

**Charting the Evolution of the Chapter 11 Transfer  
Tax Exemption: Different Subsection, Same Lack of Clarity**

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The ability to sell assets during the course of a chapter 11 case without incurring transfer taxes customarily levied on such transactions outside of bankruptcy often figures prominently in a potential debtor's strategic bankruptcy planning. However, the circumstances under which a sale and related transactions (*e.g.*, recording of mortgages) qualify for the tax exemption have been a focal point of dispute for many courts, including no less than four circuit courts of appeal. Unfortunately, these appellate rulings have done little to clarify exactly what types of asset dispositions made during the course of a chapter 11 case are exempt from tax. Adding to the confusion is a widening rift in the circuit courts of appeal concerning the tax exemption's application to asset sales occurring prior to confirmation of a chapter 11 plan.

**Tax-Free Transfers Under the Bankruptcy Code**

Section 1146(a) of the Bankruptcy Code 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 [the Bankruptcy Code], may not be taxed under any law imposing a stamp tax or similar tax." A "transfer" includes a sale of property or the grant of a mortgage lien. To qualify for the exemption, a transfer must satisfy a three-pronged test: (i) the tax must be a "stamp or similar" tax; (ii) the tax must be imposed upon the "making or delivery of an instrument of transfer"; and (iii) the transfer must be "under a plan confirmed" pursuant to section 1129 of the Bankruptcy Code.

Bankruptcy Code section 1146(a) (changed from section 1146(c) as part of the 2005 bankruptcy amendments) serves the dual purpose of providing chapter 11 debtors and prospective purchasers with some measure of tax relief while concurrently facilitating asset sales in bankruptcy and enhancing a chapter 11 debtor's prospects for a successful reorganization. Several areas of controversy have arisen concerning the scope of the section 1146(a) tax exemption. One area of debate concerns whether, in order to be exempt from taxes, asset transfers must be made as part of a confirmed chapter 11 plan, as opposed to in a separate transaction occurring at some other time during a bankruptcy case.

Chapter 11 of the Bankruptcy Code contemplates the sale of a debtor's assets under two circumstances. In the first, a plan of reorganization (or liquidation) may include among its terms a provision transferring individual assets or even the debtor's entire business. This means that creditors whose claims are "impaired" (adversely affected, such as by receiving less than full payment) have the ability to veto the sale if they vote in sufficient numbers to reject the plan as a whole and are otherwise successful in preventing it from being confirmed.

Circumstances may dictate that waiting to sell assets until confirmation of a plan at the end of a chapter 11 case is impossible or imprudent. Accordingly, assets can also be sold at any time during a bankruptcy case under section 363(b) of the Bankruptcy Code. That provision authorizes a trustee or chapter 11 debtor-in-possession, subject to court approval, to "use, sell, or lease, other than in the ordinary course of business, property of the estate." Section 363(b) sales are an invaluable tool for generating value for a bankruptcy estate that can be used to fund a plan

of reorganization or pay creditor claims. Still, courts are sometimes critical of section 363 as a vehicle for selling all, or a substantial portion, of a debtor's assets. The criticism arises because creditors, while having the right to object to a section 363(b) sale, do not enjoy, in the context of such a sale, the protections of the chapter 11 plan-confirmation process, even though the transaction may be tantamount to a chapter 11 plan given the importance of a sale of all or substantially all of the debtor's assets to the overall reorganization (or liquidation) strategy.

The interplay between section 363(b) and section 1146 has been a magnet for controversy. The phrase "under a plan confirmed" in section 1146(a) is ambiguous enough to invite competing interpretations concerning the types of sales that qualify for the tax exemption. To date, four federal circuit courts of appeal have had an opportunity to weigh in on whether section 363(b) sales qualify for the section 1146 exemption. The remaining decision at the circuit level concerning section 1146 addresses whether transactions involving nondebtors may be exempt. Unfortunately, these rulings have done little to resolve what continues to be a growing controversy.

### **The Circuits Weigh In**

The Second Circuit first addressed this issue more than twenty years ago in *City of New York v. Jacoby-Bender*, articulating the general rule that a sale need not take place as part of confirmation, so long as "consummation" of the plan depends on the sale transaction. Many lower courts have interpreted *Jacoby-Bender* to sanction tax-exempt, preconfirmation asset sales under section 363(b). Fourteen years later, the Fourth Circuit applied a restrictive approach to tax-exempt asset transfers in chapter 11, concluding in *In re NVR LP* that the term "under" should be construed as "[w]ith the authorization of" a chapter 11 plan. Explaining that the

ordinary definition of “under” is “inferior” or “subordinate,” the court observed that “we cannot say that a transfer made prior to the date of plan confirmation could be subordinate to, or authorized by, something that did not exist at the date of transfer — a plan confirmed by the court.” The Fourth Circuit accordingly ruled that more than 5,000 real property transfers made by NVR during the course of its 18-month-long chapter 11 case did not qualify for the exemption.

In 2003, the Third Circuit Court of Appeals was the next to take up the gauntlet, and it effectively sided with the Fourth Circuit in taking a restrictive view of the section 1146 exemption in *Baltimore County v. Hechinger Liquidation Trust (In re Hechinger Investment Company of Delaware, Inc.)*. Rejecting the expansive interpretation adopted by many lower courts in determining what constitutes a transfer “under” a confirmed plan of reorganization, the court of appeals held that real estate transactions consummated during the debtor’s chapter 11 case were not exempt from transfer and recording taxes because the bankruptcy court authorized the sales under section 363, and they occurred prior to confirmation of a plan of reorganization.

The Eleventh Circuit addressed the scope of the section 1146 tax exemption in two rulings, both of which were handed down in the last three years. In the first of those decisions, *In re T.H. Orlando Ltd.*, the court of appeals adopted a very expansive approach to section 1146 in examining whether a transfer must involve the debtor and estate property to qualify for the section 1146 safe harbor. Examining the language of section 1146, the Eleventh Circuit concluded that a transfer “under a plan” refers to a transfer “authorized by a confirmed Chapter 11 plan,” and a plan “authorizes any transfer that is necessary to the confirmation of the plan.” It accordingly ruled that a refinancing transaction that did not involve the debtor or property of its

estate, but without which the debtor would not have been able to obtain funds necessary to confirm a plan, was exempt from Florida's stamp tax under section 1146, "irrespective of whether the transfer involved the debtor or property of the estate."

### **The Latest Word: *Piccadilly Cafeterias***

In 2007, the Eleventh Circuit had a second opportunity to examine the scope of section 1146. In *State of Florida Dept. of Rev. v. Piccadilly Cafeterias, Inc. (In re Piccadilly Cafeterias, Inc.)*, the court of appeals considered whether the tax exemption applies to a sale transaction under section 363(b) of the Bankruptcy Code. Piccadilly Cafeterias, Inc. filed a chapter 11 case in 2003 for the purpose of consummating a sale of substantially all of its assets under section 363(b) to Piccadilly Acquisition Corporation ("PAC"), with which the debtor had executed an asset purchase agreement shortly before filing for bankruptcy.

In conjunction with its section 363(b) motion, Piccadilly requested a determination that the sale transaction was exempt from taxes under section 1146. The Florida Department of Revenue ("DOR") opposed both the sale and the transfer tax exemption. Piccadilly also sought approval of a global settlement reached with the unsecured creditors' committee and a committee of its senior noteholders. The settlement resolved the priority of distribution among Piccadilly's creditors and, according to Piccadilly, was in many ways "analogous to confirmation of a plan."

The bankruptcy court approved the sale of Piccadilly's assets to PAC for \$80 million and held that the sale was exempt from stamp taxes under section 1146. It also approved the global settlement. Shortly after the sale order became final, Piccadilly filed a liquidating chapter 11 plan, which the bankruptcy court ultimately confirmed over DOR's objection. DOR also

commenced an adversary proceeding against Piccadilly seeking a declaration that the \$39,200 in stamp taxes otherwise payable in connection with the sale was not covered by section 1146.

Both Piccadilly and DOR sought summary judgment.

The bankruptcy court granted summary judgment to Piccadilly, ruling that the asset sale was exempt from stamp taxes under section 1146. The court reasoned that the sale of substantially all of Piccadilly's assets was a transfer "under" its confirmed chapter 11 plan because the sale was necessary to consummate the plan. The district court upheld that determination on appeal. However, it noted in its decision that the parties had addressed their arguments to whether, in general, section 1146 exempts stand-alone sale transactions under section 363(b) from tax, rather than whether the tax exemption applied specifically to the sale of Piccadilly's assets. Thus, the district court concluded that specific application of the exemption to the sale of Piccadilly's assets was an issue not properly before it. Even so, the court expressly affirmed the bankruptcy court's implicit conclusion that section 1146 may apply "where a transfer is made preconfirmation."

DOR fared no better on appeal to the Eleventh Circuit. Noting that "[t]his court has yet to squarely address whether the [section 1146] tax exemption may apply to pre-confirmation transfers," the court of appeals briefly recounted the history of this issue at the appellate level, concluding that "the better reasoned approach" is found in *Jacoby-Bender* and *T.H. Orlando*, which looks "not to the timing of the transfers, but to the necessity of the transfers to the consummation of a confirmed plan of reorganization." According to the Eleventh Circuit, the language of section 1146 can plausibly be read to support either of the competing interpretations

proffered by the parties. Even so, given the statutory ambiguity, lawmakers' intentions under section 1146 can be divined by reference to other provisions of the Bankruptcy Code that expressly and unambiguously create temporal restrictions, while section 1146 does not. If Congress includes specific language in one part of a statute "but omits it in another section of the same Act," the Eleventh Circuit, emphasized, "it is generally presumed that Congress acts intentionally and purposely in the disparate inclusion or exclusion."

Finally, the court of appeals observed, "the strict temporal construction of [section 1146] articulated by the Third and Fourth Circuits ignores the practical realities of Chapter 11 reorganization cases." Even transfers expressly contemplated in a plan, the Eleventh Circuit explained, "will not qualify for the tax exemption unless they occur after the order confirming the plan is entered." According to the court, it is just as likely that a debtor may be required to close on a sale transaction as a condition precedent to the parties' willingness to proceed with confirmation. Rejecting the restrictive approach taken by the Third and Fourth Circuits, the Eleventh Circuit held that the section 1146 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 sale and the confirmed plan." However, because the exemption's application to the sale of Piccadilly's assets (as opposed to generally) was not properly before it, the court of appeals did not rule on this issue. It stated that "we leave for another day an attempt to set forth a framework for determining the circumstances under which [section 1146's] tax exemption may apply to pre-confirmation transfers."

### **Analysis**

With *Piccadilly Cafeterias*, the rift among the circuits is widening with little hope of resolution any time soon. On one side of the divide sit the Third and Fourth Circuits, which have determined that section 1146 is unambiguous and applies only to postconfirmation transfers under a plan. On the other side are the Second and Eleventh Circuits, the rulings of which can fairly be construed to apply section 1146 to preconfirmation sales under section 363(b) (including, in the case of the Eleventh Circuit, to transfers of nondebtor property), so long as they bear some nexus to confirmation of a chapter 11 plan. Thus, the debate concerning the scope of the chapter 11 tax exemption continues.

Despite what can be characterized as an evenly pitched battle at the circuit-court level, a majority of lower courts have sided with the Second and Eleventh Circuits and adopted the more liberal interpretation that section 1146 applies to preconfirmation asset sales under section 363(b). Construing the exemption to encompass most transfers of estate property during the course of a chapter 11 case is arguably more consistent with the objective of chapter 11 as a vehicle for both rehabilitating an ailing enterprise and maximizing the value of a debtor's assets for the benefit of its estate and creditors. Still, this approach is by no means universally accepted even among lower courts, particularly where a proposed sale has little or no nexus with a contemplated chapter 11 plan.

In light of the hard-line approach advocated by the Third and Fourth Circuits, chapter 11 debtors and their professionals in these jurisdictions may be well-advised to consider an overall reorganization strategy that entails asset divestitures at the plan-confirmation stage if they want the benefit of section 1146's tax exemption. In all jurisdictions, asset divestitures should be



structured in such a way that they can be fairly characterized as having been consummated as part of, or in connection with, a reorganization or liquidation strategy that results in a confirmed chapter 11 plan.

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*State of Florida v. T.H. Orlando Ltd. (In re T.H. Orlando Ltd.)*, 391 F.3d 1287 (11th Cir. 2004).

*City of New York v. Jacoby-Bender*, 758 F.2d 840 (2d Cir. 1985).

*Baltimore County v. Hechinger Liquidation Trust (In re Hechinger Investment Company of Delaware, Inc.)*, 335 F.3d 243 (3d Cir. 2003).

*In re NVR LP*, 189 F.3d 442 (4th Cir. 1999).

*State of Florida Dept. of Rev. v. Piccadilly Cafeterias, Inc. (In re Piccadilly Cafeterias, Inc.)*, 484 F.3d 1299 (11<sup>th</sup> Cir. 2007).

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