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ADMINISTRATION OF TENANCIES BY THE ENTIRETY PROPERTIES IN BANKRUPTCY: TRICKETT IS DEAD

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There has been a development regarding the way in which tenancy by the entireties ("TBE") properties are administered in bankruptcy that has the bankruptcy bar in a buzz. The case is the unpublished opinion of *Ralph Holley v. Collene Corcoran (In re Holley)*, No. 16-1081, 661 F. App'x 391 (6th Cir. October 25, 2016). In this 2016 case, the Sixth Circuit reversed the Bankruptcy Court's order that allowed the Chapter 7 trustee to pay for her administrative fees and expenses from the sale proceeds of property held and exempted under the applicable TBE exemption. *Id*. at 393. The Debtors, Ralph Holley and Melonee Monson-Holley, owned property in Michigan as tenants by the entirety and claimed that property fully exempt on their schedules under the Michigan exemption statute. The statute is MCL § 600.541(1)(n) (2012) and states:

> (1) A debtor in bankruptcy under the bankruptcy code, 11 USC 101 to 1532, may exempt from property of the estate property that is exempt under federal law or, under 11 USC 522(b)(2), the following property:
>
> (n) Property described in section 1 of 1927 PA 212, MCL 557.151, or real property, held jointly by a husband and wife as a tenancy by the entirety, except that this exemption does not apply with regard to a claim based on a joint debt of the husband and wife.

The Court found that "Michigan law protected the *entire* value of [the] couple's property– which, in this case, [consisted of] the cash proceeds from the Property's liquidation at the sale– minus deductions for those sums due to joint creditors." *Id*. at 396, citing MCL § 600.5451(1)(n)(2012). The Court further stated that "11 U.S.C. § 522(k) prohibits a bankruptcy court from charging exempt property for administrative expenses… even where a debtor has engaged in misconduct" *Id* citing *Siegel*, 134 S. Ct. at 1195-96. The bankruptcy court's ruling had found that the Debtors' requested accommodations in the sale of the property coupled with their multiple schedule amendments required the trustee to incur the administrative expenses. *In re Holley*, 661 F. App'x at 396. Since they were granted the requested accommodation, they in essence received the full benefit of the exemptions. *Id*. The Sixth Circuit disagreed with this rational and reversed for the reasons stated above. *Id*.

Administration of Tenants by Entirety Properties Before the Bankruptcy reform act of 1978

To understand the implications of this case on cases going forward it is beneficial to retrace the history of how TBE properties were administered, or not administered as the case may be, under previous bankruptcy law. The long standing case that was followed prior to the above Sixth Circuit ruling was the case of *Mich. Nat'l Bank v. Chrysler (In re Tricket*t), 14 B.R. 85 (Bankr. W.D. Mich.1981). This case was decided shortly after the Bankruptcy Reform Act of 1978, which at that time provided new powers to the trustees to administer property held as tenancy by the entirety which they previously did not have.

As explained in *Trickett*, before 1978, the bankruptcy trustees did not have jurisdiction to administer TBE properties as those properties did not pass to the bankruptcy estate. *See Id.* at 88. The Bankruptcy Act of 1898 § 70 (a)(5) provided that because property of the debtor held in entireties could not be transferred or levied upon by individual creditors, title did not vest in the trustee. During this time however, Michigan law did allow an order to levy on entireties property by a joint creditor if it first obtained a judgment against both the husband and wife and was able to show 1) a special consideration running to the wife's separate estate; or 2) a written instrument signed jointly by husband and wife. *See* MCL Sec. 557.53 and Bienefeld, *Creditors v. Tenancies by the Entirety,* 1 Wayne L. Rev. 105, 1122. Shortly after the creation of the statute, a Michigan Supreme Court case went on to clarify that the right to reach entireties property extended to joint judgment creditors. *See Sanford v. Bertrau*, 204 Mich. 24; 169 NW 880 (1918). The caveat was that if one or both of the spouses were in bankruptcy the state law remedies had to be accomplished before a discharge of the debt was ordered by the bankruptcy court. *See Fetter v. United States*, 269 F. 2d. 467 (6th Cir) and *Harris v. Manufacturers National Bank of Detroit*, 457 F. 2d. 631 (6th Cir. 1972).

In order for joint creditors to levy on TBE property where one or both of the spouses were in bankruptcy, they had to utilize the procedures set out in the case of *Lockwood v. Exchange Bank*, 190 U.S. 294 (1903). Under *Lockwood*, the Supreme Court had provided that courts may grant a lift of stay and a stay of the discharge to permit joint creditors to pursue their remedies in state court against the husband and wife and otherwise meet the requirements under state law to levy on TBE property. *Id*. at 300. Thus, before the Bankruptcy Reform Act of 1978, if one or two of the spouses filed bankruptcy, joint creditors had to file a complaint for relief from the automatic stay and a stay of discharge so that they could proceed in State court if they wanted access to payment from the equity in entireties property.

After the Bankruptcy Reform Act of 1978

Under the Bankruptcy Reform Act of 1978, 11 U.S.C. § 541 redesigned the bankruptcy estate to consist of "all legal and equitable interests of the debtor in property as of the commencement of the case." This permitted TBE property to come into the bankruptcy estate but the debtor could also exempt the property under TBE and although it would be available for the Chapter 7 to administer it could only be done for the benefit of joint creditors. *In re Trickett*, 14 B.R. at 89. *Trickett* was a landmark case, as it was the first case to address the ability of the trustee to administer these previously off-limit assets. Further, the court provided guidelines as to how the proceeds from the sale of these assets were to be distributed. It provided that lienholders, including taxes on the property, was the first debt to be paid and all the expenses for the sale and administration of the asset came before payment on joint claims or any surplus was to be paid to debtor(s), which was last on the priorities. *Id* at 91.The Sixth Circuit decision overruled Trickett and flipped this guidance on its head, rendering amounts that would have paid twelfth (joint claims) and thirteenth (surplus to debtors) in line, on *Trickett's* recommendation, are now second and third, out of three entities that can be paid from TBE proceeds. Since the proceeds are exempt and because 11 U.S.C. § 522(k) prohibits bankruptcy courts from charging exempt property for administrative expenses, the Chapter 7 Trustees cannot pay themselves or any costs associated with administrating TBE properties from the proceeds.

Practicality of Administrating Tenancy by the Entirety Property

The Sixth Circuit case of *Holley v. Corcoran* raises many questions and gives only a strict and unwavering decision that do not answer those questions. A Chapter 7 Trustee can still administer TBE properties, but if the proceeds can only go to pay lienholders, joint creditors and the TBE property owners, how does a trustee pay for her costs and time in the administration of that asset? Are Trustees' bound to administer TBE property if the end result is that the bankruptcy estate will be insolvent? In the latest *Corcoran v. Holley* decision, the trustee appealed from the bankruptcy court, which was on remand from the Sixth Circuit, which required her to turn over in excess of $20,000.00 of proceeds used to pay administrative fees. One of reasons she appealed was because the bankruptcy estate was administratively insolvent and there was no money in which to fund the turn-over Order. Unfortunately for the trustee, she provided no legal authority as to why the Debtors were not entitled to those proceeds and District Court affirmed the Bankruptcy Court decision. *See In re Holley, 594 B.R. 872 (E.D. Mich. 2018)*.

Conclusion

If it is determined the trustee is not required to administer TBE properties, joint creditors will likely have to revert back to the Pre- 1978 Bankruptcy Reform Act remedies and request a lift of stay action and stay of discharge to be able to execute against TBE properties in state court. This seems like a plausible result to the Sixth Circuit Ruling. Another possible solution is that the trustee could negotiate a "carve out" with the joint creditors where the creditor's would agree to pay the trustee her costs to administer the asset from proceeds that they would have otherwise received. This may be practical if there is only one joint creditor or if the joint debts are sizable enough that it makes economic sense. How the administration of TBE properties in Chapter 7 evolves in the future is unknown at this time. What is known is that the *Corcoran v. Holley* cases gave more teeth to the Michigan TBE exemption and one would expect to see administration of these properties in Bankruptcy in fewer and fewer cases.

TAX BENEFITS OF DEBTOR PASS-THROUGH ENTITIES ARE NOT PROPERTY OF THE ESTATE

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A bankruptcy court in North Carolina recently considered an intriguing set of facts involving a limited liability company's prepetition payment of taxes on behalf of its members. Like any good story, this one has a fascinating twist.

The name of the case is *Finley Group v. Roselli (In re RedF Marketing, LLC),* 589 B.R. 534 (Bankr. W.D.N.C. 2018). Debtor RedF lost a trademark infringement case that precipitated an involuntary bankruptcy that eventually morphed into a liquidating chapter 11 proceeding. A plan confirmed in 2012 and modified in 2013 provided that the assets would be sold to the creatively-named "Newco," and a liquidating trust was established to pursue causes of action held by the estate not transferred to Newco. The plan also provided for an exchange of mutual releases between Mr. and Mrs. Roselli, the members of RedF, and the Liquidating Agent, and for cancellation of the Rosellis' membership interests.

In 2010 and 2011, prior to the bankruptcy, RedF had made payments on behalf of the Rosellis to state and federal taxing authorities in excess of $650,000. The Liquidating Agent sued the Internal Revenue Service and the State of North Carolina to recover these payments. Things took an interesting turn in April 2014, when the Rosellis amended their 2010 and 2011 state and federal tax returns, resulting in a refund to them of approximately $650,000. They did not notify the Liquidating Agent of the amendment, nor did they notify the Liquidating Agent when they received the refunds.

This did not sit well with the Liquidating Agent, who filed an adversary proceeding against the Rosellis seeking to recover the tax refunds. The complaint and amended complaint contained a number of counts, but the ones at issue in this opinion were Count II, which sought turnover of the refunds under 11 U.S.C. § 542, and Count III, which asserted a conversion claim against the Rosellis. Those two counts came under the Court's consideration on the Roselli's motion to dismiss them under Fed. R. Civ. P. 16(b)(6).

The court first considered the arguments regarding the turnover count. It determined that the right to claim the refunds was not property of the estate. In so concluding, it reviewed several cases holding that a pass-though entity debtor does not have an interest in the tax refunds of the equity holders. It found the reasoning of *Stanziale v. CopperCom, Inc. (In re Conex Holdings, LLC),* 518 B.R. 792 (Bankr. D. Del. 2014) particularly persuasive. The *Conex* case held that the trustee of a subsidiary LLC could not recover from the parent company that used the debtor's net operating losses ("NOL") to obtain tax refunds, as those NOLs inured solely to the benefit of the single member.

The Liquidating Agent made a separate argument for equitable subrogation based upon the debtor's payment of the members' tax liability. This state law argument failed for several reasons. First, the court determined that it was barred by the applicable statute of limitations. The Liquidating Agent argued that there was no statute of limitations for a § 542 turnover claim, and that therefore the statute of limitations did not apply. The court rejected this argument, holding that the Liquidating Agent could not use § 542 to bootstrap past the statute of limitations. Section 542 did not *create* an interest in property, but merely gave the trustee a mechanism for recovering property. The existence of an interest in property was determined by state or other non-bankruptcy law, and in this case, any state law right was barred by the statute of limitations. A right of turnover under § 542 exists only once a property right has been determined to exist. Second, the court held that the Liquidating Agent had failed to plead all of the elements of a claim for equitable subrogation, because under state law, such a right was not available to a mere volunteer. Because RedF had no duty to the taxing authorities, as to them it was nothing more than a volunteer. Finally, the court held that the Liquidating Agent's argument for equitable subrogation, even if successful, would not give the Liquidating Agent a right to recover the tax returns because it would only put the Liquidating Agent in the shoes of the taxing authorities.

Having determined that the Liquidating Agent had no property interest in the tax refunds, the court made fairly short shrift of the Count III conversion claim.

In a amusingly-worded conclusion, the court noted,

> Under normal circumstances, the Liquidating Agent might have sued the Rosellis as beneficiaries, initial transferees, or even the subsequent transferees of the allegedly fraudulent tax payments that are presently being sought from the IRS. Alternatively, the

> Liquidating Agent might have sued the Rosellis for conversion of the monies in RedF's prepetition bank account, which the Rosellis used to pay their taxes. These payments may even have constituted illegal dividends under N.C. Gen. Stat. § 55-6-40 given RedF's poor financial condition. However, because the Plan released all preconfirmation claims against the Rosellis, any such endeavor is foreclosed. [589 B.R. at 549.]

The litigation against the IRS has not yet been resolved and the court's decision on the motion did not resolve all of the counts alleged against the Rosellis. However, the notion that the tax benefits and burdens of a flow-through entity are not property of the estate is worth contemplation when representing such entities or their trustees in bankruptcy as the consequences can be far-reaching.