



# LENDING AND RESTRUCTURING ALERT

**JULY 2008**

## **Supreme Court: Transfer Tax Exemption Applies Only to Post-Confirmation Transfers**

### *Overview*

Recently, the United States Supreme Court finally resolved the long-standing dispute over whether the Bankruptcy Code's exemption from stamp or similar taxes—which include state and municipal real property transfer and mortgage recording taxes—applies to assets transferred before a Chapter 11 plan of reorganization is confirmed. In short, the answer is “no.” This ruling, which represents a significant victory for taxing authorities, requires debtors to pay transfer taxes unless they postpone closings until after plan confirmation, and will affect the strategic thinking of debtors, asset purchasers, mortgage lenders and others.

### *Background*

Pre-confirmation sales of substantial assets of debtors, generally referred to as “Section 363 sales,” have become common. In practice, debtors consummate such sales in order (1) to raise money to fund plans of reorganization; (2) to maximize value as quickly as possible by selling businesses as going concerns shortly after filing for bankruptcy protection, and (3) to garner creditor support for their reorganization plans. In order to afford tax relief to debtors struggling to reorganize, some courts interpreted the Bankruptcy Code to permit debtors to sell assets before plan confirmation and still enjoy the benefit of the stamp tax exemption where the sales turned out to be essential to plan confirmation. But the Supreme Court's ruling denies bankruptcy judges such flexibility.

### *Impact*

This ruling will affect bankruptcy strategy. Real property transfer tax rates vary from jurisdiction to jurisdiction, and you must carefully weigh their impact. In the larger, more complex Chapter 11 cases, particularly those with large real estate assets, debtors will not be able to use the lure of a tax exempt transfer to attract potential purchasers. While purchasers may still be enticed by the prospect of obtaining a court order delivering property free and clear of all liens, claims and encumbrances, and a judicial finding that they have acted in good faith, the elimination of the transfer tax exemption for pre-confirmation transfers may dampen the interest of some potential purchasers, and thereby reduce the recoveries that debtors can pay their creditors. Some debtors may have to choose either to delay assets sales, and risk losing buyers, until after plan confirmation, or to accept a reduced net purchase price because the tax must be paid. Larger debtors holding multiple assets who need to dispose of some of them urgently will be harmed more than the

## HERRICK

### **New York Office**

2 Park Avenue  
New York, New York 10016  
Phone: (212) 592-1400  
Fax: (212) 592-1500

### **Princeton Office**

210 Carnegie Center  
Princeton, New Jersey 08540  
Phone: (609) 452-3800  
Fax: (609) 520-9095

### **Newark Office**

One Gateway Center  
Newark, New Jersey 07102  
Phone: (973) 274-2000  
Fax: (973) 274-2500



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smaller debtors having fewer assets (or perhaps only one), since the smaller debtors may be able to propose and confirm a plan of reorganization in less time.

Lenders holding defaulted mortgage loans sometimes prefer to recover their collateral in a Chapter 11 bankruptcy case rather than through a foreclosure sale in order to avoid having to pay state and city transfer taxes. As a result of the Supreme Court's ruling, such lenders will be required to delay taking title to the mortgaged property until after plan confirmation. This may provide some added leverage to other parties in interest in such Chapter 11 cases, who may try to enhance their recoveries or negotiate other demands or requests by attempting to obstruct or delay plan confirmation.

For further information regarding these or other lending issues, you may contact Paul Rubin at 212-592-1448 or [prubin@herrick.com](mailto:prubin@herrick.com).

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