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IN THIS ISSUE

Exculpation as a Shield to Malpractice Claims?

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INTRODUCTION

Can a Chapter 11 exculpation clause bar a legal malpractice lawsuit between an attorney and the attorney's own client? According to the Southern District of Ohio – the answer is yes.

Generally speaking, Chapter 11 exculpation clauses release parties from liability for acts or omissions arising out of the Chapter 11 proceedings. The purpose of the exculpation clause is to allow the myriad of parties involved in a bankruptcy proceeding or plan negotiation to "engage in the give-and-take of the bankruptcy proceeding without fear of subsequent litigation over any potentially negligent actions in those proceedings." *Blixseth v. Credit Suisse*, 961 F.3d 1074, 1084 (9th Cir. 2020). But the Southern District of Ohio has recently extended an exculpation clause to conclude that a claim for legal malpractice between the debtor's principal and the principal's attorney is barred. *In re Murray Energy Holdings Co.*, No. 19-56885, 2023 WL 6804362 (Bankr. S.D. Ohio Oct. 5, 2023). As a result of this ruling, attorneys should take a closer look at their exculpation clauses as a potential shield to malpractice claims.

STATUTORY BACKGROUND

Courts across the country have struggled to balance the prudential benefits of the exculpation clause with the lack of statutory authority to enter such a clause. For example, the 9th Circuit in *Blixseth*, found that it had the power to enforce a broad exculpation clause under 11 U.S.C. § 105(a). In contrast, the 5th Circuit in *Matter of Highland Cap. Mgmt., L.P.*, 48 F.4th 419, 437-438 (5th Cir. 2022) (petition for cert pending), ruled that § 524(e), which limits the discharge to the debtor, prohibits an exculpation clause that does anything more than shield the unsecured creditor committee or the trustee from actions involving their statutory duties.

In 2021, the Southern District of Ohio approved an exculpation clause, over the objection of the US Trustee, that provided broad releases to fiduciaries and non-fiduciaries and that covered conduct that occurred pre-petition. *In re Murray Metallurgical Coal Holdings, LLC*, 623 B.R. 444 (Bankr. S.D. Ohio 2021). In approving the clause, the court concluded that it had the authority to enter such a provision under §105(a), and that § 524(e) did not prohibit such a clause because that clause did not affect a debt that was subject to discharge.

STRETCHING THE EXCULPATION CLAUSE

Two years later, the Southern District of Ohio put the exculpation provision of a related debtor to test in *In re Murray Energy Holdings Co*., No. 19-56885, 2023 WL 6804362 (Bankr. S.D. Ohio Oct. 5, 2023). In this case, the estate of the debtor's principal filed a malpractice action against the attorneys for the principal alleging that the attorneys failed to properly advise the principal about personal liability under the debtor's pension plan, and failed to negotiate a release that would have terminated the principal's personal liability as to the pension plan. The confirmed plan specifically provided that the pension plan's claims against the non-debtor parties were preserved.

The defendant attorneys removed the malpractice claim to the bankruptcy court, and moved to dismiss it under the plan's exculpation clause. The exculpation clause stated:

> [N]o Exculpated Party shall have or incur, and each Exculpated Party is hereby exculpated from, any Cause of Action for any claim related to any act or omission ***based on the negotiation***, execution, and implementation of any transactions approved by the Bankruptcy Court in the Chapter 11 Cases, including the RSA, the Stalking Horse APA, the Disclosure Statement, the [Chapter 11] Plan, the Plan Supplement, the Confirmation Order, or any Restructuring Transaction ... except for claims related to any act or omission that is determined by Final Order to have constituted actual fraud, willful misconduct, or gross negligence, each solely to the extent as determined by a Final Order of a court of competent jurisdiction[.]

The Plan defined "Exculpated Party" as:

> "Exculpated Party" means collectively, and in each case solely in its capacity as such: (a) the Debtors ... and (s) with respect to each of the foregoing entities, such Entity and its current and former Affiliates, and such Entities' and their current Affiliates' directors, managers, officers, equity holders (regardless of whether such interests are held directly or indirectly), predecessors, participants, successors, and assigns, subsidiaries, and each of their respective current and former equity holders, officers, directors, managers, principals, members, employees, agents, advisory board members, financial advisors, partners ***[and] attorneys***[.]

After concluding that it had jurisdiction over the malpractice action and denying the request to abstain or sending the matter to arbitration, the Court ruled that the malpractice action was barred by the Plan's exculpation clause because the malpractice action was based off the attorneys alleged failure to negotiate a personal release of the pension claims. The court then concluded that the malpractice complaint did not state a claim for actual malice or gross negligence. The court ultimately concluded that "despite the Plaintiffs' conclusory allegation that the Defendants acted with actual malice, the claim—which they pleaded only as a 'Legal Malpractice/Professional Negligence Claim,' … falls within the type of claims covered by the Exculpation Clause." The Court then dismissed the malpractice claim with prejudice. Id. at *28.

CONCLUSION

Given the Court's holding that an exculpation clause can bar a legal malpractice claim, attorneys should take a closer look at their exculpation clauses and revise them to include a shield for malpractice claims if possible.

Death and Taxes…Unless you file for protection under the Bankruptcy Code?

By: Aaron Kenyon, Attorney at Dietrich & Kenyon, PLLC

"Our new Constitution is now established, and has an appearance that promises permanency; but in this world nothing can be said to be certain, except death and taxes."

- Benjamin Franklin, 1789

When Mr. Franklin penned the statement above, should he have qualified it with a reference to Article I, Section 8 of the US Constitution which authorized Congress to enact "uniform Laws on the subject of Bankruptcies"? In 1978, Congress took our forefathers up on the challenge and moved forward with steps to enact the "Bankruptcy Code" which cracked the foundation of Mr. Franklin's famous quote – severing the certainty of the death and tax bond and allowing individuals the ability to attack the "certainty" of the latter.

In analyzing the breadth of tax resolution opportunities that the Bankruptcy Code presents, an evaluation must be made of the several factors surrounding the nature of a Debtor's taxes: the type of tax; the status and due dates of Debtor's tax returns; the circumstances under which the Debtor's tax liability arose; the age of the Debtor's tax liabilities; and the presence of any tax liens placed on the Debtor's assets.

TYPES OF TAXES

In order to determine the dischargeability or priority of a tax claim in bankruptcy, we must first analyze the type of tax. Taxes tend to fall into a few common categories: income taxes; employment taxes; withholding/trust taxes; and excise taxes.

Income Taxes. The Cambridge dictionary defines "income tax" as "a tax on the money that a person earns from working or that a company earns from the sale of products or services". Income tax liabilities are quite common in consumer bankruptcy.

Employment Taxes. Employment taxes are liabilities of an employer for the employer portion of the FICA and Medicare taxes. Employers are responsible for matching the FICA and Medicare tax withholding of employees.

Withholding/Trust Taxes. Employers are required to withhold from an employee's wages income taxes and the employee's share of FICA and Medicare taxes. The Internal Revenue Code makes the employer a fiduciary of the United States with respect to these payroll taxes. When an employee's income taxes and share of FICA taxes are withheld from the employee's wages by the employer, the employee is treated as having paid those amounts to the IRS, whether the employer actually pays over such amounts to the IRS.

Sales Taxes. Certain businesses are also required to collect sales taxes on behalf of taxing authorities. Such sales taxes are then held in trust until they are submitting to the taxing authorities.

Collectively, these withheld or collected taxes are commonly known as "Trust Fund" which can be assessed personally to owners, officers, directors and responsible employees.

Excise Taxes. An excise tax is a tax on goods manufactured or sold in a given jurisdiction.

Penalties. The IRS may assess penalties for failure to file tax returns, failure to pay taxes due, underpayment of estimated taxes and for many other reasons due to deficiencies.

DISCHARGEABILITY TESTS

Step 1: Determine the type of tax and whether the tax is actually dischargeable.

Income Tax: Yes, if the tax liability meets the requirements in Steps 2-5 below.

Employment Taxes (Employer's Portion of FICA and FUTA): Yes, if return was due more than 3 years before the petition date. (§§507(a)(3) and 507(a)(8)(D)).

Withholding/Trust Taxes (Employee's Portion of FICA and Income): No, never dischargeable. (§§523(a)(1) and 507(a)(8)(C)).

Excise Tax: Yes, if due more than three years before petition date, or if no return filed transaction occurred more than 3 years before the petition. §§523(a)(1)(A) and 507(a)(8)(E).

Penalties (Failure to File, Pay, Deposit, Accuracy, etc): Yes, if transaction occurred more than 3 years before the petition date. §507(a)(7).

Step 2: Due date of tax return (3 Year Rule)

The tax return in question must have been due to have been filed more than three years prior to the date of the bankruptcy filing. The test is based on original due date of tax return. Generally, for bankruptcies filed after 15 April each year, the prior three tax years will not be dischargeable. For bankruptcies filed prior to 15 April each year, non-dischargeable taxes will include the prior four tax years. §507(a)(8)(A)(i).

An opportunity for bankruptcy planning occurs early in the year, when a proficient bankruptcy attorney has an opportunity to delay a filing by a few days or weeks to ensure the dischargeability of an additional portion of a client's tax liability.

When evaluating the three-year rule, one must also pay attention to tolling events: prior bankruptcy filings (time in bankruptcy plus 90 days), collection due process appeals (time in appeal plus 90 days), offers in compromise (time for offer in compromise plus 30 days), etc. Tolling events can extend the Three-Year Rule.

Step 3: Last assessment date (240 Day Rule)

The Internal Revenue Service must have assessed the filed tax return at least 240 days prior to the date on which the Debtor filed for protection under the Bankruptcy Code. §507(a)(8)(A)(ii)).

Again, one must be cognizant of tolling events as they can also extend the 240 Day Rule.

Step 4: Date return was actually filed (2 Year Rule)

The Debtor's tax return must have been filed at least two years prior to the date on which the Debtor filed for protection under the Bankruptcy Code. §523(a)(1)(B)). The return must have actually been filed by the Debtor. In some cases, when a tax payer has not filed a tax return the IRS may file a Substitute For Return (SFR) for the tax payer. A SFR does not count as a filed return for the purposes of the 2 Year Rule.

Step 5: No Fraud or Willful Evasion § 507(a)(1)(C)

If it has been determined that the Debtor has committed fraud or willful tax evasion, the resulting tax liability is never dischargeable.

PRIORITY TAXES

If not dischargeable, the Debtor's tax liability may be considered a "priority tax" and will need to be paid in full over the course of the Debtor's Chapter 13 Plan term.

Priority taxes are provided for in §507(a)(8), which uses as a qualifier for priority taxes a variation of the "3 Year Rule" and the "240 Day Rule". Tax liabilities for which the tax return in question was due to have been filed less than three years prior to the date of the bankruptcy filing and/or for which an assessment was performed (or an assessment was due to be performed) within the 240 days prior to the date of the bankruptcy filing shall be considered priority unsecured claims.

Once priority taxes have be determined, the Debtor's Chapter 13 Plan shall be required to pay all priority unsecured claims in full over the course of the Chapter 13 Plan term. At the conclusion of the Chapter 13 Plan term, if a discharge is granted, all penalties associated with priority taxes are discharged. This is not the case in Chapter 7, as the penalties on non-dischargeable tax claims are not discharged.

TAX LIENS

The words "Federal Tax Lien" can be a crushing phrase to read for any Taxpayer. But have no fear, there are ways to resolve tax liens, depending on the type of bankruptcy chosen by the Debtor.

In a Chapter 7, the tax lien will, generally, pass through the bankruptcy unaffected. The lien will continue to exist, attached to all real and personal property that has been acquired prior to the filing of the bankruptcy petition for the statutory period that the debt is collectible, generally ten years. End of story.

In a Chapter 13, a much more complicated process ensues. An assessment of the Debtor's assets must be performed in order to determine the true value of the tax lien. A tax lien is, in fact, no larger than the value of the Debtor's assets to which it can be attached to. The Bankruptcy Code provides for a process similar to that of a "cram down" that takes place to effectively resolve the tax lien over the course of the Chapter 13.

After the lien value has been determined, it must be provided for via treatment in the Debtor's Chapter 13 Plan. The secured portion of the lien, that part of the lien for which there is collateral with value, is paid through the plan. The unsecured portion is treated according to the standard rule for taxes.

Any unsecured portion of the lien that is a priority tax is paid according to its priority. If the tax year for the unsecured portion of the lien is not priority, it's paid (or not paid) just like any other general unsecured claim.

BREADTH OF THE TAX LIEN

A tax lien will attach to all the assets that the Taxpayer owns when the lien is filed, and to all assets acquired while the underlying tax is collectible.

Exemptions in bankruptcy won't save the Debtor's property from a tax lien. The lien overrules the exemption. Therefore, when calculating the value of the tax lien, the calculation is merely asset value less any secured liens.

The recorded lien reflects the amounts due on the tax years in question at the time the lien was recorded. The actual amount due for the tax lien depends on how much interest runs after recordation and whether payments have been made to reduce the tax due.

Tax liens remain valid only as long as the tax liabilities that they secure remain collectible. Taxes do not last forever. They will expire at the end of the 10-year statute of limitations. When the tax liability expires, the lien then expires as well.

VAUATION OF A TAX LIEN – HOW DO YOU ARRIVE AT LIEN VALUE?

Step 1: A Debtor's Schedule A/B will give a value to each of the debtor's assets. Larger valued assets are listed individually and smaller more common items are listed in lump sum (like household goods and clothing).

Step 2: Any liens on assets that were created prior to the filing of the tax lien are subtracted from the value of the asset. If a positive number results, that portion of this asset's value is collateral for the tax lien.

Add up all the equity from the Debtor's assets, and that's the amount of the tax lien that is genuinely secured.

Step 3: Draft a Chapter 13 Plan that pays the secured amount of the IRS claim. The secured portion of the federal tax lien must be paid with interest over the life of the Chapter 13 Plan.

Examples:

Example A

Debtor A files his Chapter 7 petition on 1 February 2023 and has filed all prior tax returns timely and no determination of fraud. Debtor A has liability for tax year 2022 in the amount of $2,500; liability for tax year 2021 in the amount of $3,000 and liability for tax year 2018 in the amount of $1,500.

Debtor A receives his discharge on 27 June 2023 and should effectively discharge all tax liabilities for tax year 2018. Because tax years 2022 and 2021 do not meet the 3 Year Rule, they are not dischargeable.

Debtor A, like many Chapter 7 debtors, may be an excellent candidate for an Offer in Compromise to resolve his residual tax liability post-discharge.

Example B

Debtor B files her Chapter 13 petition on 20 April 2022 and has filed all prior tax returns timely with no determination of fraud. Debtor B has liability for tax year 2021 in the amount of $5,000; liability for tax year 2020 in the amount of $4,000; liability for tax year 2019 in the amount of $3,000 and liability for tax year 2018 in the amount of $2,000.

Debtor B's Chapter 13 Plan must include provision for payment of 2019-2021 tax liabilities. The due dates for the tax returns generating the tax liabilities are within the three years prior to the filing of Debtor B's petition and are therefore considered priority and must be paid over the term of Debtor B's Chapter 13 bankruptcy.

Upon discharge, Debtor B should receive a discharge as to the 2018 tax liabilities and as to any penalties associated with the 2019-2021 tax liabilities.

Example C

Debtor C files his Chapter 13 petition on 10 June 2023. Debtor C has unfiled tax returns for tax periods 2018-2022. After Debtor C files his case, he completes all required tax returns (returns due in four years proceeding filing. Debtor C has liability for tax year 2022 in the amount of $4,000; liability for tax year 2021 in the amount of $5,000; liability for tax year 2020 in the amount of $4,000; and liability for tax year 2019 in the amount of $3,000. Tax year 2018 remains unfiled; the IRS has indicated an estimated tax liability of $6,000 on Debtor C's proof of claim.

Debtor C's Chapter 13 Plan must include provision for payment of 2020-2022 tax liabilities. The due dates for the tax returns generating the tax liabilities are within the three years prior to the filing of Debtor C's petition and are therefore considered priority and must be paid over the term of Debtor C's Chapter 13 bankruptcy.

Upon discharge, Debtor C should **not** receive a discharge as to the 2018 and 2019 tax liabilities as they do not meet the requirements for discharge under the Bankruptcy Code. Any penalties associated with the 2020-2022 tax liabilities shall be discharged upon the order of discharge.

Example D

Debtor D files her Chapter 7 petition on 11 November 2023 and has filed all prior tax returns timely with no determination of fraud. Debtor D has liability for tax year 2021 in the amount of $5,000; liability for tax year 2020 in the amount of $6,000; liability for tax year 2019 in the amount of $9,000; liability for tax year 2018 in the amount of $25,000; and liability for tax year 2017 in the amount of $40,000. Debtor D also has a federal tax lien filed in the amount of $60,000.

Debtor D has listed property on Schedule A/B which has a total value of $175,000. Also, Debtor D has indicated liens on her home and vehicle on Schedule D which show a balance as of the time of the filing of the bankruptcy petition in the amount of $158,000. Debtor's net equity is $17,000. Debtor D has appropriately applied exemptions to all of her property as to protect any non-exempt equity.

Debtor D receives her discharge on 1 March 2024. Debtor D's tax obligations from 2020 and 2021 are not dischargeable as they do not meet the 3 Year Rule. Liabilities from 2018 and 2019 are dischargeable; however, a portion of those liabilities will attach to the Debtor's pre-petition property. The portion of the liability is set at $17,000 as that is the net equity of the Debtor's assets at the time of filing. The lien will exist post-petition (likely until the statute of limitations has expired) and if Debtor D has real property which she sells during the statute of limitations period, the IRS will likely receive payment on the pre-petition tax lien.

Example E

Same fact pattern as Example D, however, Debtor E files her Chapter 13 petition on 11 November 2023 and has filed all prior tax returns timely with no determination of fraud. Debtor E has liability for tax year 2021 in the amount of $5,000; liability for tax year 2020 in the amount of $6,000; liability for tax year 2019 in the amount of $9,000; liability for tax year 2018 in the amount of $25,000; and liability for tax year 2017 in the amount of $40,000. Debtor E also has a federal tax lien filed in the amount of $60,000.

Debtor E has listed property on Schedule A/B which has a total value of $175,000. Also, Debtor E has indicated liens on her home and vehicle on Schedule D which show a balance as of the time of the filing of the bankruptcy petition in the amount of $158,000. Debtor's net equity is $17,000. Debtor E has appropriately applied exemptions to all of her property as to protect any non-exempt equity.

Debtor E has $11,000 in priority taxes. Debtor E has a tax lien in the amount of $17,000. Debtor E's Chapter 13 Plan must include treatment of the priority taxes ($11,000) and the secured portion ($17,000) of the Federal Tax Lien. Upon discharge Debtor E should receive a discharge as to the general unsecured tax liability ($47,000) and the remainder of the federal tax lien shall be extinguished. Any penalties associated with 2020-2022 tax liabilities shall also be discharged upon the granting of the order of discharge.

NON-BANKRUPTCY ALTERNATIVES

The Internal Revenue Service has alternatives for tax liability resolution. Some firms offering bankruptcy also find the need to utilize other non-bankruptcy alternatives to assist in serving their client. In order best serve a potential debtor/tax payer, an analysis of all resolution alternatives should be evaluated.

The IRS offers various installment agreements, offers in compromise and collection holds to assist taxpayers in resolving their liabilities to the IRS. When attempting to resolve matters directly with IRS it must be noted that they operate on their own glacial timeframe and the process can be time intensive and slow at best. A typical response time for an Offer in Compromise proposal can regularly exceed nine months.

The bankruptcy process often is a better solution for troubled taxpayers as the Bankruptcy Code establishes strict timelines for taxing authorities, which moves the process along at a more manageable pace. Those with tax problems also have issues with debt that can also be resolved through a single process in the bankruptcy courts.

Installment Agreement (IA) – 72 Months

The IRS is generally acceptable to setting up various types of installment plans as long as the installment plan will pay tax debts in full over the shorter of 72 months or the duration of the IRS statute of limitations period (10 years from due date of return).

Depending on the level of liability, the IRS may still execute a federal tax lien and/or require payment via automatic debit from a taxpayers account.

Care must be made on the part of the taxpayer to not default the installment agreement by falling out of compliance with ongoing tax obligations during the duration of the installment agreement. Compliance means filing all tax returns, making quarterly ongoing tax estimates and paying all taxes when due.

Partial Payment Installment Agreement (PPIA)

For those taxpayers not able to pay tax liabilities in full during the course of a regular installment agreement, the IRS may offer a Partial Payment Installment Agreement (PPIA). A PPIA may offer some relief of a portion of the tax liability owed.

Entering into a PPIA requires an extensive presentation of the taxpayer's financial situation (much like that of a bankruptcy petition and schedules) in an effort to prove to the IRS that the taxpayer cannot afford to pay the tax liabilities in full. The IRS will require submission of supporting documentation such as paystubs, bank statements, utility bills, documents supporting debt payments, vehicle titles, etc. The supporting document requirements are often more intensive than those required for trustees in the bankruptcy courts.

Similar to Installment Agreements, Taxpayers must stay compliant going forward. Taxpayers must also report any change in circumstance that may lead the Taxpayer to be able to pay the liability in full.

Offer In Compromise (OIC)

An Offer in Compromise may be an exceptional resolution tool for those who qualify. An OIC will compromise the total tax liability and require payment rather quickly at often a substantially lower amount. OICs must be paid, at the election of the taxpayer, in five equal monthly payments or in 24 equal monthly payments.

Those with any amount of excess income and/or equity in assets (real estate and retirement accounts) often find difficulty in securing a successful OIC. Those with equity in assets, such as equity in real estate, must go through the process of proving to the IRS that the funds are not accessible to the taxpayer – often through denials of credit for second mortgages or home equity lines of credit.

With the proper set of facts and attention to presentation, an OIC can be an attractive tool to resolve a taxpayer's debt outside of bankruptcy.

Currently Not Collectable status (CNC)

A Taxpayer may seek for a granting of Currently Not Collectable (CNC) status. This status can also be valuable as the IRS will cease collection activity and the Taxpayer will merely wait out the statute of limitation on IRS collections when the tax liability will cease to exist.

A granting of CNC status is obtained similar to that in a PPIA or an OIC. A Taxpayer must provide an extensive financial presentation proving to the IRS that there is no way that the Taxpayer can pay his or her liabilities. Periodic representations must be made in order to remain in CNC status throughout the duration of the statute of limitation period.

SUMMARY

In summary, there are effective ways of addressing a taxpayers' liabilities both inside and outside of the bankruptcy process. In practice, in the majority of cases, a Chapter 13 may be the best way to address the tax issues and the underlying debt issues that may have been the major component in the creation of the tax issues. Most delinquent taxpayers will be better served by becoming a Debtor in a bankruptcy proceeding than in addressing the tax issues with the IRS and other taxing authorities alone.