# The Municipal Attorney

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# Real Estate Tax Collections in Bankruptcy—A Disaster for the Municipality

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## Introduction

A most significant portion, if not the overwhelming bulk, of most municipalities' income is derived from real estate taxes. However, the Bankruptcy Code enacted in 1978 severely restricts the collection of millions of dollars of those tax revenues, to say nothing of the additional expenses incurred by municipalities in litigating tax matters in bankruptcy court. [Water and sewer charges are similarly affected in most instances by the matters reviewed in this article.]

The practical effect of this is perhaps best appreciated by briefly reviewing typical municipal tax collection procedures and observing their efficacy in the face of Bankruptcy Code strictures.

## Methods of Collection

New York City, like some other municipalities, uses what is called an "in rem" method of real estate tax collections. For a commercial parcel, one year (for residential property the period is three years) after the lien date for a particular tax, the property is listed in rem, which means that the City gathers all properties so situated and files a lis pendens, a notice of pendency, against them. A legal proceeding is then begun whereby approximately six months later, the treasurer deeds the property to the City. While a one year period to redeem is provided, the City is now in a strong position to recoup its loss - as indeed it should be.

Probably a more common collection device is the sale of tax liens. After taxes are unpaid for whatever period may be provided by local statute, liens on delinquent parcels are advertised for sale, meanwhile accruing much needed interest and/or penalties. (To the extent that taxes have not been forthcoming, the municipality may have to go into the market and borrow the funds necessary to run the government. Clearly, as a municipality's collections decrease, the necessity to borrow and the concomitant interest costs increase.)

Suppose, for example, that $100,000 of real property taxes are outstanding on an apartment complex. Anyone is free to buy the lien, accomplished by paying the $100,000 to the taxing authority. The municipality is thereby made whole, and the lien buyer has the right to collect what is usually quite substantial interest along with the principal.

The owner, mortgagee, tenant, or other party with such interest as the local statute may define is free to pay the principal sum plus interest to the lien buyer for a specified period, typically one or two years. At the end of that time the lienholder must give the parties so entitled one last chance to pay by sending what in many localities is referred to as a "notice to redeem." If there is no redemption, the treasurer (or other designated municipal officer) issues a deed to the lienholder.

Lest the tax collection proceedure appear harsh, observe that the various systems have been oft litigated in both federal and state courts and adjudged fair and constitutional. Moreover, the procedures are construed with exceptional strictness in favor of the property owner, so as to provide every conceivable chance to protect the owner's position.

## BANKRUPTCY CODE PROVISIONS AND THEIR EFFECTS

### -Automatic Stay

Section 362 (11 U.S.C. §362), entitled "Automatic Stay," provides in relevant part as follows:

> "(a)... a petition filed ... operates as a stay, applicable to all entities, of - * * *
> (2) the enforcement, against the debtor or against the 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;
> * * *
> (c) Except as provided in subsection (d), (e), and (f) of this section -
> (1) the stay of an act against property of the estate under subsection (a) of this section continues until such property is no longer property of the estate;
> * * *

Thus, from the moment any debtor files a petition in bankruptcy pursuant to any section, the municipality is automatically stayed from in any way pursuing collection or enforcing its rights as to past due amounts, and is subject to the

control of the bankruptcy court in this regard! The burden upon the municipality is obvious.

It may very well be that a private person or business should be estopped from collecting a debt against a debtor (petitioner) from the time of filing. Such are the vicissitudes of the business world. But a municipality should be in a different position. It collects money not for profit, but to provide essential services for all the people. Indeed, the policeman on the beat who keeps order is there only because tax money exists to pay him.

In the case of an in rem proceeding, there is no doubt that it represents "enforcement" which is stayed by §362, although, as noted, the suggestion is made that such a proscription is ill-advised.

But what of the tax lien sale method? Is that the variety of procedure which the automatic stay provisions were intended to stop? Case law that has not gone beyond the bankruptcy court level answers in the affirmative. See: In re Eisenberg, 7 Bankr. 683 (Bank. E.D.N.Y. 1980)(Not only was the procedure found to be violative of §362, but the court found the corporation counsel of the city liable for contempt. This was later reversed on December 15, 1981 by Pratt, J., in the United States District Court for the Eastern District of New York.); In re Young, 14 Bankr. 809 (Bankr. N.D. Ill. 1981); In re 2609 Corp., 13 Bankr. 1006 (Bankr. S.D.Fla. 1981).

Although not accepted by the courts, a good argument can be made that the lien sale method should not be deemed "enforcement." When a tax lien is sold, all the municipality does is place the lien buyer in the shoes of the municipality. If post petition interest is not collectible, infra, the lien buyer cannot collect it. If taking a deed to the property is stayed by the automatic stay provisions - and it is - then the debtor is still protected and cannot lose his property. But even though a debtor is in no worse position by virtue of a tax lien sale, the municipality may not sell the lien and receive its taxes from a third party once a petition is filed!

How truly serious all this is for a municipality is highlighted by Friarton Estates Corp. v. City of New York, 681 F.2d 150 (2d Cir. 1982). In that case, an owner who had not paid taxes for seven years sought to prevent foreclosure, after losing in the state courts, by filing a petition in bankruptcy solely for the purpose of obtaining the benefits of an automatic stay. To avoid widespread use of such a device, the City was bludgeoned into a settlement on unfavorable terms.

- Post Petition Interest

If a municipality's tax collection procedures are to be stopped by a bankruptcy filing, at least much needed interest and penalties should accrue. While a minority view agrees, a literal reading of §506 and case law denies the accrual of post petition interest. See e.g., In re Fashion Wear Realty Co., 14 Bankr. 287 (S.D.N.Y. 1981); City of New York v. Saper, 336 U.S. 328 (1949).

Such a construction of the statute is doubly hurtful to the municipality. First, quite obviously, it causes interest and penalties to be lost. Second, it tends to encourage delay in tax payments. Even if a prospective debtor has the money to pay taxes, there is a possible advantage in deferring that obligation and investing the sums elsewhere at a higher rate of return, pending approval of a reorganization plan.

- The Issue of Notice

It is not at all unusual for a taxing authority to have no notice of a filing of a petition in bankruptcy. Yet, even absent actual notice, the cases have held that the automatic stay provisions still apply. (In re Eisenberg, supra; In re Young, supra.)

This is, in fact, a frequent occurrence The debtor may or may not list the taxing authority as a creditor. This possibility is compounded in jurisdictions where a town may be the collector for a county, with the latter becoming involved only when parcels are noted as delinquent.

It is hardly unheard of for attorneys' offices to err in this arcane area of law, or for a clerical error to be made or for the debtor to have given his counsel incomplete data. And if the municipality has no notice of the bankruptcy, how is it to know not to put its collection machinery into effect? When it does proceed absent knowledge of the filing, it is then subject to having its action or lien sale voided. In the lien sale situation, it may then have to give up the taxes it received from a buyer and pay interest on money it should have been entitled to in the first instance!

- Assessment Problems

Even before the issue of collecting taxes arises, there is the very thorny problem of assessments. 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, in turn increasing the zeal of property owners to press for reductions.

Litigation of these cases is difficult, highly technical and most often handled by experts for both the property owner and the taxing authority. Indeed, in many jurisdictions, judges particularly knowledgeable in the field are regularly assigned to such suits. However, pursuant to §505 of the Bankrutpcy Code, the bankruptcy court has jursidiction to determine all taxes affecting the estate, whether or not they were paid or contested before a local judicial or administrative tribunal. This represents a change from a prior statute which limited the jurisdiction to unpaid taxes. Moreover under prior law, there were at least conflicting decisions as to whether the bankruptcy court had jurisdiction if the debtor had not made timely protests as mandated by local law.

So now the bankruptcy courts have entered another area with potentially enormous deleterious consequences for municipalities. The problem is compounded by the location of a bankruptcy court, which is often quite distant from the assessing authority, making the local assessment policies and procedures that much more unfamiliar.

Although local tax reduction matters are often litigated in courts, many municipalities adjudicate these matters administratively. While §505 fortunately precludes review when an administrative body has reached a determination, there is doubt as to whether the various municipal administrative systems satisfy the statutory definition of "administrative tribunal" under the §505 exclusion.

## A Practical Example

To demonstrate how truly burdensome the Bankruptcy Code can be for a tax collecting authority, here is a brief recitation of an actual recent case. Corporation X owned a large apartment complex with tax arrears of some $325,000. In February 1982 the tax liens were sold and the county was made whole.

But in September of 1981, a corporation Y had filed for bankruptcy. The county had been given no notice of this; even if it had been, it would not have known what to do with such information since no one knew of any relationship between corporation Y and the county.

Come October of 1982 and corporation Y brings an adversary proceeding in the bankruptcy court against the county, seeking to set aside the tax lien sale. The basis for the proceeding was the claim that corporation Y was the owner of the property for which liens were sold.

In this instance, the town where the property was situated was the collector for the county. The records revealed that the town listed corporation X as the owner and had so billed. The records on file with the county clerk revealed a deed on record to corporation X and a mortgage on the property given back to a lender by corporation X.

When the tax lien sale was duly advertised in the newspaper, no one came forward to protest that someone other than corporation X was in fact the owner. And what did corporation Y show in court? It came forward with a claim of two unrecorded deeds whereby corporation Y was shown to be the fee owner.

Clearly, the county could not have known this and yet the status of the law is that the tax sale will have to be voided, with the loss of significant revenue to the county.

## Remedial Action

If one multiplies all the tax collection efforts stayed and all the interest and penalties foregone as a result of bankruptcy filing throughout the fifty states, the loss and cost to the nation's taxpayers is staggering.

It is suggested that such a loss is illconceived and untoward, and the Bankruptcy Code should be amended to eliminate or, at least, ameliorate the problems. How precisely to do that is a question requiring far more space than this article can give. However, an outline follows of some thoughts in this area that can serve as a springboard for action:

(1) section 362 should be amended to provide that the automatic stay provisions do not affect any action or proceeding, legal or administrative, to foreclose or enforce in any way local property tax liens.

(2) should the foregoing be deemed too radical a change, an alternative would be to eliminate the stay as to tax liens. An exception could make the liens subject to stay upon actual notice to the taxing authority at a hearing wherein the debtor has the burden to prove substantial equity in the property above secured liens, together with a requirement that the debtor pay all current taxes. If current payments become delinquent for thirty days, the stay would be vacated upon affidavit of a municipal officer to that effect.

(3) post petition interest and penalties upon real property taxes should continue to accrue and be collectible.

(4) to the extent that the interest charged by municipalities upon delinquent real property taxes is deemed unduly high in some jurisdictions, a rate could be set; for example, the rate charged by the IRS for late federal tax payments or some percentage above the prime rate.

(5) section 505 should be amended to confine debtors in tax assessment matters to state or local judicial or administra-

tive forums. Where the time to protest an assessment has passed, the bankruptcy court should have no jurisdiction whatsoever to change assessments, since a remedy would no longer exist on the local level.

When the time to protest is still available, the debtor should be required to persuade the bankruptcy court that there is a meritorious position. If the bankruptcy court agrees, the issue should be referred to disposition by local remedies - legal or administrative - with the resultant determination to be absolutely binding upon the bankruptcy court.

Conclusion

That the intrusion of bankruptcy courts into local real property tax matters adversely affects municipalities should be obvious. Of course, the myriad details of the problems are larger than can be analyzed in this article. In addition, the remedial action would require precise drafting of suggested statutory changes, with vigorous efforts to enlighten the drafters as to the magnitude of the situation. The depth of the difficulty is well worth the effort.

Editor's Note:

As a result of the Supreme Court's decision in Northern Pipeline Construction Co. v. Marathon Pipe Line Co., 102 S.Ct. 2858 (1982), Congress must revise the Bankruptcy Code of 1978, and it is under pressure to do so quickly. In December 1982, the NIMLO Executive Committee adopted the following Resolution, which was submitted to the following members of the 97th Congress (2d sess.): Senator Strom Thurmond, Chairman, Senate Judiciary Committee; Congressman Peter W. Rodino, Jr., Chairman, House Judiciary Committee; Senator Robert J. Dole, Chairman, Subcommittee on Courts (Senate Judiciary Committee); Congressman Robert W. Kastenmeier, Chairman, Subcommittee on Courts, Civil Liberties, and the Administration of Justice (House Judiciary Committee); Senator Daniel P. Moynihan from New York; and Senator Alfonse M. D'Amato from New York.

NIMLO RESOLUTION ON REVISION OF BANKRUPTCY ACT OF 1978

WHEREAS, the United States Supreme Court, in Northern Pipeline Construction Co. v. Marathon Pipe Line Co., 102 S.Ct. 2858 (1982), ruled that the broad grant of jurisdiction to bankruptcy judges under section 1471 of the Bankruptcy Act of 1978 is violative of Article III of the United States Constitution; and

WHEREAS, the Supreme Court has stayed its judgment in Northern Pipeline through December 24, 1982 (103 S. Ct. 199 (1982)), in order to "afford Congress an opportunity to reconstitute the bankruptcy courts or to adopt other valid means of adjudication" in the administration of the bankruptcy laws; and

WHEREAS, there are several provisions in the Bankruptcy Act of 1978 that are seriously disadvantageous to municipalities, and the necessity, resulting from the Supreme Court's ruling in Northern Pipeline, of revising that Act also provides Congress with an opportunity to adopt necessary and desirable amendments regarding these objectionable provisions; and

WHEREAS, the City of New York has developed proposed amendments that will answer municipal objections to the applicable sections of the Bankruptcy Act of 1978, and those proposed amendments and a brief report explaining both the proposals and the problems they are designed to eliminate are attached hereto and incorporated herein; and

WHEREAS, in addition to the difficulties created for municipalities by sections 505, 506 and 362 fo the Act, municipalities are troubled by the expansion of jurisdiction under section 1473 of the Act (28 U.S.C. §1473(c)) to permit third parties to be sued by debtors in their own bankruptcy courts, which is violative of the fundamental principles of due process as enunciated in World-Wide Volkswagon Corp. v. Woodson, 444 U.S. 286 (1980), and may force municipalities to incur excessive costs to defend such claims in out-of-state courts or pay default judgments on otherwise frivolous claims;

NOW, THEREFORE, BE IT RESOLVED, that the National Institute of Municipal Law Officers urges that the attached proposed amendments to 11 U.S.C. §§505, 506, and 362, be adopted by Congress in legislation to revise the Bankruptcy Act of 1978 in order to better protect municipal and public interests affected by that Act.

A request for an extension beyond December 24, 1982 of the stay of the Court's judgment in Northern Pipeline was denied by the Court on December 23 (51 U.S.L.W. 3475). On February 3, 1983, Senator Dole introduced S.443 and S.445 on bankruptcy amendments, so quick congressional action may be expected (hearings were held on January 24). Any

further developments in this area will be reported in the Municipal Law Docket. In addition, the tentative program for the NIMLO Seminar in May includes speakers on the problems created for municipalities by the bankruptcy provisions and possible solutions.

The proposed amendments to the Bankruptcy Act of 1978 developed by the City of New York, and the report explaining the proposals and problems, as incorporated into the above NIMLO Resolution, may be obtained by contacting the NIMLO Washington, D.C. office.

# Villa Park, Illinois Police Chief Awarded Attorneys' Fees for Successful Defense of §1983 Claim

**by John B. Murphey, City Attorney for Country Club Hills, Forest View and Hazel Crest; Ancel, Glink, Diamond, Murphy & Cope, Chicago, Illinois**

U.S. District Court Judge Milton I. Shadur recently awarded attorneys' fees to the Police Chief of Villa Park, Illinois, as a result of the successful defense of a civil rights claim brought under 42 U.S.C. §1983. Larson v. Wind, 548 F.Supp. 479 (N.D. Ill. 1982).

## Chief Sued After Discovery Completed

Plaintiff, Jay Larson, originally sued the Village of Villa Park, the Village of Addison, and a number of police officers as a result of a shooting incident occurring on December 28, 1980. Plaintiff and a passenger were involved in a high speed chase, leading through a number of municipalities. After plaintiff stopped his vehicle at a dead end street, a number of police officers approached plaintiff, and, during the ensuing encounter, plaintiff was shot in the neck and wrist by one of the officers. Motions for Summary Judgment brought by the municipalities and the individual defendants have been denied. See Larson v. Wind, 536 F.Supp. 108 (N.D. Ill. 1982).

During the course of discovery, plaintiff took the deposition of William Kohnke, the Villa Park Police Chief. Kohnke testified that immediately following the incident, he prepared and issued a press release describing the incident and characterizing the shooting as an accident which resulted from the arresting officer's slip on an icy surface during the course of the arrest.

Plaintiff thereupon amended his Complaint by naming Chief Kohnke as a defendant and alleging that he violated plaintiff's constitutional rights by issuing a false and misleading press release. Kohnke's Motion for Summary Judgment was granted by the court. Dealing first with the claimed injury to reputation, the court held that under Paul v. Davis, 424 U.S. 693 (1976), and its progeny, a public official's damage to reputation alone does not implicate a deprivation of "liberty" or "property" sufficient to invoke the guarantees of due process. Noting the Seventh Circuit's application of Paul as requiring a "stigma plus", i.e., that the stigma to reputation must be in conjunction with the denial of a governmental right, privilege or benefit, see Margoles v. Torme, 643 F.2d 1292 (7th Cir. 1981); Elbert v. Board of Education, 630 F.2d 509 (7th Cir. 1980); and Colaizzi v. Walker, 542 F.2d 969 (7th Cir. 1976), the court held that larson did not demonstrate the existence of a "plus" factor:

> "No 'plus' is either alleged or reasonably inferable....Kohnke did not even arguably deny Larson any governmental right, privilege or benefit. Clearly, his actions were 'separate and distinct' (Margoles, 643 F.2d at 1299) from the conduct of the officers that formed the principal focus of the Complaint. Indeed, that is the thrust of the holding of Landrigan v. City of Warwick, 628 F.2d 736, 742 (1st Cir. 1980)... that an alleged cover-up of illegal conduct must itself cause damage to be actionable under §1983."

The court further held that Kohnke's issuance of the press release could not render him liable as a conspirator with those officers engaged in the shooting episode. The court noted that the shooting "was entirely completed before the claimed cover-up, and the claimed cover-up was not part of the initial planning of the episode. Under those circumstances, the bare conclusory claim of conspiracy cannot bring Kohnke's conduct under the same constitutional umbrella. Hampton v. Hanrahan, 600 F.2d 600, 621-2 (7th Cir. 1979)."

Finally, the court noted that plaintiff's claim that Kohnke issued the press release to discourage plaintiff from pursuing his legal remedies "is arrant nonsense in cause of action terms as a predicate for a §1983 claim.... Those purported motivations are not reasonably inferable from the facts and circumstances."

## Motion for §1988 Fees Granted

Following the granting of this Motion