

June 18, 2008

Supreme Court Rules Chapter 11 Debtor Cannot Avoid Transfer Taxes on 363 Sale

On June 16, 2008, the United States Supreme Court ruled that a debtor in a Chapter 11 case may not avoid transfer taxes associated with a sale of assets made prior to the bankruptcy court's approval of a Chapter 11 plan of reorganization or liquidation. In *Florida Department of Revenue v. Piccadilly Cafeterias, Inc.*, No. 07-312, 544 U.S. ____, 2008 U.S. LEXIS 5025(2008), the debtor, Piccadilly Cafeterias, Inc. ("Piccadilly"), requested permission to sell substantially all of its assets under 11 U.S.C. § 363(b)(1), and sought an exemption from any transfer or stamp taxes pursuant to 11 U.S.C. § 1146(a). This case is important to anyone having an interest in buying or selling assets in a bankruptcy case because it limits the exemption from state imposed transfer taxes to sales consummated under a confirmed plan, as opposed to sales done through a motion under section 363 of the Bankruptcy Code before a plan is confirmed.

In *Piccadilly*, the Bankruptcy Court had granted the exemption and approved a sale conducted prior to confirmation of Piccadilly's Chapter 11 liquidation plan. The Florida Department of Revenue ("Florida") filed an objection to Piccadilly's subsequent plan of liquidation, seeking an assessment of \$39,200 in stamp taxes on the transferred assets, arguing that the sale had not been consummated "under a plan confirmed" as required by 1146(a). Florida contended that Piccadilly was not entitled to an exemption under section 1146(a) because the sale had taken place before the Bankruptcy Court's confirmation of a plan. As such, Florida argued that the sale was not "under a plan confirmed." The Bankruptcy Court denied Florida's objection, holding that, because the sale was necessary to consummate the subsequent plan, it was conducted "under" the plan. The Bankruptcy Court's decision was upheld by the district court and the Eleventh Circuit.

Faced with a split of authority on the issue between the Eleventh Circuit (which allowed the exemption to apply to a sale consummated prior to plan confirmation) and the Third and Fourth Circuits (which held that the exemption did not apply under such circumstances (*In re Hechinger Inc. Co. of Del.*, 335 F.3d 442 (3d Cir. 2003) and *In re NVR, L.P.*, 189 F.3d 442 (4th Cir. 1999)), the Supreme Court agreed to review the case. In reconciling the conflicting circuit court decisions, the Supreme Court adopted the reasoning of the Third and Fourth Circuits, and reversed the decision of the Eleventh Circuit ruling. Writing for the majority, Justice Thomas said, "While both sides present credible interpretations of the [1146(a)] exemption, Florida has the better one... The interpretation advanced by Piccadilly and adopted by the Eleventh Circuit — that there must be 'some nexus between the pre-confirmation transfer and the confirmed plan' for the exemption to apply — places greater strain on the statutory text than the simpler construction advanced by Florida and adopted by the Third and Fourth Circuits." 2008 U.S. LEXIS 5025 at *14. Justice Breyer dissented, along with Justice Stevens, arguing that, inasmuch as an immediate sale may sometimes yield greater revenues for creditors or the estate, the exemption should not be precluded because of timing. In the words of the dissent, "it makes no difference whether a transfer takes place before or after the plan is confirmed." *Id.* at 42.

As a result of the Supreme Court's decision, pre-confirmation sales under section 363 of the Bankruptcy Code will be subject to transfer and stamp taxes assessed by the relevant states. Depending upon the size and scope of potential transfer taxes, debtors may, therefore, be forced to delay an asset sale so that it can be approved contemporaneously with confirmation of a plan. In many cases, debtors (and creditors) will have no choice but to bite the bullet and conduct the sale before a plan can be confirmed to avoid deterioration of asset values or the loss of favorable market conditions. *Piccadilly* will undoubtedly be hailed by detractors of early stage section 363 sales (some of whom now refer to such cases as "Chapter 3 bankruptcy cases"). At bottom, the Supreme Court's decision will require a case-by-case evaluation of potential transfer tax implications to determine the optimal time to conduct any asset sale in bankruptcy.

If you have any questions regarding the foregoing, please feel free to contact one of the attorneys listed below.

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