concerns to those actions in bankruptcy courts that seek to augment the bankruptcy estate at the

expense of third parties, primarily fraudulent conveyance avoidance actions. . . . In contrast to the decisions of these courts, a significant majority of decisions rendered since *Stern* follow Chief Justice Robert's admonition that the decision be applied narrowly.").

- *In re Advanced Beauty Solutions, LLC*, 2012 WL 603692 * 7 (9th Cir. BAP February 8, 2012) (recognizing narrow scope of *Stern*; *Stern* does not implicate questions of subject matter jurisdiction; "CirTran's failure to raise its [constitutional right] concerns until this appeal is a formidable problem." (quoting *United States v. Oloana*, 507 U.S. 725, 731 (1993) ("'No procedural principal is more familiar to this Court than that a constitutional right,' or a right of any other sort, 'may be forfeited . . . by the failure to make timely assertion of the right before a tribunal having jurisdiction to determine it.'")).

- *In re Cedar Funding, Inc.*, 2012 WL 3309683, *8 (N.D. Cal. Aug. 13, 2012). ("This court agrees with the majority view on this issue: even if *Stern* prohibits a bankruptcy court from entering final judgement [sic] in a particular statutorily core proceeding, the bankruptcy courts may still hear the proceeding and submit proposed findings to the district court.").

- *Loomis v. Hunter, Humphrey & Yavitz, PLC*, 2012 WL 3064496 (D. Ariz. July 27, 2012) (bankruptcy court may initially adjudicate dispositive motions, oversee pretrial matters and enter proposed findings of fact and conclusions of law even when it could not enter final judgment).

- *Olivie Development Group, LLC v. Park*, 2012 WL 1536207 (W.D. Wash. Apr. 30, 2012) (*Stern* did not prevent bankruptcy court from entering final order determining what was property of the estate)

- *In re Heller Ehrman LLP*, 464 B.R. 348 (N.D. Cal. 2011). Holds that bankruptcy court lacks authority enter final judgment on fraudulent conveyance claims because it is like the claims in *Northern Pipeline* and *Granfinanciera* (claim "at common law that simply attempts to augment the bankruptcy estate"); but also holds that bankruptcy court can hold onto the case, hold the trial, and submit proposes findings of fact and conclusions of law. "Since Congress delegated broader authority to bankruptcy courts in core matters than non-core matters, 28 U.S.C. § 157(b)(1), (c)(1), and the delegation included the authority to hear and determine all cases and enter appropriate orders, 28 U.S.C. § 157(b)(1), there appears to be no reason why bankruptcy courts cannot continue to hear all pre-trial proceedings and enter as an appropriate order proposed findings of fact and conclusions of law in the manner authorized by Section 157(c)(1)." To do otherwise, would "meaningfully" change the division of labor between the bankruptcy courts and district courts.

- *Samson v. Western Capital Partners LLC (In re Blixseth)*, 463 B.R. 896 (Bankr. D. Mont. 2012). Holding that (a) *Stern* does not implicate a bankruptcy court's subject matter jurisdiction and (b) bankruptcy court can submit proposed findings of fact and conclusions of law even on those core issues it does not have constitutional authority to enter final judgment on under *Stern*. In this decision, the court retracted its prior opinion in *In re Blixseth*, 2011 WL 3274042 (Bankr. D. Mont. Aug. 1, 2011).

- *In re Old Cutters, Inc.*, 474 B.R. 219 (Bankr. D. Idaho June 18, 2012) (J. Pappas). Action by secured creditor to determine the avoidability of a competing creditor's lien was within bankruptcy court's constitutional authority, where it was of "particular import" that competing creditor "filed a proof of claim…*and asserted a lien*" and where secured creditor sought to determine the "validity, extent, and priority" of that lien on the debtor's property.

Some of the original Supreme Court cases:

1. ***Northern Pipeline Construction Co. v. Marathon Pipe Line Co.*, 458 U.S. 50 (1982)**:

Reviews background of Act to Code history. "The bankruptcy courts can hear claims based on state law as well as those based on federal law."

Northern filed a petition in 1980. Shortly thereafter Northern filed in the bankruptcy court a suit against Marathon, seeking damages for alleged breaches of contract and warranty, as well as for alleged misrepresentation, coercion, and duress.

Marathon moved to dismiss the suit on the ground that the Act unconstitutionally conferred Art. III judicial power upon judges who lacked life tenure and protection against salary diminution. The U.S. intervened to defend the validity of the statute.

Section 157 did not exist at the time.

Northern made two arguments that the Act was constitutional: (1) Congress has the power to establish a legislative court and a bankruptcy court is legislative; and (2) bankruptcy courts are "adjuncts" and parties can appeal to Art. III court, so there are no constitutional concerns.

As to the first argument, the Court said that Congress has created and the courts approved three types cases which have upheld the constitutionality of legislative courts and administrative agencies: (1) territorial courts; (2) courts-martial; and (3) cases involving "public rights".

"The distinction between public rights and private rights has not been definitively explained in our precedents. Nor is it necessary to do so in the present cases, for it suffices to observe that a matter of public rights must at a minimum arise 'between the government and others.' In contrast, 'the liability of the one individual to another under the law as defined,' is a matter of private rights."

Footnote 23 says the same thing and has the "famous quote" from *Murray's Lessee* (1856 case) -- i.e. Congress cannot "withdraw from [Art. III] judicial cognizance any matter which, from its nature, is the subject of a suit at the common law, or in equity, or admiralty." The Court continues: "And it is also clear that even with respect to matters that arguably fall within the scope of the 'public rights' doctrine, the presumption is in favor of Art. III courts.").

"***But the restructuring of the debtor-creditor relations***, which is at the core of the federal bankruptcy power, must be distinguished from the adjudication of state-created private rights, such as the right to recover contract damages that is at issue in this case. The former may well be a 'public right,' but the latter obviously is not. Appellant Northern's right to recover contract damages to augment its estate is 'one of private right, that is, of the liability of one individual to another under the law as defined.'" *Stern* reiterated that the Court had never actually intended to "suggest that the restructuring of debtor-creditor relations is in fact a public right," so that question remains open today, despite this broad statement in *Marathon*. And Justice Scalia's concurring opinion suggests that he would take a much narrower view of what constitutes a "public right." He says that, in his view, "an Article III judge is required in *all* federal adjudications, unless there is a firmly established historical practice to the contrary."

Back to *Marathon*: As to the second argument, the extent to which Congress may constitutionally vest traditionally judicial functions in non-Art. III officers, there are two principles that must be followed: (1) Congress possesses substantial discretion to prescribe the manner in which a federal right *created by Congress* may be adjudicated; and (2) the functions of the adjunct must be limited in such a way that "the essential attributes" are retained in the Art. III court. If it is not a right "created by Congress" then Congress doesn't have discretion to assign traditionally judicial power to adjuncts. (i.e. there's a critical difference between rights created by federal statute and rights recognized by the Constitution).

Holding: 28 U.S.C. § 1471, as added by §241(a) of the Bankruptcy Act of 1978, has impermissibly removed most, if not all, of 'the essential attributes of the judicial power' from Art. III district court, and has vested those attributes in a non-Art. III adjunct.

2. *Granfinanciera, S.A. v. Nordberg*, 492 U.S. 33 (1989):

"There can be little doubt that fraudulent conveyance actions by bankruptcy trustees-suits, which we said in *Schoenthal* 'constitute no part of the proceedings in bankruptcy but concern controversies arising out of it'–are quintessentially suits at common law that more nearly resemble state-law contract claims brought by a bankruptcy corporation to augment the bankruptcy estate than they do creditors' hierarchically ordered claims to a pro rata share of the bankruptcy res. Therefore they appear matters of private rather than public right."

3. ***Katchen v. Landy*, 382 U.S. 323 (1966)**:

The Court holds that the bankruptcy court had authority to enter final judgment on preference lawsuit (such as it was back then) because bankruptcy courts (1) "characteristically proceed in summary fashion to deal with the assets of the bankrupt they are administering," and (2) have the "power and obligation to consider objections by the trustee in deciding whether to allow claims against the estate." The real key to the *Katchen* decision is whether the defendant filed a proof of claim *and* is the recipient of a voidable transfer. "[W]hen a bankruptcy trustee presents a[n] . . . objection to a claim [on the grounds that the creditor has received a voidable preference], the claim can neither be allowed nor disallowed until the preference matter is adjudicated."

a. "When the same issue arises as part of the process of allowance and disallowance of claims, it is triable in equity."

b. “The bankruptcy courts ‘have summary jurisdiction to adjudicate controversies relating to property over which they have actual or constructive possession.’ . . . This is elementary bankruptcy law.”

4. *Langenkamp v. Culp*, 498 U.S. 42 (1990):

The Court reaffirmed *Katchen*, holding that a preferential transfer claim can be heard in bankruptcy court “when the allegedly favored creditor has filed a claim because *then* ‘the ensuing preference action by the trustee become[s] integral to the restructuring of the debtor-creditor relationship.’’

Langenkamp, *Katchen*, and *Granfinanciera* are the source of *Stern*’s rule that a bankruptcy court can only enter a final judgment on a state law counterclaim if it is “resolved in the process of ruling on a creditor’s proof of claim.”

5. *Central Virginia Community College v. Katz*, 546 U.S. 356 (2006)

This case provides guidance as to which matters are fundamental and thus fall within the bankruptcy court’s constitutional authority: “Critical features of every bankruptcy proceeding are the exercise of exclusive jurisdiction over all of the debtor’s property, the equitable distribution of that property among the debtor’s creditors, and the ultimate discharge that gives the debtor a ‘fresh start’ by releasing him, her or it from further liability for old debts.”

2013 ARIZONA STATE BAR ANNUAL CONVENTION
Friday, June 21, 2013

COMPARATIVE ISSUES REGARDING CASH COLLATERAL AND DEBTOR-IN-POSSESSION FINANCING

PRESENTERS

Honorable Margaret M. Mann

John Harris

Frederick Petersen

Bryce Suzuki

COMPARATIVE ISSUES REGARDING
CASH COLLATERAL AND DEBTOR IN POSSESSION FINANCING

1. General Comparative Issues

    a. Differences between Cash Collateral and DIP Financing as vehicles to fund working capital

    b. Cash Collateral

        i. Simpler than DIP Financing

        ii. Limited to amount and timing of actual collections

            -- may not meet working capital or other funding needs

        iii. New debt not added to case

        iv. Procedurally easier than DIP Financing - in particular adequate protection issues

            -- preservation of status quo

            -- replacement liens often sufficient

            -- scope of collateral often does not expand

        v. In Cash Collateral context, the lender may have less leverage to achieve other goals compared to DIP Financing

    c. DIP Financing

        i. Operates as a loan, can provide more regularized working capital funding than Cash Collateral

        ii. Can be secured by post-petition liens - including priming liens, superpriority claims, other protections

        iii. Adequate protection requirements generally higher than Cash Collateral

        iv. Creditor may be able to obtain other protections or advantages

2. Cash Collateral - Some Specifics

    a. Things the creditor may ask for:

        i. Acknowledgement of default (involvement of guarantors?)

ii. Acknowledge validity of loan documents

iii. Acknowledge validity/priority of liens

iv. Resolving amount of claim

v. Acknowledge validity of any assignments

vi. Determine secured or undersecured status

vii. Release of claims against lender (involvement of guarantors?)

-- Avoidance claims

-- Pre-petition lender liability claims

-- Offsets, defenses, counterclaims

-- Subordination or recharacterization

b. Budget issues

i. What is included in the budget

ii. What is not

iii. Variances - important to deal with this possibility/keep things simple

iv. Other restrictions/conditions

-- Restriction from challenging claims

-- Restriction from opposing relief sought by lender

c. Adequate protection in Cash Collateral context

i. Replacement liens

-- Perfection of replacement liens (court order enough or new recordings?)

-- Scope of replacement liens - generally same as pre-petition collateral

ii. Adequate protection payments

-- Allocation of payments

-- Retention of payments (indefeasible or something else?)

iii. Super-priority claim

See, e.g., *In re Loral Space & Comms. Ltd.*, No. 03-41710(RDD) (Bankr. S.D.N.Y. 2003) (granting a superpriority claim as part of Cash Collateral Order)

-- Effectiveness if case converted

-- Priority of the claim

iv. Determination that adequate protection not subject to priming, subordination, or other challenge

d. Financial reporting/access to information/access to estate assets

i. How much is required

ii. Other devices to obtain same information

e. Waiver of surcharge rights

f. Require written consent from lender for various actions (or court approval?)

i. Generally applicable to matters that affect collateral position

ii. Broader limitations can become more problematic

g. Events of default - stop use of Cash Collateral

h. Automatic stay relief upon certain events/defaults

See, e.g., *In re FCX, Inc.* 54 B.R. 833 (Bankr. E.D.N.C. 1985) (granting stay relief upon default but allowing Debtor to move for injunctive relief)

i. Stipulations binding on Debtor, other parties, Committee, Trustee, etc.

i. Must understand how "binding" provisions of a Cash Collateral Order are on constituencies other than creditor and Debtor

See, e.g., *In re Velocita*, No. 02-35895 (DHS) (Bankr. D.N.J. 2002) (binding third parties)

ii. Reluctance of courts to "bind" other constituencies

j. Series of Interim Orders vs. Final Order?

k. Impact of local rules

i. Limits on "first day" relief

ii. "Finality" of protections in "first day" Orders

3. DIP Financing - Some Specifics

a. Budget/variance/covenants

i. Approval of various expenditures

ii. Rights often broader than Cash Collateral

b. Reporting

i. Financial reports

ii. Roll forward budget

iii. Status of BK efforts

iv. Meeting performance benchmarks required under DIP

c. Facility fee/extension fees/attorneys' fees

i. Easier than Cash Collateral but subject to scrutiny

See, e.g., In re Defender Drug Stores, Inc., 145 B.R. 312 (B.A.P. 9th Cir. 1992) (approving enhancement fee)

ii. "Market data" to establish reasonableness

d. Security

i. Priming lien?

-- Heightened requirements to obtain - "lien of last resort"

See, e.g., In re Stoney Creek Tech., LLC, 364 B.R. 882, 890 (Bankr. E.D. Pa. 2007) (Section 364(d) "permits the priming of an existing lien only as 'a last resort'")

ii. First lien?

iii. Roll-up

-- Issue for DIP lenders who are pre-petition lenders

-- Disfavored - in particular in early stages

See, e.g., *In re Carley Capital Group*, 128 B.R. 652 (Bankr. W.D. Wis. 1991) (disallowing a roll-up of prepetition fees and expenses); *but see In re Tower Automotive, Inc.*, No. 05-10578 (ALG) (Bankr. S.D.N.Y. 2005) (approving a $725 million DIP Financing, $425 million of which was to be used to refinance a prepetition debt owed to DIP lender)

e. Superpriority

f. Post-petition lien perfection

i. Reliance on DIP Order

ii. Formal lien perfection may be indicated, and should be provided for

g. Include adequate protection for pre-petition lenders?

i. Continuing operation of the Debtor enough?

See, e.g., *In re Tempe Land Co., LLC*, 2009 WL 1211622 (Bankr. D. Ariz. 2009) (Debtor's predictions regarding enhanced value not enough); *In re Lagoon Breeze Dev. Corp.*, 2011 WL 939016 (Bankr. S.D. Cal. 2011) (DIP loan that allowed Debtor to complete and sell condos would increase prepetition lender's collateral by $4 million)

ii. Monitoring of collateral values

iii. Other types of adequate protection

h. Remedies upon default

i. Termination of funding

ii. Stay relief?

iii. Automatic or contingent on further proceedings

iv. How "expedited" can stay relief be?

v. Other effects

i. Waivers or findings with respect to pre-petition conduct

j. Cross-collateralization

k. Liens on Article 5 causes of action

   i. Disfavored

   See, e.g., Del. Bankr. Ct. Loc. R. 4001-2(a)(2)(D) (requiring justification for lien on Art. 5 causes of action)

   ii. Are they a source of real potential value

l. Surcharge waivers

   i. Often easier than Cash Collateral

   ii. Need for specificity

m. Carve-outs

   i. Debtors/Committee/US Trustee/Other Administrative Claimants?

   ii. How much

   iii. Who benefits

   iv. "Absolute" carve-out or subject to non-availability of other payment sources

   v. Methods to limit - use of operating budget as source for professional payment during case

n. Provisions affecting Debtor's business operations

   In re Ames Dep't Stores, Inc., 115 B.R. 34 (Bankr. S.D.N.Y. 1990) (focusing on "proposed terms that would tilt the conduct of the bankruptcy case"), *In re Defender Drug Stores, Inc.*, 145 B.R. 312, 319 (BAP 9th Cir. 1992), and *In re Tenney Village Co., 104 B.R. 562, 568 (Bank. D.N.H. 1989)*

o. Second liens

4. Some Comparative Considerations

   a. When liens (particularly priming liens) are required, adequate protection requirements can be much higher - not just preserving status quo but must also protect primed lienholders from added risk of senior lien, possible default by borrower, and loss of collateral arising from DIP default

See, e.g., *In re Chevey Devco*, 78 BR 585 (Bankr. C.D. Cal. 1987) (DIP loan must provide the prepetition secured creditor with the same level of protection it would have had if there had not been a priming lien); *In re Thurston Highland Assocs.*, 2010 WL 148683 (Bankr. W.D. Wash. 2010) (57% equity cushion insufficient in light of risks)

b. Adequate protection has been difficult in current recession - property values decreasing, little or no equity in property

c. Combinations of Cash Collateral and DIP can be used to meet funding needs, which may reduce amount of DIP needed (and lessen threats to other positions)

d. Do not back parties into unnecessary corners - if Debtor operating and even minimally viable, likely a way will be found to keep it operating for some period

e. DIP roll-ups and other devices to make pre-petition debt post-petition DIP debt - risks and considerations

f. DIP can provide for "compensated due diligence"

g. DIP can allow DIP lender to "lock up" case (or otherwise give DIP lender substantial leverage) through repayment requirements and protections of DIP funding and Orders

h. Intercreditor issues that can come into play - have creditors agreed pre-petition on Cash Collateral or other funding issues?

i. Effect of Cash Collateral and DIP structures on unsecured creditors and other constituencies

2013 ARIZONA STATE BAR ANNUAL CONVENTION
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CONSUMER BANKRUPTCY CASE LAW UPDATE

PRESENTERS

Honorable Eileen W. Hollowell

Trudy Nowak

2013 STATE BAR OF ARIZONA CONVENTION

JUNE 21, 2013

ARIZONA BILTMORE, SCOTTSDALE, AZ

CONSUMER CASE LAW UPDATE

Presented by

Hon. Eileen W. Hollowell
United States Bankruptcy Judge, District of Arizona
and
Trudy A. Nowak, Esq.
Trudy A. Nowak, P.C. and Bankruptcy Trustee

DISMISSAL FOR ABUSE

***Ng v. Garmer (In re Ng)*, 477 B.R. 118 (9th Cir. BAP 2012)**
Appeal from District of Hawaii
Judges Pappas, Jury and Hollowell
Affirming the bankruptcy court, the Ninth Circuit BAP held that when ruling on a motion to dismiss for abuse under 11 U.S.C. § 707(b)(3)(B), the court did not abuse its discretion when it disallowed the debtor's monthly retirement contributions, repayment of a pension loan, and payment of a pre-petition tax debt, as an adjustment to income when evaluating the totality of the circumstances criteria set forth in *In re Price*, 353 F.3d 1135 (9th Cir. 2004). The BAP held that debtors must establish a reasonable need for the pension plan contributions and loan repayments, or the bankruptcy court may consider them to be abusive under the totality of the circumstances. The BAP also found that the bankruptcy court may properly consider changes in the debtor's circumstances, and events affecting their income and expenses, that occur between the time of the petition and the time of any decision on an 11 U.S.C. § 707(b) motion. The Panel stated that based on the plain text of 11 U.S.C. § 707(b)(1), the ability to repay creditors is based on the debtor's circumstances at the time of discharge, and that a bankruptcy judge's discretion to consider post-petition changes in a debtor's circumstances in examining the totality of the circumstances in making its final determination on a request for dismissal under § 707(b)(3)(B) is not limited by Bankruptcy Rule 1017(b)(3)(B).

EXEMPTIONS

***In re Altick*, Slip Copy, 2012 WL 5503429 (9^{th} Cir. BAP 2012)**
Appeal from N.D. Cal.
Judges Pappas, Markell and Hollowell

The Ninth Circuit BAP held that the bankruptcy court did not clearly err in finding that the debtor acted in bad faith in asserting his amended claim of exemption in an LLC. In this converted chapter 11 to chapter 7 case, the debtor disclosed his interest in an LLC, stated it had no value or equity in light of liens, and he claimed no exemption for his LLC interest. After conversion, he testified likewise at the chapter 7 341 meeting of creditors. Thereafter, the trustee received an offer for the debtor's interest in the LLC; after the sale motion was filed, the debtor amended Schedule C to claim his interest in the LLC exempt. The trustee argued the debtor acted in bad faith by filing an amendment only after he learned his interest would be sold. The Panel stated that a bankruptcy court may disallow an exemption on a showing of bad faith by the debtor or prejudice to creditors, and mentioned the most common examples are when debtors attempt to conceal an asset. The BAP held that bad faith can also be found where a debtor provides a false value regarding a disclosed asset. As a result, the BAP found that the bankruptcy court did not clearly err when it found the debtor had engaged in bad faith where the debtor misrepresented the value to creditors to induce them to support his chapter 11 plan during the chapter 11 portion of the case and declined to allow the debtor an opportunity to exempt the value of the LLC to be realized by the trustee in the chapter 7 sale.

***In re Stanton*, 457 B.R. 80 (Bankr. D. Nev. 2011)**
To successfully limit debtor's state law homestead exemption rights, under 11 U.S.C. § 522(o), limiting debtor's homestead exemption to the extent of any value of the homestead attributable to fraudulent conversion of nonexempt assets, creditor or trustee must show the following: (1) an increase in value of debtor's homestead; (2) that this increase was attributable to disposition of nonexempt assets; (3) that disposition was effected with intent to hinder, delay or defraud creditor; and (4) that disposition occurred within ten years prior to petition date. Son's payoff of mortgage on debtor's Nevada home less than ten years before her individual Chapter 11 filing, using portion of funds that she distributed to him from sale of certain nonexempt assets, could be collapsed with debtor's conversion of nonexempt assets into funds distributed to son, for purpose of establishing that increase in value of debtor's homestead was attributable to disposition of her nonexempt property, where debtor made distribution to son with understanding that he would use portion of funds to pay off her mortgage, at time when she feared imminent garnishment of nonexempt assets by judgment creditor; accordingly, to extent that debtor acted with requisite fraudulent intent, her homestead rights could be limited by 11 U.S.C. § 522(o).

***In re Tober*, 688 F.3d 1160 (9th Cir. 2012)**
Appeal from Bankrutpcy Court, District of Arizona, and BAP
Interpreting Arizona law, the Circuit held that a debtor may exempt the cash surrender value of life insurance policies and the proceeds of annuity contracts if the contract names his or her child as the beneficiary, even if the child is an adult and no longer a dependent. Case focuses on the placement of the adjectives “other” and “dependent” at the end of the clause of potential beneficiaries that allow the debtor to claim the exemption.

***In re Mohammadpour*, Case No. 4-11-bk-17790-JMM**
Memorandum Decision dated February 6, 2012
Judge Marlar concluded that Arizona’s opt-out exemption statute renders nonresident debtors ineligible for the state exemptions but does not prohibit them from utilizing the Federal exemptions pursuant to § 522(b)(3) and (d). The “hanging paragraph” of 11 U.S.C. § 522(b)(3)

states: "[I]f the effect of the domiciliary requirement . . . is to render the debtor ineligible for any exemption, the debtor may elect to exempt property that is specified under subsection (d)" of § 522. Debtors resided in Arizona from 2000 to May 16, 2011. On May 17, 2011, they moved permanently to Massachusetts and were residing there on the filing date. The Debtors lived in Arizona for the 180 days immediately preceding the 730-day period. Debtors filed Chapter 7 in Arizona on June 21, 2011 and claimed the Federal exemptions since they believed they were ineligible for Arizona exemptions because they resided in another state on the petition date. The Trustee contended that the Arizona exemptions were available to the nonresident Debtors because (1) A.R.S. § 33-1133(B) did not explicitly prohibit their use by nonresidents, and (2) opt-out state statutes have extraterritorial application. The Court discussed 11 U.S.C. § 522(b)(3)(A) and case law which holds that, even if the domiciliary state's opt-out statute is limited to residents, before the debtor can utilize the Federal exemptions, which are only available in case the debtor is ineligible for "any exemption," the state exemption statute must not be extraterritorial. The Court held that even assuming that A.R.S. § 33-1125 has extraterritorial effect, the exemption is limited to Arizona residents since Arizona's opt-out statute limits the state exemptions to residents of Arizona.

***In re Garcia*, Case No. 2:12-bk-12443-DPC**
Memorandum Decision dated March 6, 2013 by Judge Curley
The Chapter 7 Trustee objected to Debtors' exemption in a vehicle prior bringing a preference action and argued that avoidance of vehicle lien preserves the lien for the benefit of the estate over the Debtors' claimed exemption and that the Debtor may only claim an exemption to the extent that an value exceeds the lien. The Debtor argued that the estate does not succeed to an "avoided lien" if the lien itself is not valid due to lender's failure to properly perfect its lien. Judge Collins held that failure to comply with the relevant Arizona statutes for perfection of a lien in a vehicle renders the lien unperfected and "not valid *against the creditors* of an owner," but this does not render the lien wholly invalid. To the extent that a secured lender has a valid security agreement but fails to perfect its interest on the certificate of title, the Trustee prevails.

***In re Sutton Robinson*, Case No. 4:11-bk-16753-JMM**
Memorandum Decision dated March 19, 2012
Debtor's exemption in IRA funds transferred four years prepetition to a non-IRA account mistakenly by broker was upheld since the funds were traceable and were held not to be impermissible distributions. The Court held that the funds were repaid to the original IRA account and that the Debtor's IRA never ceased being an IRA, even where the Debtor did not obtain an IRA determination on this issue. The Court considered the events of the case to be procedural error rather than a failure of a fundamental requirement of the Internal Revenue Code, capable of being cured.

ALLOWANCE OF ATTORNEY FEES

Applicable Bankruptcy Code provisions:
11 U.S.C. § 327(a) permits trustees and debtors-in-possession to employ attorneys, but does not apply to debtor's counsel in Chapter 7. *Lamie v. United States*, 540 U.S. 526, 124 S. Ct. 1023 (2004).

11 U.S.C. § 330(a)(4)(B) permits reasonable compensation for representing individuals in Chapter 12 and 13 cases.
11 U.S.C. § 329 requires: (1) the counsel disclose amount and source of compensation; (2) that fees be reasonable.
Implemented by Rule 2014 (applicant must disclose services to be rendered, any connections to creditors and debts); Rule 2016 (governs what must be included in employment application, including disclosures required by § 329(a)
Failure to disclose under § 329, Rules 2014 and 2016 can be grounds for sanction. *In re Park-Helena,* 63 F.2d 877 (9th Cir. 1995).
11 U.S.C. § 330 governs compensation, with factors including: (1) time spent on services; (2) rate charged; (3) whether services were necessary or beneficial toward case completion; (4) whether time spent was reasonable in light of complexity, important, and nature of problems; (5) whether party performing is board certified; (6) whether completion was reasonable. *See In re Kerry Lewis*, 2012 WL 5880467 (Bankr. N.D.N.Y. Nov. 20, 2012)

Chapter 13 Attorney Fees in Arizona:

- Flat fee is permitted under G.O. 106 (effective June 1, 2012) <u>or</u> counsel may apply for fees pursuant to § § 329 and 330
- If counsel charging flat fee wishes to charge for extra work <u>post-confirmation</u>, time records in support of application must be provided from <u>inception</u> of case.
- For cases commenced btwn. Dec. 1, 2009 and Aug. 12, 2012, Local Rule 2084-3 applies and permits flat fee and additional flat fees for <u>post-confirmation</u> services
- *Cope*, 4-09-4215-JMM: Hourly fee application for $6,500 allowed, but "henceforth all Chapter 13 plans must be confirmed within one year of filing."
- *Davis*, 4-09-04318-JMM: Denied attorney's request for balance of flat fee where counsel withdrew prior to plan confirmation.

Chapter 7

- *Cope*, 4-09-4215-JMM: Hourly fee application for $6,500 allowed, but "henceforth all Chapter 13 plans must be confirmed within one year of filing."
- *Davis*, 4-09-04318-JMM: Denied attorney's request for balance of flat fee where counsel withdrew prior to plan confirmation.
- *Glimcher et. al.,* 2-11-15333-RJH: Prepetition retainer paid from prepetition property that was not applied by counsel to prepetition services deemed estate property. "Earned upon receipt" (EUR) retainer, either non-refundable or advanced payment, permissible if overall fee is reasonable. EUR must explicitly state that retainer is non-refundable "in terms intelligent to the client" (citing Ariz. Ethics Op. 99-02). EUR retainer not client funds but belongs to attorney, so not estate property. Security retainer is client funds held by attorney to secure payment of future legal service and remains property of client.

CHAPTER 11 ABSOLUTE PRIORITY RULE IN INDIVIDUAL CASES

***In re Friedman*, 466 B.R. 471 (9th Cir. BAP 2012)**
Appeal from Bankrutpcy Court, District of Arizona
Judges Kirscher, Clarkson, with Jury dissenting

The 2005 changes have produced a huge split among courts with respect to whether the new language of § 1129(b)(2)(B)(ii) trumps the absolute priority rule that immediately precedes it. The Ninth Circuit BAP has held that by its plain terms, the "absolute priority" rule is inapplicable in Chapter 11 cases filed by individual debtors, such that debtors' retention of their equity interests in businesses that they started up prepetition does not prevent them from "cramming down" a plan that would result in less than a 100% distribution on unsecured claims. Other courts taking the "broad view" and ruling that Congress intended abrogation of the absolute priority rule in individual Chapter 11 cases. *See SPCP Group, LLC v. Biggins,* 465 B.R. 316 (M.D.Fla.2011); *In re Shat,* 424 B.R. 854 (Bankr.D.Nev.2010); *In re Johnson,* 402 B.R. 851 (Bankr.N.D.Ind.2009); *In re Tegeder,* 369 B.R. 477 (Bankr.D.Neb.2007); *In re Roedemeier,* 374 B.R. 264 (Bankr.D.Kan.2007); *In re Bullard,* 358 B.R. 541 (Bankr.D.Conn.2007).
Courts taking the "narrow view" and ruling that BAPCPA did not abrogate the absolute priority rule in its entirety for individual Chapter 11 debtors. *See In re Maharaj*, 681 F.3d 558 (4th Cir. 2012); *In re Arnold,* 471 B.R. 578, 2012 WL 1820877 (Bankr.C.D.Cal. May 17, 2012); *In re Tucker,* 2011 WL 5926757 (Bankr.D.Or.2011); *In re Borton,* 2011 WL 5439285 (Bankr.D.Idaho 2011); *In re Lindsey,* 453 B.R. 886 (Bankr.E.D.Tenn.2011); *In re Kamell,* 451 B.R. 505 (Bankr.C.D.Cal.2011); *In re Draiman,* 450 B.R. 777 (Bankr.N.D.Ill.2011); *In re Maharaj,* 449 B.R. 484 (Bankr.E.D.Va.2011); *In re Walsh,* 447 B.R. 45 (Bankr.D.Mass.2011); *In re Stephens,* 445 B.R. 816 (Bankr.S.D.Tex.2011); *In re Karlovich,* 456 B.R. 677 (Bankr.S.D.Cal.2010); *In re Steedley,* 2010 WL 3528599 (Bankr.S.D.Ga.2010); *In re Gelin,* 437 B.R. 435 (Bankr.M.D.Fla.2010); *In re Mullins,* 435 B.R. 352 (Bankr.W.D.Va.2010); *In re Gbadebo,* 431 B.R. 222 (Bankr.N.D.Cal.2010).

STANDING IN MORTGAGE CASES

The Basics:

* Securitized Pool: A collection of mortgage loans held by a trustee in trust as collateral for securities sold to investors. Created when a lender originates a loan secured by the house that the borrower buys with the loan proceeds and then transfers the loan to one or more intermediary companies which bundle the mortgages and transfer them pursuant to a pooling and servicing agreement (PSA).
* The Players: When a mortgage held in a securitized pool becomes delinquent and/or the borrower files for bankruptcy, a number of different parties may seek to enforce the remedies provided for in the note and deed of trust signed by the borrower. The following parties frequently file pleadings in bankruptcy cases:
    * A) Trustee of the securitized pool;
    * B) The servicer under the PSA;
    * C) MERS (Mortgage Electronic Recording System), the "nominal" beneficiary listed on the deeds of trust (DOT) governing many mortgages in the pool
* Standing:* Federal court may exercise jurisdiction over a litigant only when litigant shows (a) constitutional and (b) prudential standing. Constitutional standing requires a showing of injury in fact, causation, and redressability. Prudential standing embodies judicially self-imposed limits on jurisdiction, which Real Party in Interest doctrine most important for mortgage cases. Pursuant to Fed. R. Civ. P. 17(a)(1), an action must be prosecuted in the name of the real party in interest.

* Motion for Relief from Automatic Stay:* A party seeking stay relief pursuant to § 362(d) must show that it has a colorable claim against the property. A party may do so by establishing that it is a holder of the mortgage note, a "person entitled to enforce" the mortgage note, or that it holds some ownership interest in the mortgage note.
* Proof of Claim (POC):* Commonly filed by a servicer retained pursuant to a PSA. Servicer must show that it has an agency relationship with a "person entitled to enforce" the mortgage note that serves as the basis for the proof of claim. If the servicer fails to do so, then the servicer has failed to establish standing.
* Assignment of the DOT into the pool had to be recorded: Rejected in Vasquez v. Saxon Mortg., Inc., 228 Ariz. 357, 266 P.3d 1053 (2011). Arizona Supreme Court held that assignments do not have to be recorded
* Party seeking relief from stay or filing POC must have original note: Rejected in Hogan v. Wash. Mut. Bank, 277 P.3d 781 (Ariz. 2012).
* Note and DOT were not properly or timely delivered to pool under terms of PSA: Rejected in Connelly v. U.S. Bank Nat'l Assoc. (In re Connelly), __ B.R. __, 2013 Bankr. LEXIS 484 (Bankr. D. Ariz. Feb. 6, 2013); Correia v. Deutsche Bank Nat'l Trust Co., 452 B.R. 319 (1st Cir. BAP 2011). Borrower is not a party to or third-party beneficiary of a PSA.
* MERS is fraudulent; MERS has no power as a "nominal" beneficiary to foreclose a DOT: Rejected in Cervantes v. Countrywide Home Loan, 656 F.3d 1034 (9th Cir. 2011).
* MERS members conspired to commit fraud by naming MERS as a sham beneficiary: Rejected in Cervantes; Nevada ex rel Bates v. MERS, 2012 WL 4058052 (9th Cir. Sept. 17, 2012); . Under Arizona law, civil conspiracy must be based on underlying tort, and plaintiffs have not ever identified misrepresentations made about MERS during loan origination.

TRUSTEE COMMISSIONS

***In re Salgado-Nava*, 473 B.R. 911 (9th Cir. BAP 2012)**

Absent extraordinary circumstances, under 11 U.S.C. § 330(a)(7), a trustee is entitled to the commission listed in 11 U.S.C. § 326, and not a cap. Chapter 7 trustees are no longer required to satisfy the *Johnson* factors found in 11 U.S.C. § 330(a)(3). Overruling the Bankruptcy Court, the BAP held that the fee requested by Chapter 7 trustee, in statutorily allowable amount based on distributions in case, should not have been reduced in absence of any extraordinary circumstances, based solely on bankruptcy court's determination that this statutory fee was not reasonable in light of time which trustee spent on case and nature of services rendered; where case was admittedly a typical Chapter 7 case and there were no unusual circumstances, fee had to be allowed in amount requested.

PROPERTY OF THE ESTATE

***In re Blixseth*, 684 F.3d 865 (9th Cir. 2012)**

Appeal from Bankruptcy Court, District of Montana and BAP
Judges Gould, Bybee and Bea

Debtor filed chapter 11, which was converted to Chapter 7, but did not file a Statement of Intention with respect to personal property and the Trustee did not seek a determination that the property was of value or benefit to the estate. A creditor filed several stay-relief motions to liquidate its collateral. The motions were granted and the creditor began liquidating the collateral. The trustee objected to one of the sales, arguing that the automatic stay did not terminate under § 362(h) on all of the collateral, but only the collateral identified in Debtor's schedules. The Ninth Circuit affirmed the BAP's decision that under § 362(h), all personal property secured by a scheduled debt (regardless of how or even if personal property securing a debt is scheduled) is released from the automatic stay and removed from the bankruptcy estate if a debtor fails to timely file and comply with her statement of intention.

***In re Zukerkorn*, 484 B.R. 182 (9th Cir. BAP 2012)**
Debtor was beneficiary of spendthrift trust that included a choice of law provision that designated Hawaii as the jurisdiction whose laws would be applicable. Debtor was receiving regular income from the trust but indicated in his schedules that his interest had no value and did not claim it as exempt. Trustee sought turnover of the entire principal and all income from the trust, claiming that the spendthrift clause was invalid because Debtor was both the trustee and beneficiary of the trust. Alternatively, Trustee argued that the postpetition income distributions were property of the estate under § 541(a)(5)(A). The BAP held that § 541(c)(2) excludes the corpus of the trust from property of the estate. As for the postpetition distribution of income to the debtor, the BAP held that § 541(a)(5)(A) does not apply to inter vivos trusts pursuant to *In re Neuton*, 922 F.2d 1379, 1384 n.6 (9th Cir. 1990).

AVOIDANCE OF LIEN - 522(f)

***In re Kuiken*, 484 B.R. 766 (9th Cir. BAP 2013)**
Debtor acquired property in 2003 and a judgment lien was recorded on the property in 2009. Debtor transferred property to LLC for valuable consideration in 2011. Several months later, the LLC granted a deed to the property to Debtor as a gift. Debtor filed a Chapter 7 weeks after the deed was recorded and motioned to avoid the previously recorded judicial lien on his residence under § 522(f). BAP found that because Debtor had transferred and then reacquired the property, he acquired a different interest when he reacquired the property. This new interest was acquired after the judicial lien was fixed and therefore he acquired the property subject to the lien.

STERN V. MARSHALL FALL-OUT

***Rosenberg v. Bookstein,* 2012 WL 4361255 (D. Nev. Sept. 21, 2012)**
Judge Du held that the bankruptcy court lacks constitutional authority under *Stern* to enter final judgment on statelaw fraudulent-conveyance claims, but denied the motion to withdraw the reference as premature. Article III permits a bankruptcy judge to issue proposed findings of fact and conclusions of law. The court rejected defendants' argument that the bankruptcy court lacks jurisdiction to even hear the fraudulent conveyance claims.

PROOF OF CLAIM OBJECTION/STANDING CHALLENGE

***In re Allen*, 472 B.R. 559 (9th Cir. BAP 2012)**
Original promissory note signed by Debtors was lost by original lender. Loss was evidenced by a lost-note affidavit from president of original lender that explained that the original note was missing and had attached to it a copy of the original DOT note copy that was endorsed in blank. Debtors filed an objection to a POC filed by a subsequent note assignee, arguing that the party filing the proof of claim was not a "real party in interest." The BAP held that the lost note affidavit, which the party that filed the POC had in its possession and physically presented to the bankruptcy court, was sufficient to establish the party's status as holder of the note, entitling it to file a POC in the amount owing on the DOT debt.

TURNOVER OF TAX REFUNDS

***In re Newman*, 487 B.R. 193 (9th Cir. BAP 2013)**
Appeal from D. Nev.
Judges Jury, Kirscher and Dunn
Debtor argued that because he spent the tax refunds, they were no longer in his "possession, custody or control" and he could not be ordered to turn them over under 11 USC § 542. The Bankruptcy Appellate Panel for the Ninth Circuit affirmed the decision of the Bankruptcy Court holding that, although the Debtor had spent a tax refund prior to the entry of an order for turnover under Bankruptcy Code Section 542, he was liable to the Chapter 7 Trustee for the value of the refund despite lack of present possession of the property. The Court held that § 542 does not require the debtor to have current possession of the property which is subject to turnover. "If a debtor demonstrates that [he] is not in possession of the property of the estate or its value at the time of the turnover action, the trustee is entitled to recovery of a money judgment for the value of the property of the estate."

TRUSTEE LIEN AVOIDANCE

Daff v. Wallace (In re Cass), 9th Cir. BAP, April 11, 2013 (BAP No. CC-12-1513-KiPaTa)
Chapter 7 Trustee, who avoided fraudulent transfer of the Debtor's Residence, took property subject to judgment lien, even though at the time the abstract of judgment was recorded, the Debtor had previously (fraudulently) transferred title. "The Debtor held an equitable interest in the Residence at the time the Judgment Creditors recorded their abstract, and that equitable interest was subject to attachment by her creditors. Because their perfected judgment lien attached to [the Debtor's] equitable interest in the Residence pursuant to CCP § 697.340(a), Trustee took the Residence subject to the Judgment Creditors' senior interest when he avoided and recovered it, . . . and [thus] Trustee must apply the sale proceeds from the Residence to satisfy the Judgment Creditors' claims against [the Debtor]. The Trustee had previously been permitted to pay administrative expenses from the sale proceeds. Creditors sued Debtor for nuisance and defamation. During the litigation, the Debtor transferred her Residence to her daughter for no consideration, reserving a life estate, and with her daughter's agreement that the Residence would be transferred back upon request of the Debtor. Creditors then also filed a

fraudulent transfer action against the Debtor and her daughter. Creditors obtained a judgment in the nuisance lawsuit, including punitive damages, which the Debtor appealed. Judgment Creditors recorded an abstract of judgment against the Debtor, although the Debtor had already transferred title to her Residence. After Debtor filed a chapter 7 petition, the chapter 7 trustee substituted into the fraudulent transfer action and removed it to bankruptcy court, and obtained a stipulated judgment avoiding the transfer of the Residence. The Debtor then died, which resulted in a dismissal of the then pending appeal of the state court judgment. The Trustee then filed a declaratory relief action that Judgment Creditors did not have a lien on the Residence. The Trustee sold the Residence, with the disputed lien attaching to the sale proceeds, and paid administrative expenses out of the sale proceeds. The bankruptcy held a trial and ruled that the Debtor held equitable ownership of the Residence at the time of the recording of the abstract, such that when the Trustee avoided the transfer, the Residence came into the estate subject to the judgment lien. This was true notwithstanding the fact that that the Judgment Creditors had not expressly argued that a constructive trust or resulting trust should be imposed on the Residence. BAP affirmed.

AVOIDANCE OF FRAUDULENT TRANSFER

In re Meza, Case No. 2-10-bk-11800-RJH, Decision dated February 9, 2012
Judge Haines held that the mere change of the designated beneficiary of a term life insurance policy, without a change in the ownership of policy, is not a "transfer of an interest of the debtor in property," since under Arizona law the beneficiary of a term life insurance policy has no vested interest in the policy until the death of the insured.

CHAPTER 13

***In re Welsh*, -- F.3d --, 2013 WL 1192961 (9th Cir. 2013)**
Appeal from D. Mont. and BAP, affirming both
Judges Ripple, Trott and Paez
The Ninth Circuit rejected the trustee's arguments that in determining whether the debtors proposed their Chapter 13 plan in good faith, the bankruptcy court should have considered the amount that the debtors were paying to secured creditors for luxury items (such as expensive homes, cars or other items) and also should have considered debtors' Social Security income. The Ninth Circuit refused to conclude that a plan prepared completely in accordance with the very detailed calculations that Congress set forth in BAPCPA is not proposed in good faith and said to hold otherwise would be to allow the bankruptcy court to substitute its judgment of how much and what kind of income should be dedicated to the payment of unsecured creditors for the judgment of Congress. A good faith inquiry cannot encompass considerations of what income, and how much income, a debtor is devoting to the proposed plan. The Circuit distinguished between a 11 U.S.C. § 1325(a)(3) good faith analysis which includes whether: (1) the debtor has misrepresented the facts, manipulated the Bankruptcy Code or filed in an inequitable manner; (2) the debtor's history of bankruptcy filings; (3) the debtor intended to frustrate collection of a state-court judgment; and (4) "egregious behavior is present," i.e., the debtor's motivation and forthrightness with the court in seeking relief, and a 11 U.S.C. § 1325(b)(1)(B) disposable

income requirement, which focuses on the amount of funds that Congress expects a debtor to devote to paying off unsecured creditors. These two inquiries were found to be separate and distinct. The Circuit concluded that consideration of disposable income—now defined in great detail by Congress—has no role in the good faith analysis. Further, it concluded that the calculation of disposable income requires debtors to subtract their payments to secured creditors from current monthly income without limit or qualification as to the kinds of secured payments subtracted. In this case, he above-median income chapter 13 debtors' home was worth $400,000 and encumbered by a secured claim of $330,593. The debtors owned three vehicles, only one of which was worth more than the secured claim against it. They also owned two ATVs, each of which was worth $2,700. One was encumbered by a secured claim of $3,065, and the other by a secured claim of $4,500. In addition, they owned a 2005 Airstream trailer valued at $23,000, encumbered by a secured claim of $39,000. In addition to these secured debts, the debtors owed approximately $180,500 in unsecured debt, the largest of which was their daughter's student loan debt of $60,000. The debtor-wife had a monthly income of $6,975.40, and drew a monthly pension of $1,100. The debtor-husband was retired, but listed a monthly income of $358.03 from wages, as well as Social Security income of $1,165. According to the Means Test, the debtors had monthly disposable income of $218.12.

***In re Lepe*, 470 B.R. 851 (9th Cir. BAP 2012)**
Appeal from E.D. Cal.
Judges Pappas, Dunn and Markell
Mere fact that, apart from debt owed to junior mortgagee whose lien he proposed to "strip off," debtor had only $549 in unsecured debt, and that plan was allegedly proposed solely for purpose of "strip off," did not preclude confirmation of plan as lacking requisite "good faith."
It is of no moment to court, in deciding whether proposed Chapter 13 plan satisfies "good faith" confirmation requirement, that a single factor may be indicative of bad faith, or that specific plan feature is not consistent with spirit of Chapter 13 or may indicate manipulation of the Bankruptcy Code; factors indicating good and bad faith may not be considered in isolation, but must always be weighed against totality of circumstances in each case. Among factors that bankruptcy court may consider in deciding whether Chapter 13 plan has been proposed with requisite "good faith" are the following: (1) amount of proposed payments and amount of debtor's surplus; (2) debtor's employment history, ability to earn, and likelihood of future increases in income; (3) plan's probable or expected duration; (4) accuracy of plan's statements of debts, expenses and percentage of repayment of unsecured debt, and whether any inaccuracies constitute an attempt to mislead court; (5) extent of preferential treatment between classes of creditors; (6) extent to which secured claims are modified; (7) type of debt sought to be discharged, and whether any such debt is nondischargeable in Chapter 7; (8) existence of special circumstances, such as inordinate medical expenses; (9) frequency with which the debtor has sought bankruptcy relief (10) motivation and sincerity of debtor in seeking Chapter 13 relief; and (11) burden which the plan's administration would place on trustee. As part of totality of circumstances bearing on whether Chapter 13 plan has been proposed with requisite "good faith," court may consider the following: (1) whether debtor has misrepresented facts in his petition or plan, unfairly manipulated the Bankruptcy Code, or otherwise filed his petition or plan in inequitable manner; (2) debtor's history of bankruptcy filings and dismissals; (3) whether debtor, in filing for bankruptcy, only intended to defeat state court litigation; and (4) whether debtor engaged in egregious behavior

***Parks v. Drummond (In re Parks),* 475 B.R. 703 (9th Cir. BAP 2012)**
Above-median chapter 13 Debtors relied on § 541(b)(7)(A) to propose making voluntary postpetition 401(k) contributions and deduct those payments from monthly income. Trustee objected, arguing that postpetition contributions were not authorized for calculating disposable income under § 1325(b)(2). BAP held that § 541(b)(7) only provides that prepetition contributions shall not constitute income and does not allow debtors to exclude postpetition retirement contributions when calculating disposable income. BAP reasoned that such an interpretation is supported by § 1306(2), a substantial amount of case law, and Congress' intent when amending BAPCPA.

***In re Salazar*, 465 B.R. 875 (9th Cir. BAP 2012)**
After filing chapter 13, Debtors received and spent tax refunds, a portion of which were based upon prepetition income, that were property of the estate under § 541. Debtors did not file a plan and case was converted to Chapter 7. Trustee filed a motion to compel Debtors to turn over the prepetition refund, but bankruptcy court denied the motion because the prepetition refund had already been spent and was no longer property of the estate pursuant to § 348(f)(1)(A). BAP affirmed the holding of the bankruptcy court and found that the plain meaning of § 348 (f)(1)(A) excluded the prepetition refund from property of the Chapter 7 estate because Debtors had already spent it.

***In re Renteria*, 470 B.R. 838 (9th Cir. BAP 2012)**
Debtor filed chapter 13 and proposed to pay in full, with 10% interest, one unsecured claim that was a consumer debt guaranteed by her mother. Plan proposed to pay all other unsecured claims nothing. Trustee objected to the plan but the bankruptcy court overruled the objection and confirmed, holding that preferential treatment of a co-debtor consumer claim is not subject to § 1322(b)(1)'s prohibition against unfair discrimination. Relying on legislative history for § 1322(b)(1) and the cases mentioned therein (*In re Utter*, 3 B.R. 369 (Bankr. W.D.N.Y. 1980); *In re Montano*, 4 B.R. 535 (Bankr. D.D.C. 1980)), BAP held that by use of the "however" clause in § 1322(b)(1), Congress sought to permit a chapter 13 debtor to separately classify and prefer a co-debtor consumer claim when the facts are similar to those presented in *In re Utter* and *In re Montano*.

***In re Benafel*, 461 B.R. 581 (9th Cir. BAP 2011)**
Debtor purchased a home in 1996 and used it as her principal residence until 2009. The promissory note only required that she use the property as her principal residence for one year. Debtor filed a Chapter 13 in 2010 and proposed to make monthly payments to the lender in full satisfaction of its allowed secured claim, basing the monthly payment on the current value of the property instead of the loan value. Lender objected to Debtor's attempt to cram down by arguing that § 1322(b)(2) prohibits Debtor from modifying claim solely secured by principal residence. BAP held that the time to determine whether property is Debtor's principal residence for purpose of § 1322(b)(2) is the petition date and not the time the loan was made, allowing Debtor to cram down the amount of Lender's claim.

***Danielson v. Flores (In re Flores),* 692 F.3d 1021 (9th Cir. 2012)**

Debtors filed chapter 13 and proposed a three-year plan even though they were above median income. Trustee objected to the plan and the bankruptcy court sustained the objection, confirming a five-year plan. Ninth Circuit held that the bankruptcy court could confirm a three-year plan for above-median debtors where there is no projected disposable income, even though the applicable commitment period is five years under § 1325(b)(4)(A)(ii). In its finding, the court relied on *Hamilton v. Lanning*, 130 S. Ct. 2464 (2010), for use of a forward-looking approach for projected disposable income, and on *Maney v. Kagenveama*, 541 F.3d 868 (9th Cir. 2008), for the proposition that the "applicable commitment period" is inapplicable to a plan submitted by a debtor with no "projected disposable income." The opinion contains a detailed recitation of statutory and case law.

SERVICE OF LIEN STRIP MOTIONS/ADVERSARY PROCEEDING COMPLAINTS

***In re Zimmer*, 313 F.3d 1220 (9th Cir. 2002)**

Bankruptcy Code's antimodification protection under 1322(b)(2) is only available to holders of secured claims, and so a wholly unsecured lien on a primary residence may be avoided in a Chapter 13 proceeding.

***In re Millspaugh*, 302 B.R. 90 (Bankr. D. Idaho 2003)**

Judge Myers

When a Chapter 13 debtor wishes either to strip down or strip off a creditor's lien, the ultimate responsibility of proving that notice was properly given and that relief is warranted is on the debtor. To meet the requirements of the bankruptcy rules and comply with considerations of due process, a motion to value a secured claim, either within or without a Chapter 13 plan, must be served on the affected creditors in accord with the rule governing the service of process, and debtor must file an appropriate certificate of service reflecting compliance with the rule; simply mailing the plan and notice of confirmation under the rule governing notices to parties in interest will not be sufficient, unless the master mailing list (MML) contains an address for the affected creditor that complies with the requirements of the rule governing service of process compliant service and notice is required not just for those creditors whose liens are to be stripped off by a Chapter 13 debtor; such service is also required to strip down a creditor to the value of its lien.

***In re Olson*, 2005 WL 4705071 (Bankr. D. Idaho 2005)**

Judge Pappas

Bankruptcy Court set aside a confirmation order due to the debtors' failure to properly serve a creditor under Rule 7004—there Rule 7004(h)—when attempting to strip off that creditor's lien through a motion in the chapter 13 plan. Debtors' service on HFC—which sent the Plan to a "payment processing" center or facility, and did not send it to the attention of an officer, managing agent, or an agent (such as a registered agent) authorized by law to receive service—does not comply with Rule 7004(b)(3). HFC is entitled to Rule 7004(b)(3) compliant service. Rule 7004(b)(3) provides for service by first class mail, postage prepaid:

(3) Upon a domestic or foreign corporation or upon a partnership or other unincorporated association, by mailing a copy of the summons and complaint to the attention of an officer, a managing or general agent, or to any other agent authorized by appointment or by law to receive

service of process and, if the agent is one authorized by statute to receive service and the statute so requires, by also mailing a copy to the defendant.

"That Debtors elected to send the Plan by certified mail is of no consequence. Despite the fact that many litigants seem to feel that certified mailing is somehow talismanic, it does not cure problems in the addressing of notices that violate Rule 7004. First class mail is fully adequate for corporations, provided that it is addressed and served in compliance with the commands of Rule 7004(b)(3). Certified mailing is required only under Rule 7004(h) in connection with service on insured depository institutions."

"Absent effective lien stripping, HFC's mortgage debt remains an outstanding secured claim on Debtors' residence. Such a secured claim is not provided for in the Plan under any provision of § 1325(a)(5) and, absent stripping, the provisions of § 1322(b)(2) apply. This all creates issues under § 1325(a)(1), (3) and (5)."

2013 ARIZONA STATE BAR ANNUAL CONVENTION
Friday, June 21, 2013

TAX ISSUES IN BANKRUPTCY

PRESENTERS

Tracy Essig

Michael Harrel

Gary Stickell

Rachael Zepeda

<u>Federal Taxes and Discharge</u>[1]

<u>Michael R. Harrel</u>

1. Different Types of Federal Taxes
    a. Income Tax
    b. Trust Fund Taxes
        i. I.R.C. § 6672
    c. Excise Taxes
        i. Highway use tax. I.R.C. § 4481
        ii. Estate and gift taxes
        iii. Sales taxes
        iv. Gasoline and special fuel taxes
2. The Federal Tax Assessment Process
    a. Income Tax
        i. Self-reported tax liability – immediate assessment
        ii. Deficiency procedures – IRS must issue a Notice of Deficiency for any deficiency in tax. The taxpayer may then file a Petition with the United States Tax Court, in which case, the IRS cannot assess the deficiency until the case is resolved; if the taxpayer does not file a Petition with the Tax Court, the IRS may assess after expiration of the prohibited period in I.R.C. § 6213.
3. Non-dischargeable Taxes
    a. <u>Priority Taxes</u> - Section 523(a)(1)(A)
        i. A Chapter 7 discharge does not discharge section 507(a)(8) priority taxes.
        ii. <u>Chapter 12 Discharge</u> – Section 507(a)(8) priority taxes are not discharged.
        iii. <u>Chapter 13 discharge</u> –
            1. Section 1328(a)(2) provides that section 507(a)(8) priority taxes (but not trust fund taxes under section 507(a)(8)(C)) are discharged upon entry of a discharge under section 1328(a); however section 1322(a)(2) requires that

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1 The views, opinions, and positions set forth in this document are not the official views, opinions and positions of the Internal Revenue Service or the Office of Chief Counsel.

This outline is intended as a quick reference guide. It does not include cites to all cases dealing with the issues and may not include cites to cases adverse to the propositions stated.

priority taxes (including trust fund taxes under section 507(a)(8)(C)) be paid in the plan.

2. Hardship Discharge - A discharge entered under section 1328(b) (plan not completed) does not discharge Section 507(a)(8) priority taxes.

iv. Income or gross receipts taxes

1. Three year rule - for which a return, if required, is last due, including extensions, after three years before the date of the filing of the petition. Section 507(a)(8)(A)(i).

2. Two-hundred and forty day rule – assessed within 240 days before the date of the filing of the petition, exclusive of (I) any time during which an offer in compromise with respect to that tax was pending or in effect during that 240-day period, plus 30 days; and (II) any time during which a stay of proceedings against collections was in effect in a prior case under this title during that 240-day period, plus 90 days. Section 507(a)(8)(A)(ii).

3. Unassessed but assessable – not assessed before but assessable, under applicable law or by agreement, after, the commencement of the bankruptcy case. Section 507(a)(8)(A)(iii).

4. Hanging Paragraph - An otherwise applicable time period specified in this paragraph shall be suspended for any period during which a governmental unit is prohibited under applicable nonbankruptcy law from collecting a tax as a result of a request by the debtor for a hearing and an appeal of any collection action taken or proposed against the debtor, plus 90 days; plus any time during which the stay of proceedings was in effect in a prior case under this title or during which collection was precluded by the existence of 1 or more confirmed plans under this title, plus 90 days.

v. Collected or withheld taxes - Section 507(a)(8)(C) - A tax required to be collected or withheld and for which the debtor is liable in whatever capacity. This includes liability imposed under I.R.C. § 6672 (trust fund recovery taxes), thereby codifying United States v. Sotelo, 436 U.S. 268 (1978).

vi. Employers' share of employment tax on third priority wages - Section 507(a)(8)(D) - Employers' share of employment tax on third priority wages paid under section 507(a)(3), and on wages paid before the petition date for which a return was last due (including extensions) within 3 years before the petition date, or thereafter. Tax claims which relate to wages that were earned but unpaid before the petition date and which are not entitled to third priority will be paid as general claims.

vii. Excise taxes - Section 507(a)(8)(E) - Excise taxes (which include sales taxes, estate and gift taxes, gasoline and special fuel taxes, pension plan taxes, wagering and truck taxes) on a prepetition transaction for which a return is last due (including extensions) within 3 years before the petition date, or thereafter; on a transaction occurring within 3 years before the petition date, for which no return is required.

viii. When incurred - For purposes of the section 507(a)(8) priority provisions a tax on income for a particular period is considered incurred on the last day of the taxable period; a tax on or measured by some event, such as the payment of wages, is considered incurred on the date of the transaction or event.

b. Unfiled returns - Section 523(a)(1)(B)(i) – A tax with respect to which a required return was not filed or given.

i. Flush language provides that a "return" means a return that satisfies the requirements of applicable nonbankruptcy law (including applicable filing requirements).

ii. Form 870 as a "return" – The Service at one time regarded the execution of a Form 870 (Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment) as constituting the filing of a return for purposes of I.R.C. § 6020(a). See Rev. Rul. 74-203, 1974-1 C.B. 330. See also In re Carapella, 84 B.R. 779 (Bankr. M.D. Fla. 1988) (Form 870 is a return for dischargeability purposes). However, Rev. Rul. 74-203 was revoked by Rev. Rul. 2005-59. The Service now takes the position that since a Form 870 does not purport to be a return and is not signed under penalties of perjury, it is not a return. See Rev. Rul. 2005-59, 2005-37 I.R.B. 505 (2005). Pursuant to Chief Counsel Notice CC-2006-002 (November 12, 2005), taxpayers may rely on Rev. Rul. 74-203 prior to its revocation on September 12, 2005, and the Service will not contest the dischargeability of a tax debt in bankruptcy on the basis that no return was filed if a taxpayer submitted a signed Form 870 before that date.

iii. Other Documents - The holding in Rev. Rul. 2005-59 also applies to Forms 1902-E (Report of Individual Income Tax Audit Changes) and 4549 (Income Tax Audit Changes) that are submitted after September 12, 2005. See Chief Counsel Notice CC-2006-002 (November 12, 2005). Therefore, cases holding that such forms constitute returns for dischargeability purposes should no longer be followed. See, e.g., In re Mathis, 249 B.R. 324 (S.D. Fla. 2000) (a Form 4549, which satisfies all the requirements of I.R.C. § 6020(a), constitutes a return for purposes of section 523(a)(1)(B)).

iv. Installment agreement - In In re Hatton, 220 F.3d 1057 (9th Cir. 2000), the Ninth Circuit held that neither an installment agreement nor a substitute return qualified as a return for purposes of section 523(a)(1)(B)(i). In addition to neither document being signed under penalty of perjury, the court held that neither document represented an honest and reasonable attempt to satisfy the requirements of the tax law because the debtor did not cooperate with the Service until the Service threatened to levy his wages and bank account and seize his personal property.

v. Return prepared by the IRS under I.R.C. § 6020(b) –

1. An assessment pursuant to an I.R.C. § 6020(b) return is not dischargeable, even if the taxpayer subsequently files a Form 1040. Chief Counsel Notice 2010-016;
2. State or Municipal Taxes – In re McCoy, 666 F.3d 924 (5th Cir. 2012).

c. Late-filed returns - Section 523(a)(1)(B)(ii) – A tax with respect to which a required return, report, or notice was filed, but was filed after the due date including extensions, and was filed within two years before the petition date.

d. Fraudulent returns - Section 523(a)(1)(C) - Taxes with respect to which the debtor made a fraudulent return or willfully attempted in any manner to evade or defeat such tax.

4. IRS Discharge Procedure

a. Internal Revenue Manual - http://www.irs.gov/irm/

b. Bankruptcy and Other Insolvencies. I.R.M. 5.9

i. Closing a Bankruptcy Case. I.R.M. 5.9.17

ii. Automatic Discharge System. I.R.M. 5.9.18

c. IRS no longer provides “comfort letters.” Instead, check IRS transcripts.

Department of the Treasury | Internal Revenue Service | Office of Chief Counsel

Notice

CC-2010-016

September 2, 2010

Subject:	Litigating Position Regarding the Dischargeability in Bankruptcy of Tax Liabilities Reported on Late-Filed Returns and Returns Filed After Assessment	**Cancel Date**:	Effective until further notice

Purpose

This Notice provides guidance on the application of the discharge exception under section 523(a)(1)(B)(i) of the Bankruptcy Code for a debt with respect to which a return was not filed in cases in which the taxpayer filed a Form 1040 after the due date.

Background

Pursuant to section 523(a)(1)(B)(i), an individual's bankruptcy discharge does not discharge a tax debt for which a required return was not filed. The Government successfully argued in a number of circuits that a Form 1040 filed after assessment does not qualify as a return for discharge purposes under section 523(a)(1)(B)(i). For example, In re Hindenlang, 164 F.3d 1029 (6th Cir.), cert. denied, 528 U.S. 810 (1999), the Sixth Circuit held that a document must qualify as a federal tax return under tax law to be a return for bankruptcy purposes. The court applied the test in Beard v. Commissioner, 82 T.C. 766 (1984), aff'd, 793 F.2d 139 (6th Cir. 1986), which held that if a document "contains sufficient information to permit a tax to be calculated" and "purports to be a return" and "is sworn to as such, and "evinces an honest and reasonable attempt to satisfy the law," it is a return. The Hindenlang court concluded that a Form 1040 filed after assessment serves no tax purpose and therefore was not an honest and reasonable attempt to satisfy the tax laws. Other circuits largely followed Hindenlang. See In re Payne, 431 F.3d 1055 (7th Cir. 2005); In re Moroney, 352 F.3d 902 (4th Cir. 2003); In re Hatton, 220 F.3d 1057 (9th Cir. 2000). The Eighth Circuit disagreed in In re Colsen, 446 F.3d 836 (8th Cir. 2006), holding that a document that on its face evinces an honest and reasonable attempt to satisfy the tax laws qualifies as a return, whether or not it was filed after assessment.

Section 523(a) was amended by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. The following unnumbered paragraph was added to the end of section 523(a), effective for cases filed on or after October 17, 2005:

Distribute to: X All Personnel
X Electronic Reading Room

Filename: CC-2010-016 File copy in: CC:FM:PF

> For the purpose of this subsection, the term "return" means a return that satisfies the requirements of applicable nonbankruptcy law (including applicable filing requirements). Such term includes a return prepared pursuant to section 6020(a) of the Internal Revenue Code of 1986, or similar State of local law, or a written stipulation to a judgment or a final order entered by a nonbankruptcy tribunal, but does not include a return made pursuant to section 6020(b) of the Internal Revenue Code of 1986, or a similar State or local law.

(Emphasis added.) Neither Colsen nor any of the prior decisions of the courts of appeal involved a bankruptcy case filed on or after October 17, 2005. In the dissent in Payne, Judge Easterbrook remarked that, after the 2005 legislation, an untimely return cannot lead to a discharge because of the reference to "applicable filing requirements" in the unnumbered paragraph in section 523(a). 431 F.3d at 1060. In In re Creekmore, 401 B.R. 748, 751 (Bankr. N.D. Miss. 2008), a post-October 17, 2005 case, the bankruptcy court agreed with Judge Easterbrook's dissent and concluded that any late-filed return can never qualify as a return for dischargeability purposes, unless it was prepared pursuant to I.R.C. § 6020(a). The bankruptcy court in Creekmore acknowledged that its reading of the unnumbered paragraph was harsh, but stated that debtors could avoid the problem by taking advantage of the "safe-harbor" of section 6020(a) by having the Service prepare their returns. Creekmore, 401 B.R. at 752.

Discussion

1. For bankruptcy cases filed on or after October 17, 2005, can a tax debt related to a late-filed Form 1040 be discharged?

Yes. Read as a whole, section 523(a) does not provide that every tax for which a return was filed late is nondischargeable. If the parenthetical "(including applicable filing requirements)" in the unnumbered paragraph created the rule that no late-filed return could qualify as a return, the provision in the same paragraph that returns made pursuant to section 6020(b) are not returns for discharge purposes would be entirely superfluous because a section 6020(b) return is always prepared after the due date. It is a cardinal principle of statutory construction that a statute should be construed so that no clause, sentence or word is rendered superfluous. Kawaauhau v. Geiger, 523 U.S. 57, 62 (1998) (refusing to read one provision of the Bankruptcy Code to render another superfluous).

Section 523(a)(1)(B)(ii) provides that an individual's bankruptcy discharge does not discharge a debt for which a return was filed after the last date, including any extension, the return was due, and after two years before the date of the filing of the petition in bankruptcy. The Creekmore reading would limit the application of section 523(a)(1)(B)(ii) to cases in which the Service prepares a return for the taxpayer's signature under section 6020(a) of the Internal Revenue Code. By presuming that Congress intended to limit section 523(a)(1)(B)(ii)'s long-standing discharge exception for debts with respect to which a late return was filed more than two years before bankruptcy to the minute number of cases in which the Service prepares a return for the taxpayer's signature under section 6020(a), the Creekmore reading also contradicts a special rule for interpreting the Bankruptcy Code. As the Supreme Court stated in Dewsnup v. Timm, 502 U.S. 410, 419 (1992), "This Court has been reluctant to accept arguments that would interpret the Code, however vague the particular language under consideration might be, to effect a major change in pre-Code practice that is not the subject of at least some discussion in the legislative history." Finally, the supposed "safe harbor" of section 6020(a) is illusory. Taxpayers have no right to demand that the Service prepare a return for them under that provision. We, therefore, conclude that section 523(a) in its totality does not create the rule that every late-filed return is not a return for dischargeability purposes.

2. Whether or not a Form 1040 filed after assessment is a return under nonbankruptcy law, is the related tax debt dischargeable?

No. A debt for the portion of a tax that was assessed prior to the filing of a Form 1040 is nondischargeable under 523(a)(1)(B)(i). The debt is not dischargeable because a debt assessed prior to the filing of a Form 1040 is a debt for which is return was not "filed" within the meaning of section 523(a)(1)(B)(i).[1]

For bankruptcy discharge purposes, an income tax for any given year can be partially dischargeable and partially nondischargeable. Section 523(a)(1)(A), together with section 507(a)(8)(A), excepts debts for priority taxes from discharge. Section 507(a)(8)(A) includes three alternative rules that confer priority (and nondischargeability) on income taxes. Two of those rules clearly allow priority to apply to only a portion of the tax for a given year. Section 507(a)(8)(A)(ii) generally confers priority (and nondischargeability) to income taxes that were assessed within 240 days of the bankruptcy petition. If only a portion of a year's income tax was assessed within the 240-day period, only that portion would be excepted from discharge. Section 507(a)(8)(A)(iii) generally confers priority (and nondischargeability) to income taxes that were unassessed but assessable after the bankruptcy case was filed. If only a portion of the income tax for a given year was unassessed but assessable, only that portion would be excepted from discharge. For discharge purposes, therefore, a given income tax is divided into dischargeable and nondischargeable debts if a criterion for discharge applies only to a portion of the tax.

As with section 523(a)(1)(A), a tax liability for any given year can be divided into dischargeable and nondischargeable debts under section 523(a)(1)(B)(i). Section 523(a)(1)(B)(i) excepts from discharge any "debt" for a tax with respect to which a return was not "filed." For bankruptcy discharge purposes, a debt for an income tax recorded by an assessment should be considered independently of any part of the tax for the same tax year that may be assessed later. If at the time of assessment no return has been filed, then the debt recorded by that assessment is a debt with respect to which a return was not filed and section 523(a)(1)(B)(i) applies to except it from discharge. If the taxpayer later files a Form 1040 that reports an additional amount of tax, only the portion of the tax that was not previously assessed would be a dischargeable debt based upon that subsection. The portion of a tax that was assessed before a Form 1040 was filed would be a debt for which no return was "filed" within the meaning of section 523(a)(1)(B)(i), because at the time of assessment the debtor had not met the filing requirements for that portion of the tax and the assessed portion was not calculated based upon the tax reported on the Form 1040. The assessed portion of the tax was a debt for a tax that was legally enforceable by lien or levy before any return was filed. In the case of a debtor who files a Form 1040 after assessment reporting no more tax than was previously assessed, no portion of the tax would be a dischargeable debt.

Conclusion

A Form 1040 is not disqualified as a "return" under section 523(a) solely because it was filed late. Regardless of whether a Form 1040 filed after assessment is a "return" for tax purposes, the portion of a tax that was assessed before the Form 1040 was filed is nondischargeable under

[1] Accordingly, whether a late-filed Form 1040 is a "return" – the issue addressed in Hindenlang and other cases on section 523(a)(1)(B)(i) – is irrelevant.

section 523(a)(1)(B)(i). All bankruptcy cases involving application of the discharge exception under section 523(a)(1)(B)(i) to cases involving a Form 1040 filed after assessment should be coordinated with Branch 5, Office of the Associate Chief Counsel (Procedure and Administration). Questions about this Notice should be directed to Branch 5 at (202) 622-3620.

/s/

Deborah A. Butler
Associate Chief Counsel
(Procedure & Administration)

Department of the Treasury | Internal Revenue Service | Office of Chief Counsel

Notice

CC-2006-002

November 22, 2005

Subject: Litigating Position Regarding the Definition of Returns for Bankruptcy Discharge Purposes

Cancel Date: Effective until Further Notice

Purpose

This Notice provides guidance regarding the Service's position in contesting the dischargeability of a tax debt in bankruptcy on the basis that no return was filed when a taxpayer has signed and submitted a Form 870, Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment.

Background

The four part test set forth in *Beard v. Commissioner*, 82 T.C. 766, 777-78 (1984), *aff'd*, 793 F.2d 139 (6th Cir. 1986), is the proper test for determining what constitutes a valid return for purposes of the internal revenue laws or regulations. For a document to be considered a valid return, the document must:

(1) purport to be a return;
(2) be executed under penalties of perjury;
(3) contain sufficient data to allow calculation of tax; and
(4) represent an honest and reasonable attempt to satisfy the requirements of the tax law.

In Rev. Rul. 74-203, 1974-1 C.B. 330, the Service held that a Form 870 signed by the taxpayers, husband and wife, in response to a proposed substitute for return is a return of the taxpayers for purposes of section 6020(a) of the Internal Revenue Code. Relying upon Rev. Rul. 74-203, some bankruptcy courts have held that execution of a waiver may constitute the filing of a return for purposes of Bankruptcy Code section 523(a)(1)(B) even though the document is not executed under penalties of perjury. *See*, *e.g.*, *In re Carapella*, 84 B.R. 779, 782 (Bankr. M.D. Fla. 1988) (Form 870); *In re Mathis*, 249 B.R. 324, 327 (S.D. Fla. 2000) (Form 4549, Income Tax Examination Changes); *In re Lowrie*, 162 B.R. 864, 867 (Bankr. D. Nev. 1994) (Form 1902-B, Report of Individual Income Tax Changes).

On September 12, 2005, the Service, in Rev. Rul. 2005-59, 2005-37 I.R.B. 505, revoked Rev. Rul. 74-203, and clarified when documents prepared or executed by the Service under section 6020, or waivers on assessment, constitute valid returns. Rev. Rul. 74-203 is inconsistent with *Beard* and the cases cited therein on what constitutes a return because a Form 870 does not purport to be a

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Other ______
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return and is not executed under penalties of perjury.

Position

Taxpayers are entitled to rely on Rev. Rul. 74-203 prior to its revocation. The Service will not contest the dischargeability of a tax debt in bankruptcy on the basis that no return was filed if a taxpayer submitted a signed Form 870 before the revocation of Rev. Rul. 74-203 on September 12, 2005. This position applies equally to the Form 1902, Report of Individual Income Tax Audit Changes (obsoleted 1988), and the Form 4549, Income Tax Examination Changes.

For bankruptcy cases filed on or after October 17, 2005, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) amends Bankruptcy Code section 523(a) to provide specifically that a “return” means a return that satisfies the requirements of nonbankruptcy law, including a return prepared under section 6020(a) or a written stipulation to a judgment or a final order entered by a nonbankruptcy tribunal, but not a return prepared under section 6020(b). In other words, this provision includes as returns documents meeting the *Beard* test, Rev. Rul. 2005-59 and signed stipulated decisions entered by nonbankruptcy courts, *e.g.*, the Tax Court.

Questions regarding this Notice should be directed to Branch 2 of the Office of Assistant Chief Counsel (Collection, Bankruptcy and Summons), at (202) 622-3620.

/s/
Deborah A. Butler
Associate Chief Counsel
(Procedure & Administration)

H
Rev. Rul. 2005-59, 2005-37 I.R.B. 505, 2005-2 C.B. 505, 2005 WL 2001151 (IRS RRU)

Internal Revenue Service (I.R.S.)
IRS RRU

Revenue Ruling

VALID RETURN; ELECTION TO FILE JOINT RETURN

Released: August 22, 2005
Published: September 12, 2005

Section 6013.--Joint Returns of Income Tax by Husband and Wife

This revenue ruling clarifies when documents prepared or executed by the Secretary under section 6020 of the Code, or waivers on assessment, constitute valid returns under *Beard v. Commissioner*, 82 T.C. 766 (1984), *aff'd*, 793 F.2d 139 (6th Cir. 1986), for purposes of the election to file a joint return under section 6013.

Section 6020.--Returns Prepared for or Executed by Secretary, *26 CFR 301.6020-IT: Returns prepared or executed by the Commissioner or other internal revenue officers (temporary).*

Valid return; election to file joint return. This ruling clarifies when documents prepared or executed by the Secretary under section 6020 of the Code, or waivers on assessment constitute valid returns under *Beard v. Commissioner*, 82 T.C. 766 (1984), *aff'd*, 793 F.2d 139 (6th Cir. 1986), for purposes of the election to file a joint return under section 6013. Rev. Rul. 74-203 revoked.

Valid return; election to file joint return. This ruling clarifies when documents prepared or executed by the Secretary under section 6020 of the Code, or waivers on assessment constitute valid returns under *Beard v. Commissioner*, 82 T.C. 766 (1984), *aff'd*, 793 F.2d 139 (6th Cir. 1986), for purposes of the election to file a joint return under section 6013. Rev. Rul. 74-203 revoked.

ISSUES

1. Are documents made by the Internal Revenue Service, as authorized under section 6020(b) of the Internal Revenue Code, joint returns of income tax for the husband and wife?

2. Is a document prepared by the Service under section 6020(a) and executed by a husband and wife a joint return of income tax for the husband and wife?

3. Is a Form 870 prepared by the Service and executed by a husband and wife a joint return of income tax for the husband and wife?

SITUATION 1

Taxpayers, husband and wife, failed to file a return for the 1999 tax year. A revenue agent was assigned to secure the return. The taxpayers did not provide the revenue agent all information necessary for the preparation of the return. The revenue agent made separate returns using information from other sources using tax rates applicable to married individuals filing separate returns. The taxpayers did not sign the documents made by the revenue agent.

SITUATION 2

The taxpayers, husband and wife, failed to file a return for the 1999 tax year. A revenue agent was assigned to secure the return. The taxpayers provided the revenue agent with all information necessary for the preparation of the return and expressed their intention to file a joint return. The revenue agent prepared a joint return using the information provided by the taxpayers. The taxpayers signed the joint return prepared by the revenue agent under penalties of perjury.

SITUATION 3

The taxpayers, husband and wife, failed to file a return for the 1999 tax year. A revenue agent was assigned to secure the return. The taxpayers did not provide the revenue agent all information necessary for the preparation of the return. The revenue agent did not prepare a joint return and instead prepared a Form 870, *Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment*, and the taxpayers consented to the immediate assessment of taxes for the 1999 tax year by signing the Form 870. Form 870 is not verified by a written declaration that it is made under the penalties of perjury.

LAW

In general, a document filed with the Service is treated as a return if the document: (1) contains sufficient data to calculate the tax liability; (2) purports to be a return; (3) represents an honest and reasonable attempt to satisfy the requirements of the tax law; and (4) is executed under penalties of perjury. *Beard v. Commissioner*, 82 T.C. 766, 777 (1984), *aff'd*, 793 F.2d 139 (6th Cir. 1986) (*citing Badaracco v. Commissioner*, 464 U.S. 386 (1984); *Zellerbach Paper Co. v. Helvering*, 293 U.S. 172 (1934); and *Florsheim Bros. Drygoods Co. v. United States*, 280 U.S. 453 (1930)).

Section 6013 generally authorizes a husband and wife to make a single return jointly of income tax. Section 1.6013-1(a)(1) of the Income Tax Regulations provides that a husband and wife may elect to make a joint return. Taxpayers must make an election to make a joint return on a validly filed return.

Section 6020(a) authorizes the Secretary to prepare a return for a taxpayer who fails to make and file a return if the taxpayer discloses all information necessary for the preparation of the return. If the taxpayer signs the return prepared by the Secretary, the return may be received as the taxpayer's return.

If a taxpayer fails to make a return, or makes a false or fraudulent return, section 6020(b) authorizes the Secretary to make a return from his own knowledge and from such information as he can obtain through testimony or otherwise.

Section 6065 requires that a return "shall contain or be verified by a written declaration that it is made under the penalties of perjury."

Joint return filing status under section 6013(a) is predicated on the husband and wife making an election and intending to file a joint return. Accordingly, the Service may not elect joint filing status on behalf of taxpayers in a return it prepares and signs under the authority of section 6020(b).*See Millsap v. Commissioner*, 91 T.C. 926 (1988), *acq. in result*, 1991-2 C.B. 1 (filing status used by IRS in preparing return under section 6020(b) does not bind taxpayers in later deficiency proceeding).

ANALYSIS

SITUATION 1

In Situation 1, the documents made by the revenue agent under the authority of section 6020(b) are not returns of income tax filed by the husband and wife for purposes of section 6013 because they did not sign the returns under penalties of perjury. The documents made by the revenue agent under the authority of section 6020(b) also do not constitute valid elections to file a joint return under section 6013.

SITUATION 2

In Situation 2, the document prepared by the revenue agent under the authority of section 6020(a) was signed by the husband and wife under penalties of perjury. The section 6020(a) document (1) contains sufficient data to calculate the tax liability, (2) purports to be a return, (3) represents an honest and reasonable attempt to satisfy the requirements of the tax law, and (4) is executed under penalties of perjury. The section 6020(a) document, therefore, constitutes a valid return under the four-part *Beard* test and, because it is signed by both the husband and wife, it is a joint return of income tax for purposes of section 6013.

SITUATION 3

A Form 870, although signed by both husband and wife, is not verified by a written declaration that it is made under the penalties of perjury. A Form 870 is not a return under the *Beard* test because it does not purport to be a return and it is not signed under penalties of perjury as required by section 6065. *Beard*, 82 T.C. at 777.

In Rev. Rul. 74-203, 1974-1 C.B. 330, the Service determined that a Form 870 signed by taxpayers, husband and wife, was a return of the taxpayers for purposes of section 6020(a) and a valid election to file a joint return under section 6013. Rev. Rul. 74-203 is inconsistent with *Beard* and the cases cited therein on what constitutes a valid return, because a Form 870 does not purport to be a return and is not executed under penalties of perjury.

HOLDINGS

ISSUE 1. Documents made under the authority of section 6020(b) that are not signed by the taxpayers under penalties of perjury are not returns filed by the taxpayers for purposes of section 6013 and are not valid elections to file a joint return.

ISSUE 2. A document prepared by the Service under the authority of section 6020(a) that is signed by the taxpayers under penalties of perjury is a return of the taxpayers for purposes of section 6013 and constitutes a valid election to file a joint return.

ISSUE 3. A Form 870, which includes a waiver signed by the taxpayers, is not a return filed by the taxpayers for purposes of section 6013 and does not constitute a valid election to file a joint return. This holding also applies to Form 1902, *Report of Individual Income Tax Audit Changes* (obsoleted 1988), and Form 4549, *Income Tax Examination Changes*, and any successor forms to these forms.

EFFECT ON OTHER DOCUMENTS

Rev. Rul. 74-203 is revoked. A Form 870 signed by taxpayers, husband and wife, is not a return under section 6020(a) and it is not an election to file a joint return under section 6013. This holding also applies to Form 1902, *Report of Individual Income Tax Audit Changes* (obsoleted 1988), and Form 4549, *Income Tax Examination Changes*, and any successor forms to these forms, because these documents do not purport to be returns and do not contain a jurat with a penalties of perjury clause.

DRAFTING INFORMATION

The principal author of this revenue ruling is Michael E. Hara of the Office of Associate Chief Counsel (Procedure & Administration). For further information regarding this revenue ruling, contact Michael E. Hara at (202) 622-4910 (not a toll-free call).

Rev. Rul. 2005-59, 2005-37 I.R.B. 505, 2005-2 C.B. 505, 2005 WL 2001151 (IRS RRU)

END OF DOCUMENT

Rachael Zepeda's Federal Tax Lien Cheat Sheet[1]

1. General Federal Tax Liens I.R.C. § 6321

   a. "If any person liable to pay any tax neglects or refuses to pay the same after demand, the amount (including any interest, additional amount, addition to tax, or assessable penalty, together with any costs that may accrue in addition thereto) shall be a lien in favor of the United States upon all property and rights to property, whether real or personal, belonging to such person".

   b. Generally a tax lien arises on assessment of tax; it relates back to the date of assessment from the date of notice and refusal to pay. I.R.C. § 6322.

   c. Lien can be enforced until the tax liability is satisfied or becomes legally unenforceable due to lapse of time. I.R.C. § 6322.

      1. 10-year collection statute, unless Court proceeding initiated, or statutory suspension applies. I.R.C. § 6502 and 6503.

      2. Collection suspended while automatic stay is in effect. I.R.C. § 6503(h)

   c. State law initially determines whether a taxpayer has an interest or right in the property subject to the tax lien. Aquilino v. U. S., 363 U.S. 509 (1960).

   d. After acquired property - lien attaches immediately to any property acquired by the taxpayer during the existence of the lien. See Glass City Bank v. United States, 326 U.S. 265, 268 (1945).

   e. Nominee - lien attaches to property that has been transferred to the taxpayer's nominee. Oxford Capital Corp. v. U.S., 211 F.3d 280, 284 (5th Cir. 2000).

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[1] The views, opinions, and positions set forth in this document are not the official views, opinions and positions of the Internal Revenue Service or the Office of Chief Counsel.

This outline is intended as a quick reference guide. It does not include cites to all cases dealing with the issues and may not include cites to cases adverse to the propositions stated.

f. Alter Ego - A lien attaches to property that had been transferred to the taxpayer's alter ego. G.M. Leasing Corp. v. U. S., 429 U.S. 338, 351 (1977).

2. Notice of Federal Tax Lien ("NFTL")- I.R.S. § 6323

a. Where to file – I.R.C. § 6323(f)

1. Real property - in one office designated by the State where the real property is located. In Arizona - County Recorder's Office. A.R.S. § 33-1032

2. Personal Property - (tangible or intangible) in the office designated by the state where taxpayer resides at the time of the filing. In Arizona, with respect to individuals, County Recorder's Office; with respect to corporations and partnerships, the Secretary of State.

3. Once the NFTL is properly filed, lien attaches to personal property regardless of where property is located. In re Krummel, 427 B.R. 711 (Bankr. W.D. Ark. 2010).

4. Tax lien on personal property remains valid even where a debtor moves his residence. In re Eschenbach, 267 B.R. 921 (Bankr. N.D. Tex. 2001).

b. Filing of a NFTL is not subject to any other law for filing, such as state statutes that define a different situs for filing or recording instruments affecting title to specific types of property, such as automobiles. I.R.C. § 6323(f)

c. NFTL may secure the IRS claim even though notice was filed against transferor and not the debtor. In re LMS Holding Co., 50 F.3d 1526 (10th Cir. 1995).

d. Due to avoidance powers under B.C. § 545, unless a NFTL is filed prior to the petition date or the IRS has set off rights, IRS generally will not assert a secured claim.

3. Priority of Federal Tax liens - I.R.C. § 6323

a. Priority of tax lien vs. competing liens is established by Federal law. U.S. v. Nat'l Bank of Commerce, 472 U.S. 713 (1985).

b. Basic rule – Unless a statutory exception applies, first in time is first in right." U.S. v. City of New Britain, 347 U.S. 81 (1954).

c. Priority with properly perfected Az. Dept. of Rev. State tax lien is determined by comparing assessment dates.

4. Valuation of the secured claim

a. Fair market value or replacement cost - When the debtor retains property securing the Service's claim, the property should be valued at its fair market or replacement value. Assoc. Commercial Corp. v. Rash, 520 U.S. 953 (1997); In re Taffi, 96 F.3d 1190 (9th Cir. 1996), cert. denied, 117 S. Ct. 2478 (1997).

b. Proposed use or disposition of the collateral is what is considered in valuing a secured creditor's claim. Assoc. Commercial Corp. v. Rash, 520 U.S. 953 (1977).

C. Hypothetical costs of sale – Value of tax lien is not discounted for hypothetical costs of sale with respect to property retained by the debtor. In re Taffi, 96 F.3d 1190 (9th Cir. 1996), cert. denied 117 S. Ct. 2478 (1997).

d. Personal Property – post BAPCPA, in cases of individuals in a Chapter 7 and 13, claims secured by personal property are to be valued based on replacement value of such property, without deduction for costs of sale or marketing, as of the petition date. B.C. 506(a)(2)

5. Exempt property - The Service's claim for taxes may be secured by a lien on property exempt from levy. U.S. v. Barbier, 896 F.2d 377 (9th Cir. 1990).

6. Pension plans

a. Value of a debtor's interest is not included in the value of the Service's secured claim if the pension plan is excluded from the bankruptcy estate under section 541(c)(2). See, U.S. v. Snyder, 343 F.3d 1171, 1173 (9th Cir. 2003), acq. 2004-41 I.R.B. 593.

b. Test is whether plan contains anti-alienation clauses that are enforceable under applicable nonbankruptcy law that prevent transfer of debtor's interest in the trust to the bankruptcy estate.; if yes, the plan is excluded from the bankruptcy estate under B.C. § 541(c)(2); if no, secured claim in bankruptcy includes value of debtor's interest in the pension plan, even if the plan is exempt.

c. Tax lien against debtor's interest in pension plan excluded from bankruptcy estate is not extinguished and continues to exist outside of the bankruptcy proceeding. See U.S. v. Snyder, 343 F.3d 1171, 1179 (9^{th} Cir. 2003); U.S. v. Rogers, 558 F.Supp. 2d 774 (N.D. Ohio 2008).

7. Interest

a. Federal tax lien includes interest, addition to tax, or assessable penalty and costs. I.R.C. § 6321

b. Oversecured claims – Government is entitled to receive post-petition interest on its non-consensual, oversecured, allowed tax claim. U.S. v. Ron Pair Enterprises, Inc., 489 U.S. 235 (1989).

c. Interest rate, post BAPCPA, on tax claims determined under applicable nonbankruptcy law, which is I.R.C. § 6621 rate. 11 U.S.C. § 511

1. Interest rates changes quarterly.

2. Current rate can be obtained at www.irs.gov and query "interest rate").

d. Post-petition fees, costs and penalties. In re Brentwood Outpatient, Ltd., 43 F.3d 256 (6th Cir. 1994), it was held that a non-consensual creditor, such as a taxing authority, is not entitled to post-petition fees, costs or penalties under section 506(b), even when oversecured.

8. Setoff

a. A right of setoff includes prepetition overpayments, still in the Service's possession.

b. Automatic stay does not prohibit setoff of prepetition tax refund to prepetition income tax; must lift stay in all other cases. B.C. § 362(b)(26)

c. Government can hold refund pending a resolution of tax liability. B.C. § 362(b)(26)

c. The United States is one party for purposes of setoff. In re HAL, Inc., 122 F.3d 851 (9th Cir. 1997).

9. Lien stripping

a. Chapter 7 – In Dewsnup v. Timm, 502 U.S. 410 (1992), Supreme Court held that a Chapter 7 debtor could not strip a lien on abandoned property. Courts have ruled that Dewsnup applies in Chapter 7 cases. See In re Hoekstra, 255 B.R. 285 (E.D. Va. 2000) (District court reverses bankruptcy court's holding that a federal tax lien was void under section 506(d) and holds that strip down of the lien was not permitted); In re Concannon 338 B.R. 90 (9th Cir. BAP (Ariz.),2006) In re Koppersmith, 156 B.R. 537 (Bankr. S.D. Tex. 1993). In Crossroads of Hillsville v. Payne, 179 B.R. 486 (W.D. Va. 1995), the court held that the lien cannot be stripped from exempt property, even when there is no equity in the property to which the lien can attach. See In re Williams, --- B.R. ----, 2013 WL 1113228 (Bankr. M.D.Ga., 2013) (Strip down of federal tax lien on fully encumbered real property, while allowing federal tax lien to remain on personal property in which Debtor had equity, was prohibited by Dewsnup).

b. Chapter 13 - Majority of courts have held that lien stripping is permitted. See, e.g., Bank One, Chicago v. Flower, 183 B.R. 509 (N.D. Ill. 1995); In re Cooke, 169 B.R. 662 (Bankr. W.D. Mo. 1994); In re McDonough, 166 B.R. 9 (Bankr.D. Mass. 1994). See In re Woolsey, 696 F.3d 1266 (10th Cir. 2012) (B.C. § 506(d) does not allow Chapter 13 debtor to strip off junior lien on home even though the lien did not attach to any value in the debtors' residence; Court hinted, however, that lien could have been stripped under § 1322(b)(2)).

c. Post BAPCPA, secured creditor that retains lien, retains it until the earlier of payment of debt under nonbankruptcy law or discharge. B.C. § 1325(a)(5)(B)(i).

10. Chapter 7 distributions

a. Section 724(a) allows the trustee to avoid liens for allowed claim for prepetition fines and penalties.

b. Section 724(b) provides that the tax liens are subordinated to the claims of the following creditors:

(1) To holders of liens senior to the tax lien.

(2) To priority claims specified in 507(a)(l)-(7)(with the exception of certain Chapter administrative expenses incurred in a converted case) to the extent of the amount of the allowed tax claim that is secured by the tax lien.

(3) To the holder of the tax lien, to the extent that the priority claims (507(a)(l)-(7)) did not use up the amount of the tax lien under b. above.

(4) To the holders of liens junior to the tax lien.

(5) To the holder of the tax lien, to the extent the allowed tax claim is not paid under c. above.

(6) To the estate.

c. Example:

Debtor owns a vehicle that is property of the estate Fair Market Value of $100,000

Liens:	First: Easy Loans Inc:	$20,000
	Second Lien: IRS	$25,000
	Third Lien: Even Easier Loans Inc.	$10,000
	Chapter 7 admin expenses:	$5,000
	Priority wage claims-507(a)(4)	$10,000
	Total	$70,000

B.C. § 724(b) Distribution

Senior lienholder	$20,000	
Chapter 7 admin expenses	$5,000	
Priority wage claims	$10,000	
IRS Tax Lien	$10,000	($25,000 - $15,000)
Junior lien holder	$10,000	
Tax lien	$15,000	
Estate	$30,000	

d. Before subordinating tax lien, a Trustee is required to first exhaust unencumbered assets and to recover costs associated with secured creditor's collateral from the collateral consistent with (506)(c).

11. Release of Federal Tax Liens after Chapter 7 discharge – Excluded, Exempt and Abandoned property.

a. Even if debtor's in personam liability for the taxes is discharged, ability to enforce tax liens in rem is unaffected by the discharge. Johnson v. Home State Bank, 501 U.S. 78, 84, 111 S.Ct. 2150, 115 L.Ed.2d 66 (1991),

b. Lien will not be released until the IRS determines that there is no equity in property to which the lien attaches.

c. If there is equity then the IRS will contact debtor about paying the value; once payment is secured the lien will be released.

d. If lien is not released and there has been no contact from IRS, after 4 to six weeks contact:

1. IRS Group Secretary Adam Medina (602) 636-9297

2. IRS Group Manager Ingrid Schneider (602) 636-9293

Additional references:

For information regarding IRS collection matters outside of bankruptcy consult the new IRS Collection videos: www.irs.gov query "Owe Taxes? Understanding IRS Collection Efforts"

Release of Federal Tax Liens Pub 1450: "Instructions on How to Request a Certificate of Release of Federal Tax Lien" also available on www.irs.gov

Serving an Objection to an IRS Claim

An objection to an IRS claim initiates a contested matter. To properly serve the United States in a contested matter, service must be made on the Internal Revenue Service, the U.S. Attorney for the District of Arizona and the U.S. Attorney General in Washington, D.C. Bankr. Rules 7004 (d)(4) and (5) and 9014.

Internal Revenue Service

Objections to IRS claims must be sent to:

Internal Revenue Service
PO Box 7346
Philadelphia, PA 19101-7346

Overnight mail should be directed to:

Internal Revenue Service
2970 Market Street
Mail Stop 5-Q30.133
Philadelphia, PA 19104-5016

U.S. Attorney's Office

In Phoenix, the U.S. Attorney's office is located at:

40 N. Central
Suite 1200
Phoenix , AZ 85004-4408.

If using a process server, the U.S. Attorney's Office is on 12th Floor, Renaissance Two. You can serve the receptionist Norma Fontana or Bertina Cantor.

In Tucson, the U.S. Attorney's office is located at:

405 W. Congress,
Suite 4800
Tucson, AZ 85701

Attorney General's Office

Correspondence to the Department of Justice can be sent to:

U.S. Department of Justice
950 Pennsylvania Avenue, NW
Washington, DC 20530-0001

CIO Correspondence Contacts

Bankruptcy correspondence is centralized at the Philadelphia IRS Campus.

Insolvency employees in the Centralized Insolvency Operation (CIO) at the Philadelphia campus work Chapter 7 No Asset cases and Chapter 13 cases for all US Bankruptcy Court cases.

CIO telephone numbers:

- 800-973-0424 – External number for taxpayers and their representatives
- 855-235-6787 – Fax number

Forward payments for Chapter 7 cases and Chapter 13 post confirmation cases to:

- Internal Revenue Service, PO Box 7317, Philadelphia, PA 19101-7317

Forward all other correspondence for Insolvency cases, including 341 notices for all chapters to:

- Internal Revenue Service, PO Box 7346, Philadelphia, PA 19101-7346

Chapter 9, Chapter 11, Chapter 12, Chapter 15, and most Chapter 7 Asset and Chapter 13 pre-confirmation cases remain assigned to Field Insolvency employees.

Bankruptcy & Tax Basics and Beyond from the Government Perspective –

Bankruptcy 001: A Quick Overview INTRODUCTION TO BANKRUPTCY

&

MISCELLANEOUS AND EXCITING BANKRUPTYCY - TAX ITEMS and ISSUES!

June 2013

ARIZONA STATE BAR CONVENTION

by

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BANKRUPTCY TERMS

Administrative Expense Claim: Administrative expense claim covers the liabilities that arose after the debtor's filing of bankruptcy, but before the plan of reorganization is confirmed in a Chapter 11 case or in a Chapter 7 case before it is closed. *See* 11 U.S.C. §§ 503 and 507(a)(2).

Adversarial Action: A litigation action in bankruptcy brought by a debtor, trustee or party in interest challenging an action by a party. A contested matter is a similar proceeding. The only difference between an adversarial action and a contested matter is that the Bankruptcy Code requires adversarial actions to be in a complaint format. This action is responded to by the Attorney General.

Automatic Stay: A federal law, § 362 of the Bankruptcy Code. The automatic stay provision stays all debt collection against the taxpayer on his/her/its property. The automatic stay applies to all creditors. This means that all collection efforts for taxes owed prior to the petition date must stop. The automatic stay prohibits all collection action, i.e. the recording of liens, levies, assessments, the mailing of bills and telephone calls to the debtor. Violation of the automatic stay provision is a serious matter. Once a petition has been filed, no action against a taxpayer or his/her property should be taken unless it is initiated by the Bankruptcy Unit or the Attorney General's Office.

Bankruptcy Code. A federal law (Title 11 United States Code) for the benefit and relief of creditors and debtors. The Bankruptcy Code is designed to provide: (1) a "fresh start" to a debtor (a new beginning) and (2) an orderly procedure for payment of the debts of individuals, corporations and partnerships. There are three (3) pertinent chapters under which a debtor, depending on the type of debtor, can petition for relief: Chapter 7, 11, and 13. Under the provisions of the Bankruptcy Code, a debtor may be given an opportunity to reorganize its financial affairs or the debtor's assets may be liquidated to pay creditors' claims. All assets of the debtor constitute property of the estate and are under the control of the bankruptcy court although a debtor may, depending on the case, remain in possession of its property. If a bankruptcy business is liquidated, the assets are controlled by a trustee appointed by the court. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 was passed in law and became effective in total on October 17, 2005.

Bankruptcy Estate: The property which is within the bankruptcy estate is set forth in § 541 of the Bankruptcy Code. The property and interests-in-property of a debtor under the protection of the bankruptcy court constitutes the bankruptcy estate. What constitutes property of the bankruptcy estate is defined extremely broad. In a Chapter 13 bankruptcy, this definition is expanded to include post-petition earnings. 11 U.S.C. §§ 1115 and 1306.

Case: A general term for a judicial proceeding where a court makes a determination of a controversy between different parties.

<u>Chapter 7</u>: Often referred to as a straight bankruptcy. Under this chapter of the Bankruptcy Code, the chapter 7 trustee takes control over the debtor's non-exempt property, liquidates it, and distributes the proceeds to the creditors in the order of their priority. Many Chapter 7 cases are "no assets;" that is, there are no non-exempt assets for liquidation. Prior to the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, there was a rebuttable presumption that a debtor qualified under Chapter 7. This has now been changed under the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. The "means test" must be analyzed to determine whether the individual debtor should be Chapter 7 or 13.

<u>Chapter 9</u>: This bankruptcy applies to municipalities.

<u>Chapter 11</u>: The chapter of the Bankruptcy Code which allows a corporation or an individual debtor with substantial liabilities to reorganize its/his/her financial affairs. The debtor continues to operate the business during the bankruptcy. The debtor submits a plan of reorganization for creditor and/or court approval which provides for the debtor's payment of outstanding obligations via either reorganization or liquidation.

<u>Chapter 12</u>: This bankruptcy applies to family farmers.

<u>Chapter 13</u>: The chapter of the Bankruptcy Code which allows individuals with regular income to reorganize their financial affairs. This chapter applies if, and only if, their liquidated unsecured debtors are less than $383,175.00 and their liquidated secured debts are less than $1,149,525.00. The debtor submits a plan for court approval which provides for payments to the creditors. The creditors, unlike in a Chapter 11, do not get to vote on the plan. The scope of the discharge is broader in a Chapter 13 than in other chapters and used to be referred as a "Superdischarge," but is more likely now an "enhanced discharge."

<u>Chapter 15</u>: This Chapter applies to situation where there is a bankruptcy occurring in a foreign jurisdiction, but there is property of the bankruptcy estate is a different jurisdiction. This allows an orderly manner to deal with the bankruptcy estate property in the different jurisdiction.

<u>Claim</u>: Any type of obligation owed by a debtor to a creditor. Broadly defined by the Bankruptcy Code in §101(5). In a bankruptcy, to protect a claim a "Proof of Claim" is filed. *See* "Proof of Claim" definition herein. It can be either a right to payment or an equitable remedy. The claim does not have to be liquidated, fixed, matured, non-contingent or undisputed. Types: The Bankruptcy Unit files various types of claims with the bankruptcy court depending upon the tax status of the debtor. These claims include:

A. Secured claims: These are claims in which the Department has recorded/filed a "Notice of Tax Lien" prior to the filing of the petition.

B. Priority Claims: Those unsecured claims set forth in 11 U.S.C. § 507, as to taxes in particular, *see* § 507(a)(8).

C. General Unsecured Claims: Claims which are neither entitled to priority treatment nor are secured.

D. Administrative Claims: Mainly in a chapter 11, these claims are for expenses associated with the debtor's operations post-petition-pre-confirmation and include taxes incurred by a taxpayer after the petition date. *See* § 503(b) of the Bankruptcy Code.

Claims Bar Date: A date by which claims against a debtor must be filed in a bankruptcy proceeding or the claim will not be recognized. In chapter 7 and 13 bankruptcies, the governmental bar date is one hundred eighty (180) days from the date of filing bankruptcy. 11 U.S.C. § 502(b)(9). In a Chapter 11, the bar date can be either one hundred eighty (180) days from the filing of bankruptcy or approval of the disclosure statement, unless otherwise set by the court. In a Chapter 13 bankruptcy, the claims bar date can be sixty (60) days after delinquent tax returns are filed. 11 U.S.C. §1308.

Closed Case: A case in which a court has made a final determination with respect to all of its aspects and no further action will be taken.

Complaint: The first document filed with a court (in bankruptcy - in an adversarial action) by a party which states the facts of an alleged wrongful activity on the part of some other party and requests that the court take some action to rectify the matter.

Confirmation: Official approval of a Chapter 11 Plan of Reorganization or Chapter 13 Plan by a bankruptcy court. In a Chapter 11 bankruptcy, the creditors vote on the plan of reorganization and can object to it. In a Chapter 13, the Court approves the plan; creditors can only object to it, but do not vote on it. In either Chapter 11 or 13, parties can stipulate to confirmation (commonly referred to as S.O.C.).

Debtor: Generally, it is a term which refers to someone who owes money. In bankruptcy, the term refers to the individual(s) and business entity(ies) which are the subject of the bankruptcy.

Debtor-in-Possession: A debtor in a Chapter 11 bankruptcy which continues to operate the business after the filing of bankruptcy.

Discharge: In bankruptcy, the decree of the bankruptcy court which extinguishes a debtor's personal liability of certain types of debts. A creditor whose debt is discharged cannot pursue the debtor personally for repayment of the debt. Certain debts are excepted from the discharge and are called "non-dischargeable." The exceptions to discharge for an individual under Chapters 7 and 11 (and a hardship discharge in a Chapter 13 bankruptcy) are set forth in 11 U.S.C. § 523.

Disclosure Statement: Applies in Chapter 11 bankruptcies. A disclosure statement must provide adequate information for the hypothetical reasonable investor to make a decision of whether to vote for confirmation of a plan of reorganization. In essence, the disclosure statement gives a history of the case; the listing and characterization of claims; the payment of claims; and a comparison of the amount of distribution if the case were in a Chapter 7 versus the Chapter 11. This document requires approval from the bankruptcy court. Upon approval, it is sent to all creditors and parties in interest with the plan of reorganization.

Discovery: Devices parties can use to learn information in a contested matter and/or adversarial action. Types of discovery include Requests for Admission, Requests for Production and/or Interrogatories.

Dismissal: An action by the Court, either with or without the consent of all parties, where the case or matter is dismissed without any further action to be taken. If a case is dismissed, it is as if it never occurred. Dismissal is not the same as a discharge. *See* definition of "Discharge" herein.

Docket Number: The docket is a listing in the Court's records of all documents filed with the Court, minute entries entered, and records of hearings in the administration of a case. The numbers are generally in chronological order following the filing date and time of the document.

Exempt Property/Exemption: For policy reasons as determined by either the Congress or a state legislature, collection actions cannot be effected against certain property (i.e., homestead exemption). An exemption is a legislatively decided amount of equity and/or money that a debtor is entitled to keep. It is based on a policy decision. Non-consensual lien holders cannot get to the protected, AKA "exempted" property. Please note that a consensual lien holder can get to the exempted property if the debtor has waived the exemption rights. Also, statutorily (state legislature or Congress can eliminate or modify the application of the exemption(s). For example, the general exemption provisions do not apply to taxing authorities. Further, the bankruptcy Code has its own exemptions which a State may or may not chose to adhere to; that is, the State may "opt out" of the federal Bankruptcy Code exemptions.

First Meeting of Creditors: A meeting pursuant to 11 U.S.C. § 341 of the Bankruptcy Code where the debtor is required to appear and be available to answer questions from creditors. Commonly referred to as the "341 meeting."

505 Action: An action in bankruptcy court under 11 U.S.C. § 505 where a debtor can challenge the amount of tax allegedly owed.

Interrogatories: Questions, generally in a written form, by one party propounded on another in an adversarial action or contested matter.

Lien: A lien represents a creditor's claim against, or interest in, property of a debtor for the payment of a debt. In order for a lien to be enforceable as against other creditors and the debtor it must be "perfected." To be perfected, a lien against real property (e.g., land, houses) must be recorded with the

County Recorder in the county where the real property is located. Liens against personal property (e.g., property that is not associated with real estate such as money, furniture, inventory, etc.) must be filed in the Office of the Secretary of State. Each jurisdiction may have its own laws/regulations concerning perfecting of a lien. In a bankruptcy, a lien must be perfected to be a secured claim.

Liquidation: With respect to a business, the act of ending its affairs and settling its claims and debts by converting the business' assets into cash, determining liabilities and applying the cash to the payment of the debts in the order of their priority. With respect to individuals, the act of collecting and selling of all non-exempt assets. After which, the proceeds are distributed to creditors based on the priority of the debts.

Means Test: This is a new provision added under the Bankruptcy Abuse Prevention and Consumer protection Act of 2005 that creates a standard as to when an individual can proceed in bankruptcy under Chapter 7 or Chapter 13. It also applies as to which parties have the ability to challenge whether a debtor can be in Chapter 7 or Chapter 13.

No Asset Chapter 7 Case: No non-exempt property exists in the estate to liquidate. Therefore, no distribution to the creditors will occur.

Objection to Claim: An action where either a debtor, trustee, or creditor challenges a claim filed by a particular creditor.

Open Bankruptcy Case: A bankruptcy which has not been closed and is still active in the bankruptcy system.

Perfection of a Lien: Outside the tax arena, it is commonly referred to as "perfection of a secured claim." An action taken to make a lien enforceable as against the debtor and third parties (i.e. creditors and potential creditors). To be perfected, a lien against real property (e.g., land, houses) must be recorded with the County Recorder in the county where the real property is located. Liens against personal property (e.g., property that is not associated with real estate such as money, furniture, inventory, etc.) must be filed in the Office of the Secretary of State. In a bankruptcy, a lien must be perfected to be a secured claim.

Petition: A formal, written request to a court in a legal proceeding requesting judicial action. Within the context of a bankruptcy proceeding, the petition refers to the first document filed by a debtor with a federal bankruptcy court which seeks all the protection of the Bankruptcy Code, i.e., automatic stay. A petition may be voluntary if it is filed by the debtor. An involuntary petition may be filed against a debtor by a sufficient number of the debtor's creditors. If the court approves an involuntary petition, the debtor will be forced into bankruptcy proceedings.

Petition Date: The date a petition for bankruptcy is received by the bankruptcy court. The automatic stay provision is effective as of the date and time the petition is filed with the court.

Plan of Reorganization: A detailed document filed by the debtor in a Chapter 11 bankruptcy that proposes an orderly schedule for the payment of debts. The plan provides the method and timing of payments by the debtor to creditors. The plan will also provide for the discharge of any debts. Creditors vote on the confirmation of the plan. Prior to approval, or confirmation, of the plan, the bankruptcy court holds a hearing to review whether it satisfies all requirements of the Bankruptcy Code.

Post-Confirmation: Refers to the period of time after the bankruptcy court has confirmed a plan of reorganization.

Post-Petition: Refers to the period of time after a petition commencing the bankruptcy is filed with the bankruptcy court, but generally prior to the entry of confirmation and/or discharge.

Preference Period: This is based on the § 547 of the Bankruptcy Code. The Code sets two (2) time periods, ninety (90) days for non-insiders and one (1) year for insiders. The Court may overturn any payments/actions that occurred during this period which enable a creditor to receive more than it would have under a Chapter 7 bankruptcy. There are certain elements of Bankruptcy Code § 547 that must be satisfied for a payment/action to be considered a preference.

Priority: The priority of the claim is set forth in 11 U.S.C. § 507 of the Bankruptcy Code. This section establishes the order in which the various creditors' unsecured claims are paid in all chapters of bankruptcy. Congress created the order of priority.

Pre-Petition: Refers to the period of time before the bankruptcy petition is filed with the bankruptcy court.

Proof of Claim: Acronym (P.O.C.), Statement under oath filed in a bankruptcy by a creditor in which the creditor indicates the amount owed to the creditor by the debtor, the circumstances under which the claim arose and the type of claim, i.e., priority, secured, etc. A debtor can file a proof of claim for a creditor.

Property of the Estate: See Bankruptcy Estate definition herein.

Purchase Money Security Interest: A creditor can have this type of security interest when it loans money for the purchase of a particular item, i.e. a refrigerator, television, etc. The creditor has a specified period by which to perfect its security interest under state law (usually 20 days). The Bankruptcy Code provides for the allowance of a purchase money security interest and the perfection post-petition. 11 U.S.C. § 546.

Reinstatement of Case: If a bankruptcy gets dismissed, it can be reinstated. That is, revived and become an active bankruptcy case again.

Request for Admission: A discovery device. In the request from one party to another is listed specific statements. The receiving party must, within a specified time period, admit or deny their truth.

If not answered within such time, the statements are deemed admitted. It is extremely important that Requests for Admission be answered timely.

Stipulation: A court document where the parties agree to take some action or not take an action. Stipulations are filed with the Court.

Statements and Schedules: Refers to the debtor's statement of affairs and schedules of assets and liabilities. These documents contain important information about the debtor, i.e. debts, assets, etc. They are filed with the bankruptcy court at the same time, or shortly after, the filing of the Petition.

2004 Exam: An information-gathering device. A creditor or party in interest can require the debtor to answer questions about the bankruptcy, assets, reorganization, etc. and/or produce documents regarding the same.

Trustee: In a Chapter 7, it is a person appointed to supervise the liquidation and distribution of an estate. In a chapter 13, it is a person who reviews the debtor's plan, oversees its operation, and distributes payments. In a Chapter 11, a trustee may not be appointed.

United States Trustee: An attorney employed by the Federal government who generally looks at all bankruptcies and does a general review of current bankruptcies. The United States Trustee, who may be active in some cases, but not all, is not the same as the chapter 7 or 13 trustees.

EXEMPTIONS

An exemption is a legislatively decided amount of equity and/or money that a debtor is entitled to keep. It is based on a policy decision. Non-consensual lien holders cannot get to the protected, AKA "exempted" property. Please note that a consensual lien holder can get to the exempted property if the debtor has waived the exemption rights. Also, statutorily (state legislature or Congress can eliminate or modify the application of the exemption(s). States have their own exemptions. Thus, with respect to municipalities, state agencies, etc., one needs to ascertain what exemptions are applicable to any given governmental entities/municipality. For example, the general exemption provisions do not apply to taxing authorities. The Bankruptcy Code created its own exemptions. *See* 11 U.S.C. §522. A State may or may not chose to adhere to; that is, the State may "opt out" of the federal Bankruptcy Code exemptions. *Id.* §522(b)(2). The Arizona Department of Revenue uses its own exemptions pursuant to State law. See: A.R.S. §42-1204

42-1204. Property exempt from levy

A. The following property is exempt from levy:

B.

1. Wearing apparel and school books as are necessary for the taxpayer or members of his family.

2. So much of the fuel, provisions, furniture, personal effects, arms for personal use, livestock and poultry as provided for in section 6334 of the internal revenue code.
3. The books and tools necessary for the trade, business or profession of the taxpayer as provided for in section 6334 of the internal revenue code.
4. Mail, addressed to any person, which has not been delivered to the addressee.
5. If the taxpayer is required by judgment of a court of competent jurisdiction, entered prior to the date of levy, to contribute to the support of his minor children, so much of his salary, wages or other income as is necessary to comply with such judgment.
6. Any amount payable to or received by an individual as wages or salary for personal services, or as income derived from other sources, during any period, to the extent that the total of such amounts payable to or received by him during such period does not exceed the applicable exempt amount determined under subsection D of this section.

B. The officer seizing property of the type described in subsection A of this section shall appraise and set aside to the owner the amount of such property declared to be exempt. If the taxpayer objects at the time of the seizure to the valuation fixed by the officer making the seizure, the department shall summon three disinterested individuals who shall make the valuation.

C. Notwithstanding any other law of this state, no property or rights to property shall be exempt from the levy provided in this article other than the property specifically made exempt by subsection A of this section.

D. The following wages, salary and other income payable to or received by an individual are exempt from levy under subsection A, paragraph 6 of this section:

1. In the case of an individual who is paid or receives all wages, salary and other income on a weekly basis, the amount of such compensation received during any week which is exempt from levy is the amount determined pursuant to section

6334(d) of the internal revenue code and which is verified in such manner as set forth in section 6334.

1. In the case of any individual not described in paragraph 1 of this subsection, the amount of the wages, salary and other income payable to or received during any applicable pay period or other fiscal period, as determined under rules prescribed by the department, which is exempt from levy under subsection A, paragraph 6 of this section is an amount, determined under such rules, which as nearly as possible will result in the same total exemption from levy for such individual over a period of time as the individual would have under paragraph 1 of this subsection if, during such period of time, the individual were paid or received such wages, salary and other income on a regular weekly basis.

Claims

A. Definition 11 U.S.C. § 101(5)

§ 101 Bankruptcy Code

(5) "claim" means-

(A) right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured; or

(B) right to an equitable remedy for breach of performance if such breach gives rise to a right to payment, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured;

Layperson's Terms

In bankruptcy, claim is defined very broadly; it can be virtually anything. *Compare with* "Proof of Claim," discussed herein.

Proof of Claim

Layperson's Terms

A document filed with the Bankruptcy Court which sets forth the liabilities of a creditor asserting the debtor owes him, her or it. *See* definition of claim in discussed aboven.

Pre-Petition Claim

Layperson's Terms

A pre-petition proof of claim covers those liabilities that arose or could have arisen prior to the debtor's filing for bankruptcy.

Administrative Expense Proof of Claim

Administrative expense proof of claim covers the liabilities that arose after the debtor's filing of bankruptcy, but before the plan of reorganization is confirmed in a Chapter 11 case or in a Chapter 7 case before it is closed.

Estimated Claims

<u>Estimated Tax Returns</u>

A taxing authority can file an estimated proof of claim when either (1) a proposed assessment has been issued or may be forthcoming or (2) a debtor has not filed a tax return. 11 U.S.C. § 502. Section 502(c) of the Bankruptcy Code provides:

> (c) There shall be estimated for purposes of allowance under this section-
>
> (1) Any contingent or unliquidated claim, affixing or liquidation of which, as the case may be, would unduly delay the administration of the case; or
>
> (2) Any right to payment arising from a right to an equitable remedy for breach or performance.

11 U.S.C. § 502(c).

The taxing authority can, after having timely filed its estimated proof of claim, amend it to list a specific claim amount after the debtor files the requisite return(s) or the audit liability has been established. The assessment need not become final. The amendment to the proof of claim will be allowed. *See In re Tanaka Bros. Farms, Inc.*, 36 F.3d 996 (10th Cir. 1994). However, the amendment must relate to the same tax period(s) listed on the estimated claim.

One method of dealing claims is like the Arizona Department of Revenue which uses a specific methodology based upon the county where the debtor resides to determine the estimated amount for an income tax liability when no return has been filed. An econometrics study by the Department determined the average individual income tax liability by county. This average is used whenever an estimated amount is listed by the Department in its proof of claim. This methodology is used in every case. Prior to filing a proof of claim with an estimated amount, the Department does a search to ensure that the debtor earned income, giving a reasonable basis to believe that a return should have been filed.

With respect to business taxes (i.e., withholding, transaction privilege, etc.), the Department analyzes other returns filed by the debtor. The Department then averages the monthly liability on the previously filed returns and uses that figure for its estimate. The Department will take into account seasonal adjustments when determining its estimated liability. If no return has ever been filed, the Department uses the average transaction privilege or withholding tax filing liability for the state as its estimated figure.

A debtor is required to ensure that <u>all</u> tax returns, regardless of tax type, are filed in Chapter 13 bankruptcies. Rule 2083-5, Local Rules of Bankruptcy Procedure for the District of Arizona. Specifically, Rule 2083-5 provides:

> The debtor shall, by no later than seven business days before the first day set for confirmation of the plan, file any due but unfiled tax returns. The debtor shall show cause at the confirmation hearing why any tax returns which are due have not been filed. If the tax returns are not filed within such time and the debtor fails to show cause why the returns have not been filed, then the trustees may move for dismissal of the case.

Id.

Further, the Bankruptcy Courts in the District of Arizona are automatically dismissing chapter 13 bankruptcies where the debtor has not filed all outstanding tax returns within sixty (60) days of the scheduled first meeting of creditors. The Department provides notice of the outstanding unfiled tax returns to the assigned Chapter 13 Trustee prior to the first meeting of creditors. Sixty-five (65) days thereafter the Department notifies the Chapter 13 Trustee of those debtors who still have failed to file the outstanding tax return(s). The Chapter 13 Trustee can and will then dismiss those cases.

To protect the Department's interests, the Department thirty (30) days after the First Meeting of Creditors (also known as the 341 meeting) will refer the case to the Attorney General's Office if a tax return is still unfiled. The Attorney General's Office will file an objection to the debtor's Chapter 13 plan on the Department's behalf. This will ensure either that the returns are filed or the case is dismissed.

In Chapter 11 bankruptcies, the Department will take action in the bankruptcy court if the debtor has outstanding unfiled tax return(s). The Department will obtain an order from the bankruptcy court requiring the debtor to file the outstanding tax returns within thirty (30) days of entry of the order. If the outstanding tax return(s) relate to post-petition tax periods, the Department will also seek their payment (plus any outstanding administrative expenses) within the same time. A debtor's failure to comply with the order will result in the Department filing an action with the bankruptcy court asking that the case be dismissed for failing to comply with the court's order.

Regardless of the chapter, the outstanding tax returns and/or payment of any outstanding post-petition taxes should be filed with the "Arizona Department of Revenue, Bankruptcy and Litigation Section, Bankruptcy Unit, 1600 West Monroe, Phoenix, Arizona 85007." By sending all required returns, documents, and/or payments to the "Bankruptcy and Litigation Section, Bankruptcy Unit" at the Department, the debtor, as well as the Department will be ensured of prompt processing of any and all returns and/or payments.

EXAMPLE OF A FORM LETTER RE: FILING OF RETURNS

ARIZONA DEPARTMENT OF REVENUE

1600 WEST MONROE - PHOENIX, ARIZONA 85007-2650

Jan Brewer
GOVERNOR

IF YOU HAVE NOT FILED YOUR STATE TAX RETURN(S)
YOUR CASE CAN BE DISMISSED

The Arizona Department of Revenue shall file an objection to your bankruptcy plan if outstanding tax return(s) are not filed thirty (30) days prior to the last day for filing an objection to your Chapter 13 plan.

In order to determine if you are required to file, consult the tax booklet for the tax period(s) in question.

I. IF YOU ARE REQUIRED TO FILE:

If you did not file and have all necessary information, prepare and submit your signed return to:

Arizona Department of Revenue
1600 W Monroe, Room 720
Phoenix, Az, 85007
Attn.: Bankruptcy/Litigation Section
Attach any required copies of Federal Schedules, 1099's, and w-2's.

If you have already filed the required return(s), submit a copy to the above listed address, even if you live outside the Phoenix area. For questions call (602) 716-7806.

II. IF YOU BELIEVE YOU ARE NOT REQUIRED TO FILE:

Submit an AFFIDAVIT signed under penalty, of perjury, notarized, and dated. stating the reasons why you are not required to file the returns.

In the affidavit, list income from all sources, both taxable and non-taxable for each year.
Send the information to the above listed address.

III. IF YOU NEED ADDITIONAL INFORMATION TO FILE YOUR RETURNS:

W-2 OR 1099--Contact your EMPLOYER(S)

IF NOT RECEIVED, CONTACT THE IRS

FORMS: Contact Licensing at 602-542-4260

PRE-RECORDED INFORMATION: Call 800-845-8192

Automatic Stay

A. 11 U.S.C. § 362(a)

Layperson's Terms

The automatic stay arises upon the filing of a bankruptcy and prevents any collection from being taken against the debtor or its property. The automatic stay is very broad. Violation of the automatic stay can result in sanctions. *See* Section IV(B) herein.

§ 362 Automatic Stay

(a) Except as provided in subsection (b) of this section, a petition filed under section 301, 302, or 303 of this title, or an application filed under section 5(a)(3) of the Securities Investor Protection Act of 1970, operates as a stay, applicable to all entities, of—

(1) the commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the commencement of the case under this title, or to recover a claim against the debtor that arose before the commencement of the case under this title;

(2) the enforcement, against the debtor or against property of the estate, of a judgment obtained before the commencement of the case under this title;

(3) any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate;

(4) any act to create, perfect, or enforce any lien against property of the estate;

(5) any act to create, perfect, or enforce against property of the debtor any lien to the extent that such lien secures a claim that arose before the commencement of the case under this title;

(6) any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title;

(7) the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor; and

(8) the commencement or continuation of a proceeding before the United States Tax Court concerning the debtor.

11 U.S.C. § 362(h)

§ 362 Automatic Stay

(h) An individual injured by any willful violation of a stay provided by this section shall recover actual damages, including costs and attorneys' fees, and, in appropriate circumstances, may recover punitive damages.

11 USCA § 362, Automatic stay.

11 U.S.C. § 362(b)(4)

§ 362 Automatic Stay

Statute:

(b) The filing of a petition under section 301, 302, or 303 of this title, or of an application under section 5(a)(3) of the Securities Investor Protection Act of 1970, does not operate as a stay –

* * *

(4) under paragraph (1), (2), (3), or (6) of subsection (a) of this section, of the commencement or continuation of an action or proceeding by a governmental unit or any organization exercising authority under the Convention on the Prohibition of the Development, Production, Stockpiling and Use of Chemical Weapons and on Their Destruction, opened for signature on January 13, 1993, to enforce such governmental unit's or organization's police and regulatory power, including the

enforcement of a judgment other than a money judgment, obtained in an action or proceeding by the governmental unit to enforce such governmental unit's or organization's police or regulatory power;

The exceptions to the automatic stay are set forth in § 362(b). Section 362(b)(4) allows the commencement or continuation of a suit by a governmental unit if the suit is brought pursuant to the government's "police or regulatory power." "Police or regulatory power" refers to the government's right to promote order, safety, security, health, morals and the general welfare.

The theory of this exception is that bankruptcy should not be a haven for wrongdoers, thus the automatic stay should not prevent governmental regulatory, police, and criminal actions from proceeding.

The courts use two tests to determine whether a suit is based on the "police or regulatory power."

1. "Pecuniary purpose" Test. Under this test if the government acted <u>solely</u> to advance a pecuniary interest, it will be bound by the automatic stay and all activity must cease. The government may have a pecuniary motive and seek money damages; however, collection is barred by the stay.

2 "Public policy" Test. This test distinguishes between actions that effectuate public policy and actions that adjudicate a private right. Only those actions that effectuate or promote public policy are exempt from the automatic stay.

A governmental unit acting under its police and regulatory powers may seek and achieve entry of a money judgment based on §362(b)(4). However, enforcing or collecting on the money judgment must be made through the Bankruptcy Court. Any attempt to pursue normal collection procedures will violate the automatic stay. It is not always clear what governmental actions will be deemed to be an exercise of police and regulatory powers or collection. The decision rests solely with the bankruptcy court.

The exception is utilized in a variety of contexts:

Damage actions for violations of environmental laws fall within the police and regulatory exemption and are exempted from the automatic stay. *City of New York v. Exxon Corp.*, 932 F.2d 1020 (2nd Cir. 1991). Ninth Circuit case law holds that the automatic stay does not prevent <u>entry</u> of a "money judgment" during the pendency of a bankruptcy based on the "police and regulatory powers" exception; however, enforcement of a "money judgment" is barred by the automatic stay. *In re Universal Life Church,* 128 F.3d 1294 (1997). The 9th Circuit has not addressed the application of § 362(b)(4) as it applies to suits concerning environmental protection. Enforcement of an injunction which sought to prevent future damage and rectify harmful environmental hazards did not violate the stay even though the debtor would have to spend money (which would come from the bankruptcy estate) to address the violations. *See Penn Terra Ltd. v. Department of Environmental Resources,* 733 F.2d 267 (3rd Cir. 1984); (Even if it costs the debtor money to comply with an injunction which requires environmental clean up, the enforcement of that injunction is not stayed). *Also, see Commonwealth Oil Refining Co. v. United States Environmental Protection Agency,* 805 F.2d 1175 (5th Cir. 1986).

The *Penn Terra* court held the automatic stay did not apply because the government was not seeking entry of a money judgment, the judgment was not intended to provide compensation for past injuries, and the judgment was not reducible to a sum certain. Instead, the injunction was meant to prevent future harm to and to restore damage done to the environment. The 3rd Circuit has allowed the entry of "money judgment" but not the enforcement thereof. *United States v. Nicolet, Inc.*, 857 F.2d 202 (3rd Cir. 1988). A governmental action taken regarding a pre-existing environmentally hazardous area which is not continuing though, may be subject to the automatic stay.

Proceedings seeking revocation of professional licenses due to misconduct fall within the police and regulatory power. *Thomassen v. Division of Medical Quality Assurance,* 15 B.R. 907 (9th Cir. BAP 1981); *Wade v. State Bar of Arizona,* 948 F.2d 1122 (9th Cir. 1991). Proceeding seeking revocation of a professional license due to non-payment of taxes does not fall within the police and regulatory power exception and is banned by the automatic stay. *In re Norton,* 128 B.R. 592 (D.Ver. 1991).

The stay exception applies to suits brought under Title VII, violations of the Fair Labor Standard Act, civil enforcement actions to enjoin the purchase and sale of securities, fraud actions, and enforcement proceedings for reinstatement of employees with back pay. *In re Commonwealth Companies, Inc.*, 913 F.2d 518 (8th Cir. 1990).

Allowing proceedings suspending a liquor license because the license was issued under the Board's statutory authority to regulate the use and sale of liquor is an example of the application of § 362(b)(4). *In re Newport Assembly Restaurant, Inc.*, 142 B.R. 22 (Bankr. D. R.I. 1992). However, the Ninth Circuit has held that the failure of a state liquor board to approve the transfer of a license for nonpayment of tax constitutes an act to collect a claim and violates the automatic stay. *In re Farmer's Market, Inc.,* 792 F.2d 1400 (9th Cir. 1986). Case law indicates that failure to pay taxes does not invoke the police and regulatory power thus the exception would not apply. *In re Mason,* 18 B.R. 817 (Bankr. W.D. Tenn. 1982).

11 U.S.C. § 362(b)(9)

A governmental taxing authority can proceed with an audit up to and including the issuance of an assessment. If, under state law, the finalizing of the assessment would create a lien against the debtor's property, then the automatic stay provisions of 11 U.S.C. § 362(a) would prohibit that action (the creation of the lien, not the finalizing of the assessment) from occurring. The applicable provision relating to a taxing authority's ability to do an assessment is 11 U.S.C. § 362(b)(9), which provides:

> (9) under subsection (a), of--
>
> (A) an audit by a governmental unit to determine tax liability;
>
> (B) the issuance to the debtor by a governmental unit of a notice of tax deficiency;
>
> (C) a demand for tax returns; or
>
> (D) the making of an assessment for any tax and issuance of a notice and demand for payment of such an assessment (but any tax lien that would otherwise attach to property of the estate by reason of such an assessment shall not take effect unless such tax is a debt of the debtor that will not be discharged in the case and such property or its proceeds are transferred out of the estate to, or otherwise revested in, the debtor).

Therefore, if a state is intending to do an audit, it may so proceed. Additionally, the state can list on its proof of claim an estimated amount, stating that an audit is ongoing and the proof of claim will be revised at the completion. Of course, before filing the proof of claim, an analysis waiving sovereign immunity should be completed.

It should be noted that the Ninth Circuit Court of Appeals recently held that a State Court did not have jurisdiction to determine if the automatic stay applied. *In re Gruntz*, 166 F.3d 1020 (C.A.9 (Cal.) 1999). The Court of Appeals held that only the Bankruptcy Court had exclusive jurisdiction to determine the application of 11 U.S.C. § 362(b)(4). *But see In re Baldwin-United Corp. Litigation,* 765 F.2d 343, 347 (2d Cir. 1985); *United States v. Acme Solvents Reclaiming, Inc.*, 154 B.R. 72 (N.D. Ill. 1993); *U.S. v. Sugarhouse Realty, Inc.*, 162 B.R. 113, 115 (E.D. Pa. 1993). *In re Bona,* 124 B.R. 11 (S.D.N.Y. 1991).

Other statutory provisions that can be used to enforce tax payment and/or Applicable law after the filing of a Chapter 11 Bankruptcy

28 U.S.C §959 Trustees and receivers management; State laws

(a) Trustees, receivers or managers of any property, including debtors in possession, may be sued, without leave of the court appointing them, with respect to any of their acts or transactions in carrying on business connected with such property. Such action shall be subject to the general equity power of such court so far as the same may be necessary to the ends of justice, but this shall not deprive a litigant of his right to trial by jury.

(b) Except as provided in section 1166 of title 11, a trustee, receiver or manager, appointed in any cause pending in any court of the United States, including a debtor in possession, shall manage and operate the property in his possession as such trustee, receiver or manager according to the requirements of the valid laws of the State in which such property is situated, in the same manner that the owner or possessor thereof would be bound to do if in possession thereof.

28 U.S.C. § 960 Tax Liability

(a) Any officers and agents conducting any business under authority of a United States court shall be subject to all Federal, Sate and local taxes applicable to such business to the same extent as if it were conducted by an individual or corporation.

(b) A tax under subsection (a) shall be paid on or before the due date of the tax under applicable non bankruptcy law, unless –

(1) the tax is a property tax secured by a lien against property that is abandoned within a reasonable period of time after the lien attaches by the trustee in a bankruptcy case under title 11; or
(2) payment of the tax is excused under a specific provision of title 11,

In a case pending under chapter 7 of title 11, payment of a tax may be deferred until final distribution is made under section 726 of title 11, if –

(3) the tax was not incurred by a trustee duly appointed or elected under chapter 7 of title 11; or
(4) before the due date of the tax, an order of the court makes a finding of probable insufficiency of funds of the estate to pay in full the administrative expenses allowed under section 503(b) of title 11 that have the same priority in distribution under section 726(b) of title 11 as the priority of that tax.

OTHER ACTIONS THAT CAN OCCUR REGARDLESSS OF THE AUTOMATIC STAY

Bankruptcy/Audit Information

CHAPTER 7

PRE-PETITION TAX PERIODS: **POST-PETITION TAX PERIODS:**

OK to Audit: • Tax liability against an individual debtor that is or will be non-dischargeable. • For an individual income tax or transaction privilege tax liability: 1. Non-filed return, report or any other notice required to be given to the taxing authority. 2. An audit was assessed within 240 days of the filing of the bankruptcy (self-assessment included). This period can be extended if: 1) an offer-in-compromise was pending plus 30 days. 2) any time collections was stayed (i.e. automatic stay, plus 90 days). 3. If the return was required to be filed within 3 years of the filing of the bankruptcy. 4. Add tax audit that could have been assessed before the filing of the bankruptcy but was not assessed prior to	• Luxury taxes where the return, if required, is due to be filed, including all extensions, within 3 years of the filing of bankruptcy. Or, if no return is required, then within 3 years when the "transaction" given rise to the tax occurred. • Property tax incurred and last payable within 1 year of the filing of bankruptcy. Note: if a personal property return was required to be filed and was not, then this 1 year limitation does not apply. • Withholding tax (or trust fund taxes). **Do not Audit:** • If the debtor is a corporation. • If the pre-petition tax liability is determined to be dischargeable.	**OK to Audit:** • An audit for any tax period that comes due after the petition date.	

the filing of the bankruptcy. 5. Return filed late within 2 years of the filing of the bankruptcy. 6. Excise tax			

CHAPTER 11 (INDIVIDUAL)

PRE-PETITION TAX PERIODS:
POST-CONFIRMATION

POST-PETITION

PRE-

CONFIRMATION

OK to Audit: • Tax liability against an individual debtor which is or will be non-dischargeable. • For an individual income tax or transaction privilege tax liability: 1. Non-filed return, report or any other notice required to be given to the taxing authority. 2. An audit was assessed within 240 days of the filing of the bankruptcy (self-assessment included). This period can be extended if: 1) an offer-in-compromise was pending plus 30 days. 2) any time collections was stayed (i.e. automatic stay, plus 90 days).	• Luxury taxes where the return, if required, is due to be filed, including all extensions, within 3 years of the filing of bankruptcy. Or, if no return is required, then within 3 years when the "transaction" given rise to the tax occurred. • Property tax incurred and last payable within 1 year of the filing of bankruptcy. Note: if a personal property return was required to be filed and was not, then this 1 year limitation does not apply. • Withholding tax (or trust fund taxes).	**OK to Audit:** • Post-petition – Pre-confirmation individual income and transaction privilege tax as long as the proof of claim is filed within 30 days of the plan of reorganization's confirmation. The claim may be an estimate if the audit is not completed.	• OK to proceed as routine audit. The issue may arise regarding when collection can occur A proof of claim for Administrative Expenses must be filed no less than 30 days per court order and/or the plan of reorganization. **Do not Audit:** • Assuming the notice of bankruptcy was provided to the governmental unit. If the tax liability is for a pre-petition period and the bar date for filing the proof of claim has expired and no proof of claim was filed for the tax period in question and the plan was confirmed. • If the debtor is an individual, the pre-

3. If the return was required to be filed within 3 years of the filing of the bankruptcy. 4. Add tax audit that could have been assessed before the filing of the bankruptcy but was not assessed prior to the filing of the bankruptcy. 5. Return filed late within 2 years of the filing of the bankruptcy. 6. Excise tax			petition tax liability is dischargeable.

CHAPTER 11
(BUSINESS/NON-INDIVIDUAL)

PRE-PETITION TAX PERIODS: **POST-PETITION**
POST-CONFIRMATION

PRE-
CONFIRMATION

OK to Audit: • Tax liability against an individual debtor which is or will be non-dischargeable. • For an individual income tax or transaction privilege tax liability: 1. Non-filed return, report or any other notice required to be given to the taxing authority. 2. An audit was assessed within 240 days of the filing of the bankruptcy (self-assessment included). This	• Luxury taxes where the return, if required, is due to be filed, including all extensions, within 3 years of the filing of bankruptcy. Or, if no return is required, then within 3 years when the "transaction" given rise to the tax occurred. • Property tax incurred and last payable within 1 year of the filing of bankruptcy. Note: if a personal property return was required to be filed and was not, then this 1 year limitation does not apply.	**OK to Audit:** • As long as the proof of claim is filed within 30 days of the plan of reorganization's confirmation. The claim may be an estimate if the audit is not completed. Post-Confirmation tax periods • OK to proceed as routine audit. A proof of claim for Administrative Expenses must be filed no less than 30 days prior to the disclosure statement.	**Do not Audit:** • Assuming notice of bankruptcy was provided to the governmental unit. If the tax liability is for a pre-petition period, and: 1) the bar date for filing the proof of claim has expired. 2) no proof of claim was filed for the tax period in question. 3) the plan was confirmed • If the debtor is a corporation, the pre-petition tax liability is not entitled to priority treatment and/or will be

period can be extended if: 1) an offer-in-compromise was pending plus 30 days. 2) any time collections was stayed (i.e. automatic stay, plus 90 days). 3. If the return was required to be filed within 3 years of the filing of the bankruptcy. 4. Add tax audit that could have been assessed before the filing of the bankruptcy but was not assessed prior to the filing of the bankruptcy. 5. Return filed late within 2 years of the filing of the bankruptcy. 6. Excise tax	• Withholding tax (or trust fund taxes).		discharged. • If the debt is for a post-petition/pre-confirmation tax period, and the plan of reorganization was confirmed more than 30 days per court order and/or the plan of reorganization's language.

CHAPTER 13

PRE-PETITION TAX PERIODS: POST-CONFIRMATION

POST-PETITION

PRE-

CONFIRMATION

OK to Audit: • Tax liability against an individual debtor which is or will be non-dischargeable. • For an individual income tax or transaction privilege tax liability: 1. Non-filed return, report or any other notice required to be	• Luxury taxes where the return, if required, is due to be filed, including all extensions, within 3 years of the filing of bankruptcy. Or, if no return is required, then within 3 years when the "transaction" given rise to the tax occurred. • Property tax incurred and last payable	All claims must be filed by the bar date to file claims or the Department must petition the court to amend our claim. Objections to plans are required to be filed within 25 days of the first meeting of creditors (341 date). As to any pre-petition returned filed late and not by the 341 date,	**Do not Audit:** • If the debtor is a corporation (Chapter 13 does not apply to corporations). • For any pre-petition tax liability that would be discharge.

given to the taxing authority. 2. An audit was assessed within 240 days of the filing of the bankruptcy (self-assessment included). This period can be extended if: 1) an offer-in-compromise was pending plus 30 days. 2) any time collections was stayed (i.e. automatic stay, plus 90 days). 3. If the return was required to be filed within 3 years of the filing of the bankruptcy. 4. Add tax audit that could have been assessed before the filing of the bankruptcy but was not assessed prior to the filing of the bankruptcy. 5. Return filed late within 2 years of the filing of the bankruptcy. 6. Excise tax	within 1 year of the filing of bankruptcy. Note: if a personal property return was required to be filed and was not, then this 1 year limitation does not apply. • Withholding tax (or trust fund taxes).	the taxing authority has 60 days from the date of filing of the return to file the proof of claim.	

Determination of Tax Liability
11 U.S.C. § 505

Section 505 (11 U.S.C. § 505)

§ 505. Determination of tax liability.

Section 505(a) of the Bankruptcy Code allows a debtor to have a Bankruptcy Court determine the amount or even the legality of a certain types of taxes, as well as any interest or penalties relating to the tax. If the debtor has already litigated the amount or legality of the tax, then he/she/it cannot bring it before the Bankruptcy Court under Section 505(a). **Alert**: under the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (hereinafter "BAPCPA"), ad valorem taxes (property taxes) cannot be challenged if the time for appeal under applicable non-bankruptcy law has expired. 11 U.S.C. § 505(b)(2) (C).

BAPCPA ALERT: A governmental entity can now file with the Clerk of the Court a designated place to receive service of the return and/or any protest of a liability which can be challenged under § 505.

Lien
A.R.S. § 42-1151 Liens

Taxing authorities can have statutes which directly impact their claim. Each agency/governmental entity may have/not have such provisions or statutory powers. A statute check would be required to determine the exact limitations/powers of a governmental entity. For example, the date of when the taxing authority's lien takes effect is governed by statute. The following is an example of a taxing authority's lien:

A.R.S. 42-1151. Lien

A. If any tax, interest or penalty which the department is required to collect is not paid by a taxpayer when due, such unpaid amounts constitute a lien upon all property and rights to property, whether real or personal, belonging to the taxpayer or acquired by him from the date the amounts are assessed or the date the return prescribing the liability is filed until the liability for the assessed amounts is satisfied.

Upon a final assessment, the taxing authority may pursue collections against the taxpayer. The property the lien can attach to is also governed by statute. For example, the homestead exemption is not enforceable against the Arizona Department of Revenue. A.R.S. §42-1202. However, unless the lien is "perfected," the taxing authority cannot affect collections against the taxpayer's property where other creditors hold a perfected superior secured interest. Again, this limitation is per statute. *See* A.R.S §§ 42-1151, *et seq*. BAPCPA ALERT: Taxing authorities' liens were not subject to avoidance by a Bankruptcy trustee/debtor under Bankruptcy Code § 545. Under the revisions to the Bankruptcy Code, this is no longer true. A taxing authorities lien can be avoid now per §545, where appropriate.

Priorities
11 U.S.C. § 507

A. General

The priority of the claim is set forth in Section 507 of the Bankruptcy Code. This Section establishes the order in which the various creditors' unsecured claims are paid in all chapters of bankruptcy. This provision does not apply to secured tax liabilities (assuming that the taxing authority's claim is fully secured; it can be split becoming both secured and unsecured. The latter would need to be analyzed to see if it qualifies as a priority tax.

B. 11 U.S.C. § 507(a)(2) – Administrative Expenses

The order of priority was created by Congress. **BAPCPA ALERT:** Congress did change the order of priorities under §507. Administrative expenses (i.e. attorney's fees, post-petition taxes set forth in § 503(b)(1)(B), etc) now are second in order of priority, behind domestic support obligations and chapter 11 trustee fees versus a chapter 7 trustee's.

BAPCPA ALERT: Administrative tax liabilities have been modified. The Bankruptcy Code now clearly states that taxes are entitled to administrative status, including property taxes. *Id.* It further states that the post-petition taxes (administrative expenses) shall be paid and not request for payment should be required. *Id.* This is consistent with the requirements of 28 U.S.C. 960 which requires that post-petition taxes be paid, which certain exceptions, i.e. taxing authority excuses it, it was a tax incurred prior to a Chapter 7 trustee taking over the business, a court finding of "probable insufficiency of funds." Also, the failure to keep current on the post-petition taxes, both the filing of the returns and the payment of the liabilities there under, are grounds for dismissal or conversion in Chapter 11 bankruptcy. *See 1112(b)(4)(I).* To note, BAPCPA does require a debtor to have filed those pre-petition tax returns or face dismissal or conversion [§ 1308(c)(11)] or denial of confirmation [1328(a)(4)].

C. 11 U.S.C. § 507(a)(8) (Tax Priority Provision for Withholding, Ad Valorem, Income and/or Transaction Privilege Taxes)

Section 507(a)(8) determines which pre-petition taxes are entitled to priority treatment. It is the type of tax that will govern whether it is entitled to priority treatment under the Bankruptcy Code. The analysis of the type of tax is based on its statutory language as interpreted versus how it viewed in the "tax arena." For example, it is commonly stated that in Arizona there is a "sales tax" and that it would be a excise tax. In the tax world that may be true. However, under the statute, Arizona has a gross receipts tax, thereby directly impacting which provision of § 507 applies. No difference exists between transaction privilege taxes and income taxes under the Bankruptcy Code.

Taxes, also, are not merely a tax because it is called one. Like wise, the opposite is true. Thus, the scope of what can be a tax can be quite broad (i.e. worker's compensation payments to an injured employee when the employer did not have the requisite insurance).

BAPCPA ALERT: Note that any time period contained in § 507(a)(8) shall, as to a governmental unit, be suspended in certain circumstances. The stay shall be for any period of time, for a specific time period based upon a given event having occurred, such as: the governmental unit was prohibited from collecting the tax due to applicable non-bankruptcy law as a result of a request by the debtor for a hearing and an appeal of any collection action taken or proposed to be taken; a bankruptcy stay was in effect or where collections was stayed due to the existence of a plan, plus 90 days added to whatever extensions would occur based upon the event which applies. § 507(a)(8) (unmarked, look to the end of that provision).

Guide to Determine If Tax is Priority
Under 11 U.S.C. § 507(a)(8)

1. Income and/or Transaction Privilege Taxes.
11 U.S.C. § 507(a)(8)(A)

Bankruptcy Code
§ 507. Priorities.

(a) The following expenses and claims have priority in the following order:

(8) Eighth, allowed unsecured claims of governmental units, only to the extent that such claims are for --

(A) a tax on or measured by income or gross receipts *for a taxable year ending on or before the date of the filing of the petition* --

(i) for which a return, if required, is last due, including extensions, after three years before the date of the filing of the petition;

(ii) assessed within 240 days *before the date of the filing of the petition exclusive of*—

(I) any time during which an offer in compromise with respect to that tax was pending or in effect during that 240-day period, plus 30 days; and

(II) any time during which a stay of proceedings against collection was in effect under this title during the 240-day period, plus 90 days.

(iii) other than a tax of a kind specified in section 523(a)(1)(B) or 523(a)(1)(C) of this title, not assessed before, but assessable, under applicable law or by agreement, after, the commencement of the case;

Steps to Follow

1. Is the tax an unsecured claim?
   If yes, proceed to the next question.
   If no, the priority provision of the Bankruptcy Code does not apply.

2. Is the tax for income or gross receipts (e.g., transaction privilege taxes, commonly referred to in Arizona as "sales tax")?
   If no, see other subsections (B) through (E) of § 507(A)(8)
   If yes, do one of the follow rules apply:
      the three (3) year rule --507(a)(8)(A)(i)
      the 240 day rule -- 507(a)(8)(A)(ii)
      the not assessed but assessable rule -- 507(a)(8)(A)(iii)

The Three (3) Year Rule -- 507(a)(8)(A)(i)

The key focus of the "Three Year Rule" is the date the return was required to be filed. Look to the type of tax involved, applicable statutes and regulations; and what the debtor is – an individual's filing requirement may be different then a business entities'. The common cause of confusion is that the date the return was filed will be analyzed. Such action is erroneous. For purposes of the Rule, it does not matter when the return was filed or if it was filed at all.

Petition filing date
minus three years ______________________________ Petition filing date
MM/DD/YY
MM/DD/YY

(1) Draw a time line showing the petition filing date on the far right, and the petition filing date minus three years, on the far left.

(2) Mark on the time line the date when the tax return was required to be filed, include all extensions (requested by the debtor, governmental entity is stayed from enforcing collection action, etc, plus 90 days).

(3) If your mark falls on or to the right of the far left of your time line (within the three (3) year period determined above), then the taxes are entitled to priority treatment.

(4) If the mark falls before the far left of your time line, the tax is not entitled to priority under the "Three Year Rule." Go to the next page and see if the "240 Day Rule" applies.

The 240 Day Rule -- 507(a)(8)(A)(ii)

The key focus of this rule is the date the tax was assessed. An assessment can occur two ways, either by the taxpayer filing a return or by an audit. If the assessment is by a filed return, then the assessment date is the Department's "Established Date." If the assessment is by an audit then it depends on whether the proposed audit is protested. "Protesting" a proposed audit means that the taxpayer disputes some aspect of it, ranging from not owing any of it due to factual reasons to challenging the underlying law. After the notice of audit is mailed to the taxpayer, if the taxpayer does not protest within the following designated time frames (depending on tax type), then the assessment will become final.

(a) The protest period of transaction privilege taxes is 45 days.
(b) The protest period for income taxes is 90 days.
(c) Jeopardy assessment is good immediately.

If the audit is protested, there are many avenues it can go (i.e., Hearing Office, Board of Tax Appeals, Tax Court, etc.). When the audit protest is resolved, the assessment date is the Department's "Audit Demand Date." The Arizona Department of Revenue is prohibited from taking collection actions until ten (10) days after the Audit Demand Letter is sent, assuming that the tax is not paid or a payment arrangement is not entered into between the parties. <u>**BAPCPA ALERT**</u>: Thus, when a proposed assessment is appealed it is prohibited from taking collection actions and, the suspension now added as a part of § 507(a)(8) under BAPCPA would apply.

In determining if the 240 Day Rule applies apply the following:

(1) Was there a final assessment?
If yes, go to No. 2.
If no, go to the next rule (Not Assessed But Assessable).

Petition filing date
minus 240 days ________________________________ Petition filing date
MM/DD/YY
MM/DD/YY

(2) Draw a time line showing the petition filing date on the far right and the petition filing date minus 240 days on the far left. Go to No. 3.

(3) Determine when the assessment became final, include all extensions (requested by the debtor, governmental entity is stayed from enforcing collection action, etc, plus 90 days), and mark on the time line the assessment date. Go to No. 4.

(4) Does the mark (the assessment date) fall on or to the right of the far left of the time line?
If yes, then the tax is a priority tax.
If no, the tax is not a priority tax.

(5) If the mark falls before the far left of your time line, then go to the "Not Assessed, But Assessable Rule."

Not Assessed But Assessable Rule -- 507(a)(8)(A)(iii)

This rule can be confusing due to it being poorly written. The best way to understand it is to know what kind of assessment it does not apply to and what kind it does not. It does not apply to audits which have become final, to debtors who have not filed the tax return for the period in question, filers or taxpayers who have filed late returns within two (2) years of the date of the bankruptcy petition. The "Not Assessed But Assessable Rule" applies to "add tax audits." I

An add-tax audit occurs in situations where the taxpayer has filed the requisite return, but the there has been a determination that more money is/may be owed. This rule can come into effect in either the situation where no audit has been started, but under the law, one could begin or, alternatively, one was started prior to the filing of bankruptcy, but not completed before the petition date, i.e. the state's audit is put on hold pending the resolution of a federal one and, the tax payer forgets about before filing bankruptcy.

In determining whether the Rule applies, apply the following:

(1) Does the tax liability relate to a final assessment?
If yes, this rule does not apply.
If no, go to No. 2.

(2) Do the taxes relate to a non-filer audit?
If yes, this rule does not apply.
If no, go to No. 3.

(3) Was the return filed late within two (2) years of the filing of the bankruptcy petition?
If yes, this rule does not apply
If no, go to No. 4.

(4) Could an audit pursuant to state law (A.R.S. § 42-113) be performed as of or after the date of the debtor's filing of bankruptcy?
If yes, then the tax is a priority tax.
If no, this rule does not apply.

2. Ad Valorem Taxes Priority - 11 U.S.C. § 507(a)(8)(B)

Ad valorem taxes are property taxes. They can be either real or personal property type taxes. The type of tax involved will be dependent upon the type of property involved. Additionally, the type of property may impact the calculation of and/or the tax liability in general. Certain types of property are governed by statute to determine their liability, i.e. religious institutions, mines, telecommunications, shopping centers, etc. Likewise, the type of property involved will directly impact what actions are required for filing tax reports, payment of tax liabilities, etc. and may impact how claim is viewed/treated.

Property taxes have a payment date after the assessment date (aka lien date). For example, real property taxes for the 2004 tax year works as follows: the lien date is January 1, 2004, but the taxes do not come due until October 1, 2004 and March 1, 2005. **BAPCPA ALERT**: The Bankruptcy Code now provides that a priority ad valorem tax is that tax which comes due within one (1) year of the filing of bankruptcy. This is a change in that the Bankruptcy Code used to look to the assessment date for priority tax determinations instead. The new change will increase the window for those types of ad valorem taxes that will qualify as a priority.

The question is: did the ad valorem tax liability amount come due with one (1) year of the filing of bankruptcy?

If yes, then the tax is a priority tax.
If no, this rule does not apply.

3. Trust Fund Taxes
11 U.S.C. § 507(a)(8)(C)

All trust fund taxes (i.e., withholding) are entitled to priority status regardless of the time period of the tax in issue.

Exceptions to Discharge

A. General - 11 U.S.C. § 523

"Discharge" is what every debtor hopes to achieve by filing for protection under Title 11, aka the "Bankruptcy Code;" it is the "Brass Ring," so to speak. It is not a "forgiveness of debt" as some like to say. Instead, it is the "extinguishment of personal liability of a Claim." A Claim under the Bankruptcy Code is much more widely defined under the Bankruptcy Code [virtually anything per 11 U.S.C. §101(5)]. Collections may not be affected against a debtor personally through means such as levy, garnishment, seizure, perfection of lien, etc. However, if a lien was perfected against a debtor's existing property pre-petition, then collections can be affected against that property up to the debtor's interest in it.

"Exceptions to Discharge" means those debts which for policy reasons, Congress has determined cannot be discharged, i.e., alimony, child support, damages due to drunk driving, etc. It does not extinguish perfected secured liability which has attached to property.

The receipt of a discharge does not necessarily preclude collection actions against collateral, as opposed to pursuing collection/an action against the debtor. Dischargeability analysis must occur either from both the creditor and the debtor perspective. That, however, is not the end of the analysis. It is important to note that even though a Claim may be discharged, it does not mean that the claim will not be paid. The debt in question could be required to be paid as a priority debt (i.e. in a Chapter 13 bankruptcy all priority tax claims must be paid under the plan, these same liabilities would be non-dischargeable otherwise). Alternatively, if the creditor possesses a secured claim, the debtor will either satisfy it or surrender the security; thus, the creditor receives payment one way or another.

The bottom line is that a "discharge" in a bankruptcy and its ramifications are very much case-fact specific. It is dependant upon:

1) The type of debtor
2) The Bankruptcy Chapter filed
3) The type of discharge sought and;
4) The Claim, <u>NOT</u> debt, in issue.

B. Dischargeability and Taxes

11 U.S.C. § 523(a)(1)

1. Introduction.

<u>**BAPCPA ALERT:**</u> BAPCPA has impacted the discharge provisions of the most common Chapters filed in bankruptcy, namely Chapters 7, 11, and 13. The effects are on a variety of claim types. The focus here is the impact on taxes; to educate both the creditor and debtor, so as to protect their respective interests and to know their rights, respectively BAPCPA. The applicable provision is:

Section 523 is the most significant provision. **<u>BAPCPA ALERT:</u>** As a result of BAPCPA, it now has application in the aforementioned three (3) bankruptcy types. It provides:

(a) A discharge under section 727, 1141, 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual debtor from any debt-

(1) for a tax or a customs duty—

(A) of the kind and for the periods specified in section 507(a)(2) or 507(a)(8) of this title, whether or not a claim for such tax was filed or allowed:

(B) with respect to which a return, *or equivalent report or notice,* if required—

(i) was not filed *or given*; or

(ii) was filed *or given* after the date on which such return, *report or notice* was last due, under applicable law or under any extension, and after two years before the date of the filing of the petition, or

(C) with respect to which the debtor made a fraudulent return or willfully attempted in any manner to evade or defeat such tax;

While these changes may seem minor on their face, nothing could be further from the truth. The following discussion shall cover the dischargeability analysis in the predominant chapters of bankruptcy.

2. Guide to Dischargeability-for Individuals, Sole Proprietorships, and General Partners in Chapters 7, 11 and 13.

The following is a guide to determine whether income taxes and/or non-trust fund transaction privilege ("sales") taxes for an **individual** debtor in either a Chapter 7 or 11 bankruptcy are non-dischargeable. **<u>BAPCPA ALERT:</u>** It does **<u>now</u>** apply to a Chapter 13 individual debtor bankruptcy. § 1328(a)(2). If the tax liability is for trust fund taxes (i.e., withholding), it is non-dischargeable for an individual in either a chapter 7, 11or 13. If an individual debtor files a Chapter 7, 11 or 13 bankruptcy, answer the following questions:

1. Was a required tax return, *equivalent report or notice* filed?

   If yes, proceed to question No. 2.
   If no, the tax is non-dischargeable pursuant to Section 523(a)(1)(B)(i).

2. Was there a late return, *report or notice* filed within the two (2) years immediately preceding the filing of bankruptcy?

   If yes, the debt is non-dischargeable pursuant to Section 523(a)(1)(B)(ii).
   If no, proceed to question No. 3.

3. Was the return fraudulent or was there an attempt to evade taxes?

   If yes, the debt is non-dischargeable pursuant to Section 523(a)(1)(C).
   If no, proceed to question No. 4.

BAPCPA ALERT: The recent changes make the above listed types of tax liabilities non-dischargeable. Thus, a Chapter 13 debtor receives the same discharge, as to those factors listed above, as that of an individual Chapter 7 and/or Chapter 11 debtor.

BAPCPA ALERT: Further, the types of tax liabilities that now are non-dischargeable have been expanded. Arizona's law provides that a taxpayer who has had some change in income is required to file a return, report or some type of notice with the State taxing authority. Per the statute, the taxpayer has the choice of what to provide to the taxing authority. A tax return was not required. Based on this, the Ninth Circuit Court of Appeals held that the "required return" element of § 523 (a)(1)(B) was not satisfied and, therefore, if a taxpayer did have additional liability, was required to notify the taxing authority of this fact and did nothing or did it late within two (2) years of the filing of bankruptcy, the tax claim would be discharged, assuming it did not fit within any of the other requirements. Now, the failure of a debtor did have additional liability, was required to notify the taxing authority of this fact and did nothing or did it late within two (2) years of the filing of bankruptcy, the tax claim would be non-dischargeable.

Back to the Guide to determine dischargeability for Individuals, Sole Proprietorships, and General Partners in Chapters 7 [523(a)(1)], 11 [1141(d)(2) & (6)] and 13 (hardship discharge).

4. Were the taxes for a taxable period for which the return(s) was (were) required to be filed, including all extensions, within three (3) years of the filing of bankruptcy?

   If yes, the debt is non-dischargeable pursuant to Sections 523(a)(1)(A) and 507(a)(8)(A)(i).
   If no, proceed to question No. 5.

5. Were the taxes assessed within two hundred forty (240) days of the filing of bankruptcy?

   a. If yes, the debt is non-dischargeable pursuant to Sections 523(a)(1)(A) and 507(a)(8)(A)(ii).
   b. If no, did the debtor make an offer-in-compromise with respect to the taxes?

      i) If yes, and the taxes were assessed within the past two hundred forty (240) days, plus the additional time now provided under BAPCPA (*See* the Priority Guidelines for income taxes and/or transaction privilege taxes herein), the debt is non-dischargeable pursuant to Sections 523(a)(1)(A) and 507(a)(8)(A)(ii).
      ii) If no, the debt is dischargeable.

   c. If no and the debtor did not make an offer-in-compromise, the debt is dischargeable. Proceed to question No. 6.

6. Have the taxes been assessed?

   If yes, *see* question No. 5 above.
   If the answer is no, then ask the following:

   a. Does the tax relate to a non-filer?

If yes, the assessable but not assessed rule of Section 507(a)(8)(A)(iii) does not apply, but the debt is not dischargeable pursuant to Section 523(a)(1)(B)(i).
If no, proceed to (b).

b. Was the return filed late and within two (2) years of the filing of the bankruptcy petition?

If yes, the assessable but not assessed rule of Section 507(a)(8)(A)(iii) does not apply, but the debt is not dischargeable pursuant to Section 523(a)(1)(B)(ii).
If no, proceed to (c).

c. Were the taxes still assessable under state law as of the date of filing of bankruptcy?

If yes, then the tax is a priority tax and is non-dischargeable pursuant to Sections 523(a)(1)(A) and 507(a)(8)(A)(iii).

BAPCPA ALERT: The reason this portion has been separated is due to the limitations on Chapter 13, non-hardship discharge. These provisions do not apply to a regular Chapter 13 discharge. That being said, the effect is of no consequence since the types of tax liabilities shall be paid under the Chapter 13 plan if a discharge is desired. § 1322(a)(1). Under BAPCPA, liabilities that arise from non-filed tax return(s) in a Chapter 13 case are not dischargeable. If the taxing authority was to do a non-filer audit now under BAPCPA, the liability would be neither non dischargeable nor payable in the plan per §507(a)(1)(8)(A)(iii). The only exception would be if the debtor to signed off on the proposed assessment and it exceeded the 240 day requirement (assuming that no other portion of §§ 507 or 523 apply). This would have the impact of creating a tax return under certain case law. (Section 523 also now defines "return" much broader which would further support this argument.) Thus, the debtor would not be a non-filer.

BAPCPA ALERT: Per § 1141(d)(6), a private entity (non-governmental entity) can benefit from the non-dischargeability provisions listed above. Section 523 (a) 14A) now provides that if the debt, i.e. credit card, was used to pay a tax that would be non-dischargeable under § 523(a)(1), then it would also be non-dischargeable.

Note: Although a tax liability may be non-dischargeable under the guide listed above, if a Chapter 11 plan of reorganization for an individual is confirmed with language providing the debt is discharged and is completed, the liability will be discharged. The plan will be viewed as a contract between the debtor and the Department. The Bankruptcy Court will hold that the taxing authority gave up its right to assert the taxes were non-dischargeable. However, BAPCPA does impact this issue as well. **BAPCPA ALERT:** In order for an individual debtor to receive the Chapter 11 discharge, all payments under the plan must be completed. § 1141(d)(5)(A). Also, a Chapter 11 debtor (not limited to individuals) must pay the pre-petition tax liability within 5 years of the filing of bankruptcy, regardless if it is secured or unsecured priority. § 1129(a)(9)(C) & (D). The payments must be regular, equal payments (no balloon payments) and can not be any less favorable than any non-priority unsecured creditor. *Id.*

3. Guide to Determine Dischargeability for Corporations in Chapters 7 and 11

Per the Bankruptcy Code, a corporation does not receive a discharge. 11 U.S.C. § 727(a)(1). For an entity to receive a discharge it must survive the bankruptcy. In a Chapter 7 bankruptcy, the assets of the corporation are liquidated by the chapter 7 trustee. Since the assets of the corporation are liquidated, it will be subsequently a defunct, non-viable entity. Therefore, it cannot receive a discharge.

A corporation receives a "superdischarge" upon confirmation of its plan of reorganization. 11 U.S.C. § 1141(d). **BAPCPA ALERT:** Section 1141(d)(1) has been modified to limit the "super-discharge" of a Chapter 11. Now, a corporation will not receive a discharge if the debt was the result of a a fraudulent tax return or willfully attempted to evade or defeat a tax or custom. §1141(d)(6). The same is true if the debt to the government arose out of improper conduct on behalf of the corporate debtor in obtaining money, property, services, credit, etc. *Id* Regardless of the discharge, claims will be paid per the terms of the confirmed plan of reorganization. As a result of the "superdischarge," all liabilities arising pre-confirmation are discharged. *Id.* This would even include pre-petition tax liabilities which, but for the bankruptcy, could have been assessed after confirmation. Provided that the proper default language is contained in the plan of reorganization, collections can be affected against the debtor in the event there is a default in the plan (i.e., the required plan payments are not made). It is important to remember that the Chapter 11 discharge does not affect the Department's ability to pursue collections on post-confirmation liabilities. If the confirmed plan of reorganization provides that it is of a liquidating nature, then the dischargeability analysis set forth herein would apply.

4. Guide to Determine Dischargeability in a Chapter 13

Only an individual can receive a discharge in a Chapter 13. 11 U.S.C. §§ 109 and 1328. Chapter 13 is limited to only individuals; a corporation, partnership, etc. cannot file for protection under Chapter 13. The discharge formally received by an individual in a Chapter 13 is commonly referred to as a "superdischarge." **BAPCPA ALERT:** Now, the individual debtor who completes the Chapter 13 plan receives an "improved discharge

The Chapter 13 debtor must make regular monthly payments to a Chapter 13 trustee (who distributes the funds to creditors) pursuant to a confirmed Chapter 13 plan before the improved discharge is received. A Chapter 13 plan will now last five (5) years. The "improved discharge" still does give a debtor a better discharge than in a Chapter 7. *See* §§ 523 & 1328(a). An improved discharge is less favorable than a super discharge. The successful Chapter 13 debtor can not now discharge taxes and/or certain civil restitution and/or damages incurred in a personal injury action, but can still extinguish personal liabilities that arose in other situations which would not be discharged in a Chapter 7. *Id.* It is important to remember that secured claims will be paid up to the value of the debtor's interest in the property, regardless of whether they are dischargeable or not.

The Chapter 13 improved discharge does not affect post-petition tax liabilities. Collection of post-petition tax liabilities may be affected by the bankruptcy in general. *See* §§ 1306 & 1327.

Specific Changes under BAPCPA

Attached is a chart which discusses the changes, focus being on the tax issues, as a result of the implementation of the BAPCPA. It includes some of those changes discussed herein, as well as other tax and non-tax changes.

Bankruptcy Chapter	Entity Type	Bankruptcy Code Provision	General Summary	General Notations
Chapter 7	Individual (Note: presumption is no longer that a person qualifies under Chapter 7. Individual may have to be under a Chapter 13 (*See* discussion of "Means Test").	11 U.S.C. §523 Discharge: If qualifies under Chapter 7 (rebuttable presumption is that Chapter 7 is not available), then occurs in the ordinary course of the given bankruptcy locale/district.	Not all debts are dischargeable. Some non-dischargeable debts do not require any further action (i.e. certain tax claims), while others require litigation (i.e. 11 U.S.C. §523(C). ***<u>Changes: per the Reform Act</u>***: No longer limited to on "returns: being "required." Also, includes "equivalent report or notice." Note: there are various changes to Section 507(a)(8), the priority provision. This provision is incorporated into Section 523 for dischargeability purposes. "Three Year Rule" - tax period definition to be inclusive of the year of filing bankruptcy. §507(a)(8). "240 day Rule" – look to 240 days before the filing of bankruptcy. The period is greater if an offer-in-compromise is pending or in effect. *Id.* Date is extended by 30 days from those extensions. Also, if collections has been stayed during the 240 day rule, then add an additional 90 days to it. (*In re Harris*).	Varies by jurisdiction. In Arizona 4 – 6 months from the first meeting of the creditors. ***<u>Changes: per the Reform Act</u>***: Administrative expenses are now second in Priority behind alimony, child support, and trustee fee if appointed. Impacts on payments, not dischargeabilities. Post-petition tax liabilities for an ongoing business may be impacted. §507(a)(2). Tax returns due post-petition and all liabilities due thereunder must be filed and paid unless specifically excepted out in a particular provision of Title 11 or particular situations in a Chapter 7 bankruptcy. 28 U.S.C. §960. Also See §521 which provides that a debtor can be compelled to

			Amount for determining secured claim status is replacement- standard is the retail merchant would pay for it standard. §506(a)(2). Property tax now go by the date the tax was incurred, instead of assessed. ***<u>Important Global Change to all Section 507(a)(8) provisions</u>***: If governmental unit is prohibited "from collecting" a debt either due to: 1.) "applicable non-bankruptcy law" due to a protest filed by the debtor, then governmental entity get the remainder of the 240 days, plus an additional 90 days, and/or 2.) if a prior bankruptcy (ies) had (have) been filed, then the number of applicable time period is increased by the number of days the stay was in effect if another bankruptcy had been filed which caused the stay of collections If a debt to a private creditor for which the funds obtained went to pay a non-dischargeable tax, then it too would be non-dischargeable. §507(a)(14A). The applicable interest rate is that which it would be under applicable non-bankruptcy law. §551.	file outstanding tax returns that become due post-petition or obtain an extension. Failure to do so can result in a dismissal or conversion. Tax liens now qualify as statutory liens for purposes of Section 545. This will result in tax liens perfected within the 90 days which did not occur in the normal course of businesses for that industry, being subject to preferences. §547

	Partnership	Discharge: Same as individuals for the individual, human partners. The only limitations are dependent on the type of partnership (same as with a limited liability corporation).	Many of the provisions of an individual apply since an individual, non-corporate partner may apply. The only limitations are dependent on the type of partnership (same as with a limited liability corporation).	As to individuals, the same as above.
	Corporation	Discharge: Corporations do not receive a discharge. Their assets are liquidated, leaving nothing at the end of the bankruptcy.	Some of the various provisions would apply if the Debtor business continued to operate post-petition, which is very rare.	Does not occur
Chapter 11	Individual	Discharge: Same as with a Chapter 7 bankruptcy. 11 U.S.C. §1141 incorporating 11 U.S.C. §523	***<u>Changes: per the Reform Act</u>***: Debtor has five (5) years from the date of the petition to pay in "cash" regular installments in a manner not less favorable than the "most favored nonpriority unsecured creditor provided for by the plan (excluding the administrative convenience class). §1129(a)(9)(C). Same treatment can be applicable to secured tax claims. *<u>Id</u>*. In a "small	Upon entry of confirmation order or other plan date specified. ***<u>Changes: per the Reform Act</u>***: Failure to keep current on the filing of returns post-petition can result in the

			business case" bankruptcy, the plan must be filed and_confirmed within 45 days of the filing of bankruptcy. §11929(e). The applicable interest rate is that which it would be under applicable non-bankruptcy law. §551. May retain property even if he/she does not pay all claimants in full, as long as all required domestic support obligations. *See* 1129(b)(2)(B). This negates the "absolute priority rule" for purposes of an individual. Property of the estate is now expanded to be in line with the provision contained in Chapter 13. s1115(a). That is, "property of the estate" shall include pre- and post-petition property until the case is either dismissed, converted or closed.	dismissal or conversion of the case. §1111. Tax returns due post-petition and all liabilities due thereunder must be filed and paid unless specifically excepted out in a particular provision of Title 11 or particular situations in a Chapter 7 bankruptcy. 28 U.S.C. §960. Also See §521 which provides that a debtor can be compelled to file outstanding tax returns that become due post-petition or obtain an extension. Failure to do so can result in a dismissal or conversion. The "small business debtor" must file periodic reports stating various things, including whether r it is in compliance with the filing of and the payment of taxes. § 308. If the Debtor is not current, then it must state so and explain how it got in such situation and it will correct the situation. *Id.*

				Tax liens now qualify as statutory liens for purposes of Section 545. Confirmation does not equate to discharge for an individual. Discharge occurs upon the completion of all payments required under a confirmed plan. §1141(d)(5).
	Partnership	Discharge: Same as individuals for the individual, human partners. The only limitations are dependent on the type of partnership (same as with a limited liability corporation)	Same as individuals	As to individuals, the same as above.
	Corporation	Discharge - A Corporation gets a "super-discharge" upon confirmation, albeit a smaller one then pre-Reform Act. All claims that did and/or could have arisen before the	***New Change***: Tax which arise due fraudulent corporate debt or tax/customs that arise due to a fraudulent return or willful attempt to evade or to defeat the taxes. §1141(d) *See* Individual Chapter 11 herein for terms under a plan.	See Individual above as to interest rates, requirement to file tax returns and pay; keeping current on tax returns and priority provisions.

		filing of bankruptcy (pre-petition) and/or after the filing of bankruptcy but before confirmation (post-petition and pre-confirmation) are discharged and paid, or not, per the terms of the plan. 11 U.S.C. §1114.		
Chapter 13	Individual	**<u>Discharge:</u>** Old way: If a debtor completes their plan, then a "super-discharge" is given. The "super-discharge" extinguishes the personal liability of a claim on all but a few (i.e. child support, alimony, criminal restitution, etc.). ***<u>Changes: per the Reform Act</u>***:		**<u>Old Way:</u>** Upon completion of plan payments (3 – 5 years). ***<u>Changes Per the Reform Act:</u>*** The plan shall be last for five (5) years from the date the first payment is due. §1322. Confirmation hearing shall be held 20 – 45 days after the first meeting of creditors ("FMC"). Tax claims under §507(a)(8) are entitled to

		The Debtor still receives a larger discharge then in a Chapter 7, but not as great as it was pre reform. An individual now receives the same discharge as to taxes as he/she would in a Chapter 7 debtor. The net effect is now debtors have certain types of tax debts be non-dischargeable (i.e. non-filers up to four years prior to the bankruptcy being filed, non-filer audits which did not become final or start pre-petition; filed late within two (2) years of the filing of bankruptcy). Priority taxes [§507(a)(8)] per		interest if debtor has dollars left after paying all allowed claims. §1322. Delinquent pre-petition tax returns (up to 4 years prior to the petition date) must be filed prior to the FMC. §1307. If not, filed, trustee can continue FMS 120 days to get returns filed. If debtor establishes that failure to file return is due to "circumstances beyond the control of the debtor" can get an additional 30 days to file return(s). *Id.* Note: Failure to keep current on the filing of returns post-petition can result in the dismissal or conversion of the case. §1308. There can be setoffs of pre-petition tax refunds against pre-petition debts. §362(b). Note: if there is a dispute regarding the liability, the taxing authority can hold the tax refund until resolution of the matter.

		will be paid in the plan, but certain ones (i.e. those mentioned above) will neither be paid nor discharged upon completion of the plan. 11U.S.C.§1328(b)		Tax liens now qualify as statutory liens for purposes of Section 545.
			If a debtor does not successfully complete their plan, they can request from the Bankruptcy Court that a "hardship discharge" be entered. The effect is the individual debtor receives the same discharge as in a Chapter 7. The applicable interest rate is that which it would be under applicable non-bankruptcy law. §551.	Upon entry by the Court.
	Partnership	Discharge: Same as individuals (Assuming that the partner is an individual not a business entity). If not an individual, they cannot qualify for		As to individuals, the same as above.

		a Chapter 13.		
	Corporation	Discharge: Chapter 13 does not apply.		

ARIZONA CORPORATE TRANSACTION PRIVILEGE TAXES & PERSONAL LIABILITY

UNDERSTANDING:

ARIZONA STATE DEPARTMENT OF REVENUE
v.
ACTION MARINE, INC., et al.

ANSWERS, QUESTIONS OR MORE CONFUSION???

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PERSONAL LIABILITY OF COPORATE TRANSACTION PRIVILEGE TAXES (commonly referred to as "sales taxes") FOR NON-INDIVIDUAL TAXES

The Arizona Department of Revenue has taken a more assertive stance in the pursuit of collecting the taxes from the officers and directors since late 2003/early 2004. What options and/or actions the Department has depends upon the type of tax involved and how the liability is categorized.

The first issue that must be addressed is whether it is responsible officer liability or an assessment of a 100% penalty. The differences may not leap out at the tax practitioner, but they are very significant. The two (2) key differences between these types of liability assessments are 1.) a change in the elements that must be proved and 2.) what can be charged and/or what accrues. With a 100% penalty, the tax authority must establish intent. It is not merely sufficient to state that the taxes were collected, the individual in question had a responsibility to turn the taxes over to the state, and there was a failure to do so. The 100% penalty requires that the person who failed to turn over the funds had the willful intent; That is, there is a statutory requirement that the failure to pay the tax was "willful," as in with the federal statutory equivalent 26 U.S.C. § 6672.

With responsible officer, you have the same burdens with the exception of the intent component. Thus, the government does not have to establish that the responsible officer, director, etc. had any intention, either positive or negative, when the tax collected was not given to the taxing authority. Yes, it is significantly easier on those taxing authorities that rely on responsible officer liability, as opposed to 100% penalty. Questions are simple:

1. What taxes are involved?

2. Was the tax passed along to the ultimate consumer?

3. Did the taxpayer collect the money from the ultimate consumer? And

4. Did the taxpayer turnover the collected money to the tax authority?

Another benefit of using a responsible officer approach as opposed to the 100% penalty is that it is an assessment of the tax. Like with any other tax, there can be the accrual of interest and the imposition of a penalty. As each year passes, the interest is compounded with the tax. Interest would continue to accrue on this higher amount until paid in full. With a 100% penalty, that is not the case. There is no penalty on a penalty. There is no interest accrual on a penalty. Thus, for a tax authority, the ability to use 100% healthy approach is a win-win; that is, they have less to prove and can, potentially, collect any higher amount.

The next question is what kind of taxes is involved. The two taxes on interest are withholding and transaction privilege tax ("TPT") (which is commonly referred to erroneously as "sales tax"). The withholding tax provisions are set forth in A.R.S. § 43-431, *et. seq.* The relevant provision for the tax practitioner who is advising his/her client about personal liability is A.R.S. § 43-435, which states:

> Any person required to collect, truthfully account for and pay over any tax imposed by this title who fails to do so is, in addition to other penalties provided by law, personally liable for the total amount of the tax not collected or accounted for and paid over.

The language is quite clear that if a person, i.e. an employer, takes money out of the account of an employee for withholding taxes, fails to do so, then that employer is personally liable for the 100% tax. This person is liable for the total amount collected and/or not accounted for and paid over to the State. This person is also responsible for any penalties that are incurred. There is not much dispute or issue in connection with withholding taxes.

The tax issue is the TPT. People commonly confuse and/or mistake TPT to be the same as a traditional sales tax. This is a significant mistake. A traditional sales tax has the tax burden on the ultimate consumer. The retailer is not responsible for the sales tax, at least as to paying it. The retailer's liability comes in when the money for taxes collected from the ultimate consumer, held in trust by the retailer for the benefit of the tax authority and it is then not turned over to the tax authority. A traditional sales tax, like that of a withholding tax, is nothing more than a trust fund tax. It is a simple and easy situation to ascertain why the liability is imposed in these cases.

Arizona uses a TPT. With the TPT, the retailer has the tax burden for the "privilege" of doing business in the state of Arizona. Whether the tax is passed on to the ultimate consumer is irrelevant for purposes of original tax liability (thus, those retailers that advertise that they shall pay the "sales tax" for a given promotion is doing nothing more than what the law requires). The problem is that most retailers pass the tax on to the ultimate consumer. This leads to the problem of what does the State do when the retailer passed the tax on to the consumer, but did not remit the money to the taxing authority?

In order to address this issue the state looks to A.R.S. § 42-5028, which provides:

> A person who fails to remit any additional charge made to cover the tax or truthfully account for and pay over any such amount is, in addition to other penalties provided by law, personally liable for the total amount of the additional charge so made and not accounted for or paid over.

The problem is - does the term "person" mean the taxpayer and/or does it also apply to the officers and/or directors. A.R.S. § 42-5028 states "person" can be broadly defined, but it does not necessarily readily include the officers and/or directors. The argument is that the person is not the person responsible to pay the tax. The intent of A.R.S. § 42-5028 may be to address the situation where the TPT was passed on to the ultimate consumer. The problem was/is that the language of A.R.S. § 42-5028 is not the best-worded, leading to the problem before the courts.

The Arizona Supreme Court addressed the issue in its recent decision in *Arizona State Department of Revenue v. Action Marine, Inc. et al.* ("Action Marine"). The decision addressed directly the issue of whether officers and/or director can be held liable for funds collected by an individual at the business entity for the purposes of TPT that are not turned over to the State pursuant to A.R.S. § 42-5028. This decision did not address whether the Department could use other methods for pursuing an individual for the TPT liability, i.e. piercing the corporate veil, invalid corporate status, unjust enrichment, conversion fraud, etc. The Arizona Supreme Court reversed the Court of Appeal's decision that had held that an officer, director, etc. was not liable that has the authority to direct what gets paid, can be liable for the tax amount that is collected, but not turned over to the State.

The decision is a unique one. Generally, taxing statutes are read strictly against the government and more favorably to the taxpayers. *See*: *Ebasco Services, Inc. v. Arizona State Tax Commission*, 105 Arizona 94, 459 P.2d 719 (1969); *Wenner v. Dayton-Hudson Corp.*, 123 Ariz.203, 598 P.2d. 1022 (Ariz. App. 1979); *Dennis Development Co. v. Department of Revenue*, 122 Ariz. 465, 595 P.2d. 1010 (Ariz. App. 1979).

Such was not the case in Action Marine. A review of the decision clearly supports the old adage that bad facts make bad law.[1] The individuals involved in Action Marine were clearly not the token example of good business compliance with the requisite laws.

The facts of the case were:

1. Action Marine was a corporation in the business of selling marine products.

2. Its practices were less then one would hope for, i.e. selling the same boat four (4) times to different individuals.

3. Action Marine filed for bankruptcy in July 2002.

4. Action Marine neither filed post-petition sales tax returns nor paid TPT ("sales") taxes.

5. The Department sought an order from the bankruptcy court requiring Action Marine to file returns and pay taxes.

6. The bankruptcy court ordered the debtor Action Marine to file returns.

7. Action Marine filed the tax returns, which showed money due, but nothing was paid with them.

8. The bankruptcy proceedings concluded with liquidation of Action Marine. The Department received no payment to the Department of the taxes.

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[1] This is best supported by the language set forth in the actual decision. The Court said that one reason that also justified its decision was:

> Moreover, interpreting "person" to include corporate officers or directors assuages concerns that such persons might abuse the privilege of limited liability protection by collecting money from customers under the guise of a state imposed tax, using such monies for other purposes, forcing the taxpayer into bankruptcy, and later claiming limited liability protection. *Cf. Garrett*, 79 Ariz. at 392-93, 291 P.2d at 210 (noting legislature's intent to preclude taxpayers from profiting by collecting money under the guise of a tax). It also encourages those charged with remitting separately collected TPT funds to remit them promptly to ADOR.

Page 9, Paragraph 17.

The Department then filed a lawsuit in State Court against the officers, directors and shareholders of Action Marine seeking payment of the taxes. The individuals responded that with several different arguments, which were: 1.) there was no assessment of tax by the Department; 2.) that the bankruptcy discharged the tax debt; and 3.) A.R.S. § 42-5028 was unconstitutional as vague. The Tax Court ruled in favor of the State, whereas the Court of Appeals reversed.

The Supreme Court stated that A.R.S. § 42-5028 definition of "person" did include officers and/or directors. The Court went through a lengthy discussion of the statute and the legislature's intent. The Court also looked at how other states handled the issue. The Court commented that most states did provide for such enforcement. In support of its position, it cites both sales tax states as well as TPT states.[2] Such rationale is not supported by such an analysis since the statutorily imposed tax burdens are contradictory. The ultimate issue cited by the Supreme Court is now one to determine responsible officer/director liability, but instead to create a potential for responsible individual liability; that is if the burden of establishing the liability and the person's authority can be satisfied.

The Court did not address the issue about the need for the Department to do an assessment prior to the enforcement of the collections. The Court did state that the potential liability would not be limited to the officer and/or director. Instead, it could be much broader. As the Court stated:

> For the remand, we note that a "person" liable under § 42-5028 must have a duty to remit the taxes. *E.g.*, *Inselman*, 334 B.R. at 271 (expressing concern about imposing liability for taxes too broadly). Other jurisdictions require the officer, director, or responsible person to have had control over, responsibility for, or supervision of the money collected to pay the tax. *E.g.*, Cal. Rev. & Tax. Code § 6829(a); 35 Ill. Comp. Stat. 735/3-7(a); Minn. Stat. § 297A.61(2)(c); Mo. Rev. Stat. §144.157(3); Ohio Rev. Code Ann. § 5739.33; *see*

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[2] The Court stated:

> Finally, we note that of the states that have a sales, transaction privilege, or similar tax, a supermajority statutorily imposes personal liability on corporate officers. ADOR has been pursuing withheld taxes from corporate officers and directors under this interpretation of § 43-435. 3 *E.g.*, Ark. Code Ann. § 26-18-501 (1997); Cal. Rev. & Tax. Code § 6829(a) (1998); Colo. Rev. Stat. § 39-21-116.5 (2007); Conn. Gen. Stat. § 12-414a (2000); Del. Code Ann. tit. 30. While including corporate officers within the definition of "person" in § 42-5001(8) would have unmistakably established our legislature's intent and forestalled this lawsuit, we conclude that by enacting § 42-5028, the legislature meant to bring Arizona within the national trend of imposing personal liability on those individuals who fail to remit such taxes.

Pages 9 & 10, Paragraph 18.

also N.J. Stat. Ann. § 54:32B-2(w) (2007) (including any officer who is under a duty to act); *Purcell v. United States*, 1 F.3d 932, 937 (9th Cir. 1993) (finding that a person responsible under 26 U.S.C. §6672 for collecting and remitting income tax withholding was one who "'had the final word as to what bills should or should not be paid' if such individual had the authority required to exercise significant control over the corporation's financial affairs, regardless of whether he exercised such control in fact"). Such tests assist in determining whether the person was responsible for remitting or had assumed a duty to remit monies collected to pay TPTs.

Page 17, Paragraph 29.

Thus, personal liability would/could be applicable to the individual who has "duty to remit the taxes." The Court states that in determining liability, the court below should look to who held the authority to direct payments. Such person can be anyone who has such authority; it could range from the bookkeeper to the manager to a clerk, etc.; the key is a fact intensive search as to the person's responsibilities and/or authority.

The Court did make a significant change as to what can be collected. The Department, operating under a responsible officer approach, was pursuing the tax AND interest and penalty. The Court in Action Marine changed what the Department could collect. Action Marine holds that the State is entitled to only the amount collected by the taxpayer when passed on to the ultimate consumer. There is neither any interest accrual nor is there any penalty that can be assessed. The Court limited the Department to only the amount collected. The end result is that the Department's collections are more akin to the 100% penalty.

The strange twist of the decision is that if the taxpayer collects more than the tax, then it must turn over the entire amount collected to the State. The strange effect is that if there is no tax liability owed by the taxpayer and, assume for sake of argument, the Department has no place to apply these excess funds (unless it quickly determines that a bond is required), what is to happen to these extra dollars? The only place where the excess funds can go is back to the taxpayer via a refund with the payment of interest that has accrued. Another interesting issue is what if the individual does not identify the extra amount as being a "tax amount" on the bill of sale? Is there then the possible assessment/liability against the person who could be responsible for directing payment? Yes, there would be tax liability for the gross sale, but query if it, although understood to be tax by the retailer and the consumer, could qualify as responsible officer liability if not turned over. It would not be an easy case; that is, it would be difficult for it to hold/find that there had been a failure by the individual to turnover the "tax" amount. The bottom line is that the Department is/will be faced with fact intensive issues relating to the TPT – responsible person issue.

It is important to understand that the practical effect of the court's ruling is merely to give legal basis for the actions taken by the State. That being said, the Department is not issuing any proposed assessment to the party who the taxing authority believes collected the funds, but failed to turn them over to the State. As it currently stands, those cases where there is the belief that responsible officer and/or director liability might exist are referred to the Arizona Attorney General's Office ("AG's Office"). The AG's Office thereafter files a Complaint in State Superior Court seeking a judgment holding that the responsible officer, director, and/or person owes the funds in question to the State. **Such an action is not an assessment that is issued by the Department**. Instead, the action is tantamount to a litigation action where a judgment is sought for unjust enrichment and/or conversion of State property being entered against a party.

It is important to note that an individual who is served such a complaint should not merely concede such issue that the liability is a tax and/or there is/has been any assessment. There is not legal basis for saying it without a stipulation to it or a decision by the court. There are numerous factual and legal issues that must be answered prior to the justification of such a judgment, i.e. did the State prove that the party in question direct how and which bills are to be paid. Likewise, if the State files a proof of claim in a bankruptcy asserting a priority claim or, thereafter, asserts the "tax" is non-dischargeable, the individual should contest the allegation for the same reason. In bankruptcy, it should be further noted that, even if a State court judgment is entered (depending upon the language contained in it), it is not a tax since there was never an assessment by the Department. There are clear procedures that the Department must follow in order for there to be an assessment and to ultimately make these taxes non-dischargeable/entitled to priority treatment, none of which are currently being taken. Based on the actions being taken currently, the standards for such a statement/determination have not been satisfied.

Further, Action Marine also modifies the current approach taken by the State. The benefit of pursuing responsible officer, as opposed to the 100% penalty like the Internal Revenue Service, is that there is no requirement for the taxing authority to establish the bad intent on the responsible officer. Additionally, the responsible officer approach, assuming there is an assessment by the Department, would allow for there to be accrual of interest on the tax amount and the assessment of a penalty. The 100% penalty approach does not allow for such actions. There is neither the accrual of interest nor the assessment of a penalty.

The true concern of the tax practitioner is that the taxing authority (please remember the same issue could also apply to cities that impose TPT – sales tax) began to push it to issue an assessment, as opposed to the current approach of bringing the matter in the courts, and the individual does not timely respond (45 days). The Department would then have its assessment. This would give the tax authority much more in the way of rights and powers as to collections. For example, if there is no assessment by the State, then it cannot use any of its statutory collection tool set forth in A.R.S. § 42-1151 *et. seq*. The only tools available for collection would be the standard methods used in any litigation action. It would also defeat in the issue as to the lack of an assessment. Further, it would aid the taxing authority in a bankruptcy analysis in determining what taxes would be non-dischargeable and/or entitled to priority. Please note, whether the Action Marine decision will be supported in bankruptcy is unknown. One judge in Arizona did issue a ruling that was contrary to Action Marine, albeit it was issued prior to the Supreme Court's ruling. *See In re Inselman*, 334 B.R. 267 (Bankr. Ariz. 2005).

What the ultimate outcome will be in that form is unknown at this time. The bottom line that is passed to the responsible officer issue is that the Supreme Court has issued its decision supporting responsible individual liability. As a tax practitioner is important that, when representing an individual who is being charged (not assessed) with the potential liability, to remember that there are a number of defenses that can still be asserted. Those defenses are both factual and there still exists potential legal arguments in connection with the imposition of responsible individual liability as the statute is currently written, i.e. failure to issue an assessment, certain constitutional issues, etc.

The dissenting opinion clearly sets forth the legal issues associated with responsible officer/director liability as well as the "problems" with the majority's opinion and that the statute should be modified if the Legislature wishes to get the results obtained currently by the Action Marine decision.[3] As stated by the Dissent:

> The Court's reading of § 42-5028 has the practical virtue of encouraging corporate officers and directors to be vigilant in assuring that additional charges are remitted and not spent to discharge other corporate debt. Indeed, it is difficult to excuse the Randalls' failure to safeguard funds which were taken from Action Marine's customers on the representation (either express or implied) that they were needed to pay the TPT. But before we in effect pierce

[3] The action taken in this case is directly contradictory to one decided by a bankruptcy in an Arizona Bankruptcy case involving the same issue. *See In re Inselman*, 334 B.R. 267 (Bankr. D. Ariz. 2005)

the corporate veil and impose substantial liability on these individuals in the name of good public policy, I would require that the legislature more clearly enunciate its direction that we do so.

Page 24, Paragraph 40.

The Majority decision recognizes the "benefit" of the decision as recognized by the Dissent, and responds by stating that is reason for finding that its reading and interpretation of "person" is exactly what the legislature meant in creating A.R.S. §42-5028. Pages 15 and 16, Paragraph 27.

It is fair to say that this issue is not over yet . . . .

Arizona Department of Revenue
Subpoena Ad Testificandum and/or Duces Tecum

In the matter of the tax liability of:

Taxpayers Name:
Tax ID Number (s): EIN# : TPT#

The Arizona Department of Revenue

TO:

Pursuant to provisions of ARS § 42-1006, you are directed to appear, unless all of the below discovery is completed and delivered on or prior to the date set forth regarding the appearance date, before the Director of the Arizona Department of Revenue, or his delegate, to give testimony relating to the determination of the tax liability or collection of the tax liability of the above-named taxpayer(s) for the period(s) designated, and/or then and there produce the following books, records, papers and other data: MARCH 01, 2005 - DECEMBER 31, 2008

DEFINITIONS AND INSTRUCTIONS FOR USE QUESTIONS IN LIEU OF TESTIMONY AND REQUESTS FOR ADMISSION

a. All information is to be divulged which is in the possession of the taxpayer(s) or others who may have obtained custody of such information on behalf of the taxpayer(s).

b. The word "you" is used and meant to include the taxpayer(s) and its agents, investigators, employees and other representatives. The word "persons" includes any natural person, firm, corporation, partnership, joint venture, LLC or other forms of business entity.

c. Where an individual question calls for an answer which involves more than one part, each part of the answer should be clearly set out so that it is understandable.

d. The term "document" means every writing and record of every type and description, whether or not in the possession, custody or control of you, your agents, attorneys, servants or representatives, including, but not limited to correspondence, emails, memoranda, and written notes, statements, computer printouts, tapes and records of all types, studies, books, pamphlets, schedules, pictures, voice recordings and every other device or medium on which or through which information of any type is transmitted, recorded or preserved. The term "document" also means a copy where the original is not in your possession, custody, or control, and every copy of a document if such copy is not an identical duplicate of the original.

e. Where a question requests that you identify a document, state: 1) a description of the document, 2) the author of the document, 3) the date of the document, 4) the addressee(s) of the document, 5) the contents of the document, 6) the name(s) of any person whose name or signature appears on the document, and 7) the person who has present custody and control of the document.

f. Where a question requests that you identify a person, state his or her: 1) full name, 2) present or last-known home address and telephone number, 3) present employer's name and address, 4) if employed by a party to this action, the position that the person held with such party at any and all times material to such question.

g. Where information or knowledge in possession of a party is requested, such request includes knowledge of the party's agent, representatives, employees and, unless a privilege applies, that person's attorneys; and further, in answering these interrogatories, you are to furnish such information as is available to you, not merely such information as is in your own knowledge. This means information known by or in possession of your agents or employees, including your attorneys, or any agent who has investigated such matter for you or your attorneys.

h. In the event that your answer to any question is "not applicable" or similar phrase or answer, explain in detail why that question is not applicable.

i. In the event that your answer to any question is "do not know" or similar phrase or answer, explain in detail who, if anyone, would know the answer to that question, where the answer to the question might be found and all efforts that were made by you to obtain the answer to the question.

j. Space is provided for your answers after each question. In the event the space provided is not sufficient for your answer to any question, please attach a separate sheet of paper with the additional information.

j. Unless otherwise stated, the following questions in lieu of testimony are directed to the time periods covered by the audit period.

k. As used in these questions in lieu of testimony, the term "audit period" refers to transaction privilege tax ("TPT") periods MARCH 01, 2005 - DECEMBER 31, 2008.

QUESTIONS IN LIEU OF TESTIMONY

No. 1: .Identify each and every title/position you held in the Taxpayer corporation and the dates that you held such position or title.

No. 2: State the duties of the position(s) identified in Interrogatory No. 1 above?

No. 3: State the number of shares you have held in the Taxpayer corporation and the total amount of shares issued by the Taxpayer corporation.

No. 4: State whether or not you were a director of the Taxpayer corporation.

No. 5: In your position, did you report to others within the Taxpayer corporation as to financial decisions including, but not limited to, which bills to pay, when to pay them, the amount to be paid, the Taxpayer corporation's budget, loans to and from the Taxpayer corporation and payroll? _______

A. If your answer is yes, state the name, address, and corporate title of the individual(s) that you reported to with respect to each of the financial matters applicable above.

B. If you had limited authority to authorize and pay creditors, including taxing authorities, state the nature and amount of your authority.

C. State why you did not issue checks within your authority to the Plaintiff in order to cover the taxes at issue.

D. As to the taxes at issue and if you required authority from another party or parties for authorization to pay those taxes, did you seek that authority and when?

E. As to other creditors and if you required authority from another party or parties for authorization to pay those creditors, did you seek that authority and when?

No. 6: List all checking and savings accounts maintained by the Taxpayer corporation and identify each such account by bank, branch of said bank and account number.

A. Did you have check signing authority with respect to each checking and savings account maintained by the corporation? _______

A. If the answer is yes on some accounts but no on others, identify each account to which you had signing authority.

B. If the answer is no, identify the individual(s) that had such authority as to each account maintained by the Taxpayer corporation.

No. 7: Did you have the authority to hire and dismiss employees? _______ If not, please identify the person(s) with authority to do so.

No. 8: Did you have the authority to enter into contracts on behalf of the Taxpayer corporation? _______ If not, please identify the person(s) with authority to do so.

No. 9: Did you have the authority to purchase equipment, property, and/or supplies for the Taxpayer corporation? _______ If not, please identify the person(s) with authority to do so.

No. 10: Did you have the authority to review invoices to the Taxpayer corporation and pay those invoices or recommend that the invoices be paid? _______ If not, please identify the person(s) with authority to do so.

No. 11: Did you have authority to sign tax returns on behalf of the Taxpayer corporation? _______ If not, please identify the person(s) with authority to do so.

No. 12: State whether or not you had control over or could recommend the adoption or rejection of the Taxpayer corporation's business plans. _______ If not, please identify the person(s) with authority to do so.

No. 13: State whether or not you claim documents and other records of the taxpayer corporation were stolen, destroyed or lost ______________________.

A. Identify the location of the documents or other records at the time they were stolen, destroyed or lost.

B. If the documents or other records were not in your possession at the time they were stolen, destroyed or lost, identify the person(s) who had physical custody of the documents or other records.

C. State whether or not you filed any police reports, insurance claims or any other claim or had any correspondence with regard to any person(s) that had custody or on whose property those records were located and identify each such report, claim or correspondence including to whom each report, claim or correspondence was directed and when it was directed.

DEFINITIONS AND INSTRUCTIONS FOR USE FOR PRODUCTION OF DOCUMENTS

a. All documents or records to be provided include those in the possession of the taxpayer(s) or others who may have obtained custody of such information on behalf of the taxpayer(s).

b. The word "you" is used and meant to include the taxpayer(s) and its agents, investigators, employees and other representatives. The word "persons" includes any natural person, firm, corporation, partnership, joint venture, LLC or other forms of business entity.

c. Unless otherwise stated, the following documents requested are directed to the time periods covered by the audit period.

d. As used herein, the term "audit period" refers to transaction privilege tax ("TPT") periods MARCH 01, 2005 - DECEMBER 31, 2008.

REQUEST FOR PRODUCTION OF DOCUMENTS

1. As to the Taxpayer corporation, copies of any and all corporate bank statements, check registers, cancelled checks, or other bank records, including, but not limited to, signature cards or agreements, for accounts that the corporation had during the audit period(s).

2. As to the Taxpayer corporation, copies of all corporate accounts receivable, accounts payable, general ledgers and payroll ledgers for the audit period(s).

3. As to the Taxpayer corporation, copies of any and all corporate contracts or receipts from

customers during the audit period(s).

4. As to the Taxpayer corporation, copies of all corporate documents contained in the corporate minute book, copies of the by-laws, minutes of all meetings, special or otherwise, and records of stock transfers.

5. As to both the Taxpayer corporation and to you, copies of all correspondence, by letter, memorandum or email, pertaining to any and all financial decisions made or considered by or on behalf of the Taxpayer corporation.

6. As to the Taxpayer corporation, copies of the corporation's income tax returns for the tax years in which the transaction privilege tax or withholding tax liabilities fell.

7. Copies of your personal income tax returns for the tax years in which the transaction privilege tax or withholding tax liabilities fell.

8. If you maintain documents or records have been stolen, destroyed or lost, provide copies of police reports, insurance claims or any other claim or correspondence with any person(s) that had custody or on whose property those records were located.

Place and time for appearance: 1600 West Monroe, Phoenix, Arizona 85007. At the Arizona Department of Revenue:

Before, Revenue Officer, on the _31st _ day of _ MAY, _2012_ Year, at __2:00 pm__. Failure to comply with this subpoena will subject you to proceedings in Superior Court to enforce the requirements of this subpoena. Issued under the authority of the Arizona Department of Revenue this ____________ day of______________, 2012

Under penalties of perjury, I declare that to the best of my knowledge and belief, that the information I provided is accurate and complete.

____

Print Name **Signature** **Date**

A person with a disability may request a reasonable accommodation such as a sign language interpreter by contacting Viola Tiedemann, (602) 716-6331. Requests should be made as early as possible to allow time to arrange the accommodation.

I certify that I served the Subpoena Duces Tecum attached herewith on:

Date: ______________________ ______________Time:______________

TO:

____

____

____

Signature Title Date

Subscribed and sworn to before me

on:____

My Commission Expires On:__________________ Notary Public:__________________________

ADOR 64-1092 (8/00)

IN THE MESA MUNICIPAL COURT

MARICOPA COUNTY, ARIZONA

STATE OF ARIZONA, Plaintiff, vs. Defendant.	)	NO. **ORDER**

The Court has considered the Defendant's Motion to Dismiss Re: Statute of Limitations, the State's Response thereto, the Defendant's Reply and the arguments of counsel presented at hearing. The Court has also considered the State's and Defendant's post-argument Memorandum.

A.R.S. Section 13-107(B)(2) provides prosecutions for misdemeanor offenses must be commenced within one year after actual discovery by the State or within one year after discovery should have occurred with the exercise of reasonable diligence.

Defendant argues the complaint in this matter charges five separate misdemeanor charges, which allegedly occurred July 26, 2011. Among the charges is the allegation Defendant did not remit Transaction and Privilege Tax allegedly owed by his former business, which Defendant alleges ceased business operations in November

Thus, Defendant argues the State would have had actual notice that taxes were not remitted soon after the business closed but certainly well before July 26, 2011. Further, Defendant comports, if the State denies actual notice, the Court could certainly conclude that through the exercise of reasonable diligence, the City should have discovered that fact in time to commence timely prosecution.

Therefore, Defendant contends because the State had either actual knowledge of the violation or should have known, through the exercise of reasonable diligence, that the alleged violation occurred at the close of the business, a complaint filed some 19 months later would be barred by the Statute of Limitations.

The State contends, the Arizona Corporation Commission lists Defendant as the Manager of . and that the limited liability corporation is still in good standing. Further, the Defendant historically signed and filed the Transaction Privilege Tax (TPT) and Use Tax Returns for the with the City of Mesa every month.

The State also contends Defendant failed to file tax returns and remit tax beginning in December 2003. Thereafter, the city began collection efforts to get the tax returns filed and payment of monies owed remitted. Telephonic and field contacts were made with the Defendant beginning in 2007. Defendant on September 11, 2007, told the City he would take care of his outstanding balance. On February 19, 2009, Defendant apologized for not completing his returns and remitting the tax. Again, on the date of October 26, 2009, Defendant informed city he was working on some of the tax returns and he would start sending the returns the following week. Through this process the City received no returns nor remittal of payments.

On May 12, 2010, the City sent an audit letter to Defendant, informing Defendant due to his failure to provide documentation to complete an audit after numerous attempts, the City prepared an estimated jeopardy assessment per Mesa City Code Section 5-10-571. Because the City did not receive requested records from Defendant, the City issued a jeopardy assessment for periods of February 2008 through December 2008, and January 2009 through September 2009. The jeopardy assessment was based on actual returns filed and remitted by Defendant in 2007. The audit assessment was completed and finalized on July 16, 2011.

Subsequently, Defendant ignored multiple notices and requests to resolve the tax liability without pursuing additional enforcement action. On March 22, 2012, Defendant admitted to a City representative he had collected tax money from his customers but would not respond when asked where those funds went. The State contends the Mesa City Code authorizes continuing accumulation of unpaid taxes, penalty and interest until the entire amount is paid in full under, under Section 5-10-540A.

Further, the State portends the Mesa City Code allows the City Tax Collector to "assess additional tax due at any time within four (4) years after the date on which the return is required to be filed or within four (4) years after the date on which the return is filed, whichever period expires later." (M.C.C. Section 5-10-550(A)(1)

The court, by looking at interpretation and application of A.R.S. Section 13-107(B), and attempting to determine and effect the legislature's intent, the process is hindered by some ambiguity in the statute. Under A.R.S. Section 13-107(B)(2), the one year limitation period is triggered by the State's actual or constructive "discovery." But, unfortunately, the statute does not prescribe "what" must actually or constructively be discovered for the limitation clock to begin ticking. Nor does the statute state the degree of certainty with which the discovery must be made. As example, does the limitation period begin when the state discovers or reasonably should have discovered that a suspect possibly committed an offense, or rather, that he or she probably or definitely did so?

Because the statute does not clearly address or answer such questions, it requires a look beyond the wording and to consider other relevant factors in determining its meaning and application in this matter. In State v. Jackson, 208 Ariz. 56, 90 P.3d 90 (2004), the Court noted that, "Arizona criminal statutes of limitations do not begin to run until the State actually discovers or should have discovered *that the offense occurred.*" The Court further noted in Jackson, that, *"to the extent that statement suggests that, under Section 13-107(B), the limitation period commences when the government has actually discovered or through the exercise of reasonable diligence should have discovered that the suspect probably committed the offense in question, we agree."*

The Jackson Court also noted, in citing State v. Wilson, 573 N.W. 2d 248 (Iowa 1998), in providing guidance for discovery task on remand, the Wilson Court stated:

> *"We are satisfied that the discovery rule here should include a probable cause element and a due or reasonable diligence requirement. We*

therefore hold that "discovery" for purposes of section 802.5 (Iowa code providing for similar relief sought under Arizona's statute of limitation laws) *occurs when the authorities know or should know in the exercise of reasonable diligence that there is probable cause to believe a criminal fraud has been committed. The probable cause requirement fits well with the language of section 802.5, which requires 'discovery of the offense.' The due or reasonable diligence requirement is in harmony with our civil discovery rule. It also promotes one of the purposes of a criminal statute of limitations: to discourage inefficient or dilatory law enforcement."*

The Jackson Court then concluded by finding this reasoning persuasive, and therefore likewise adopted "a probable cause element" in construing and applying section 13-107(B). Therefore, ... the limitation period under that statute begins *"when the authorities know or should know in the exercise of reasonable diligence that there is probable cause to believe a criminal (offense) has been committed."* In other words, the facts ultimately discovered and used to support probable cause will be highly relevant in determining whether, with reasonable diligence, the state should have discovered such facts more than 1 year before the prosecution was commenced.

The Jackson Court additionally noted, *"in considering such factors as the statute's spirit, purpose, consequences, and effects, we have no reason to believe the legislature intended to require the state to commence a prosecution before it possesses adequate information to legally initiate charges."*

Finally, mere suspicion or conjecture that a suspect might have committed an offense is insufficient to trigger the limitation period. In construing criminal statutes, the court must apply practical, common sense constructions, not hyper-technical ones that would tend to frustrate the legislative intent. State v. Rodriguez, 205 Ariz. 392, 71 P.3d 919 (App. 2003)

Applying the probable-cause standard, this court cannot conclude the state would or should have discovered probable cause to charge the Defendant by on or "well" before the one year limitation time period (June 19, 2011).

State's argument includes in its allegations by its pleadings, Defendant delayed and promised yet to file the unfiled tax returns to the City of Mesa for over several years of time period. Further, State contends by its pleadings, the City prepared and submitted an estimated jeopardy assessment per Mesa City Code Section 5-10-571, which was completed and finalized on July 16, 2011.

In sum, the record does not support a finding, as argued by the Defendant, that the state should have discovered more than one year before Defendant was charged, that he probably had committed the charged offenses. Only after attempts from the State to obtain promised tax returns and representations by Defendant he would prepare and submit un-submitted tax returns over specified time periods, and the presentation of an estimated jeopardy assessment from last previously filed tax return, were the complaints filed on June 19, 2012.

Therefore, Defendant's motion to dismiss for statute of limitations violation is denied at this time.

DONE IN OPEN COURT, this date: 3 April 2013

Robin W. Allen, Magistrate
Mesa Municipal Court

IN THE MESA MUNICIPAL COURT

MARICOPA COUNTY, ARIZONA

STATE OF ARIZONA, Plaintiff, vs. Defendant.	))))))))))	NO. **O R D E R**

The Court has considered the Defendant's Motion to Dismiss Re: Lack of Jurisdiction, the State's Response thereto, the Defendant's Reply, and the arguments of counsel presented at hearing. The Court has also considered the State and Defendant post-argument Supplemental Memorandum.

Generally, the issue of criminal liability of a person for the commission of a misdemeanor is a matter of proof for trial. However, in this matter it is not disputed that any liability arises solely out of the economic activities of the limited liability company of which the Defendant was a primary member, and thus resolution of the issue presented can be determined prior to trial as a matter of law.

The Defendant was criminally charged with having failed to pay taxes on behalf of his limited liability company, . While Defendant may have had control over the company's business choices and had an obligation to pay taxes, this was a civil obligation. In the case of <u>State v. Angelo</u>, 166 Ariz. 24, 800 P.2d 11 (1990), the Arizona Supreme Court held the officers of a corporation could not be criminally liable for failing to file tax returns with the State of Arizona. The State attempted to distinguish the *Angelo, id.*, by relying on a duty imposed by the Mesa City Code upon "specific people within an LLC to account for and pay the taxes owed to the City. The specific provision of the Mesa City Code provides:

Section 1-23-300, Personal Liability; Presumptions (5005)

(A) Every person with a duty, at any time, to account for and pay over any tax or other amount owed the City, every person who has control or supervision over the payment of any tax or other amount owed the City and every person who has been charged with the responsibility to pay over any tax or other amount owed the City shall be personally liable, jointly and severally, for any additional monies not paid to the City. (5005)

(B) The dissolution, termination or withdrawal from the City of any person shall not affect or discharge the personal liability established by Subsection (A). (5005)

(C) The cessation of business by any person shall not affect or discharge the personal liability created by Subsection (A). (5005)

(D) For purposes of Subsection (A), there shall be a rebuttable presumption that the following persons have a duty to account for and pay over tax and any other amount owed the City. (5005)

BUSINESS FORM	**PERSONS LIABLE**
1. Sole Proprietorship	The Proprietor
2. Partnership	Each Partner
3. Limited Partnership	General Partner
4. Joint Venture	Each participant in the joint venture
5. Corporation	Any officer with control over the Activity giving rise to the debt
6. Limited Liability Company	Each member, manager, or officer
7. Trust	Any Trustee
8. Other Association	Any individual with control over the Activity giving rise to the debt

Failure to pay the tax results in a lien on property. Nothing within the statutory scheme warns an individual that he or she might be subject to criminal sanctions if the business entity to which they belong fails to pay the mandated taxes. Further, under the Mesa City Code, each member, manager or officer of a limited liability company may be liable for the taxes. The State argues it is unreasonable to "claim that a person who is given a duty to pay taxes, and could be jointly and severally liable for the amounts, would not know that they have a duty to pay taxes so as to be on notice for criminal prosecution . . . ." One purpose for limited liability companies is to avoid personal liability. Even civil liability is avoided in most situations. A.R.S. Ann. Section 29-651.

In State v. Angelo, id., the Arizona Supreme Court held:

> A tax payer is *"any person who is liable for any tax which is imposed by this article."* A.R.S. Sec. 42-1301(14). Under prior law, the Department collected transaction privilege taxes from every *"person"* engaged in the business of prime contracting. A.R.S. 42-1308(A). added by Laws 1985, ch. 298, Sec. 16, effective August 7, 1985, repealed by Laws 1988,ch. 161, Sec. 1, effective July 1, 1989. See also, former A.R.S. Sec. 42-1310(2)(i). Moreover, under the present and former code, the *"person"* who does not file a transaction privilege return is the party subject to criminal liability. A *"person"* can either be an individual or a corporation. A.R.S. Sec. 42-1301(8).
>
> In the Angelo case, Angelo Company, Inc. is the taxpayer. It is the entity conducting the business of prime contracting in Arizona. The corporation is therefore the "person liable" within the contemplation of Arizona statutes. See People v. Parvin, 125 Ill. 2d 519, 533 N.E. 2d 813 (1988) (president and sole shareholder of a taxpayer corporation was not the "person" engaged in the business of selling, and thus could not be held criminally liable for failure to file retailer's occupation tax return). Because only the corporation is the taxpayer, only it is obligated to file a return and only it is subject to criminal liability for failure to do so.

The Supreme Court continued and expressed the logical extension of the State's position could lead to absurd results as:

> [a] corporation could authorize several individuals to verify its tax return: its officers, accountants, bookkeepers, attorneys, or other employees. By the state's logic, all of these individuals would be subject to criminal liability if the corporation were to fail to file a transaction privilege tax return.

By extension, the State's argument in the case before this Court could also lead to absurd results if every member of every limited liability were to be deemed subject to criminal liability each time the company failed to pay the City, of Mesa's taxes. Furthermore, in the Angelo case, the Arizona Supreme Court continued and determined there must be a clear warning of the potential from criminal liability before the State can imposed criminal penalties under the due process clause of the Constitution.

The Arizona Supreme Court said:

"Although disregarding such corporate form might conceivably be appropriate in the context of civil tax liability, due process requires that, for purposes of imposing criminal liability on an individual for a corporation's failure to pay a tax return, the statutes must clearly impose the duty to file a return upon an identified individual. Due process requires that a penal statute's definitions be precise and definite." Pierce v. U.S., 314 U.S. 306, 62 S. Ct. 237, 86 L. Ed. 226 (1941) "Due process demands that the statute provide fair notice that engaging in the proscribed conduct risks criminal penalties." Papachriston v. City of Jacksonville, 405 U.S. 156, 92 S. Ct. 839, 31 L. Ed.2d 110 (1972) "The statute must define the offense in terms that people of average intelligence can understand." State v. Varela, 120 Ariz. 596, 587P2d 1173 (1978)

In Arizona Department of Revenue v. Action Marine, Inc., 218 Ariz. 141, 181 P.3d 188 (2008), the Arizona Supreme Court found civil liability on the part of a corporation's officers or directors for the corporation's failure to remit a transaction privilege tax. The Arizona Supreme Court distinguished the civil penalty from the criminal consequences and recognized the *Angelo* opinion resolved the issue of the State's attempt to hold the officers and directors of a corporation criminally responsible.

The State presents a compelling policy argument in favor of imposing personal liability on the operator of an LLC, who failed to file and remit appropriate transaction taxes to the City of Mesa. However, the court finds that the Court's holding in State v. Angelo, 166 Ariz. 24, 800 P.2d 11 (1990) is on point and controlling, as the Defendant has argued in this matter. In accordance, personal criminal liability is precluded, and the Motion to Dismiss is granted as to this Defendant. It is also further ordered vacating any pending and remaining court dates in this matter.

DONE IN OPEN COURT, this date: 3 April 2013

Robin W. Allen, Magistrate
Mesa Municipal Court

Copy of the foregoing delivered this
date: 4/10, 2013, to:

Patricia A. Tracey, Assistant City Prosecutor
Mesa City Prosecutor's Office
250 East First Avenue, 2nd Floor
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By

2013 ARIZONA STATE BAR ANNUAL CONVENTION
Friday, June 21, 2013

COMMUNITY PROPERTY AND BANKRUPTCY: A MATCH MADE IN . . .

PRESENTER

Daniel Furlong

BANKRUPTCY AND COMMUNITY PROPERTY

Daniel Furlong, Attorney, Prescott, Arizona, February 22, 2013

Introduction

The Bankruptcy Code in 11 U.S.C. §524(a)(3) deals with the situation where only one spouse files bankruptcy in a community property state and the married couple has debts which are collectable from any community property. For purposes of this explanation we will assume the wife is filing for bankruptcy and we will refer to the wife as the "filing wife." The wife is referred to as the "debtor" for purposes of bankruptcy. We will assume the husband is not filing for bankruptcy at this time and we will refer to the husband as the "non-filing husband." Legally it makes no difference if we reverse the situation so a husband is filing for bankruptcy and a wife is not filing for bankruptcy.

The law is dealing with two competing interests:

> Giving the marital community a discharge because all community property may be seized by the bankruptcy court even though only one spouse filed bankruptcy. The husband may receive a benefit even though he did not file bankruptcy.
>
> Preventing the wife from getting the benefit of two chapter 7 bankruptcies (her own bankruptcy and a later bankruptcy by her husband) in less than 8 years. The husband may harmed by the wife's prior bankruptcy.

All Community Property Becomes Part Of The Bankruptcy

By filing bankruptcy, the filing wife is filing personally for herself and indirectly for the marital community of the husband and wife. When only the wife files bankruptcy and there are "community claims" as defined by bankruptcy law, then <u>all</u> non-exempt community property as defined by 11 U.S.C. §541(a)(2) (set forth later in this explanation) becomes part of the filing wife's bankruptcy estate. In other words, the non-filing husband may have his interest in non-exempt community property taken by the bankruptcy court to pay community claims.

It does not matter if the non-filing husband agrees or disagrees with the bankruptcy filing by the wife. His consent is not required. For example, the U.S. District Court for the District Of Arizona ruled that all community property becomes part of the bankruptcy estate when one spouse files bankruptcy during the middle of a divorce case which has been ongoing for years, if the divorce court has not divided the community property at the time the bankruptcy is filed. *Birdsell v. Petersen,* 437 B.R. 858 (D. Ariz. 2010). In the *Birdsell* case the U.S. District Court said the bankruptcy court may use the equitable doctrine of recoupment to allow the non-bankrupt spouse a setoff/defense/counterclaim against the bankruptcy trustee taking all of the community property.

The Community Discharge

The filing wife normally receives a discharge of liability for debt. The bankruptcy discharge of the filing wife in a community property state also gives a discharge to the marital community. This discharge is called the "community discharge" and it discharges community claims as discussed later. The non-filing husband's current and future community income and community property are protected by the discharge. The husband receives this benefit even though he did not file bankruptcy. This is explained in the legislative comments to Section 524 of the bankruptcy code:

> *Subsection (a) also codifies the split discharge for debtors in community property states. If community property was in the estate and community claims were discharged, the discharge is effective against community creditors of the nondebtor spouse as well as of the debtor spouse.*

The bankruptcy discharge order mentions the affect of section 524:

> *In a case involving community property: There are special rules that protect certain community property owned by the debtor's spouse, even if that spouse did not file a bankruptcy case.*

A Community Claim Under Bankruptcy Law

The community discharge from the filing wife's bankruptcy prevents a creditor holding an unsecured "community claim" from collecting from present or future community property of the married couple. A community claim is defined in 11 U.S.C. §101(7) as a claim which may be collected from community property of the kind specified in 11 U.S.C. §541(a)(2).

11 U.S.C. §101(7):

> *The term "community claim" means [a] claim that arose before the commencement of the case concerning the debtor for which property of the kind specified in section 541(a)(2) of this title is liable, whether or not there is any such property at the time of the commencement of the case.*

11 U.S.C. §541(a)(2):

> *All interests of the debtor and the debtor's spouse in community property as of the commencement of the case that is -*
>
> *(A) under the sole, equal, or joint management and control of the debtor; or*
>
> *(B) liable for an allowable claim against the debtor, or for both an allowable claim against the debtor and an allowable claim against the debtor's spouse, to the extent that such interest is so liable.*

If no bankruptcy is filed, under Arizona law a debt incurred by the husband before marriage is the husband's sole and separate debt, but ARS 25-214(B) allows that debt to be collected from the husband's contributions to the community property. The common result under Arizona law is that the husband's wages after marriage may be garnished to pay the husband's pre-marital debts even though the wages are community property of both spouses. This Arizona law was enacted to prevent the husband from protecting the husband's wages simply by getting married.

The result is different if the wife files bankruptcy. Bankruptcy law preempts state law. Bankruptcy law classifies the non-filing husband's pre-marital debt as a community claim because ARS 25-214(B) allows it to be collected from community property which is under the sole, equal or joint management or control of the filing wife. The wages earned during marriage by the non-filing husband are community property under state law per ARS 25-211. ARS 25-214(A) gives both spouses equal management, control and disposition rights over the non-filing husband's wages.

As a result of the right of equal management of the wages under Arizona law and as a result of the liability of the wages for the pre-marital debt, the non-filing husband's wages are community property which are liable for a community claim as defined in 11 U.S.C. §541(a)(2). The community discharge under 11 U.S.C. 524(a)(3) prohibits collection from either the husband's or wife's community property/income after bankruptcy despite the fact that only the wife filed bankruptcy and despite the fact that the husband incurred the debt before marriage. An somewhat similar situation occurred in *In re Sweitzer*, 111 B.R. 792 (Bankr. W.D. Wis. 1990) except the debt was incurred as a sole and separate debt by the non-filing husband when the married couple resided in a non-community property state. The couple then moved to Wisconsin, a community property state, where only the wife filed bankruptcy.

Objections To The Community Discharge
Because Of Fraud Or Other Wrongful Conduct By The Non-filing Spouse

If the community creditor believes that the non-filing husband would not be entitled to a discharge of a debt under 11 U.S.C. §523 if the non-filing husband filed a hypothetical bankruptcy, such as for a debt incurred fraudulently or for willful and malicious injury, then the community creditor must file a non-discharge suit in the filing wife's bankruptcy and obtain a judgment of non-discharge. The suit must be filed no later than 60 days after the first date set for the wife's meeting of creditors unless the time limit is extended by the court. The suit will be against the non-filing husband even though he did not file bankruptcy. The failure to do this allows the community to receive a discharge.

Objections To The Community Discharge
Because Of A Prior Bankruptcy By The Non-filing Spouse,
Even If The Non-filing Spouse Was Single At The Time

Normally there is an 8 year waiting period between chapter 7 bankruptcies (filing date to filing date) to be eligible to receive a discharge. 11 U.S.C §727(a)(8). In our example, the wife cannot file a second chapter 7 bankruptcy for another 8 years if she wants a discharge in a second chapter 7. (This assumes a creditor or trustee would object per Bankruptcy Rule 4004(a) to a discharge if the wife filed chapter 7 less than 8 years after the prior chapter 7.)

Can a married couple discharge community debts if the husband and wife file alternate individual chapter 7 bankruptcies less than 8 years apart? For example, what if the wife files chapter 7, then 4 years later the husband files, then 4 year later the wife files when she is eligible (8 years from the wife's prior chapter 7), then 4 years later the husband files when he is eligible (8 years from the husband's prior chapter 7)? The answer depends on whether the trustee or creditors file a motion by a deadline.

As before, for purposes of this explanation we will assume the wife files chapter 7 and obtains a discharge. Assume the marital community incurs new community debt after the wife's chapter 7. The husband can file his own bankruptcy at any time whether or not he remains married to the wife. This is because the husband will not have filed a chapter 7 in the 8 years before he files bankruptcy. However, there is a catch. If the couple remain married, reside in a community property state and the husband files Chapter 7 bankruptcy less than 8 years after wife's bankruptcy filing, then their marital community will not receive a discharge of any community debt in the husband's bankruptcy if an objection is filed.

Apparently it does not matter if the wife was single when she filed chapter 7 and she married and incurred community debt after her bankruptcy. The mere fact that she received a discharge in a prior bankruptcy gives creditors and the trustee the right to object to the community discharge in her husband's later chapter 7. 11 U.S.C.

§524(b)(2). A person considering marriage may want to ask a fiancé about prior bankruptcies.

The trustee or a creditor may object to the community discharge based on the wife's prior bankruptcy. This is done by filing a motion objecting to the community discharge. The motion must be filed no later than 60 days after the first date set for the meeting of creditors in the husband's chapter 7. If the objection is made, then the judge will rule that the marital community is denied a community discharge in the husband's bankruptcy. See 11 U.S.C. §524(b)(2), §727(a)(8), Bankruptcy Rule 4004(a). If the objection is not made, then there will be a community discharge.

Apparently a ruling denying a community discharge will allow the community creditors, after the husband's bankruptcy, to collect from community property as defined in 11 U.S.C. §541(a)(2). Apparently this will allow the filing of collection lawsuits to garnish community income such as the husband's paychecks and the wife's paycheck and to seize and sell their non-exempt community assets. If so, the husband's bankruptcy may be of little value to him as long as he remains married to wife and lives in a community property state unless after bankruptcy he has significant sole and separate income and sole and separate property which remain protected by his discharge.

The husband's chapter 7 will discharge his liability for any non-community claims. It is tempting, but inaccurate, to assume that a sole and separate debt under Arizona law is the same as a non-community claim under bankruptcy law. As discussed above, some Arizona sole and separate debt, such a pre-marital debt, is classified under bankruptcy law as a community claim because Arizona law allows the sole and separate debt to be collected from some of the community property.

As a practical matter, as long as the couple remain married, the wife's chapter 7 probably prevents the husband from benefitting much from filing his own chapter 7 within 8 year after the wife filed her chapter 7 bankruptcy. Otherwise a married couple could discharge community debts by filing alternate separate chapter 7 bankruptcies every 4 years. However, if the trustee or creditors do not file the motion objecting to the discharge before the deadline in the husband's bankruptcy, then the marital community will receive a discharge.

What Notice Must Be Given To Creditors?

The law is not clear whether specific notice must be given to creditors that the person filing bankruptcy ("debtor") is married to a specific person and that a community discharge will be granted unless an objection is filed. Creditors normally only receive a one page Notice giving the name of the debtor, but not giving the name of the debtor's non-filing spouse. There is a space in the Notice where the debtor is required to list any other names used by the debtor and any business names used by the debtor. An extremely cautious debtor might utilize this space in the Notice to list the name of the non-filing spouse, any other names used by the non-filing spouse and the social security number of the non-filing spouse so that the creditors receive this information in the Notice. (This may create a problem with credit reporting agencies and creditors erroneously believing the non-filing spouse filed bankruptcy.) It is doubtful that the law requires this information about the spouse to be in the Notice for the following reason. There is a questionnaire entitled "Statement Of Financial Affairs" which requires the debtor in a community property state to list the name any current spouse and the names of all spouses in the last 8 years. The Statement Of Financial Affairs is not automatically sent to creditors. The Statement Of Financial Affairs is filed with the court and available from the clerk of the court and available for review online by persons who have registered with the court to review documents online. Therefore a creditor may obtain and review the Statement Of Financial Affairs to determine whether the debtor has a spouse and whether an objection may be filed.

When Does A Marital Community End?

The marital community continues as long as the husband and wife remain married, neither dies, and they live in a community property state. *In re Kimmel*, 378 B.R. 630 (9th Cir. BAP 2007); *Burman v. Homan (In re Homan)*, 112 B.R. 356, 360 (9th Cir. BAP 1989). After a divorce, both former spouses remain liable for community debts. *Community Guardian Bank v. Hamlin*, 182 Ariz. 627, 898 P.2d 1005 (App. 1995)(This case did not involve bankruptcy.) As commentators have stated:

> *...the Devil himself could effectively receive a discharge in bankruptcy if he were married to Snow White.*
>
> *If [the Devil] does not treat her better than his creditors, [Snow White] will, by divorcing him, deny his discharge.*

In re Kimmel, 378 B.R. 630 (9th Cir. BAP 2007);

What Is Not Protected By The Community Discharge?

Section 524 does not protect the non-exempt sole and separate property of the non-filing spouse. Most married couples in community property states do not own sole and separate property, so this is not usually a problem. The non-filing spouse's non-exempt sole and separate property and non-exempt sole and separate income remain liable after bankruptcy for pre-bankruptcy community debt if the non-filing spouse incurred that community debt. ARS §25-215(D).

The non-filing spouse's non-exempt sole and separate property and non-exempt sole and separate income remain liable for pre-bankruptcy sole and separate debts of the non-filing spouse.

Examples

Joe and Sally are husband and wife. They have been married for 10 years. They have lived in Arizona, a community property state, for the entire 10 years of their marriage. They own community property. They have community debts. Neither has filed bankruptcy in the last 8 years.

Joe and Sally both work for a living. Their paychecks are community property.

Joe and Sally jointly bought a airplane while married, using their savings from their paychecks during marriage. The airplane is community property and is not exempt.

Joe owned a speed boat when he married Sally. The boat was all paid for before the marriage. Joe has kept the speed boat. The speed boat is Joe's sole and separate property.

Joe owned a $5,000 certificate of deposit before he married Sally. Joe still has the certificate of deposit. The certificate of deposit is Joe's sole and separate property. Joe earns $400 of interest each year on the certificate of deposit. The $400 interest is Joe's sole and separate income.

What happens if Sally files chapter 7 bankruptcy, Sally obtains a discharge, Joe does not file bankruptcy, they remain married, they continue to live in a community property state and they have the following debts and non-exempt assets?

1. AIRPLANE. The airplane is community property and is not exempt. The bankruptcy court can take the airplane and sell it to pay debts. Joe can loose his one half community property interest in the airplane even though he did not file bankruptcy with Sally.

2. HOSPITAL BILL. During the marriage Sally incurred $50,000 in medical bills because she was ill. Joe never agreed to be responsible for these debts. The medical bills are community debts.

> A. Sally’s liability for the hospital bill is discharged by her bankruptcy.
>
> B. The marital community receives a discharge also. The hospital cannot collect the bill out of Joe’s future wages because the wages are community property.
>
> C. The hospital cannot collect out of Joe’s speed boat, certificate of deposit, or the $400 interest because those are Joe’s sole and separate property and Joe did not incur the hospital bill.

3. BANK ONE LOAN. Before the marriage, Joe borrowed $10,000 from Bank One. He never paid off this debt. If there were no bankruptcy, under Arizona law this would be a sole and separate debt, but ARS 25-215(B) would allow Bank One to collect this debt from any sole and separate property of Joe and from Joe’s wages and from any other contribution of Joe to the community property that would have been Joe’s sole and separate property if single. However, bankruptcy law classifies this as community claim because under Arizona law it is collectable from some of the community property (Joe’s wages).

> A. Sally was never liable for Joe’s sole and separate Bank One loan. Bank One cannot collect from Sally before or after her bankruptcy.
>
> B. Joe’s sole and separate debt to Bank One is not discharged by Sally’s bankruptcy. Bank One can collect out of Joe’s speed boat, certificate of deposit and the $400 interest because those are Joe’s sole and separate property.
>
> C. Bank One cannot collect out of Joe’s future community wages even though Joe incurred the debt before marriage. Bankruptcy law preempts Arizona law which normally would allow Bank One to collect from Joe’s wages. Bankruptcy law classifies this as a community claim and prohibits collection from community property.

4. BANK FIVE LOAN. Before the marriage, Sally borrowed $10,000 from Bank Five. She never paid off this debt. If there were no bankruptcy, under Arizona law this would be a sole and separate debt, but ARS 25-215(B) would allow Bank Five to collect this debt from any sole and separate property of Sally and from Sally’s wages and from any other contribution of Sally to the community property that would have been Sally’s sole and separate property if single. However, bankruptcy law classifies this as community claim because it is collectable from some of the community property (Sally’s wages).

> A. Joe was never liable for Sally’s sole and separate Bank Five loan. Bank Five cannot collect from Joe or his sole and

separate property before or after Sally’s bankruptcy.

B. Sally’s liability to Bank Five is discharged by Sally’s bankruptcy. Bank Five cannot collect from Sally.

C. The marital community receives a discharge. Bank Five cannot collect from any community property or community income.

5. CREDIT UNION LOAN. During the marriage Joe borrowed $5,000 from the Credit Union for living expenses for Joe and Sally. Only Joe signed the loan agreement. Sally never signed anything to be responsible for this debt. The Credit Union debt is a community debt.

A. Sally’s liability for the Credit Union loan is discharged because of her bankruptcy.

B. The marital community receives a discharge also. The Credit Union cannot collect the loan out of Joe’s future wages because those wages are community property. The Credit Union cannot collect out of any community property owned by Joe and Sally.

C. The Credit Union can collect out of Joe’s speed boat, certificate of deposit, and the $400 interest, because those are Joe’s sole and separate property, and Joe incurred the Credit Union loan. ARS §25-215(D) provides that the sole and separate property of a spouse that incurs a community debt is liable for that debt.

6. SOLE AND SEPARATE LOAN TO JOE DURING MARRIAGE. During the marriage Joe borrowed $10,000 for reasons that did not benefit the marital community. The lender/creditor agreed in writing that the debt was only the sole and separate debt of Joe and agreed that Sally and the marital community had no liability. This debt is a sole a separate debt of Joe. Under Arizona law it may be collected from Joe’s sole and separate property and Joe’s sole and separate income. It may not be collected from Joe’s contribution to the community.

A. Sally was never liable for this sole and separate loan. The creditor cannot collect from Sally before or after her bankruptcy.

B. Because this is not a community claim under bankruptcy law, the marital community does not receive a discharge of this debt, but this has no practical effect. The creditor cannot collect the loan out of Joe’s future wages because those wages are community property. The creditor cannot collect out of any community property owned by Joe and Sally.

C. The creditor can collect out of Joe’s speed boat, certificate of deposit, and the $400 interest, because those are Joe’s sole and separate property, and Joe incurred the sole and separate loan.

2013 ARIZONA STATE BAR ANNUAL CONVENTION
Friday, June 21, 2013

JUDGES' MATRIX
ELECTRONIC EVIDENCE PROCEDURES

TECHNOLOGY IN THE COURTROOM - THE FUTURE IS NOW!

PRESENTERS

Honorable Brenda Moody Whinery

Hilary Barnes

Jody Corrales

Bradley Cosman

Kyle Hirsch

Josh Kahn

Dale Schian

ELECTRONIC EVIDENCE PROCEDURES
UNITED STATES BANKRUPTCY COURT FOR THE DISTRICT OF ARIZONA
ARIZONA STATE BAR CONVENTION BANKRUPTCY CLE
JUNE 21, 2013

Judge	Electronic Exhibits Mandatory?	Exhibit Procedures
RJH	NO	Except when exhibits are very few in number, they shall be brought to court in tabbed and indexed exhibit books at the time of commencement of any evidentiary hearing. The Court requires at least one original exhibit book, which the witness may use during testimony, one bench copy, and one copy for opposing counsel. There is no need to arrange for the marking of such exhibits in advance.
GBN	NO	Exhibits shall be brought to court at the time of commencement of the evidentiary or final hearing. Voluminous exhibits shall be in tabbed and indexed binders. Exhibits will be marked by the courtroom deputy at the time they are offered into evidence. The original exhibits shall be maintained by the courtroom deputy. Additional copies shall be provided for opposing counsel, the witness and for the bench by the proponent of the exhibit.
SSC	YES	Electronic exhibits may be presented in the following formats: CD-Rom, Audiotape, Videotape, Electronically filed documents, Power Point, or other exhibit programs, such as Sanctions or Trial Director. Counsel shall provide the Courtroom Clerk with a disc or thumb drive containing the exhibits that will become part of the official record, and shall provide an additional thumb drive for Judge Curley's use. Counsel are encouraged to confer on presenting one thumb drive that contains both parties' exhibits. Plaintiff's exhibits should be identified by numbers; Defendant's exhibits should be identified by alphabet. Provide the Courtroom Deputy with an exhibit list of all exhibits to be submitted. Exhibit list may be emailed to Wanda Garberick. Contact Wanda Garberick at 602-682-4148 or sscecfhearing@azb.uscourts.gov two (2) weeks prior to the trial to schedule a time for testing. The parties shall be responsible for presentation of the evidence, including operating any computer program, the document camera, or any video device. This may be done by the lawyer presenting the evidence or by another person providing assistance. The Courtroom Deputy will not assist the parties during the trial or hearing. **GUIDELINES FOR DOCUMENT PRESENTATIONS**: 1. Select landscape mode (horizontal format) for presentations. This format fits the document camera and monitors the best. 2. Use fonts that are easy to read with a size of 20 point or greater and

		maintain at least a 2-inch border all around. 3. Use bright, bold colors. 4. Use simple charts, such as pie and bar charts. 5. Provide copies of your handouts to all parties <u>before</u> hearing. 6. To avoid constantly re-aligning and focusing from the document camera: 1) staple pages together; 2) tape the bottom page to the document camera; 3) zoom and focus on first page; 4) turn the following pages when ready; and 5) if you experience a "bleed," insert a blank piece of paper between each page. 7. Connection Types: VGA, S-video, composite video, HDMI, Display Port and DVI. 8. Resolution up to 1024 x 768.
EWH	YES	Electronic exhibits may be presented in the following formats: CD-Rom, audiotape, videotape, electronically filed documents, Power Point, or other exhibit programs, such as Sanctions or Trial Director. The Courtroom Deputy will not mark the electronic exhibit with a traditional exhibit tag. Instead, counsel and/or parties are to work together to properly mark the exhibits and to provide an electronic list of all exhibits using the form provided below to the Courtroom Deputy along with an electronic copy of the exhibits. The exhibit list should also be filed on the case docket. The parties are encouraged to exchange the exhibits in electronic format and have them available for their own use during the hearing. Counsel and/or parties who present electronic exhibits are to contact Teresa Mattingly at 520-202-7968 or Teresa_Mattingly@azb.uscourts.gov two (2) weeks prior to the trial to schedule a time for testing. **GUIDELINES FOR DOCUMENT PRESENTATIONS**: 1. Select landscape mode (horizontal format) for presentations. This format fits the document camera and monitors the best. 2. Use fonts that are easy to read with a size of 20 point or greater and maintain at least a 1/2-inch border all around. 3. Use bright, bold colors. 4. Use simple charts, such as pie and bar charts. 5. Provide copies of your handouts to all parties <u>before</u> hearing. 6. To avoid constantly re-aligning and focusing from the document camera: 1) staple pages together; 2) tape the bottom page to the document camera; 3) zoom and focus on first page; 4) turn the following pages when ready; and 5) if you experience a "bleed," insert a blank piece of paper between each page.

		7. Connection Types: VGA, S-video, composite video, HDMI, Display Port and DVI. 8. Resolution up to 1024 x 768.
DPC	YES	Counsel should meet and confer as to how best to combine both parties' exhibits on the same thumb drive. Plaintiff's exhibits should be identified by numbers; Defendant's exhibits should be identified by alphabet. Please provide the Courtroom Deputy with an electronic exhibit list. At the time of trial or evidentiary hearing, counsel should provide to the Court two (2) thumb drives that contain both parties' exhibits. One will be retained by the Clerk as part of the official court record; the other will be used by Judge Collins. Counsel and/or parties who present electronic exhibits are to contact Rhonda Vaughan (602-682-4228 or Rhonda_Vaughan@azb.uscourts.gov prior to the trial to schedule a time for testing. The parties shall be responsible for presentation of the evidence, including operating any computer program, the document camera, or any video device. This may be done by the lawyer presenting the evidence or by another person providing assistance. The Courtroom Deputy will not assist the parties during the trial or hearing.
BMW	NO	No specific procedures specified yet. However, this may change in the near future.
EPB	YES	Electronic exhibits may be presented in the following formats: CD-Rom, audiotape, videotape, electronically filed documents, Power Point, or other exhibit programs, such as Sanctions or Trial Director. The Courtroom Deputy will not mark the electronic exhibit with a traditional exhibit tag. Instead, counsel and/or parties are to work together to properly mark the exhibits and to provide an electronic list of all exhibits to the Courtroom Deputy. Please contact Lorraine Davis at 602-682-4188 or Lorraine Davis@azb.uscourts.gov one (1) week prior to the trial/hearing to schedule a time for testing. **GUIDELINES FOR DOCUMENT PRESENTATIONS**: 1. Select landscape mode (horizontal format) for presentations. This format fits the document camera and monitors the best. 2. Use fonts that are easy to read with a size of 20 point or greater and maintain at least a 1/2-inch border all around. 3. Use bright, bold colors. 4. Use simple charts, such as pie and bar charts.

		5. Provide copies of your handouts to all parties before hearing. 6. To avoid constantly re-aligning and focusing from the document camera: 1) staple pages together; 2) tape the bottom page to the document camera; 3) zoom and focus on first page; 4) turn the following pages when ready; and 5) if you experience a "bleed," insert a blank piece of paper between each page. 7. Connection Types: VGA, S-video, composite video, HDMI, Display Port and DVI. 8. Resolution up to 1024 x 768.

2013 STATE BAR OF ARIZONA ANNUAL CONVENTION
Friday, June 21, 2013

You Want Me To Do What?
Ethics for the Bankruptcy Practitioner

Presentation by Associate Members of the Arizona Bankruptcy American Inn of Court

Mentors: Susan Freeman, Cary Forrester, Lori Winkelman, and Edward Bernatavicius

PRESENTERS

Alissa Brice	**Cindy Greene**
Andrea Wimmer	**Elizabeth Fella**
Jody Corrales	**Kenneth Neeley**
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MODERATED BY: The Honorable Daniel P. Collins

TOPICS

I. Maintaining Client Confidences vs. Duty of Candor to the Tribunal: The Juxtaposition of Ethical Rules 1.6 and 3.3

II. Disclosure and Disgorgement/Denial of Fees in Bankruptcy Cases

III. Attorney Compensation in Bankruptcy

IV. Post-Petition Fees in Consumer Cases: Do's and Don'ts

I. MAINTAINING CLIENT CONFIDENCES VS. DUTY OF CANDOR TO THE TRIBUNAL: THE JUXTAPOSITION OF ETHICAL RULES 1.6 AND 3.3

Rule 42, Arizona Rules of Supreme Court (Ethics Rules) – Selections from the Preamble

[7] Many of a lawyer's professional responsibilities are prescribed in the Rules of Professional Conduct, as well as substantive and procedural law. However, a lawyer is also guided by personal conscience and the approbation of professional peers. A lawyer should strive to attain the highest level of skill, to improve the law and the legal profession and to exemplify the legal profession's ideals of public service.

[9] In the nature of law practice, however, conflicting responsibilities are encountered. Virtually all difficult ethical problems arise from conflict between a lawyer's responsibilities to clients, to the legal system and to the lawyer's own interest in remaining an ethical person while earning a satisfactory living. The Rules of Professional Conduct often prescribe terms for resolving such conflicts. Within the framework of these Rules, however, many difficult issues of professional discretion can arise. Such issues must be resolved through the exercise of sensitive professional and moral judgment guided by the basic principles underlying the Rules. These principles include the lawyer's obligation to protect and pursue a client's legitimate interests, within the bounds of the law, while acting honorably and maintaining a professional, courteous and civil attitude toward all persons involved in the legal system.

ER 1.2. Scope of Representation

(d) A lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent, but a lawyer may discuss the legal consequences of any proposed course of conduct with a client and may counsel or assist a client to make a good faith effort to determine the validity, scope, meaning or application of the law.

E.R. 1.6 Confidentiality of Information

(a) A lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent, the disclosure is impliedly authorized in order to carry out the representation or the disclosure is permitted or required by paragraphs (b), (c) or (d), or ER 3.3(a)(3).

(b) A lawyer shall reveal such information to the extent the lawyer reasonably believes necessary to prevent the client from committing a criminal act that the lawyer believes is likely to result in death or substantial bodily harm.

(c) A lawyer may reveal the intention of the lawyer's client to commit a crime and the information necessary to prevent the crime.

(d) A lawyer may reveal such information relating to the representation of a client to the extent the lawyer reasonably believes necessary:

> (1) to prevent the client from committing a crime or fraud that is reasonably certain to result in substantial injury to the financial interests or property of another and in furtherance of which the client has used or is using the lawyer's services;

(2) to mitigate or rectify substantial injury to the financial interests or property of another that is reasonably certain to result or has resulted from the client's commission of a crime or fraud in furtherance of which the client has used the lawyer's services;
(3) to secure legal advice about the lawyer's compliance with these Rules;
(4) to establish a claim or defense on behalf of the lawyer in a controversy between the lawyer and the client, to establish a defense to a criminal charge or civil claim against the lawyer based upon conduct in which the client was involved, or to respond to allegations in any proceeding concerning the lawyer's representation of the client; or
(5) to comply with other law or a final order of a court or tribunal of competent jurisdiction directing the lawyer to disclose such information.
(6) to prevent reasonably certain death or substantial bodily harm.

E.R. 1.6 – Select Comments

[4] Paragraph (a) prohibits a lawyer from revealing information relating to the representation of a client. This prohibition also applies to disclosures by a lawyer that do not in themselves reveal protected information but could reasonably lead to the discovery of such information by a third person. A lawyer's use of a hypothetical to discuss issues relating to the representation is permissible so long as there is no reasonable likelihood that the listener will be able to ascertain the identity of the client or the situation involved.

[5] Except to the extent that the client's instructions or special circumstances limit that authority, a lawyer is impliedly authorized to make disclosures about a client when appropriate in carrying out the representation some situations, for example, a lawyer may be impliedly authorized to admit a fact that cannot properly be disputed or, to make a disclosure that facilitates a satisfactory conclusion to a matter. Lawyers in a firm may, in the course of the firm's practice, disclose to each other information relating to a client of the firm, unless the client has instructed that particular information be confined to specified lawyers.

[7] Although the public interest is usually best served by a strict rule requiring lawyers to preserve the confidentiality of information relating to the representation of their clients, the confidentiality rule is subject to limited exceptions. Paragraph (b) recognizes the overriding value of life and physical integrity, and requires the lawyer to make a disclosure in order to prevent homicide or serious bodily injury that the lawyer reasonably believes is intended by a client. In addition, under paragraph (c), the lawyer has discretion to make a disclosure of the client's intention to commit a crime and the information necessary to prevent it. It is very difficult for a lawyer to "know" when such unlawful purposes will actually be carried out, for the client may have a change of mind.

[8] Paragraph (c) permits the lawyer to reveal the intention of the lawyer's client to commit a crime and the information necessary to prevent the crime. Paragraph (c) does not require the lawyer to reveal the intention of a client to commit wrongful conduct, but the lawyer may not counsel or assist a client in conduct the lawyer knows is criminal or fraudulent. See ER 1.2(d); see also ER 1.16 with respect to the lawyer's obligation or right to withdraw from the representation from the client in such circumstances. Where the client is an organization, the lawyer may be in doubt whether contemplated conduct will actually be carried out by the organization. Where necessary to guide conduct, in connection with this Rule, the lawyer may make inquiry within the organization as indicated in ER 1.13(b).

[9] The range of situations where disclosure is permitted by paragraph (d)(1) of the Rule is both broader and narrower than those encompassed by paragraph (c). Paragraph (c) permits disclosure

only of a client's intent to commit a future crime, but is not limited to instances where the client seeks to use the lawyer's services in doing so. Paragraph (d)(1), on the other hand, applies to both crimes and frauds on the part of the client, and applies to both on-going conduct as well as that contemplated for the future. The instances in which paragraph (d)(1) would permit disclosure, however, are limited to those where the lawyer's services are or were involved, and where the resulting injury is to the financial interests or property of others. In addition to this Rule, a lawyer has a duty under ER 3.3 not to use false evidence.

[10] Paragraph (d)(2) addresses the situation in which the lawyer does not learn of the client's crime or fraud until after it has been consummated. Although the client no longer has the option of preventing disclosure by refraining from the wrongful conduct, there will be situations in which the loss suffered by the affected person can be rectified or mitigated. In such situations, the lawyer may disclose information relating to the representation to the extent necessary to enable the affected persons to mitigate reasonably certain losses or to attempt to recoup their losses. Paragraph (d)(2) does not apply when a person who has committed a crime or fraud thereafter employs a lawyer for representation concerning that offense.

[11] A lawyer's confidentiality obligations do not preclude a lawyer from securing confidential legal advice about the lawyer's personal responsibility to comply with these Rules. In most situations, disclosing information to secure such advice will be impliedly authorized for the lawyer to carry out the representation. Even when the disclosure is not impliedly authorized, paragraph (d)(3) permits such disclosure because of the importance of a lawyer's compliance with the Rules of Professional Conduct.

[12] Where a legal claim or disciplinary charge alleges complicity of the lawyer in a client's conduct or other misconduct of the lawyer involving representation of the client, the lawyer may respond to the extent the lawyer reasonably believes necessary to establish a defense. The same is true with respect to a claim involving the conduct or representation of a former client. Such a charge can arise in a civil, criminal, disciplinary or other proceeding and can be based on a wrong allegedly committed by the lawyer against the client or on a wrong alleged by a third person, for example, a person claiming to have been defrauded by the lawyer and client acting together. The lawyer's right to respond arises when an assertion of such complicity has been made. Paragraph (d)(4) does not require the lawyer to await the commencement of an action or proceeding that charges such complicity, so that the defense may be established by responding directly to a third party who has made such an assertion. The right to defend also applies, of course, where a proceeding has been commenced.

[14] Other law may require that a lawyer disclose information about a client. Whether such a law supersedes ER 1.6 is a question of law beyond the scope of these Rules. When disclosure of information relating to the representation appears to be required by other law, the lawyer must discuss the matter with the client to the extent required by ER 1.4. If, however, the other law supersedes this Rule and requires disclosure, paragraph (d)(5) permits the lawyer to make such disclosures as are necessary to comply with the law.

[15] Paragraph (d)(5) also permits compliance with a court order requiring a lawyer to disclose information relating to a client's representation. If a lawyer is called as a witness to give testimony concerning a client or is otherwise ordered to reveal information relating to the client's representation, however, the lawyer must, absent informed consent of the client to do otherwise and except for permissive disclosure under paragraphs (c) or (d), assert on behalf of the client all nonfrivolous claims that the information sought is protected against disclosure by this Rule, the

attorney-client privilege, the work product doctrine, or other applicable law. In the event of an adverse ruling, the lawyer must consult with the client about the possibility of appeal. See ER 1.4. Unless review is sought, however, paragraph (d)(5) permits the lawyer to comply with the court's order.

[16] In situations not covered by the mandatory disclosure requirements of paragraph (b), paragraph (d)(6) permits discretionary disclosure when the lawyer reasonably believes disclosure is necessary to prevent reasonably certain death or substantial bodily harm.

[17] Paragraph (d) permits disclosure only to the extent the lawyer reasonably believes the disclosure is necessary to accomplish one of the purposes specified. Where practicable, the lawyer should first seek to persuade the client to take suitable action to obviate the need for disclosure. In any case, a disclosure adverse to the client's interest should be no greater than the lawyer reasonably believes necessary to accomplish the purpose. If the disclosure will be made in connection with a judicial proceeding, the disclosure should be made in a manner that limits access to the information to the tribunal or other persons having a need to know it and appropriate protective orders or other arrangements should be sought by the lawyer to the fullest extent practicable.

[18] Paragraph (d) permits but does not require the disclosure of information relating to a client's representation to accomplish the purposes specified in paragraphs (d)(1) through (d)(5). In exercising the discretion conferred by this Rule, the lawyer may consider such factors as the nature of the lawyer's relationship with the client and with those who might be injured by the client, the lawyer's own involvement in the transaction and factors that may extenuate the conduct in question. A lawyer's decision not to disclose as permitted by paragraph (d) does not violate this Rule. Disclosure may be required, however, by other Rules. Some Rules require disclosure only if such disclosure would be permitted by this Rule. See ERs 1.2(d), 4.1(b), 8.1 and 8.3. ER 3.3, on the other hand, requires disclosure in some circumstances regardless of whether such disclosure is permitted by this Rule. See ER 3.3(b).

[19] If the lawyer's services will be used by the client in materially furthering a course of criminal or fraudulent conduct, the lawyer must withdraw, as stated in ER 1.16(a)(1). After withdrawal the lawyer is required to refrain from making disclosure of the client's confidences, except as otherwise provided in ER 1.6. Neither this Rule nor ER 1.8(b) nor ER 1.16(d) prevents the lawyer from giving notice of the fact of withdrawal, and the lawyer may also withdraw or disaffirm any opinion, document, affirmation, or the like.

[22] The duty of confidentiality continues after the client-lawyer relationship has terminated. See ER 1.9(c)(2). See ER 1.9(c)(1) for the prohibition against using such information to the disadvantage of the former client.

ER 3.3. Candor Towards the Tribunal

(a) A lawyer shall not knowingly:

(1) make a false statement of fact or law to a tribunal or fail to correct a false statement of material fact or law previously made to the tribunal by the lawyer;

(2) fail to disclose to the tribunal legal authority in the controlling jurisdiction known to the lawyer to be directly adverse to the position of the client and not disclosed by opposing counsel; or

(3) offer evidence that the lawyer knows to be false. If a lawyer, the lawyer's client or a witness called by the lawyer has offered material evidence and the lawyer comes to

know of its falsity, the lawyer shall take reasonable remedial measures, including, if necessary, disclosure to the tribunal. A lawyer may refuse to offer evidence, other than the testimony of a defendant in a criminal matter, that the lawyer reasonably believes is false.

(b) A lawyer who represents a client in an adjudicative proceeding and who knows that a person intends to engage, is engaging or has engaged in criminal or fraudulent conduct related to the proceeding shall take reasonable remedial measures, including, if necessary, disclosure to the tribunal.

(c) The duties stated in paragraphs (a) and (b) continue to the conclusion of the proceeding, and apply even if compliance requires disclosure of information otherwise protected by ER 1.6.

(d) In an ex parte proceeding, a lawyer shall inform the tribunal of all material facts known to the lawyer which will enable the tribunal to make an informed decision, whether or not the facts are adverse.

E.R. 3.3 – Select Comments

[1] This Rule governs the conduct of a lawyer who is representing a client in the proceedings of a tribunal. See ER 1.0(m) for the definition of "tribunal." It also applies when the lawyer is representing a client in an ancillary proceeding conducted pursuant to the tribunal's adjudicative authority, such as a deposition. Thus, for example, paragraph (a)(3) requires a lawyer to take reasonable remedial measures if the lawyer comes to know that a client who is testifying in a deposition has offered evidence that is false.

[2] This Rule sets forth the special duties of lawyers as officers of the court to avoid conduct that undermines the integrity of the adjudicative process. A lawyer acting as an advocate in an adjudicative proceeding has an obligation to present the client's case with persuasive force. Performance of that duty while maintaining confidences of the client, however, is qualified by the advocate's duty of candor to the tribunal. Consequently, although a lawyer in an adversary proceeding is not required to present an impartial exposition of the law or to vouch for the evidence submitted in a cause; the lawyer must not mislead the tribunal by false statements of law or fact or evidence that the lawyer knows to be false.

[3] An advocate is responsible for pleadings and other documents prepared for litigation, but is usually not required to have personal knowledge of matters asserted therein, for litigation documents ordinarily present assertions by the client, or by someone on the client's behalf, and not assertions by the lawyer. Compare ER 3.1. However, an assertion purporting to be on the lawyer's own knowledge, as in an affidavit by the lawyer or in a statement in open court, may properly be made only when the lawyer knows the assertion is true or believes it to be true on the basis of a reasonably diligent inquiry. There are circumstances where failure to make a disclosure is the equivalent of an affirmative misrepresentation. The obligation prescribed in ER 1.2(d) not to counsel a client to commit or assist the client in committing a fraud applies in litigation. Regarding compliance with ER 1.2(d), see Comment [10] to that Rule. See ER 8.4(b), Comment [2].

[5] Paragraph (a)(3) requires that the lawyer refuse to offer evidence that the lawyer knows to be false, regardless of the client's wishes. This duty is premised on the lawyer's obligation as an officer of the court to prevent the trier of fact from being misled by false evidence. A lawyer does not violate this Rule if the lawyer offers the evidence for the purpose of establishing its falsity.

[6] If a lawyer knows that the client intends to testify falsely or wants the lawyer to introduce false evidence, the lawyer should seek to persuade the client that the evidence should not be offered. If the persuasion is ineffective and the lawyer continues to represent the client, the lawyer must refuse to offer the false evidence. If only a portion of a witness's testimony will be false, the lawyer may call the witness to testify but may not elicit or otherwise permit the witness to present the testimony that the lawyer knows is false.

[8] The prohibition against offering false evidence only applies if the lawyer knows that the evidence is false. A lawyer's reasonable belief that evidence is false does not preclude its presentation to the trier of fact. A lawyer's knowledge that evidence is false, however, can be inferred from the circumstances. See ER 1.0(f). Thus, although a lawyer should resolve doubts about the veracity of testimony or other evidence in favor of the client, the lawyer cannot ignore an obvious falsehood.

[10] Having offered material evidence in the belief that it was true, a lawyer may subsequently come to know that the evidence is false. Or, a lawyer may be surprised when the lawyer's client or another witness called by the lawyer offers testimony the lawyer knows to be false, either during the lawyer's direct examination or in response to cross-examination by the opposing lawyer. In such situations or if the lawyer knows of the falsity of testimony elicited from the client during a deposition, the lawyer must take reasonable remedial measures. In such situations, the advocate's proper course is to remonstrate with the client confidentially, advise the client of the lawyer's duty of candor to the tribunal and seek the client's cooperation with respect to the withdrawal or correction of the false statements or evidence. If that fails, the advocate must take further remedial action. If withdrawal from the representation is not permitted or will not undo the effect of the false evidence, the advocate must make such disclosure to the tribunal as is reasonably necessary to remedy the situation, even if doing so requires the lawyer to reveal information that otherwise would be protected by ER 1.6. It is for the tribunal then to determine what should be done - making a statement about the matter to the trier of fact, ordering a mistrial or perhaps nothing.

[11] The disclosure of a client's false testimony can result in grave consequences to the client, including not only a sense of betrayal but also loss of the case and perhaps a prosecution for perjury. But the alternative is that the lawyer cooperate in deceiving the court, thereby subverting the truth-finding process which the adversary system is designed to implement. See ER 1.2(d). Furthermore, unless it is clearly understood that the lawyer will act upon the duty to disclose the existence of false evidence, the client can simply reject the lawyer's advice to reveal the false evidence and insist that the lawyer keep silent. Thus, the client could in effect coerce the lawyer into being a party to fraud on the court.

[12] Lawyers have a special obligation to protect a tribunal against criminal or fraudulent conduct that undermines the integrity of the adjudicative process, such as bribing, intimidating or otherwise unlawfully communicating with a witness, juror, court official or other participant in the proceeding, unlawfully destroying or concealing documents or other evidence or failing to disclose information to the tribunal when required by law to do so. Thus, paragraph (b) requires a lawyer to take reasonable remedial measures, including disclosure if necessary, whenever the lawyer knows that a person, including the lawyer's client, intends to engage, is engaging or has engaged in criminal or fraudulent conduct related to the proceeding.

[13] A practical time limit on the obligation to rectify false evidence or false statements of law and fact has to be established. The conclusion of the proceeding is a reasonably definite point for the

termination of the obligation. A proceeding has concluded within the meaning of this Rule when a final judgment in the proceeding has been affirmed on appeal or the time for review has passed.

[14] Ordinarily, an advocate has the limited responsibility of presenting one side of the matters that a tribunal should consider in reaching a decision; the conflicting position is expected to be presented by the opposing party. However, in an ex parte proceeding, such as an application for a temporary restraining order, there is no balance of presentation by opposing advocates. The object of an ex parte proceeding is nevertheless to yield a substantially just result. The judge has an affirmative responsibility to accord the absent party just consideration. The lawyer for the represented party has the correlative duty to make disclosures of material facts known to the lawyer and that the lawyer reasonably believes are necessary to an informed decision.

[15] Normally, a lawyer's compliance with the duty of candor imposed by this Rule does not require that the lawyer withdraw from the representation of a client whose interests will be or have been adversely affected by the lawyer's disclosure. The lawyer may, however, be required by ER 1.16(a) to seek permission of the tribunal to withdraw if the lawyer's compliance with this Rule's duty of candor results in such an extreme deterioration of the client-lawyer relationship that the lawyer can no longer competently represent the client. Also see ER 1.16(b) for the circumstances in which a lawyer will be permitted to seek a tribunal's permission to withdraw. In connection with a request for permission to withdraw that is premised on a client's misconduct, a lawyer may reveal information relating to the representation only to the extent reasonably necessary to comply with this Rule or as otherwise permitted by ER 1.6.

Nix v. Whiteside, 475 U.S. 157, 106 S.Ct. 988, 89 L.Ed.2d 123 (1986)

Background: This case arose out of the context of a criminal case where, prior to having the defendant testify, the defendant's attorney admonished the defendant that in the event defendant testified falsely, it would be the attorney's duty to advise the court that the defendant was committing perjury. The defendant's testimony at trial did not include the wrong fact, and he was convicted. Following his conviction, he moved for a new trial claiming that he had been deprived of a fair trial by what his attorney told him. This motion was denied. He then sought federal habeas corpus relief which was denied by the District Court, but allowed by the Court of Appeals. The US Supreme Court granted certioari to determine whether the attorney's admonitions with respect to the defendant's intent to perjure himself had the effect of depriving the defendant of his right to effective assistance of counsel.

Why this matters in the bankruptcy context: The United States Constitution, and the Bill of Rights place a very high value on making sure a criminal defendant's rights are protected to the fullest extent possible. Neverthless, the Supreme Court held in Nix that these rights do not negate the duty of candor to the tribunal for the attorney. It seems to follow that if the constitutionally guaranteed rights owed to a criminal defendant are not detrimentally affected by counsel's duty of candor, a debtor in bankruptcy cannot possibly have a greater right to confidentiality.

Select Quotes from the *Nix* Opinion:

- Discussing the effect of the applicable rules of profession conduct for attoneys: "These standards confirm that the legal profession has accepted that an attorney's ethical duty to advance the interests of his client is limited by an equally solemn duty to comply with the law and standards of professional conduct; it specifically ensures that the client may not use false evidence. This special duty of an attorney to prevent and disclose frauds upon the court derives from the recognition that perjury is as much a crime as tampering with witnesses or jurors by way of promises and threats, and undermines the administration of justice. See 1 W. Burdick, Law of Crime §§ 293, 300, 318-336 (1946)." *Nix*, 475 U.S. at 168-69.

- Quoting from Model Rules of Professional Conduct, Rule 3.3, Comment (1983): "When false evidence is offered by the client, however, a conflict may arise between the lawyer's duty to keep the client's revelations confidential and the duty of candor to the court. Upon ascertaining that material evidence is false, the lawyer should seek to persuade the client that the evidence should not be offered or, if it has been offered, that its false character should immediately be disclosed." *Id.* at 169. (Internal Citations Omitted).
- Discussing the Amicus Brief filed by the American Bar Association in the case: "The essence of the brief amicus of the American Bar Association reviewing practices long accepted by ethical lawyers is that under no circumstance may a lawyer either advocate or passively tolerate a client's giving false testimony." *Id.* at 170-71.
- Discussing the juxtaposition of the constitutional right to testity with the duty of candor to the tribunal: "[T]hat privilege cannot be construed to include the right to commit perjury. Having voluntarily taken the stand, petitioner was under an obligation to speak truthfully." *Id.* at 173 (Internal Citations Omitted).

The Arizona State Bar had occasion to examine this issue in the criminal context and issued **State Bar of Arizona Ethics Opinion 00-02[1]: Confidentiality; Candor Toward Tribunals; Criminal Representation; Perjury in March 2000.** The full opinion is available on the State Bar Website, at http://www.azbar.org/Ethics/EthicsOpinions/ViewEthicsOpinion?id=258.

What About Former Clients? Is Withdrawal as Counsel of Record the Answer?

ER 1.9. Duties to Former Clients

(a) A lawyer who has formerly represented a client in a matter shall not thereafter represent another person in the same or a substantially related matter in which that person's interests are materially adverse to the interests of the former client unless the former client gives informed consent, confirmed in writing.

(b) A lawyer shall not knowingly represent a person in the same or a substantially related matter in which a firm with which the lawyer formerly was associated had previously represented a client:

(1) whose interests are materially adverse to that person; and

(2) about whom the lawyer had acquired information protected by ERs 1.6 and 1.9(c) that is material to the matter;

unless the former client gives informed consent, confirmed in writing.

(c) A lawyer who has formerly represented a client in a matter shall not thereafter:

(1) use information relating to the representation to the disadvantage of the former client except as these Rules would permit or require with respect to a client, or when the information has become generally known; or

(2) reveal information relating to the representation except as these Rules would permit or require with respect to a client.

[1] Formal Opinions of the Committee on the Rules of Professional Conduct are advisory in nature only and are not binding in any disciplinary or other legal proceedings. (State Bar of Arizona 1998).

State Bar of Arizona Ethics Opinion 05-05: Candor to Tribunal; Client Perjury; Confidentiality, 7/2005

"This opinion reviews the ethical dilemma posed when an attorney learns that, due to a former client's apparent perjury in a civil proceeding, the attorney has offered false material evidence to a tribunal. The Committee concludes that the Arizona Rules of Professional Conduct, under the facts of this case, provide that the attorney's duty of candor to the tribunal overcomes the ethical duty of preserving the former client's confidences and that the attorney must take reasonable remedial measures effective to undo the effect of the false evidence with respect to the affected tribunal."

Select Quotes from Ethics Opinion 05-05:

- "Under the present Arizona Rules of Professional Conduct, however, the balance has shifted away from preserving client confidences and towards the attorney's duty of candor to the tribunal. ER 3.3(c) explicitly requires the disclosure of a client's false testimony notwithstanding that the attorney "knows" of the false testimony via a client's confidential communication. The Rules make the policy determination that insuring the integrity of the decision-making process trumps, in some instances, a lawyer's traditional duty to protect a client's confidences."
- "Given Attorney's actual knowledge of having unwittingly offered false material evidence resulting from Client's deception, Attorney now has an ethical duty under ER 3.3(a)(3) to take "reasonable remedial measures." The Committee stresses, however, that disclosures made pursuant to ER 3.3 should be narrowly tailored and no broader than necessary to undo the effect of the tainted evidence. See ER 3.3 cmt. [10] (stating that purpose of reasonable remedial measures is to "undo the effect of the false evidence"). Cf. ER 1.6(b) & cmt. [12] (permitting disclosure of client confidences only to the extent necessary to accomplish the purposes set forth in the Rule). "
- "If neither withdrawal of the evidence nor termination of the representation would effectively remediate the fraud, the attorney should consider disclosing the client's misconduct to the tribunal. This drastic step should be taken only after all other reasonable measures have first been tried and failed or carefully considered and rejected."
- "Thus, and unless the ethical obligation under ER 3.3 has run its time limit, an attorney is ethically obligated to "make such disclosure to the tribunal as is reasonably necessary to remedy the situation" even if to do so would otherwise contravene ER 1.6. ER 3.3 cmt. [10]. Further, the fact that a client may ultimately face a prosecution for perjury is not a reason for an attorney to withhold disclosure. See ER 3.3 cmt. [11]; see also Ariz. Op. 93-10, at 4 (stating that if a lawyer has "knowledge" of a client's perjury in a proceeding in which the lawyer represented the client, then ER 3.3 requires disclosure to the tribunal if intermediate remedial measures prove ineffective)."
- "ER 3.3(c) makes clear that the ethical obligation to take reasonable remedial measures survives the end of the attorney-client relationship. The ethical obligation terminates only when the tainted proceedings have concluded."

CONCLUSION by the State Bar in Ethics Opinion 05-05:

"Unless the proceedings are deemed concluded (e.g., an appeal ended or the time to take an appeal has expired), an attorney in a civil proceeding must take reasonable remedial measures upon learning that he or she has unwittingly offered false material evidence due to a client's deception. The duty to take such measures applies only when the attorney has actual knowledge of the false evidence and the evidence is material. Reasonable remedial measures are to be taken in steps and should be no broader than necessary to undo the effect of the tainted evidence. The first step should normally be a private consultation with the client explaining the need to withdraw the tainted evidence and advising that the attorney has a duty to take remedial steps even if the client refuses."

"Failing that attempt at counseling, the attorney's second step should be to seek withdrawal of the evidence from the tribunal's consideration without the client's consent. The attorney can cite ethical obligations as the reason for seeking withdrawal of the evidence, but should normally not inform the tribunal of the client's misconduct (e.g., that the client committed perjury), if such a withdrawal of the evidence would undo the effect of the false evidence. In that circumstance, an attorney must also consider whether he or she has a conflict of interest with the client necessitating an attempt to withdraw from the representation."

"As a last step and only if no other steps would undo the effect of the false evidence, an attorney must make an explicit disclosure of the client's misconduct to the tribunal. In addition, if an attorney has terminated, or been discharged from, a representation and the former client has retained successor counsel, the former attorney should consider whether involving successor counsel would be part of an appropriate remedial measure."

THE BANKRUPTCY CODE

It is important to be aware that as Debtor's Counsel, **YOUR** signature on the petition also constitutes a certification purusant to 11 U.S.C. §707(b)(4)(D), which provides:

> "The signature of an attorney on the petition shall constitute a certification that the attorney has no knowledge after an inquiry that the information in the schedules filed with such petition is incorrect. "

Examples of Consequences Imposed for Hiding Assets and Lying in Bankruptcy:[2]

- *United States v. Lenny Kyle Dykstra*, No. 2:11-CR-00415-DDP (U.S. District Court C.D. CA - Los Angeles Div. 01/27/2012).

Former professional baseball pitcher Lenny ("Nails") Dykstra was sentenced to six months in federal prison for bankruptcy fraud in 2012 and ordered to pay $200,000 in restitution. Dykstra filed bankruptcy and concealed and sold furnishings and baseball memorabilia that belonged to the bankruptcy estate. In connection with bankruptcy, it is a federal criminal offense punishable up to 5 years in prison and $500,000 in fines to conceal assets, make false oaths, make false claims, commit bribery, destroy estate property and withhold property from the trustee, among other things.

- *In re Villalobos*, No. 12-18838 (Bankr. Ariz. 01/07/2013).

The debtor failed to disclose a preferential payment of $8,035 to a relative. The trustee filed a motion requesting the Court to order the debtor's attorney to disgorge attorney fees. Judge Marlar agreed and stated:

[2] Case summaries prepared by Daniel Furlong, Esq. for a prior CLE and reproduced here with the author's permission.

"The Trustee's current motion is addressed to the legal and ethical responsibilities of Debtors' counsel to report, and herself discover and disclose, these same, critical facts. Her job is not to protect the Debtors from the legal consequences of their behavior. Debtors' counsel does not plead that she did not know of this fact at the time the case was being processed by her. She only now asks for the court's understanding and mercy."

"The Debtors' attorney was wrong in not disclosing this critical fact. Bankruptcy is not a game of "hide the ball," to force others within the system to ferret out critical facts. If a lawyer wishes to play that game, she stands to forfeit her license to practice law, and subjects her clients to fines and prison time for perjury in signing their bankruptcy papers under oath."

"Here an appropriate sanction is disgorgement of the entire fee, $2,074. Counsel shall disgorge $2,074 to the Trustee for distribution to creditors. This shall be done within 30 days. Once received, the Trustee shall file a receipt with the court. A final order will be separately entered. Any appeal must be filed within 14 days after its entry on the docket. FED. R. BANKR. P. 8002."

- *In re Kwiatkowski*, No. 10-71359 (Bankr. E.D. Mich. 01/25/2013).

The Chapter 13 debtor in his schedules listed a deficiency debt of $0 owing after a house foreclosure when the debtor knew or had reason to know the deficiency debt was at least $250,000. Had the debtor accurately listed this debt, the debtor would not have qualified for Chapter 13 because his unsecured debts would have been $532,145 and therefore exceeded the $360,475 unsecured debt limit in Chapter 13. The Court found bad faith and dishonesty. The Court refused to confirm any Chapter 13 plan because the debt was not eligible for Chapter 13. As a sanction for dishonesty and bad faith, the Court denied the opportunity to convert to Chapter 11. The debtor was given the option of either converting to Chapter 7 or dismissing the bankruptcy with a prohibition on filing a new bankruptcy for one year.

- *McElhanon v. Hing*, 728 P.2d 256, 151 Ariz. 386 (Ariz. App. 1985).

An attorney maybe held liable in a civil action as a conspirator for assisting a client in a fraudulent transfer to defraud a creditor.

Who Controls the Attorney-Client Privilege in a Chapter 7 Business Case: Trustee or Debtor? [3]

The Chapter 7 Trustee is generally vested with control over the attorney-client privilege, including whether to waive or exercise said privilege. Subsection (e) of Section 542 authorizes the court, after notice and a hearing, to order an attorney, accountant or any other person to turn over or disclose to the estate documents or books "relating to the debtor's property or financial affairs," subject to any privilege that may be asserted by the professional holding them.

In *Commodity Futures Trading Commission v. Weintraub*, 471 U.S. 343 (1985), the specific issue addressed by the US Supreme Court was whether the trustee for a corporate debtor has the

[3] Case summary prepared by Arizona Bankruptcy American Inn of Court members: The Hon. Charles G. Case, Steven Berger, Esq., Tami Lewis, Esq., Dawn Maguire-Bayne, Esq., Scott Brown, Esq., A. Evans O'Brien, Esq., Jessica Sabo, Esq. and John Smith, Esq. for a prior CLE and reproduced here with the authors' permission.

power to waive the debtor's attorney-client privilege with respect to pre-petition communications. The Court held that **the trustee – not the corporate debtor –** is vested with control over the exercise or waiver of the attorney-client privilege, reversing an earlier Seventh Circuit decision.

In reaching this conclusion, the Supreme Court stated that section 542(e) of the Bankruptcy Code was not dispositive, but merely created "an invitation for judicial determination of privilege questions." *Id.* at 351. The Court said:

> In light of the lack of direct guidance from the Code, we turn to consider the roles played by the various actors of a corporation in bankruptcy to determine which is most analogous to the role played by the management of a solvent corporation. *See Butner v. United States*, 440 U.S. 48, 55, 99 S. Ct. 914, 918 (1979). Because the attorney-client privilege is controlled, outside of bankruptcy, by a corporation's management, the actor whose duties most closely resemble those of management should control the privilege in bankruptcy, unless such a result interferes with policies underlying the bankruptcy laws.

The Supreme Court found that, because of the extensive duties imposed upon a trustee in administering the estate, the trustee, rather than the directors of the corporation, occupies the position most closely analogous to the solvent corporation's management. *Id.* at 353. The Court also noted that granting the trustee control of the debtor's attorney-client privilege would not impair any policy of the bankruptcy laws, but instead would serve the important goal of maximizing the value of the estate--a goal that would be frustrated if the former management of the debtor were able to control the privilege. *Id.* The Court stated that "[t]he Code's goal of uncovering insider fraud would be substantially defeated if the debtor's directors were to retain the one management power [i.e., control of the privilege] that might effectively thwart an investigation into their own conduct." *Id.*

The Court found no merit in the debtor's counsel's arguments that vesting the trustee with control of the privilege would chill communications between attorneys and their corporate clients, discriminate against insolvent companies, and leave unprotected the interests of shareholders. Id. at 354. With respect to the latter argument, the Court stated that "[o]ne of the painful facts of bankruptcy is that the interests of shareholders become subordinated to the interests of creditors." Id. at 355. Such subordination, the Court noted, is consonant with the "hierarchy of interests created by the bankruptcy laws." *Id.*

Work Product Privilege

The work-product doctrine protects such items as "interviews, statements, memoranda, correspondence, briefs, mental impressions, [and] personal beliefs." *Hickman v. Taylor*, 329 U.S. 495, 510, (1947). The purpose of the doctrine is to encourage careful and thorough preparation by counsel and it provides him or her with a "certain degree" of privacy, free from necessary intrusion by opposing parties and their counsel. *Id.*

Federal Rule of Civil Procedure 26(b)(3) provides that "[o]rdinarily, a party may not discover documents and tangible things that are prepared in anticipation of litigation or for trial by or for another party or its representative (including the other party's attorney, consultant, surety, indemnitor, insurer, or agent). But subject to Rule 26(b)(4), those materials may be discovered if:

(1) they are otherwise discoverable under Rule 26(b)(1); and

(2) the party shows that it has substantial need for the materials to prepare its case and cannot, without undue hardship, obtain their substantial equivalent by other means.

The burden initially rests on the party asserting the work product doctrine to prove the documents were prepared in anticipation of litigation; the burden then shifts to the party seeking discovery to show just cause to invade the adversary's work product. *In re Tri State Outdoor Media Group*, Inc. 283 B.R. 358 (Bankr. M.D. Ga. 2002).

Bankruptcy Specific Work Product Case Law[4]

- Any work product privilege attaching to email communications between chapter 11 debtor's insiders and their attorneys was waived as to communications that involved potential dispute between insiders and estate, and that insider's counsel disclosed to debtor's attorney and consultant. *In re Asia Crossing, Ltd.*, 322 B.R. 247 (Bankr. S.D. N.Y. 2005).
- Documents disclosed to testifying expert including attorney's work product are discoverable. *In re McRae*, 295 B.R. 676 (Bankr. N.D. Fla. 2003).
- Handwritten notes of counsel for unsecured creditor's committee protected as work product. "The Notes sought by the Debtor go to the very heart of the work product doctrine. They contain the attorney's on-the-spot mental impressions, thoughts and strategies, and are not subject to discovery absent proof that there is at least a compelling need for the documents…." *In re JMP Newcor Intern., Inc*., 204 B.R. 963, 966 (Bankr. N.D. Ill. 1997).
- Investigator's report not protected by the attorney-client privilege but will be protected by the work-product doctrine. *In re Sorrento's I, Inc*., 195 B.R. 502, 506 (Bankr. M.D. Fla. 1996).
- Work product doctrine applies to production of documents prepared in anticipation of litigation and Federal Rule of Civil Procedure 26(b)(3) applies to motions under Bankruptcy Rule 2004 through Bankruptcy Rule 9014 and Rule 26 has not been limited to discovery where litigation has been commenced. *In re Financial Corp. of America*, 119 B.R. 728 (Bankr. C.D. Ca. 1990).

Arizona Specific Case Law[5]

- Under ARCP Rule 26(b)(3), limited protection is afforded to documents and tangible things "prepared in anticipation of litigation or for trial by or for another party or by or for that other party's representative . . .". An expert retained by counsel or by the client at counsel's direction to investigate and produce reports on technical aspects of specific litigation is considered part of the lawyer's investigative staff and the opinions and theories of such expert constitute protectable "work product." Daniel J. McAuliffe & Shirley J. McAuliffe, Arizona Civil Rules Handbook, Rule 501 pg. 1052 (2011 ed.); *citing State ex rel. Corbin v. Ybarra*, 161 Ariz. 188, 777 P.2d 686 (1989).
- The work-product doctrine does not immunize from discovery a lawyer's written or oral communications with an expert who has been hired to provide expert testimony, even if the lawyer hired the expert. *Id.*; *citing Emergency Care Dynamics, Ltd. v. Superior Court In and for County of Maricopa*, 188 Ariz. 32, 932 P.2d. 297 (Ct. App. Div. 1 1997).
- A party waives the work-product protection ordinarily afforded the work of a consulting expert when the party designates that expert to testify at trial. *Green v. Nygaard*, 213 Ariz. 460, 143 P.3d 393 (Ct. App. Div. 2 2006).

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[4] Case summaries prepared by Arizona Bankruptcy American Inn of Court members: The Hon. Charles G. Case, Steven Berger, Esq., Tami Lewis, Esq., Dawn Maguire-Bayne, Esq., Scott Brown, Esq., A. Evans O'Brien, Esq., Jessica Sabo, Esq. and John Smith, Esq. for a prior CLE and reproduced here with the authors' permission.

[5] *Id.*

- The work-product protection can be reinstated by removing the designation before expert-opinion evidence is offered from the witness through production of a report, responses to discovery, or expert testimony. *Id.*

II. DISCLOSURE AND DISGORGEMENT/DENIAL OF FEES IN BANKRUPTCY CASES

I. <u>Disclosure</u>

a. Attorneys for the bankruptcy estate are held to a high standard. Under Section 327(a) they may not "hold or represent an interest adverse to the estate," and under Section 327(c), although they are not disqualified "solely" because of employment by or representation of a creditor, the bankruptcy court "shall" disapprove their employment upon objection if there is an "actual conflict of interest." 11 U.S.C. § 327(a) and (c).

b. Bankruptcy Rule 2014 requires professionals to be employed by the trustee, debtor or creditors' committee to disclose in a verified statement "all" of their connections to the following:

   i. Debtor and its attorneys and accountants;

   ii. Creditors and their attorneys and accountants;

   iii. Parties in interest and their attorneys and accountants; and

      1. The parties in interest that should be identified pursuant to Bankruptcy Rule 2014 will vary based upon the facts of a particular case, but may include:
         a. Insiders (i.e., officers and directors);
         b. Indenture and bond trustees;
         c. Major shareholders;
         d. Major bondholders;
         e. Major contract parties; and
         f. Subsidiaries and affiliates of debtor.

   iv. United States Trustee or any person employed by the United States Trustee.

c. Other matters/information that professionals must disclose:

   i. Unpaid fees or prepetition claims (and the waiver of any prepetition claims).

   ii. Fee arrangements (including the receipt of any retainer or payment by third parties).

      1. *See* 11 U.S.C. § 329(a); *see also In re Kendavis Indus. Int'l, Inc.*, 91 B.R. 742, 762 (Bankr. N.D. Tex. 1988) (disgorging undisclosed retainer); *In re Metro. Enviro., Inc.,* 293 B.R. 871, 889-90 (Bankr.

N.D. Ohio 2003) (disgorging fees in light of undisclosed guaranty of fees by insider).

2. *In re Crimson Invest., N.V.,* 109 B.R. 397, 402 (Bankr. D. Ariz. 1989) (concluding that counsel's failure to disclose forthrightly the source of its compensation should warrant denial of all compensation).

iii. Amounts received during the preference period.

1. *In re James River Coal Co.*, No. 03-04095-MH3-11, 2008 WL 764215, at *8 (Bankr. M.D. Tenn. March 21, 2008) (affirming bankruptcy court's dismissal of avoidance action to recover pre-petition payments to debtor's investment banker based on res judicata effect of disclosure of the transfers in professionals' retention and fee applications).

2. *In re PHP Healthcare Corp.*, No. 98-2608, 2002 WL 923932, at *5 (Bankr. D. Del. May 7, 2002) (permitting avoidance action to proceed to trial and rejecting accounting firm's argument that court orders approving its retention and final fee application were res judicata as to potential preference received by firm, due to failure of firm to disclose potential preferential payment); *In re BCP Mgmt., Inc.*, 320 B.R. 265, 279-80 (Bankr. D. Del. 2005) (same).

iv. Amounts held by professional in trust or as custodian.

1. *In re Sabre Int'l, Inc.*, 289 B.R. 420, 427 (Bankr. N.D. Ohio 2003) (denying fees because accounting firm's original affidavit did not disclose that it was holding $46,000 in trust on account of prepetition services).

v. Joint defense agreements executed by professionals and parties that are adverse to estate.

1. *In re Molten Metal Tech., Inc.*, 289 B.R. 505, 512-14 (Bankr. D. Mass. 2003) (denying final fee application and disgorging interim fees paid to special counsel for failing to disclose that it was a party to a joint defense agreement restricting its ability to disclose information concerning insiders that possessed adverse interests to the estate).

vi. Information concerning conflict waivers by major creditors.

1. *In re Jore Corp.,* 298 B.R. 703, 730-31 (Bankr. D. Mont. 2003) (vacating retention order, disqualifying counsel and disgorging substantially all fees because counsel failed to disclose "no litigation" exception in conflict waiver by debtor's post-petition lenders).

vii. Source of pre-petition retainer and involvement in negotiation of certain pre-petition agreements among debtors, affiliates, and certain creditors.

1. *Neben & Starrett v. Chartwell Fin. Corp. (In re Park-Helena Corp.)*, 63 F.3d 877, 881 (9th Cir. 1995) (stating that "a fee applicant must disclose the precise nature of the fee arrangement, and not simply identify the ultimate owner of the funds.") (quotations omitted).

2. *In re Crimson Invest., N.V.*, 109 B.R. 397, 402 (Bankr. D. Ariz. 1989) (reasoning that debtor's counsel had an interest materially adverse to secured creditors and the bankruptcy estate, and therefore, required a denial of all compensation to debtor's counsel).

3. *American International Refinery, Inc.*, 436 B.R. 364 (Bankr. W.D. La. 2010) (No disqualifying conflict found, but disclosure violations resulted in disgorgement of 20% of fees awarded).

d. All connections must be disclosed, regardless of relevance. Coy or incomplete disclosures that leave the court to ferret out relevant information are insufficient. Professionals that fail to disclose potential conflicts in a spontaneous, timely and complete manner "proceed at their own risk" and may suffer disqualification and disgorgement of all fees.

i. *Kravit, Gass & Weber, S.C. v. Michel (In re Crivello)*, 134 F.3d 831, 836 (7th Cir. 1998) ("Though [Rule 2014] allows the fox to guard the proverbial hen house, counsel who fail to disclose timely and completely their connections proceed at their own risk because failure to disclose is sufficient grounds to revoke an employment order and deny compensation.").

ii. *In re Hot Tin Roof, Inc.,* 205 B.R. 1000, 1003 (B.A.P. 1st Cir. 1997) (stating that attorney "cannot pick and choose which connections are relevant or trivial").

iii. *In re Leslie Fay Cos., Inc.*, 175 B.R. 525, 536 (Bankr. S.D.N.Y. 1994) (stating that professional seeking retention cannot make unilateral determination "regarding relevance of a connection").

iv. *In re Bruno*, 327 B.R. 104, 110 (Bankr. E.D.N.Y. 2005) (stating that the duty of disclosure is of such importance, that the failure of an attorney to disclose all relevant connections is "an independent basis for the disallowance of fees").

v. *In re BH & P, Inc.*, 949 F.2d 1300, 1318 (3d Cir. 1991) (stating that "[n]egligence does not excuse the failure to disclose a possible conflict of interests") (quotations omitted).

vi. *In re Granite Partners*, 219 B.R. 22, 42-43 (Bankr. S.D.N.Y. 1998) (reducing fees and expenses of trustee's law firm that violated Rule 2014(a) when it did not supplement its original disclosure after its representation of adverse client grew from 5 to 400 cases during the bankruptcy proceedings).

vii. *In re Sonicblue Inc.*, 2007 Bankr. LEXIS 1057 (Bankr. N.D. Cal. Mar. 26, 2007) (reasoning that unless adequate disclosure is made and prior approval of the court is obtained, committee counsel can be denied compensation if at any time during the representation counsel is not a disinterested person).

viii. *Rome v. Braunstein*, 19 F.3d 54, 59 (1st Cir. 1994) (affirming bankruptcy court's order that denied fee application of debtor's counsel due to disqualifying conflicts).

ix. *In re EWC, Inc*. (138 B.R. 276 (Bankr. W.D. Ok. 1992) (Failure to disclose potential conflicts is enough to disqualify counsel, regardless of whether it was materially adverse or de minimis, and denial and disgorgement of all compensation was warranted).

e. Fees do not have to be entirely denied or disgorged for failure to disclose potential conflicts. Court may reduce fees instead of denying or disgorging all fees. If there is no actual conflict or harm to the estate and the professional provided a benefit to the estate, then court may use its discretion to allow partial compensation.

i. *In re Film Ventures International, Inc.*, 75 B.R. 250, 252-53 (B.A.P. 9th Cir. 1987) (reasoning that an attorney's failure to completely disclose his connections with the debtor was grounds for denial of compensation wholly apart from the act of representing conflicting interests, however, the Bankruptcy Court had discretion to allow or deny the attorney's fees).

ii. *LSS Supply, Inc.*, 247 B.R. 280, 282 (Bankr. D. Ariz. 2000) (Compensation was denied in part; court reasoned that the debtor's counsel was required to make complete disclosure of connections, and the fact that no actual harm occurred does not preclude sanctions).

iii. *In re Begun*, 162 B.R. 168 (Bankr. N.D. Ill. 1993) (Denial of all fees to real estate broker was not required, despite broker's failure to disclose connections with Chapter 7 trustee's law firm; § 328(a) gives the Court discretion to reduce compensation to professionals already employed under § 327).

iv. *In re Al Gelato Continental Desserts, Inc.*, 99 B.R. 404 (Bankr. N.D. Ill. 1989) (law firm's fees would be reduced by 10% as sanction for failure to disclose representation of potentially adverse interest as required by Bankruptcy Rule 2014(a)).

v. *In re Diamond Mortgage Corporation of Illinois*, 35 B.R. 78 (Bankr. N.D. Ill. 1990) (Holding that attorney's services were of some benefit to estate but 60% of requested fees would be denied as sanction for attorney's failure to make full disclosure to court and representation of adverse interests).

III. ATTORNEY COMPENSATION IN BANKRUPTCY

11 U.S.C. § 329 – Debtor's Transactions with Attorneys

(a) Any attorney representing a debtor in a case under this title, or in connection with such a case, whether or not such attorney applies for compensation under this title, shall file with the court a statement of the compensation paid or agreed to be paid, if such payment or agreement was made after one year before the date of the filing of the petition, for services rendered or to be rendered in contemplation of or in connection with the case by such attorney, and the source of such compensation.

(b) If such compensation exceeds the reasonable value of any such services, the court may cancel any such agreement, or order the return of any such payment, to the extent excessive, to—

> **(1)** the estate, if the property transferred—
>
> > **(A)** would have been property of the estate; or
> >
> > **(B)** was to be paid by or on behalf of the debtor under a plan under chapter 11, 12, or 13 of this title; or
>
> **(2)** the entity that made such payment.

Federal Rule of Bankruptcy 2016 – Compensation for Services Rendered and Reimbursement of Expenses

(a) APPLICATION FOR COMPENSATION OR REIMBURSEMENT. An entity seeking interim or final compensation for services, or reimbursement of necessary expenses, from the estate shall file an application setting forth a detailed statement of (1) the services rendered, time expended and expenses incurred, and (2) the amounts requested. An application for compensation shall include a statement as to what payments have theretofore been made or promised to the applicant for services rendered or to be rendered in any capacity whatsoever in connection with the case, the source of the compensation so paid or promised, whether any compensation previously received has been shared and whether an agreement or understanding exists between the applicant and any other entity for the sharing of compensation received or to be received for services rendered in or in connection with the case, and the particulars of any sharing of compensation or agreement or understanding therefor, except that details of any agreement by the applicant for the sharing of compensation as a member or regular associate of a firm of lawyers or accountants shall not be required. The requirements of this subdivision shall apply to an application for compensation for services rendered by an attorney or accountant even though the application is filed by a creditor or other entity. Unless the case is a chapter 9 municipality case, the applicant shall transmit to the United States trustee a copy of the application.

(b) DISCLOSURE OF COMPENSATION PAID OR PROMISED TO ATTORNEY FOR DEBTOR. Every attorney for a debtor, whether or not the attorney applies for compensation, shall file and transmit to the United States trustee within 14 days after the order for relief, or at another time as the court may direct, the statement required by §329 of the Code including whether the attorney has shared or agreed to share the compensation with any other entity. The statement shall include the particulars of any such sharing or agreement to share by the attorney, but the details of any agreement for the sharing of the compensation with a member or regular associate of the attorney's law firm shall not be required. A supplemental statement shall be filed and transmitted to the United States trustee within 14 days after any payment or agreement not previously disclosed.

(c) DISCLOSURE OF COMPENSATION PAID OR PROMISED TO BANKRUPTCY PETITION PREPARER. Before a petition is filed, every bankruptcy petition preparer for a debtor shall deliver to the debtor, the declaration under penalty of perjury required by §110(h)(2). The declaration shall disclose any fee, and the source of any fee, received from or on behalf of the debtor within 12 months of the filing of the case and all unpaid fees charged to the debtor. The declaration shall also describe the services performed and documents prepared or caused to be prepared by the bankruptcy petition preparer. The declaration shall be filed with the petition. The petition preparer shall file a supplemental statement within 14 days after any payment or agreement not previously disclosed.

Rules of Professional Conduct – ER 1.5 Fees

(a) A lawyer shall not make an agreement for, charge, or collect an unreasonable fee or an unreasonable amount for expenses. The factors to be considered in determining the reasonableness of a fee include the following:

(1) the time and labor required, the novelty and difficulty of the questions involved, and the skill requisite to perform the legal service properly

(2) the likelihood, if apparent to the client, that the acceptance of the particular employment will preclude other employment by the lawyer

(3) the fee customarily charged in the locality for similar legal services

(4) the amount involved and the results obtained

(5) the time limitations imposed by the client or by the circumstances

(6) the nature and length of the professional relationship with the client

(7) the experience, reputation, and ability of the lawyer or lawyers performing the services and

(8) the degree of risk assumed by the lawyer.

(b) The scope of the representation and the basis or rate of the fee and expenses for which the client will be responsible shall be communicated to the client in writing, before or within a reasonable time after commencing the representation, except when the lawyer will charge a regularly represented client on the same basis or rate. Any changes in the basis or rate of the fee or expenses shall also be communicated in writing before the fees or expenses to be billed at higher rates are actually incurred. The requirements of this subsection shall not apply to court-appointed lawyers who are paid by a court or other governmental entity.

(c) A fee may be contingent on the outcome of the matter for which the service is rendered, except in a matter in which a contingent fee is prohibited by paragraph (d) or other law. A contingent fee agreement shall be in a writing signed by the client and shall state the method by which the fee is to be determined, including the percentage or percentages that shall accrue to the lawyer in the event of settlement, trial or appeal, litigation and other expenses to be deducted from the recovery, and whether such expenses are to be deducted before or after the contingent fee is calculated. The agreement must clearly notify the client of any expenses for which the client will be liable whether or not the client is the prevailing party. Upon conclusion of a contingent fee matter, the lawyer shall provide the client with a written statement stating the outcome of the matter and, if there is a recovery, showing the remittance to the client and the method of its determination.

(d) A lawyer shall not enter into an arrangement for, charge, or collect:

(1) any fee in a domestic relations matter, the payment or amount of which is contingent upon the securing of a divorce or upon the amount of alimony or support, or property settlement in lieu thereof;

(2) a contingent fee for representing a defendant in a criminal case; or

(3) a fee denominated as "earned upon receipt," "nonrefundable" or in similar terms unless the client is simultaneously advised in writing that the client may nevertheless discharge the lawyer at any time and in that event may be entitled to a refund of all or part of the fee based upon the value of the representation pursuant to paragraph (a).

(e) A division of a fee between lawyers who are not in the same firm may be made only if:

(1) each lawyer receiving any portion of the fee assumes joint responsibility for the representation;

(2) the client agrees, in a writing signed by the client, to the participation of all the lawyers involved; and

(3) the total fee is reasonable.

Rules of Professional Conduct – ER 1.15 Safekeeping Property

(a) A lawyer shall hold property of clients or third persons that is in a lawyer's possession in connection with a representation separate from the lawyer's own property. Funds shall be kept in a separate account maintained in the state where the lawyer's office is situated, or elsewhere with the consent of the client or third person. Other property shall be identified as such and appropriately safeguarded. Complete records of such account funds and other property shall be kept by the lawyer and shall be preserved for a period of five years after termination of the representation.

(b) A lawyer may deposit the lawyer's own funds in a client trust account only for the following purposes and only in an amount reasonably estimated to be necessary to fulfill the stated purposes:

(1) to pay service or other charges or fees imposed by the financial institution that are related to operation of the trust account; or

(2) to pay any fees or charges related to credit card transactions or to offset debits for credit card chargebacks.

(c) A lawyer shall deposit into a client trust account legal fees and expenses that have been paid in advance, to be withdrawn by the lawyer only as fees are earned or expenses incurred.

(d) Upon receiving funds or other property in which a client or third person has an interest, a lawyer shall promptly notify the client or third person. Except as stated in this Rule or otherwise permitted by law or by agreement between the client and the third person, a lawyer shall promptly deliver to the client or third person any funds or other property that the client or third person is entitled to receive and, upon request by the client or third person, shall promptly render a full accounting regarding such property.

(e) When in the course of representation a lawyer possesses property in which two or more persons (one of whom may be the lawyer) claim interests, the property shall be kept separate by the lawyer until the dispute is resolved. The lawyer shall promptly distribute all portions of the property as to which the interests are not in dispute.

Arizona State Bar Ethics Opinion 98-06 (June, 1998)

An attorney's obligations to a third party under Rule of Professional Conduct 1.15 are triggered when an attorney has actual knowledge of that third party's "interest" in funds the attorney has received from a client. A third party has an "interest" in the funds if the party has a "matured legal or equitable claim" to the funds. Once on notice, the attorney has these duties:

1) to promptly notify the third person;
2) to promptly deliver to the client and third person only funds or property the party is entitled to receive; and
3) if the attorney has any "good faith doubt" as to who is entitled to receive any disputed funds, the attorney must notify the third party, investigate with reasonable diligence, promptness and competence, hold only the disputed funds in trust pending resolution of the dispute, and resolve the dispute by negotiation, arbitration or, if necessary, by filing an interpleader action.

Lamie v. U.S. Trustee, 540 U.S. 526, 124 S. Ct. 1023 (2004)

Background: Before 1994, § 330(a) of the Bankruptcy Code authorized a court to "award to a trustee, *to* an examiner, to a professional person employed under section 327 . . ., *or to the debtor's attorney*" "(1) reasonable compensation for . . . services rendered by such trustee, examiner, professional person, or attorney. . . ." In 1994 Congress amended the Code with a reform Act. The Act altered § 330(a) by deleting "or to the debtor's attorney" from what was § 330(a) and is now § 330(a)(1). This change created apparent legislative drafting error in the current section. The section is left with a missing "or" that infects its grammar. And its inclusion of "attorney" in what was § 330(a)(1) and is now § 330(a)(1)(A) defeats the neat parallelism that otherwise marks the relationship between current §§ 330(a)(1) ("trustee, . . . examiner, [or] professional person") and 330(a)(1)(A) ("trustee, examiner, professional person, or attorney"). In this case, petitioner filed an application with the Bankruptcy Court seeking attorney's fees under § 330(a)(1) for the time he spent working on behalf of a debtor in a Chapter 7 proceeding. The Government objected to the application. It argued that § 330(a) makes no provision for the estate to compensate an attorney who is not employed by the estate trustee and approved by the court under § 327. Petitioner admitted he was not employed by the trustee and approved by the court under § 327, but nonetheless contended § 330(a) authorized a fee award to him because he was a debtor's attorney. In denying petitioner's application, the Bankruptcy Court, District Court, and Fourth Circuit all held that in a Chapter 7 proceeding § 330(a)(1) does not authorize payment of attorney's fees unless the attorney has been appointed under § 327.

Holding: Under the Code's plain language, § 330(a)(1) does not authorize compensation awards to debtors' attorneys from estate funds, unless they are employed as authorized by § 327. If the attorney is to be paid from estate funds under § 330(a)(1) in a Chapter 7 case, he must be employed by the trustee and approved by the court.

Select Quotes from the *Lamie* Opinion:

- Petitioner argues that this Court must look to legislative history to determine Congress' intent because the existing statutory text is ambiguous in light of its predecessor. He claims that subsection (A)'s "attorney" is facially irreconcilable with the section's first part since the two parts' lists were previously parallel. He claims also that only a drafting error can explain the missing conjunction "or" between "an examiner" and "a professional person" since the text was previously grammatically correct. The starting point in discerning congressional intent, however, is the existing statutory text, *Hughes Aircraft Co.* v. *Jacobson,* 525 U.S. 432, and not predecessor statutes. So this Court begins with the present statute.
- That the present statute is awkward, and even ungrammatical, does not make it ambiguous on the point at issue. A debtor's attorney not engaged under § 327 does not fall within the eligible class of persons that the first part of § 330(a)(1) authorizes to receive compensation:

trustees, examiners, and § 327 professional persons. Subsection (A) allows compensation for services rendered by four types of persons (the same three plus attorneys), but unless an applicant is in one of the classes named in the first part, the kind of service rendered is irrelevant. The missing "or" does not change this conclusion. Numerous federal statutes inadvertently lack a conjunction, but are read for their plain meaning. Here, the missing "or" neither alters the text's substance nor obscures its meaning. Subsection (A)'s nonparalleled fourth category also does not cloud the statute's meaning. "Attorney" can be straightforwardly read to refer to those attorneys who qualify as § 327 professional persons. Likewise, neighboring § 331, which permits both debtors' attorneys and § 327 professional persons to receive interim compensation, most straightforwardly refers to § 327 debtors' attorneys. This reading may make "attorney" in § 330(a)(1)(A) surplusage, but surplusage does not always produce ambiguity. When there are two ways to read the text — either attorney is surplusage, which makes the text plain, or attorney is nonsurplusage, which makes the text ambiguous — applying a rule against surplusage is inappropriate.

- The plain meaning that § 330(a)(1) sets forth does not lead to absurd results. Petitioner's arguments — that this Court's interpretation will lead to a departure from the principle of prompt and effectual administration of bankruptcy law and attributes to Congress an intent to eliminate compensation essential to debtors' receipt of legal services — overstate § 330(a)(1)'s effect. Compensation remains available through various permitted means. Compensation for debtors' attorneys in Chapter 12 and 13 bankruptcies, for example, is not much disturbed by § 330 as a whole. Moreover, compensation for debtors' attorneys in Chapter 7 proceedings is not altogether prohibited. Sections 327 and 330, taken together, allow Chapter 7 trustees to engage attorneys, including debtors' counsel, and allow courts to award them fees. Section 327's limitation on a debtor's incurring debts for professional services without the trustee's approval also advances the trustee's responsibility for preserving the Chapter 7 estate. Add to this the apparent sound functioning of the bankruptcy system in the Fifth and Eleventh Circuits, which have both adopted the plain meaning approach, and petitioner's arguments become unconvincing. And § 330(a)(1) does not prevent a debtor from engaging in the common practice of paying counsel compensation in advance to ensure that a bankruptcy filing is in order.
- With a plain, nonabsurd meaning in view, this Court will not read "attorney" in § 330(a)(1)(A) to refer to "debtors' attorneys," in effect enlarging the statute's scope. See *Iselin* v. *United States,* 270 U.S. 245, 251. This Court's unwillingness to soften the import of Congress' chosen words even if it believes the words lead to a harsh outcome is longstanding.
- Though it is unnecessary to rely on the 1994 Act's legislative history, it is instructive to note that the history creates more confusion than clarity about the congressional intent. History and policy considerations lend support both to petitioner's interpretation and to the holding reached here. This uncertainty illustrates the difficulty of relying on legislative history and the advantage of resting on the statutory text.

Examples of Cases Where the Court Ordered Disgorgement of Fees

- *In re Smitty's Truck Stop, Inc.,* 210 B.R. 844 (1997)

Order was entered denying all compensation to debtor's attorney for his services in Chapter 11 case and requiring attorney to disgorge his previously undisclosed prepetition retainer by the United States Bankruptcy Court for the District of Wyoming, and attorney appealed. The Bankruptcy Appellate Panel, McFeeley, Chief Judge, held that: (1) failure on part of Chapter 11 debtor's attorney to properly reveal, in disclosure statement, the retainer he received prepetition was itself a sufficient basis for denying all compensation; (2) mere fact that Chapter 11 petition was filed on emergency basis, and that attorney's failure to properly disclose the retainer may have been inadvertent, would not excuse attorney's failure to file supplemental disclosure statement; and (3) attorney's failure to disclose potential conflict of interest warranted order denying all fees to attorney and requiring him to disgorge retainer.

- *In re David J. Glimcher,* 469 B.R. 835 (Bank. Ariz. 2012)

The threshold issue here, and perhaps the only issue, is when does a retainer become the attorney's money instead of the client's. This matter comes before the Court on the Chapter 7 Trustee's Motion to Compel Turnover, and the response filed by Debtor's counsel. The Trustee requested an order from the Court compelling turnover of the pre-petition retainers paid to both Debtor's counsel and the pre-petition retainer paid to Wright Tax Solutions ("Wright" or "Wright Tax Solutions").

The Court finds and concludes that the pre-petition retainers paid to Debtor's counsel and Wright were paid from pre-petition property of the Debtor, and to the extent that such property had not been applied pre-petition for services rendered pre-petition, the retainers became property of the bankruptcy estate once the voluntary petition was filed. Both Debtor's counsel and Wright remained employed as professionals of the post-petition Chapter 7 Debtor, but neither was ever employed by the Chapter 7 bankruptcy estate. The retainers retained their character as property of the estate, and neither Debtor's counsel nor Wright had any authority to apply these pre-petition funds to pay for post-petition professional services rendered to the individual Debtor, and not to the bankruptcy estate. Accordingly, the Court finds that the Motion to Compel Turnover must be granted.

IV. POST-PETITION FEES IN CONSUMER CASES

"Do's And Don'ts of Post-Petition Fees in Chapter 7 Bankruptcy"

I. Debtors "who cannot pay in full can tender a smaller retainer for prepetition work and later hire and pay counsel once the proceeding begins—for a lawyer's aid is helpful in prosecuting the case as well as in filing it." *Bethea v. Robert J. Adams & Assocs.*, 352 F.3d 1125, 1128 (7th Cir.2003). A debtor is free to use postpetition funds to pay for postpetition legal services. *Lamie v. Trustee*, 540 U.S. 526, 535–36, 124 S.Ct. 1023, 157 L.Ed.2d 1024 (2004).

II. Any agreement (such as a post-dated checks written prepetition for postpetition services) with a Debtor that gives rise to prepetition claims is dischargeable, and attempts to enforce such an agreement are violations of the Automatic Stay or the Discharge Injunction. *In re Waldo*, 417 B.R. 854, 885 (Bankr.E.D.Tenn.2009).

III. A "Two-Contract Procedure" that meets specific tests may allow for postpetition payment for postpetition work on a consumer Chapter 7 case. *Walton v. Clark & Washington, P.C.*, 469 B.R. 383 (Bankr.M.D.Fla.2012).

a. Prepetition agreement must clearly and fully set forth the costs, fees, and representation arrangement associated with the filing of the debtor's case;

    i. it must inform the debtor that the prepetition payments are for prepetition services only;

    ii. The fact that it is a "Two-Contract Procedure" must be clearly stated on a cover page to the agreement; and

    iii. A separate acknowledgement of receipt and review of the "Two-Contract Procedure" disclosures must be signed by the client.

b. Prepetition agreement must specify the client's three options for proceeding with the case;

    i. the client can proceed pro se,

    ii. the client can retain the firm that filed the petition, or

    iii. the client can retain another firm.

c. A cooling off period must be allowed between the time of the filing of the petition and the time the law firm requires execution of a contract for postpetition services (during the cooling off period, the law firm must continue to represent the client); and

d. If the law firm is hired for postpetiton work a supplemental disclosure that sets out the additional fees must be filed.

QUICK REFERENCE GUIDE: RULES AND STATUTES

Rules of the Supreme Court of Arizona, Rule 42 – Arizona Rules of Professional Conduct (Ethics Rules)

E.R. 1.2 - Scope of Representation and Allocation of Authority between Client and Lawyer
E.R. 1.5 - Fees
E.R. 1.6 - Confidentiality of Information
E.R. 1.9 - Confidentiality of Information
E.R. 1.15 - Safekeeping Property
E.R. 3.3 - Candor Toward the Tribunal

Title 11, U.S. Code (Bankruptcy Code)

11 U.S.C. §101(5) - Definitions
11 U.S.C. §327 – Employment of professional persons
11 U.S.C. §328 – Limitation on compensation of professional persons
11 U.S.C. §329 - Debtor's transactions with attorneys
11 U.S.C. §362(a)(6) - Automatic Stay
11 U.S.C. §524(a)(2) - Effect of Discharge
11 U.S.C. §707(b)(4)(D) – Dismissal of a case or conversion to a case under chapter 11 or 13

Federal Rules of Bankruptcy Procedure (FRBP)

Rule 2014 - Employment of Professional Persons
Rule 2016 - Compensation for Services Rendered and Reimbursement of Expenses
Rule 9011 - Signing of Papers; Representations to the Court; Sanctions; Verification and Copies of Papers

FULL TEXT OF RULES AND STATUTES ON FOLLOWING PAGES

ER 1.2 - Scope of Representation

(d) A lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent, but a lawyer may discuss the legal consequences of any proposed course of conduct with a client and may counsel or assist a client to make a good faith effort to determine the validity, scope, meaning or application of the law.

ER 1.5 - Fees

(a) A lawyer shall not make an agreement for, charge, or collect an unreasonable fee or an unreasonable amount for expenses. The factors to be considered in determining the reasonableness of a fee include the following:

(1) the time and labor required, the novelty and difficulty of the questions involved, and the skill requisite to perform the legal service properly

(2) the likelihood, if apparent to the client, that the acceptance of the particular employment will preclude other employment by the lawyer

(3) the fee customarily charged in the locality for similar legal services

(4) the amount involved and the results obtained

(5) the time limitations imposed by the client or by the circumstances

(6) the nature and length of the professional relationship with the client

(7) the experience, reputation, and ability of the lawyer or lawyers performing the services and

(8) the degree of risk assumed by the lawyer.

(b) The scope of the representation and the basis or rate of the fee and expenses for which the client will be responsible shall be communicated to the client in writing, before or within a reasonable time after commencing the representation, except when the lawyer will charge a regularly represented client on the same basis or rate. Any changes in the basis or rate of the fee or expenses shall also be communicated in writing before the fees or expenses to be billed at higher rates are actually incurred. The requirements of this subsection shall not apply to court-appointed lawyers who are paid by a court or other governmental entity.

(c) A fee may be contingent on the outcome of the matter for which the service is rendered, except in a matter in which a contingent fee is prohibited by paragraph (d) or other law. A contingent fee agreement shall be in a writing signed by the client and shall state the method by which the fee is to be determined, including the percentage or percentages that shall accrue to the lawyer in the event of settlement, trial or appeal, litigation and other expenses to be deducted from the recovery, and whether such expenses are to be deducted before or after the contingent fee is calculated. The agreement must clearly notify the client of any expenses for which the client will be liable whether or not the client is the prevailing party. Upon conclusion of a contingent fee matter, the lawyer shall provide the client with a written statement stating the outcome of the matter and, if there is a recovery, showing the remittance to the client and the method of its determination.

(d) A lawyer shall not enter into an arrangement for, charge, or collect:

(1) any fee in a domestic relations matter, the payment or amount of which is contingent upon the securing of a divorce or upon the amount of alimony or support, or property settlement in lieu thereof

(2) a contingent fee for representing a defendant in a criminal case or

(3) a fee denominated as "earned upon receipt," "nonrefundable" or in similar terms unless the client is simultaneously advised in writing that the client may nevertheless discharge the lawyer at any time and in that event may be entitled to a refund of all or part of the fee based upon the value of the representation pursuant to paragraph (a).

(e) A division of a fee between lawyers who are not in the same firm may be made only if:

(1) each lawyer receiving any portion of the fee assumes joint responsibility for the representation

(2) the client agrees, in a writing signed by the client, to the participation of all the lawyers involved and

(3) the total fee is reasonable.

ER 1.6 - Confidentiality of Information

(a) A lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent, the disclosure is impliedly authorized in order to carry out the representation or the disclosure is permitted or required by paragraphs (b), (c) or (d), or ER 3.3(a)(3).

(b) A lawyer shall reveal such information to the extent the lawyer reasonably believes necessary to prevent the client from committing a criminal act that the lawyer believes is likely to result in death or substantial bodily harm.

(c) A lawyer may reveal the intention of the lawyer's client to commit a crime and the information necessary to prevent the crime.

(d) A lawyer may reveal such information relating to the representation of a client to the extent the lawyer reasonably believes necessary:

(1) to prevent the client from committing a crime or fraud that is reasonably certain to result in substantial injury to the financial interests or property of another and in furtherance of which the client has used or is using the lawyer's services;

(2) to mitigate or rectify substantial injury to the financial interests or property of another that is reasonably certain to result or has resulted from the client's commission of a crime or fraud in furtherance

of which the client has used the lawyer's services;
(3) to secure legal advice about the lawyer's compliance with these Rules;
(4) to establish a claim or defense on behalf of the lawyer in a controversy between the lawyer and the client, to establish a defense to a criminal charge or civil claim against the lawyer based upon conduct in which the client was involved, or to respond to allegations in any proceeding concerning the lawyer's representation of the client; or
(5) to comply with other law or a final order of a court or tribunal of competent jurisdiction directing the lawyer to disclose such information.

<u>ER 1.9 - Duties to Former Clients</u>

(a) A lawyer who has formerly represented a client in a matter shall not thereafter represent another person in the same or a substantially related matter in which that person's interests are materially adverse to the interests of the former client unless the former client gives informed consent, confirmed in writing.
(b) A lawyer shall not knowingly represent a person in the same or a substantially related matter in which a firm with which the lawyer formerly was associated had previously represented a client:
(1) whose interests are materially adverse to that person; and
(2) about whom the lawyer had acquired information protected by ERs 1.6 and 1.9(c) that is material to the matter;
unless the former client gives informed consent, confirmed in writing.
(c) A lawyer who has formerly represented a client in a matter shall not thereafter:
(1) use information relating to the representation to the disadvantage of the former client except as these Rules would permit or require with respect to a client, or when the information has become generally known; or
(2) reveal information relating to the representation except as these Rules would permit or require with respect to a client.

<u>ER 1.15 - Safekeeping Property</u>

(a) A lawyer shall hold property of clients or third persons that is in a lawyer's possession in connection with a representation separate from the lawyer's own property. Funds shall be kept in a separate account maintained in the state where the lawyer's office is situated, or elsewhere with the consent of the client or third person. Other property shall be identified as such and appropriately safeguarded. Complete records of such account funds and other property shall be kept by the lawyer and shall be preserved for a period of five years after termination of the representation.
(b) A lawyer may deposit the lawyer's own funds in a client trust account only for the following purposes and only in an amount reasonably estimated to be necessary to fulfill the stated purposes:
(1) to pay service or other charges or fees imposed by the financial institution that are related to operation of the trust account, or
(2) to pay any fees or charges related to credit card transactions or to offset debits for credit card chargebacks.
(c) A lawyer shall deposit into a client trust account legal fees and expenses that have been paid in advance, to be withdrawn by the lawyer only as fees are earned or expenses incurred.
(d) Upon receiving funds or other property in which a client or third person has an interest, a lawyer shall promptly notify the client or third person. Except as stated in this Rule or otherwise permitted by law or by agreement between the client and the third person, a lawyer shall promptly deliver to the client or third person any funds or other property that the client or third person is entitled to receive and, upon request by the client or third person, shall promptly render a full accounting regarding such property.
(e) When in the course of representation a lawyer possesses property in which two or more persons (one of whom may be the lawyer) claim interests, the property shall be kept separate by the lawyer until the dispute is resolved. The lawyer shall promptly distribute all portions of the property as to which the interests are not in dispute.

<u>ER 3.3 - Candor Towards the Tribunal</u>

(a) A lawyer shall not knowingly:
(1) make a false statement of fact or law to a tribunal or fail to correct a false statement of material fact or law previously made to the tribunal by the lawyer;
(2) fail to disclose to the tribunal legal authority in the controlling jurisdiction known to the lawyer to be directly adverse to the position of the client and not disclosed by opposing counsel; or
(3) offer evidence that the lawyer knows to be false. If a lawyer, the lawyer's client or a witness called by the lawyer has offered material evidence and the lawyer comes to know of its falsity, the lawyer shall take reasonable remedial measures, including, if necessary, disclosure to the tribunal. A lawyer may refuse to offer evidence, other than the testimony of a defendant in a criminal matter, that the lawyer reasonably believes is false.
(b) A lawyer who represents a client in an adjudicative proceeding and who knows that a person intends to engage, is engaging or has engaged in criminal or fraudulent conduct related to the proceeding shall take reasonable remedial

measures, including, if necessary, disclosure to the tribunal.
(c) The duties stated in paragraphs (a) and (b) continue to the conclusion of the proceeding, and apply even if compliance requires disclosure of information otherwise protected by ER 1.6.
(d) In an ex parte proceeding, a lawyer shall inform the tribunal of all material facts known to the lawyer which will enable the tribunal to make an informed decision, whether or not the facts are adverse.

11 U.S.C. 101 – Definitions

….

(5) The term "claim" means—

(A) right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured; or

(B) right to an equitable remedy for breach of performance if such breach gives rise to a right to payment, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured.

....

11 U.S.C. § 327 - Employment of professional persons

(a) Except as otherwise provided in this section, the trustee, with the court's approval, may employ one or more attorneys, accountants, appraisers, auctioneers, or other professional persons, that do not hold or represent an interest adverse to the estate, and that are disinterested persons, to represent or assist the trustee in carrying out the trustee's duties under this title.

(b) If the trustee is authorized to operate the business of the debtor under section 721, 1202, or 1108 of this title, and if the debtor has regularly employed attorneys, accountants, or other professional persons on salary, the trustee may retain or replace such professional persons if necessary in the operation of such business.

(c) In a case under chapter 7, 12, or 11 of this title, a person is not disqualified for employment under this section solely because of such person's employment by or representation of a creditor, unless there is objection by another creditor or the United States trustee, in which case the court shall disapprove such employment if there is an actual conflict of interest.

(d) The court may authorize the trustee to act as attorney or accountant for the estate if such authorization is in the best interest of the estate.

(e) The trustee, with the court's approval, may employ, for a specified special purpose, other than to represent the trustee in conducting the case, an attorney that has represented the debtor, if in the best interest of the estate, and if such attorney does not represent or hold any interest adverse to the debtor or to the estate with respect to the matter on which such attorney is to be employed.

(f) The trustee may not employ a person that has served as an examiner in the case.

11 U.S.C. § 328. - Limitation on compensation of professional persons

(a) The trustee, or a committee appointed under section 1102 of this title, with the court's approval, may employ or authorize the employment of a professional person under section 327 or 1103 of this title, as the case may be, on any reasonable terms and conditions of employment, including on a retainer, on an hourly basis, on a fixed or percentage fee basis, or on a contingent fee basis. Notwithstanding such terms and conditions, the court may allow compensation different from the compensation provided under such terms and conditions after the conclusion of such employment, if such terms and conditions prove to have been improvident in light of developments not capable of being anticipated at the time of the fixing of such terms and conditions.

(b) If the court has authorized a trustee to serve as an attorney or accountant for the estate under section 327(d) of this title, the court may allow compensation for the trustee's services as such attorney or accountant only to the extent that the trustee performed services as attorney or accountant for the estate and not for performance of any of the trustee's duties that are generally performed by a trustee without the assistance of an attorney or accountant for the estate.

(c) Except as provided in section 327(c), 327(e), or 1107(b) of this title, the court may deny allowance of compensation for services and reimbursement of expenses of a professional person employed under section 327 or 1103 of this title if, at any time during such professional person's employment under section 327 or 1103 of this title, such professional person is not a disinterested person, or represents or holds an interest adverse to the interest of the estate with respect to the matter on which such professional person is employed.

11 U.S.C. § 329 – Debtor's Transactions with Attorneys

(a) Any attorney representing a debtor in a case under this title, or in connection with such a case, whether or not such attorney applies for compensation under this title, shall file with the court a statement of the compensation paid or agreed to be paid, if such payment or agreement was made after one year before the date of the filing of the petition, for services rendered or to be rendered in contemplation of or in connection with the case by such attorney, and the source of such compensation.

(b) If such compensation exceeds the reasonable value of any such services, the court may cancel any such agreement, or order the return of any such payment, to the extent excessive, to—

(1) the estate, if the property transferred—

(A) would have been property of the estate; or

(B) was to be paid by or on behalf of the debtor under a plan under chapter 11, 12, or 13 of this title; or

(2) the entity that made such payment.

<u>11 U.S.C. § 362 – Automatic Stay</u>

(a) Except as provided in subsection (b) of this section, a petition filed under section <u>301</u>, <u>302</u>, or <u>303</u> of this title, or an application filed under section 5(a)(3) of the Securities Investor Protection Act of 1970, operates as a stay, applicable to all entities, of—

….

(6) any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title;

….

<u>11 U.S.C. § 524 – Effect of Discharge</u>

a) A discharge in a case under this title—

….

(2) operates as an injunction against the commencement or continuation of an action, the employment of process, or an act, to collect, recover or offset any such debt as a personal liability of the debtor, whether or not discharge of such debt is waived; and

….

<u>11 U.S.C. 707 – Dismissal of a case or conversion to a case under chapter 11 or 13</u>

….

(b)

….

(4)

….

(D) The signature of an attorney on the petition shall constitute a certification that the attorney has no knowledge after an inquiry that the information in the schedules filed with such petition is incorrect.

….

<u>Rule 2014 - Employment of Professional Persons</u>

(a) Application for an order of employment. An order approving the employment of attorneys, accountants, appraisers, auctioneers, agents, or other professionals pursuant to § 327, § 1103, or § 1114 of the Code shall be made only on application of the trustee or committee. The application shall be filed and, unless the case is a chapter 9 municipality case, a copy of the application shall be transmitted by the applicant to the United States trustee. The application shall state the specific facts showing the necessity for the employment, the name of the person to be employed, the reasons for the selection, the professional services to be rendered, any proposed arrangement for compensation, and, to the best of the applicant's knowledge, all of the person's connections with the debtor, creditors, any other party in interest, their respective attorneys and accountants, the United States trustee, or any person employed in the office of the United States trustee. The application shall be accompanied by a verified statement of the person to be employed setting forth the person's connections with the debtor, creditors, any other party in interest, their respective attorneys and accountants, the United States trustee, or any person employed in the office of the United States trustee.

(b) Services rendered by member or associate of firm of attorneys or accountants. If, under the Code and this rule, a law partnership or corporation is employed as an attorney, or an accounting partnership or corporation is employed as an accountant, or if a named attorney or accountant is employed, any partner, member, or regular associate of the partnership, corporation or individual may act as attorney or accountant so employed, without further order of the court.

<u>Rule 2016 – Compensation for Services Rendered and Reimbursement of Expenses</u>

(a) Application for compensation or reimbursement. An entity seeking interim or final compensation for services, or reimbursement of necessary expenses, from the estate shall file an application setting forth a detailed statement of (1) the services rendered, time expended and expenses incurred, and (2) the amounts requested. An application for compensation shall include a statement as to what payments have theretofore been made or promised to the applicant for services rendered or to be rendered in any capacity whatsoever in connection with the case, the source of the compensation so paid or promised, whether any compensation previously received has been shared and whether an agreement or understanding exists between the applicant and any other entity for the sharing of compensation received

or to be received for services rendered in or in connection with the case, and the particulars of any sharing of compensation or agreement or understanding therefore, except that details of any agreement by the applicant for the sharing of compensation as a member or regular associate of a firm of lawyers or accountants shall not be required. The requirements of this subdivision shall apply to an application for compensation for services rendered by an attorney or accountant even though the application is filed by a creditor or other entity. Unless the case is a chapter 9 municipality case, the applicant shall transmit to the United States trustee a copy of the application.
(b) Disclosure of compensation paid or promised to attorney for debtor. Every attorney for a debtor, whether or not the attorney applies for compensation, shall file and transmit to the United States trustee within 14 days after the order for relief, or at another time as the court may direct, the statement required by § 329 of the Code including whether the attorney has shared or agreed to share the compensation with any other entity. The statement shall include the particulars of any such sharing or agreement to share by the attorney, but the details of any agreement for the sharing of the compensation with a member or regular associate of the attorney's law firm shall not be required. A supplemental statement shall be filed and transmitted to the United States trustee within 14 days after any payment or agreement not previously disclosed.
(c) Disclosure of compensation paid or promised to bankruptcy petition preparer. Before a petition is filed, every bankruptcy petition preparer for a debtor shall deliver to the debtor, the declaration under penalty of perjury required by § 110(h)(2). The declaration shall disclose any fee, and the source of any fee, received from or on behalf of the debtor within 12 months of the filing of the case and all unpaid fees charged to the debtor. The declaration shall also describe the services performed and documents prepared or caused to be prepared by the bankruptcy petition preparer. The declaration shall be filed with the petition. The petition preparer shall file a supplemental statement within 14 days after any payment or agreement not previously disclosed.

Rule 9011 – Signing of Papers; Representations to the Court; Sanctions; Verification and Copies of Papers
(a) Signature. Every petition, pleading, written motion, and other paper, except a list, schedule, or statement, or amendments thereto, shall be signed by at least one attorney of record in the attorney's individual name. A party who is not represented by an attorney shall sign all papers. Each paper shall state the signer's address and telephone number, if any. An unsigned paper shall be stricken unless omission of the signature is corrected promptly after being called to the attention of the attorney or party.
(b) Representations to the court. By presenting to the court (whether by signing, filing, submitting, or later advocating) a petition, pleading, written motion, or other paper, an attorney or unrepresented party is certifying that to the best of the person's knowledge, information, and belief, formed after an inquiry reasonable under the circumstances,--[1]

(1) it is not being presented for any improper purpose, such as to harass or to cause unnecessary delay or needless increase in the cost of litigation;
(2) the claims, defenses, and other legal contentions therein are warranted by existing law or by a nonfrivolous argument for the extension, modification, or reversal of existing law or the establishment of new law;
(3) the allegations and other factual contentions have evidentiary support or, if specifically so identified, are likely to have evidentiary support after a reasonable opportunity for further investigation or discovery; and
(4) the denials of factual contentions are warranted on the evidence or, if specifically so identified, are reasonably based on a lack of information or belief.

(c) Sanctions. If, after notice and a reasonable opportunity to respond, the court determines that subdivision (b) has been violated, the court may, subject to the conditions stated below, impose an appropriate sanction upon the attorneys, law firms, or parties that have violated subdivision (b) or are responsible for the violation.

(1) How initiated

(A) By motion. A motion for sanctions under this rule shall be made separately from other motions or requests and shall describe the specific conduct alleged to violate subdivision (b). It shall be served as provided in Rule 7004. The motion for sanctions may not be filed with or presented to the court unless, within 21 days after service of the motion (or such other period as the court may prescribe), the challenged paper, claim, defense, contention, allegation, or denial is not withdrawn or appropriately corrected, except that this limitation shall not apply if the conduct alleged is the filing of a petition in violation of subdivision (b). If warranted, the court may award to the party prevailing on the motion the reasonable expenses and attorney's fees incurred in presenting or opposing the motion. Absent exceptional circumstances, a law firm shall be held jointly responsible for violations committed by its partners, associates, and employees.

(B) On court's initiative. On its own initiative, the court may enter an order describing the specific conduct that appears to violate subdivision (b) and directing an attorney, law firm, or party to show cause why it has not violated subdivision (b) with respect thereto.

(2) Nature of sanction; limitations. A sanction imposed for violation of this rule shall be limited to what is sufficient to deter repetition of such conduct or comparable conduct by others similarly situated. Subject to the limitations in subparagraphs (A) and (B), the sanction may consist of, or include, directives of a nonmonetary nature, an order to pay a penalty into court, or, if imposed on motion and warranted for effective deterrence, an

order directing payment to the movant of some or all of the reasonable attorneys' fees and other expenses incurred as a direct result of the violation.

(A) Monetary sanctions may not be awarded against a represented party for a violation of subdivision (b)(2).

(B) Monetary sanctions may not be awarded on the court's initiative unless the court issues its order to show cause before a voluntary dismissal or settlement of the claims made by or against the party which is, or whose attorneys are, to be sanctioned.

(3) Order. When imposing sanctions, the court shall describe the conduct determined to constitute a violation of this rule and explain the basis for the sanction imposed.

(d) Inapplicability to discovery. Subdivisions (a) through (c) of this rule do not apply to disclosures and discovery requests, responses, objections, and motions that are subject to the provisions of Rules 7026 through 7037.

(e) Verification. Except as otherwise specifically provided by these rules, papers filed in a case under the Code need not be verified. Whenever verification is required by these rules, an unsworn declaration as provided in 28 U.S.C. § 1746 satisfies the requirement of verification.

(f) Copies of signed or verified papers. When these rules require copies of a signed or verified paper, it shall suffice if the original is signed or verified and the copies are conformed to the original.

Patrons 2013

Century Club
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Barton & Storts
Beer & Toone PC
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Gary R Blume
Bonnett Fairbourn Friedman & Balint PC
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Carmichael & Powell PC
Hon Tom C Cole
Tom Crowe
Thomas J Davis
Dickinson Wright/Mariscal Weeks
Antonio Dominguez
Farrell & Bromiel PC
Fromm Smith & Gadow PC
Aris J Gallios
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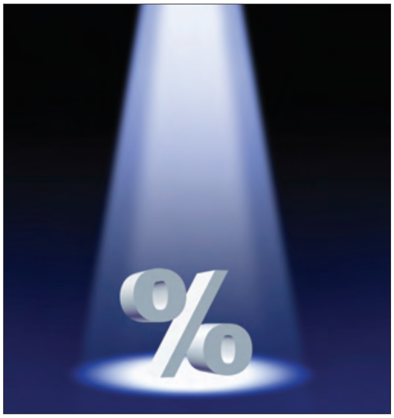

Contested Bankruptcy Plans:

Determining a risk-adjusted cram-down interest rate for secured debt

The determination of an appropriate cram-down interest rate is one of the most litigated and contested issues in the bankruptcy arena today.

It is much more likely that a reorganization plan will get confirmed if the proposed interest rates and plan projections are reasonable and supportable.

Many bankruptcy plans today are contested based upon feasibility of the debtor's Plan, and the proposed rate of interest for secured creditors. In fact, these may be the final issues the court considers before a plan is confirmed.

Cram-Down Interest Rates – In Re: *Till*

The determination of an appropriate interest rate in a bankruptcy case is normally governed by the formula approach used in In Re *Till*, 541 U.S. 465 (2004). Other cases have addressed the applicability of the formula approach in Chapter 11 cases.

The Interest Rate Analysis

The Code requires that a rate of interest should be such that the sum of the present values of the proposed deferred cash payments, when discounted at an appropriate rate, equals or exceeds the amount of the allowed secured claim. An interest rate analysis must consider, among other things, whether there is an efficient market for the restructured obligation and what rate could be used as a baseline for determining an appropriate interest rate.

Defining the Base Rate

A majority of courts hold that where no efficient market can be established, the court should apply the "prime-plus" formula as set forth in *Till*. According to *Till*, this approach looks to the national prime rate as a base rate. Another approach uses a "riskless" base rate, such as that of a U.S. Treasury bill. Either way, risk factors must be added to the base rate to arrive at an appropriate interest rate.

Key Step: Determining Risk Adjustments

The more subjective component in calculating a cram-down interest rate is the risk adjustment added to the base rate. The risk adjustment, according to *Till*, "depends on such factors as the circumstances of the estate, the nature of the security, and the duration and feasibility of the reorganization plan."

The risk adjustment takes into account additional risk, such as risk of non-payment related to the borrower's assets and operations. A debtor's projection of future cash flows has a direct impact on the interest rate; questionable feasibility would increase risk, and therefore the risk adjustment.

Improve the Outcome of Your Case: Consult an Expert Early in the Process

The best way to ensure that proposed interest rates and plan projections are supportable is to involve your financial expert in the early stages, before the debtor's plan is filed.

By consulting an expert in advance to analyze feasibility and risk, the plan will have a much better chance of confirmation.