

# Are private sector bankruptcies breaking the public bank?

**As the number of bankruptcies grows, the amount of uncollected taxes and interest payments climbs. Bankruptcy code expert Bruce J. Bergman takes a look at how the law works, and, more importantly, how it should be revised.**

Quietly and rather insidiously, the huge Federal Bankruptcy Code passed in 1978 is siphoning off millions of dollars that cities and counties might be collecting. For most municipalities, a significant portion of their income is raised through real estate taxes. Anything that impedes that is a most serious matter.

How the Bankruptcy Code intrudes is a problem not widely recognized. To better understand its impact, a brief review of tax collection procedures is in order.

With slight variation, two basic methods exist by which cities and counties collect real property taxes — *in rem* and sales of tax liens. Using New York City as an example, one year after a lien date for a particular tax a commercial property is listed *in rem*. This means that all parcels similarly situated are gathered and a *lis pendens* (notice of pendency) is filed with the county clerk. This simply notifies the world that some action is being taken.

A legal proceeding is then begun. Based upon a failure to pay taxes (some six months later), the treasurer divests the defaulting property owner of title deeding the property to the city. It should be noted, however, that the property owner has a one-year period to "redeem" his property. At least, the city is in a position to recoup its lost taxes.

More common, particularly with counties, is the tax lien sale. After taxes are unpaid for a certain period provided by local statute, liens on delinquent parcels are advertised for sale. Meanwhile, interest and penalties accrue.

To the extent that taxes are unpaid,

**Mr. Bergman** is a Deputy County Attorney of Nassau County, New York, as well as Deputy Bureau Chief, Municipal Affairs and Special Litigation. He is also counsel to the Garden City, New York, firm of Jonas, Libert & Weinstein. Adjunct Assistant Professor of Real Estate with the Real Estate Institute of New York University and Chairman of the Real Property Law Committee of the Nassau County Bar Association.



**The bankruptcy courts are entering areas with potentially enormous consequences for local governments, says Bergman.**

the municipality may have to borrow the funds needed to run the government. In other words, as collections *decrease*, the need to borrow, and hence the interest costs, *increase*.

Although they may seem draconian to some, these tax collection methods are reasonable approaches for municipalities to use to keep taxes moving into the coffers. But the Bankruptcy Code intrudes.

**T**he most pervasive area arises from Section 362 of the code — the automatic stay provisions. They provide, in essence, that the moment any person, corporation or entity files a bankruptcy petition an automatic stay of any action against the property exists.

It may be that a private person should be halted from collecting a debt against such a petitioner. That's a risk of the business world.

It is quite a different matter when applied to a city or county. A municipality does not collect money for a profit. Its collections provide such essential services as police protection, garbage collection, waste treatment and water supply.

Suppose that a municipality, in endeavoring to support these services, is in the midst of an *in rem* proceeding to collect those monies. The courts have ruled that such a proceeding represents the kind of "enforcement" which must cease.

The fact is that the more common tax lien method should be treated differently. When a tax lien is sold, it can be argued that the municipality has done nothing more than put the lien buyer in the same position as the municipality. If interest can't be collected on that lien, the lien buyer can't collect it any more than the county could have. Similarly, if the automatic stay prohibits the giving of a deed to the property, the debtor is still protected and can't lose it.

Still, the courts have ruled that even though the debtor is in no worse position because of the tax lien sale, the municipality may *not* sell the lien. This means it can't receive its taxes from a third party once the petition is filed. In fact, if a municipal officer knowingly violates the automatic stay, he is in jeopardy of a contempt citation in bankruptcy court.

There was a case where an owner had not paid taxes for seven years. After losing battles in the state courts to keep the property, solely to stave off the loss of the parcel, the owner filed a petition in bankruptcy court. To avoid encouraging wider use of such a device, the city was forced to settle the matter on unfavorable terms.

The notice question compounds the situation. Municipal officials are aware that it is not at all unusual for the taxing authority to have no notice of the filing of a bankruptcy petition. Yet, even without this notice, the courts have held that the municipality is still stayed.

In actuality, this is a frequent occurrence. It is more likely in jurisdictions where a town may be the collector for a county. In this case, the county becomes involved only when parcels are noted as delinquent.

It is not unusual for attorneys' offices to err in this arcane area of law, for a clerical error to be made, or for the debtor to give his lawyer incomplete data. If it has no notice of the bankruptcy, how is the municipality to know not to put its collection machinery to work?

When it does proceed, the municipality is subject to having its action or lien sale voided. In the case of a lien sale, it may then have to give up the taxes received. Even worse, it may have to pay interest on money it should have been entitled to in the first place!

Another major difficulty centers on the question of interest accruing after a petition is filed. If a county's tax collection procedures are to be stopped by a



bankruptcy filing, at least the much needed interest and penalties should continue to be assessed. Some courts have agreed with such a view. The majority, however, do not. As a result, the collection of post petition interest is denied.

The effect of this is more serious than it first appears. Obviously, it causes interest and penalties to be lost. In addition, it encourages delay in tax payments. Even if a debtor can pay his taxes, he finds it advantageous to defer that obligation while investing the sums elsewhere at a higher rate of return. His interest accrues while awaiting approval

of a reorganization in bankruptcy. The municipality receives nothing.

There's more. Even before the issue of collecting taxes arises, the very weighty problem of assessment exists. In New York State, for example, *certiorari* proceedings to reduce assessments, particularly for commercial parcels, have become epidemic.

With municipalities strapped for revenue, property taxes have been a primary source of relief. This, in turn, increases the zeal of property owners to press for reductions.

Litigation of these cases is difficult and highly technical. Most often it is

handled by experts for both the property owner and the taxing authority. Indeed, judges knowledgeable in the field are regularly assigned to such suits.

However, according to Section 505 of the Bankruptcy Code, the bankruptcy court can determine *all* taxes affecting the estate. This holds true whether or not the taxes were paid or contested before a local judicial or administrative tribunal.

Such action represents a change from prior statute which limited the jurisdiction to *unpaid* taxes. At least under the old law conflicting decisions existed as to whether the bankruptcy court had jurisdiction if the debtor had not made timely protests as mandated by local law.

So now we have the bankruptcy courts entering another area with potentially enormous consequences for municipalities. The problem is heightened by the location of the courts. Often they are quite distant from the assessing authority. This makes the local assessment policies and procedures that much more unfamiliar.

Many municipalities adjudicate these matters administratively. While Section 505 fortunately precludes review when an administrative body has reached a decision, doubt exists as to whether the various municipal administrative systems satisfy the statutory definition of "administrative tribunal" under the section's exclusion.

If you multiply all the collection efforts stayed, and the interest and penalties foregone as a result of filings throughout the 50 states, the loss and cost to municipalities is staggering. Such a loss is illogical.

The Bankruptcy Code should be amended to eliminate or at least ameliorate the problems. Here are some thoughts about how this should be accomplished:

- First, the automatic stay provisions should be amended so as not to affect any action or proceeding, legal or administrative, to foreclose or in any way to enforce local property tax liens.

- Second, post petition interest and penalties upon real property taxes should, by law, continue to accrue and be collectible.

- Third, in tax assessment matters, debtors should be confined to state or local judicial or administrative forums and specifically excluded from the bankruptcy courts.

Of course, remedial action would require precise drafting of suggested statutory changes. It would also require vigorous efforts to enlighten the drafters as to the magnitude of the situation. However, the depth of the problems is well worth the effort.

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