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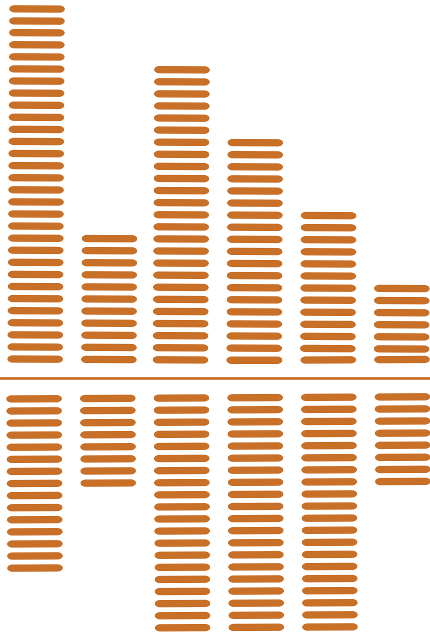

DISTRESSED INVESTING

Inside the Bankruptcy Process

Thursday, June 11, 2009

I. About the Speakers

II. Recent Developments in Credit Bidding

III. Rule 2019 Disclosure and Committee Membership Issues

IV. Pre-Packaged and Pre-Arranged Bankruptcies

V. Tax Considerations for Distressed Investing

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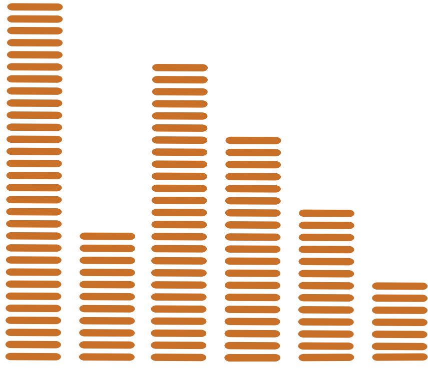

I. About the Speakers

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Lawrence V. Gelber is a partner in the Business Reorganization Group of Schulte Roth & Zabel LLP. His practice includes matters related to corporate restructuring, bankruptcy, creditors' rights, debtor-in-possession financing and distressed mergers & acquisitions.

Selected representations include:
Reorganization Cases (Debtor Representations)
Quigley Company Inc., NTL Inc., Safety-Kleen Corp., Fansteel Inc., CAI Wireless Systems Inc., Brazos Sportswear Inc., Mid-American Waste Systems Inc., United Merchants & Manufacturers Inc., Victoria Creations Inc., Wang Laboratories Inc.

Secured/Unsecured Creditors
Ableco Finance LLC, Cerberus Partners LP, Silver Point Capital LP, Wells Fargo Foothill Inc., N.Y. District Council Carpenters Benefit Funds, IUE Pension Fund, Monro Muffler Brake Inc.

Investors/Acquirers
Cerberus Capital Management LP, Prentice Capital Management LP, Tinicum Inc., Pouschine Cook Capital Management LLC, Castle Harlan Partners LP, Gerber Asset Management LLC, Gracie Capital LLP, Monro Muffler Brake Inc., Leucadia National Corp., Regiment Capital Advisors LLC

After receiving his B.A., *magna cum laude*, from Tufts University in 1980, Larry graduated *cum laude* from New York University School of Law in 1992. He is a member of the Turnaround Management Association, the American Bankruptcy Institute, the New York City Bar Association and the American Bar Association's Section of Business Law. He has had articles published in *The Bankruptcy Strategist* and has spoken at conferences sponsored by the American Bankruptcy Institute and William J. O'Neill Great Lakes Regional Bankruptcy Institute.

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David M. Hillman, a partner in the Business Reorganization Group at Schulte Roth & Zabel LLP, concentrates his practice in corporate restructuring and creditors' rights litigation, with an emphasis on Chapter 11 bankruptcy cases, as counsel to secured and unsecured creditors, bank groups, bondholders, creditors' committees, shareholders and other parties. David has significant experience litigating issues involving contested 363 sales, plan confirmation, lender liability, financing and cash collateral disputes, fraudulent transfers, preferences, equitable subordination, recharacterization, substantive consolidation and breach of fiduciary duty, among other disputes.

Some recent transactions David has handled include:

- Counsel to D.B. Zwirn Special Opportunity Fund as secured creditor, DIP lender and stalking horse bidder in Chapter 11 cases of *Everything But Water et al* (retail)
- Counsel to Cerberus Partners LP in $1 billion fraudulent transfer action in connection with bankruptcy case of *Mervyn's LLC* (retail)
- Counsel to Panasonic Corporation of North America in Chapter 11 case of *Visteon Corporation* (automotive)
- Counsel to secured creditor in out-of-court restructuring (radio broadcasting)
- Counsel to secured creditor in out-of-court asset foreclosure (automotive/account servicing)
- Counsel to secured creditor in out-of-court equity foreclosure (manufacturing)
- Counsel to Panasonic Corporation of North America as secured and unsecured creditor in Chapter 11 cases of *Circuit City Stores, Inc. et al* (retail)
- Counsel to ad hoc committee of noteholders in out-of-court restructuring (pharmaceutical)
- Counsel to Ableco Finance as agent for pre-petition secured lenders and as agent for post-petition lenders in Chapter 11 bankruptcy cases of *Global Motorsports Group* and affiliates (retail)
- Counsel to Sandell Asset Management as unsecured creditor in connection with out-of-court restructuring and bankruptcy case of *Earth BioFuels Inc.* (energy)
- Counsel to post-confirmation plan administrator for *Deltak LLC* (manufacturing)
- Counsel to creditors' committee in *Global Power Equipment Group et al.* (manufacturing)

David received his J.D., *cum laude*, from Albany Law School, where he was associate editor of the *Law Review* , and his B.A., *cum laude*, from New York State University at Oneonta.

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Dan Kusnetz is a partner in the Tax Group at Schulte Roth & Zabel LLP. His practice concentrates in tax planning for complex transactions, including mergers & acquisitions, private equity, bankruptcy, workouts, corporate restructuring and distressed asset investing, structured finance and real estate.

Dan received his LL.M. in taxation from New York University School of Law; his J.D., *magna cum laude*, from Tulane University Law School, where he was managing editor of the *Tulane Law Review* and Order of the Coif; and his B.A., *cum laude*, from Tulane University.

Significant recent engagements and transactions include:

- Representation of Chrysler LLC and its debtor subsidiaries in Chapter 11 reorganization.
- Representation of senior secured lenders in acquisition and recapitalization of Lenox Inc., a Chapter 11 debtor.
- Tax counsel to Lionel LLC in successful Chapter 11 reorganization.
- Served as tax counsel to debtors and creditors committees in numerous Chapter 11 cases over the past 20 years including: TWA, Drexel Burnham Lambert, Phar-Mor Drugstores, Resorts International, Bibb Companies; NY Daily News; Seaman's – Levitz Furniture; Ranger Industries & Mayflower Group.
- Representation of Cerberus Capital Management LP in the acquisition of a controlling interest in Chrysler LLC.
- Representation of an institutional real estate investor in a $3 billion leveraged recapitalization of a real estate joint venture.
- Representation of a major investment bank in connection with the formation of Argentine and Brazilian real estate private equity funds.
- Tax counsel to a major European bank in the acquisitions of controlling interests in fund-of-funds (hedge and private equity) managers with over $4 billion of assets under management.

Dan is a member of numerous tax bar organizations and is a frequent speaker on tax topics at conferences.

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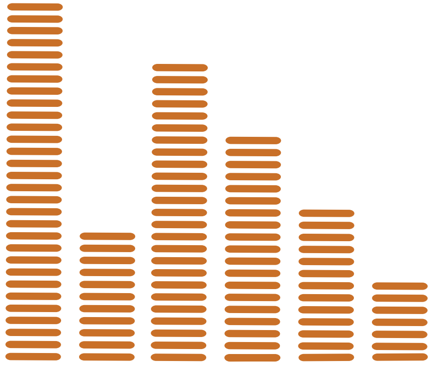
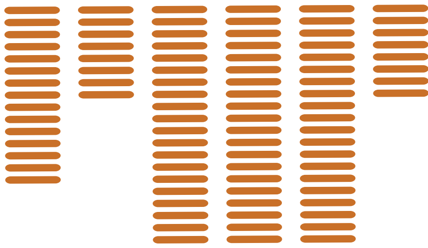


II. Recent Developments in Credit Bidding



Recent Developments in Credit Bidding

Lawrence V. Gelber

I. *Clear Channel Outdoor, Inc. v. Knupfer* (*In re PW, LLC*) 391 B.R. 25 (B.A.P. 9th Cir., 2008)

A. *Holding:* The Ninth Circuit's Bankruptcy Appellate Panel (the "BAP") held that the Bankruptcy Code ("Code") did not authorize a bankruptcy court to approve the sale of a debtor's property free and clear of a junior lien outside the reorganization plan context. Additionally, the court held that junior creditor's appeal of the lien-stripping provision in a court-approved asset sale order was not moot, for the court could still grant effective relief without prejudicing any party.

B. *Facts:*

1. *Parties*. The debtor, PW, LLC ("PW"), developed California real estate. The senior lender, DB Burbank, LLC ("DB"), held a first lien securing a $40 million claim on substantially all of PW's assets. The junior lender, Clear Channel Outdoor ("CC"), held a second lien on the same assets with a $2.5 million claim. After PW filed for Chapter 11 protection, the court ordered the appointment of a trustee. *Id.*

2. *Asset Sale Approved*. When PW and the trustee could not reach an agreement on a Chapter 11 plan, the parties agreed to sell PW's assets and obtained court approval of such sale. The parties agreed that, if there were no qualified overbidders, PW would credit bid its loan amount as the stalking horse bidder. Although CC objected to the sale, the bankruptcy court entered an order authorizing the sale (the "Sale Order") free and clear of CC's lien pursuant to Code § 363(f)(5) (stating property may be sold free and clear of a lien "only if . . . [the secured creditor] could be compelled in a legal or equitable proceeding, to accept a money satisfaction of [its lien]"). As there were no overbidders, DB purchased the assets. The sale was confirmed by an order of the bankruptcy court (the "Sale Confirmation Order") which found that DB was a purchaser in good faith. DB's credit bid meant there were no assets to which CC's lien could attach. As CC received no payment on account of its secured claim, and saw its lien release extinguished by operation of the law when the sale closed, it appealed both the Sale Order and Sale Confirmation Order.

C. *Legal Analysis:*

1. *Sale Not Free and Clear of CC's Lien*. In holding that the sale could not be free and clear of CC's lien, the BAP relied on § 363(f)(3) of the Code, which states that property *may* be sold "free and clear" of a lien only if the "price at which such property is to be sold is greater than the aggregate value of all liens on such property." 11 U.S.C. § 363(f)(3). Here, PW's property sold for less than the aggregate value of all liens on the property and, therefore, the sale was not free and clear of CC's interest.

2. *Section 365(f)(5) Did Not Support Sale Order*. As noted above, under § 363(f)(5) of the Code, property may also be sold free and clear of a junior lien holder's interest if that junior lien holder could be compelled, in a legal or equitable proceeding, to accept money in satisfaction of such interest. The BAP noted that a question left unanswered was whether there was an available legal or equitable proceeding through which a court could "compel" CC to release

its lien for "payment of an amount that was less than full value" of CC's claim. 391 B.R. at 45-46. The BAP remanded to allow the parties to identify if such a proceeding existed.

3. *CC's Appeal Was Not Moot.* Although the BAP held that the appeal from the *sale* itself was equitably moot (primarily due to third-party reliance on the Sale Confirmation Order and the sale closing), an appeal challenging the lien-stripping was not. The BAP further held that § 363(m) of the Code (protecting good faith sales and leases of property from reversal) was only intended by Congress to protect sales and leases—not lien-stripping. *Id*. at 36.

II. *In re GWLS Holdings, Inc.,* 2009 WL 453110 (Bankr. D. Del., Feb. 23, 2009)

A. *Holding*: Based on the underlying loan documents, the U.S. Bankruptcy Court for the District of Delaware allowed the collateral agent for the debtors' senior lenders to credit bid for the debtors' assets despite the fact that one of the senior lenders had objected to participating in the acquisition. *Id*. at 6.

B. *Facts*:

1. *Parties*. GWLS Holdings Inc. and others (the "Debtors") had a pre-petition debt structure which included a $337 million credit facility secured by a first lien on substantially all of the Debtors' assets. The Debtors had granted a single lien to a collateral agent (the "Agent") pursuant to a collateral agreement for the ratable benefit of all of the first-lien lenders.

2. *Lender Objects to Credit Bid.* The Debtors sought approval of a credit bid sale of their assets to the first lien-lenders pursuant to § 363 of the Code. One of the first-lien lenders, holder of a $1 million claim, objected to the sale (the "Objecting Lender"), arguing that the loan agreement required the unanimous consent of all of the lenders to proceed with the sale. The Objecting Lender relied on the waiver and amendment provision in the loan agreement, which provided that, "no . . . waiver and no . . . amendment, supplement or modification [of the terms of any of the credit documents] shall . . . release all or substantially all of the Collateral or alter the relative priorities of the secured obligations entitled to the Liens of the Security Documents, in each case without the written consent of all Lenders . . . ." 2009 WL 453110 at *2 (emphasis in original). The Objecting Lender argued that credit bidding was an amendment or waiver, for it effectively released the lien on the collateral.

3. *Agent's Rights Under Credit Agreement*. Both the Agent and the Debtors countered that the bid did not require unanimous consent of all lenders, based on a separate provision of the loan agreement. That provision empowered the Agent to "take such actions on its behalf and to exercise such powers as are delegated to the . . . Agent by the terms hereof and thereof, together with such actions and powers as are reasonably incidental thereto." *Id.* at *3. One of the powers delegated to the Agent in the collateral agreement was the power to dispose of the collateral.[1] The Agent thus argued that he could dispose of and deliver the collateral by any means, including a credit bid.

C. *Legal Analysis.*

1. *Sole Issue Contractual Interpretation*. During the hearing, the parties had agreed, "that the sole issue was the contract interpretation issue of whether the applicable agreements required unanimous written consent of the First Lien Lenders in order for the credit bid to proceed." *Id*. The court explained that under New York law, "a contract must be interpreted and enforced according to the plain meaning of its unambiguous terms . . . ." *Id.* at *4.

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[1] The collateral agreement provided that in an event of default, including the filing of a bankruptcy petition, the "Agent, on behalf of other Secured Parties, may exercise all rights and remedies of a secured party under the New York UCC or other applicable law. Without limiting the generality of the foregoing, the . . . Agent . . . may sell, lease, license, sublicense, assign, give option or options to purchase, or otherwise dispose of and deliver the Collateral or any part thereof." *Id.*

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2. *Agent Permitted to Credit Bid Objecting Lender's Claim*. The court held that based on the contractual language, the Agent was allowed to enter into a proposed credit bid on behalf of all of the first-lien lenders. Rejecting the Objecting Lender's argument, the bankruptcy court found that this contractual language "clear[ly] and unambiguous[ly] contemplated that the . . . Agent could credit bid without unanimous consent of the . . . Lenders." *Id.* at 6. Accordingly, the court permitted the Agent to credit bid the Objecting Lender's claim, allowing the sale free and clear of all liens and claims, including the Objecting Lender's $1 million claim.

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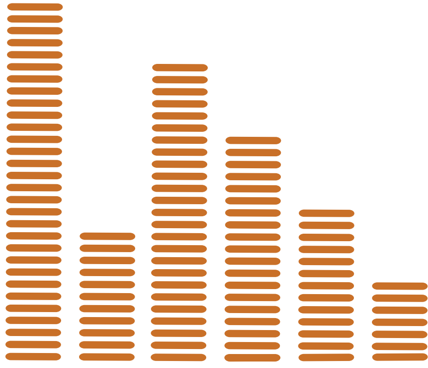
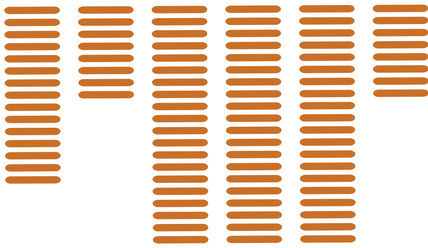


III. Rule 2019 Disclosure and Committee Membership Issues



Rule 2019 Disclosure and Committee Membership Issues

Lawrence V. Gelber and David M. Hillman [1]

I. Overview of Federal Rules of Bankruptcy Procedure Rule 2019 and Application

Bankruptcy Rule 2019 ("Rule 2019") is a disclosure rule designed to facilitate the open and fair process of a Chapter 11 reorganization case. This section summarizes the disclosure requirements set forth in this rule and the holdings of several key cases that address whether groups or committees are required to comply with its disclosure requirements.

A. Bankruptcy Rule 2019

Rule 2019 requires every entity or committee representing more than one creditor or equity security holder in a Chapter 11 case to file a verified statement setting forth:

1. The name and address of the creditor or equity security holder;

2. The nature and amount of the claim or interest and the time of acquisition thereof unless it is alleged to have been acquired more than one year prior to the filing of the petition;

3. The pertinent facts and circumstances in connection with the employment of the entity and, in the case of a committee, the name or names of the entity or entities at whose instance, directly or indirectly, the employment was arranged or the committee was organized or agreed to act; and

4. With reference to the time of . . . the organization or formation of the committee . . . the amounts of claims or interests owned by . . . the members of the committee . . . the times when acquired, the amounts paid therefor, and any sales or other disposition thereof.[2]

The court, on its own initiative or upon motion of any party in interest, must determine whether a committee has failed to comply with Rule 2019's disclosure requirements. Should the court determine that the committee failed to comply, it may refuse to permit the committee to be heard further or to intervene in the case.[3]

B. Recent Decisions

Traditionally, bankruptcy courts appeared to view compliance with Rule 2019's disclosure requirements as a mere formality. However, distressed investors' increased participation in Chapter 11 bankruptcy cases has led parties in interest in several cases to challenge the adequacy of *ad hoc* committee members' Rule 2019 disclosures, thus compelling the bankruptcy courts to consider Rule 2019 and its disclosure requirements on a more substantive level.

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[1] The authors gratefully acknowledge the assistance of Aaron Wernick and Brittany Barrient, summer associates at Schulte Roth & Zabel LLP, in the preparation of this outline.

[2] Fed. R. Bankr. P. 2019 (2007).

[3] *Id.*

1. *In re Northwest Airlines Corp.*[4]

The *Northwest Airlines* case arose during the wave of airline bankruptcies in 2005 and, among other things, led to a dispute over the scope of Rule 2019 disclosures required by *ad hoc* committees. There, a group of distressed investors holding common stock issued by Northwest Airlines Corp. formed an *ad hoc* committee (the "Ad Hoc Committee") and requested the appointment of an official committee of equity security holders. Northwest moved to compel the Ad Hoc Committee's compliance with Rule 2019, claiming that its Rule 2019 disclosure statement did not include the amounts of equity interests owned by members of the Ad Hoc Committee, the times when the interests were acquired, the amounts paid therefor, and any sales or other disposition thereof. The Ad Hoc Committee, seeking to protect confidential proprietary information regarding its members' purchases of Northwest stock, argued that no committee member represented any party other than itself, that only the members' counsel represented more than one equity security holder, and that its counsel did not have any claims against or interests in Northwest or anything else to disclose.

The court granted Northwest's motion to compel disclosure of the Ad Hoc Committee members' holdings of interests in the debtor. The court emphasized the important role that *ad hoc* committees play in reorganization cases, noting that, "[b]y appearing as a 'committee" of shareholders, the members purport to speak for a group and implicitly ask the court and other parties to give their positions a degree of credibility appropriate to a unified group with large holdings."[5]

The Ad Hoc Committee then filed a motion requesting authority to file under seal the disclosures required by Rule 2019 regarding its members' purchases of Northwest stock. The court denied the motion to file under seal, reasoning that any interest that individual committee members had in withholding confidential information was overridden by the transparency and fairness interests that Rule 2019 sought to protect.[6]

2. *In re Scotia Development LLC*[7]

The Rule 2019 disclosure issue reemerged later that same year in the U.S. Bankruptcy Court for the Southern District of Texas. In the *Scotia Development* case, however, the court denied the debtor's motion to compel an *ad hoc* noteholder group to fully comply with Rule 2019. The debtor had sought to have the court compel the noteholder group to file a complete and proper verified statement disclosing its membership and its individual members' interests. The noteholders argued that they were not subject to the disclosure requirements of Rule 2019 because they were merely a group who happened to be represented by the same law firm and did not represent anyone other than their own members. The court agreed with the noteholders, finding that the group was not a "committee" within the meaning of Rule 2019 and therefore was "not subject to the disclosure requirements under Rule 2019."[8]

3. *In re Chrysler LLC*[9]

Recently, the U.S. Bankruptcy Court for the Southern District of New York was called upon to interpret the disclosure requirements of Rule 2019, albeit in a different context. In *Chrysler*, certain so-called Non-TARP Lenders sought authority to file, in redacted form and under seal, the

[4] 363 B.R. 701 (Bankr. S.D.N.Y. 2007).

[5] *Id.* at 703.

[6] 363 B.R. 704, 709 (Bankr. S.D.N.Y. 2007).

[7] No. 07-20027-C-11 (Bankr. S.D. Tex. 2007).

[8] *Id.* at 2.

[9] No. 09-50002 (Bankr. S.D.N.Y. May 5, 2009).

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disclosures required under Rule 2019, purportedly in order to protect reputational interests. (The Non-TARP lenders alleged that they would be subjected to ridicule or scorn, and that they had already received death threats as a result of the highly-public nature of their opposition to the sale of Chrysler's assets to a new entity led by Fiat.) The court rejected the lenders' various theories in support of their motion to file their Rule 2019 Statement under seal, and required the lenders to comply with Rule 2019's disclosure requirements.

C. Proposed Changes to Rule 2019

The apparent rift resulting from the divergent holdings of the *Northwest* and *Scotia* bankruptcy courts in the application of Rule 2019's disclosure requirements has highlighted the need for consistent disclosure standards with respect to *ad hoc* groups or committees participating in Chapter 11 cases. In response, the U.S. Courts' Advisory Committee on Bankruptcy Rules has announced that it is considering amending Rule 2019.

While the Advisory Committee has yet to issue proposed amendments, industry groups and judges have weighed in on how Rule 2019 should be changed. The Loan Syndications and Trading Association ("LSTA") and the Securities Industry and Financial Markets Association ("SIFMA") have advocated for the repeal of Rule 2019. These groups argue that distressed investors' participation in Chapter 11 cases provides liquidity in distressed debt markets, thus benefiting the reorganization process, and that proposals to preserve or enhance disclosure requirements would have a chilling effect on the distressed debt market and reorganization process.

A Special Task Force of the ABA Section of Business Law recently issued a report regarding proposed changes to Rule 2019. The report set forth three proposed amendments:

1. To apply the Rule uniformly to *ad hoc* committees, official committees, and all other groups of creditors or equity holders that band together through shared professionals to advance common positions and strategies;

2. To include a provision giving the Bankruptcy Court authority . . . to enter an order waiving the requirement of disclosure of the purchase price or trade date information or other information that a claim or equity holder believes is confidential; and

3. To provide more clarity as to when supplemental disclosure is required.[10]

Two bankruptcy judges have also weighed in on proposed changes to Rule 2019. First, Judge Robert E. Gerber of the U.S. Bankruptcy Court for the Southern District of New York sent a letter to the Advisory Committee urging changes to Rule 2019. Judge Gerber acknowledged the important role that distressed investors play in bankruptcy cases, but warned the Advisory Committee that these investors' interest in maximizing short-term returns might be inconsistent with Chapter 11's overarching goal of stabilizing and reorganizing businesses. Judge Gerber thus offered several amendment proposals to the Advisory Committee:

1. Clarify that short positions or derivatives of economic substance held by committee members must be disclosed;

2. Require disclosure of interests in derivatives . . . that result in a decoupling of record or beneficial ownership and economic risk;

3. Require that any disclosures must include such additional information as is necessary to make that which was disclosed not misleading;

[10] *Report of the Business Bankruptcy Committee Special Task Force on Bankruptcy Rule 2019*, Dec. 12, 2008.

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4. Require disclosure of any position or interest that would result in a financial gain upon the failure or delay of the Chapter 11 case, or upon decreased recoveries by any other constituency;

5. Clarify that Rule 2019 requires disclosure of the required information for each individual member of any group, and that disclosure in the aggregate is insufficient;

6. Clarify that Rule 2019 covers any instance in which multiple creditors are represented by the same counsel, regardless of whether they call themselves a "committee"; and

7. Broaden Rule 2019 to provide that without having first made the required disclosures, no party in interest (including a single party in interest, committee, or group of parties in interest):

   (a) Shall make any representation to the court as to the amount or nature of its ownership or control of any debt of (or interest in) the debtor (or any of the debtors in a multi-debtor case),

   (b) Shall be heard on any motion involving a determination by the bankruptcy court that reasonably can be expected to be subject to judicial discretion, or to involve consideration of what is in the best interests of a debtor, its creditors, or equity security holders.[11]

In addition, Judge Robert D. Drain, also a Southern District of New York bankruptcy judge, has written to the Advisory Committee. In his letter, Judge Drain expressed his support for Judge Gerber's proposals and his desire to preserve an amended form of Rule 2019.[12]

II. Potential Securities Law Consequences of Forming Groups

In addition to the Rule 2019 disclosure requirements, "group" formation in connection with a public company bankruptcy case also may trigger disclosure requirements under federal securities laws, under which any person who acquires, directly or indirectly, five percent of a corporation's equity must disclose the number and percentage of shares owned, as well as the purpose of the acquisition, on Schedule 13D within ten days of crossing the five percent threshold.[13] Alternatively, any person who, among other requirements, purchases greater than five percent of a corporation's equity securities not for the purpose or effect of changing or influencing control of the issuer may file a short-form disclosure statement on Schedule 13G.[14]

A group of two or more persons or entities acting together for the purpose of acquiring, holding, voting or disposing of an issuer's securities, will be deemed to be a "person" for purposes of Schedule 13D/13G reporting. Accordingly, even if Rule 2019 did not mandate in a given case that *ad hoc* committee members disclose their intent for purchasing equity securities of a Chapter 11 debtor corporation, federal securities disclosure laws may be applicable, and may serve as a deterrent to forming distressed investor groups in those instances in which distressed investors are, or might be, reluctant to disclose the reasons for their holdings.

III. Informal or *Ad Hoc* Committees

A. Benefits of Participating in *Ad Hoc* Committees

Notwithstanding the potential Rule 2019 or federal securities law disclosure requirements, there can be a number of advantages to participating as a member of an *ad hoc* committee in a Chapter 11

[11] *Letter of Judge Robert E. Gerber,* Jan. 9, 2009.

[12] *Letter of Judge Robert D. Drain,* Jan. 13, 2009.

[13] Filing of Schedules 13D and 13G.

[14] *Id.*

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bankruptcy case. Most result from the effects of collaboration of individual creditors or equity security holders with common interests. For example, *ad hoc* committees find that they have enhanced power due to their increased numbers, their unity and coordination with each other, and their ability to work together to develop creative solutions. Participation affords committee members an “expansive” right to appear and be heard on any and all issues arising out of a bankruptcy case,[15] because when committees appear and voice their concerns, courts often accord special weight to their views. Formation of a committee also allows its members to share the costs of participation in the Chapter 11 process, which can be significant. (In addition, §§ 503(b)(3)(D) and (4) of the Bankruptcy Code provide that costs, including professional fees, incurred by an entity—which may include an *ad hoc* committee in making a “substantial contribution” to the case, will be paid by the estate as priority administrative expense claims.[16]) Above all, participation in an *ad hoc* committee may be beneficial because it can provide a creditor or equity security holder the ability to wield enhanced influence in a bankruptcy case without being subject to formal court oversight or to the enhanced fiduciary obligations attendant to membership on a statutory committee.

B. Burdens of Participating in *Ad Hoc* Committees

There are, however, several potential disadvantages associated with participation in an *ad hoc* committee. As discussed above, Rule 2019 may require *ad hoc* committee members to disclose confidential or proprietary information. This disclosure could not only open a window to a distressed investor’s trading strategies, but could also negatively effect the committee’s negotiating leverage, particularly once the debtor knows the true scope of economic risk facing the committee members. As a result, investors who wish to maintain not only the confidentiality of their holdings in a Chapter 11 debtor, but also the timing and pricing of their purchases of those holdings, may not be inclined to sit on *ad hoc* committees at all, despite the several advantages of participation. Finally, participation in an *ad hoc* committee may restrict trading freedom (*e.g.*, if a member of an *ad hoc* committee acquires material non-public information about the debtor by virtue of its position on the committee, it will be precluded from trading while in possession of that information).

IV. Creditors’ Committees

A. Benefits of Participating on Creditors’ Committees

Under §1102(b)(1) of the Bankruptcy Code, a creditors’ committee “ordinarily” must consist of “the persons, willing to serve, that hold the seven largest claims against the debtor of the kind represented by the committee.”[17] As with participation on an *ad hoc* committee, service on a creditors’ committees carries with it certain advantages. The members of the creditors’ committee are appointed by the U.S. Trustee soon after the commencement of the case; thus, throughout virtually the entire process, they have a seat at the negotiating table from which they can wield significant influence over the direction and ultimate outcome of the case. Creditors’ committee members have a duty both to investigate the financial affairs of the debtor and to participate in formulating a plan of reorganization. These duties provide them with access to a great deal of information about the debtor and the debtor’s assets, information that likely would not otherwise be available to them. Their decision-making authority allows for greater control over the treatment of their own claims.

Membership on a creditors’ committee also substantially reduces the cost to individual creditors of participation in the Chapter 11 process. The fees and costs of court-approved professionals hired to advise a creditors’ committee, including counsel and accountants, are payable by the debtor as administrative expense claims. Additionally, although no provision in the Bankruptcy Code allows for remuneration for the actual services performed as a member of a creditors’ committee, any personal

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[15] Howard J. Steinberg. *Bankruptcy Litigation*. 2nd Ed. Thomson/West, 2008.

[16] Paul D. Leake and Mark G. Douglas. “Ad Hoc Committee Disclosure Requirements – a Bitter Pill to Swallow for Distressed Investors.” *Business Restructuring Review*. May/June 2007.

[17] Thomas J. Salerno and Jordan A. Kroop. *Bankruptcy Litigation and Practice: A Practitioner’s Guide* 4th Ed. Vol. I. New York: Wolters Kluwer Law and Business, 2008.

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expenses incurred by committee members in performing their duties, such as travel expenses, may be reimbursed by the estate.

B. Burdens of Participating on Creditors' Committees

Although the Bankruptcy Code suggests that the typical creditors' committee will consists of seven members, it is not uncommon that fewer than seven persons or entities will be willing to assume the burdens and responsibilities of membership, first and foremost of which is the duty to safeguard the interests of all parties comprising the committee's constituency. Not surprisingly, this duty may often conflict with an investor/participant's own self-interests. Although committee members are not required to entirely abandon their own interests while taking an active role in the committee, they must not advance those interests at the expense of the committee's constituents. Further, while a committee member has qualified immunity (*e.g.*, there is no absolute immunity from suits related to actions that may damage a debtor's business or reorganization efforts) as long as it executes its duties in good faith, a willful violation of its fiduciary obligations could render the committee member liable for, among other things, monetary damages.

The obligations associated with participation on a creditors' committee also include, among others, a duty to consult with the debtor as to matters of case administration, and a duty—imposed as part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005—to "provide access to information for creditors who . . . (i) hold claims of the kind represented by that committee and (ii) are not represented by that committee." (Non-member creditors still will not be entitled to access confidential or privileged information provided by the debtor to the committee.) Members are also obligated to solicit and receive comments from all creditors regarding developments in the Chapter 11 case and, like members of *ad hoc* committees, are subject to trading restrictions if they receive material non-public information from or about the debtor. (In some public company Chapter 11 cases, courts have entered so-called "trading orders," which establish procedures to allow for the otherwise-restricted trading, but these orders involve potentially burdensome procedures, ethical walls, reporting requirements, and an overall extra level of complexity. Also, violation of a trading order may result in harsh penalties such as sanctions, disgorgement of profits, and/or removal from the committee.)

C. Additional Considerations for Participating in Creditors' Committees

If an entity wishes to serve on a creditors' committee, there are a few practical steps that it should take. First, it should express its interest in serving to the U.S. Trustee. In most districts, committees are appointed at a formal organizational meeting held by the U.S. Trustee, so a representative from the entity should attend that meeting and be prepared to convince the Trustee that the entity's presence on the committee would advance the goal of ensuring adequate representation of all interests, including those of the debtor and the other creditors. If the entity is unable to convince the U.S. Trustee to appoint it voluntarily, the entity may petition the bankruptcy court to override that decision. To override the U.S. Trustee's decision, the entity must demonstrate that the committee as appointed by the Trustee will not adequately represent the interests of all affected constituents, or that the entity was somehow wrongfully excluded from the committee. However, the court accords substantial deference to the decision of the U.S. Trustee in this matter. If the interests of the entity are significantly adverse to those of the committee as formed by the U.S. Trustee, the entity may petition the court to appoint an additional committee comprised of persons or entities with interests similar to those of the entity in question (*e.g.,* a landlords' committee or a tort victims committee).

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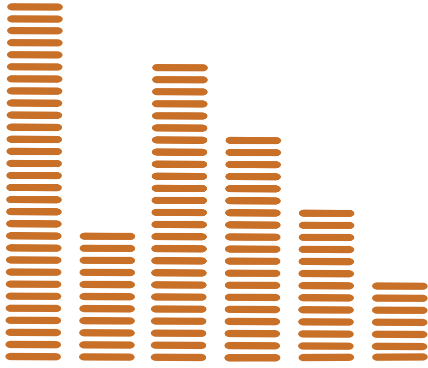

IV. Pre-Packaged and Pre-Arranged Bankruptcies

Pre-Packaged and Pre-Arranged Bankruptcies

Lawrence V. Gelber and David M. Hillman

I. Pre-Packaged Bankruptcy

A. *Scenario*: Before commencing a bankruptcy case, future debtor negotiates a plan with lenders, bondholders and/or other key constituents, then (also prior to commencement of the case) solicits acceptances of the plan so that an already accepted plan can be filed on the petition date and promptly be considered for confirmation.

B. *Recommended Applications*: Balance sheet restructurings (*i.e.*, cases involving a relatively small number of significant creditors who are willing to cooperate to rationalize a debtor's capital structure). Not recommended for companies in need of operational restructuring (*e.g.*, lease rejections).

C. *Process*:

1. Future debtor negotiates terms of plan with key constituents and, perhaps, enters into plan support or "lock-up" agreements with those constituents, pending negotiation of definitive documentation (*i.e.*, plan, disclosure statement and ancillary documents).

2. Future debtor disseminates plan and disclosure materials to those impaired creditors and/or interest holders entitled to vote on plan; disclosure materials must contain "adequate information" (*i.e.*, information of type and amount adequate to permit a hypothetical reasonable investor to make informed decision to vote to accept or reject plan).

3. If sufficient impaired creditors (2/3 in amount and 1/2 in number) and/or interest holders (2/3 in amount) vote to accept plan, debtor commences bankruptcy case and files plan on first day, together with petition and appropriate "first day motions," such as scheduling motion, schedules of assets and liabilities and statement of financial affairs, financing motion, and/or bar date motion.

4. Court schedules and promptly holds hearing(s) to approve disclosure statement and confirm plan. Barring any significant complications, plan may be confirmed—and debtor may exit Chapter 11—in 30–60 days.

D. *Advantages*:

1. Avoids risk, cost, and delays of extended and/or contested bankruptcy proceedings; permits debtor to bind holdouts (*e.g.*, recalcitrant bank syndicate members or bondholders).

2. Assures a court-approved and court-supervised restructuring.

3. Assures orderly transfer of title, free and clear of all liens, claims, interests and encumbrances, pursuant to a plan confirmed by court order.

4. Minimizes disruption to company's operations, maximizes debtor's control of its case, and means less deterioration of the debtor's property over time.

5. Tax advantages include the following:

   (a) In states with high transfer taxes, use of a prepackaged plan is a means to accomplish a consensual transfer of distressed real estate. (Bankruptcy Code exempts transfers pursuant to a bankruptcy plan from state transfer taxes provided that the sole purpose of the plan is not tax avoidance.)

   (b) Plan may provide for transfer of title in a subsequent calendar or tax year.

E. *Disadvantages*:

1. Not feasible if primary creditors are adverse.

2. Not feasible if debtor has a large number of creditors with a variety of types of claims (*e.g.*, trade creditors, employees, landlords and equipment lessors) that require impairment to ensure success of restructuring.

3. Not feasible if debtor has significant amount of contingent claims.

4. Pre-petition negotiation and solicitation takes time; future debtor does not receive benefit of "breathing spell" offered by automatic stay during negotiation and solicitation phase of a traditional Chapter 11 case.

5. Pre-petition disclosure and solicitation may publicize future debtor's financial distress. Could result in:

   (a) Unsecured creditors commencing an involuntary bankruptcy case

   (b) Creditors tightening credit terms or ceasing to provide credit

   (c) Lower credit ratings

6. Generally more expensive than an out-of-court restructuring.

7. Risk exists that bankruptcy court determines, after bankruptcy case has been filed, that pre-petition solicitation process failed to meet Bankruptcy Code's requirements.

F. *Additional Considerations*:

1. Transfers of property under plan will be exempt from transfer/stamp taxes.

2. Securities issued under plan may be exempt from registration requirements of Securities Act of 1933.

3. Trade claims generally will remain unimpaired and be paid in full in the ordinary course of business.

4. Administrative costs (*e.g.*, post-filing expenses and costs of Chapter 11 case) must be satisfied in full, in cash, by debtor on or before plan is consummated.

II. Pre-Arranged Bankruptcy

A. *Scenario*: Before commencing a bankruptcy case, future debtor negotiates a plan with lenders, bondholders, and/or other key constituents. Key constituents often will be required to enter into a

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lock-up/plan support agreement before debtor will commence case. Debtor files plan and a disclosure statement on or shortly after commencing its case and solicits acceptances of plan promptly thereafter.

B. *Recommended Applications*: Like pre-packaged cases, works best for balance sheet restructurings (*i.e.*, cases involving a relatively small number of significant creditors who are willing to cooperate to rationalize a debtor's capital structure but whose votes cannot be solicited prior to case commencement[1]). Also, not recommended for companies in need of operational restructuring.

C. *Plan Support/Lock-Up Agreements*:

1. *Scenario:* Supporters of plan receive debtor's commitment to key, negotiated benefits under plan (*e.g.*, specified payment terms, interest rate, beneficial timing of payments, favorable conversion of debt to equity, releases, etc) in exchange for committed support of plan.

2. *Key Terms*:

(a) In exchange for negotiated benefits received under Plan, creditors typically agree to, among other things:

(i) Support plan

(ii) Vote to accept plan and/or use best efforts to obtain confirmation of plan

(iii) Refrain from objecting to confirmation of plan

(iv) Refrain from proposing, pursuing or supporting any competing plan

(v) Refrain from taking action to convert or dismiss the debtor's Chapter 11 case

(vi) Refrain from trading their claims against or securities of debtor, unless assignee agrees to be bound by plan support agreement

(b) Plan supporters often insist on milestones (*e.g.*, timing of approval of disclosure statement, confirmation hearing and effectiveness of plan) to keep confirmation process on track.

3. *Two Notes of Caution*:

(a) Section 1125(b) of Bankruptcy Code prohibits solicitation of votes to accept a plan during the pendency of a bankruptcy case unless, when transmitted to voting persons or entities, plan is accompanied by a court-approved disclosure statement. To avoid allegations of improper solicitation, parties should be sure to enter into plan support agreement before bankruptcy case is commenced. *See In re Stations Holding Co.*, Case No. 02-10882 (MFW) (Bankr. D. Del. 9/25/02); *In re NII Holdings, Inc.*, Case No. 02-11505(MFW) (Bankr. D. Del. 10/22/2002).

(b) Entering into a plan support/lock-up agreement may preclude a creditor from being eligible to serve on a statutory committee of unsecured creditors. Parties should consider including a "fiduciary out" provision in plan support/lock-up agreement if they intend to seek to serve on the committee.

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[1] Inability to solicit votes prior to case commencement may be due to, among other things, insufficient time and resources, insufficient committed support to assure acceptance, or lack of available exemption from registration requirements under securities laws

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4. *Pre-Packaged vs. Pre-Arranged*:

(a) Pre-arranged bankruptcy can be used instead of pre-packaged bankruptcy if debtor is unable to reach a deal with a sufficient number of its impaired creditors (*i.e*., less than 2/3 in amount and 1/2 in number) to carry vote, but is able to obtain committed support of a significant amount of the affected impaired class (*e.g.,* 40–50%).

(b) In a pre-arranged bankruptcy case, risk of infirmities in solicitation process is reduced because solicitation procedures will be pre-approved by bankruptcy court.

(c) Pre-arranged bankruptcy case likely will be more costly and time-consuming than pre-packaged bankruptcy case because of extended period in bankruptcy; extended time in bankruptcy also may result in debtor having less control over case than in a pre-packaged case, in which plan has been accepted before the petition date and, often, no creditors' committee will be appointed.

(d) Pre-arranged bankruptcy case likely will require more DIP financing than pre-packaged case.

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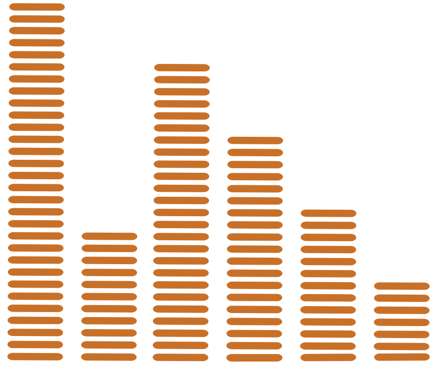
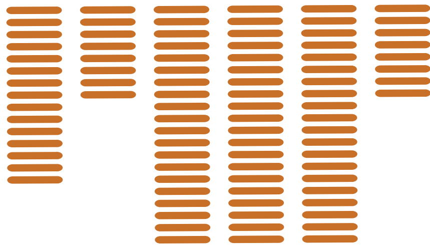


V. Tax Considerations for Distressed Investing



Tax Considerations for Distressed Investing

Dan A. Kusnetz

I. Distressed Company Acquisition Structures

A. Debt-for-debt exchanges out of bankruptcy

1. Tax-Free Recapitalizations—If the debt exchanged and the debt acquired are both "securities," the exchange will be a recapitalization under § 368(a)(1)(E).

(a) Tax consequences to Issuer and Holder: There is no gain or loss on the exchange to the Issuer or Holder, but beware of accrued and unpaid interest. Also note: Where the new principal amount exceeds the old principal amount, the Holder could have an "excess principal amount" issue, which could require the Holder to include that amount as income under § 356.

2. Taxable Transactions—If the exchange is not a recapitalization, then it could be a taxable transaction. Where existing debt terms are being modified, the modification will be taxable if it constitutes a significant modification of the debt instrument.

(a) Tax consequence of a significant modification to Issuer and Holder: The modification is treated as a taxable exchange, and both the Holder and the Issuer may recognize a gain or loss on the exchange.

(i) The Holder will recognize a gain or loss equal to the difference between the issue price of the new debt and the Holder's tax basis in the old debt. Additionally, the Holder will have interest income for any accrued but unpaid interest to the extent the interest income has not already been taken into income.

(ii) The issue price of the new debt will be equal to its stated principal amount so long as the old and new debts were not traded on an established market. If new notes are traded on an established market, their issue price will equal their fair market value on the date of issuance. If the old notes were traded on an established market but the new notes are not, the issue price of the new notes will equal the fair market value of the old notes on the date of the exchange.

(iii) The Issuer will recognize cancellations of indebtedness ("COD") income to the extent the old debt's adjusted issue price (*i.e.*, the outstanding amount of debt immediately before the discharge) exceeds the amount paid to satisfy the debt. (See COD discussion below at IV.)

(b) Tax consequence if not a significant modification: There is not a taxable exchange, and neither party has tax consequences.

(c) Examples of "modifications" include a change of obligor, an addition or deletion of a co-obligor and a change in the recourse nature of the instrument.

(d) Examples of "significant" modifications include:

(i) Change in yield of more than a *de minimis* amount

(ii) Change in the timing of payments

(iii) Change of the obligor on recourse debt instrument

(iv) Change in priority of debt

(e) Beware: If the new debt instrument allows for paid-in-kind ("PIK") interest, parties will need to test the new instrument under the AHYDO rules. (Note: 2009 Recovery Act suspends the AHYDO rules for instruments issued during the period beginning on Sept. 1, 2008, and ending on Dec. 31, 2009, so long as the debt instrument is replacing a non-AHYDO debt instrument and the Issuer remains the same.)

B. Debt-for-debt exchanges in bankruptcy

1. A debt-for-debt exchange in bankruptcy receives the same treatment as a debt-for-debt exchange outside of bankruptcy, except that the Issuer can take advantage of bankruptcy-specific COD rules. (See COD discussion below at IV.)

C. Debt-for-equity exchanges outside of bankruptcy

1. If the debt constitutes a security, then a debt-for-equity exchange is a recapitalization. (See the discussion above for tax consequences of a recapitalization.)

2. If the exchange is not a recapitalization because the debt is not a security, then the debt-for-equity exchange is a taxable exchange.

(a) Tax consequences to Holder: The Holder will recognize gain (or loss) to the extent the fair market value of the equity received exceeds (or is less than) the Holder's basis in the debt exchanged (unless the exchange qualifies under § 351).

(b) Tax consequences to Issuer: The Issuer will recognize COD income to the extent the adjusted issue price of the debt exchanged exceeds the fair market value of the equity issued.

(i) There are special rules for valuing partnership interests. Under Proposed Treasury Reg. § 1.108-8(b)(1), a partner can use the liquidation value of the partnership to determine the fair market value of the interest.

D. Debt-for-equity exchanges in bankruptcy

1. Debt-for-equity exchanges in bankruptcy get the same treatment as when outside of bankruptcy, except:

(a) The Issuer can take advantage of bankruptcy-specific COD rules (See COD discussion below at IV); and

(b) The Holder may be able to take advantage of §§ 382(l)(5) or (l)(6) if such an exchange would trigger an ownership change under § 382. (See §§ 382(l)(5) and (l)(6) discussion below at III.)

E. Credit-bidding by lenders (outside of a G reorganization context)

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1. Generally, the lender(s) buy assets from U.S. debtors in exchange for outstanding debt claims.

2. The lenders may need to pool debt claims into a joint venture where multiple lenders are participating.

   (a) The lenders may form an entity treated as a partnership or a corporation from a tax perspective.

      (i) Beware of the application of § 362(e) when forming a corporation.

   (b) When the joint venture makes an acquisition, the lenders will need to determine the joint venture's basis in the acquired assets.

      (i) Treas. Reg. § 1.166-6 provides that the lender's basis in the assets acquired is equal to the fair market value of the property on the date of its acquisition. The Treas. Reg. also provides a presumption that the fair market value of the property is the amount for which it is bid in by the lender. Under the presumption, if the full amount of the debt is bid, then the fair market value of the property equals the full amount of the debt.

      (ii) The lenders may overcome the presumption on fair market value in (i) above by proving by clear and convincing evidence that the fair market value of the assets acquired is different than the amount of debt claims surrendered (generally proven by obtaining a contemporaneous third-party appraisal).

      (iii) Beware: Where the debt was acquired at a discount or has been marked-to-market for TAX PURPOSES, the Treas. Reg. presumption could trigger gain to the lender on the exchange.

3. Tax treatment to lenders

   (a) The lender recognizes gain (or loss) on the exchange to the extent the value of the assets acquired exceeds (or is less than) the lender's adjusted basis in the debt exchanged. Where the lender has full basis in the debt and relies on the presumption in the Treas. Reg., there should be no gain or loss on the exchange.

   (b) The Net Operating Losses ("NOLs") do not carry over with the assets. The NOLs will be left behind with the Debtor.

4. Tax treatment to Debtor

   (a) The Debtor recognizes gain (or loss) on the exchange to the extent the fair market value of the assets transferred exceeds (or is less than) the Debtor's adjusted tax basis in those assets.

   (b) Additionally, the Debtor could have COD income to the extent the amount of outstanding debt cancelled is less than the fair market value of the assets transferred, so long as debt is recourse.

   (c) Where the Debtor is in bankruptcy, § 108 limits the effects of COD income. Where the Debtor is not in bankruptcy, COD income is fully taxable. (See COD discussion below at IV.)

F. Credit-bidding in a G reorganization context

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1. Generally, a G reorganization occurs where a new corporation (“Newco”) acquires substantially all of the assets of the Debtor in exchange for Newco stock/debt and the Debtor distributes the Newco stock/debt to its shareholders in complete liquidation of the Debtor. § 368(a)(1)(G).

2. The G reorganization provision is not an elective provision. If a taxpayer does not want a tax-free transaction, the taxpayer should be careful not to accidentally fall into the reorganization provision.

3. Primary benefits of G reorganization: There is no gain on the exchange to the parties and all of the tax attributes (including NOLs) carryover to Newco.

4. Primary detriments of G reorganization: No party can recognize a loss and there is no step-up in the basis of the assets acquired.

5. Techniques for busting a G reorg

G. Acquisition of stock of Debtor (not in exchange for Cancellation of indebtedness)

1. Tax treatment to acquirer: The acquirer takes a basis in the stock of the Debtor equal to the purchase price. NOLs will remain with the Debtor but may be subject to a § 382 limitation. (See § 382 discussion below at II.)

2. Where 50% of the stock of the Debtor will be held by current shareholders and debt holders, §§ 382(l)(5) or (l)(6) could apply. (See §§ 382(l)(5) and (l)(6) discussions below at III.)

3. Tax treatment to seller: The seller will realize gain or loss on the sale of stock equal to difference between the fair market value of consideration received less the adjusted tax basis in stock sold.

H. NOL planning where Debtor is not selling all of its assets

1. If Debtor sells most of its assets, but not all, it could try to preserve its NOLs for future add-on acquisitions to shelter the operating income of an add-on business.

2. Beware of § 384. A taxpayer cannot use existing NOLs to shelter gain on the sale of newly acquired appreciated assets for five years.

3. Beware of the *de facto* liquidation doctrine. If the Debtor does not maintain a trade or business, the IRS could take the position that the Debtor *de facto* liquidated, and the NOLs disappeared.

II. NOL Limitations From Ownership Changes—§ 382: General Overview

A. The purpose behind the enactment of § 382 was the prevention of loss-trafficking.

B. § 382 applies upon an “ownership change.” An “ownership change” is generally where the ownership of a corporation changes by more than 50% during a testing period. To test an ownership change, one looks at the holdings of 5% shareholders (which include the public group).

C. § 382 imposes a limitation on the use of pre-change and built-In losses

1. The limitation is calculated based on the value of the loss corporation immediately before the ownership change, multiplied by the long-term tax-exempt rate (currently at 4.61%).

2. There is a special computation in certain bankruptcy contexts.

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D. § 382 allows a corporation to carry over its unused limitation for as long as corporation has pre-change losses.

E. Please note that a corporation's built-in gains can increase its limitation.

F. § 382 contains a continuity of business requirement.

1. The corporation must continue the business that generated the pre-change losses for two years after the ownership change; otherwise the limitation is reduced to zero.

G. Special rules apply in bankruptcy cases.

III. Special § 382 Rules in Bankruptcy Cases—§§ 382(l)(5) and (l)(6).

A. For § 382(l)(5) to apply:

1. Debtor must be under Title 11 bankruptcy jurisdiction, AND

2. Continuing shareholders and "qualified creditors" of Debtor must own at least 50% of Debtor immediately after the ownership change.

(a) Qualified creditors are (i) old and cold creditors (holding debt at least 18 months prior to the Title 11 filing) or (ii) trade creditors that have continuously held the debt.

3. There is no continuity of business requirement, but Debtor needs more than an insignificant amount of active trade or business under Treas. Reg. § 1.269-3(d)(1).

4. There is a toll charge for applying § 382 (l)(5).

(a) There is a denial of interest deductions on debt converted into equity for the three taxable years preceding the taxable year of the ownership change and during part of change year ending on change date.

(b) The NOL carryover is recalculated as if no deduction is allowed for the denied interest deductions.

5. The § 382 limitation will be reduced to zero if a second ownership change occurs within two years.

(a) Typically, trading orders restrict the trading of the corporation's stock by 5% shareholders (or persons that would be 5% shareholders as a result of the trade) to avoid a second ownership change.

6. The Debtor may elect out of § 382(l)(5), which is especially useful where Debtor foresees a second ownership change.

B. § 382(l)(6)

1. Section 382(l)(6) is available for Debtors that cannot qualify for § 382(l)(5) or elect out of § 382(l)(5).

2. Section 382(l)(6) allows the value of the Debtor for § 382 limitation purposes to be increased by the surrender or cancellation of creditor claims even if such cancellation does not occur immediately before the ownership change. The result is that the § 382 limitation amount will be higher in many cases.

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3. Another benefit provided by § 382(l)(6) is that the relief is preserved under § 382(l)(6) even if there is a second ownership change within two years.

IV. Cancellation of Indebtedness Income ("COD")

A. Generally, a debt issuer recognizes COD income to the extent the debt's adjusted issue price exceeds the amount paid to satisfy the debt. COD income is recognized in the year of discharge unless one of the statutory exceptions applies. These exceptions permit the exclusion of COD income from gross income at the cost of a reduction of tax attributes.

B. The 2009 Recovery Act created new deferral rules for COD income realized after Dec. 31, 2008, and before Jan. 1, 2011, pursuant to new § 108(i).

1. The debt issuer can elect to defer COD income until 2014, recognizing it ratably over a five-year period beginning with the 2014 taxable year.

2. The debt issuer must elect to defer recognition of COD income. This is a problem for hedge funds because the election is made at the partnership level. Election at the partnership level is problematic where partners have competing tax goals.

3. Guidance is expected to be issued by Treasury shortly on the mechanics of making the election and on which debt instruments are considered "applicable debt instruments" that are eligible to make the election. Further guidance is expected later in 2009.

4. If deferral of COD income is elected, normal rules about ability to exclude COD income for Chapter 11 debtors or insolvent taxpayers will not apply.

C. In the bankruptcy context, § 108(a)(1)(A) states that COD income is not recognized by the Debtor.

1. Instead, the Debtor reduces its tax attributes via priority rules. NOLs are the first tax attribute reduced, followed by other attributes, including tax credits and ultimately asset basis.

2. Where the bankrupt Debtor is a partnership, the exclusion of COD income does not apply unless the partners meet the qualifications for exclusion.

D. In partnerships with COD income, there is a great deal of latitude, and lack of guidance, on how the COD income is to be allocated among the partners.

1. If the debt relief is treated as "gain" from disposition of the underlying assets back to the lender (typically the case where the debt is non-recourse), then the applicable Treas. Regs. under § 752 provide clear guidance for how to allocate the "minimum gain" attributable to the debt relief.

2. If the debt relief is treated as COD income (typically the case where the debt is recourse), there are very few sources of guidance on how the allocation must be done and so partners are free to be creative. Approaches may include:

(a) Allocation to partners in the same manner that other forms of income are allocated generally.

(b) Allocation to partners in the same manner that the underlying discharged debt was allocated among the partners for § 752 purposes for inclusion in the partners' tax basis.

3. Determination of whether the discharged debt is recourse or non-recourse is not as clear as might be expected.

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(a) State law (non-tax) determinations of recourse vs. non-recourse may be used.

(b) The use of SPVs and disregarded entities can create *de facto* non-recourse debt where the debt has full recourse to the legal obligor but limited recourse to the ultimate taxpayer's assets.

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