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Minimizing a Debtor’s Tax Exposure: The Mechanics of Preserving NOLs in Chapter 11
Andrew G. Mirisis, Former Law Clerk to the Honorable Kevin Gross, Chief Judge United States Bankruptcy Court for the District of Delaware and Georgetown University Law Center, Tax LL.M., with distinction, 2011

Net Operating Losses (“NOLS”) can be a valuable asset for a company that finds itself operating within the United States Bankruptcy Code. NOLs from prior loss years can be used to offset future income if the company successfully emerges from bankruptcy, with minimal structural change to the financial foundation of the bankrupt corporation, and thus, preserving NOLs should be a priority for restructuring advisors and professionals. The Internal Revenue Code (“IRC”) delineates very specific requirements and procedures for preserving NOLs within, and outside of, chapter 11, and includes, in Section 382 of the IRC, very specific limitations on the use of NOLs that arise prior to certain changes in a debtor company’s ownership. Understanding those procedures and their limitations, as well as the bankruptcy specific safe harbors contained in IRC Sections 382(l)(5) and (6), will allow debtors' professionals and advisors to structure Bankruptcy Code Section 363 sales and plans of reorganization that allow the debtor to fully utilize all its NOLs irrespective of a change in ownership typical in bankruptcy restructurings.

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The Kathryn R. Heidt Memorial Award

On October 26, 2012, the ABA Business Law Section Business Bankruptcy Committee was delighted to award the annual Kathryn R. Heidt Memorial Award to attorney Lisa P. Sumner.

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A webinar entitled "I Consent [To the Bankruptcy Court Hearing] - Not So Fast!!!" was produced in November 2012. Additionally, in September 2012 the Committee presented a webinar entitled, "Are the Boundaries of Section 546(e) Really Safe."

Above is a link to the full webinars and to the slide show presentations.

Materials from the Business Bankruptcy Committee 2012 Fall Meeting

At the Fall Meeting of the ABA Section of Business Law Business Bankruptcy Committee in San Diego, members of the Committee presented a number of informative and interesting programs. Above is a link to all of the materials provided at these programs. (Access to some of the articles requires your ABA password.)

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The Business Bankruptcy Committee invites you to submit articles for possible publication in future issues. The articles do not need to be long or in-depth, and it is a great way to get involved in the Business Bankruptcy Committee. Articles can survey the law nationally or locally, discuss particular business bankruptcy issues, or examine a specific case. If you are interested in submitting an article, please contact Newsletter Editor-in-Chief Marvin Ruth at mrvth@lrlaw.com or Editor Natalie Daghbandan at natalie.daghbandan@bryancave.com.
Minimizing a Debtor’s Tax Exposure: The Mechanics of Preserving NOLs in Chapter 11

Net Operating Losses (“NOLs”) can be a valuable asset for a company that finds itself operating within the United States Bankruptcy Code, 11 U.S.C. § 101 et seq. (the “Bankruptcy Code”). NOLs from prior loss years can be used to offset future income if the company successfully emerges from bankruptcy, with minimal structural change to the financial foundation of the bankrupt corporation (“LossCo”), and thus, preserving NOLs should be a priority for restructuring advisors and professionals. The Internal Revenue Code, 26 U.S.C. § 1 et seq. (the “IRC”) delineates very specific requirements and procedures for preserving NOLs within, and outside of, chapter 11, and includes, in Section 382 of the IRC, very specific limitations on the use of NOLs that arise prior to certain changes in a LossCo’s ownership. Understanding those procedures and their limitations, as well as the bankruptcy specific safe harbors contained in IRC Sections 382(l)(5) and (6), will allow debtors’ professionals and advisors to structure Bankruptcy Code Section 363 sales and plans of reorganization that allow the LossCo to fully utilize all its NOLs irrespective of a change in ownership typical in bankruptcy restructurings.

A. Applying the IRC Section 382 Limitation in General

Section 382 of the IRC limits the ability to utilize NOLs that exist prior to a corporation’s ownership change. Generally, a Section 382 ownership change occurs when the percentage of a
loss corporation’s equity\(^1\) owned by one or more “5% shareholders”\(^2\) increases by more than 50 percentage points over the lowest percentage of stock owned by such shareholder(s) at any time during the relevant testing period, which is the lesser of three years or as long as the entity was a loss corporation.\(^4\) If a Section 382 ownership change occurs, the 382 limitation\(^5\) applies and limits the pre-change NOLs that a LossCo can use every year to offset post-change income. The limitation is calculated by multiplying the value of the stock of the corporation immediately before the ownership change by the federal long-term tax exempt rate, as determined under IRC § 1274(d).

This, however, is only a yearly limitation. To the extent the pre-change NOLs exceed that year’s 382 limitation, the remaining pre-change NOLs can be carried forward to the next year to offset year two’s income. Year two’s offset, however, is also limited to the 382 limitation. For example, if LossCo has $500 of NOLs, a yearly 382 limitation of $50 and $60 income in year one post-change, that LossCo would only be permitted to utilize up to $50 of NOLs each year to offset post-change income. Moreover, if the yearly 382 limitation is not exhausted by the taxable income for a post-change year, LossCo can carry the remainder of the unused yearly 382 limitation forward to year two, in addition to the new year two 382 limitation. For instance, if LossCo has $100 in NOLs, a yearly 382 limitation of $40, but only $30 of

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\(^1\) This includes common stock and “plain vanilla” preferred stock as defined in 26 U.S.C. § 1504(a)(4); See also 26 U.S.C. § 382(e)(1).

\(^2\) This can be both direct and indirect ownership. Beneficially ownership counts for purposes of 382. Moreover, all shares owned by anyone less than a 5% shareholder are aggregated and count as one shareholder for purposes of the 382 rules. Therefore, in a company where three individuals own common stock but each individually only hold 2%, 3%, and 4% (therefore none are on their own 5% shareholders), they are aggregated as a single public group and treated as a 5% shareholder under the aggregation rules. IRC § 382(g)(2); See 26 Treas. Reg. § 1.382-2T(j)(1)&(2).

\(^3\) Defined in section 382(g)(2)

\(^4\) 26 U.S.C. §382(i).

\(^5\) Another way to think of this is that the 382 “limitation” is a yearly loss allowance.
taxable income in year one post-change, the $10 of the unused year one 382 limitation can be carried forward and used in year two, in addition to year two’s $40 382 limitation, allowing LossCo $50 of available NOLs to offset year two’s taxable income.

It is important to note that the 382 limitation does not apply to post-change NOLs. LossCo is permitted to utilize post-change NOLs, in full, only if it generates the new NOLs after the 382 ownership change. Finally, if LossCo does not experience a Section 382 change of control, its NOLs are freely usable, without limitation, in any year there is taxable income subject to the twenty year carryforward provision.6

B. The IRC’s Special Bankruptcy Rules

In chapter 11 cases, debtors frequently pay off creditors by issuing new equity. This could trigger a 382 ownership change to the extent the old equity is completely replaced. However, if the debtor is balance sheet insolvent (i.e., its liabilities exceed its assets), the Section 382 limitation formula will not function properly because the debtor’s stock in that situation will be valued at zero, which when multiplied by the long-term tax exempt rate, would fail to yield a 382 loss allowance. Consequently, a bankrupt corporation in such a situation would be completely prohibited from utilizing any of its pre-change NOLs. To prevent this unintended result, Congress created special bankruptcy rules 382(l)(5) and 382(l)(6) in the IRC.

A LossCo that qualifies for Section 382(l)(5) is unimpeded by the Section 382 limitation, thereby allowing a qualifying LossCo unlimited use of its pre-change NOLs. To qualify for 382(l)(5), a LossCo’s pre-change shareholders and “qualified creditors” together, must own, 50% or more of the fair market value and voting power of LossCo’s stock7 immediately after the

7 This does not include section 1504 plain vanilla preferred stock.
A qualified creditor is a party which has either held the stock/debt for at least 18 months before filing of the bankruptcy or holds ordinary course of business debt. Additionally, there are two important caveats. The first requires that LossCo recalculate its NOLs as if the corporation did not receive interest deductions the year of the change and the prior three years. The second, provides that if LossCo experiences a second 382 ownership change within two years from the first 382(l)(5) ownership change, the 382 limitation on the second change is zero and LossCo is prohibited from utilizing any of its pre-change NOLs. If LossCo can satisfy these two restrictions, Section 382(l)(5) is a highly desirable safe harbor from the 382 loss limitations that allows a debtor the unfettered use of its pre-change NOLs.

The second safe harbor, 382(l)(6), allows a corporation to value its stock after the ownership change for 382 purposes, by multiplying the long-term tax exempt rate by the lesser of: (1) the pre-change gross asset value, or (2) the post-change stock value, to determine the section 382 limitation. Although not as desirable as 382(l)(5), opting for 382(l)(6) allows a debtor to preserve some of its pre-change NOLs by avoiding the normal application of the 382 limitation. Moreover, there is an additional requirement applicable to both safe harbors that must be satisfied to prevent a complete disallowance of NOLs under 382: continuity of business enterprise (“COBE”). COBE requires that the LossCo (or its successor) either continue the old corporation’s historical business or use a significant portion of the LossCo’s assets in the new business.

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C. Preserving NOLs in a Chapter 11

If an insolvent debtor wants to utilize its pre-change NOLs, it must satisfy 382(l)(5) or opt to use 382(l)(6) to calculate the 382 limitation. To do this, the debtor must file a NOL Motion to ensure that a Section 382 change of control does not occur prior to a Section 363 sale or the effective date of a chapter 11 plan.\(^\text{14}\) The NOL Motion is a common first day motion in a chapter 11 case where the debtor is a publicly traded company. The purposes of the NOL Motion are to: (1) provide notification to all classes of shareholders of an injunction prohibiting the acquisition of ownership of such stock above a certain threshold; and (2) ensure the debtor’s ability to preclude certain transfers, and to monitor and possibly object to other changes in the ownership of debtor’s stock, to ensure that a 50% change of ownership does not occur prior to a Section 363 sale or the effective date of a chapter 11 plan.

Generally, the NOL Motion requires that any person or entity that beneficially owns LossCo stock totalling 4.5% or more (a “Substantial Equity Holder”) of the total common stock of LossCo on or after the motion date, must file and serve a notice (the “Substantial Ownership Notice”), that details that person or entity’s stock ownership in LossCo.\(^\text{15}\) Additionally, the NOL Motion will require that, fifteen days prior to the proposed date of any transfer of stock or options that would result in an increase of LossCo stock beneficially owned by any person that is or becomes a Substantial Equity Holder, the person or entity file and serve a notice (the “Equity Acquisition Notice”) that specifically describes the stock to be acquired.\(^\text{16}\) The same applies to a

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\(^{14}\) If a 382 change of control occurred prior to the Bankruptcy Code § 363 sale, there would be two change of control transactions which would trigger the second 382(l)(5) caveat, resulting in a zero 382 loss allowance.

\(^{15}\) See generally Debtors’ Motion for Entry of (I) Interim and Final Orders Establishing Notification Procedures Regarding Restrictions on Certain Transfers of Interests in the Debtors and (II) Order Scheduling Final Hearing, 09-50026 (D.I. 88) (GM NOL Motion) at ¶ 36(a)(1).

\(^{16}\) Id. at ¶ 36(a)(2).
person or entity seeking to dispose of LossCo stock or options through an ("Equity Disposition Notice") and an ("Equity Trading Notice"). The Debtor and Official Committee of Unsecured Creditors have an objection period after any of the Trading Notices, to object to any proposed transfer of stock or options on the ground that such transfer may adversely affect the Debtors’ ability to utilize tax attributes (including NOLs) as a result of an ownership change under Section 382 or 383 or the IRC. If an objection is filed, the proposed transaction is not effective unless approved by the Court. Finally, as of the date of the NOL Motion and until further Court order to the contrary, any acquisition, disposition, or other transfer of the Debtors’ equity securities in violation of the NOL Motion procedures, is null and void ab initio as a violation of the automatic stay.

D. Sidenote: a Special Carveout for TARP Recipients

The issues created when the United States Treasury ("Treasury") took equity positions in entities receiving TARP funds forced the Treasury to create a special carveout from Section 382 for TARP recipients. In short, after providing struggling companies, such as General Motors ("GM") with direct equity infusions through TARP, the Treasury realized that when it sold its shares, it would trigger a Section 382 change of control. For example, through its bankruptcy proceeding, old GM sold substantially all of its assets under Section 363 to the Treasury Sponsored Purchaser, which created a new shell company ("New GM"). The shareholders of New GM included old GM’s creditors; the Treasury; the auto unions; and the Canadian

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17 Id. at ¶ 36(a)(3).
18 Id. at ¶ 36(a)(4).
19 Id.
20 Id. at ¶ 36(a)(5)
21 J. Mark Ramseyer & Eric Bennett Rasmussen, Can the Treasury Exempt its Own Companies from Tax? The $45 Billion GM NOL Carryforward, (Harvard Law and Economics Paper, No. 690 forthcoming)
government, who exchanged their old GM debt for new equity.\textsuperscript{22} The Treasury took a 61% stake in New GM, the sale of which, however, would trigger a Section 382 change of control transaction.\textsuperscript{23} When Congress approved TARP and it was implemented by the Treasury, the Treasury did not intend that the direct government equity infusions and eventual disposition of those shares would trigger a Section 382 change of control transaction and the resulting loss limitation provisions, thereby eviscerating a company’s ability to utilize NOLs to offset future income. To pre-empt this problem the Treasury issued a series of Notices\textsuperscript{24} that exempted TARP bailout recipients from the Section 382 provisions when the Treasury sold its shares.\textsuperscript{25}

E. Conclusion

NOLs can be a valuable asset for a debtor emerging from chapter 11. The ability to offset future taxes by applying NOLs preserved under Section 382 can be a foundational building block of the corporation’s post-bankruptcy financial success. To preserve and utilize the benefits of NOLs, restructuring advisors must be diligent in drafting and enforcing the NOL Motion to ensure it complies with Section 382, and must structure the plan of reorganization or Section 363

\textsuperscript{22} Id.
\textsuperscript{23} Id.
\textsuperscript{25} The propriety of these Notices has been criticized by some commentators arguing that TARP recipients, such as GM, improperly benefited from the exemption from § 382, and if Treasury’s sale of its shares triggered a § 382 change of control, the loss limitation should have applied to the TARP recipients. See Ramseyer & Rasmussen, (questioning the legality of the Treasury’s decision to exempt TARP Bailout recipients from the § 382 rules and by Notice allowing these companies to keep their losses despite the fact that a change of control transaction occurred triggering the § 382 loss limitation provisions); Andrew Ross Sorkin, \textit{Bending the Tax Code and Lifting A.I.G.’s Profit}, DEALBOOK, Feb. 27. 2012, available at http://dealbook.nytimes.com/2012/02/27/bending-the-tax-code-and-lifting-a-i-g-s-profit/ (arguing that A.I.G’s earnings are artificially inflated as a result of Treasury’s Notices that exempted A.I.G. (among others) from the § 382 loss limitation provisions and deprived the IRS from collecting taxes on A.I.G.’s earnings).
sale to qualify for one of the two IRC bankruptcy safe harbors, Sections 382(l)(5) and (6). This will prevent the full application of the Section 382 loss limitation and will allow the debtor the limited or unfettered use of its pre-change NOLs to offset future income.
Spotlight on Lisa P. Sumner
Recipient of the Kathryn R. Heidt Memorial Award

On October 26, 2012, the ABA Business Law Section Business Bankruptcy Committee was delighted to award the annual Kathryn R. Heidt Memorial Award to attorney Lisa P. Sumner. This memorial award honors Kate’s memory. Kate died unexpectedly in May of 2005 at the age of 51. At the time of her death, she was the chair of the ABA Business Law Section’s Business Bankruptcy Committee. Kate was a tenured member of the faculty at the University of Pittsburgh School of Law. She was an accomplished author, scholar, teacher, lawyer, and administrator. In addition to her leadership roles at the ABA, she served in leadership capacities at the American Association of Law School’s Section on Creditors’ and Debtors’ Rights. She was a counselor in the truest sense of the word -- a wonderful mother, a friend to many, a dedicated mentor to students and young lawyers, and a trusted voice of wisdom who left us too soon. This Award is designed to serve as a lasting tribute to all she was and all for which she stood and to recognize the importance of bankruptcy education and scholarship to the ABA Business Bankruptcy Committee and the bankruptcy profession.

When asked what receiving this award meant to her, Mrs. Sumner responded, “Ever since I became involved in the Business Bankruptcy Committee, I heard our colleagues talk about Kate with such professional admiration and personal fondness that I felt I missed something very special by never having the chance to know her. Her story was inspiring to me though, and helps motivate me to make whatever contributions I can to leadership, education and mentoring in our practice area despite life’s other challenges. I’m incredibly honored to receive the award, and believe it is a great tribute to her legacy that although she is gone, the women and men who worked directly with her on our Committee have invested the same time and energy she gave them to promote the growth of younger attorneys like me. It makes me want to work even harder to live up to the standard she set.”

Mrs. Sumner is a partner in the Raleigh office of Poyner Spruill LLP and serves as the Assistant Leader of her firm’s Financial Services Section. She concentrates on bankruptcy and commercial litigation matters with licenses to practice in North Carolina, South Carolina and Virginia. Mrs. Sumner’s practice reflects her extensive experience and expertise in a wide range of bankruptcy and insolvency matters, involving cash collateral, DIP financing, claims objection and lien contests, stay relief, confirmation and executory contracts, out-of-court workouts and forbearance agreements, selling and purchasing assets in bankruptcy and defending and prosecuting avoidance actions. Her practice also includes representation of banks and other business interests as plaintiff and defendant in commercial litigation including lender liability.

In addition to being honored with this Award, Mrs. Sumner has been recognized in the 2013 Edition of The Best Lawyers in America® for Bankruptcy and Creditor Debtor Rights/Insolvency and Reorganization Law; ranked in Business North Carolina magazine’s “Legal Elite” in Bankruptcy for 2010 through 2012; ranked among Law & Politics magazine’s North Carolina “Rising Stars” for Bankruptcy & Creditor/Debtor Rights in 2009 and recognized as a Triangle “Mover & Shaker” by Business Leader Media from 2009 to 2010.

Mrs. Sumner serves on the Board of Directors and as Programs Chair of Carolinas Network of the International Women’s Insolvency and Restructuring Confederation (IWIRC);
Chair of the Business Bankruptcy Committee of the North Carolina Bar Association Bankruptcy Section; on the Board of Directors of Carolinas Chapter of Turnaround Management Association and as Chairperson of the Membership Committee for the American Bar Association Business Law Section Business Bankruptcy Committee.

Mrs. Sumner earned her Juris Doctor from Duke University in 1994 and her Bachelor’s degree from University of North Carolina, *magna cum laude*, in 1991.
Eligibility for the Award

In order to be eligible to receive the Kathryn R. Heidt Memorial Award, individuals must meet the following criteria:

• Be an attorney or law student;
• Be a member of the ABA;
• Be under age 45 at the time of the nomination;
• Either have published a recent article on a bankruptcy related topic in an ABA sponsored publication or have produced a significant report, study, or other work product in conjunction with service on the ABA Business Bankruptcy Committee, a subcommittee of the ABA Business Bankruptcy Committee, or task force of the ABA Business Bankruptcy Committee;
• Have demonstrated leadership potential within the ABA or the larger legal community; and
• Have displayed generosity of spirit.