Bankruptcy Practice for the

Tax Certificate Investor in New Jersey

A Primer

The following is a general outline of bankruptcy law and procedures for tax lien investors in New Jersey.

Although Bankruptcy law is federal, and the Bankruptcy Code is the same wherever you encounter it in the United States, the practices that are described in this memo may not be the same in your jurisdiction. Bankruptcy practice involves a number of factors that are State and jurisdiction specific. First, Bankruptcy law applies the law of the State to determine the nature and priority of your interest. The exact nature of the product that you purchase at the sale in your State (lien or deed) will determine the scope of your rights in the bankruptcy. Having said that, most, if not all interests that are sold for taxes are secured, and may be afforded a first lien position (at least in the case of liens).

Second, each jurisdiction has its own "local rules" – codified procedures that apply the Federal Bankruptcy Statutes and Rules, but specifically describe how one goes about participating as a creditor in a Chapter proceeding in that jurisdiction. What works in New Jersey will not necessarily work in Georgia, or even Pennsylvania (where I also practice). For those reasons, although this primer may be instructive for those of you who are faced with the problem of a bankruptcy filing be the owner of the property on which you have purchased an interest, it will not fully describe your rights, obligations, and, most importantly, the procedures that you should take immediately to protect your interest, and to give you the best opportunity either to share in a bankruptcy distribution, or obtain relief from the automatic stay, so that you can enforce your rights under State law.

I. The First Question - When is the bankruptcy filed?

A. Before the municipal tax sale.

The Automatic Stay (Section 362 of the Bankruptcy Code, further described below) stays the sale of the tax sale certificate by the municipality. That sale cannot go forward unless stay relief was first obtained. If you purchased a tax sale and it later turned out that the property owner was in bankruptcy prior to the sale date, your certificate is void. **Depending upon how your jurisdiction handles sales in error, y**ou should seek to have the selling municipality buy it back from you. Take this action as soon as you learn, because you will not necessarily receive the interest rate on the Certificate back from the municipality. **At least not where I practice.**

There is an alternative that would permit you to go into the Bankruptcy Court and attempt to validate the sale that has already taken place, after the fact. (In the arcane language of the law, this is referred to as "nunc pro tunc", or "now as then" approval.) There may be circumstances, too numerous to get into here, where this would be the better approach. Oddly enough, here in New Jersey, an attorney for the Debtor may consent to this relief. That is because you have undoubtedly bid down the rate on the tax sale certificate, to the benefit of the Debtor. If the certificate goes back to the municipality, it will be held at the 18% statutory rate. **Since the lien will not go away,** the debtor will want to include your claim in the P

B. If the bankruptcy is filed after you purchased the Certificate, but before or during the foreclosure /enforcement process. process.

In this instance, you are stopped (stayed) from proceeding with your collection proceedings, unless you obtain **relief from the automatic stay.** (See below.) This is not a

real possibility at the outset of a bankruptcy filing, since the Court will give the Debtor quite a bit of time to get her act together. (But see Chapter 7 proceedings below.) Relief may be possible once the case is under way, based upon the particular facts.

II. Actions to Take upon Learning of a Bankruptcy Filing

Generally, the first step is **always** (with one exception) to file a Proof of Claim as soon as possible, as the time frame for the filing is limited – 70 days, unless you are not in the initial list of creditors. A missed deadline to file the claim is quite difficult to overcome. The form of the proof of claim will depend upon the type of bankruptcy filed.

A. Chapter 7. A Chapter 7 is a liquidation proceeding and can be filed by an individual or a corporation. The Debtor's assets, if any, are marshaled and distributed to creditors, in return for a discharge of debts (for individuals – a corporation does not receive a discharge) . Once a bankruptcy proceeding in Chapter 7 has commenced, by initial filing or by conversion from another Chapter, the United States Trustee appoints a disinterested person as a trustee to administer the bankruptcy estate. The Trustee's duties include collecting monies due to the estate or converting estate assets into monies for the estate, as well as distributing funds to claimants in the priorities fixed by the Bankruptcy Code.

1. If a debtor owns real estate, the Trustee must determine if there is enough equity to sell the property and distribute proceeds to creditors. If there is no equity in the property, or simply not enough to warrant the efforts of a sale, the trustee may "abandon" that property on notice to all parties. This is the "no asset" bankruptcy described below. The practical effect of abandonment of property from the bankruptcy estate is that the asset is no longer considered property of the estate and stands as if no petition was ever filed. Nevertheless, no tax sale or

foreclosure may take place until (a) stay relief is obtained, or (2) the property is abandoned and the bankruptcy is discharged or closed.

The vast majority of Chapter 7's are "no asset" filings. That means there will be no distribution to creditors. **You do not file a proof of claim**. The original Notice that you receive will tell you not to file. Most Chapter 7 filings are completed within three to four months. It may be best to wait it out and then proceed in State court when the case is closed.

2. In an Asset Chapter 7 (there is real estate with equity). File a proof of claim (using the Official Form). Attach the Certificate and Assignments (if any). Show a redemption calculation for the date of the bankruptcy filing. Indicate that interest will continue to accrue until the actual date of redemption. Generally, the redemption figure will be supplied by the Tax Collector. Include counsel fees and costs as provided by Court Rules, if you are at the stage of your foreclosure where these may be recovered. When the property is sold by the Trustee, you will be redeemed, with interest, almost always at the closing of the sale. (See **Note 3** below regarding the interest rate.) If you paid a premium for the certificate, and you are still within the time period for refund of the premium it will be refunded by the municipality, like any other redemption. That five-year time period for recoupment of the premium from the municipality is extended by one day for each day that that the bankruptcy is open. (**Note 4.)**

B. Chapter 13.

1. A Chapter 13 can only be filed by persons (not corporations) and is often known as a "wage-earner's" bankruptcy. This is because the Bankruptcy Code requires a Chapter 13 debtor to have "regular income." A Chapter 13 involves a payment plan whereby the debtor re-pays all or a portion of its debts over a period up to five years. Often a Chapter 13 will be filed to cure

arrears in connection with a mortgage, car payments, rental obligations, or taxes. Depending on the amount of the Debtor's assets, and ability to pay, unsecured creditors may receive anything from zero to 100% of their claims. The Debtor will list its debts and defaults. The Debtor's income and expenses are presented and the excess income must be applied to the plan. This excess income is paid to a Chapter 13 Trustee who, if the plan is approved, distributes the payments as received to the approved creditors.

2. Frequently, when a tax lien is involved, the Debtor will file a "sale or refinance" Plan. Generally, these plans involve minimum payments to the Trustee, combined with the commitment to sell or refinance the property with a certain period of time (generally, one year, or a bit more or less, is the standard.)

3. <u>In a Chapter 13, you must file a proof of claim.</u> This is the most complex proof of claim. The law says that unaccrued interest is never supposed to be included in a proof of claim. However, the Chapter 13 trustees in New Jersey lack the ability and the resources to calculate interest on a proof of claim, and the lienholder is entitled to interest on its claim at the rate fixed by State law. As a result, you should calculate the amount due as of the filing date. You should also calculate the amortized rate of interest to be payable over the course of the proposed plan, which (if it is not a sale or refinance plan) is most often over sixty months. This is the figure that appears in the claim. You should specifically itemize each component of the claim, as it is likely to be accruing interest at different rates. The most common example today is a certificate that accrues interest at zero percent (0%), while the subsequent taxes that you paid earn interest at 18%. These must be broken down in your proof of claim (generally a schedule attached), so that you can demonstrate that you are only seeking interest on the portions of your claim that actually accrue interest. Additionally, do not attempt to collect interest on your fees and costs, or on the interest

that accrued on the claim prior to the filing. It is collectable, but no "interest on interest". The penalty for attempting to collect more that is lawful is the forfeiture of the entire certificate, so extreme caution is advised.

Lastly, if you paid a premium for your certificate, this amount should never be included in the claim calculation. Premiums in New Jersey are recovered from the selling municipality, and never from the property owner.

C. Chapter 11

1. A Chapter 11 is often a complex matter which will require the involvement of legal counsel to assist you. A Chapter 11 is a reorganization proceeding where a plan will be proposed for the repayment of some or all of the existing debt. It may be filed by a corporation or an individual. Again, vigorous protection of a certificate holder's interest should be undertaken here to ensure proper protection of the tax sale certificate. A Creditor may file its own plan of reorganization, after the Debtor's exclusive period expires.

2. In a Chapter 11, you will always file a proof of claim, again within a fairly short deadline after the filing date. In form and substance, it is very similar to the asset Chapter 7 proof of claim, in that it includes the amount due only as of the date of the bankruptcy filing, with an indication that interest will continue to accrue until the lien is redeemed. Although successful Chapter 11 and Chapter 13 cases both end with a confirmed Plan, the rules relating to Chapter 13 Plans are quite a bit different. Those Plans can only last for up to five years, and must be first proposed immediately after the case is filed (although they may be modified). Chapter 11 Plans frequently are negotiated, and may takes months (or more) to propose, and even longer to be confirmed. Hence, there is no possibility of including unaccrued interest in the Chapter 11 proof

of claim. Nonetheless, the holder of a tax sale certificate is entitled to payment of all of its interest, at the statutory rate(s) until full redemption is made.

Some Chapter 11 variations = one old and one new.

The old one is the "single asset real estate chapter 11. Plan has to be filed in 90 days, and confirmed within a reasonable time thereafter. This is likely to be the Chapter 11 that you will see. Otherwise, just like a normal 11 – Plan and Disclosure Statement.

The new "Subchapter V" of Chapter 11 – a simplified version of Chapter 11 filings for smaller businesses. This was passed before the pandemic, but appears to be well timed to address the possible onslaught of small business bankruptcies.

2. Debt limit was originally $2,725,625, but was increased in by the CARES act to $7,500,000.

3. There is a trustee appointed in every case, which is unlike a typical Chapter 11. The trustee does not run the business, but essentially assists the debtor in getting a Plan confirmed.

4. The Plan must be filed within 90 days of the petition date, with limited exceptions.

5. There are no committees – in particular, no creditor's committee. There are no opportunities for a competing Plan. There is no separate disclosure statement process. That information is contained in the Plan itself. It appears that there are form Plans that are being adopted by the individual Districts, and some version of the form Plan will be expected to be used by the debtor.

6. In a major change from the typical bankruptcy, owners (equity) can retain an interest in the business while modifying the rights of unsecured creditors, so long as all of the "disposable income" of the debtor is utilized in the Plan.

7. The Plan is up to five years, but it must be at least three years. In this way, it appears very much like a Chapter 13.

This is a somewhat shortened version of the new law. From the standpoint of the tax lien investor whose enforcement has been stayed by the filing, it would appear that the practice will be very similar to a Chapter 13. That is, file a proof of claim in the form, and with the calculations that you would make in a Chapter 13. If you claim typically would include interest over the life of the Plan, as it would in a New Jersey Chapter 13, provide that same calculation, and using the total as the amount claimed. It seems that the Plan will be filed in time for you to file your claim based upon the term proposed. There do not appear to be any rights afforded the debtor in this new Chapter 11 iteration that would adversely impact upon tax lien holders. HOWEVER, this is a new provision of the Statute, and there are very few cases upon which to rely for advice.

III. The Automatic Stay

A. When a bankruptcy is filed, there is an automatic stay placed in effect even if you have not been notified of the bankruptcy's filing. The automatic stay is a protective mechanism of the Bankruptcy Code and is designed to give the debtor a respite from the onslaught of creditors.

(There are limitations on the automatic stay, based upon consecutive bankruptcy filings after dismissals. The second filing, and other filings within a year, the automatic stay is not quite so automatic.)

The automatic stay is one of the fundamental debtor protections provided by the bankruptcy laws. It gives the debtor a breathing spell from his creditors. It stops all collection efforts, all harassment, and all foreclosure actions. It permits the debtor to attempt a repayment or reorganization plan, or simply to be relieved of the financial pressures that drove him into bankruptcy.

The stay bars any act to create, enforce, or perfect a lien against property of the bankruptcy estate and prohibits creditors from taking legal action -- including garnishment of wages, foreclosure or repossession of property, or eviction -- without the permission of the court. It also prohibits a tax sale.

B. Obtaining Relief from the Automatic Stay. Many Chapter 13 or Chapter 11 debtors (not to mention Chapter 7 Trustees) do not pay property taxes after they file the petition in bankruptcy (referred to as "post-petition taxes"). This failure to pay post-petition taxes is a violation of the Bankruptcy Code, in addition to allowing a lien to be created that has priority over your tax lien. You should make it a practice to monitor the payment of taxes by your debtor, checking a couple of weeks after the quarterly due date. If non-payment continues for two or more

quarters, instruct your attorney to file for relief from the Automatic Stay. This is a "no lose" motion. Either you obtain relief and you can proceed with enforcement of your lien in State court, or the debtor will pay the taxes, and you will obtain an Order that ensures that if it happens again, you will not have to file another motion. You will just have to certify to the Court that there is a default in the Order. Plus you can generally recover some of the motion costs and counsel fees from the debtor.

A Few Additional Notes:

NOTE 1: Do not pay post-petition taxes after your proof of claim is filed. It changes the amount of your claim, meaning you won't be paid in full by the Plan. If post-petition taxes are not being paid, use fact to file the stay relief motion described above.

NOTE 2: Actions taken in violation of the Automatic Stay are void. You can go through a complete foreclosure proceeding, never having learned of the bankruptcy filing, and completing your foreclosure. Your judgment is not valid, unless you can somehow get the bankruptcy court to grant stay relief back to the beginning of the case ("nunc pro tunc" – see above). That means all of your work is for naught.

NOTE 3: Although there was a period of time, ending in 2014, where there was some doubt, now it is clear that the interest rate established by State law on tax sale certificates **cannot be modified by the Bankruptcy Court.**

NOTE 4: As mentioned above, the New Jersey state law regarding the refund by the municipality of the premium on redemption of the lien was amended several years ago. In order to account for the fact that you may not be able to obtain redemption in five years if a bankruptcy is in process, the deadline for obtaining a refund of the premium after the certificate is issued is

automatically extended beyond five years by one day for each day that the property owner is in a bankruptcy proceeding.

IV. Bankruptcy Filing After Your Final Judgment is Entered

A. Voidable Preferences and Fraudulent Transfers: These are relatively new causes of action, at least in the world of tax certificate investors. They have caused, and will continue to cause significant problems for New Jersey tax lien holders, because New Jersey certificates are acquired by a "bid down" procedure (the interest rate at the auction starts at 18%, and the successful bidder is the party who bids the lowest rate of interest, or the highest premium, if the rate is bid down to zero). Final judgment in the typical foreclosure process does not involve a Sheriff's sale auction, with some limited exceptions. Therefore, the Courts have decided that this method of acquiring certificates (no "bid up"), and the foreclosure without a Sheriff's sale, does not establish fair market value for the property. These factors open the transfer of title by final judgment to bankruptcy court scrutiny. Similar rulings have been reached in the 7th Circuit, where there are similar procedures for bidding down the rate, and obtaining final judgments in tax foreclosure resulting in loss of title without benefit of an auction sale.

The following causes of action are available to a former property owner who files a bankruptcy (usually a Chapter 13, but it can be a Chapter 11) within two years of the date that title to the property transferred to the lien holder. The former property owner/now debtor files a petition in bankruptcy, followed by a complaint in that bankruptcy to recover either the property itself, or the lost equity in the property. The grounds are that the transfer (meaning the final judgment that caused title to vest in the tax lien holder) was either a voidable preference or a fraudulent transfer. What are the differences?

1. Voidable preference – if the transfer took place within 90 days of the date of the bankruptcy filing, and it enabled the creditor/tax lien holder to obtain more than was owed (the redemption amount), the transfer may be a "voidable preference". The debtor had to be insolvent on the date of the transfer – not "rendered insolvent", as is the case with fraudulent transfers.

2. Fraudulent transfer - if the transfer took place less than two years from the date of the filing of the bankruptcy, and the tax lien holder recovered more than was owed, and there was equity in the property that could have been distributed to other creditors had title not been lost, the final judgment could be deemed to be a fraudulent transfer. The debtor was either insolvent or rendered insolvent by the transfer on the date of the transfer. DO NOT confuse this with actual fraud, which is where one is intentionally misled in order to cause her to change her position to her detriment. One does not have to prove intent to defraud to maintain a bankruptcy fraudulent transfer action.

There are two remedies available to the debtor who prevails in one of these actions. Either the debtor's estate, which are the assets that are available for distribution to creditors, can recover the property itself, or the Court can calculate the amount that the estate lost by comparing the value of the property on the date taken to the amount owed – in other words, to recover the equity in the property for the other creditors. That will be recoverable as money damages. Although it is not completely clear, it appears that if the property has been sold prior to the bankruptcy filing in an "arm's length" transaction, the recovery should not be return of the property. There may still be a money damage award.

3. Defending the Voidable Preference and Fraudulent Transfer Action. **These defenses are the author's views, based upon actual litigated matters. There is no guaranty that every**

Judge will agree with these legal positions. Judges are human beings, and there is not a large body of precedent, since many of these cases are settled before trial or the results of a dispositive motion are obtained.

Generally, it is possible to determine at or near the outset if it is best to litigate or settle when a preference or fraudulent transfer action is filed.

The first level of analysis is to determine the difference between the redemption amount and the fair market value of the property acquired. If the figure is large compared to the property value, you are dealing with potential liability. As a practical matter, these cases rarely are filed where it was a close question as to whether the property was worth substantially more than the lien redemption. However, reasonable minds can differ on the value of a property. If the case goes to trial, proofs by way of expert testimony may have to be obtained, so that the Court can reach a determination of the property value. If there is little value in the property above the redemption amount, this may turn out to be either a foreclosing lien holder's defense to the claim, or at least a reduction in the possible recovery sufficient to drive an acceptable settlement. If there is little or no equity, there is little or no recovery for the benefit of the debtor's unsecured creditors.

In both preference and fraudulent conveyance actions, there is a requirement that the debtor was insolvent when the transfer was made, or was rendered insolvent by the transfer in a fraudulent transfer case. Occasionally this will not be the case, particularly if the debtor owns other real property. Remember, one does not need to be insolvent to file a bankruptcy petition – there is no test to qualify for the filing.

A NJ Bankruptcy Judge just ruled last week that the date of the transfer is the date of the filing of the lis pendens, and not the date that the final judgment was entered. I don't believe it, but it

may become a useful defense, in that the time starts many months before you take title. (But see the Addendum below.)

Another potentially very useful defense relates to the equity that the Debtor had in the property prior to the loss of that property in the foreclosure. Any recovery made by the Debtor in one of these actions must be for the benefit of the unsecured creditors of that debtor. There are many instances where the foreclosure action resulting in final judgment cleared the title of junior (older) tax liens, and perhaps mortgages. The amounts due on these "cleared" liens may have exceed the value of the property. If the Debtor was successful in recovering the property, or obtaining a money judgment representing her equity, those foreclosed liens would come back – the liens would re-attach to the property, or to the proceeds of the financial award by the Court. Recovery of the property to satisfy claims that are secured by that property is not considered to be recovery for "the benefit of the estate", since no recovery will flow to the unsecured creditors. Hence, when the facts support the defense – that the foreclosure created equity, but the debtor had no equity while she owned the property – a strong argument can be advanced that the case should be dismissed.

In New Jersey, the 3rd Circuit recently has confirmed lower court decisions that these causes of action to "claw back" properties lost at tax foreclosure are available to debtors and trustees in bankruptcy. Hence, taking title to a property by tax foreclosure; particularly one with significant equity above the lien redemption, may not be the end of you involvement with the former property owner. A bankruptcy filing by an individual divested of her largest asset may become the norm, and not an exception. These actions are being filed in greater numbers. This has the potential to impact significantly the insurability of title to properties obtained by final judgment in tax foreclosure. Title underwriters could well determine that there is a two-year waiting period to see if a bankruptcy is filed before a title policy, without exception, can be issued.

ADDENDUM REGARDING FRUADULENT TRANSFER AND VOIDABLE PREFERENCE ACTIONS - a brief update.

As mentioned above, just before this memo first was produced, a New Jersey Bankruptcy Judge determined, in a decision that now has been published, that the time to bring a voidable preference action is ninety (90) days from the date of the filing of the lis pendens. This will be considered the date of the transfer of the property, as opposed to the date of entry of the Final Judgment in tax foreclosure, when title to the property actually passes to the lien holder. The significance of this decision is that a final judgment in tax foreclosure will rarely, if ever be entered less than ninety (90) days after the lis pendens is filed. As a practical matter, this might take the preference action out of the equation when a debtor is seeking to recover a property taken by tax foreclosure.

In February, 2021, in a separate matter alleging a fraudulent conveyance, another New Jersey Bankruptcy Judge ruled that in and action to recover a property lost at tax foreclosure, the date of transfer of the property is, again, determined by the date of the recording of the lis pendens. This decision has not yet been published. Since the Debtor has two years from the date of the transfer to bring the fraudulent conveyance action (as opposed to ninety days under the voidable preference statute), it is more likely that a former property owner could file a petition in bankruptcy after the loss of the property, but within two years of the recording of the lis pendens. However, since the cause of action for fraudulent transfer also requires that the debtor was insolvent on the date of transfer, or was rendered insolvent by the transfer, query whether a debtor who still owns the property (since the lis pendens filing does not divest him of title) will be rendered insolvent by the filing of a lis pendens. It has the potential to make the solvency of the debtor on the date of the transfer an issue, and a possible defense to the voidable transfer claim. Kudos to my fellow tax

lien practitioners, Keith Bonchi, Esquire and Gary Zeitz, Esquire for their creative advocacy that resulted in these decisions.