

The Incredible Expanding Section 1146(c)¹

Section 1146(c), in its own way, is a modest example of the “unfunded mandates” that were a topic of such concern in the 1980s. It states that the “making or delivery of an instrument of transfer under a plan confirmed under section 1129” may not be taxed under any law imposing a “stamp tax or similar tax.” The section is not, of course, confined on its face to state and local taxes but, since the federal government does not impose such taxes, it only affects nonfederal entities. Thus, in its wisdom, the federal government chooses to give debtors with a confirmed plan a small benefit from the coffers of state and local governments.

While, perhaps, mildly annoying, the section has not been thought to be a major problem. The amount at stake in a given case is usually relatively small, both because stamp taxes are generally only in the range of 1% of the transaction amount, and because the language appears to deal with only that limited number of transfers that are actually made at the time of the plan confirmation. Since the vast majority of cases do *not* confirm a plan, most bankruptcy transfers would not be affected. That assumption, though, has been challenged in a number of recent cases that seek to take a far greater bite from state taxpayers by expanding the exception, both as to the character of the taxes and the number of transactions covered.

This would be objectionable enough if the issues were clearly presented, but that doesn't always happen. Such motions are often made without a listing of the property being transferred, so tax authorities do not know if they are affected. Even more problematic is a growing practice by which the motion refers to Section 1146, but the debtor's proposed order includes a broader exemption. For instance, in KMart's sale motion concerning its “e-commerce assets,” the motion referred to “stamp taxes and similar taxes,” but the proposed *order* also referenced “sales and transfer taxes.” Section 1146, of course, does not even refer to “transfer” taxes, much less “sales” taxes, so a party that merely read the motion would have no notice that an order might be entered that would bar collection of such taxes. Similarly, in GST Telecom, the motion **sought to avoid taxes “under any law imposing a stamp or similar tax,”** but the proposed order stated that the transfer “**shall not be taxed under any . . . law imposing or claiming to impose a stamp tax or a sale, transfer, or other similar tax on any of the Debtor's transfers or sales**” (Emphasis added.) **The number of cases in which these stealth orders have been appearing argues against this being merely an inadvertent drafting issue.**

Those vastly expanded exemptions, which include sales, capital gains, or use taxes, could exempt not only 1% of the sales prices, but 5, 10, 20% or more, which are amounts states cannot afford to forego in these difficult budget times. After these orders began to appear, a number of states became increasingly vigilant in challenging them. Just as they have put debtors on notice that they will contest orders broadly exempting going out of business sales from state law regulation, so too they have

¹ The views expressed herein are solely those of the author and should not be attributed to any Attorney General or member of their staff.

been working together to make a concerted effort to catch these Section 1146 stealth orders. In addition, they are also filing substantive oppositions to the more straightforward attempts to expand Section 1146.

On the merits, the states believe there is a strong case to be made against both ways of expanding Section 1146. The easier attack is on the attempts to expand the scope of the tax that is covered and courts have generally agreed with the states when they have raised timely objections. In *In re 995 Fifth Avenue Associates, L.P.*, 963 F.2d 503, 511 (2nd Cir. 1992), for instance, the court held that a sale was not exempt from a 10% tax imposed under New York State law on gains derived from real property transfers. An essential element of §1146(c) taxes, the court held, is that they used a low tax rate—typically one percent or less. Two recent cases from Delaware took the same position. In *In re GST Telecom, Inc.*, 2002 WL 442233, slip op. p. 3 (D. Del. 2002), the court held that Washington’s 6.5% sales or use tax, was not a stamp tax, since such taxes rarely exceed about 1% and later used the same reasoning in *In re GST Telecom, Inc.*, 2002 WL 1737445 (D.Del. 2002) to hold that California’s 4.75% sales tax was also not a “stamp” tax. The same view has been expressed in *CCA Partnership v. Director Revenue*, 70 B.R. 696, 697-698 (Bankr. D.Del. 1987) and *In re CCA Partnership*, 72 B.R. 765, 767 (D.Del. 1987), *aff’d* 833 F.2d 303 (3rd Cir. 1987).

In short, this issue, is one that states are not likely to lose – so long as they are willing to come into bankruptcy court to litigate the issue. Debtors have not been loath to write these overly broad orders in the apparent hope that the states will not wish to lose their immunity and will not object thereto. It has not been uncommon for courts to hold that a state can be placed in a **“Catch 22” position without any violation of the Eleventh Amendment. The state can remain out of the case and have the federal court enter an overly broad default order that will, nevertheless, have binding, *res judicata* consequences; or it can come into the federal court and, thereby waive its immunity. (Just how broadly such a waiver extends, no one quite knows.) The Fourth Circuit endorsed the view that states could be forced into this Hobson’s choice in *State of Maryland v. Antonelli Creditors’ Liquidating Trust*, 123 F.3d 777, 786-787 (4th Cir. 1997), itself a Section 1146 case, in the course of which it held that the state could be bound by an order that violated the Code, and must waive its immunity in order to raise that issue.²**

² The opinion purports to not decide the statutory issue, although the court made clear that it doubted there was a violation. However, it made equally clear that it would allow the state to be bound even if it were convinced that the state’s view of Section 1146 was correct.

However, the Supreme Court has recently held in the case of *South Carolina State Ports Authority*, 122 S. Ct. 1864, 1876 (2002) that states cannot be forced into making such a choice. Where the state's only options are to refuse to appear and be bound by the order, or to appear and waive its immunity so a binding order can be entered against it, the Court held that the state *had* been coerced to appear. The states submit that the same analysis applies here. One cannot obtain a binding order and then explain it away as merely "declaring" something about the meaning of the Code. Declaratory judgments are as much subject to the Eleventh Amendment as any other judgment³ and the entry of binding judgments is precisely what the judicial power is for. *U.S. v. Shaw*, 309 U.S. 495, (1940) ("The suggestion that the order . . . is in reality not a judgment but only a 'judicial ascertainment' of credits does not affect our conclusion. No judgment . . . is more than that."). If the judgment is not meant to have a binding effect, then it is merely an advisory opinion, which no federal court has the power to issue. See, e.g., *In re Pattullo*, 271 F.3d 898, 901-902 (9th Cir. 2001); *Rhone-Poulenc Surfactants and Specialties, L.P. v. C.I.R.*, 249 F.3d 175, 181 (3rd Cir. 2001) (court could not "declare" meaning of statutes which might never be dispositive; until a decision would have a binding effect, any views expressed on the meaning of the law would be advisory opinion).

Nevertheless, the states still must confront decisions, such as *In re Linc Capitol, Inc.*, 280 B.R. 640 (Bankr. N.D. Ill. 2002) in which the court simultaneously held that *it* could opine, in the abstract, about whether Section 1146 applied to pre-confirmation transfers, but that the *state* could not argue about whether its taxes was covered by the section without filing an adversary action and submitting itself to the court's jurisdiction.⁴ On the other hand, the court in *In re Automation Solutions International, LLC*, 274 B.R. 527 (Bankr. N.D. Cal. 2002) took a markedly different approach in red-penciling the debtor's proposed sales order, which included a provision declaring that the tax did not apply to preconfirmation transactions. The court noted that it was not in the business of entering comfort orders and that to do so

³ "[S]overeign immunity applies regardless of whether a . . . suit is for monetary damages or some other type of relief." *Ibid.*

⁴ The court stated that the conclusion that Section 1146 applied "was not made pursuant to an exercise of jurisdiction over the State; rather, it was entered pursuant to jurisdiction over the debtor and sale of its property," but in raising issues about its taxes "the State has not identified a concrete controversy between it and Linc with regard to the exemption possible under § 1146(c), and has not presented a particular tax issue for determination. Moreover, a declaratory ruling must be sought by Adversary Complaint." Why declaration of the meaning of the law did not equally require a "concrete controversy" by the debtor and the existence of an adversary party are interesting questions that the opinion does not answer.

would be futile in any event, since the failure to properly serve the motion as for an adversary proceeding would preclude it from being binding on the taxing authorities in any event.

The states face a greater problem with respect to the other branch of cases – whether transfers that do *not* occur in connection with a plan confirmation should also be covered by this section. The quintessential case in this regard was *Clerk of Circuit Court for Anne Arundel County v. NVR Homes, Inc.*, 222 B.R. 514 (E.D. Va. 1998), *reversed* 189 F.3d 442 (4th Cir 1999). The debtor, a home builder, was in bankruptcy for some eighteen months, during which time it sold houses in the ordinary course of business and paid recording taxes. When it proposed its plan, it asserted that *all* of those sales were made “under a plan confirmed” because it wouldn’t have been able to get *to* a plan unless it had stayed in business and sold homes. Thus, since it needed to stay in business to confirm a plan, any sales that assisted in that goal *were* under a “plan confirmed.”⁵ The district court found that argument to be persuasive and the same reasoning has been used in other cases, such as *In re Permar Provisions, Inc.*, 79 B.R. 530 (Bankr. E.D.N.Y. 1987), *In re Hechinger Investment Co. of Delaware, Inc.*, 276 B.R. 43, 47 (D.Del., Mar 18, 2002) (“appropriate reading of Section 1446(c) would require only that a plan be ultimately confirmed. Thus, it is the fact of plan confirmation, rather than its timing, that is critical”), and *GST Telecom, supra*.

In some of those cases the argument was made that the sale needed to be made quickly to preserve the maximum value for the estate and waiting until confirmation would take too long. This was the court’s rationale in *GST*, where it treated the assets of a failed telecom as a wasting asset. And, there is little doubt that the early sale allowed creditors to receive more for largely worthless assets than they would have received if the sale were delayed. The problem with this reasoning, though, is that it suggests that multi-million dollar deals would founder if the debtor is required to pay a 1% recording tax to complete them. By the very nature of the Section 1146 taxes, it is obvious that the exemption can only have the most trivial effect on the viability of a transaction. While there are many vociferous debates over the effect of a 20 or 25% capital gains tax, can anyone seriously suggest that a deal will rise or fall based on whether a stamp tax has to be paid? The fact is that this is a trivial benefit for debtors and, precisely because it has only a minimal effect, there is no need to engage in legal gymnastics to try to expand the scope of the exception. Quick sales may be necessary to facilitate confirmation, but, if so, they will take place with or without this modest tax windfall.

⁵ “The business conducted during this . . . period is essential to the success of both the plan of reorganization and the debtor's emergence from bankruptcy. . . . These transfers . . . enabled NVR to remain a viable operation and avoid liquidation.” 222 B.R. at 518-519.

To be sure, a debtor and its creditors would always prefer not to pay tax – but if Congress had meant to exempt all sales during the case, or even all sales that helped to reach confirmation, there surely were more straightforward ways of saying so. Even the courts that rely on the “necessity” of the transfers to justify exempting preconfirmation sales are sensitive to an obvious counter – what if the plan *doesn't* confirm? Even if an eventual confirmation can retroactively bless transfers that were made before the plan was even a gleam in the debtor’s eye, what if the case later crashes and burns (as most do)? Surely the debtor is not entitled to the exemption then, but what are the alternatives?.

The government could try to collect the tax from the debtor after the case converts to Chapter 7 or is dismissed, but this is hardly practical. A debtor that cannot confirm a plan is often administratively insolvent. If so, will the court let the government collect in full while other creditors can clearly see that they will get little or nothing? (Even assuming there is enough to pay the tax in full?) Possibly, but taxing authorities are understandably wary of relying on that route. To their credit, the Delaware courts have begun requiring the debtor to escrow funds sufficient to pay the taxes as a condition of allowing such sales to be treated as exempt. But this “solution” raises as many questions as it answers. Who should hold such an escrow? Is the government entitled to interest on the taxes withheld? Can the debtor treat the escrow as cash collateral and use it if it provides adequate protection? The Code, of course, has no answers or insights on these issues..

In addition, courts taking this view often try to limit their holding to transfers that are “essential” or “necessary” to reach confirmation. Yet, as the *Hechinger* court noted, Section 1146 has no such limitations as to transfers made pursuant to a confirmed plan. Thus, to justify excepting transactions that do *not* take place under a plan, the court must invent a new limitation that is not contained in Section 1146. Moreover, in imposing this extrastatutory limitation, courts again face many new issues – should the standard be whether the transfer is necessary for confirmation? Or merely helpful? (Will a court ever concede that it is approving a Section 363 sale that is *not* helpful, indeed essential, to the case?) What level of proof is needed? Who bears the burden of proof? And, what evidence is relevant? Again, there is no easy answer to such questions since the courts must answer them without guidance from any language in the Code..

The Fourth Circuit recently analyzed the issue in *In re NVR, L.P.*, 189 F.3d 442 (4th Cir. 1999) and emphatically rejected the broad interpretation espoused above.

We must conclude that Congress, by its plain language, intended to provide exemptions only to those transfers reviewed and confirmed by the court. Congress struck a most reasonable balance. If a debtor is able to develop a Chapter 11 reorganization and obtain confirmation, then the debtor is to be

afforded relief from certain taxation to facilitate the implementation of the reorganization plan. Before a debtor reaches this point, however, the state and local tax systems may not be subjected to federal interference. Id. at 458.

Its decision contains a detailed analysis of prior case law, particularly from the Second Circuit that is often relied on as supporting the broad view, and explains why those cases are not inconsistent with the plain language reading of the statute. Tax exemptions are, in general, to be narrowly construed – a principle that applies even in bankruptcy. See *California State Board of Equalization v. Sierra Summit, Inc.*, 490 U.S. 844, 851-52 (1989) (“Although Congress can confer an immunity from state taxation, ¹/₄a court must proceed carefully when asked to recognize an exemption from state taxation that Congress has not clearly expressed). Yet, here, the courts have adopted an ever-more elaborate structure to justify a broad tax exemption. Such structures often collapse under its own weight when they cannot find a clear base in the language of the Code. The states respectfully suggest that there is no need to read Section 1146 as giving anything more than what it says on its face – a moderate reward for those who cross the finish line and confirm a plan. Unlike a box of Cracker Jacks, it doesn’t need to provide a prize for everyone.