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Supreme Court Narrowly Construes State and Local Tax Exemption for Asset Sales in Chapter 11 Proceedings

On June 16, 2008, the United States Supreme Court, in *Florida Dept. of Revenue v. Piccadilly Cafeterias, Inc.*, Case No. 07-312, held that a bankruptcy court may not exempt a debtor from state transfer taxes on the sale of its assets prior to confirmation of its Chapter 11 plan. In a 7-2 decision, the Court reversed the order of the Bankruptcy Court for the Southern District of Florida (the "Bankruptcy Court"), which applied Section 1146(a) of the U.S. Bankruptcy Code, formerly designated as 1146(a) prior to the enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, to exempt Piccadilly Cafeterias, Inc. ("Piccadilly"), from documentary stamp taxes imposed by the Florida Department of Revenue ("Florida"), on the sale of substantially all of its assets through a public auction. The holding is anticipated to affect billions of dollars in state tax revenue collection, and it will have a significant impact on creditors of corporate debtors that elect to dispose of their assets in pre-confirmation sales under Section 363 of the Bankruptcy Code.

Pre-confirmation asset sales under Section 363 of the Code are common in Chapter 11 cases, and the trend toward such sales has grown stronger over the last few years. However, the Section 1146(a) tax exemption has not been uniformly applied. Section 1146(a) provides as follows:

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.

Piccadilly sought approval from the Bankruptcy Court for the sale of its assets prior to confirmation of its Chapter 11 plan, over Florida's objection for nonpayment of taxes. The Bankruptcy Court, following the reasoning of courts in the Second Circuit, interpreted the exemption on a "transfer under a plan confirmed," to include asset sales preceding confirmation of a Chapter 11 plan, so long as necessary to confirmation of the plan, and held that the sale under Section 363 of the Code was exempt from the imposition of Florida's documentary stamp tax. On appeal, both the District Court for the Southern District of Florida and the Eleventh Circuit Court of Appeals affirmed the Bankruptcy Court's order.

Courts in the Third and Fourth Circuits had taken a different view, interpreting Section 1146(a) to apply solely to transfers effectuated through a confirmed plan. These courts have held that Congress intended to provide exemptions only for transfers "reviewed and confirmed by the court," and thus a transfer "under a plan confirmed" contemplates only those transfers occurring after the date of confirmation.



The Supreme Court granted Florida’s petition for a writ of certiorari in order to resolve the disparity among the circuits. Florida argued in support of its appeal that the plain language of Section 1146(a) provides for a limited exemption from stamp and similar taxes on post-confirmation transfers made under the authority of a confirmed plan, and asked the Court to interpret Section 1146(a) as setting forth a simple bright-line rule.

On the other hand, Piccadilly advocated the conclusion that Section 1146(a) applies to pre-confirmation transfers that are “instrumental” to consummation of a Chapter 11 plan. Piccadilly argued that the text of Section 1146(a) is ambiguous and the intent of the provision, as well as the Chapter 11 structure, is best carried out by a broader interpretation of its application.

Ultimately the Court was swayed by Florida’s argument that §1146(a) exempts only those transfers made pursuant to a Chapter 11 plan that has been confirmed. The Court held that this interpretation was “ [t]he most natural reading of §1146(a)’s text, the provision’s placement within the Code, and applicable substantive canons.” The Court particularly noted that “recognizing an exemption from state taxation that Congress has not clearly expressed” would offend fundamental principles of federalism.

This decision is unlikely to significantly deter the current trend of pre-confirmation Section 363 sales. However, while the ruling substantially benefits the tax collection efforts of state and local government authorities, it will impede the recovery efforts of unsecured creditors, who already generally receive significantly less than they bargained for when a company liquidates through Chapter 11.

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