Supreme Court Decides that Pre-Confirmation Transfer Tax Exemptions are No Longer on the Menu in *Piccadilly Cafeterias*

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On June 16, 2008, the United States Supreme Court (the "Court") held that section 1146(a)[1] of Title 11, 11 U.S.C. § 101 *et seq.* (the "Bankruptcy Code") only affords a stamp-tax exemption to transfers made pursuant to a confirmed Chapter 11 plan of reorganization, thereby resolving a conflict among several federal circuit courts.[2] While the bright-line rule established by the Court is clear, its practical implications fail to comport with the realities of most Chapter 11 cases today. The Bankruptcy Code is meant to preserve going concerns and maximize property available to satisfy creditors. The Court's narrow interpretation of section 1146(a) is inconsistent with these basic tenets and, as a result, debtors must now think twice before conducting asset sales and transfers prior to confirming a plan of reorganization.

Background

Section 1146(a) provides that "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."[3] The Court of Appeals for the Second Circuit defined the elements of a stamp tax:

> (1) [it is] imposed only at the time of transfer or sale of the item at issue; (2) the amount due is determined by the consideration for, par value of, or value of the item being transferred; (3) the tax rate is a relatively small percentage of the consideration, par value, or value of the property; (4) the tax is imposed irrespective of whether the transferor enjoyed a gain or suffered a loss on the sale or transfer; and (5) in the case of state documentary transfer taxes, the tax must be paid as a prerequisite to recording.[4]

Up until 2007, the only federal circuit courts to have decided the issue of whether a pre-confirmation [5] transfer of assets was exempt, pursuant to section 1146(a), from the stamp tax imposed by state taxing authorities were the Court of Appeals for the Third Circuit (the "Third Circuit") and the Court of Appeals for the Fourth Circuit (the "Fourth Circuit"). Both courts ruled that such transfers were not exempt.[6] The landscape soon changed in April 2007 when the Court of Appeals for the Eleventh Circuit (the "Eleventh Circuit") in *Florida Department of Revenue v. Piccadilly Cafeterias, Inc.* held that pre-confirmation transfers were exempt from stamp and similar taxes pursuant to section 1146 (a).[7] The Court granted certiorari in order to resolve the conflict among the federal circuit courts.

Split Among the Circuits

The "Temporal" Interpretation

In *NVR*, the Fourth Circuit held that a debtor's pre-confirmation transfer of real estate did not fall within the scope of section 1146(c)'s exemption provision prohibiting a stamp or similar tax on transfers "under a plan confirmed."[8] The debtor completed multiple real property transfers prior to confirming its plan of reorganization. Years after its plan became effective, *NVR* filed a motion in the bankruptcy court seeking a declaration that it was exempt from certain transfer and recordation taxes paid in connection with its pre-confirmation real property transfers.[9] The lower courts held

that these transfers were necessary to *NVR's* reorganization and emergence from bankruptcy and were "all in furtherance of, or in connection with the Plan," thus satisfying the statutory requirement that a transfer be made "under a plan confirmed."[10]

On appeal, the Fourth Circuit, guided by the Court's decision in *Sierra Summit*,[11] interpreted section 1146(c) very narrowly and held that "transfers taking place prior to the date of a reorganization plan's confirmation are not covered by § 1146(c)."[12] In support of its decision, the Fourth Circuit quoted *Sierra Summit* for the proposition that "a court must proceed carefully when asked to recognize an exemption from state taxation that Congress has not clearly expressed."[13] In the view of the Fourth Circuit, the term "under" could not be interpreted to include pre-confirmation transfers. To do so would create "new and improved tax exemptions for debtors in reorganization proceedings."[14] The Fourth Circuit did not believe that the federal courts' power was so expansive — "Congress, by its plain language, intended to provide exemptions only to those transfers reviewed and confirmed by the [bankruptcy] court."[15]

Four years later, the Third Circuit was confronted with a very similar issue. Hechinger, a retailer of home and garden care products, filed motions, pursuant to sections 363 and 365 of the Bankruptcy Code, to sell its real property interests and leasehold interests prior to the confirmation of its plan of liquidation. In connection with each of these motions, Hechinger sought a declaration from the bankruptcy court that the proposed sales would be exempt from transfer and recording taxes.[16] The bankruptcy court overruled the objections of the county and state taxing authorities and issued the declarations sought by Hechinger, on the condition that the court would eventually confirm Hechinger's Chapter 11 plan. In support of its decision, the bankruptcy court stated that "Hechinger's proposed sales were under a plan confirmed under section 1129 within the meaning of 11 U.S.C. § 1146(c), since a transfer … that is essential to or an important component of the plan process, even if it occurs prior to plan confirmation, is under a plan within the meaning of § 1146 (c)."[17] The district court subsequently affirmed the bankruptcy court's decision for the reasons stated by the bankruptcy court.[18]

On appeal, the Third Circuit determined "whether [Hechinger's] sales were carried out 'under' the eventually confirmed plan."[19] It concluded that "the phrase 'under a plan confirmed' in section 1146(c) was most likely intended to mean 'authorized by a plan confirmed.'"[20] The Third Circuit's conclusion that the term "under" means "authorized by" was influenced by (i) its consideration of the multiple meanings for the word "under" in two well-respected dictionaries,[21] (ii) its belief that this reading fit best within the remaining language of section 1146(c) [22] and (iii) its belief that that this interpretation gives the phrase "under a plan confirmed" the same meaning ascribed to it in section 365(g).[23] In addition, the Third Circuit relied on two canons of statutory construction — specifically, (i) "tax exemption provisions are to be strictly construed," and "federal laws that interfere with a state taxation's scheme must be narrowly construed in favor of the state."[24] In the opinion of the Third Circuit, "[s]ection 1146(c) both constitutes a tax exemption and interferes with the State of Maryland's scheme of property taxation."[25] Therefore, the Third Circuit held that section 1146 (c) must be narrowly construed in favor of the taxing authorities.

The "Necessity" Interpretation

In April 2007, the Eleventh Circuit became the third federal circuit court to decide "whether pre-confirmation transfers may constitute transfers 'under a plan confirmed.'"[26] However, the Eleventh Circuit declined to follow the "strict temporal limitation articulated by the Third and Fourth Circuits,"[27] and instead held that pre-confirmation transfers that are necessary for the consummation of a confirmed plan are eligible for the tax exemption provided by section 1146(c). [28]

Piccadilly sought, pursuant to section 363(b) of the Bankruptcy Code, to sell substantially all of its assets. In connection with its sale motion, Piccadilly sought an exemption from stamp taxes pursuant to section 1146(c).[29] The bankruptcy court granted Piccadilly's request because it believed that the sale was necessary to consummate the plan (which was filed within six weeks after the sale was approved by the bankruptcy court).[30] The district court subsequently affirmed the bankruptcy court's decision.[31]

In upholding the lower courts' decisions, the Eleventh Circuit reasoned that the better analytical approach to section 1146(c) is to determine whether a transfer is necessary to the consummation of a reorganization plan, as opposed to merely determining the applicability of section 1146(c) based on the timing of the asset transfer.[32] Despite the Department of Revenue's assertion that section 1146(c) should be read to impose a temporal restriction (*i.e.*, the asset transfer must occur *after* a plan is confirmed), the Eleventh Circuit stated that "[w]here Congress includes particular language in one section of a statute but omits it in another section of the same Act, it is generally presumed that

Congress acts intentionally and purposely in the disparate inclusion or exclusion."[33] The Eleventh Circuit recognized that the Third and Fourth Circuits held that tax exemptions are to be narrowly construed, but the Eleventh Circuit stated that remedial statutes, such as the Bankruptcy Code, are to be liberally construed.[34] Therefore, the Eleventh Circuit declined to follow the decisions of the Third and Fourth Circuits because those courts ignored the practical realities of Chapter 11 cases and, instead, the Eleventh Circuit held that "[section] 1146(c)'s tax exemption may apply to *those* pre-confirmation transfers that are necessary to the consummation of a confirmed plan of reorganization, which, at the very least, requires that there be some nexus between the pre-confirmation transfer and the confirmed plan."[35]

The Decision of the U.S. Supreme Court

The Court reversed the Eleventh Circuit's decision and held that "[section] 1146(a) affords a stamp tax exemption only to transfers made pursuant to a Chapter 11 plan that has been confirmed."[36] Despite Piccadilly's attempts to demonstrate that the meaning of the term "under" in section 1146(a) is ambiguous and should be read broadly in order to reflect the practical realities of Chapter 11 cases, the Court narrowly interpreted "under" to mean "with the authorization of" and found further support for its decision in the canon of construction which cautions courts to proceed carefully when being asked to recognize an exemption from state taxation that is not clearly expressed by Congress.

The Meaning of "Under"

Piccadilly asserted that the term "under" when used in the phrase "under a confirmed plan" means "in accordance with."[37] The Florida Department of Revenue asserted that the term "under" means "with the authorization of" or "inferior or subordinate" to the object to which it refers.[38] The Court acknowledged that both parties proffered credible interpretations of this term, but held that the Department of Revenue's interpretation was more credible.[39] In the opinion of the Court, Piccadilly's interpretation "places greater strain on the statutory text than the simpler construction advanced by Florida and adopted by the Third and Fourth Circuits."[40]

Piccadilly also proffered textual and contextual arguments in order to demonstrate that the term "under," when compared to its usage in other sections of the Bankruptcy Code, is ambiguous in the context of section 1146(a).[41] These arguments proved to be unavailing, and the Court failed to perceive any ambiguity within the statute.[42] If the statutory context suggested anything, the Court noted, it is that section 1146(a) is intended to deal with post-confirmation transfers since this specific code section is found within a sub-section of Chapter 11 entitled "POSTCONFIRMATION MATTERS."[43] Finally, the Court stated that even if it were to adopt Piccadilly's broad interpretation of the term "under," Piccadilly still could not prove that the asset transfer in question was consummated "in accordance with" a confirmed plan because Piccadilly did not have a plan on file at the time that it closed the asset sale.[44]

The Canons of Construction

The Court also considered various canons of statutory construction proffered by each of the parties. Florida evoked two such canons: (i) "Congress is presumed to be aware of an administrative or judicial interpretation of a statute and to adopt that interpretation when it reenacts a statute without a change"[45], and (ii) "courts should proceed carefully when asked to recognize an exemption from state taxation that Congress has not clearly expressed"[46] so as to not interfere with the administration of a state's taxation scheme. Florida asserted that if the exemption was to be extended, it would have to unwind collected stamp taxes and would be required to constantly monitor whether a debtor's plan becomes confirmed.[47]

Piccadilly asserted that courts do not need to proceed carefully when there is a "clear expression of an exemption from state taxation" overriding a state's authority to tax.[48] In Piccadilly's view, section 1146(a) embodies that clear expression of an exemption.[49] In addition, Piccadilly urged the Court to consider the maxim espoused by the Eleventh Circuit: "a remedial statute such as the Bankruptcy Code should be liberally construed."[50] Ultimately, the Court decided that *Sierra Summit*'s federalism principle required a narrow interpretation of section 1146(a).[51] If it were to follow Piccadilly's suggestion and recognize an exemption for pre-confirmation transfers, the Court would be recognizing an exemption that was not clearly expressed by Congress.[52] Thus, in the words of the Third Circuit, "it is not for us to substitute our view of … policy for the legislation which has been passed by Congress."[53]

The Bright-Line Rule

In conclusion,the Court adopted the Fourth Circuit's summation of section 1146(a) which sets forth a straightforward bright-line rule regarding the applicability of section 1146(a):

> 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.[54]

Justice Breyer's Dissent

Justice Breyer, with whom Justice Stevens joined, sided with Piccadilly and characterizes the statute as ambiguous. In his opinion, the text based arguments proffered by the parties and reviewed by the majority did not clearly support one position over another. In addition, the canons of construction did not lend any further guidance in drawing a conclusion. Rather, the dissenters looked to the purpose of the exemption—to encourage and facilitate bankruptcy asset sales.[55] They acknowledged that a transfer may take place before confirmation of a plan because the plan process takes time, and there are times when it is more advantageous for a debtor to sell its assets as quickly as possible in order to preserve the assets' value.[56] To the extent that the majority's opinion promotes the sale of assets later in a case, there is a greater chance that a debtor would realize less value for its assets. Thus, the majority opinion would have the effect of inhibiting the Bankruptcy Code's basic objectives— preserving going concerns and maximizing property available to satisfy creditors. Therefore, the dissenting justices believed that section 1146(a) supplies a "clear enough rule— transfers are exempt when there is confirmation and are not exempt when there is no confirmation."[57]

The Immediate Implications of *Piccadilly*

While the Court's bright-line rule is clear, its practical implications do not comport with the realities of most Chapter 11 cases today. Ever since the enactment of BAPCPA, the majority of Chapter 11 filings have been liquidations in which debtors, during the first 60 to 90 days of their cases, seek to either sell their businesses as going concerns or sell substantially all of their assets to the highest bidders. During this critical period, debtors typically focus on identifying and realizing value for their largest assets—realization which often occurs well before plan confirmation. Only once sales are completed are debtors typically able to draft, file (and in many cases fund) their plans of reorganization/liquidation. In addition to causing the modification of forms of asset purchase agreements and sale orders that will be filed in the bankruptcy courts, the Court's decision adds yet another layer of administrative cost to a debtor's estate that will further diminish the recovery to general unsecured creditors. Debtors will need to perform a cost/benefit analysis and decide whether paying administrative expenses associated with owning and maintaining assets through plan confirmation (in combination with potentially receiving significantly less value for the asset) outweighs the applicable stamp tax (but potentially higher bid) a debtor will have to pay if it consummates a sale prior to plan confirmation. Given the high number of liquidating cases with quickly diminishing estate assets, the application of section 1146(a) post-*Piccadilly* may very well discourage quick pre-confirmation asset sales by significantly increasing their costs.

In the end, without any Congressional intervention, debtors will either sell their assets before confirmation and pay the stamp tax, thereby reducing estate assets, or they will sell their assets after confirmation at a time when the assets are likely worth less than when the debtors first filed their bankruptcy petition. Therefore, Congress should take note of *Piccadilly*'s potential practical implications, and consider modifying section 1146(a) in a manner consistent with the interpretation and suggestions of the Eleventh Circuit as well as the underlying principles of the Bankruptcy Code.

Footnotes:

[1] Section 1146(a) was previously designated as section 1146(c). This modification to section 1146 occurred in 2005 as a result of the amendments to the Bankruptcy Code wherein former sections 1146(a) and (b) were both deleted. *See* Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, § 719(b)(3), 119 Stat. 133 ("BAPCPA"). As a result, throughout this article, sections 1146(a) and 1146(c) will be used interchangeably.

[2] *See Fla. Dep't of Revenue v. Piccadilly Cafeterias, Inc.*, No. 07-312, 2008 WL 2404077 (U.S. June 16, 2008).

[3] 11 U.S.C. § 1146(a).

[4] *In re 995 Fifth Ave. Assocs., L.P.,* 963 F.2d 503, 512 (2d Cir. 1992).

[5] In 1985, the Court of Appeals for the Second Circuit was also asked to decide whether a debtor was exempt from a stamp tax pursuant to section 1146(c) of the Bankruptcy Code; however, unlike the issue before the Third, Fourth and Eleventh Circuits, the sale of real property occurred after its plan of reorganization was confirmed. *SeeCity of New York v. Jacoby-Bender, Inc.* (*In re Jacoby-Bender, Inc.*), 758 F.2d 840 (2d Cir. 1985).

[6] *See Baltimore County v. Hechinger Liquidation Trust* (*In re Hechinger Inv. Co. of Del.*), 335 F.3d 243 (3d Cir. 2003) (hereinafter, "*Hechinger*"); *NVR Homes, Inc. v. Clerks of the Circuit Courts* (*In re NVR, L.P.*), 189 F.3d 442 (4th Cir. 1999) (hereinafter, "*NVR*").

[7] *Fla. Dep't of Revenue v. Piccadilly Cafeterias, Inc.* (*In re Piccadilly Cafeterias, Inc.*), 484 F.3d 1299 (11th Cir.), *cert. granted*, 128 S. Ct. 741 (2007), *rev'd and remanded*, No. 07-312, 2008 WL 2404077 (U.S. June 16, 2008) (hereinafter, "*Piccadilly*").

[8] *NVR*, 189 F.3d at 442.

[9] *Id.* at 447.

[10] *Id*. at 455.

[11] *Cal.State Bd. of Equalization v. Sierra Summit, Inc.*, 490 U.S. 844 (1989).

[12] *NVR*, 189 F.3d at 456.

[13] *Id*. at 457, *quoting Sierra Summit*, 490 U.S. at 851-52 (internal quotations omitted).

[14] *Id*.

[15] *Id.*at 458.

[16] *Hechinger*, 335 F.3d at 246.

[17] *Id*. at 247 (internal quotations omitted).

[18] *Id*. at 248.

[19] *Id*. at 251-52.

[20] *Id*. at 254.

[21] *See id*. at 252.

[22] *See id*. at 253 ("It is a 'normal rule of statutory construction that 'identical words used in different parts of the same act are intended to have the same meaning.'") (citations omitted).

[23] *See id*. at 254.

[24] *Id*. (citations omitted).

[25] *Id*.

[26] *Piccadilly*, 484 F.3d at 1302.

[27] *Id*. at 1304.

[28] *Id*.

[29] *Id.*at 1301.

[30] *Id*. at 1302.

[31] *Id*. (Note: On appeal to the district court, the parties did not address the issue of whether the tax exemption applied to the sale of Piccadilly's assets; rather, the parties' arguments focused on whether the section 1146(c) exemption ever applied to pre-confirmation asset transfers. Notwithstanding, the district court affirmed the bankruptcy court's "implicit conclusion" that section 1146(c) may apply to pre-confirmation transfers.)

[32] *Id*. at 1304.

[33] *Id*., *quoting Shotz v. City of Plantation, Fla.*, 344 F.3d 1161, 1168 (11th Cir. 2003) (internal quotations omitted).

[34] *Id*. (citation omitted).

[35] *Id*.

[36] *Piccadilly*, 2008 WL 2404077, at *1.

[37] *Id. at* *5.

[38] *Id*. at *4.

[39] *Id. at *5.*

[40] *Id*.

[41] *See id.* at *6-*7.

[42] *Id*. at *8.

[43] *Id*.

[44] *Id*.

[45] *Id.* at *10, *quoting Lorillard v. Pons*, 434 U.S. 575, 580-81 (1978) (internal quotations omitted).

[46] *Id*., *quoting Hechinger*, 335 F.3d at 254, (*quoting Sierra Summit*, 490 U.S. at 851-52) (internal quotations omitted).

[47] *Id*.

[48] *Id*.

[49] *Id*.

[50] *Id*. at *11 (citations omitted) (internal quotations omitted).

[51] *Id*.

[52] *Id*.

[53] *Id*. at *12, *quoting Hechinger*, 335 F.3d at 256 (internal quotations omitted).

[54] *Id*. at *13, *quoting NVR*, 189 F.3d at 458.

[55] *Id*. at *15; *see* 8 Collier on Bankruptcy, ¶ 1146.02, p. 1146-3 (15th ed. rev. 2005).

[56] *Id*. at *16, *citing In re Piccadilly Cafeterias, Inc.*, 379 B.R. 215, 224 (S.D. Fla. 2006).

[57] *Id*. at *16.