

# BANKRUPTCY AND FORECLOSURE: How to Respond and Collect

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## 1. Bankruptcy

Federal law governs the procedure by which the assets of an insolvent person or business are distributed amongst creditors. A bankruptcy court supervises the proportionate repayment of pre-petition debts (arising before the case was filed), and also ensures that post-petition debts, especially “administrative expenses” like ongoing taxes, are kept current.

The three primary types are:

- Chapter 7 Liquidation: a trustee sells any nonexempt assets to pay the debtor's creditors. *If discharged and you were not notified of the bankruptcy - it is still discharged because there was no proof of claim required to file*
- Chapter 11 Reorganization: the debtor, usually a business, proposes a plan to repay debts over five years or less
- Chapter 13 Wage-earner's plan: a trustee manages an individual's plan to repay debts over five years or less using anticipated earnings

A “proof of claim” is the creditor's itemization of amounts owed which must be filed early in the case unless (typically in Chapter 7) the creditors are instructed not to do so.

Debts are prioritized by type, and the lowest are unlikely to be paid much or anything. Secured municipal taxes like real estate assessments are among the highest while unsecured taxes like motor vehicle assessments are lower but still “priority.”

Creditors can ask the bankruptcy court to convert a case from a Chapter 11 or 13 into a Chapter 7, or dismiss the case completely, if the debtor violates the plan or does not keep post-petition debts current.

The "automatic stay" makes it contempt of court for a creditor to do nearly anything to attempt to collect a debt against the debtor personally or any property relevant to the bankruptcy until after any dismissal. For example, during a taxpayer's bankruptcy a municipality cannot:

- demand payment or threaten any collection effort
- refuse a DMV release
- revoke or deny a permit
- garnish wages or bank accounts
- submit adverse credit bureau reports
- allow a marshal or collection agency to continue collection efforts
- start or continue litigation or a tax sale

Despite the automatic stay, the tax collector can (and usually should):

- send a regular tax bill that does not demand payment
- file lien continuance certificates
- assign tax liens to third parties
- accept unsolicited voluntary payments from the debtor (although a bankruptcy trustee might be able to force the town to refund it later)
- ask banks, escrow agents, and junior encumbrancers to pay the taxes
- warn the debtor's lawyer that post-petition taxes are not being paid
- enforce regular police and regulatory powers against the debtor

Pre-petition debts include all taxes assessed before the case was filed, since even transferring or destroying the property after the assessment would not prevent the debtor from having to pay the tax when it is later billed, at least for personal property taxes. In re Columbia Gas, 37 F.3d 982 (3<sup>rd</sup> Cir. 1994). This means a tax collector receiving a bankruptcy petition filed between October 1 and July 1 should include the not-yet-due tax in a proof of claim, rather than assuming it will be paid as an administrative expense. The law is unclear as to whether motor vehicle taxes, which can be prorated to accommodate post-assessment transfers, must be treated the same way.

After a liquidation or successful plan, the bankruptcy court issues a "discharge" which forever prohibits any effort to collect the debts against the person. Liens for secured taxes (like real estate and sewer) survive a Chapter 7 discharge, so a tax sale or foreclosure against the delinquent property itself (as opposed to efforts

Oct 1st  
Not in  
they are  
date incurred  
Not due

against the person's money or other property) remains possible. Unsecured taxes (like motor vehicles, and personal property delinquencies beyond the equipment's value) which came due without penalty more than one year before the bankruptcy was filed are uncollectable after discharge.

- Example: Debtor files Chapter 7 on July 31, 2010 and is later discharged. His July 1, 2009 motor vehicle bill can still be demanded and DMV release denied, because it could have been paid without interest less than one year before he filed bankruptcy. His motor vehicle bills from earlier years, however, are discharged.
- Example: Debtor files Chapter 7 on August 5, 2010 and is later discharged. His July 1, 2009 motor vehicle bill and all older ones are discharged, and a tax collector risks contempt of court by demanding payment or refusing to sign a DMV release.

## 2. Foreclosure

A "lien" is the assertion of a claim against property to secure payment of a debt. The lien may or may not be consensual, and the debt may or may not be disputed. For example, an auto mechanic might claim a lien in a car and refuse to release it to the owner until the repairs are paid for.

One type of lien, a "mortgage," is a pledge of real property as security for a loan. For example, banks accept mortgages in homes as collateral for borrowed money contingent on nonpayment.

Some liens are "inchoate" (automatic and paperless) and the law will presume other creditors are aware of them. For example, in Connecticut, unpaid construction work is an inchoate lien on the property for 90 days after it ceases (unless continued by recording a paper lien), so prospective buyers and mortgage banks must ask about construction work or risk overestimating the property's value. Other liens, like those which secure civil judgments, must be filed in public records in order to be "perfected" and bind third parties.

When several creditors claim liens in one property, the relative priorities of the liens are determined by their age and type. The tax liens of towns and districts

generally enjoy the highest priority, followed by WPCA and water liens, followed by community association liens. Most private liens, such as mortgages and judgment liens, are prioritized based on the date each was recorded (older ones having priority over newer ones).

**Sec. 12-172. Tax liens; precedence; enforcement.** The interest of each person in each item of real estate, which has been legally set in his assessment list, shall be subject to a lien for that part of his taxes laid upon the valuation of such interest, as found in such list when finally completed, as such part may be increased by interest, fees and charges... Such lien, unless otherwise specially provided by law, shall exist from the first day of October or other assessment date of the municipality in the year previous to that in which such tax, or the first installment thereof, became due until two years after such tax or first installment thereof became due and, during its existence, shall take precedence of all transfers and encumbrances in any manner affecting such interest in such item, or any part of it...

“Foreclosure” means converting a contingent interest in property into ownership. If a creditor can prove a payment default or other entitlement, the creditor may receive either title to the property itself or the proceeds of its sale to a third party. Generally speaking, creditors with higher priority than the foreclosing creditor are totally unaffected, while creditors with lower priority are apportioned any excess or get nothing. The property’s owner (the debtor) is lowest in priority, but will receive any sale proceeds left over after all of the lienholders are paid in full.

Judicial foreclosures are those conducted by a court. Foreclosures of mortgages, judgment liens, mechanic’s liens, and assigned tax liens must be done this way. (Nonjudicial foreclosures include tax sales and certain auctions of seized personal property.) By law, a judicial foreclosure must name all lower-priority lienholders as defendants; they are not being sued for money but instead to notify them that their liens are at risk. Creditors with liens equal or superior to the foreclosing lienholder are not involved in the lawsuit and not affected by its outcome.

In Connecticut, a real estate foreclosure is always either “strict” or “by sale”:

A strict foreclosure is ordered only if the debtor has little or no equity in the property; that is, he owes the foreclosing creditor roughly what the property is worth or even more. The court assigns a “law day” on which the property’s owner will lose title if he does not pay the debt. The following day, the next-lowest lienholder has the option of paying the debt to buy the property or instead losing his own lien. Each creditor with higher priority has to make the same choice on each successive day. If none pays, the foreclosing creditor takes title automatically

on the last day, and files a notice in the land records identifying itself as the new owner.

A foreclosure by sale is ordered whenever the debtor has equity in the property, the IRS is a lienholder, or circumstances warrant the protections of a sale. The court engages a neutral attorney, called "the committee," to advertise and conduct a public auction. So long as the highest bid is at least 60-70% of the property's assessed value, the court will usually approve the sale and hold the proceeds on deposit (less the committee's fees and expenses). The creditors apply for and receive the funds according to their priorities, and after the deposit is exhausted the lower-priority lienholders receive nothing.

Since tax liens have such high priority, municipalities are generally not even notified that a mortgage bank or other lienholder is foreclosing. The property will be sold or transferred subject to the tax liens, and the new owner must pay them or lose his new property to a collection action by the municipality.

**Official Foreclosure By Sale Committee Deed Form:**

... Said premises are conveyed subject to (a) all prior liens and encumbrances which are prior in right to the mortgage/lien foreclosed; (b) all taxes, sewer assessments and sewer use charges (if any); (c) all building, building line and zoning regulations of the Town of \_\_\_\_\_, and all other governmental regulations and provisions of any public or private law; and (d) such state of facts that an accurate survey or personal inspection of the premises would disclose.

Nevertheless, a tax collector must be vigilant when a tax-delinquent property is in foreclosure. Lien certificates and other formalities should be double-checked to ensure that whomever acquires the property has no technical defense to paying the prior owner's taxes. The property itself should be monitored for the disrepair, abandonment, or even deliberate damage which foreclosure litigation encourages, threatening the municipality's ability to collect. If the debtor has no other significant assets, losing his home to foreclosure will also cost the municipality its chance of collecting his unpaid motor vehicle or personal property taxes. Finally, an imminent foreclosure sale often incites a bankruptcy filing, which will prohibit the tax collector from starting her own collection efforts.

The filing of a foreclosure can also present the tax collector with an opportunity. Tax debt chips away at the lienholders' recovery because it complicates the foreclosure litigation, devalues the property for bidders, and comes directly out of the foreclosing creditor's pocket in the likely event that it assumes title. Mortgage banks often accept a tax collector's invitation to bring the taxes current early in the

litigation. This is especially true if a tax sale is threatened, since it can be completed much faster than the foreclosure, leaving the bank with nothing to foreclose.

If the foreclosure is commenced by another municipality (such as a district or WPCA) on land owing taxes to both, the tax collector has the right to join as a plaintiff to share in the proceeds. If the tax collector chooses not to do so, the liens will survive the other municipality's foreclosure and can be collected separately afterward.

**Sec. 12-181. Foreclosure of tax liens...** The tax collector of any municipality may bring suit for the foreclosure of tax liens in the name of the municipality by which the tax was laid, and all municipalities having tax liens upon the same piece of real estate may join in one complaint for the foreclosure of the same, in which case the amount of the largest unpaid tax shall determine the jurisdiction of the court. If all municipalities having tax liens upon the same piece of real estate do not join in a foreclosure action, any party to such action may petition the court to cite in any or all of such municipalities as may be omitted, and the court shall order such municipality or municipalities to appear in such action and be joined in one complaint. The court in which action is commenced shall continue to have jurisdiction thereof and may dispose of such action in the same manner as if all the municipalities had commenced action by joining in one complaint. If one or more municipalities having one or more tax liens upon the same piece of property are not joined in one action, each of such municipalities shall have the right to petition the court to be made a party plaintiff to such action and have its claims determined in the same action, in which case the same court shall continue to have jurisdiction of the action and shall have the same rights to dispose of such action as if all municipalities had originally joined in the complaint. The court having jurisdiction under the provisions of this section may limit the time for redemption, order the sale of the real estate, determine the relative amount of the undivided interest of each municipality in real estate obtained by absolute foreclosure if two or more municipalities are parties to one foreclosure action or pass such other decree as it judges to be equitable. If one or more municipalities foreclose one or more tax liens on real estate and acquire absolute title thereto and if any other municipality having one or more tax liens upon such real estate at the time such foreclosure title becomes absolute has not, either as plaintiff or defendant, been made a party thereto, the tax liens of each of such other municipalities shall not be thereby invalidated or jeopardized.

## Frequently Asked Bankruptcy Questions / Scenarios

- (1.) What is the difference between a Chapter 7, Chapter 11 and Chapter 13 Bankruptcy?  
Do I need to do anything different as a creditor?
- (2.) I received a Notice of Chapter 7 Bankruptcy, indicating that creditors 'need not' file a Proof of Claim. Should I still file a Proof of Claim anyway? *Don't bother*
- (3.) I just received a Notice of Chapter 7 Bankruptcy indicating that the case was previously filed under Chapter 11 (or Chapter 13). What date do I use to determine if a debt is dischargeable? (E.g., the original filing date of the Chapter 11 or Chapter 13 case, or the date the case was converted to a Chapter 7 case?)
- (4.) I prepared my Proof of Claim form; do I need to send a copy to the Attorney for the Debtor, the Bankruptcy Trustee, AND the Bankruptcy Clerk? *In an electronic filing it goes to everyone* **Yes**
- (5.) What does the term 'Automatic Stay' mean?
- (6.) I received a Notice of Bankruptcy listing ONLY the husband (John Smith) as the debtor. (a) There are motor vehicle taxes due in the name of John and/or Mary Smith. Does the automatic stay prohibit me from collecting this tax bill? (b) There are taxes due on the 2006 grand list in John and/or Mary Smith's name, and taxes due on the 2007 grand list ONLY in Mary's name. Does the automatic stay prohibit me from collecting the 2006 grand list before the 2007 grand list? *you have to give her a release*
- (7.) I received a Notice of Bankruptcy in the name of an individual debtor ONLY. But, he owes other motor vehicle taxes in the name of his 'd/b/a,' as well as a separate 'LLC'. Does the Automatic Stay prohibit me from collecting the taxes due under these two entities? *A DBA is not a legal company - the DBA is under the bankruptcy.*
- (8.) I received a Notice of Chapter 7 Bankruptcy in June 2009. (a.) Does the Automatic Stay prohibit me from collecting motor vehicle taxes that will be due July 1, 2009, i.e., due AFTER the filing date of the case (post-petition)? (b.) Can I collect on a January 2009 motor vehicle tax, since it is not dischargeable?
- (9.) I received a Notice of Bankruptcy in June 2009. However, I received a payment from the debtor's escrow account, through his bank, in July 2009, paying the real estate taxes on his/her house. May I keep this payment, or should I return it, due to the Automatic Stay? *keep!*
- (10.) Does the bulk mailing of a tax bill, a demand notice or a delinquent notice, or the filing a real estate tax lien continuing certificate violate the Automatic Stay provisions of the Bankruptcy code? *ok to do in a bulk mailing*
- (11.) I received a Notice of Bankruptcy for a debtor owing delinquent taxes in my town. Do I need to attend the Meeting of Creditors? *If you have a stake in it or have IRS*

*Do they have to pay current taxes during a bankruptcy*

(12.) I received a Discharge of Debtor notice from the Bankruptcy Court for a Chapter 7 case. How do I determine if the following debts are dischargeable?

- a. Motor Vehicle Taxes
- b. Real Estate Taxes
- c. Personal Property Taxes

(13.) I received a Discharge of Debtor notice from the Bankruptcy Court for a Chapter 7 case originally filed August 15, 2009. Since my 2007 grand list taxes for motor vehicle and personal property tax bills are due in multiple installments (July 1, 2008 & January 1, 2009), is the entire bill discharged, or just the July 2008 installments?

(14.) A taxpayer who previously was discharged through a Chapter 7 bankruptcy contacted my office and wanted to pay his/her motor vehicle taxes that had been discharged. Can I accept this 'voluntary' payment? *yes.*

(15.) I was recently contacted by a taxpayer who filed a Chapter 7 Bankruptcy in April 2006, and subsequently received a Discharge of Debtor. However, the town was never notified of the case, since we were omitted in error as a Creditor. Can I require him/her to pay (a.) their 2002 GL supplemental (due 01/01/04); (b.) their 2003 GL (due 07/01/04); (c.) their 2004 GL (due 07/01/05); **AND** (d.) their 2005 GL (due 07/01/06) grand list delinquent motor vehicle taxes?

(16.) What is an Administrative Claim? Do I file that any different than a regular Proof of Claim? What sort of taxes and or charges would constitute an Administrative claim?

(17.) How do I determine if a debt is pre-petition or post-petition, and therefore should be included as an Administrative Claim? (b.) Do I use the October 1<sup>st</sup> uniform assessment date, or do I use the actual due date of the bill (July 1<sup>st</sup>)?

(18.) A debtor owes current year (2008 GL) and prior year (2007 GL) real estate, (business) personal property and motor vehicle taxes. A lien continuing certificate was filed on the land records for the 2007 real estate delinquency, and a UCC1 was filed for the 2007 personal property delinquency. How do I determine which debts are secured priority, unsecured priority, and unsecured non-priority when preparing my Proof of Claim form?

(19.) What is the 'Basis for Claim' when a Tax Collector is preparing a Proof of Claim? *Taxes*

*If a taxpayer pays a tax while in bankruptcy you can take the \$ but you may need to give it back. Preference.*



(20.) I received a Notice of Dismissal (not Discharge, but Dismissal) for a particular bankruptcy case. How does this affect the Tax Collector? *CO for it.*

(21.) I just received a notice that a property owner has filed for bankruptcy. (a.) The property is in my tax sale. What should I do? (b.) Our attorney was foreclosing on the property. What should I do? (c.) We are assigning / selling the lien. What should I do?

*Stop! pull out of the tax sale* *let it go through*

(22.) I just received a payment from the Bankruptcy Trustee. The debtor owes more than \$500. The payment was for only \$100, and it was noted that my unsecured ~~non~~ priority tax bill would be paid at less than 100%. (a.) What do I do with the balance of that tax bill? (b.) Can I make the taxpayer pay it in order to get a clearance for DMV?

*to put balance in suspense issue release*

(23.) I have received my 4<sup>th</sup> Notice of Bankruptcy filing for this debtor. The first 3 were dismissed, because the debtor failed to meet the requirements of the case. Is there anything I can do about this? *yes, the new laws may allow you to override the stay.*

*PACER - for electronically see + file bankruptcy stuff*

## *Bankruptcy Vocabulary*

Abandonment: If a trustee or debtor in possession abandons property, the property becomes subject to the same treatment as if the case had never occurred. The automatic stay no longer applies to abandoned property. This happens generally when there is no equity in the property.

Automatic Stay (also called Order for Relief): Federal order prohibiting any creditor from taking any action against the debtor without the permission of the bankruptcy court. This stay prevents all acts to collect on a claim, including commencement or continuation of any judicial or administrative proceedings to collect; any act to obtain possession of property of the debtor's estate; and any act to enforce collection of a lien against property of the estate.

Claim: Creditor's right to payment from the debtor. Also any right to an equitable remedy for breach of performance if that breach gives rise to a right to payment.

Confirmation: the approval of a bankruptcy reorganization plan by the Court. Confirmation of the debtor's plan will serve to discharge the debtor from all claims except as otherwise provided in the plan.

*1st debt*  
Conversion: When one chapter of bankruptcy is converted to another – for ex., Chapter 13 converted to Chapter 7. For purposes of determining what is dischargeable debt, the date of conversion will apply (~~most recent date~~). Conversion may also have an effect on the priority status of the municipality's claim. Conversion terminates one case and commences another.

Creditor: Entity or person who has a claim against the debtor. Creditors file proofs of claim in an effort to recover payment from the debtor's estate.

Debtor: Entity or person who has filed a petition with the bankruptcy court. (It is politically incorrect to refer to the debtor as "the bankrupt.")

Debtor's Estate: the value of all of the property of the debtor that may be used by the court to pay creditors. The filing of the bankruptcy petition creates the estate. Estate will include all legal and equitable interests of the debtor in property as of the filing date.

Discharge: Relief from the obligation to pay certain debts; the bankruptcy court's final "forgiveness" of certain debts. The municipality can no longer take action to collect on discharged debts. They are uncollectible. Note, however, that just because a debtor has been discharged does NOT mean that ALL of his or her taxes are discharged or uncollectible. A dischargeable debt is usually an unsecured claim for which there are insufficient assets in the estate. (See Dischargeability section of outline)

Dischargeable Debts: Debts that arose prior to the order for relief (automatic stay) or before the confirmation of a bankruptcy plan that are determined by the bankruptcy court to be unsecured or undersecured

Dismissal: When the bankruptcy court “throws out” the debtor’s case without taking action to discharge his or her debts. Once a case is dismissed, collection may be pursued as if the bankruptcy never happened. Unless the court says otherwise, a dismissal restores all property rights to the position they were in had the case not been commenced. Theoretically, you could back out and re-calculate / reapply payments made, as if there had been no bankruptcy at all.

Petition: Debtor’s application to the bankruptcy court to commence a bankruptcy proceeding under federal law.

Plan (of reorganization): Debtor’s proposal under Ch. 11 or Ch. 13 to designate classes of claims and proposals for payment over time

Proof of Claim: Form that must be filed with the bankruptcy trustee by the creditor to protect the creditor’s claim. The claim should include all taxes, interest and charges due as of the date of the filing.

Relief from Stay: Creditors may file a motion to obtain relief from the automatic stay in order to pursue post-petition debt and if necessary, to enforce collection of that debt, for example through foreclosure or tax sale. A motion is filed to deal with undue delay on the part of the debtor, either in making payment on postpetition debt, or in filing a plan (Chapter 11, Chapter 13).

Secured creditor: A creditor whose claim is secured by a lien on property in which the estate has an interest. A claim that is not secured by a lien is an unsecured claim. Claims can be partially secured and partially unsecured depending on the value of the debtor’s property.

Trustee: Appointed to examine the assets and the debts of the debtor, to oversee the liquidation of the debtor’s assets in Chapter 7 cases and, in other cases, to oversee the reorganization of the debtor’s affairs and pay claims.

