

Stamp Tax Exemption Does Not Apply to Transfers Made Before a Plan of Reorganization is Confirmed

On June 16, 2008, the United States Supreme Court decided the case of Florida Department of Revenue v. Piccadilly Cafeterias, Inc., 128 S.Ct. 2326 (2008), which is an important decision for all chapter 11 debtors seeking to sell their assets under Section 363 of the Bankruptcy Code. Historically, debtors have avoided stamp taxes and other transfer taxes that would have resulted from asset sales occurring outside of bankruptcy. Now, with the Supreme Court's decision in Piccadilly, this practice is no longer viable without first confirming a Chapter 11 plan of reorganization.

Background

Piccadilly Cafeterias, Inc. sought and received permission from the bankruptcy court to sell substantially all of its assets outside the ordinary course of business pursuant to Section 363(b)(1) of the Bankruptcy Code. Piccadilly planned to sell the assets as a going concern and sought an exemption under Section 1146(a) of the Bankruptcy Code from any stamp taxes that might otherwise have been incurred in the transfer. Section 1146(a) provides as follows:

The issuance, transfer, or exchange of a security, or the making 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.

The bankruptcy court approved the auction of the debtor's assets, and the winning bidder agreed to purchase Piccadilly's assets for \$80 million. However, a precondition to the asset sale was a global settlement agreement under which the priority for the eventual distribution of the sale proceeds among Piccadilly's various creditors was identified. The bankruptcy court approved the asset sale and the global settlement agreement, and ruled that the sale was exempt from any stamp taxes under Section 1146(a).

Shortly after the closing of the asset sale, Piccadilly filed its initial Chapter 11 plan of reorganization, which provided for the distribution of the sale proceeds in accordance the global settlement agreement. The Florida Department of Revenue filed an objection to the debtor's plan and sought a declaration that \$39,200 in stamp taxes it had assessed on certain of the assets transferred in the asset sale fell outside of the exemption because the transfer of assets had not been "under a plan confirmed" as required by the language of Section 1146(a). The bankruptcy court confirmed the plan in October 2004 over the objection of the Florida Department of Revenue. Cross motions for summary judgment with respect to the stamp tax issue were filed and the bankruptcy court granted summary judgment in favor of Piccadilly, finding that the asset sale was in fact a transfer "under" the confirmed plan because the sale was necessary for the plan to be consummated.

The district court upheld the decision finding that, in certain instances, Section 1146(a) provides for an exception to stamp taxes even when a transfer occurs before confirmation. While noting that is holding conflicted with the approaches taken by the Third and Fourth Circuits, the Eleventh Circuit affirmed as well, holding that the Section 1146(a) exemption can apply to those pre-confirmation transfers that are necessary in order to consummate a confirmed plan of reorganization. The Supreme Court granted certiorari to resolve the Circuit split.



The Supreme Court Decision

The Supreme Court reversed the Piccadilly court's decision and found that the Eleventh Circuit's interpretation of Section 1146(a) placed too great a strain on the statutory text.

The Court held that even if the language in Section 1146(a) were deemed ambiguous, nothing in other sections of the Bankruptcy Code support Piccadilly's assertion that the statute should be interpreted so broadly that the term "under" in the statute should in fact be interpreted as meaning "in accordance with". The Court also found convincing the fact that Section 1146(a) is actually a part of a subchapter entitled "Postconfirmation Matters." The Court further observed that even if it were to adopt Piccadilly's broad definition of the term "under" in Section 1146(a), Piccadilly's interpretation of the statute still faced obstacles because the asset transfer at issue could hardly be said to have been consummated "in accordance with" any plan subsequently confirmed under Chapter 11 when no plan had even been submitted to the bankruptcy court at the time the transfer was conducted.

Finally, and perhaps most significantly, the Court recognized that it had to proceed carefully whenever it is asked to recognize an exemption from state taxation that is not otherwise clearly expressed by Congress. The Court noted that it must construe the Section 1146(a) language strictly in favor of the States to prevent federal interference with the administration of State taxation schemes. The Court recognized that if it accepted Piccadilly's interpretation of the Section 1146(a) exemption, it would be effectuating an exemption from state taxation that Congress had not expressly authorized, thus violating a canon of federalism. The Court also agreed with the Fourth Circuit's summation of the Section 1146(a) exemption – "If a debtor is able to develop a Chapter 11 reorganization and obtain confirmation, then the debtor is to be afforded relief from certain taxation to facilitate the implementation of the reorganization plan. Before a debtor reaches this point, however, the state and local tax systems may not be subjected to federal interference." *Piccadilly*, 2008 WL 2404077 at *13 (quoting *In re NVR, LP*, 189 F.3d 442, 458 (4th Cir. 1999)). The Court addressed the Eleventh Circuit's "practical realities" justification for its ruling by noting that to the extent the current state of Chapter 11 reorganizations is making postconfirmation transfers a thing of the past, it is incumbent upon the Legislative Branch, and not the Judiciary Branch, to determine if the Bankruptcy Code should be revised.

Looking Forward

The Court's decision in the Piccadilly case, while not surprising, warrants caution by all players in a Chapter 11 bankruptcy case where a proposed transfer of assets may result in a liability for stamp taxes or similar taxes that are due on the sale of assets. If such taxes are likely to be incurred and the amount is such that the parties to the transaction wish to avoid the taxes, then a sale of the debtor's assets should only take place after confirmation of a plan of reorganization that contemplates such a transaction to effect the terms of the plan.

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