

Court's Denial of Debtors' Motion to Modify which sought a refund from Trustee or Unsecured Creditors for additional income taxes owed due to a lawsuit settlement that the Trustee disbursed to the unsecured creditors per the terms of a Modification Order entered pursuant to Trustee's Motion to Modify previously filed for that purpose

Case: 09-10108 Nordstrom

Facts: The Debtors' filed their bankruptcy in 2009. At that time, the Debtors did not disclose in their schedules any interests in any lawsuit or claim. The Debtors' proposed Chapter 13 plan was confirmed a few months later.

In 2013, I received from a law firm a check in the amount of \$33,597.67 made payable jointly to the Debtors and me as the Chapter 13 Trustee administering the case, such funds representing settlement proceeds from a class action lawsuit that the law firm was representing the Debtors. Upon review of the underlying schedules, I confirmed that the lawsuit was not disclosed in the Debtors' schedules nor was it claimed as exempt property. Based upon such, I filed my Motion to Modify the terms of the Debtors' confirmed plan thereby seeking authority from the Bankruptcy Court to add this lump payment to the plan base and to immediately disburse the funds toward the payment of any unpaid administrative claims, unpaid unsecured claims, and then toward the payment of any unpaid secured and other claim being paid through the plan. This Motion was served upon the Debtors, their attorney, and the matrix. The Debtors filed an objection to my Motion to Modify, thereby generally denying all of the allegations of the Motion to Modify thereby causing such to be set for hearing on the 5/1/13 Beaumont Docket. At the hearing, the Debtors withdrew their objection and the Court granted the Motion to Modify by the entry of the proposed Order Confirming Modified Chapter 13 Plan.

In that the settlement check was made payable jointly to the Debtors and myself, I filed my Motion to Compel Turnover of the funds belonging to the Bankruptcy Estate held by the law firm, thereby requesting that the settlement check be reissued payable only to me as the Trustee. This Motion was served upon the Debtors, their bankruptcy attorney, the law firm representing the Debtors in the underlying cause of action, and the matrix. This Motion was granted without objection by any party on 6/14/13. Thereafter, I received the replacement check from the law firm and I was able to deposit such and immediately disburse to the unsecured creditors pursuant to the terms of the Modification Order (there was no unpaid administrative claims and there was not sufficient funds to pay the unsecured creditors in full to allow for any further disbursements to the secured claims).

On 3/25/14, the Debtors filed their Motion to Modify wherein they sought to reduce the plan base by \$10,600.00, thereby seeking a refund of this \$10,600.00 from the Trustee in order to allow the Debtors to pay their resulting federal and state tax liability that purportedly arose from the settlement proceeds.¹

I objected to the Motion to Modify, thereby raising the following objections/defenses (among others):

¹ The proposed Modification Order submitted by the Debtors with their Motion to Modify contained this provision:

Due to the class action lawsuit settlement Case No. 1216-CV-20561 Thomas et al v. U.S. Bank National Associates, et al, the Debtors have incurred post-petition tax liability in the amount of \$8,548.00 in federal taxes and \$2,052.00 in state of Missouri taxes. The Chapter 13 Trustee SHALL disburse this money to the Debtor within 10 days of this order.

--The Debtors' proposed modification is underfunded in that the Debtors seek reimbursement of funds previously disbursed by the Trustee to the unsecured creditors pursuant to the previous Modification order.

--The Debtors are barred by res judicata from now seeking an interest in a portion of these settlement funds in that the previous Modification Order is a valid and final Court order with its provisions binding upon the Debtors.

--The Debtors' Motion to Modify constitutes a collateral attack of a final Court Order (ie, the previous Modification Order).

The Court set the Debtors' Motion to Modify for hearing on the Beaumont 4/30/14. Witnesses and exhibits were timely designated by all parties.

Ruling: The Court denied the Debtors' Motion to Modify as a matter of law without the necessity of any additional testimony or evidence, citing primarily the fact that the Motion to Modify constituted an improper collateral attack of the Court's final Modification Order previously entered herein. The Court specifically rejected the Debtors' argument that the personal taxes of the Debtors did not constitute an administrative expense of the Chapter 13 Estate that had to be paid in that the Chapter 13 Estate is not a taxable entity.

The Court did make a further comment that, if the Debtors had raised a timely objection at the time of the Trustee's Motion to Modify that they would incur a \$10,600.00 tax liability as a result of this lawsuit settlement, the Court would have been inclined to have allowed the Debtors to keep that portion of the lawsuit settlement. The Court noted that I, as the Trustee on behalf of the creditors, would not have been entitled to any more than the amount of the settlement net of any taxes that may become due.

Trustee: I regret that the Debtors incurred a \$10,600.00 tax liability as a result of this lawsuit settlement. Had this potential tax liability had been brought to my attention (upon proper evidence that such a tax liability would in fact exist), I would have worked with the Debtors and their attorney to make sure that these funds were properly reserved in order to pay such a tax liability. However, this should have been brought to my attention in the form of an objection to my Motion to Modify. The Debtors waited for over a year after I filed my Trustee's Motion to Modify to file their Motion to Modify (long after I had disbursed all of the settlement funds pursuant to the terms of a valid, final Modification Order). I understand their argument that they did not know about their potential tax liability until after they received a 1099 showing the settlement funds as miscellaneous taxable income. However, the Debtors' failure to perform due diligence by investigating the tax consequences with respect to these settlement funds upon their receipt of my Trustee's Motion to Modify is not grounds to attack a final Modification Order or for requiring either the unsecured creditors or the Trusteeship to pay this tax liability.

John J. Talton
Chapter 13 Trustee
Eastern District of Texas
Tyler, Marshall, Lufkin, and Beaumont Divisions