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***Bankruptcy Practice Alert:
Recent Supreme Court Decision Potentially
Impedes Creditors' Recovery in Chapter 11 Cases***
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A shareholder in the firm, Inez M. Markovich concentrates her practice in the areas of business reorganization and bankruptcy, loan restructuring, commercial finance transactions and creditors' rights. She has played significant roles representing secured and unsecured creditors in a variety of complex bankruptcy matters, including negotiations, documentation and obtaining approval of debtor-in-possession financings, cash collateral stipulations and adequate protection payments, Section 363 asset sales and strategic advice on negotiating of Chapter 11 plans. In addition, she represents various commercial banks, leasing companies and other financial institutions in all aspects of secured lending, asset-based lending, syndicated lending, leasing and credit enhancement transactions.

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On June 16, 2008, the United States Supreme Court entered a decision that is likely to have an impact on chapter 11 debtors who elect to sell their assets prior to the confirmation of any plan of reorganization, as well as their creditors. In Florida Department of Revenue v. Piccadilly Cafeterias, Inc., Case No.07-312, 2008 U.S. LEXIS 5025 (U.S. June 16, 2008), the Court held that assets sold at pre-confirmation § 363 sales are not exempt from state stamp taxes, including real estate transfer taxes,¹ as the exemption is only applicable to the transfers that occur pursuant to an already confirmed plan of reorganization.

The practice of selling assets prior to confirmation of a bankruptcy plan has become common in chapter 11 cases. Proponents of pre-confirmation sales believe that these transfers enable chapter 11 debtors to propose a confirmable plan by providing funds for distribution to creditors. However, courts have not interpreted the tax exemption provision found in § 1146(a) of the Bankruptcy Code uniformly. Section 1146(a) provides, in relevant part:

The issuance, transfer, or exchange of a security, or the making or delivery of an instrument of transfer under a plan confirmed ... may not be taxed under any law imposing a stamp tax or similar tax.

11 U.S.C. § 1146(a) (emphasis added).

For instance, the Second Circuit has held that sales of debtors' assets were exempt so long as those assets were "essential to confirmation of the plan,"² while

the Third and Fourth Circuits have taken the position that Congress intends to provide exemptions only for transfers occurring after the date of the chapter 11 plan confirmation.³ In light of the existing split of authority among the circuits with respect to treatment of such pre-confirmation sales for § 1146(a) exemption purposes, the United States Supreme Court decided to hear this issue and resolve the disparity among the courts.

In the Piccadilly Cafeterias case, the debtor sought the bankruptcy court's approval of the sale of its assets prior to confirmation of its reorganization plan, over the State of Florida's objection for nonpayment of taxes. The bankruptcy court interpreted the exemption on a "transfer under a plan confirmed" to include asset sales preceding confirmation of a chapter 11 plan so long as the sales are necessary to confirmation of the plan. Thus, the bankruptcy court, affirmed by both the district court and the court of appeals, held that the § 363 sale of real properties was exempt from the imposition of Florida's stamp tax.

The Supreme Court was ultimately swayed by the State of Florida's argument that the Bankruptcy Code exempts only those asset transfers made pursuant to a chapter 11 plan that has already been confirmed. The Court therefore announced a simple bright-line rule that the plain language of § 1146(a) provides for a limited exception from stamp and transfer taxes only on post-confirmation transfers.

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While the Court's decision will have the immediate impact of benefitting the tax collection efforts of state and local government authorities, it will also shape the legal strategy of both debtors and creditors in chapter 11 proceedings by impeding debtors' ability to maximize the value of their bankruptcy estates and creditors' recovery efforts in chapter 11 cases.¹

Prior to the Piccadilly Cafeterias decision, debtors would liquidate their real and/or personal assets prior to confirming (or even proposing) a plan of reorganization, and, in many jurisdictions, so long as such sales were later incorporated in a chapter 11 plan (whether a plan of reorganization or a liquidation plan) that was confirmed by the bankruptcy court, the transfers were tax-exempt. Secured creditors holding liens on the debtors' assets often benefited from these § 363 sales as well because the opportunities presented by pre-confirmation asset sales attracted many investors in the distressed-companies market who bought either the assets being sold by the debtor or the secured creditors' claims secured by such assets. As a result, secured creditors frequently recovered a substantial part (if not all) of their claims at the relatively early stages of chapter 11 procedures.

In light of the Supreme Court's recent ruling, however, debtors appear to have less of an incentive to sell their assets prior to the approval of a chapter 11 plan. In practical terms, this decision means that secured creditors will have to wait even longer before receiving the value of their secured claims. Instead of encouraging secured creditors to collaborate with debtors on sales of debtors' assets, the Piccadilly decision will force secured creditors to aggressively seek relief from the automatic stay and liquidate their collateral under the applicable state law, thus further frustrating debtors' efforts to reorganize their business affairs or, at the very least, maximize the recovery for the unsecured creditors. While it is still likely that, in light of the realities of the current economic downturn, certain debtors will have no choice other than to sell some or all of their assets prior to plan confirmation, as the sales are no longer eligible for a tax exemption, they will generate even less funds for distribution to the unsecured creditors.*

****This advisory is published by Deeb, Petrakis, Blum & Murphy, P.C. It contains a summary of legal information and is not intended to constitute legal advice on specific matters.***

¹While the Bankruptcy Code does not define the term "stamp tax," stamp taxes are creations of state or local law designed for revenue purposes to tax transfers of personal property or real estate. See In re T.H. Orlando Ltd., 391 F.3d 1287 (11th Cir. 2004).

²See In re Permar Provisions, Inc., 79 B.R. 530 (Bankr. E.D.N.Y. 1987).

³See Baltimore County v. Hechinger Liquidation Trust (In re Hechinger Inv. Co. of Del., Inc.), 335 F.3d 243 (3d Cir. Del. 2003); NVR Home\$ Inc. v. Clerks of the Circuit Courts (In re NVR L.P.), 189 F.3d 442 (4th Cir. 1999).

⁴While this commentary does not focus on state law exemptions, lenders should keep in mind that, in the event they end up placing a winning credit bid at a § 363 sale, they may still be entitled to an exemption from transfer taxes under the applicable state law.