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CODE ENFORCEMENT AND BANKRUPTCY: Protecting the Community While Not Running Afoul Of the Bankruptcy Laws

Robert J. Kerwin, Esq.
Tarlow, Breed, Hart & Rodgers, P.C.
101 Huntington Avenue
Boston, MA 02199
(617) 218-2039
rkerwin@tbhr-law.com

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Robert J. Kerwin, Esq.[*]

INTRODUCTION

Enforcing building codes, zoning laws and collecting taxes are activities which are at the core of municipal work. At first glance, these activities constitutionally protected municipal activities would not appear to be activities that could be deemed to run afoul of the U.S. Bankruptcy Laws, should a taxpayer file a petition for relief. However, if undertaken without due consideration bankruptcy implications, these core municipal activities could give rise to a claim by the bankruptcy debtor that the municipality has violated the bankruptcy laws.

The purpose of this article is to provide municipal counsel with an overview of bankruptcy and a general discussion of potential issues (and sanctions) which may arise in conjunction with these municipal activities when an individual or company has filed a petition for relief in the U.S. Bankruptcy Court. The article concludes with some recommendations designed to achieve the municipal objectives but also to offer "next steps" for the challenging bankruptcy issues.

OVERVIEW

Many experienced municipal counsel are unaware of the extent to which federal bankruptcy laws pre-empt state laws in several key areas. Congress derives its power to pass federal bankruptcy laws from the U.S. Constitution. The framers at the Constitutional Convention expressly reserved for Congress the power "to establish....uniform laws on the subject of Bankruptcies throughout the United States." U.S. Const., Art. I, § 8 (1792). Federal bankruptcy law pre-exempts state law options most visibly by the automatic stay on actions which effect a bankruptcy debtor's property, the collection of local taxes and the power of the debtor to seek and obtain a discharge of certain taxes.

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The laws pertaining to the Automatic Stay, the discharge of certain debts and the exemption of select assets are unique to bankruptcy. The Bankruptcy Code imposes a statutory scheme and establishes a priority for the distribution of assets to creditors and the conduct of the creditors towards the bankruptcy debtor during the administration of the case.

The Federal Government's ability to pass laws that essentially rewrite a bankruptcy debtor's statutory and contractual obligations is broad and expansive. As one commentator noted:

> "Through the exercise of this power, the federal government may assume control over the assets and affairs of a debtor, disregarding all manner of contractual and property rights of creditors and other investors, and encourage or force the parties interested in the debtor's affairs to accept in satisfaction of their claims an entirely different package than that for which they originally bargained (emphasis supplied)." Rogers, The Impairment of Secured Creditors' Rights in Reorganization: A Study of the Relationship Between the Fifth Amendment and the Bankruptcy Clause. 96 Har. L. Rev. 973, 973-74 (1983).

These uniform bankruptcy laws appear largely at Title 11 of the U.S. Code.[1] In 1978, Congress passed a sweeping revision of the Bankruptcy Act, known as the U.S. Bankruptcy Code ("Bankruptcy Code"). Several amendments have been made to the Bankruptcy Code including the most recent changes, signed into law in 2005.[2]

CONGRESSIONAL EFFORTS TO PROVIDE DEBTOR A "FRESH START"

Notwithstanding the recent amendments to Title 11, the underlying policy of a fresh start embodied in the U.S. Bankruptcy Code has not changed. Through the "discharge" "exemption" and "automatic stay" provisions, pre-bankruptcy proceedings against a debtor are generally suspended, assets are preserved and the debtor, where possible, is relieved of certain obligations. As the U.S. Supreme Court has often reaffirmed, bankruptcy is designed to give a "fresh start."

[1] There are some bankruptcy laws that appear in Title 28 and Title 18, but they are principally jurisdictional or relate to certain criminal penalties, which may be imposed for the misuse of federal bankruptcy laws

[2] Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA"), Pub. L. No. 109-8, 119 Stat. 23, 11 U.S.C. § 101, *et seq*.

> "The provisions of the acts…aimed to 'relieve the honest debtor from the weight of oppressive indebtedness and permit him to start afresh, free from the obligations and responsibilities consequent upon business misfortunes,' and to give him' a new opportunity in life and a clear field for future effort, unhampered by the pressure of discouragement and pre-existing debt."
> Louisville Bank v. Radford 295 U.S. 555, 582 (1935) (quoting Local Loan Co. v Hunt, 292 U.S. 234, 244 (1934).

The Bankruptcy Code's "fresh start" orientation manifests itself time and time again in a bankruptcy proceeding. For example, the debtor's normal obligations to pay past due municipal taxes or face lien foreclosure of the taxpayer's equity right of redemption is frequently altered as a result of confirmation of a bankruptcy debtor's plan of reorganization.

The current Bankruptcy Code, 11 U.S.C. § 101 *et seq*. (the "Bankruptcy Code") like its predecessor, the Bankruptcy Act, is designed to function as a self-contained system that "reconciles all the financial affairs of a debtor as they exist at the time of filing.[3] It has been compared conceptually to the probate process in that it is designed to resolve the affairs of the debtor in a logical and coherent manner.

THE AUTOMATIC STAY

Immediately upon the filing of a voluntary Bankruptcy Petition, the Automatic Stay provisions of Section 362 of the U.S. Bankruptcy Code become effective. As the name suggests, the 'Stay' automatically enjoins the prosecution of activities against the bankruptcy debtor or the debtor's property. Section 362(a) sets out eight specific types of actions which are enjoined:

1. The commencement or continuation of a civil proceeding against the debtor;
2. The enforcement against the debtor of a judgment obtained before the commencement of the case;
3. Any act to obtain possession of property of 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

[3] "Fundamentals of Bankruptcy, A Lawyer's Guide" 1991 at xxv

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 *[the exceptions to which are not within the subject of this article]*.

Almost all litigation that is pending before State or Federal Courts is stayed by the filing of a bankruptcy petition. 11 U.S.C. §362(a) (2), (3), (4), (5), and (7). Subparagraph 6 of § 362 precludes any action by a creditor to collect or recover a claim including evictions, lease terminations, repossessions, garnishments, attachments and foreclosures. All collection efforts such as telephone calls, letters, and personal or other contacts with the debtor (in

LIMITATIONS TO THE AUTOMATIC STAY

While broad, the Automatic Stay does not extend to all circumstances. Certain limited exceptions are enumerated under Section 362. The most important exception from the perspective of a city or town is found in 11 U.S.C. § 362 (b)(4). It provides in applicable part:

> The filing of a petition….does not operate as a stay…. of the commencement or continuation of an action or proceeding by a governmental unit…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 (emphasis supplied).

11 U.S.C. § 362(b)(4). Congress included this provision in the Bankruptcy Code in order that debtors not improperly seek refuge under the stay in an effort to inhibit governmental functions. In re: Mohawk Greenfield Motel Corp., 239 B.R. 1, 5-6 (Bankr. D. Mass. 1999) relying upon United States vs. Nicolet, 857 F.2nd 202, 207 (3rd Cir. 1988). Yet, Congress did not define the term "police or regulatory power". The legislative history pertaining to

this provision offers no clear insight as to the breadth of allowed local police or regulatory power:

> [P]aragraph (4) excepts commencement or continuation of actions and proceedings by governmental units to enforce police or regulatory powers. Thus, where a governmental unit is suing a debtor to prevent or stop violation of fraud; environmental protection, consumer protection, safety or similar police or regulatory laws or attempting to fix damages for violation of such law, the action or proceeding is not stayed under the automatic stay.[4]

Hence, in many instances when a municipality seeks to enforce municipal codes and ordinances, the municipality is faced with a challenge by the debtor that the municipality's actions are not a valid exercise of "police" powers. It is well settled that the police powers exception to the automatic stay "does not apply if the government takes legal action to advance its own 'pecuniary' interest (or perhaps the pecuniary interest of others).

VALID "POLICE POWERS" EXERCISE RE: MUNICIPAL CODE ENFORCEMENT

The exception does apply if the government acts in the interest of 'public safety and welfare.' In re Spookyworld, Inc., 346 F. 3rd 1, 9 (1st Cir. 2003). The Spookyworld case provides some guidance relative to the lawful exercise of policy powers (and offers some cautions as well). For seven years, the debtor had operated a horror theme park in Berlin, Massachusetts on land held in a trust established and administered by the Debtor's principal and his spouse. The park, as the name suggests, was dedicated to the holiday of Halloween. In the years prior to the filing of the bankruptcy petition, the debtor operated a hayride, and a small retail area. These activities were housed in a brick building and small wooden barn. The debtor subsequently added a metal building to accommodate a museum display. Subsequent metal buildings were added to accommodate a "phantom mine shaft", wax museum and cirque macabre (which included juggling clowns and a contortionist). Spookyworld 346 F3d at 9. By its eighth year of operation, the Spookyworld operations covered three buildings and employed approximately 500 people.

Notwithstanding the growth of Spookyworld operations, no building permit was ever obtained for the interior sections. The Berlin building

[4] H.R. Rep. No. 95-595, 95th Congress., 1st Sess. 343 (1977); S. Rep. No. 95-989, 95th Cong., 2nd Sess. 51-52, reprinted in 1978 U.S.C.C.A.N. 5787,5838, 5963, 6299.

inspector would conduct his annual review of the premises and thereafter issued a certificate of occupancy for each of the buildings. In the eighth year of operations, the building inspector notified the Debtor that the certificates of occupancy were rescinded on account of the Debtor's failure to comply with the Massachusetts State Building Code.[5] The Building Code had been amended the prior year to include sprinkler systems. Shortly before Halloween, the building inspector ordered that certain buildings would have to be closed pending compliance.

The Debtor claimed that the shutting down of its operations during its only month of yearly operations was inappropriate. Though some pre-litigation discussion apparently occurred concerning possibly maintenance of a fire watch on the premises, the Town ordered that the buildings should close. Spookyworld 346 F3d at 9. The Debtor appealed to the State Board of Building Appeals. When the Debtor still had not closed the attraction, the Town obtained injunctive relief in state court and a monetary sanction for noncompliance. The Debtor thereafter filed a Chapter 11 bankruptcy petition operations. The day after the bankruptcy filing, Town representatives and a state police officer arrived at the debtor's location and insisted upon the closure of the allegedly noncompliant buildings. The Debtor sought Bankruptcy Court relief with a request to the Bankruptcy Judge, to enjoin the Town, its fire department and building inspector from continuing to seek relief in state court. Town counsel represented at the Bankruptcy Court hearing that the continued operations of the debtor's business posed an immediate danger to the safety and welfare of the Debtor's patrons. The Bankruptcy Court ruled that Section 362 (b)(4) precluded consideration of the merits of the dispute and that if the "Town's assertions were incorrect, it was for the state court to sort it out". Spookyworld 346 F3d at 40.

An adversary proceeding followed in the Bankruptcy Court at which the Debtor contended that the Town exaggerated the risk to the public and actually misrepresented the statements made by state public officials and further that it was denied procedural or substantive due process.[6] The Bankruptcy Court concluded that the bad faith limitations of Section 362 (b)(4) were inapplicable, where the primary motive of the Town was to protect the public safety and welfare and that the Town was within its rights to shutdown the Debtor's operation. The shutdown was not deemed to be a

[5] The Building Code violations included the failure to include appropriate sprinkler systems.

[6] The Bankruptcy Court also relied upon the Rocker Feldman doctrine in its decision. Under the Rooker Feldman doctrine, "where a party did not actually present its federal claims in state court, Rooker-Feldman forecloses lower federal court jurisdiction over claims that are "inextricably intertwined" with the claims adjudicated in a state court." Sheehan v Marr, 207 F. 3d 35, 39 (1st Cir. 2000).

violation of the automatic stay. The Bankruptcy Court recommended[7] to the U.S. District Court to enter judgment against the debtors.

ENVIRONMENTAL ISSUES

The case of In re Ridey Lynn Gandy, 327 B.R. 796 (S.D. Texas, 2005), examines the lawful use by a County of its police powers to restrict activities of a bankruptcy debtor for violations of state environmental laws. In Gandy, Harris County filed suit in state court against the Debtor for violations of the Texas Solid Waste Disposal Act and the Texas Clean Air Act. The County requested injunctive relief, fees and costs. The County alleged together with the intervenor, Texas Commission on Environmental Quality, that the Bankruptcy Debtor had unlawfully used his property to store debris (including tree stumps) from site clearings and construction projects. Six months after the filing of the state court action, the Debtor filed a petition for relief under Chapter 13 of the Bankruptcy Code and filed a "suggestion of bankruptcy" in the state court action. Harris County and the Texas Commission on Environmental Quality thereafter filed a motion in the U.S. Bankruptcy Court to Determine the Non-Applicability of the Stay pursuant to 11 U.S.C. § 362(b)(4).

As with the Spookyworld case, the Bankruptcy Court conducted a two prong test to determine if the action of the governmental unit falls within the "police and regulatory power exception". The Bankruptcy Court acknowledged that both Harris County and the Texas Commission on Environmental Quality are governmental units within the definition of Section 101(27) of the Code. The Court next addressed the more challenging question as to whether the governmental unit was enforcing its police powers. Stated otherwise, the Bankruptcy Court examined whether the "governmental unit was pursuing a matter of public interest rather than advancing the government pecuniary interest", Gandy at 803 relying upon Commonwealth Cog., 913 F. 2d 518, 523 (B.A.P. 8th Cir., 1990). "This test requires courts to distinguish between a police and regulatory enforcement action and an attempt by a governmental unit to collect money damages that do not arise from an exercise of a governmental unit's police or regulatory power." Gandy at 804.

Gandy also examined whether the governmental unit's activities passed the "public policy" test. The Court noted that under the "public

[7] The Bankruptcy Court also discussed at length the Court's jurisdiction to hear this matter as a "core" proceeding under the Bankruptcy Code but a lengthy discussion of the same has been omitted except to note that when parties in a bankruptcy context request a jury trial, the district court has the power to assign the jury trial to the bankruptcy judge.

policy" test, the proceedings must be designed to "effectuate public policy" rather than adjudicate private rights. Id. In applying the "police and regulatory exception" tests to the Debtor's case, the Bankruptcy Court found that the lawsuit fell within the police and regulatory powers excepted by §362(b)(4) under both the pecuniary interest and public policy tests. The Bankruptcy Court found that Harris County and the Texas Commission on Environmental Quality were both pursuing a matter of public safety and welfare through injunctive relief rather than seeking a monetary award. The Court also allowed that the purpose of the governmental units was to further public policy instead of adjudicating private rights. Interestingly, the evidentiary disputes concerning whether there was an immediate threat and whether the Bankruptcy Debtor was in violation of the law, did not seem to impact upon the Bankruptcy Court's determination that the state court suits could proceed and were not stay violations. Gandy at 805.

PECUNIARY CLAIMS

The decisions of In re Spookyworld and In re Gandy must be contrasted with In re: Enron (Enron Corporation, et al.) v. People of the State of California, 314 B.R. 524 (Bankr. S.D. NY, 2004). In Enron, the Bankruptcy Debtor sought entry of a declaratory judgment and injunction to enforce the automatic stay with regard to a complaint filed by the California Attorney General in the California Superior Court. The complaint was filed toward the end of the Enron confirmation hearings for restitution, disgorgement and other civil penalties under the California Business Professional Code. The California complaint's purpose was to seek separate damages to compensate the state for Enron's market manipulation in the California electricity markets. It should be noted that California filed a proof of claim in the bankruptcy proceeding and indeed actively participated in the confirmation process. The Bankruptcy Court looked to the "purpose" of the governmental unit action, and did not address an analysis of the legitimacy of the underlying action. Using the same two prong analysis, the Bankruptcy Court found that California had brought the action primarily to protect the state's pecuniary interest and not to protect the public safety or health of the citizens of California. Id, 46-48. The Bankruptcy Court noted with respect to the lawsuit that the automatic stay applied and that therefore the litigation was void *ab inito*. The Bankruptcy Court did grant Enron's request for a permanent injunction under Rule 65 of the Federal Rules of Civil Procedure.

LIQUOR LICENSE – STAY VIOLATION CONCERN

It is common outside of a bankruptcy setting for municipalities to condition the renewal or transfer of a liquor license upon the payment of outstanding municipal taxes. At the same time, bankruptcy debtors pursuant to §363(f) frequently receive Bankruptcy Court authority to sell or transfer liquor licenses free and clear of liens (including municipal liens). It is therefore impermissible for a municipality without Bankruptcy Court consent, to delay the license transfer on the condition that the outstanding unpaid taxes must first be satisfied. Unlike real estate or *ad valorem* liens, the taxes owed on liquor licenses do not typically establish a security interest in the liquor license and the attempt by a municipality to preclude transfer may well violate Bankruptcy law. See Stern v. Commonwealth of Massachusetts Alcoholic Beverage Comm'n., In re: J.F.D. Enterprises, Inc., 183 B.R. 343-349 (Bankr. D. Mass. 1995).

IMPACT OF STAY VIOLATIONS

There are instances where the municipality is determined to have acted in violation of the automatic stay and that the debtor is owed damage by the municipality. A debtor, to recover actual damages for willful violations of the automatic stay, must establish, (i) a violation of the automatic stay must have occurred; (ii) the violation must have been committed willfully; and (iii) the violation must have injured the debtor. In re: Augustin Rosa, 313 B.R. 1, 6-7 (Bankr., D. Mass., 2004). It is very important to note that the willfulness requires only that the creditor have knowledge of the petition and that the act which violates the automatic stay be intentionally done. Rosa at 7. With respect to the imposition of punitive damages, it is not of consequence that the actor is a municipality. In Rosa, the Bankruptcy Court noted that the City had continued to prosecute a tax lien by the issuance of a lieN foreclosure correspondence. The Court noted the obligation of the municipality to inform its employees as to the pendency of the bankruptcy action notwithstanding the size or implied logistical issues in disseminating information city-wide. The U.S. Bankruptcy Court determined that the continued prosecution of a tax lien foreclosure was a violation of the automatic stay, notwithstanding the Debtor's failure to prove damages or some form of nefarious intention. In issuing sanctions for the continued prosecution, the Bankruptcy Court disallowed the City's proof of claim and awarded attorneys fees and damages for the equivalent of intentional infliction of emotional distress. Id.

Practical Recommendations

Getting the word out within the municipality concerning the bankruptcy filing: Section 342(b) of the Bankruptcy Code requires that a notice shall issue from the bankruptcy clerk after a filing of a petition of relief. Section 342(g) provides that a monetary penalty may not be imposed on a creditor for violation of a stay in effect….unless notice of the filing is brought to the attention of the creditor. While such, in theory, protects a municipality from alleged sanctionable conduct, all too often, one or more departments of a municipality have actually received notice of the filing, but because of the deluge of paper and electronic communications, omitted dissemination of the notice to other departments of the municipality who may also be dealing with the Debtor. Hence it is appropriate to set up both a system of dissemination throughout the municipal departments (and, as appropriate, school municipal employees), as well as access by municipal officials to the electronic service center for bankruptcy information known as 'Public Access to Court Electronic Records' ("PACER").[8] Please be aware that though dissemination of the information in some systematic way is highly recommended, that it is a separate sanctionable offense to use the dissemination of this information to discriminate in any way against a bankruptcy debtor for filing a petition for relief.[9]

Conduct periodic educational programs on bankruptcy issues. With changes in the Bankruptcy Code, Federal Bankruptcy Rules and the Local Bankruptcy Rules it is important to conduct reviews of issues so as not to run afoul of the Bankruptcy Code.

Comfort orders are appropriate where concern may exist. When in doubt seek confirmation that the Action does not violate the bankruptcy stay. See 11 U.S.C. § 362(j); see also 11 U.S.C. §362 (c)(4)(A)(ii). The Code permits such while most Courts do not countenance the issuance of so-called after-the-fact "comfort orders" or orders issued when such are truly not necessary, it is appropriate to consider seeking the same to avoid a determination that the perceived lawful exercise of policy powers violates the automatic stay. This may possibly be presented in the form of a motion

[8] The PACER Weblinks include: http://pacer.psc.uscourts.gov (Pacer Service Center); Pacer Court Specific Links: http://pacer.psc. Uscourts.gov/psco/cgibin/links.pl and individual courts may also be accessed for general information to that particular court (eg., Massachusetts Bankruptcy Court: https://ecf.mab.uscourts.gov).

[9] In this regard, the writer has addressed claims by debtors who have contended that they were embarrassed or made a public spectacle in various Treasurer / Collector Offices or when they applied for various licenses. One particular teller reportedly announced that a bankruptcy debtor, while in line at a license renewal station that he had filed bankruptcy. There is very much an atmosphere in the Bankruptcy Courts of zero tolerance for this sort of Scarlet Letter behavior and such might be deemed to be a violation of 11 U.S.C. § 525.

to confirm that the municipality's proposed action, does not violate the automatic stay. One cannot emphasize more strongly that such a motion, should be filed prior to the proposed action as motions to ratify or provide *nunc pro tunc* approval of the action are dimly viewed.[10]

[10] In the event of a case with a single real estate asset (as defined in 11 U.S.C. § 101(51)B, there may be additional opportunities. Absent a debtor filing a confirmable reorganization plan, relief from the stay must be granted after the 'later of the ninety period after entry if the order of relief or such additional times as the Court orders.