



STATE OF IDAHO

OFFICE OF THE ATTORNEY GENERAL

BOISE 83720

JIM JONES
ATTORNEY GENERAL

TELEPHONE
(208) 334-2400

April 20, 1988

Board of County Commissioners
and Prosecuting Attorney
Caribou County
County Courthouse
Soda Springs, ID 83276

THIS CORRESPONDENCE IS A LEGAL GUIDELINE OF THE
ATTORNEY GENERAL SUBMITTED FOR YOUR GUIDANCE

Re: Bankruptcy Upon the Claim of a County for Property Taxes
Incurred by the Bankrupt Owner

Gentlemen:

You have asked for an opinion regarding the effect of two orders entered in a bankruptcy proceeding upon the claim of the county for property taxes incurred by the bankrupt owner. Because of the complexity of the particular court action and the lack of access to the various litigation developments in the proceeding and the file itself we can only provide you with legal guidelines as to the possible effect of the bankruptcy court orders.

QUESTIONS:

1. What effect does a pending bankruptcy proceeding have on a county's power to make a delinquency entry against property in bankruptcy for nonpayment of property taxes?
2. What is the effect on property tax liens of an authorized sale of the property by a United States Bankruptcy Court free of the liens?
3. What is the effect of an order of a United States Bankruptcy Court that fails to transfer a tax lien on property in bankruptcy to the proceeds from the property sold free of the lien?

Celebrate
IDAHO
1890 • CENTENNIAL • 1990

CONCLUSIONS:

1. While a bankruptcy proceeding is pending, a county is prohibited from making a delinquency entry against property in bankruptcy until the bankruptcy "stay" is lifted and any delinquency entry made contrary to the stay is void.
2. A county loses its tax liens on property sold free of the liens in a United States Bankruptcy proceeding.
3. A county's tax liens do not transfer to the proceeds from the sale of property sold in a United States Bankruptcy proceeding free of the liens.

ANALYSIS:

A large industrial property owner in a county filed Chapter 11, reorganization bankruptcy, in October, 1985. At the end of the year it paid the ad valorem property taxes attributable to the portion of the year prior to the bankruptcy filing, but not afterwards. Nor did it pay its 1986 property taxes. Delinquency entries were made against the real property as required by Idaho Code §§ 63-1109 and 63-1114. Previously, Idaho property tax liens would have arisen January 1st of the year in which the tax levies were made, even though the levies occurred later in the year. Idaho Code §§ 63-102 and 63-104. (This opinion assumes all personal property which was taxed was in the county on January 1, 1985.) In Idaho, ad valorem real property tax liens are superior to all other liens, even those liens that predate it. Trust & Savings Bank v. Werner, 36 Idaho 601, 606; 215 P. 458 (1923), cert. den. 264 U.S. 594 (1924); Bosworth v. Anderson, 47 Idaho 697, 707; 280 P. 227 (1929). Idaho courts likely would treat personal property liens the same way. Cf, Scottish Amer. M. Company, Ltd. v. Minidoka County, 47 Idaho 33, 39; 272 P. 498 (1928); Metropolitan Life Ins. Co. v. Twin Falls Co., 56 Idaho 93, 98 (1935). See, Op. Idaho Att'y Gen., 85-1 (1985).

In mid-1987 the owner sold its property with the authorization of a U.S. Bankruptcy Court "free and clear" of all liens attached to the property. The order authorizing this sale had followed a court hearing presumably preceded by notice of the proposed sale to the county, as well as to all of the owner's creditors. The county did not object to the proposal or participate in the court hearing.

In ordering the sale, the bankruptcy court order provided initially that all liens on the property were transferred to the proceeds of the sale, but more specific provisions stated that the liens would only transfer to the proceeds as provided in the "approved agreement" of sale as modified by terms worked out in

the court hearing and referred to in the order as Exhibit B. Presumably, the county tax liens were excluded from attaching to the proceeds of the sale. (We did not have access to the "approved agreement" or Exhibit B.) A subsequent amended court order identified those liens that transferred to the proceeds. The county's tax liens are not mentioned in the amended order. No appeal was taken from either order.

The questions posed in your opinion request deal with the effect these bankruptcy proceedings had on the county's tax claims and lien rights.

A. DELINQUENCY ENTRIES

When a landowner fails to pay ad valorem property taxes, the county tax collector is required to make an "entry of delinquency" of the taxes on the real property assessment roll, which entry has "the force and effect of a sale to the Tax Collector" of the property in trust for the county. Idaho Code § 63-1109. "The county is deemed to be the purchaser of the property described in such delinquency entry" Idaho Code § 63-1114. Unless the landowner "redeems" his property by paying the outstanding taxes, interest and penalties within three years from the date of the entry, the property will be deeded over to the county. Idaho Code § 63-1126A.

Bankruptcy law prohibits county officials from making delinquency entries and issuing tax deeds while property of a landowner is in bankruptcy proceedings. The filing of a bankruptcy triggers the "automatic stay" which prohibits, among other acts:

(3) any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate;

11 U.S.C. § 362(a)(3). As the legislative history makes clear, the "purpose of this provision is to prevent dismemberment of the estate." H.R. Report No. 595, 95th Cong., 1st Sess. 341 (1977); S. Rep. No. 989, 95th Cong., 2nd Sess. 56 (1978). Virtually all the property owned by a corporation in bankruptcy is "property of the estate." 11 U.S.C. § 541. As a rule, "acts taken in violation of the automatic stay are ... deemed void and without effect...." In re Albany Partners, Ltd., 749 F. 2d 670, 675 (11th Cir. 1984). See, Colliers on Bankruptcy ¶ 362.04(3)(15th Ed. 1979). The stay remains in effect until the stay is lifted by court order against the property or when the property is no longer part of the bankruptcy estate, such as by confirmation of a plan of reorganization. 11 U.S.C. §§ 362(c)(1) and (d); 1141(c).

This analysis assumes that ad valorem property tax liens can even arise against property in bankruptcy. The automatic stay also prohibits "any act to create ... any lien against property of the estate." 11 U.S.C. § 362(a)(4). One court has held this provision prevents ad valorem tax liens from arising under a property tax scheme similar to Idaho's. In re Carlisle Court, Inc., 36 B.R. 209, 214 (Bkrtcy. D.C. 1983).

However, a United States Court of Appeals has recognized under an exception to the stay in §§ 362(b)(3) and 546(b) of the bankruptcy code the superiority of property tax claims of Maryland and Baltimore that arose after the bankruptcy filing. Md. Nat. Bank v. Mayor & City Council of Baltimore, 723 F.2d 1138, 1143 (4th Cir. 1983). The court pointed out that under Maryland law, which is like Idaho's, no bona fide purchaser could ever take the property ahead of ad valorem real property tax liens:

One regularly buys real estate knowing that purchase entails an obligation to meet future real estate taxes when they become due and payable and that perfection of the rights to collect automatically occurs on the first day of July in each and every year.

723 F.2d at 1142-1143, fn. 10. The court characterized the arising of the tax lien as "perfection under § 546(b)" of the bankruptcy code. 723 F.2d at 1144.

Unlike its treatment of real property tax liens, though, the Maryland court held that liens for personal property taxes involving "moveable personalty" did not arise in bankruptcy because "there is no assurance that the taxing authorities will indeed have the power to tax the given item of personal property in any given year." 723 F.2d at 1144, fn. 14. The different treatment for personal property has been followed by other courts. See, In re Electric City, Inc., 43 B.R. 336 343 (Bkrtcy. W.D. Wash. 1984) ("In the case of personal property, ... taxation and the lien thereon are dependent on its existence and identification." -- unlike real estate); In re Cumming Market, Inc., 53 B.R. 224 (Bkrtcy. Vt. 1985) (when lien was created it did not relate back to a time before bankruptcy); In re Continental Corp., 1 B.R. 680, 688 (Bkrtcy. N.D. Ill. 1979) (Michigan personal property tax liens could not "attach until ... long after the date of bankruptcy").

This is an area that remains unsettled, but it is assumed for the purposes of this opinion that the county acquired liens against the property after the filing of the bankruptcy.

B. LOSS OF PROPERTY TAX LIEN

United States bankruptcy laws specifically authorize the sale "other than in the ordinary course of business" of property in bankruptcy free and clear of any liens upon the property, property tax liens included. 11 U.S.C. § 363(b) and (f). This authority has long been held to be constitutional. Van Huffel v. Harkelrode, 284 U.S. 225, 228-229, 52 S.Ct. 115, 76 L.Ed. 256 (1931); Gardner v. New Jersey, 329 U.S. 565, 578, 67 S.Ct. 467, 91 L.Ed. 504 (1947). Current bankruptcy law grants the power to make such extraordinary sales of bankruptcy property to the trustee, but in the reorganization form of bankruptcy, Chapter 11, the trustee's powers are typically performed by the owner of the property, the "debtor in possession." 11 U.S.C. §§ 363(b); 1107(a). Although the bankruptcy code does not require it, in practice and recently by rule, an extraordinary sale of bankruptcy property is subjected to court approval. Bankruptcy Rule 6004(c).

Further, notice of the proposed sale and an opportunity to object must be given to all of those with an interest in the property. 11 U.S.C. § 363(b)(1). Such creditors can, on request, prevent a sale unless they are granted "adequate protection" of their interest in the property. 11 U.S.C. § 363(e). See, United States v. Whiting Pools, Inc., 462 U.S. 198, 209, 103 S.Ct. 2309, 76 L.Ed.2d 515 (1983) ("Tax collectors also enjoy the generally applicable right under § 363(e) to adequate protection for property subject to their liens").

Typically, "adequate protection" will be satisfied if the claim on the property "attaches to the proceeds of the sale." H.R. Rep. No. 595, 95th Cong., 1st Sess. 345 (1977); S. Rep. No. 989, 95th Cong., 2nd Sess. 56 (1978). "Adequate protection" can also mean granting the lien holder a replacement lien on other property of the bankrupt landowner, including property not otherwise subject to ad valorem property taxes. 11 U.S.C. § 361(2).

If timely and adequate notice of the intended property sale is not given to a lienholder, that lienholder can void the sale or assert a lien against the proceeds from the sale. Ray v. Norseworthy, 90 U.S. (23 Wall.) 128, 135, 136-137, 23 L.Ed. 116 (1875) ("Secured creditors ... must have due opportunity to defend their interests and consequently must be properly notified"); Factors, Etc., Ins. Co. v. Murphy, 111 U.S. 738, 742-743, 4 S.Ct. 679, 28 L.Ed. 582 (1884); M.R.R. Traders, Inc. v. Cave Atlantique, Inc., 788 F.2d 816, 818 (1st Cir. 1986); In re Fernwood Markets, 73 B.R. 616, 620-621 (Bkrtcy. E.D. Pa. 1987). See also, New York v. New York, N.H. & H.R.R. Co., 344 U.S. 293, 296, 73 S.Ct. 299, 97 L.Ed. 333

(1953) (holding that a city not given notice of the claims deadline did not lose its property tax liens against railroad property, despite a court decree transferring property "to the newly organized company free from the city's liens"). In this case, a review of the court proceedings on file has to be made to determine if the county was given timely notice of the proposed sale.

Additionally, a proposed sale of property in bankruptcy out of the "ordinary course of business" free of liens on the property must meet one of five conditions: (1) nonbankruptcy law permits a sale free of a lien; (2) the lienholder consents; (3) the sale price of the property is greater than the value of the liens; (4) the lien claimed is in a bona fide dispute; or (5) the lienholder could be compelled to accept a money satisfaction of its claim in a court proceeding. 11 U.S.C. § 363(f).

For an Idaho county trying to protect its liens and timely objecting to a proposed sale, only condition (3) is likely to provide an avenue allowing the sale to take place over its objection because under bankruptcy law, unlike Idaho law, ad valorem tax liens can become valueless. A bankruptcy court has the authority to grant a lien senior to all liens already attached to the property in bankruptcy to a lender who advances new financing for a business. 11 U.S.C. § 364(1) (after notice and an opportunity to be heard). Hence, where such a senior lien had been granted, one court held that junior liens on the property had no "value" and the objection of their lienholders was immaterial because the value of the property was only enough to satisfy senior liens against it and the senior lienholders agreed to the sale. In re Beker Industries, Corp., 63 B.R. 474-476 (Bkrtcy. S.D.N.Y. 1986).

Finally, in reorganization bankruptcy, Chapter 11, courts are requiring "a sound business purpose" before permitting an extraordinary sale of property. Stephens Industries, Inc. v. McClung, 798 F.2d 386, 390 (6th Cir. 1986); In re Industrial Valley Refrig. & Air Cond. Supplies, 77 B.R. 15, 17 (Bkrtcy. E.D. Pa. 1987).

Still, even though the conditions for allowing a sale are not met, if the requisite notice to lienholders is given, bankruptcy law treats an extraordinary sale of property to a "good faith" purchaser as final and free of liens previously attached to the property. 11 U.S.C. § 363(m). See, In re Magwood, 785 F.2d 1077, 1080 (D.C. Cir. 1986); In re K.C. Mach. & Tool Co., 816 F.2d 238, 242 (6th Cir. 1987); In re Exennium, 715 F.2d 1401 (9th Cir. 1983); In re Bel Air Associates, Ltd., 706 F.2d 301, 304-305 (10th Cir. 1983).

Hence, in In re Mach. & Tool Co., supra, the City of Detroit lost its property tax liens on the sold property:

Whether the abandonment order was valid or not, the property has been sold to a good faith purchaser. The City of Detroit did not move to stay the sale pending appeal. That being so, the City's argument that the liens continued to attach to the property is mooted and the liens now attach solely to the proceeds of the sale.

816 F.2d at 242. Only in extraordinary circumstances will a confirmed property sale in bankruptcy be set aside. Matter of Chung King, Inc., 753 F.2d 547, 549-550 ("fraud, mistake or a like infirmity" -- "mistake" equated with lack of notice); In re Abbotts Dairies of Pennsylvania, Inc., 788 F.2d 143, 149-150 (3rd Cir. 1986) (sale "not moot" in case where purchaser was not acting in good faith -- purchaser had offered lucrative employment to seller's principal officer).

C. ORDER TRANSFERRING LIENS

The initial court order authorizing the sale of property stated that all liens on the property were "transferring, affixing and attaching to the net proceeds of the transfer in the order of their priority as determined by the court, ..." (Order, p.4.) That paragraph is referred to by the amending order as the "seventh decretal paragraph," and was substantially amended to provide that only certain liens on the property transferred to the proceeds. (Amending Order, pp.2-3.) Both orders referred to the "approved agreement" which allocated proceeds from the sale beyond those proceeds awarded to the senior lienholder (identified as CBBL). (Order, p.4.) Another paragraph, identified by the amended order as the "Ninth decretal paragraph" in the original order, seemingly determines the allocation and payment of the remaining proceeds to lienholders "in accordance with the approved agreement" subject to the order of the court. (Amending Order, p.4.) A review of the "approved agreement" is essential to determine how the county's tax liens were treated.

Moreover, a determination must be made of whether the motion and notice initiating the hearing to allow the sale of the assets and transfer of the liens to the proceeds, dated June 16, 1987, was served upon the county. If the motion and notice adequately informed the county that its property tax liens were not protected by the proposed sale, then the order and the amending order are res judicata -- final-- as to the county at this stage. See, In re Penn-Dixie Industries, Inc., 32 B.R. 173, 177 (Bkrtcy. S.D.N.Y. 1983), where counties lost

their tax liens on property of a reorganized debtor by not objecting to the reorganization plan or the order confirming it which terminated their liens, and relegated the counties' claims to a six year payout period.

If the notice to the county of the proposed order was inadequate, the county may have recourse under Rule 60(b)(1) of the Federal Rules of Civil Procedure on the basis of "mistake, inadvertence, surprise or excusable neglect," and Bankruptcy Rule 9024 which incorporates the federal rule. Matter of Whitney-Forbes, Inc., 770 F.2d 692, 696 (7th Cir. 1985). The grounds for setting aside the orders must be asserted within one year of their entry, Rule 60, F.R.C.P.

Finally, even if the county has lost its ad valorem property tax liens, it is not without a remedy. The property tax claims for 1986 and part of 1987 are all post-petition bankruptcy claims -- and are entitled to administrative expense treatment out of the unsecured assets of the bankrupt debtor. 11 U.S.C. §§ 507(a)(1); 503(b)(1)(B)(i). See, Matter of Hirsch-Franklin, Enterprises, Inc., 63 B.R. 864, 869-871 (Bkrcty. M.D. Ga. 1986) (property taxes); In re Carlisle Court, Inc., supra. See also, United States v. Friendship College, Inc., 737 F.2d 430 (8th Cir. 1984) (employment taxes). In addition to a claim for taxes, the counties can claim as an administrative expense any penalties related to those taxes -- but not interest. 11 U.S.C. § 503(b)(1)(C). In re Mark Anthony Const., Inc., 78 B.R. 260 (9th Cir. BAP. 1987). Further, before a debtor can obtain confirmation of a plan or reorganization in Chapter 11, the plan must provide for payment of all administrative expense claims, upon the "effective date of the plan." 11 U.S.C. § 1129(a)(9)(A). The plan will also have to provide for payment of the county's pre-bankruptcy 1985 tax claim. 11 U.S.C. §§ 1129(a)(9)(B); 507(a)(7)(B). The county will have to monitor any proposed plan before it is confirmed and the county may have to move to have its post-petition tax claim allowed as required by 11 U.S.C. § 503(b).

CONCLUSION:

The delinquency entries made against the property in bankruptcy are without effect and the county cannot issue itself a tax deed for the nonpayment of the bankrupt landowner's property taxes. Further, it is likely, if the county was given adequate notice of the intended sale of the property subject to its tax liens, that the sale freed the sold property of the county's liens. The current owner of that property is not saddled with tax liens that may have been incurred while its seller owned the property. If the county was given adequate notice of the bankrupt landowner's intention to transfer only

certain liens, not including the county's, to the proceeds of the property sale then the county's ad valorem property tax liens did not transfer to those proceeds. However, if the county did not receive adequate notice of the effect of the sale on its liens, or if the notice misled the county by stating that the liens on the property would transfer to the proceeds, then the county may have recourse to attack and have modified the allocation of liens on the proceeds. Finally, even though the county may have lost its liens, or may never have acquired liens on the property following the bankruptcy, it still has a claim as for administrative expenses for the property taxes incurred by the landowner while operating under bankruptcy. Payment of those post-bankruptcy taxes must be provided for in any plan of reorganization.

Respectfully,

JOHN W. RUEBELMANN
Deputy Attorney General