

**TRANSFER-TAX CONSIDERATIONS IN  
REAL ESTATE  
BANKRUPTCY PROCEEDINGS**

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*Editors' Synopsis: This Article discusses the scope of the section 1146(c) exemption and its impact on the taxes associated with property being transferred by a bankrupt debtor. With the number of bankruptcy filings at record levels, this Article outlines ways to reduce the amount of transfer and recording taxes owed through the use of confirmed plans and consensual agreements with creditors.*

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Section 1146(c) of the Bankruptcy Code exempts from state or local transfer or stamp taxes the issuance, transfer, or exchange of a security, or the making or delivery of an instrument of transfer pursuant to a plan confirmed under Chapter 11 of the Bankruptcy Code.<sup>1</sup> The exemption from transfer taxes, which the plain language of section 1146(c) clearly establishes, applies to corporations, partnerships, and other forms of business entities (including, presumably, limited liability companies (“LLC”s)), as well as to individuals. The section 1146 exemption also extends to solvent debtors who file Chapter 11 plans in good faith<sup>2</sup> and to

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<sup>1</sup> Section 1146(c) states: “The issuance, transfer, or exchange of a security, or the making or delivery of an instrument of transfer under a plan confirmed under section 1129 of this title, may not be taxed under any law imposing a stamp tax or similar tax.” 11 U.S.C. § 1146(c) (2003) (providing special tax rules applicable only to Chapter 11 reorganizations). See *In re Woodland Builders, Inc.*, 87 B.R. 774, 779 (Bankr. D. Conn. 1988) (holding that sales of real property by Chapter 7 trustee in connection with liquidation of debtor’s estate were subject to state’s real estate conveyance taxes); *In re Shank*, 240 B.R. 216, 224 (Bankr. D. Md. 1999) (“The only taxes for which the Bankruptcy Code provides forgiveness post-confirmation are transfer taxes for real property transferred pursuant to a confirmed plan of reorganization.”); *In re Hechinger Inv. Co.*, 254 B.R. 306, 316 (Bankr. D. Del. 2000), *aff’d*, 276 B.R. 43 (D. Del. 2002), *rev’d* 2003 U.S. App. LEXIS 1449 (3rd Cir. July 18, 2003) (“The statute [section 1146] makes clear that transfers by Chapter 7, 9, 12 and 13 debtors do not qualify for the exemption.”). Section 728 of Chapter 7 of the Bankruptcy Code, although entitled “Special Tax Provisions” (the same title as section 1146), does not contain an exemption provision from transfer taxes similar to section 1146(c). See 11 U.S.C. § 728 (2003). But see 11 U.S.C. § 1231(c) (2003) (containing an exemption provision applicable to family farmers that is virtually identical to section 1146(c) with respect to a confirmed plan).

<sup>2</sup> See *In re Amsterdam Ave. Dev. Assocs.*, 103 B.R. 454, 459 (Bankr. S.D.N.Y. 1989) (“The plain language of section 1146(c), in referring to all plans, makes no differentiation

liquidations under Chapter 11—a benefit not available in Chapter 7 liquidations.<sup>3</sup> Although the statutory exemption is not, by its language, limited to state and local transfer and stamp taxes, the practical effect of the exemption encompasses this limitation because the federal government does not impose such taxes at the present time. However, under section 1129(d) of the Bankruptcy Code, upon request by a governmental unit, the court will not confirm a plan “if the principal purpose of the plan is the avoidance of taxes.”<sup>4</sup> Section 1129(d) provides that the governmental unit has the burden of proof on this issue.<sup>5</sup>

According to one bankruptcy court,

Congress enacted § 1146(c) to facilitate reorganization by giving debtors tax relief from stamp or similar tax, such as transfer taxes, for transfers of property pursuant to an instrument of transfer under a confirmed plan. By exempting the transaction from tax, § 1146(c) reduces the obligations encumbering the property, thereby making a greater portion of the sale proceeds available to creditors and affords debtor a quick and efficient means of distributing and discharging its obligations under the plan.<sup>6</sup>

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between solvent and insolvent debtors.”).

<sup>3</sup> See *In re Hagerstown Fiber, L.P.*, 226 B.R. 353, 359 (Bankr. S.D.N.Y. 1998) (“[I]n Chapter 7 [as opposed to Chapter 11] the estate will lose the benefit of 11 U.S.C. § 1146(c). . . .”); *In re Smoss Enters. Corp.*, 54 B.R. 950, 951-52 (E.D.N.Y. 1985) (“[T]he claim that § 1146(c) applies to plans only of ‘reorganization’ and not of ‘liquidation’ is plainly meritless.”), *aff’d without opinion*, 1986 U.S. App. LEXIS 28677 (2d Cir. N.Y. Mar. 31, 1986); *In re Permar Provisions, Inc.*, 79 B.R. 530, 534 n.10 (Bankr. E.D. N.Y. 1987) (finding that legislative history of section 1146(c) supports “conclusion that a tax exemption is available under a liquidating plan”).

<sup>4</sup> 11 U.S.C. § 1129(d) (2003).

<sup>5</sup> See *id.* Section 1129(d) states:

Notwithstanding any other provision of this section, on request of a party in interest that is a governmental unit, the court may not confirm a plan if the principal purpose of the plan is the avoidance of taxes or the avoidance of the application of section 5 of the Securities Act of 1933. In any hearing under this subsection, the governmental unit has the burden of proof on the issue of avoidance.

11 U.S.C. § 1129(d) (2003).

<sup>6</sup> *In re Kerner Printing Co.*, 188 B.R. 121, 124 (Bankr. S.D.N.Y. 1995) (citations omitted). See also *CCA P’ship v. Dir. of Revenue (In re CCA P’ship)*, 70 B.R. 696, 698 (Bankr. D. Del. 1987) (“[I]t [section 1146(c)] provides the debtor with the speediest and most efficient means possible to distribute and discharge its obligations. To place additional obligations on the property may defeat these purposes and circumvent the intent of the Code.”), *aff’d* 72 B.R. 765 (D. Del. 1987), *aff’d without opinion*, 833 F.2d 304 (3d Cir. 1987); *In re Cantrup*, 53 B.R. 104, 106 (Bankr. D. Colo. 1985) (stating that imposition

## Relief under section 1146(c)

may be requested by motion filed by any party to the transaction, commencing a contested matter, an Adversary Proceeding Complaint to declare a transaction exempt from a tax, a creditor's objection to a Plan; an adversary proceeding complaint to retrieve tax paid under protest, a motion for reargument of a court's dismissal of a case; and by Mandamus.<sup>7</sup>

The availability of the section 1146(c) exemption should be of great interest to lenders and borrowers in connection with mortgage loan workouts and restructuring, especially in these troubled economic times. Many states, counties, and municipalities impose significant transfer taxes in connection with conveyances of real property, whether made voluntarily or (in some states and municipalities) as the result of foreclosures or other enforcement actions. Such taxes and impositions often add insult to injury to secured lenders who plan to take title, either voluntarily or involuntarily, to real property collateral from delinquent borrowers. These taxes or impositions may be especially burdensome if the value of the property transferred is significant or multiple properties are to be conveyed. These expenses often can be eliminated if the transfer occurs as part of a borrower's consensual or "pre-packaged" Chapter 11 bankruptcy reorganization plan.<sup>8</sup> Such cost considerations, therefore, could well play

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of real estate transfer tax certainly will affect the price received by the estate.).

<sup>7</sup> Richard H. W. Maloy, *The Stamp Tax Exemption in Chapter 11 Cases*, 1 RUTGERS BANKR. L.J. 1, 2 (2002).

<sup>8</sup> A pre-packaged bankruptcy plan has been described as follows:

A pre-packaged bankruptcy plan is a relatively risk-free way to avoid the hazards and expenses of litigation that could result from an unsuccessful workout attempt. It also provides protection down the road for the lender if the borrower fails to perform and title is transferred to the lender. A pre-packaged bankruptcy plan is negotiated by the lender with the borrower and key creditors before, and submitted to the bankruptcy court simultaneously with, a voluntary Chapter 11 filing by the debtor. It is often used in large workouts when there are few significant creditors other than the lender, for example, when only current trade debt exists, and the claims of the other creditors are to be paid substantially or in full as part of the plan. A pre-packaged plan eliminates the risks, costs, and delays of contested bankruptcy proceedings and assures a court-approved and court-supervised plan as well as an orderly transfer of title.

John C. Murray, *The Lender's Guide to Single-Asset Real Estate Bankruptcies*, 31 REAL PROP. PROB. & TR. J. 393, 478 (1996).

a part in determining the “exit strategy” of both lenders and borrowers.<sup>9</sup>

## II. SCOPE OF THE SECTION 1146(C) EXEMPTION

### A. Definition of “Stamp or Similar Tax”

The Bankruptcy Code does not define “stamp tax” or “similar tax.” Section 1146(c), which was enacted as part of the general revision of the federal bankruptcy laws in 1978, broadened the scope of the exemption to include taxes similar to stamp taxes.<sup>10</sup> The legislative history applicable to section 1146(c) provides little guidance and does not indicate what Congress intended by adding the words “or similar tax.”<sup>11</sup> Black’s Law Dictionary defines stamp tax as “[a] tax imposed by requiring the purchase of a revenue stamp that must be affixed to a legal document (such as a deed or note) before the document can be recorded.”<sup>12</sup> Black’s definition further provides that a stamp tax is “[a]lso termed *documentary-stamp tax*.”<sup>13</sup> As the Second Circuit stated in *995 Fifth Avenue Associates, L.P. v. New York State Department of Taxation and Finance (In re 995 Fifth Avenue Assoc., L.P.)*,<sup>14</sup> “This definition indicates that there are at least two attributes to a stamp tax, as that term is commonly understood: the tax must be paid prior to recordation and the amount due is generally governed by the consideration provided in the instrument.”<sup>15</sup> The court set forth the following “common elements” shared by all stamp or similar taxes under section 1146(c):

- (1) they are imposed only at the time of transfer or sale of the item at issue;
- (2) the amount due is determined by the consideration for,

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<sup>9</sup> The bankruptcy court, however, cannot confirm a consensual pre-packaged Chapter 11 bankruptcy plan if its primary purpose is the avoidance of taxes. *See supra* note 4 and accompanying text.

<sup>10</sup> 11 U.S.C. § 1146(c) (1979) (amending U.S.C. § 267 (1938)).

<sup>11</sup> *See* H.R. REP. NO. 95-595, 95th Cong., 1st Sess. 421 (1977) (“Subsection (c) exempts from stamp taxes the issuance, transfer, or exchange of a security, or the making or delivery of an instrument of transfer under a plan. The subsection is derived from section 267 of the Bankruptcy Act.”). Section 267 of the Bankruptcy Act of 1898 applied only to corporate reorganizations under former Chapter 10. Section 1146(c) expanded the exemption to apply to all individuals and entities eligible to file for reorganization under Chapter 11.

<sup>12</sup> BLACK’S LAW DICTIONARY 1471 (7th ed. 1999).

<sup>13</sup> *Id.* (emphasis in text). Black’s defines “documentary tax” as “[a] stamp required to be affixed to a deed or other instrument before it is recorded.” *Id.* at 498.

<sup>14</sup> 963 F.2d 503 (2d Cir. 1992).

<sup>15</sup> *Id.* at 511.

par value of, or value of the item being transferred; (3) the tax rate is a relatively small percentage of the consideration, par value or value of the property; (4) the tax is imposed irrespective of whether the transferor enjoyed a gain or suffered a loss on the underlying sale or transfer; and (5) in the case of state documentary taxes, the tax must be paid as a prerequisite to recording.<sup>16</sup>

## B. Eligible Transfers

### 1. *Transfers Involving Non-Debtor Parties*

The section 1146(c) exemption generally has been deemed to limit eligible transfers to those over which the bankruptcy court has jurisdiction. These transfers include those that affect the debtor and property of the debtor's estate but do not include transfers between third parties. For example, in *In re Kerner Printing Co.*,<sup>17</sup> the bankruptcy court held that subsequent sales and purchases of condominium units by non-debtor parties were not exempt under section 1146(c) from New York City's Real Property Transfer Tax.<sup>18</sup> The confirmed bankruptcy plan provided for the transfer of the bankruptcy estate's property interests in the condominiums to a non-debtor entity, which subsequently resold the units to third-party purchasers.<sup>19</sup> The court found that the exemption did not apply because no agency relationship existed between the debtor and the newly created party to whom the debtor's fee interest in the condominium units was transferred.<sup>20</sup> The court stated that, "[c]ases in which § 1146(c) has been found applicable uniformly involve transfers of estate assets by debtors-in-possession."<sup>21</sup>

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<sup>16</sup> *Id.* at 512. Based on its application of these criteria, the court held that the New York gains tax was not a stamp or similar tax. *See id.* at 513. *See also* Robert A. Morse, *Annotation, Exemption Under 11 U.S.C.S. sec. 1146(c), From Payment of Tax Under Any Law Imposing Stamp Tax Or Similar Tax*, 108 A.L.R. FED. 701 (1992) (secs. 2-4); *see infra* note 21 and accompanying text.

<sup>17</sup> *See* 188 B.R. 121 (Bankr. S.D.N.Y. 1995).

<sup>18</sup> *See id.* at 122.

<sup>19</sup> *See id.* at 123.

<sup>20</sup> *See id.* at 125.

<sup>21</sup> *Id.* at 124. *See also* California State Bd. of Equalization v. Sierra Summit, Inc., 490 U.S. 844, 851-52 (1989) ("Although Congress can confer an immunity from state taxation . . . '[a] court must proceed carefully when asked to recognize an exemption from state taxation that Congress has not clearly expressed.'" (citations omitted)); *Mensch v. E. Stainless Corp. (In re Eastmet Corp.)*, 907 F.2d 1487, 1489 (4th Cir. 1990) (holding that while non-debtor purchase money deed of trust can be described "as 'part of the same transaction' by which [the buyer] acquired the debtor's real property, that does not elevate

Because section 1146(c) focuses on the transaction itself, and not the individual parties involved, the exemption generally applies regardless of whether the debtor or the grantee is obligated to pay the tax under applicable state law.<sup>22</sup>

## 2. Mortgages and Deeds of Trust

Bankruptcy courts consistently have held that giving a mortgage or deed of trust is a transfer under section 1146(c).<sup>23</sup> Furthermore, the

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the deed of trust to the status of something ‘under a plan confirmed’); *In re Bel-Aire Invs., Inc.*, 142 B.R. 992, 995 (Bankr. M.D. Fla. 1992) (holding that section 1146(c) exemption does not apply to non-debtor transactions); *cf.* *Maryland v. Antonelli Creditors’ Liquidating Trust*, 123 F.3d 777, 785 (4th Cir. 1997) (ruling that transfers at issue fell within literal terms of section 1146(c) exemption because liquidating trust the debtor established to take title to properties and subsequently sell them to third parties was an “adequate means” for liquidating substantially all of debtor’s property; it was not a “patently invalid” means of disposition; and it was “entirely appropriate to use a liquidating trust to sell and distribute an extremely large estate . . . which would otherwise consume a large amount of judicial resources and dissipate much of the estate in legal costs;” and stating that bankruptcy court had correctly distinguished *Kerner* on the basis that “in that case the so-called new entity was actually the single creditor (or its assignee) most likely to be benefited by the transfers over time.”). *See generally* *Morse*, *supra* note 16, at sec. 8.

<sup>22</sup> *See CCA P’ship*, 72 B.R. at 766 (upholding ruling of bankruptcy court that precluded State Director of Revenue from dividing liability for stamp or similar tax between debtor-grantor and solvent grantee when transfer was pursuant to confirmed plan, and upholding the bankruptcy court’s reasoning that “a stamp tax is, by definition, a tax on the instrument of transfer, not on the parties to the transfer or the act of recording the transfer”); *Cantrup*, 53 B.R. at 106 (ruling that because city’s real estate transfer tax was stamp tax or similar tax, grantee of deed from trustee was entitled to section 1146(c) exemption, whether presented for recording by grantor or grantee); *cf.* *Lake v. Gleeson*, 11 Pa. D. & C. 2d 584, 586 (Pa. 1956) (holding that under section 267 of Bankruptcy Act, while trustee could not be made liable for transfer tax for “making or delivering of instruments of transfer,” nothing in the Bankruptcy Act relieved grantee who “accepted the deed and presented it for recording”) (emphasis in original); *Amsterdam*, 103 B.R. at 460-61 (acknowledging that while section 1146(c) exemption may apply to non-debtor grantee required to pay transfer tax, the argument that proper focus is not on parties to tax but on instrument itself is “misplaced” because the issue, not the answer, was whether the mortgage executed by non-debtors was an “instrument under a plan” for purposes of the section 1146(c) exemption).

<sup>23</sup> *See* 11 U.S.C. § 101(54) (2003) (indicating that under the Bankruptcy Code, “‘transfer’ means every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with property or with an interest in property, including retention of title as a security interest and foreclosure of the debtor’s equity of redemption.” The recording of a mortgage modification agreement pursuant to a Chapter 11 plan presumably also would be a “transfer” entitled to the section 1146(c) exemption. *See Hughes v. Lawson (In re Lawson)*, 122 F.3d 1237, 1240 (9th Cir. 1997) (“Granting of security for a debt is a transfer under the Bankruptcy Code.”); *Eastmet Corp.*, 907 F.2d at 1489 (“[T]here can be no doubt that the deed of trust transaction involved the making or

section 1146(c) exemption applies to taxes imposed at the time of recording the mortgage, at least in those situations where the debtor obtains the mortgage or deed of trust as a means to fund the plan. In *New York City v. Baldwin League of Independent Schools (In re Baldwin League of Independent Schools)*,<sup>24</sup> the district court ruled that the section 1146(c) exemption applied to a recording tax on a pre-confirmation convertible mortgage that the debtor obtained to fund its Chapter 11 reorganization plan.<sup>25</sup> The court reasoned that the exemption applied because the debtor was the borrower, and recording the mortgage was a practical necessity to the consummation and effectiveness of the plan.<sup>26</sup> The court also noted that the mortgage was the only source of funding for the plan.<sup>27</sup>

### 3. Taxes Held not to be “Stamp or Similar Tax”

The section 1146(c) exemption has been held not to apply to the New York state gains tax, because that tax, unlike a stamp or similar tax, is solely contingent on the profitability of the underlying transaction. For example,

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delivery of an instrument of transfer.”); *City of New York v. Jacoby-Bender, Inc. (In re Jacoby-Bender, Inc.)*, 758 F.2d 840, 842 (2d Cir. 1985) (reflecting “Congress’s understanding that ‘transfer’ is a word of broad meaning” under Bankruptcy Code); *First Fed. Sav. & Loan v. Hulm (In re Hulm)*, 738 F.2d 323, 327 (8th Cir. 1984) (holding that broad definition of transfer includes grant of mortgage); *Amsterdam*, 103 B.R. at 458 (“[L]ike a stamp tax, the mortgage recording tax is charged on a written instrument recognized in law in evidence of the enforcement of legal rights.” (citation omitted)).

<sup>24</sup> See 110 B.R. 125, 127-28 (Bankr. S.D.N.Y. 1989). See also *City of New York, Various Transfers and Recording of Mortgage Pursuant to a Chapter 11 Bankruptcy Order Are Not Subject to Real Property Transfer Tax or Mortgage Recording*, FLR-4708, Sept. 4, 1997, at p.2 (“[T]he [New York City Recording Tax] has been held to be a stamp tax within the meaning of 11 U.S.C. § 1146(c).” (citing *Baldwin*)).

<sup>25</sup> See *id.* at 127.

<sup>26</sup> See *id.* at 128.

<sup>27</sup> See *id.* at 127. The court stated that “[the lender] cannot seriously contend that [the debtor’s] \$7 million mortgage of its sole asset . . . is not ‘reasonably necessary’ to the reorganization plan.” *Id.* The court also noted that “the mortgage recording tax is in fact a ‘stamp tax or similar tax,’ because the amount is determined by the consideration cited in the document, because payment is a prerequisite to recordation, and because the tax is imposed on a written instrument”. *Id.* at 126. See also *Eastmet Corp.*, 907 F.2d at 1489 (ruling that purchase-money deed of trust was an “instrument of transfer” under section 1146(c)); *cf. Amsterdam*, 103 B.R. at 459-60 (holding that while giving of mortgage is transfer of property pursuant to approved plan, and section 1146(c) exemption applies to mortgage tax, the exemption does not apply to mortgage tax imposed on mortgage given by non-debtor, borrower-buyer to conclude purchase). Presumably, transfers of the debtor’s leasehold interest (or interests) under a confirmed Chapter 11 bankruptcy plan would also benefit from the section 1146(c) exemption.

in *995 Fifth Avenue*, the court held that the New York state gains tax was not a stamp or similar tax because it was paid at a rate of ten percent of the gain, rather than one percent or less, which the court considered the norm for true transfer taxes. Furthermore, the court noted, the tax was imposed only on the gain or profit on the transaction as opposed to a transfer tax, which is imposed regardless of gain or profit. The court reasoned that, unlike a stamp or similar tax, “under the gains tax, the consideration for the sale . . . is not determinative of the amount due under the gains tax.”<sup>28</sup>

Courts also have held that the section 1146(c) exemption does not apply to a state’s sales or use tax.<sup>29</sup> Although the U.S. Supreme Court has not yet ruled on the section 1146(c) issue with respect to pre-confirmation dispositions of property,<sup>30</sup> it is not unconstitutional for a state to impose a

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<sup>28</sup> *995 Fifth Avenue*, 963 F.2d at 513. See also *Jacoby-Bender*, 758 F.2d at 841-42 (holding that the New York gains tax is not a stamp or similar tax within meaning of section 1146(c)); *Scheffel v. New York Dep’t of Taxation & Fin. (In re Lehal Realty Assocs.)*, 133 B.R. 9, 12-13 (Bankr. S.D.N.Y. 1991), *vacated by* 184 B.R. 205 (Bankr. S.D.N.Y. 1993) (dismissing trustee’s action against State seeking refund of gains tax assessed against sale of debtor’s property); *Heller v. New York*, 81 N.Y.2d 60, 61 (1993) (holding that New York gains tax does not represent incidental expense such as recording fee, transfer tax, or similar expense in connection with transfer of property). New York’s gains tax, CLS Tax Act Art. 31-B, was repealed in 1996. See N.Y. L. 1996, ch. 309, § 171 (eff. July 13, 1996).

<sup>29</sup> See, e.g., *In re GST Telecom, Inc.*, No. 00-1982, 2002 U.S. Dist. LEXIS 18745, at \*15-18 (D. Del. July 29, 2002) (ruling that California sales tax on “all retailers” for “the privilege of selling personal property” is not a stamp or similar tax and does not qualify for exemption under section 1146(c), because the tax rate is not “a relatively small percentage of the consideration for, par value of, or value of the item being transferred” (citation omitted); and stating that “California’s sales tax [in contrast to a stamp or similar tax] does not tax instruments of transfer,” and “California’s 4.75% tax rate far exceeds the generally accepted one-percent stamp tax rate”). In a related case, *In re GST Telecom, Inc.*, No. 00-1982, 2002 U.S. Dist. LEXIS 4662, at \*11 (D. Del., March 20, 2002), the district court held that Washington’s use tax, imposed at the rate of 6.5 %, “is too large to qualify as a stamp or similar tax under section 1146(c).” See also *Sierra Summit*, 490 U.S. 853-54 (holding that 28 U.S.C. § 960 permitted imposition of California sales and use tax on bankruptcy trustee’s liquidation sale); *Henry v. Vermont (In re Henry)*, 135 B.R. 6, 10-11 (Bankr. D. Vt. 1991) (requiring debtor to pay appropriate state land gains tax on property sold during liquidation of estate); cf. *In re Columbia River Broad., Inc.*, No. 387-05943-57, 1989 Bankr. LEXIS 1819, at \*7-8 (Bankr. D. Or. 1989) (holding that bankruptcy trustee was entitled to exemption from state taxation where tax was personal property tax on sales of inventory assets in ordinary course of business and not transfer tax). See generally Melanie Rovner Cohen & Donna M. Zak, *Beyond the Summit Decision: The Still Unresolved Issues of the Applicability of State Transfer Taxes to Bankruptcy Sales*, 95 COM. L. J. 46, 49-50, 52-53 (1990) (discussing *Sierra Summit* and application of section 1146(c) exemption to sales and use taxes).

<sup>30</sup> See discussion *infra* Part III.

sales or use tax on a bankrupt estate.<sup>31</sup>

### C. Transfer of a “Security”

An interesting question is whether a transfer of equity interests in a debtor that is a partnership or an LLC would qualify for the section 1146(c) exemption. Section 1146(c) applies to “the issuance, *transfer*, or exchange of a *security*, or the making or delivery of an instrument of *transfer* under a plan.”<sup>32</sup> The Bankruptcy Code includes, within the definition of “security,” an “interest of a limited partner in a partnership,”<sup>33</sup> and defines “transfer” as “every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with property or with an interest in property.”<sup>34</sup> The Bankruptcy Code also includes the following within the definition of security: note, stock, treasury stock, bond, debenture, collateral trust certificate, pre-organization certificate or subscription, transferable share, voting-trust certificate, certificate of deposit, certificate of deposit for security, investment contract, certificate of interest, or participation in a profit-sharing agreement in an oil, gas, or mineral royalty or lease, any other claim or interest commonly known as security, and certificate of interest or participation in temporary or interim certificate for receipt for, or warrant or right to subscribe to or purchase or sell, a security.<sup>35</sup> If the language in the bankruptcy court’s order approving

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<sup>31</sup> See *Sierra Summit*, 490 U.S. at 849 (“[T]here is now no constitutional impediment to the imposition of a sales tax or use tax on a liquidation sale. . . .”); *GST Telecom*, 2002 U.S. Dist. LEXIS 4662, at \*11 n. 7 (finding such taxes constitutional).

<sup>32</sup> 11 U.S.C. § 1146(c) (2003) (emphasis added).

<sup>33</sup> 11 U.S.C. § 101(49)(A)(xiii) (2003).

<sup>34</sup> 11 U.S.C. § 101(54) (2003).

<sup>35</sup> See 11 U.S.C. § 101(49)(A)(i)-(xv) (2003). See also *In re Follansbee Bros.*, 42 F. Supp. 448, 449-50 (W.D. Pa. 1940) (holding that trustee’s certificates, issued upon order of court in reorganization proceeding, having no coupons attached and not being in registered form, were not subject to federal stamp tax as corporate securities under Revenue Act of 1926; the court noted that “[u]nder the Chandler Act, 11 U.S.C.A. § 1 *et seq.*, no possible claim could be made by the Collector, as Section 267 of that Act expressly exempts the issuance or exchange of securities under any plan confirmed under the Bankruptcy Act, but the instant claim arose prior to the passage of that Act”); cf. *Moore v. Stewart*, 125 F.2d 538, 540 (6th Cir. 1942) (holding that certificates of indebtedness issued by trustee of railroad corporation in corporate reorganization proceedings were not subject to documentary stamp tax under Revenue Act of 1926 because they were issued by trustee and not corporation); *Senfour Inv. Co. v. King County*, 404 P.2d 760, 761 (Wash. 1965) (holding that former 11 U.S.C.S. § 671 did not prohibit levy of state tax on transfer of real property from insolvent corporate debtor to corporation formed to purchase debtor’s assets pursuant to reorganization plan under Chapter 10 of National Bankruptcy Act). See generally R.D. Hursh, *Annotation: What Constitutes Corporate Securities, Bonds,*

a Chapter 11 plan (or in its sale order) is carefully drafted to state that the transfer of the partnership or LLC interest(s) constitutes the transfer of securities in connection with the implementation of the plan, the section 1146(c) exemption should apply.<sup>36</sup>

Because LLCs are still relatively new state-law creations, the treatment of these entities in bankruptcy is uncertain. For example, will LLCs be treated as partnerships or corporations for bankruptcy purposes?<sup>37</sup> There are no specific provisions in the Bankruptcy Code or Bankruptcy Rules that deal with LLCs, and the application of bankruptcy law and specific Bankruptcy Code provisions is uncertain. The Bankruptcy Code does not include an LLC within the definition of a debtor that is eligible for relief. However, it is likely that a bankruptcy court would conclude that an LLC would qualify as a debtor under the Bankruptcy Code.<sup>38</sup> With respect to LLC interests, if the governing documents of an LLC provide that the membership interests are securities, then such interests will be treated as securities instead of general intangibles under the Uniform Commercial Code ("UCC"). The units of capital held by members of the LLC thereupon will be considered securities governed by Article 8 of the UCC, as adopted in the particular state.<sup>39</sup> Although LLCs are not defined or specifically dealt

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*Debentures, and the Like Subject to Federal Stamp Tax*, 36 A.L.R.2d 975 (1954).

<sup>36</sup> See 11 U.S.C. § 101(49)(xiv) (2003), which provides that the definition of security includes any "other claim or interest commonly known as 'security.'"

<sup>37</sup> See *In re ICLNDS Notes Acquisition, LLC*, 259 B.R. 289, 292 (Bankr. N.D. Ohio 2001) ("[A]n LLC is neither a corporation or a partnership, as those terms are commonly understood. Instead, an LLC is a hybrid.").

<sup>38</sup> See *id.* ("There is no specific reference in the Code to a limited liability company. Under the rules of construction applicable to the Code, however, the use of the term 'includes' is not limiting . . . . In other words, individuals, corporations and partnerships are clearly eligible for relief, but other similar entities are as well.") (citation omitted).

<sup>39</sup> See U.C.C. § 8-103(c) (2003). So-called mezzanine financing often involves extending credit to equity holders of an LLC, with the lender taking a pledge of the parties' equity interests in the LLC. Under section 9-102(a)(49) of the UCC's Revised Article 9 (enacted into law in most states on July 1, 2001), these types of assets can be either "investment property" or "general intangibles." Investment property is "a security, whether certificated or uncertificated, security entitlement, securities account, commodity account, or commodity contract." U.C.C. § 9-102(a)(49) (2003). A security interest in investment property may be perfected by control, by filing, or, if the investment property is a certificated security, by possession. See U.C.C. §§ 8-301, 9-313(a), 9-328 (2003). The UCC defines general intangibles as "personal property, including things in action, other than accounts, chattel paper, commercial tort claims, deposit accounts, documents, goods, instruments, investment property, letter-of-credit rights, letters of credit, money, and oil, gas, or other minerals before extraction. The term includes payment intangibles and software." U.C.C. § 9-102(a)(42) (2003). A payment intangible is "a general intangible

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under which the account debtor's principal obligation is a monetary obligation" and software. *Id.* at § 9-102(a)(61). In essence, general intangibles are the residual category of personal property that is not included in the other defined types of collateral. A security interest in a general intangible is perfected by filing. *See* U.C.C. § 9-310(a) (2003). To have a priority security interest in the pledged collateral that will prevail over purchasers, other lenders, and creditors using judicial process to obtain a lien on the collateral, the mezzanine lender must perfect its interest in the collateral. *See* U.C.C. § 9-308(a) (2003). Perfection of a security interest in a pledge of an interest in an LLC can be accomplished by (i) filing a UCC-1 financing statement in the appropriate jurisdiction if the security interest is deemed a general intangible or is investment property, U.C.C. § 9-314 (2003); (ii) taking possession of the collateral pursuant to U.C.C. § 9-313(a) (2003), which also provides that a perfected security interest in certificated securities may be obtained by taking delivery of the certificated securities under UCC § 8-301; or (iii) control under § 9-314(c), if the security interest is deemed investment property, UCC § 9-314 (2003). While the general rule is that the earlier of the first to file or perfect has established priority, perfection by control will prime a security interest in the same property that is perfected by any other method of perfection, even if the control occurs after the time of first perfection. *See* U.C.C. § 9-328(1) (2003). Section 9-331(b) of Revised Article 9 also makes explicit what was implied under former Article 9 and is explicit under Article 8; when investment property collateral is transferred to a person protected under UCC Article 8, Article 9 defers to the rights of protected purchasers under Article 8, to the extent Article 8 provides rights to those protected persons. *See* U.C.C. § 9-331 (2003). Thus, although perfection by filing is available, to the extent possible lenders should always seek to perfect their interests in pledges of LLC membership interests by control. If the governing documents of an LLC provide that the membership interests are securities, then such interests will be treated as securities instead of general intangibles. If an issuer thus opts into Article 8, the lender's interest in the collateral is deemed investment property, and the lender can obtain "Protected Purchaser Status" under U.C.C. § 8-303. A lender has Protected Purchaser Status when it gives value for the interest without notice of any adverse claim and has control of the security. *See* U.C.C. § 8-303(a) (2003). Protected Purchaser Status will enable the lender to defeat any adverse claim, including claims of third parties that treat their interests as general intangibles and who perfect by filing in the jurisdiction in which the debtor is located. Section 9-106 of Revised Article 9, by reference to UCC § 8-106, provides that a secured party takes control of an uncertificated security, such as a pledge of an uncertificated LLC membership interest if "(1) the uncertificated security is delivered to the purchaser; or (2) the issuer has agreed that it will comply with instructions originated by the purchaser without further consent by the registered owner." U.C.C. § 8-106 (2003). Delivery will occur, under UCC § 8-103, when the issuer registers the purchaser, the lender, or a third party not closely related to or controlled by the debtor—other than a securities intermediary—who holds on behalf of the lender, as the registered owner. Control of a certificated security occurs when the lender or a third person not closely connected to or controlled by the debtor has possession of the certificate, and when the certificate is (i) issued in bearer form, (ii) issued to the debtor as owner with an endorsement in blank, or (iii) the lender has an assignment separate from the certificate signed in blank by the debtor. *See* U.C.C. § 8-106. *See also* Steven O. Weise, et al., *It's Time to Take a Close Look at UCC Article 9*, 19 CAL. REAL PROP. J. 3, 7-8 (2001). An example of an amendment to an LLC Operating Agreement that contains the necessary language to opt into article 8 is the

with in the Bankruptcy Code, it is arguable that the transfer of LLC interests that are deemed to be securities likewise should be entitled to the section 1146(c) exemption and should not be subject to transfer taxes (to the extent that taxes on such transfers otherwise would apply under applicable state law) because of the similarity to transfers of partnership interests.

### III. PRE-CONFIRMATION V. POST-CONFIRMATION TRANSFERS

Several bankruptcy courts have examined the language in section 1146(c), which states that only transfers occurring “under a plan confirmed” are exempt from taxation. The issue raised is whether this specific language applies only to a transfer that occurs subsequent to court approval and confirmation of the plan, or whether it can also be construed to apply to a transfer that is part of a submitted bankruptcy plan which is an essential component of the plan confirmation but is not approved and confirmed by the court until after the transfer of the property. The resolution of this issue is of utmost importance to bankruptcy trustees and debtors in possession because it is often necessary, to pay current debts and to fund the Chapter 11 reorganization plan, that the debtor be able to sell assets as quickly as possible during the course of the bankruptcy proceeding before the assets begin to lose value. In *GST Telecom*,<sup>40</sup> the bankruptcy court stated, “Given the reality of business and bankruptcy practice, adopting a rule that requires all bankruptcy transfers to occur post-confirmation would seem to frustrate section 1146(c)’s stated purpose of facilitating reorganization in a large number of cases.”<sup>41</sup>

Unfortunately, the court decisions in this area have not been consistent. Governmental tax authorities have, in some cases, argued that the property transfer occurred prior to confirmation of the plan and should not be entitled to the section 1146(c) exemption. For example, in *In re NVR, Ltd.*,<sup>42</sup> the debtor, a residential builder, sought a declaration that section 1146(c) exempted it from transfer and recordation taxes that it had paid in

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following:

Pursuant to [APPLICABLE] Code [REFERENCE TO APPLICABLE STATE UNIFORM COMMERCIAL CODE § 8-103(c)], the Units of Company capital held by Members of the Company shall be considered to be securities governed by [ARTICLE 8 STATE REFERENCE] of the [APPLICABLE] Code.

<sup>40</sup> No. 00-1982, 2002 U.S. Dist. LEXIS 4662, at \*6.

<sup>41</sup> *Id.* at \*6.

<sup>42</sup> 189 F.3d 442 (4th Cir. 1999).

connection with the transfer of real property during the bankruptcy period.<sup>43</sup> The debtor also sought a refund of those taxes from the state and local taxing authorities.<sup>44</sup> The Fourth Circuit, reversing the holdings of the bankruptcy and district courts, held that only transfers occurring after the consummation of the plan are entitled to protection.<sup>45</sup> The court referred to the dictionary meaning of “under” and concluded that a transfer made before the confirmation date of the plan could not be under (i.e., subordinate to or authorized by) a plan that had not yet been confirmed by the court.<sup>46</sup> The court “conclude[d] that Congress, by its plain language [under a plan confirmed], intended to provide exemptions only to those transfers reviewed and confirmed by the court.”<sup>47</sup> The taxing authorities did not argue that transfers of real property occurring after the date of confirmation and during the remainder of the bankruptcy proceedings were not exempt under section 1146(c).<sup>48</sup>

However, the majority of courts reject the holding of *NVR*, and the trend of recent bankruptcy court decisions has been to extend the benefit of the section 1146(c) exemption to sales of real property that occur prior to, but in accordance with, a subsequently confirmed Chapter 11 bankruptcy plan. In *Jacoby-Bender*,<sup>49</sup> the Second Circuit faced the issue of whether

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<sup>43</sup> See *id.* at 447.

<sup>44</sup> See *id.* at 448.

<sup>45</sup> See *id.* at 454.

<sup>46</sup> See *id.* at 456.

<sup>47</sup> *Id.* at 458.

<sup>48</sup> See *id.* at 456.

<sup>49</sup> 758 F.2d 840, 841 (2d Cir. 1985). See also *In re Lopez Dev., Inc.*, 154 B.R. 607, 609 n.3 (Bankr. S.D. Fla. 1993) (upholding debtor’s claim, after plan confirmation, for refund of transfer taxes paid at time of recording of deeds to two properties notwithstanding subsequent dismissal of case, and rejecting argument that section 1146(c) is applicable only to post-confirmation transfers because such an interpretation would not facilitate Chapter 11 plans); *Smoss Enterprises*, 54 B.R. at 951 (finding that sale was under the plan because “the transfer of the property was essential to the confirmation of the plan”); *Permar Provisions*, 79 B.R. at 533-34 (holding that section 1146(c) exempted from taxation a transfer of real property that occurred more than one year before confirmation of Chapter 11 plan, where sale facilitated confirmation of plan); *GST Telecom*, 2002 U.S. Dist. LEXIS 4662, at \*2 (“The court agrees that property transfers made prior to confirmation may be protected under section 1146(c).”); *Linc Capital*, 2180 B.R. at 647 (ruling that sale was under confirmed plan where plan provided for sale and sale was approved twenty-five days before confirmation and consummated just prior to plan confirmation). In Chapter 11 cases, authority to sell real estate or other significant assets before confirmation of a reorganization plan may depend upon the articulation of a sound business purpose. See *Committee of Equity Security Holders v. Lionel Corp. (In re Lionel Corp.)*, 722 F.2d 1063, 1070-71 (2d Cir. 1983) (listing the following factors to consider in determining whether business

section 1146(c) exempted the debtor from paying transfer taxes on a Chapter 11 property sale that was not specifically authorized in the debtor's bankruptcy reorganization plan. The bankruptcy court had already confirmed the plan, and the precise question was whether the terms of the confirmed plan encompassed the property sale, thereby making it a part of a "plan confirmed" under section 1146(c).<sup>50</sup> The Second Circuit ruled that the section 1146(c) exemption applied to the property sale, reasoning it was irrelevant whether the plan "empower[ed] the debtor to make a specific sale or deliver a specific deed."<sup>51</sup> The court found that it was not necessary to identify each and every transfer that might occur under the plan. Rather, it was sufficient to include much broader language that generally outlined the activities that must occur to implement and consummate the plan.<sup>52</sup>

The Fourth Circuit, in *NVR*, criticized the lower courts' reasoning that the property transfers occurring during the bankruptcy period were necessary for the debtor to reorganize and emerge from bankruptcy and were therefore "all in furtherance of, or in connection with the Plan,"<sup>53</sup> and were under a plan confirmed.<sup>54</sup> The Fourth Circuit stated that, "This logic has enjoyed some acceptance by other courts, primarily by courts claiming to adhere to the Second Circuit's decision in [*Jacoby-Bender*]."<sup>55</sup> According to the Fourth Circuit, lower courts have altered and extended the holding of *Jacoby-Bender*, "changing the test from 'necessary to the consummation of a plan,' to 'necessary to the confirmation of a plan.'"<sup>56</sup> The Fourth Circuit stated, in dicta, that the conclusion "that every transfer 'essential' to a plan's confirmation is by definition 'under a plan confirmed'

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justification exists: "the proportionate value of the asset to the estate as a whole, the amount of elapsed time since the filing, the likelihood that a plan of reorganization will be proposed and confirmed in the near future, the effect of the proposed disposition on future plans of reorganization, the proceeds to be obtained from the disposition vis-à-vis any appraisals of the property, which of the alternatives of use, sale or lease the proposal envisions and, most importantly, whether the asset is increasing or decreasing in value"). See also *Stephens Indus., Inc. v. McClung*, 789 F.2d 386, 389-90 (6th Cir. 1986); *In re Delaware & Hudson Ry. Co.*, 124 B.R. 169, 176 (D. Del. 1991); *In re Engineering Prod. Co.*, 121 B.R. 246, 248 (Bankr. E.D. Mo. 1990); *In re Channel One Communications, Inc.*, 117 B.R. 493, 496 (Bankr. E.D. Mo. 1990); *In re Brethren Care*, 98 B.R. 927, 933 (Bankr. N.D. Ind. 1989); *In re Crowthers McCall Pattern, inc.*, 114 B.R. 877, 883-86 (Bankr. S.D.N.Y. 1990).

<sup>50</sup> See *id.* at 841.

<sup>51</sup> *Id.*

<sup>52</sup> See *id.* at 842.

<sup>53</sup> 189 F.3d at 455.

<sup>54</sup> See *id.*

<sup>55</sup> *Id.*

<sup>56</sup> *Id.* at 456.

is ‘fundamentally flawed’” and without basis in section 1146(c).<sup>57</sup> The Fourth Circuit sought to distinguish *Jacoby-Bender* by stating that the earlier opinion did not deal with a preconfirmation transfer, but rather, it dealt with whether section 1146(c) applied to a transaction that was not mentioned in a confirmed plan.<sup>58</sup>

In *Baltimore County v. Hechinger Investment Co. of Delaware (In re Hechinger Investment Co. of Delaware)*,<sup>59</sup> the Third Circuit agreed with the Fourth Circuit’s holding in *NVR* and held that section 1146(c) does not apply to real estate transactions that occur prior to confirmation of a Chapter 11 bankruptcy plan. The court reversed the holding of the district court, which upheld the bankruptcy court’s decision granting the debtor’s motion to enter a declaration that certain real property transfers were exempt from state transfer and recording taxes pursuant to section 1146(c). However, the district court conditioned its opinion upon the bankruptcy court’s eventual confirmation of a Chapter 11 plan. The Third Circuit construed “under a plan confirmed” in the language of section 1146(c) as meaning that the action is “authorized” under such a plan. Therefore, the court ruled, because the transfers in the instant case were not made under the authority of a confirmed plan (because they occurred prior to confirmation of the plan), but rather under the authority of sections 363 and 365 of the Bankruptcy Code, they were not entitled to the section 1146(c) exemption. The court also reasoned that tax exemptions provisions should be strictly construed and that “federal laws that interfere with a state’s taxation scheme must be narrowly construed in favor of the state.”<sup>60</sup> Finally, the Third Circuit rejected the debtor’s assertion that limiting the exemption to post-confirmation transfers would frustrate the purpose of section 1146(c), which is to facilitate Chapter 11 plans by permitting debtors to sell assets when “business realities” compel them to do so before court confirmation of the plan of reorganization. The court stated that “it is not for us to substitute our view of . . . policy for the legislation which has been passed by Congress,”<sup>61</sup> and reasoned that there existed a countervailing rationale to the debtor’s position, i.e., limiting federal

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<sup>57</sup> *Id.*

<sup>58</sup> *See id.* But see *In re Linc Capital, Inc.*, 280 B.R. 640, 647 (Bankr. N.D. Ill. 2000) (“However, the bankruptcy court opinion showed that the transfer in *Jacoby-Bender* was a preconfirmation transfer, though the court’s approval of the sale came after confirmation.”).

<sup>59</sup> No. 02-1917, 2003 U.S. App. LEXIS 14449 (3d Cir. July 18, 2003) (Nygaard, J., dissenting).

<sup>60</sup> *Id.* at \*26-27.

<sup>61</sup> *Id.* at 34.

interference with state revenue collection. In a vigorous dissent, Judge Nygaard argued that section 1146(c) is ambiguous and that the word “under” should not be narrowly construed to mean only “authorized,” and could be read to mean “in accordance with” in order to apply to both pre-confirmation and post-confirmation transfers. Judge Nygaard further argued that the Bankruptcy Code, as a remedial statute, should be liberally construed so as not to impede reorganization and to provide relief to debtors when compelled by business circumstances to sell assets under a plan ultimately approved by the bankruptcy court.

In *In re 310 Associates, L.P.*, the federal district court reversed the bankruptcy court’s order granting an exemption to the debtor under section 1146(c) from payment of municipal real estate transfer taxes.<sup>62</sup> The issue on appeal was whether the transfer of the debtor’s property (commercial buildings that were the debtor’s principal assets) was under a plan confirmed within the meaning of section 1146(c).<sup>63</sup> The debtor admitted that no plan of reorganization had even been drafted at the time of the transfer. The court ruled that under this factual situation the transfer was not an essential or important component of any plan at the time of the conveyance, and that the court need not determine whether the transfer was under a plan confirmed.<sup>64</sup> The court stated that “the City should not be required to wait until some indeterminate time when there may be a plan before collecting the taxes which it was entitled to collect at the time of the transfer.”<sup>65</sup> The court cautioned that its holding was “a narrow one” and that

[t]he clear language of section 1146(c) states that only transfers occurring “under a plan confirmed” are exempt from taxation. A transfer cannot be “under a plan confirmed” if, at the time of the transfer, no plan has been drafted. It is therefore not necessary to decide whether section 1146(c) exempts from taxation a transfer that occurs after a plan has been introduced but not yet confirmed.<sup>66</sup>

The court reasoned that *Jacoby-Bender* was inapposite because it involved a post-confirmation transfer and did not address the timing issue raised in the present case.<sup>67</sup> The court also distinguished *995 Fifth Avenue* on the basis that the Second Circuit in that case did not address whether section

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<sup>62</sup> 282 B.R. 295 (S.D.N.Y. 2002).

<sup>63</sup> *See id.* at 295.

<sup>64</sup> *See id.* at 297.

<sup>65</sup> *Id.* at 299.

<sup>66</sup> *Id.*

<sup>67</sup> *See id.* at 299-300.

1146(c) applies to a transfer occurring before the drafting of a plan.<sup>68</sup> The court further distinguished *995 Fifth Avenue* on the basis that the parties never litigated this issue.<sup>69</sup> The court in *310 Assocs.* stated that “[a] transfer cannot take place with the authorization of a plan that has not been drafted. Nor can a transfer be inferior or subordinate to a plan that has not been drafted. To determine otherwise would render both the words ‘plan’ and ‘confirmed’ in section 1146(c) meaningless.”<sup>70</sup>

One commentator has suggested that applying the section 1146(c) exemption to pre-confirmation sales of real estate results in the imposition of an extra-statutory limitation that is not contained in section 1146(c), and raises the following questions, none of which the bankruptcy code or existing case law answers: “Should the standard be whether the transfer is necessary for confirmation? Or merely helpful? . . . What level of proof is necessary? Who bears the burden of proof? And what evidence is relevant?”<sup>71</sup>

A potential problem also could arise when a pre-confirmation sale has occurred and no transfer tax has been paid because the plan-confirmation order or sale order provided that the transfer was subject to the section 1146(c) exemption. If the reorganization plan is ultimately withdrawn, dismissed, or otherwise not confirmed by the bankruptcy court (or the case is converted to a Chapter 7 liquidation proceeding), the only remedy for the taxing authority may be to bring an action to attempt to recoup the unpaid transfer tax, together with applicable interest and penalties. But bringing such an action could be impractical, expensive, and time-consuming.<sup>72</sup>

#### IV. CONSTITUTIONAL CHALLENGES TO THE SECTION 1146(C) EXEMPTION

##### A. Sovereign Immunity Under the Eleventh Amendment

State and local taxing authorities have argued—mostly without success—that the Eleventh Amendment to the U.S. Constitution prohibits a bankruptcy court from exercising jurisdiction to determine whether property transfers are exempt from transfer and recording taxes under the section 1146(c) exemption. The Eleventh Amendment states that “[t]he Judicial power of the United States shall not be construed to extend to any

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<sup>68</sup> See *id.* at 300-01.

<sup>69</sup> See *id.*

<sup>70</sup> 282 B.R. at 299.

<sup>71</sup> Karen Cordry, *The Incredible Expanding* § 1146(c), 21 ABI J. 10, 48 (2003).

<sup>72</sup> See *id.*

suit in law or equity, commenced or prosecuted against one of the United States by citizens of another state, or by citizens or subjects of any Foreign State.”<sup>73</sup>

The Eleventh Amendment divests federal courts of jurisdiction over private suits against non-consenting states, and is based on the principle that each state is a sovereign entity within the federal system.<sup>74</sup> The U.S. Supreme Court held, in *Seminole Tribe of Florida v. Florida*,<sup>75</sup> that the Eleventh Amendment, absent a waiver of sovereign immunity either by the United States Congress pursuant to a valid power or by the state itself, precludes a suit against a state instrumentality in federal court.<sup>76</sup> According to the Supreme Court, “Even when the Constitution vests in Congress complete lawmaking authority over a particular area, the Eleventh Amendment prevents congressional authorization of suits by private parties against unconsenting States.”<sup>77</sup>

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<sup>73</sup> U. S. CONST. amend. XI.

<sup>74</sup> *See id.* The Eleventh Amendment does not specifically mention sovereignty. However, at the time the original thirteen states ratified the U.S. Constitution in 1789, and throughout history, it was a common law principle that the king could not be brought into the king’s court. *See Magnolia Venture Capital Corp. v. Prudential Sec., Inc.*, 151 F.3d 439, 443 (5th Cir. 1998) where the court states:

The doctrine of sovereign immunity embodies the maxim that “The King can do no wrong,” and can be traced back to ancient times. Sovereign immunity, as it has been interpreted in the federal courts, actually encompasses two separate, but related, concepts—state sovereign immunity, or common law sovereign immunity, and Eleventh Amendment immunity, or constitutional sovereign immunity. These immunities shield the sovereign, or the state, from suits against it in its own courts as well as from suits against it in federal court (citations omitted).

*See also Alden v. Maine*, 527 U.S. 706, 728 (1999) (“[S]overeign immunity derives not from the Eleventh Amendment but from the structure of the original Constitution itself.”); *Palm v. Stack (In re Palm)*, 286 B.R. 710, 713 (Bankr. N.D. Iowa 2002) (“The Supreme Court holds an expansive view of sovereign immunity. The principle does not derive from the Eleventh Amendment, but rather it is said to be inherent in the structure of the original Constitution.”); *Balser v. Dep’t of Justice*, 327 F.3d 903, 907 (9th Cir. 2003) (“The United States, as a sovereign, is immune from suit unless it has waived its immunity.” (citations omitted)); *In re Knapp*, 294 B.R. 334, 338 (Bankr. W.D. Wash. 2003) (holding that under its sovereign immunity, “The United States is immune from suit absent an unequivocally expressed waiver”); *Russell v. United States Dep’t of the Army*, 191 F.3d 1016, 1019 (1999).

<sup>75</sup> *See* 517 U.S. 44 (1996).

<sup>76</sup> *See id.* at 54, 72-73.

<sup>77</sup> *Id.* at 72. The Supreme Court did not specifically address how the Eleventh Amendment interacted with bankruptcy law; however, it did note that “it has not been widely thought that the federal . . . bankruptcy . . . statutes abrogated the States’ sovereign immunity.” *Id.* at 72 n.16. *See also* *Federal Mar. Comm’n v. South Carolina State Ports*

Although the Eleventh Amendment expressly bars only lawsuits against States by citizens of other States in federal court, the Supreme Court has extended the scope of the Amendment to bar suits against states by their own citizens when such suits seek damages to be paid out of the state's treasury.<sup>78</sup> The Eleventh Amendment also has been interpreted to protect non-consenting states from suits in state as well as federal courts,<sup>79</sup> and has been extended to administrative claims against non-consenting states filed with executive branch agencies.<sup>80</sup> However, Eleventh Amendment immunity generally does not extend to an independent political subdivision such as a city or a county, unless the city or county is deemed to be "an arm of the state."<sup>81</sup>

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Auth., 535 U.S. 743, 751 (2002) (stating that "[d]ual sovereignty is a defining feature of our Nation's constitutional blueprint). States, upon ratification of the Constitution, did not consent to become mere appendage of the Federal Government. Rather, they entered the Union 'with their sovereignty intact.'" (citation omitted)).

<sup>78</sup> See *Quern v. Jordan*, 440 U.S. 332, 337 (1979); *Hans v. Louisiana*, 134 U.S. 1, 15 (1890); *Sacred Heart Hosp. of Norristown v. Pennsylvania* (*In re Sacred Heart Hosp.*), 133 F.3d 237, 241 (3d Cir. 1998); *Hechinger*, 254 B.R. at 309, *aff'd*, 276 B.R. 48 (D. Del. 2002), *rev'd* 2003 U.S. App. LEXIS 1449 (3d Cir. July 18, 2003).

<sup>79</sup> See *Alden*, 527 U.S. at 754 ("States retain immunity from private suit in their own courts."); *Magnolia Venture Capital*, 151 F.3d at 443 ("a state may waive its common law sovereign immunity without waiving its Eleventh Amendment immunity under federal law"); *Nelson v. La Crosse County Dist. Atty.* (*In re Nelson*), 301 F.3d 820, 828 (7th Cir. 2002) ("[T]he [Eleventh Amendment] has been interpreted to protect non-consenting states from suit in state as well as federal court." (emphasis in original)).

<sup>80</sup> See *Fed. Mar. Comm'n*, 535 U.S. at 759-60 (extending Eleventh Amendment protection to administrative claims against non-consenting states filed with executive-branch agencies, reasoning that federal agencies share strong similarities with federal courts); *Regents of the Univ. of Cal. v. Doe*, 519 U.S. 425, 429 (1997) ("It has long been settled that the reference to actions 'against one of the United States' [in the Eleventh Amendment] encompasses not only actions in which a State is actually named as the defendant, but also certain actions against state agents and state instrumentalities." (citations omitted)); *Nelson*, 301 F.3d at 827 n.7 ("The Eleventh Amendment extends to state agencies and departments and . . . to state employees acting in their official capacities."); *State Bd. of Education v. Harleston* (*In re Harleston*), 331 F.3d 699, 702-03 (9th Cir. 2003) (holding that immunity under Eleventh Amendment applies to state agencies).

<sup>81</sup> See *Alden*, 527 U.S. at 756 (stating that Eleventh Amendment "does not extend to suits prosecuted against a municipal corporation or other governmental agency which is not an arm of the State."); *Lake County Estates, Inc. v. Tahoe Reg'l Planning Agency*, 440 U.S. 391, 401 (1979) ("[T]he [Supreme] Court has consistently refused to construe the [Eleventh] Amendment to afford protection to political subdivisions such as counties and municipalities, even though such entities exercise a 'slice of state power.'" (citation omitted)); *Mount Healthy City Sch. Dist. Bd. of Educ. v. Doyle*, 429 U.S. 274, 280 (1977) ("The bar of the Eleventh Amendment to suit in federal courts extends to States and state officials in appropriate circumstances, but does not extend to counties and similar municipal

Congress may not pass a law under its Article I powers to vest federal courts with jurisdiction to hear such suits.<sup>82</sup> This prohibition would appear to apply to actions by bankruptcy courts also.<sup>83</sup> However, the Supreme Court in *Seminole Tribe* noted that, notwithstanding Eleventh Amendment immunity, “[S]everal avenues remain open for ensuring state compliance with federal law.”<sup>84</sup> In addition, the Seventh Circuit in *Nelson* pointed out that “[b]ecause of Article I’s grant of exclusive power to the federal government to legislate in the bankruptcy context, and by virtue of the Supremacy Clause, a State may very well have its rights affected by a bankruptcy proceeding.”<sup>85</sup>

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corporations.”); *Eason v. Clark County Sch. Dist.*, 303 F.3d 1137, 1141 (9th Cir. 2002) (“[T]he Eleventh Amendment does not extend to counties and municipal corporations.”); *Nelson*, 301 F.3d at 827 n.7 (quoting *Alden*, 527 U.S. at 756, with approval); *NVR*, 189 F.3d at 454 (“local governments do not enjoy sovereign immunity under the Eleventh Amendment”); *Hadley v. N. Ark. Cmty. Technical Coll.*, 76 F.3d 1437, 1438 (8th Cir. 1996); *Hale O Kuala Church v. Maui Planning Comm’n*, 229 F. Supp. 2d 1056, 1068-69 (D. Haw. 2002) (holding that county was not an “arm of the state” entitled to sovereign immunity under Eleventh Amendment, and stating that “[m]erely because the County is applying state law does not automatically grant it state immunity”); *In re Polygraphex Systems, Inc.*, 275 B.R. 408, 413 (Bankr. M.D. Fla. 2002) (stating, “Whether a local government entity is protected by Eleventh Amendment immunity turns upon whether it is an ‘arm of the state,’” and holding that a property appraiser is a county official rather than an agent of the state and is therefore not entitled to Eleventh Amendment immunity); *cf.* *Moor v. County of Alameda*, 411 U.S. 693, 717-21 (1973) (holding that California counties are not arms of state or alter egos of state for purposes of diversity jurisdiction). The Ninth Circuit applies a five-factor test to determine whether an agency is an arm of the state:

- (1) whether a money judgment would be satisfied out of state funds, (2) whether the entity performs central government functions, (3) whether the entity may sue or be sued, (4) whether the entity has the power to take property in its own name or only the name of the state, and (5) the corporate status of the entity.

*Eason*, 303 F.3d at 1141 (quoting *Mitchell v. Los Angeles Comm. Col. Dist.*, 861 F.2d 198, 201 (9th Cir. 1988)); *Balser*, 327 F.3d at 907 (ruling that bankruptcy trustee is immune from suit under doctrine of sovereign immunity, and stating that “[i]n sovereign immunity analysis, any lawsuit against an agency of the United States or against an officer of the United States in his or her official capacity is considered an action against the United States.”).

<sup>82</sup> See *Alden*, 527 U.S. at 706 (holding that states likewise retain immunity from private suits in their own courts, which Congress may not abrogate by Article I); *Seminole Tribe*, 517 U.S. at 72-73.

<sup>83</sup> See *Nelson*, 301 F.3d at 831 (“[W]hile the Supreme Court has yet to specifically consider Congress’ attempt at abrogating the States’ sovereign immunity in the bankruptcy context, every court to address the issue since *Seminole Tribe* concluded that it may not do so under its Article I powers.”).

<sup>84</sup> *Seminole Tribe*, 517 U.S. at 72 n.16.

<sup>85</sup> *Nelson*, 301 F.3d at 837. See also *Int’l Shoe Co. v. Pinkus*, 278 U.S. 261, 265

A state may be divested of its immunity if Congress expresses a clear intent to do so and acts pursuant to a valid constitutional provision (for example, when Congress enacts a new federal cause of action), or if a state voluntarily consents to suit in federal court.<sup>86</sup> A state voluntarily consents

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(1929) (“The power of Congress to establish uniform laws on the subject of bankruptcies throughout the United States is unrestricted and paramount . . . . The national purpose to establish uniformity necessarily excludes state regulation . . . . States may not pass or enforce laws to interfere with or complement the Bankruptcy Act or to provide additional or auxiliary regulations.”); *H.J. Wilson Co. v. Comm’r of Revenue for Mass. (In re Service Merchandise Co.)*, No. 01-6050, 2003 U.S. App. LEXIS 12729, at \*6 (stating that “[f]or the reasons set forth in the *Hood* case, we hold that the Commissioner is entitled to sovereign immunity in this matter”); *Regions Bank of La. v. Rivet*, 224 F.3d 483, 492 (5th Cir. 2000) (holding that although states have power to define property interests, bankruptcy jurisdiction over property is paramount and despite assertions of sovereign immunity, State has no authority to interfere with, or provide additional regulations regarding, transfers of property under bankruptcy court jurisdiction); *Hood v. Tenn. Student Assistance Corp. (In re Hood)*, 262 B.R. 412, 421 (B.A.P. 6th Cir. 2001) (“The Supreme Court has consistently recognized that the Constitutional authority of Congress to enact uniform bankruptcy laws necessarily impacts the sovereignty of the States in their legislative and judicial functions.”), *aff’d and remanded by* 319 F.3d 755 (6th Cir. 2003); *Polygraphex Systems*, 275 B.R. at 420 (“federal law has supremacy in respect of a bankruptcy court’s dealing with the liquidation and distribution of debtors’ assets to creditors”); *In re Stanley*, 273 B.R. 907, 911 (Bankr. N.D. Fla. 2002) (holding that a state cannot restore its sovereign immunity by withdrawing its proof of claim); *Amsterdam*, 103 B.R. at 458 (ruling that “Congress can confer immunity from state taxation, and through its bankruptcy power, may constitutionally exempt Chapter 11 debtors from state taxation under § 1146(c).”).

<sup>86</sup> See *Magnolia Venture Capital*, 151 F.3d at 444 (holding that state waives sovereign immunity through its constitution, statutes or court decisions and waiver cannot be implied from circumstantial evidence). See also *Harleston*, 331 F.3d at 701 (“[A] state, by filing a proof of claim, waives in sovereign immunity with respect to adjudication of that claim . . .”). The court went on to say, “[W]hen . . . the state files a proof of claim, it waives sovereign immunity with respect to an adversary proceeding arising from the same transaction or occurrence as that claim”). *Id.* at 703. Interestingly, individual states and their agencies that have raised the issue of sovereign immunity rely almost exclusively on the Eleventh Amendment, and not the Tenth Amendment. The Tenth Amendment states: “The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people.” U.S. CONST. amend. X.

The Tenth Amendment “states but a truism that all is retained [by the states] which has not been surrendered.” *United States v. Darby*, 312 U.S. 100, 124 (1941). By its terms, the Tenth Amendment does not purport to limit the commerce power or any other enumerated power of Congress. The main purpose of the Tenth Amendment was to alleviate the concern that the new federal government would usurp the authority of the states. The Tenth Amendment does not enumerate the states’ reserved powers, which traditionally have included internal matters such as local government, education, regulation of commerce, labor and business within the state, as well as certain family concerns such as divorce and inheritance. In *Alden*, 527 U.S. at 714, the Supreme Court stated, “Any doubt regarding the

by enacting a state statute or constitutional provision or by waiver based on affirmative conduct.<sup>87</sup>

Section 106 of the Bankruptcy Code, as amended in its entirety by the Bankruptcy Reform Act of 1994,<sup>88</sup> provides for a limited waiver of sovereign immunity in bankruptcy cases. Section 106 was intended to waive common law sovereign immunity and also the protection of the Eleventh Amendment from suits in federal courts.<sup>89</sup>

Section 106(a) provides: "A governmental unit . . . is deemed to have waived sovereign immunity with respect to a claim against such governmental unit that is property of the estate and that arose out of the same transaction or occurrence out of which the claim of such governmental unit's claim arose."<sup>90</sup>

Section 106(a) is the only section of the Bankruptcy Code that expressly addresses the issue of sovereign immunity. Although section 106(a) provides for a waiver of sovereign immunity under certain conditions, it is not an abrogation provision. Section 106(a) renders a state liable to suit only when the claim against the government is property of the estate and the state participates in the bankruptcy proceeding by filing a

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constitutional role of the States as sovereign entities is removed by the Tenth Amendment, which, like the other provisions of the Bill of Rights, was enacted to allay lingering concerns about the extent of the national power . . . The federal system established by our Constitution preserves the sovereign status of the States." However, Justice Souter, in a vigorous dissent, joined in by Justices Stevens, Ginsburg, and Breyer, vehemently disagreed with this statement and the Court's holding, stating, "There is no evidence that the Tenth Amendment constitutionalized a concept of sovereign immunity as inherent in the notion of statehood, and no evidence that any concept of inherent sovereign immunity was understood historically to apply when the sovereign sued was not the [federal government]." *Id.* at 761.

<sup>87</sup> See Laura B. Bartell, *Getting to Waiver—A Legislative Solution to State Sovereign Immunity in Bankruptcy After Seminole Tribe*, 17 BANKR. DEV. J. 17 (2000); Hon. Randolph J. Haines, *Getting to Abrogation*, 75 AM. BANKR. L.J. 447 (2001); Richard Lieb, *Eleventh Amendment Immunity of a State in Bankruptcy Cases*, 7 AM. BANKR. INST. L. REV. 269 (1999); Susan Randall, *Sovereign Immunity and the Uses of History*, 81 NEB. L. REV. 1 (2002).

<sup>88</sup> Pub. L. No. 103-394, § 202, 108 Stat. 4106, 4121 (codified as amended in scattered sections of 11 U.S.C.).

<sup>89</sup> See 2003 COLLIER PAMPHLET EDITION, BANKRUPTCY CODE, § 106, Overview of Section 106, pp. 68-69 ("Sovereign immunity is merely a doctrine that provides for immunity from suit. It does not obviate the applicability of the Bankruptcy Code to any governmental unit under the Supremacy Clause. Rather, sovereign immunity precludes, in some instances, a person's right to sue certain governmental units for enforcement of rights which exist under the Code or nonbankruptcy law.").

<sup>90</sup> 11 U.S.C. § 106(b) (2003).

claim.<sup>91</sup> Following the Supreme Court's decision in *Seminole Tribe*, a number of courts have held that Congress lacked authority under Article I of the Constitution to enact section 106(a).<sup>92</sup>

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<sup>91</sup> See *U.S. v. Nordic Village, Inc.*, 503 U.S. 30, 34 (1992) (holding that section 106(a) unequivocally waives sovereign immunity regarding monetary relief in connection with compulsory counterclaims); *Hoffman v. Connecticut Dep't of Income Maint.*, 492 U.S. 96, 101-02 (1989) ("The language of § 106(a) carefully limits the waiver of sovereign immunity under that provision, requiring that the claim against the governmental unit arise out of the same transaction or occurrence as the governmental unit's claim."); *Nelson*, 301 F.3d at 834-35 (stating that "when a state files a claim in a bankruptcy case there is a limited waiver of sovereign immunity," and "[w]aiver of sovereign immunity must be unequivocal"); *NVR*, 189 F.3d at 454 (ruling that Eleventh Amendment prohibits federal courts from determining whether tax refunds are due to debtor under section 1146(c) of Bankruptcy Code, and because resolution of this issue requires exercise of federal court jurisdiction over state and refund of monies, contested matter constitutes suit against state).

<sup>92</sup> See, e.g., *Dep't of Transp. & Dev. v. PNL Asset Mgmt. Co. (In re Estate of Fernandez)*, 130 F.3d 1138 (5th Cir. 1997)

We hold that Section 106(a) of the Bankruptcy Code is unconstitutional. Congress cannot locate the authority claimed here to abrogate sovereign immunity in either the Bankruptcy Clause or in Section 5 of the Fourteenth Amendment. Nor does extending federal jurisdiction to private successors to the FDIC avoid the reach of the Eleventh Amendment.

*Id.* at 1139. See also *Nelson*, 301 F.3d at 831-32 ("[T]he Supreme Court's holding in *Seminole Tribe* . . . extends to all of Congress' Article I powers, including the Bankruptcy Clause, and thus . . . Section 106(a) was unconstitutional under the Eleventh Amendment.") (citation omitted); *Murphy v. Michigan Guar. Agency (In re Murphy)*, 271 F.3d 629, 631-32 n.3 (5th Cir. 2001) (referring to "[n]umerous courts [that] have applied the sovereign immunity doctrine in the bankruptcy context," and have "found either that the state did not waive its sovereign immunity or that Congress did not effectively abrogate that immunity." (citations omitted)); *Arecibo Cmty. Health Care, Inc. v. Puerto Rico*, 270 F.3d 17, 21 n.5 (1st Cir. 2001), *cert. denied*, 123 S. Ct. 73 (2002) (*vacating* prior First Circuit panel decision, 244 F.3d 241 (1st Cir. 2001), and stating that "Congress lacks the authority to abrogate Puerto Rico's Eleventh Amendment immunity pursuant to § 106(a)" (citation omitted)); *Mitchell v. Franchise Tax Bd. (In re Mitchell)*, 209 F.3d 1111, 1119 (9th Cir. 2000) ("[Section] 106(a) is not remedial, and thus was not an appropriate exercise of Congress' enforcement powers."); *Sacred Heart Hosp.*, 133 F.3d at 243 (holding that section 106(a) is not a valid abrogation provision); *Schlossberg v. Maryland (In re Creative Goldsmiths of Washington, D.C., Inc.)*, 119 F.3d 1140, 1145 (4th Cir. 1997), *cert. denied*, 523 U.S. 1075 (holding that as applied to state governmental units, § 106(a) is unconstitutional); *King v. State of Florida (In re King)*, 280 B.R. 767, 777-78 (Bankr. S.D. Ga. 2002) (stating that "[s]ection 106(a) is unconstitutional as applied to the states," and holding that because sovereign immunity protects state and state had taken no action to waive that immunity or otherwise consent to suit, debtor's complaint for turnover of debtor's tax refund for child support and for contempt would be dismissed); *In re Sae Young Westmont-Chicago, LLC*, 276 B.R. 888, 895 (Bankr. N.D. Ill. 2002) ("[A] majority of bankruptcy courts hold . . . that Congress cannot abrogate states' immunity to suits in federal court under its power to enact uniform bankruptcy laws."); *cf. In re Claxton*, 273 B.R. 174, 182-

## B. “Suit” Against the State

The Eleventh Amendment applies only to a “suit” against a state. There is no statutory definition of this term, and bankruptcy courts have struggled with this issue. According to one court,

[t]he only well-established rule is that an action by a private party against a state, which seeks entry of a monetary judgment against the state, is a suit for purposes of the Eleventh Amendment. The majority view in bankruptcy is that an adversary proceeding against a state is a suit under the Eleventh Amendment.<sup>93</sup>

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83 (Bankr. N.D. Ill. 2002) (striking down section 106 as an invalid abrogation of state sovereign immunity but finding that states ceded sovereignty over substance of national bankruptcy law). *But see Hood*, 262 B.R. at 414 (holding that section 106(a) does not offend Eleventh Amendment because Congress may validly abrogate state’s Eleventh Amendment immunity by legislating pursuant to power to establish uniform bankruptcy laws). *See also* Eric R. Sender, Note & Comment: *The Constitutionality of Section 106: A Historical Solution to a Modern Debate*, 18 BANKR. DEV. J. 131 (2001); Shauna Fuller Veach, Note, *Dissension Among the Ranks—The Courts are at Odds Over 11 U.S.C. § 106 and its Purported Abrogation of Sovereign Immunity in the Bankruptcy Code*, 32 U. MEM. L. REV. 475 (2002); Kenneth N. Klee et al., *State Defiance of Bankruptcy Law*, 52 VAND. L. REV. 1527, 1546-56 (1999) (examining effect of sovereign immunity on section 106).

<sup>93</sup> *Hechinger*, 254 B.R. at 311. *See Nelson*, 301 F.3d at 827 n.6 (“The term ‘suit’ as used in the Eleventh Amendment applies to adversarial proceedings such as the one before us” (citation omitted)); *Murphy*, 271 F.3d at 633 (holding that adversary proceeding to determine dischargeability of student loan debt constituted a suit for purposes of Eleventh Amendment); *Mitchell*, 209 F.3d at 1116-17 (ruling that adversary proceeding to determine dischargeability of taxes owed to the states constitutes a suit under Eleventh Amendment); *In re A.H. Robins Co., Inc.*, 251 B.R. 312, 321-22 (E.D. Va. 2000) (holding that debtor’s motion, involving request for interpretation of terms of confirmed Chapter 11 plan and asserting that debtor was entitled to claim net operating losses on its state income taxes, was in nature of suit and therefore subject to sovereign immunity claim of taxing authorities). *But see Arizona v. Bliemeister (In re Bliemeister)*, 296 F.3d 858, 862 (9th Cir. 2002) (ruling that the Eleventh Amendment did not bar the debtor’s adversary proceeding to determine dischargeability of debt to Industrial Commission of Arizona because the State had waived the right to assert sovereign immunity when it did not raise issue until it filed supplemental brief); *Hill v. Blind Indus. & Servs.*, 179 F.3d 754, 763 (9th Cir. 1999), *amended by* 201 F.3d 1186 (9th Cir. 2000) (holding that sovereign immunity may be forfeited where state failed to assert immunity until opening day of trial); *Equal Employment Opportunity Comm’n v. Trans World Airlines, Inc.*, 2001 U.S. Dist. LEXIS 25126 (Oct. 11, 2001), at \*5 (Memorandum Order) (holding that sale order under section 363(f) of Bankruptcy Code was not a declaratory judgment implicating sovereign immunity and that under Bankruptcy Rules an adversary proceeding is not required); *Polygraphex*, 275 B.R. at 420 (acknowledging that “[t]here is no precise definition of ‘suit’ for purposes of the immunity provided by the Eleventh Amendment,” and that “federal law has supremacy in respect of a bankruptcy court’s dealing with the liquidation and distribution of debtor’s assets to creditors” (citation

In *In re Hechinger Inv. Co. of Delaware, Inc.*,<sup>94</sup> the district court upheld the bankruptcy court's decision that the debtor was entitled to the section 1146(c) exemption, and rejected one state and two counties' taxing authorities' arguments that the Eleventh Amendment barred the debtor's motions because the requested relief would bind the state and prevent it from collecting revenue.<sup>95</sup> The district court distinguished the Fourth Circuit's opinion in *NVR*, which held that the debtor's motion to recover transfer taxes previously paid by the debtor (which required the court to have jurisdiction over the state and sought a direct recovery from the state's treasury) was a suit against the debtor for purposes of the Eleventh Amendment.<sup>96</sup> The district court reasoned that in this case, unlike the factual situation in *NVR*, "the State was not named as a defendant, nor was it served with a summons. Instead, the Bankruptcy Court's jurisdiction was based on its power to interpret the bankruptcy laws as they apply to the debtors and their estates."<sup>97</sup> The district court held that "a proceeding where the bankruptcy court is not required to exercise jurisdiction over the State is not a suit against the State within the meaning of the Eleventh Amendment."<sup>98</sup>

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omitted)). See also Leonard H. Gerson, *A Bankruptcy Exception to Eleventh Amendment Immunity: Limiting the Seminole Tribe Doctrine*, 74 AM. BANKR. L.J. 1, 4 (2000) ("Actions in bankruptcy are not simply individual suits against a state. Instead, they are part of a collective process."); W. HOMER DRAKE, JR., BANKRUPTCY PRACTICE § 3.03 (2d ed. 1995) ("Adversary Proceedings, as the name implies, relate to proceedings commenced in the bankruptcy court that are adversary in nature in which one party seeks affirmative relief from another before a bankruptcy court sitting as a trial court over the matters in litigation before it" (emphasis in original)); BANKR. R. § 7003 (2002) (requiring that an adversary proceeding be commenced by the filing of a complaint).

<sup>94</sup> 276 B.R. 43 (Bankr. D. Del. 2002), *aff'd* 276 B.R. 48 (D. Del. 2002), *rev'd* 2003 U.S. App. LEXIS 14449 (3d Cir. July 18, 2003). The Third circuit, in reversing the holdings of the bankruptcy court and the district court, held that it was not required in this case to address the Eleventh Amendment issue before proceeding to the merits (i.e., whether the real estate sales at issue were protected by the section 1146(c) tax exemption).

<sup>95</sup> See *id.* at 46-47.

<sup>96</sup> See 189 F.3d at 442.

<sup>97</sup> *Hechinger*, 276 B.R. at 46.

<sup>98</sup> *Id.* (citation omitted). See also *In re Nat'l Cattle Congress*, 247 B.R. 259, 270 (Bankr. N.D. Iowa 2000) ("A bankruptcy case standing alone is not necessarily a 'suit' against a sovereign, even though the sovereign's pecuniary interest may be inadvertently eliminated or modified.") (citation omitted); *Texas ex rel. Bd. of Regents of the Univ. of Tex. Sys. v. Walker*, 142 F.3d 813, 823 (5th Cir. 1998) (stating that "the granting of a bankruptcy discharge does not offend the Eleventh Amendment—although commencement of certain adversary proceedings directly against a state that has not filed a proof of claim in a bankruptcy case would do so."); *In re Midway Airlines Corp.*, 283 B.R. 846, 850

The district court also rejected the taxing authorities' argument that the Tax Injunction Act prevented the bankruptcy court from exercising jurisdiction over the debtor's tax liability and the taxing authorities' demand for payment of the recording taxes. The Tax Injunction Act states that federal courts "shall not enjoin, suspend or restrain the assessment, levy or collection of any tax under State law where a plain, speedy and efficient remedy may be had in the courts of such State."<sup>99</sup> The district court found that the bankruptcy court correctly concluded that "a state court cannot offer a 'plain, speedy and efficient remedy' as to the tax exemption in 1146(c) because 1146(c) arises under the Bankruptcy Court's exclusive and original jurisdiction under Title 11."<sup>100</sup> The district court further rejected the taxing authorities' argument that section 505 of the Bankruptcy Code, which grants the court authority to determine the amount or legality of any tax, does not permit a bankruptcy court to enjoin the collection of a tax unless it is related to a claim against the debtor or its estate.<sup>101</sup> The district court concurred with the conclusion of the bankruptcy court that, "[t]here is no requirement in [Section] 505 that a debtor must exhaust available state law remedies as a precondition for obtaining a bankruptcy court ruling on such liability."<sup>102</sup> The district court also reasoned that the debtor's motion was not a proceeding to determine the tax liability of individuals or entities other than the debtor.<sup>103</sup>

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(E.D.N.C. 2002) (holding that the debtor's motion to determine extent of automatic bankruptcy stay did not implicate the Eleventh Amendment because the State Department of Labor, which sent letter to debtor regarding alleged violation with respect to pre-petition wages, was not named a defendant); *Sae Young Westmont-Chicago*, 276 B.R. at 897-98 (motion by debtor to assume unexpired lease from state agency did not qualify as a "suit" against the state for Eleventh Amendment purposes).

<sup>99</sup> 28 U.S.C. § 1341 (2000).

<sup>100</sup> *Hechinger*, 276 B.R. at 47.

<sup>101</sup> Section 505(a)(1) of the Bankruptcy Code states:

Except as provided in paragraph (2) of this subsection, the court may determine the amount or legality of any tax, any fine or penalty relating to a tax, or any addition to tax, whether or not previously assessed, whether or not paid, and whether or not contested before and adjudicated by a judicial or administrative tribunal of competent jurisdiction.

11 U.S.C. § 505(a)(1) (2000). *See also Polygraphex Systems*, 275 B.R. at 421 ("to construe a motion brought under section 505 against the State of Florida as a 'suit in law or equity' in violation of the Eleventh Amendment would be inconsistent with the plain meaning of that Amendment.").

<sup>102</sup> *Hechinger*, 254 B.R. at 315.

<sup>103</sup> *See also In re Stoeker*, 179 F.3d 546, 549 (7th Cir. 1999), *aff'd sub nom* Raleigh v. Illinois Dep't of Revenue, 530 U.S. 15 (2000) ("If federal courts could not determine the debtor's liability for state taxes—if they had to abstain pending a determination of that

Other bankruptcy courts have followed the reasoning of the court in *Hechinger*. For example, in *Linc Capital*, a conclusion of law, entered prior to the entry of an order approving the sale of certain assets by the debtor, provided that the section 1146(c) exemption would apply, conditioned upon the subsequent confirmation of the plan.<sup>104</sup> The State of Illinois objected, claiming that no judgment had been entered specifically exempting any Illinois transfer taxes by the order approving the sale or by the later order approving confirmation of the debtor's plan.<sup>105</sup> However, the State neither appealed the entry of either order nor did it file an adversary proceeding to seek a declaratory judgment action to contest either order, as required under the applicable federal Bankruptcy Rules.<sup>106</sup> The bankruptcy court held that the conclusion of law was not a suit against the State of Illinois, and therefore the State could not assert a claim of sovereign immunity.<sup>107</sup> The court reasoned that if the State wished to litigate whether the section 1146(c) exemption would apply to any particular taxes, "it must file an Adversary Complaint seeking declaratory judgment on that question. The filing of such Complaint would clearly be an act of waiver of sovereign immunity, but such action has not been filed by it."<sup>108</sup> The court held that a sale under a confirmed plan, which provided for a section 1146(c) exemption for the payment of transfer taxes, could be used as a shield to defend against subsequent collection efforts in state court.<sup>109</sup> However, the court noted that the Eleventh Amendment would prohibit a debtor from

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liability in state court—bankruptcy proceedings would be even more protracted than they are."); *Lehal Realty*, 133 B.R. at 12 ("In the absence of a demand for a money judgment against a state, the issue of sovereign immunity is not implicated because 11 U.S.C. § 505(a)(1) expressly authorizes this court to 'determine the amount or legality of any tax . . . .'"); *Nat'l Cattle Congress*, 247 B.R. at 270 ("A bankruptcy case standing alone is not necessarily a 'suit' against a sovereign, even though the sovereign's pecuniary interest may be inadvertently eliminated or modified.").

<sup>104</sup> See 280 B.R. 640 (Bankr. N.D. Ill. 2002).

<sup>105</sup> See *id.* at 640.

<sup>106</sup> See *id.*

<sup>107</sup> See *id.* at 641.

<sup>108</sup> *Id.* at 642. See also *Lapides v. Bd. of Regents of Univ. Sys. of Ga.*, 535 U.S. 613, 619-24 (2002) (holding that state waives Eleventh Amendment sovereign immunity when it removes case from state court to federal court); *Creative Goldsmiths*, 119 F.3d at 1148 (holding that "where a defendant's assertions in a state-instituted federal action, including those made with regard to a state-filed proof of claim in a bankruptcy action, amount to a compulsory counterclaim, a state has waived any Eleventh Amendment immunity against that counterclaim in order to avail itself of the federal forum.").

<sup>109</sup> See *Linc Capital*, 280 B.R. at 645.

bringing an adversary proceeding to obtain a ruling as to specific taxes.<sup>110</sup>

### C. The “Catch 22” Dilemma

One commentator has suggested that a taxing authority seeking to challenge the section 1146(c) exemption faces a “Catch 22” dilemma. A

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<sup>110</sup> See also *Gardner v. New Jersey*, 329 U.S. 565, 573-74 (1947) (holding that state’s sovereign immunity did not bar debtor from asserting defensive objections to proof of claim filed by State in bankruptcy proceeding); *Arecibo*, 270 F.3d at 27-29 (vacating prior First Circuit panel decision, 244 F.3d 241 (1st Cir. 2001), and affirming ruling of district court that held by filing proof of claim and thus invoking jurisdiction of bankruptcy court, state agencies affirmatively waived sovereign immunity from claims related to their proof of claim); *Antonelli*, 123 F.3d at 786-87 (holding that bankruptcy court ruling that confirmed section 1146(c) exemption with respect to sale of estate assets was not impermissible suit against the State because the State was not compelled to appear and the bankruptcy court ruling did not require it to assert jurisdiction over the State; rather, court’s order related to property of State that was in court’s constructive custody); *995 Fifth Avenue*, 963 F.2d at 508-09 (holding that State of New York, by filing an administrative expense claim, waived its Eleventh Amendment immunity with respect to gains tax paid by debtor, and stating, “Congress possesses the authority to condition a state’s participation in a bankruptcy proceeding on its waiver of Eleventh Amendment immunity.”); *In re A.H. Robins Co.*, 235 B.R. at 413 (ruling that the Eleventh Amendment barred debtor’s motion to interpret confirmed Chapter 11 plan); *Stoeker*, 202 B.R. at 447 (stating that “[the state agency] voluntarily consented to the limited subject matter jurisdiction and the equitable powers of this Court and the claim procedures under the Bankruptcy Code when it filed its proof of claim,” and ruling that trustee’s objection to claim did not constitute action involuntarily forcing state agency to unwillingly defend motion or related adversary proceeding.); cf. *Sheehan v. West Virginia Dep’t of Envtl. Prot. (In re T & T Fuels, Inc.)*, 55 Fed. Appx. 121, 124 (4th Cir. 2003) (holding that trustee’s claim for attorneys’ fees that were incurred in pursuing causes of action for bankruptcy estate did not amount to compulsory counterclaim against state agency’s proof of claim, and therefore state agency had not waived its Eleventh Amendment immunity with respect to adjudication of trustee’s claim.); *Murphy*, 271 F.3d at 632-33 (holding that adversary proceeding against State to determine dischargeability of debtor’s student loan debt constituted suit within meaning of Eleventh Amendment, but acknowledging that granting of bankruptcy discharge does not violate Eleventh Amendment); *Aer-Aerotron, Inc. v. Texas Dep’t of Transp.*, 104 F.3d 677, 680 (4th Cir. 1997) (holding that state’s letter demanding payment of claim, without more, was not filing of proof of claim for purposes of section 106, and state did not waive its Eleventh Amendment immunity by such action); *In re Automation Solutions Int’l, LLC*, 274 B.R. 527, 528-29 (Bankr. N.D. Cal. 2002) (striking “patently improper” provisions of proposed order approving sale, including provision that transfer tax was entitled to section 1146(c) exemption, because issue was not before court or necessary part of court’s order and taxing authority had not been served with notice or otherwise been made aware that its rights were being adjudicated); *Nat’l Cattle Congress*, 247 B.R. at 272 (ruling that Indian tribe did not waive its sovereign immunity by filing proof of claim that expressly reserved its sovereign immunity, although the tribe could be required to either withdraw its proof of claim or assert an unqualified claim by removing disclaimer).

taxing authority has two options. First, it can do nothing when the bankruptcy court confirms a bankruptcy reorganization plan or enters an order that provides for applicability of the section 1146(c) exemption to the sale of certain of the debtor's assets, notwithstanding that the taxing authority may consider the exemption to be unwarranted or overly broad. In the alternative, the taxing authority can voluntarily submit to the jurisdiction of the court, in which event it could be deemed to have waived its sovereign immunity.<sup>111</sup> However, as stated by the Fourth Circuit in *Maryland v. Antonelli Creditors' Liquidating Trust*:

It is true that if a state wishes to challenge a bankruptcy court order of which it receives notice, it will have to submit to federal jurisdiction . . . . The state, of course, well may choose not to appear in federal court. But that choice carries with it the consequence of foregoing any challenge to the federal court's actions. While forcing a state to make such a choice may not be ideal from the state's perspective, it does not amount to the exercise of federal judicial power to hale a state into federal court against its will and in violation of the Eleventh Amendment. Instead, it is the result of Congress' constitutionally authorized legislative power to make federal courts the exclusive venue for administering the bankruptcy law.<sup>112</sup>

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<sup>111</sup> See Cordry, *supra* note 71, at 47.

<sup>112</sup> *Antonelli*, 123 F.3d at 787. See also *New York v. Irving Trust Co.*, 288 U.S. 329, 333 (1933) ("The federal government possesses supreme power in respect of bankruptcies. If a state desires . . . the assets of a bankrupt, she must submit to appropriate requirements by the controlling power; otherwise, orderly and expeditious proceedings would be impossible and a fundamental purpose of the Bankruptcy Act would be frustrated." (citation omitted)); *Arecibo*, 270 F.3d at 29 ("We recognize that our conclusion here presents a state with something of a Hobson's choice: 'either subject yourself to federal court jurisdiction or take nothing' . . . . Even the Eleventh Amendment, however, does not ensure a state the choice of a desirable alternative."); *Schulman v. California (In re Lazar)*, 237 F.3d 967, 978 (9th Cir. 2001) ("[W]hen a state or an 'arm of the state' files a proof of claim in a bankruptcy proceeding, the state waives its Eleventh Amendment immunity with regard to the bankruptcy estate's claims that arise from the same transaction or occurrence as the state's claim."); *Rose v. United States Dep't of Educ. (In re Rose)*, 187 F.3d 926, 929 (8th Cir. 1999) (ruling that in Chapter 7 proceeding, the state waived sovereign immunity as to dischargeability of student loan debt when state student loan agency filed proof of claim); *Virginia v. Collins (In re Collins)*, 173 F.3d 924, 929-31 (4th Cir. 1999) (ruling that where State was not named as defendant, served with process, or compelled to appear, "Nothing compels the state to submit to the . . . bankruptcy court[']s jurisdiction], and the court's power to allow or deny a state's claim derives from the court's jurisdiction over the bankruptcy estate. In short, if a state wishes to share in the estate, it must submit to federal

In *Federal Maritime Commission v. South Carolina State Ports Authority*,<sup>113</sup> the Supreme Court held that state sovereign immunity barred the Federal Maritime Commission (“FMC”), a federal administrative agency, from adjudicating a private party’s complaint against a nonconsenting state.<sup>114</sup> The Court found that because the FMC’s adjudications so strongly resembled civil suits, state sovereign immunity applied.<sup>115</sup> The Court reasoned that a state could not be forced into making a Hobson’s choice of refusing to appear and be bound by the court’s order, or electing to appear and be deemed to have waived its Eleventh Amendment immunity.<sup>116</sup> The Court stated that a state seeking to defend itself against a complaint filed with the FMC “must defend itself in front of the FMC or substantially compromise its ability to defend itself at all,” and if it failed to appear and defend against the complaint, it could then not argue the merits of its position in an appeal of the FMC’s ruling.<sup>117</sup> According to the Court, “To conclude that this choice does not coerce a State to participate

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jurisdiction.” The Court found that motion to reopen bankruptcy to determine dischargeability of debt did not constitute a suit against one of the United States for Eleventh Amendment purposes.); *Georgia Dep’t of Revenue v. Burke (In re Burke)*, 146 F.3d 1313, 1319 (11th Cir. 1998) (“[B]y filing a proof of claim in the debtors’ respective bankruptcy proceedings, the State waived its sovereign immunity for the purposes of the adjudication of those claims.”); *DeKalb County Div. of Family & Children Servs. v. Platter (In re Platter)*, 140 F.3d 676, 680 (7th Cir. 1998) (holding that when State voluntarily enters federal forum by filing a claim, “it cannot run back to seek Eleventh Amendment protection when it does not like the result”); *WJM, Inc. v. Mass. Dep’t of Pub. Welfare*, 840 F.2d 996, 1004-05 (1st Cir. 1988) (“[A]n effective waiver [of Eleventh Amendment immunity] . . . may occur even when the waiving party is between a rock and a hard place.” (internal citations omitted)); *cf. Nelson*, 301 F.3d at 838 (finding that *in rem* exception to Eleventh Amendment immunity was not applicable where debtor brought adversary proceeding against State and its employees, who were necessary, named parties in the action); *Wyoming Dep’t of Transp. v. Straight (In re Straight)*, 143 F.3d 1387, 1392 (10th Cir. 1998) (stating that “§ 106(b) does not pretend to abrogate a state’s immunity, it merely codifies an existing equitable circumstance under which a state can choose to preserve its immunity by not participating in a bankruptcy proceeding or to partially waive that immunity by filing a claim.”); *Creative Goldsmiths*, 119 F.3d at 1147 (holding that without State’s consent, bankruptcy court lacked jurisdiction to hear bankruptcy trustee’s adversary action against State to avoid alleged preferential transfer); Gil Seinfeld, *Waiver-in-Litigation: Eleventh Amendment Immunity and the Voluntariness Question*, 63 OHIO ST. L. J. 871 (2002) (discussing waiver-in-litigation cases and their impact on the Supreme Court’s prohibition against constructive waiver).

<sup>113</sup> 535 U.S. 743, 760-61 (2002).

<sup>114</sup> *See id.* at 760.

<sup>115</sup> *See id.*

<sup>116</sup> *See id.* at 763-64.

<sup>117</sup> *Id.* at 762.

in an FMC adjudication would be to blind ourselves to reality.”<sup>118</sup>

## V. PRACTICAL CONSIDERATIONS

### A. Refusal to Record Transfer Documents

Although the section 1146(c) exemption clearly applies to transfers of real property under a confirmed bankruptcy plan,<sup>119</sup> persuading county recorders to record the deed or other transfer document without payment of the transfer tax can be a frustrating—and often futile—experience. The expeditious and efficient transfer of property can be significantly delayed or even prevented, to the detriment of the debtor as well as creditors of the bankruptcy estate, if the county recorder’s office refuses to record the transfer document notwithstanding the order of the bankruptcy court stating that the transfer is exempt under section 1146(c). The filing clerk at the recorder’s office nonetheless may demand payment of the applicable stamp or transfer tax based on, among other things, one or more of the following arguments:

- (1) The plan, or order approving the plan, that states that the exemption is applicable has not itself been recorded;
- (2) The transfer is occurring before the plan has been confirmed by the bankruptcy court and is therefore not under a plan confirmed as required by section 1146(c), or applicable state law, or tax regulations, or bankruptcy case law if the jurisdiction prohibits—or is unclear with respect to—the recording of transfer documents before the bankruptcy court has confirmed the Chapter 11 bankruptcy plan;
- (3) It is not clear from the plan or order that it applies to the specific transaction for which the exemption is claimed;
- (4) The sovereign immunity doctrine under the Eleventh Amendment to the U.S. Constitution prohibits a bankruptcy

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<sup>118</sup> *Id.* at 763-64. *See also* Roberts v. Florida Dep’t of Educ. (*In re* Roberts), 2002 BNH 22, 2002 Bankr. LEXIS 888, at \*6 (Bankr. D.N.H., June 10, 2002) (unreported opinion) (“the [Florida Department of Education] did not waive its immunity through consent because it did not file a proof of claim or otherwise participate in the Debtor’s bankruptcy case.”). It may be possible to challenge the bankruptcy court’s jurisdiction without waiving the taxing authority’s sovereign immunity claim. *See* Pavlovich v. Sup. Ct., 29 Cal. 4th 262, 265-66 (2002) (Baxter, J., dissenting) (upholding Texas resident’s motion to quash service, and rejecting personal jurisdiction of California’s courts, in trade infringement case involving posting of offending computer code on website).

<sup>119</sup> *See* 11 U.S.C. § 1146(c) (2003).

court from exercising jurisdiction to determine that property transfers are exempt from transfer and recording taxes under the section 1146(c) Bankruptcy Code exemption.

Some states will not record transfer documents that claim the section 1146(c) exemption unless and until the bankruptcy court has confirmed the debtor's Chapter 11 reorganization plan. For example, the State of Washington imposes an excise tax on the transfer of real property that must be paid at the time of recording unless an exemption recognized by Washington regulations clearly applies. The Washington Administrative Code ("WAC") provides that the only exemption under Washington law applicable to a transfer of real property as the result of a bankruptcy proceeding is as follows:

- (1) The real estate excise tax does not apply to conveyances of real property by a trustee in bankruptcy or debtor in possession made under either a Chapter 11 plan or Chapter 12 plan *after the bankruptcy plan is confirmed* (emphasis added).
- (2) The date when the bankruptcy plan was confirmed, the court case cause number, and the bankruptcy chapter number must be cited on the affidavit when claiming this exemption.<sup>120</sup>

This provision of the WAC makes it clear that the exemption applies only after the bankruptcy court has confirmed the reorganization plan, and requires that a "Real Estate Excise Affidavit" set forth the information evidencing plan confirmation.<sup>121</sup> This affidavit must be submitted to the County Recorder with the deed or other transfer instrument at the time of recording. However, an interpretive ruling issued by the Washington State Department of Revenue in 1992<sup>122</sup> allowed a refund of the excise tax that was paid at the time of a pre-confirmation transfer, upon the filing of a request for refund, when the final approved and confirmed plan included the following: specific provision for the sale; a reference to the bankruptcy court's previous order authorizing and approving the sale; and a statement that the pre-confirmation transfer was essential to the success and

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<sup>120</sup> WASH. ADMIN. CODE § 458-61-230 (2002) (entitled "Bankruptcy").

<sup>121</sup> This clarifying language was added to WASH. ADMIN. CODE § 458-61-230 in 2000. See Wash. St. Reg. 00-04-055 (proposed Jan. 28, 2000) (stating that it "interprets application of real estate excise tax by federal bankruptcy statutes . . . consistent with the most recent federal circuit court ruling [*NVR*]").

<sup>122</sup> See Det. No. 92-317, 12 WTD 485 (1992). This interpretive ruling was based on the *Jacoby-Bender*, *Smoss Enters.*, and *Permar* decisions.

implementation of the plan. The interpretive ruling also noted that the transfer tax paid by the debtor at the time of the pre-confirmation of the sale of the property “was paid under protest.” Although this interpretive ruling was issued eight years before the clarification to the rule in 2000, which referred specifically to conveyances of real property “after the plan is confirmed,” it would—at least arguably—apply to current transfers where the conditions set forth therein have been met with respect to a plan that is ultimately approved by the bankruptcy court.<sup>123</sup> In the State of New York, which has a mortgage recording tax, a specific title insurance endorsement entitled “Mortgage Tax Endorsement” is available. This endorsement provides that the policy insures the owner of the indebtedness secured by the insured mortgage(s) against loss or damage that the insured may sustain

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<sup>123</sup> See also Technical Assistance Advisement No. 93(M)-008, Fla. Dep’t of Revenue, 1993 Fla. Tax LEXIS 136 (stating that with respect to pre-confirmation transfers, assumptions of debt, and mortgage pursuant to order of bankruptcy court, and based on applicable case law finding that transfers, assumptions and mortgage were necessary and essential to final confirmation of plan, “[N]o documentary stamp tax or intangible tax would be due on the transfers, the assumptions, promissory notes or the joint venture mortgage, as contemplated by the Agreement and the Company Plan”); N.Y. CLS Tax § 1405 b.8 (exempting from payment of New York State real estate transfer tax “[c]onveyances given pursuant to the federal bankruptcy act”); 20 NY CRR § 644.1(b)(3) (2003) (exempting from New York State mortgage tax “[m]ortgages made pursuant to a confirmed plan under section 1129 of Chapter 11 of the Bankruptcy Code (section 252 of the Tax Law and section 1146 of the Bankruptcy Code”)); CHICAGO, ILL. MUN. CODE § 3-33-060(K) (2003) (exempting from real estate transfer tax “[t]ransfers made pursuant to a confirmed plan of reorganization as provided under Section 1146(c) of Chapter 11 of the United States Bankruptcy Code of 1978, as amended”). The State of Michigan exempts from payment of transfer taxes on written instruments and transfers of property “[a] written instrument that this state is prohibited from taxing under the United States constitution or federal statutes.” MICH. COMP. LAWS ANN. § 207.526, sec. 6(c) (West 1994). In addition, MICH. COMP. LAWS ANN. § 207.527, sec. 7 (West 1994) states that “[a] tax is not imposed by [the State Real Estate Transfer Tax Act, M.C.L.S. § 207.521 *et seq.* (2002)] upon a written instrument that conveys or transfers property or an interest in the property to a receiver, administrator, or trustee, whether special or general, in a bankruptcy or insolvency proceeding.” See also § 23-03(j)(8) of the Rules of the City of New York, which exempts from the New York City Real Property Transfer Tax, transfers pursuant to a confirmed plan of reorganization under § 1146 of the Bankruptcy Code. The City of New York Department of Finance also has issued a letter ruling stating that the New York City Real Property Transfer Tax and the New York City Mortgage Recording Tax do not apply to transfers of (or the creation of) interests in real property, including mortgages, easements and leases, where “each of the transactions [described in the letter ruling] has been ruled to be necessary and appropriate to the implementation of the Plan and the Plan has been confirmed by an Order of the Bankruptcy Court.” City of New York Dep’t of Finance, *Various Transfers and Recording of Mortgage Pursuant to a Chapter 11 Bankruptcy Order are not Subject to Real Property Tax or Mortgage Recording Tax*, FLR 97-4708, Sept. 4, 1997, at p.2.

because all mortgage recording taxes required to be paid on the insured mortgage(s) have not been paid. Presumably the title insurer, before issuing this endorsement, would ascertain that such taxes had in fact been paid or that sufficient funds had been escrowed to cover the potential tax liability, plus interest and penalties.

Parties wishing to record conveyances of real property in connection with confirmed plans or confirmation orders, or pre-confirmation orders of sale, may have limited options if recorders' offices balk at recording the transfer documents without payment of the transfer taxes determined to be owing by the applicable taxing authorities.

Payment of the taxes, even under protest, at the time of recording the transfer documents may present a dilemma if the debtor or trustee subsequently brings an action against the taxing authority seeking a refund of the tax paid. This action may be deemed to constitute a suit against the taxing authority that would enable the taxing authority to argue that the action should be dismissed for violating its Article 11 sovereign immunity.<sup>124</sup>

#### B. Escrow (and Other) Arrangements for Disputed Taxes

The bankruptcy reorganization plan, or the bankruptcy court order approving the plan or the transfer of real property, should specifically state that the section 1146(c) exemption applies to the specific transfer and any other property transfer(s) contemplated by the plan or order. Also, it could provide that an amount equal to the transfer tax otherwise imposed on the transfer be escrowed with the court or a third party, such as a bank or title insurance company. For example, in *310 Associates*, the bankruptcy court's order approving the transfer agreement between the debtor and the purchaser provided as follows:

As soon as practicable after the Closing, the Debtor shall be, and hereby is, authorized to deposit in a separate, interest bearing escrow account, monies from the Account (as defined hereinbelow [*sic*]), earmarked "310 Associates, L.P.—City 1146(c) taxes," the sum of \$100,000, or such other amount as may be necessary (the "Escrowed Funds") to pay any City real property transfer tax or any other applicable City stamp or similar tax, and any potential interest and/or penalties thereon that may be due on the recordation of any documents or instruments reflecting the sale of the Assets subject

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<sup>124</sup> See *supra* note 93 and accompanying text.

to this Order. . . . If a Plan of Reorganization in this case ultimately is not confirmed, the City may apply to this Court for appropriate relief, and this Order is without prejudice to the rights of the City in such eventuality.<sup>125</sup>

One commentator has noted that with respect to Chapter 11 bankruptcy proceedings filed in Delaware involving transfers of real property:

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.<sup>126</sup>

The use of escrowed funds for the potential payment of transfer taxes also poses other problems, especially if a title insurer is asked to insure the transaction and act as the escrow agent. For example, in Washington State, the excise tax (as discussed above) on a conveyance that is subject to the section 1146(c) exemption constitutes a lien on the title to the subject real property. If the title company is asked to issue an owner’s policy in connection with the transaction to the purchaser, and does so without ensuring the transfer tax is paid at the time of recording, even if under protest, then the title insurer could incur liability under the policy. This liability includes the expense of the applicable transfer tax with interest and penalties. This liability could occur if the Washington Department of Revenue subsequently sought to collect the tax based on an internal audit of the transaction, or if the seller, the debtor, or trustee failed or refused to pay the tax. Given these circumstances, the only alternative for the title company may be to require payment of the transfer tax as a condition of

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<sup>125</sup> 310 *Assocs.*, 282 B.R. at 295, 297-98 (alterations in original). In *Permar Provisions*, 79 B.R. at 532, 534, the amount of the disputed New York City real property tax had been placed into escrow with a title company and the deed had been recorded without payment of the recording tax. The court held that the transfer was exempt under section 1146(c), and directed the escrow agent to release the escrowed funds to the trustee for further distribution in accordance with the approved plan. See also *Amsterdam*, 103 B.R. at 456 (directing New York county register, as part of interim interlocutory order, to record prospective deed and prospective mortgage without payment of deed or mortgage taxes, provided that escrow be established for payment of disputed mortgage taxes).

<sup>126</sup> Cordry, *supra* note 71, at 48.

issuing an owner's title policy without an exception for the unpaid transfer or stamp taxes.

Another issue to address is how long an escrow for unpaid transfer taxes should remain open. For example, the accrual of interest and penalties could be substantial if the escrow remains in effect for an inordinate period of time. At some point the total amount due, including interest and penalties, could exceed the available funds held in escrow if the taxing authority ultimately prevails. Also, the title insurer may be unwilling to extend the same coverage to subsequent purchasers if it insures the original purchaser without exception for nonpayment of the transfer taxes because adequate funds have been escrowed. Furthermore, if the debtor or purchaser files a subsequent bankruptcy proceeding before the original escrow proceeds have been disbursed, the status and ownership of the escrowed funds may be questionable. The escrow agreement itself must be carefully drafted and must be satisfactory to the debtor, the purchaser, the escrow agent, and the bankruptcy court.

To minimize the chance that a recorder's office will not record a transfer instrument claiming the section 1146(c) exemption without first receiving payment of the stamp or transfer tax, the confirmed plan (or order confirming the plan or the sale) should contain specific language that the section 1146(c) exemption applies to the subject transfer or transfers, and the plan itself may need to be recorded. The final plan or order also should fully describe, to the extent possible, the documents and transfers to be covered by the exemption, which includes the applicability of the section 1146(c) exemption to related financing of mortgages, assignments of leases, or other transfer documents described or contemplated in the plan.<sup>127</sup>

Where feasible, it may be desirable for the debtors, their attorneys, the trustee, or the title insurance company to seek a confirmation or "comfort letter" from the applicable taxing authority in advance of the sale or transfer. The confirmation or comfort letter would acknowledge the taxing authority's agreement not to prevent or contest the recording of certain specified transfer documents that occur as the result of the assertion that such transfers were exempt from taxation under section 1146(c) of the Bankruptcy Code. The letter also would confirm the taxing authorities' agreement that no transfer or stamp tax would be due upon recordation of

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<sup>127</sup> Sample provisions for insertion in bankruptcy plans and sale orders are set forth in Appendix A to this article. A sample form of Affidavit requesting an exemption from recording taxes, to be delivered to the taxing authority at or prior to recording mortgage-modification documents, is attached as Appendix A-1 to this Article.

the transfer documents.<sup>128</sup> However, the applicable taxing authorities may be unable or unwilling to acknowledge in advance, in writing, that the section 1146(c) exemption will apply to the transfer and that payment of the tax will not be required as a condition to recordation.

## V. CONCLUSION

Bankruptcy filings continue to rise to all-time record levels. Approximately 40,000 businesses file for bankruptcy every year. Of the sixteen largest business bankruptcy filings in the country since 1980, ten have been filed between March 2001 and December 2002. Five of the top ten business bankruptcies in U.S. history occurred during 2002: Enron, WorldCom, Global Crossing, United Airlines, and Consec. All told, 191 public companies with more than \$368 billion in assets filed for bankruptcy in 2002.<sup>129</sup> During 2001 and 2002, companies with \$626 billion in assets have filed for Chapter 11.<sup>130</sup> These statistics are far in excess of the aggregate asset total of all corporate bankruptcy filings during the previous ten years.<sup>131</sup> As noted by one commentator, “each year millions of dollars are being collected or forgiven in stamp taxes as a result of the impact of § 1146(c) on Chapter 11 plans.”<sup>132</sup> Being required to pay transfer and recording taxes, which can be quite significant in certain jurisdictions, often adds significant additional costs to purchasers of real estate from bankruptcy estates. Secured lenders who take title to their secured real property collateral in Chapter 11 proceedings also face these costs. However, under section 1146(c), relief from these impositions is available if the transfer is structured as part of the confirmed bankruptcy plan of reorganization. In addition, in certain jurisdictions, if the transfer is pursuant to a pre-confirmation order of the bankruptcy court authorizing the sale, and in accordance with the plan ultimately confirmed by the court, relief is available. In a loan workout situation in the current real estate market, significant transfer-tax costs may have a high level of economic impact and may be a critical consideration. When property owned by the bankrupt debtor is transferred subject to the section 1146(c) exemption

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<sup>128</sup> A sample form of pre-transfer letter to be delivered to the taxing authority requesting this confirmation is attached as Appendix B to this Article.

<sup>129</sup> See <http://www.bankruptcy.data.com>, New Generation Research, Boston, Mass. (last visited Jan. 28, 2003); Kathy M. Kristof, *No End in Sight to Big-Name Bankruptcy Surge*, LOS ANGELES TIMES, Jan. 2, 2003, Part 3, at 1.

<sup>130</sup> See *id.*

<sup>131</sup> See *id.*

<sup>132</sup> See Maloy, *supra* note 7, at 19.

(especially in single-asset real estate bankruptcy cases), the lender may be able to recover its real property collateral at a lower cost, free and clear of liens and encumbrances and without the payment of often significant transfer or stamp taxes. This, in turn, may encourage the lender—at least in certain factual situations—to agree to a consensual plan that reduces bankruptcy expenses and delays and perhaps even frees up additional funds for unsecured creditors. However, the plan must be structured so that it does not run afoul of section 1129(d) of the Bankruptcy Code, which prohibits confirmation of a plan that has as its principal purpose the avoidance of taxes.<sup>133</sup>

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<sup>133</sup> See *supra* notes 4-5 and accompanying text. The reorganization plan should not be deemed a violation of section 1129(d) if the achievement of transfer-tax savings is *a* principal purpose of an otherwise valid plan, as opposed to *the* principal purpose. The reorganization plan, or the order confirming the sale of real property of the estate, should contain specific language similar to the following: “The principal purpose of the Plan is not the avoidance of taxes or the avoidance of the requirements of Section 5 of the Securities Act of 1933.” Transfer and stamp taxes generally are in the range of one percent of the sale price or value of the property being transferred. However, the aggregate amount of city, county, and state transfer and stamp taxes imposed may be hundreds of thousands—and even millions—of dollars in connection with the conveyance of a unique commercial property in a major urban location (such as New York, Chicago or Los Angeles) or in connection with the transfer of several commercial properties by the debtor or trustee in accordance with (or in anticipation of) the confirmed Chapter 11 reorganization plan.

**APPENDIX A**  
**SAMPLE PROVISIONS FOR INSERTION IN BANKRUPTCY**  
**PLANS AND SALE ORDERS**  
**Definition of Transfer Taxes;**  
**Applicability of Exemption (Plan)**

\_\_\_\_\_. Transfer Taxes. Transfer Taxes are defined in the Plan as any and all stamp taxes or similar taxes including any interest, penalties and additions to the tax which may be applicable in connection with a Transfer or in connection with the modification of the \_\_\_\_\_ Mortgage Obligations pursuant to Article \_\_\_\_ of the Plan, including, without limitation, any applicable mortgage recording taxes, \_\_\_\_\_ State Real Property Transfer Tax imposed under \_\_\_\_\_ and \_\_\_\_\_ City Transfer Tax imposed under \_\_\_\_\_ of the \_\_\_\_\_ of the \_\_\_\_\_ City [Administrative Code], including any penalty, interest and additions to the tax in connection with the foregoing.

\_\_\_\_\_. Section 1146 (c) Exemption. Pursuant to Section 1146(c) of the Bankruptcy Code, the issuance, transfer or exchange of any security under the Plan, or the making or delivery of an instrument of transfer under the Plan, may not be taxed under any law imposing a stamp tax or similar tax.

**Sample Transfer Tax Provisions in Plan Confirmation**  
**Order or Pre-Confirmation Bankruptcy Order**  
**Providing for Sale of Real Property (or for Mortgage or**  
**Transfer of Lease of Real Property)**

\_\_\_\_\_. Section 1146(c) Exemption. In accordance with Section 1146(c) of the Bankruptcy Code, the issuance, transfer or exchange or the reversion, transfer, sale and conveyance of any real or personal property of Debtor or the Trustee [in accordance with the Plan], including without limitation the sale and conveyance of the Property, is hereby exempt from, and is not to be taxed under, any state or local law imposing a stamp tax, transfer tax or similar tax.

\_\_\_\_\_. Direction to Tax Authorities. Each and every federal, state, and local government agency or department is hereby directed to accept any and all documents and instruments necessary or appropriate to consummate the sale/assignment of the Properties, all without imposition and payment of any stamp tax, transfer tax or similar tax, pursuant to Section 1146(c) of the Bankruptcy Code. The register or recorder of deeds (or other similar

recording agency) is hereby directed to accept and include a certified copy of this Order along with any other appropriate conveyance documents used to record and index the transfer of the Properties in the appropriate public records.

\_\_\_\_\_. Sale in Contemplation of Plan. The sale of the Property to Buyer is a prerequisite to Debtor's ability to confirm and consummate a plan or plans of reorganization. The sale is a sale in contemplation of a plan and, accordingly, a transfer pursuant to 11 U.S.C. § 1146(c), which shall not be taxed under any law imposing a transfer tax or similar tax.

**Injunction Against Taxing Authorities  
(Plan, Plan Confirmation Order or Sale Order)**

\_\_\_\_\_. Injunction Against Taxing Authorities. The \_\_\_\_\_ [Department of Revenue] and all other \_\_\_\_\_ state and local taxing authorities will be enjoined from the commencement or continuation of any action to collect from the Debtor, the General Partners, the Equity Interest Holders, \_\_\_\_\_'s nominee, assignee or designee, the \_\_\_\_\_ Entities, or any creditor of the Debtor, or to charge against the Property any Transfer Taxes, which shall in all events be exempt from payment as provided under Section 1146(c) of the Bankruptcy Code.

**Confirmed Plan (Sale Plus Modification of Loan Documents)**

\_\_\_\_\_. Request for Order Approving Transfer. \_\_\_\_\_ may elect, which election shall be made by \_\_\_\_\_ in the exercise of its sole and absolute discretion, to file a motion with the Court for entry of an order (separate from and in addition to the Confirmation Order) specifically approving any Transfer or the modification of the \_\_\_\_\_ Loan Documents as contemplated by Article \_\_\_\_\_ hereof, or both, and (i) finding and providing that the Transfer and related delivery of the Deed or instruments of transfer were effected under the Plan within the meaning of section 1146(c) of the Bankruptcy Code, and (ii) directing the Recorder's Office of \_\_\_\_\_ County, \_\_\_\_\_ to record the deed reflecting the Transfer and/or the agreement embodying the modification to the terms and provisions of the \_\_\_\_\_ Loan Documents, which agreement is described more particularly in Article \_\_\_\_\_ hereof, and/or in addition to or in the alternative, to record the Final Confirmation Order (including this Plan, as confirmed, attached as an Exhibit thereto), unconditionally and without reservation notwithstanding the nonpayment of any alleged Transfer Taxes.



**SCHEDULE 1**

Mortgage Modification Documents Presented for Recording

1. Note and Mortgage Modification and Severance Agreement.
2. Substitute Mortgage A.
3. Assignment of Leases and Rents.
4. Substitute Mortgage B.
5. Second Assignment of Leases and Rents.

**APPENDIX B**  
**SAMPLE FORM OF PRE-TRANSFER LETTER**  
**TO BE DELIVERED TO TAXING AUTHORITY**  
 [LETTERHEAD OF LAW FIRM OR  
 TITLE INSURANCE COMPANY]

\_\_\_\_\_, 200\_\_

**To County Recording Officers:**

\_\_\_\_\_ (“Debtor”) is a corporation emerging from Chapter 11 bankruptcy. In connection with its Chapter 11 reorganization plan (“Plan”), Debtor will be granting first and second mortgages and assignments of rents and leases (collectively, the “Mortgages”) on approximately \_\_\_\_ properties in \_\_\_\_ states to \_\_\_\_\_ Company or another commercial bank acting as collateral agent. The first mortgages will secure Debtor indebtedness in the amount of approximately \$\_\_\_\_ million and the second mortgages will secure Debtor indebtedness in the amount of approximately \$\_\_\_\_million. Debtor is issuing all such indebtedness (the “Indebtedness”) in connection with the Plan.

Pursuant to section 1146(c) of the U.S. Bankruptcy Code, it is our understanding that (1) the issuance, distribution, transfer or exchange of the credit agreements evidencing the Indebtedness and (2) the making, delivery or recording of any instrument of transfer under, in furtherance of, or in connection with the Plan, including any mortgages, assignments or other instruments of transfer executed in connection with any transactions arising out of, contemplated by or in any way related to the Plan are not subject to any document recording tax, stamp tax, conveyance fee, intangibles tax, mortgage tax, real estate transfer tax, mortgage recording tax or other similar tax or governmental assessment.

As the Mortgages will be executed pursuant to the Plan, Debtor should be exempt under section 1146(c) from any mortgage recording tax, intangibles tax or similar tax ordinarily assessed in your jurisdiction in connection with the recording of a mortgage, deed of trust or deed to secure debt. Please confirm your understanding that no such tax will be due upon recording of the Mortgages in your office. We would also appreciate knowing of any additional information or evidence you may require in connection with such recordation in order to confirm the availability of the exemption. Please respond to the undersigned. Thank you very much for your consideration.

[LAW FIRM]

[TITLE INSURANCE COMPANY]