N O T E S O N

DEBTOR/CREDITOR

R E L A T I O N S

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No Stiffing Uncle Sam

Under the federal bankruptcy statute, unpaid income taxes more than three years old may be discharged. However, more recent taxes are not discharged absent payment in full. If a taxpayer can keep the IRS at bay for three years, taxes may be discharged.

Courts have been divided as to whether a bankruptcy case, which prevents the IRS from taking collection action for several years and is then dismissed, extends the three-year period in a second bankruptcy case. For example, a taxpayer who failed to pay 1997 income taxes files a Chapter 13 case in 1998. The case continues until 2001 and is then dismissed. During this time, the automatic stay prevents the IRS from taking collection action. If the taxpayer then files a Chapter 7 case in 2002, the 1997 taxes are more than three years old.

On March 4, 2002, the United States Supreme Court resolved this issue by determining that equitable principles do not permit a taxpayer to avoid payment of taxes through this device. The period of time during which the first bankruptcy was pending is not counted against the three-year period in the second bankruptcy.

Young v. United States, 122 S.Ct. 1036 (2002).

Fraud Discharged

Under the bankruptcy law, claims arising from a debtor's fraud normally may not be discharged. Claims arising from breach of contract may be discharged. What is the result where a lawsuit seeking recovery for fraud is settled, thereby converting the fraud claim into a contract claim under the settlement agreement? Appellate courts are divided as to whether the nondischargeable status of the fraud claim applies to the new contract claim.

The United States Court of Appeals for the Fourth Circuit, which covers Maryland, ruled last month that the settlement extinguishes the fraud claim. The contract claim under the settlement agreement can be discharged in a subsequent bankruptcy. The court reasoned that its ruling would encourage settlements of fraud claims.

The opposite effect may be more likely, as the defrauded party must weigh the risk of a bankruptcy when considering whether to settle with the defrauder. The ruling makes settlement less attractive.

Archer v. Warner (In re Warner), 283 F.3d 230 (4th Cir. 2002).

Escrow Funds Outside Bankruptcy

It bears repeating that property held in escrow is not part of the bankruptcy estate of the escrow holder. This was recently illustrated when a bankruptcy trustee was unable to recover funds diverted from a debtor-attorney's escrow account, because the diverted funds were not part of the bankruptcy estate.

Because funds held in escrow can be kept out of bankruptcy, escrows are useful tools when structuring transactions with financially troubled entities. The use of escrows for dispersing loan proceeds or providing collateral security can insulate such funds from the major effects of another party's bankruptcy.

Stevenson v. J.C. Bradford & Co. (In re Cannon), 277 F.3d 838 (6th Cir. 2002).

This newsletter is intended to inform its readers of developments in the area of debtor/creditor relations. It is not legal advice or a legal opinion regarding any specific matter. You should consult a lawyer regarding any questions relating to your particular situation.

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