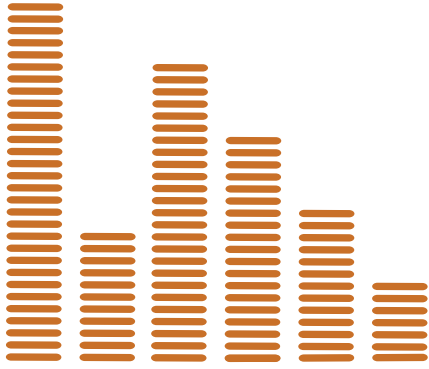


DISTRESSED INVESTING

Out-of-Court Restructurings

Wednesday, June 24, 2009

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I. About the Speakers





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Adam C. Harris is a partner in the Business Reorganization Group at Schulte Roth & Zabel. His practice focuses on corporate restructuring, workouts and creditors' rights litigation. In addition to representing Chapter 11 debtors, such as Ormet Corp., Lionel LLC, and several portfolio companies in out-of-court restructurings, Adam's significant representations of investment funds and financial institutions include the following:

- The agent and term lenders in connection with the Chapter 11 cases (and simultaneous proceedings under the Companies' Creditors Arrangement Act in Canada) of Pope & Talbot Inc. and its affiliates
- The agent and term lenders in the Chapter 11 cases (and simultaneous proceedings under the Companies' Creditors Arrangement Act in Canada) of AbitibiBowater, Inc. and its affiliates
- A private equity fund in connection with the proposed acquisition of a substantial portion of the assets of Delphi Corporation and its affiliates
- A group of private equity funds, in their capacity as term lenders, in connection with the "credit bid" acquisition of substantially all of the assets of Lenox Brands, Inc.
- A group of private equity funds, in their capacity as lenders, in connection with the "credit bid" acquisition of substantially all of the assets of Pappas Broadcasting
- A financial institution in connection with the out of court acquisition of a radio broadcast company
- The first lien lenders in connection with the Chapter 11 cases of DBSD North America, Inc. and its affiliates
- The largest single mortgage certificate holder in the Chapter 11 cases of Extended Stay Hotels, Inc. and its affiliates
- Several portfolio companies of private equity funds in connection with out of court exchange offers, debt repurchases and other capital restructurings

Adam received his J.D., *magna cum laude*, from Georgetown University School of Law, in 1996, and his B.A. from Emory University in 1982. He is listed in *Best Lawyers in America* and is a frequent author and public speaker on issues related to investment funds and investment advisers.



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Dan A. Kusnetz is a partner in the Tax Group at Schulte Roth & Zabel. 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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Michael M. Mezzacappa is a partner in the Finance Group at Schulte Roth & Zabel. His practice focuses on the representation of commercial and investment banks, finance companies and hedge funds in domestic and cross-border finance transactions, including asset-based financings, acquisition financings, mezzanine financings, subordinated debt financings, tranche B financings, debtor-in-possession financings, restructurings and workouts.

Significant representations include:

- A commercial finance company, as agent, in connection with a \$32.5 million credit facility to the operator of a chain of premium seafood restaurants
- A commercial finance company, as agent, in connection with a \$35 million credit facility to a chemicals manufacturer
- A hedge fund, as collateral agent, in connection with a \$63 million financing facility to a manufacturer of lawn and garden products
- A hedge fund, as collateral agent, in connection with a \$180 million financing facility to finance the purchase by a private equity fund of a chemicals manufacturer
- A hedge fund, as agent for a group of term B lenders, in connection with a \$200 million second-lien credit facility to a software company
- A hedge fund, as collateral agent, in connection with a \$210 million debtor-in-possession financing facility to a pharmaceuticals company, which financing facility refinanced a \$180 million prepetition financing facility by that same hedge fund
- A syndicate of hedge funds and private equity funds in connection with a \$98 million note purchase facility to a film production company
- A syndicate of hedge funds in connection with a \$108 million term loan facility to an educational and library publishing company, and a restructuring of such facility in connection with a broader restructuring of the debt of the company

Michael obtained his J.D., *magna cum laude*, from New York Law School and his B.S., with honors, from City University of New York. He is a member of the American Bar Association and the New York City Bar Association.



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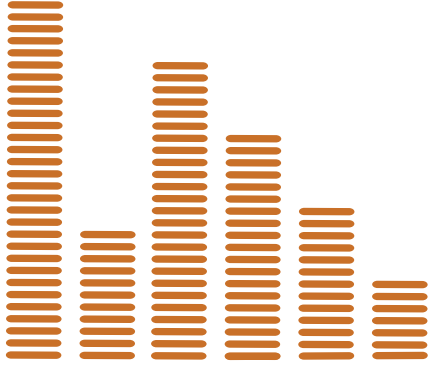
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John M. Pollack is a partner in the Business Transactions Group at Schulte Roth & Zabel, where he practices in the areas of mergers and acquisitions, leveraged buyouts, distressed investing, debt restructurings and private equity.

Significant representations include:

- LNR Property Holdings, a Cerberus Capital Management portfolio company, in its completed tender offer and consent solicitation for certain term loans issued under its credit agreement
- Various other borrowers in connection with senior loan and subordinated debt tender offers, exchange offers and related consent solicitations
- Cerberus in its proposed acquisition of Option One Mortgage Corp., H&R Block Inc.'s non-prime residential lending and servicing business
- Cerberus in its equity investment in vehicles formed to acquire \$15 billion in nonprime residential mortgage assets from UBS
- Cerberus in its acquisition of convertible units issued by Ambac
- Cerberus in its acquisition of approximately \$300 million of model home assets from Residential Capital
- CVC Capital Partners in the acquisition of Adisseo Group, the animal nutrition business of Aventis SA, and its subsequent sale to China National Chemical Corp.
- Altor Fund in the acquisition of Lowrance Electronics, a publicly traded manufacturer of GPS and SONAR products, in a two-step tender offer/merger

John graduated *magna cum laude* from The George Washington Law School, earning their award for Highest Overall Proficiency in Securities Law. He also graduated *magna cum laude* from The George Washington University. At SRZ's Annual Private Investment Funds Seminar in January, John spoke on "Acquiring and Financing Distressed Assets" and at the firm's April 2008 Investment Management Hot Topics Seminar, he tackled the topic of "What to Consider When Buying: Mortgage Servicing Rights, Whole Loans and Asset-Backed Securities in Distressed Situation."



II. Out-of-Court Restructuring of Distressed Debt





Out-of-Court Restructuring of Distressed Debt

Adam C. Harris, Dan A. Kusnetz, Michael M. Mezzacappa and John M. Pollack

In light of the current market conditions, there is renewed interest in distressed debt investments. A key consideration in making a successful investment in distressed debt is investing in a company that has the potential to be successfully restructured, and understanding the manner in which the restructuring may take place. These materials provide a brief overview of certain aspects of the out-of-court restructuring process.

I. Overview

A. Restructuring of Distressed Debt - Why and How

When deciding whether to invest in the debt of a distressed company, an investor should first consider the causes underlying the distress to determine whether a restructuring is feasible, and whether that restructuring is likely to occur out of court or through a more formal court supervised process. These causes can be broadly grouped into two categories:

1. Business issues, such as economic slowdowns, obsolete products or business models, unrealistic business plans or poor management, or unwieldy legacy liabilities, and
2. Balance sheet issues, such as burdensome debt covenants, insufficient liquidity or excessive leverage.

Companies plagued by business issues typically are more difficult to restructure, as they involve operational, management and other fundamental changes to the business that are oftentimes difficult to effectuate outside of a formal court process. Companies plagued by balance sheet issues, however, are more susceptible to out-of-court restructurings and often represent attractive distressed investment opportunities for financial investors.

B. In-Court vs. Out-of-Court Restructuring

Once an investor has identified a potential distressed investment opportunity, the investor must determine whether the restructuring will likely be done out of court or through an in-court process (*i.e.*, under Chapter 11 of the United States Bankruptcy Code). The decision of which process to use is inherently one that will be determined by the company. However, in many instances negotiations between the company and its creditors with respect to a potential restructuring will afford the investor the opportunity to weigh in on the in-court versus out-of-court debate. Many factors should be taken into consideration when making this decision, including the direct and indirect costs of the restructuring, the capital structure of the debtor, the types of debt owed by it, the severity of the debtor's financial distress, the need to eliminate legacy liabilities (such as pension or retiree health obligations) or burdensome contracts, and the overall condition of the industry in which the debtor operates. Below is a brief comparison of the costs and benefits of each option.

1. Benefits of Out-of-Court Restructuring

Out-of-court restructurings are widely perceived as having lower direct costs (and likely lower indirect costs) than Chapter 11 restructurings because it avoids the higher legal and administrative costs caused by the legal complexity and procedural demands of Chapter 11, as well as the adverse impact on the debtor's business and employees that can result from a Chapter 11 filing. Additionally, the overall time required for an out-of-court restructuring is typically shorter than that of a Chapter 11 restructuring because court approvals are not required for decision making and many litigation issues associated with Chapter 11 can be avoided.

However, not all debtors can practically restructure out of court. One of the largest barriers to effective out-of-court restructurings is the capital structure of a debtor. Debtors with numerous creditors asserting a broad range of claims (including trade, funded debt, litigation and other claims) are less likely to be able to coordinate a restructuring plan with all parties. Further, there is a greater likelihood that there will be one or more holdout creditors who refuse to participate in the restructuring plan. When there are a large number of such creditors, those creditors willing to participate in the restructuring may not be sufficient to provide the debtor with all of the relief it needs, and the debtor may still need to file for Chapter 11, incurring costs that could have otherwise been avoided.

2. Benefits of Chapter 11 In-Court Restructuring

Chapter 11, while generally more expensive and time consuming, tends to alleviate the multiple creditor problem by allowing the debtor to negotiate with fewer parties (as a result of coordinating heterogeneous creditors into related groups based upon similarity of claims), providing for approval of the debtor's restructuring plan (which will be binding on all members of a creditor class) by less than all of the creditors in a particular class,¹ and permitting the court to cram down a fair and reasonable plan on dissenting parties. In addition, Chapter 11 offers the benefit of the automatic stay (which imposes order on creditors), and permits superpriority DIP financing (although current market conditions have greatly reduced the number of lenders willing to provide DIP financing). Finally, Chapter 11 provides a means for a debtor to eliminate legacy liabilities and burdensome contracts that is not otherwise available.

C. Choosing a Method of Restructuring

Because of the varying costs and benefits offered by each manner of restructuring, neither option is a 'one-size-fits-all' solution for all debtors. Certain debtors will benefit from taking advantage of the lower costs associated with an out-of-court restructuring. Among debtors in this category are the following:

1. Debtors having relatively few creditors with similar claims, since these debtors are less likely to have the problems associated with multiple creditors.
2. Debtors having relatively more debt owed to bank creditors or bondholders and less owed to trade creditors (although in many restructurings trade claims are unaffected).

Other debtors will benefit from the various advantages offered by Chapter 11. Among debtors in this category are the following:

1. Debtors having numerous creditors asserting broad categories of claims, since these debtors are less likely to effectively coordinate with all parties in an out-of-court restructuring and will benefit greatly from the automatic stay and the coordination of creditors available under Chapter 11.

¹ The Bankruptcy Code requires the approval of 66% in dollar amount and more than 50% in number (of those actually voting) of each impaired class of claimholders.

2. Debtors having relatively more debt owed to trade creditors and less to bank creditors or bondholders, since trade debt is more likely to be held by many, varied creditors.
3. Debtors that are in more severe financial distress and/or operating in weaker industries, since a more complex reorganization requiring superpriority DIP financing and reduced transaction costs will likely be required for these debtors.

II. Effecting an Out-of-Court Solution

The term “out-of-court restructuring” takes into account a wide variety of activities. However, most out-of-court restructurings can be broadly grouped into two categories:

- A. Activities designed to raise additional capital; and
- B. Activities designed to repurchase or restructure existing debt, each of which can have positive or negative effects on some or all of a company’s creditors.

1. Raising Additional Capital

Many companies in financial distress will seek to raise additional capital. Although not always a long-term cure, the infusion of additional cash into a company will often provide a company with much needed time to attempt to resolve the underlying business problems that led to its financial distress. In other instances (such as companies experiencing a short-term liquidity crisis), the additional funds may go a long way toward resolving the problem entirely.

For distressed companies, the most common ways of raising capital include selling assets and borrowing funds. These activities can be a benefit or a detriment to investors depending on the circumstances, as discussed in more detail below.

(a) Asset Sales

Asset sales, which usually involve a company selling an asset, a group of assets, a subsidiary or a business unit, can be an effective way for a financially distressed company to raise capital.

Whether the asset sale is ultimately beneficial to the company depends on the specific facts and circumstances surrounding the sale. Key considerations include the sale price received, the percentage of the company’s EBITDA that the asset generated prior to the sale, and the use of proceeds from the sale. For example, if a non-productive asset is sold at a fair price, the sale is likely to be beneficial, whereas the sale of an asset that is important to the business (even if sold at a fair price) may be detrimental to the business in the long-term. Similarly, if the proceeds from an asset sale are used to repay secured debt or to repurchase unsecured debt at a discount, the asset sale may prove to be a positive event for the company, whereas proceeds applied to ongoing working capital needs may prove to be less beneficial.

It is not clear whether a company that is known to be in severe financial distress will be able to consummate a substantial asset sale outside of Chapter 11 easily. Potential purchasers may have concerns regarding successor liability (in the case of a business unit or subsidiary), or that the asset sale might be voided as a fraudulent transfer in the event the company subsequently filed for bankruptcy protection. Such purchasers may therefore prefer to complete the sale within a Chapter 11 bankruptcy proceeding, despite the fact that the transaction would likely be subject to additional scrutiny as a result.

(b) Secured Financings

Another way for a company in financial distress to raise capital is to borrow against its assets. However, a company in financial distress is likely to have few unencumbered assets (thereby limiting its access to traditional lenders), and may lack sufficient excess value in its encumbered assets to attract second lien lenders. In addition, a company's existing loan documents may limit or prohibit additional secured indebtedness.

Secured debt may also be troublesome for unsecured creditors, not only because the secured debt will have structural priority over the unsecured debt, but because a rapid liquidation of collateral by secured creditors is unlikely to maximize value for the unsecured creditors. In addition, to the extent that a secured creditor is "fully-secured", it will be entitled to post-petition interest and other payments in a bankruptcy proceeding, which will further deplete the remaining funds available to the unsecured creditors.

These factors, combined with the current credit market, make it a challenge for many companies in financial distress to obtain financing. As a result, some distressed companies turn to creative solutions to obtain financing. For example, Sirius XM Radio Inc. ("Sirius XM"), despite serious financial difficulties, was recently able to obtain new secured financing by awarding a substantial equity stake in the company to its lender in exchange for a new credit facility.

Sirius XM, faced with impending maturities of certain of its existing debt, was able to secure a \$280 million senior secured loan from Liberty Media Corporation ("Liberty Media"), at 15% interest, to be used to make its maturing debt payments and for general corporate purposes. In addition, Liberty Media agreed to make a \$150 million term loan to Sirius XM's wholly-owned subsidiary, XM Satellite Radio Inc. ("XM"), at 15% interest, upon the successful amendment of XM's existing credit facilities to extend the maturities thereof on terms reasonably satisfactory to Liberty Media. Liberty Media also offered to purchase up to \$100 million of XM's existing debt.

In return, Liberty Media would receive 12.5 million preferred shares of Sirius XM, which would be convertible into 40% of Sirius XM's outstanding common stock. Liberty Media agreed not to acquire more than 49.9% interest in Sirius XM for a period of 3 years. This agreement, driven by tax considerations, strives to try to ensure that Sirius XM's approximately \$6 billion of net operating losses (NOLs) would be preserved in the transaction. While these NOLs are not likely to be valuable to Sirius XM, given its prospects for profitability, they can be very valuable to Liberty Media, which would have the ability to use them to the extent that it acquired a controlling interest in Sirius XM after the 3 year period.

C. Repurchasing or Restructuring of Existing Debt

1. Repurchasing of Existing Debt

Repurchasing of debt (particularly when the debt can be purchased for a price that is less than its face value) may be an appropriate solution for a company that is seeking to reduce its leverage. This option is primarily available with respect to public debt since the terms of bank debt typically prohibit the borrower from becoming a lender under such facility or from purchasing and cancelling debt on a non-pro-rata basis. Public debt can be repurchased privately (via either open market purchases made through dealers or purchases made directly from existing holders) or publicly (through a tender offer). (Tender offers can be made exclusively for cash, or as exchange offers for other debt or securities; in this section, only cash tender offers will be discussed; exchange offers will be discussed in the "Restructuring Existing Debt" section below.) Open market purchases, direct purchases and cash tender offers all require the company to have cash on-hand or at least access to available cash (e.g., from a third party lender) to fund the purchase price of the purchased debt. In addition, such purchases must be permitted under the terms of the company's existing loan documents.

D. Private Purchases (Open Market Repurchases and Direct Purchases):

The easiest way for a company to purchase its own debt at a discount is by making private purchases, either in the open-market through broker-dealers at the then current market price, or directly from individual holders in individually-negotiated private transactions.

Private purchases are most effective when a company is seeking to repurchase a small percentage of its bonds or when the bonds are not widely-held, and are attractive because they can be consummated fairly quickly, easily and discretely, provide the company with a great deal of flexibility in terms of timing and price, require limited documentation and generally do not result in significant shifts to the market price of the bonds.

However, private purchases are significantly less effective in the following situations:

1. Amending indentures through an exit consent process. (Amendments require the consent of at least a majority of the outstanding bonds, and all such purchases must be timed to close simultaneously since bonds will usually cease to be outstanding for voting purposes under the applicable indenture once they have been purchased by the company. In addition, many indentures require that each holder be offered the same consideration for a consent solicitation.)
2. Purchasing bonds at a time when the company is in possession of material information that has not been disclosed to the public. (Private purchases are subject to Rule 10b-5 and the other antifraud and insider trading provisions of the Securities Exchange Act of 1934, as amended (the "Exchange Act").)
3. Purchasing bonds over an extended period of time. (The market price for the bonds will often increase if the public is aware that the company is intending to purchase such bonds; therefore purchases must be timed carefully in light of the reporting requirements to which the company is subject.)
4. Acquiring all or a substantial portion of a series of outstanding bonds. (Private purchases must be structured so that they do not inadvertently constitute a tender offer under the Exchange Act. Failure to comply with the tender offer rules may result in civil lawsuits in addition to an enforcement action by the Securities and Exchange Commission (the "SEC").)

The term "tender offer" is not defined in the Exchange Act, but the leading court case in this area, *Wellman v. Dickinson*, 475 F.Supp. 783 (S.D.N.Y. 1979), provided that the following eight elements were characteristic of a tender offer (although not all eight elements need to be present for a series of purchases to constitute a tender offer): "(1) active and widespread solicitation of public [securityholders] for the [securities] of an issuer; (2) solicitation made for a substantial percentage of the issuer's [securities]; (3) offer to purchase made at a premium over the prevailing market price; (4) terms of the offer are firm rather than negotiable; (5) offer contingent on the tender of a fixed number of [securities], often subject to a fixed maximum number to be purchased; (6) offer open only a limited period of time; (7) offeree subjected to pressure to sell his [securities];" and "(8) public announcements of a purchasing program concerning the target company precede or accompany rapid accumulation of large amounts of the target company's securities."

Although the SEC has acknowledged this test (in SEC Release 34-43069 (July 24, 2000)), it also acknowledged that other courts have relied on different factors to determine whether a series of purchases would constitute a tender offer (*e.g.*, *Hanson Trust plc v. SCM Corp.*, 774 F.2d 47 (2d Cir. 1985), in which the court found that the relevant determination is whether sellers need the protections of the tender offer rules), so it is crucial that each series of purchases be carefully analyzed and evaluated.

E. Public Purchases (Cash Tender Offers):

If a company intends to purchase bonds that are widely held or to acquire all or a substantial portion of a series of its bonds at a fixed price, a tender offer, in which the company approaches all holders of a series of its bonds with an offer to purchase all or a portion of such bonds, may be an appropriate option. (Tender offers may be accompanied by consent solicitations to amend or eliminate covenants, liens or events of default with respect to the bonds that are not tendered, as a means of encouraging participation in the tender offer. This technique is discussed in the “Exchange Offers” section below, but can also be employed with respect to cash tender offers.)

In a cash tender offer, a company offers to purchase bonds for cash pursuant to the rules and regulations promulgated under the Exchange Act. Cash tender offers for bonds (*i.e.*, bonds with no equity features) are subject to Regulation 14E (most notably Rule 14e-1) of the Exchange Act, and do not require that any filings be made with the SEC. Cash tender offers for debt securities with equity features are subject to additional regulations, including Rule 13e-4 of the Exchange Act (and, in certain instances, Rule 13e-3 of the Exchange Act (the “going-private” rule)), and require that specified filings be made with the SEC.

A cash tender offer is generally preferable to private purchases in the following situations:

1. The repurchase is for a large quantity of bonds (on either an absolute or relative basis).
2. The repurchase needs to be subject to specified conditions.
3. The repurchase needs to amend or waive provisions of the indenture through an exit consent process.

F. Restructuring Existing Debt

To the extent existing debt cannot be repurchased (due to a lack of available cash to fund such purchases or otherwise), another option for alleviating financial strain may be to restructure existing debt to make the terms more manageable. This restructuring can take a variety of forms, ranging from amendments of individual covenants and events of default; to restructuring of payment schedules, maturities, and principal amount; to conversion of all or a portion of the debt to equity. Restructuring bank debt and public bond debt generally involve very different paths and are discussed separately below.

1. Restructuring Syndicated Credit Facilities

Credit facility amendments are usually implemented as a result of a borrower approaching the agent of a syndicated credit facility regarding an existing or potential default under the loan documents that, unless waived or cured, would give the lenders the right to accelerate the debt. As a result, the borrower and lenders (through the agent) generally enter into a negotiation, which, if successful, results in a restructuring of the loan that is memorialized in an amendment to the loan documents.

Many amendments can be implemented (and become binding on all holders) to the extent the borrower obtains the agreement of the “required lenders” (usually lenders holding in excess of 50% or 66.6% of the commitments and loans thereunder), but certain types of amendments require that the amendment be approved by all lenders (such as extension of the maturity date, reduction in principal amount or amortization rate, reduction in interest rate, and change in collateral security).

2. Restructuring Bonds

(a) Bondholder Committees

Because there is no agent that acts as an official representative of the bondholders,² to amend or restructure bond debt, the company can either approach all the bondholders directly at the same time (through a consent solicitation, cash tender offer or exchange offer) or, more likely, invite a few of the largest bondholders to organize an informal bondholder committee so that a negotiation can begin.³ In other situations, a significant bondholder will begin the process by contacting other bondholders to organize such a committee. There are no requirements as to how the bondholder committee is formed, or which bondholders can serve on such a committee, although the group usually represents a significant percentage of the bonds, and generally, not less than 25%.

The members of the bondholder committee have no legal authority to bind any other bondholder. Rather, the bondholder committee's role is to analyze the company's financial situation and then work with the company's management to negotiate what they deem to be the best solution to maximize the value of the bondholders' interests (it being understood that no bondholder committee member has any duty to any other bondholder).

The bondholder committee can play an important role in influencing the out-of-court restructuring process. As such, in many respects, as an investor, it is advantageous to participate in such a committee. However, there are some strategic issues that must be considered before either making an investment with the goal of participating on the bondholder committee, or participating on the bondholder committee itself.

First, in order to be considered as a candidate for the bondholder committee, a bondholder must accumulate a significant amount of the bonds (and correspondingly, a significant amount of risk). Even after making a significant investment, there is no guarantee that the bondholder will be asked to participate on the bondholder committee.

Second, members of a bondholder committee are often required to review material nonpublic information about the company in order to negotiate meaningfully with the company on behalf of the bondholders, and, as such are required to sign confidentiality agreements with the company. This results in the bondholder becoming "restricted", which means that the bondholder cannot disclose the material nonpublic information it receives, and, except as described below, cannot legally purchase or sell securities of the company. This can be disadvantageous to the bondholder committee member by limiting its ability to increase or exit its investment, and this disadvantage must be weighed against the advantage of participating on the bondholder committee and having the ability to influence the course of the restructuring.

There are four primary ways in which bondholder committee members seek to lessen the impact of becoming "restricted":

- (i) Bondholder committees will often retain legal and financial advisors to, in the first instance, review material nonpublic information, and then (without disclosing the detail) make recommendations to the bondholder committee members on how to proceed.

² Although the indenture trustee is the legal representative of the bondholders, the indenture trustee will generally only act when instructed by all or a specified percentage of the bondholders.

³ In certain situations, a company may decide to forego the bondholder committee, and proceed to make a tender offer directly to all holders, but even in these types of situations, proposals are usually informally discussed with certain large holders before they are presented.

- (ii) Bondholder committee members may delay the date on which they first receive confidential information, and then negotiate an agreeable date on which the company will publicly disclose such information to limit the time during which the trading activities of the bondholder committee members must be restricted.
- (iii) Bondholder committee members that are institutional investors establish ethical walls, in which the institutional investor institutes internal procedures designed to prevent information provided to the bondholder committee member representative from being disclosed to the institutional investor's other personnel.
- (iv) Bondholder committee members that wish to buy or sell securities of the company for which they are acting as a bondholder committee member advise the counter-parties to their trades that they may hold material, non-public information and require such counterparties to execute a "big boy letter", which generally contains representations on behalf of the counterparty that it is financially sophisticated and is aware that the bondholder committee member may have material, nonpublic information that may affect the value of the traded securities and a waiver of all claims against the bondholder committee member arising out of the nondisclosure.

Once the bondholder committee has reached an agreement with the company's management with respect to the proposed restructuring, the consents of the requisite bondholders must be obtained. The scope of the agreed changes will determine whether a consent solicitation alone will be sufficient to effect the necessary changes or whether an exchange offer should be pursued. In many instances, an exchange offer will be accompanied by a consent solicitation as discussed further in the "Exchange Offers" section below.

(b) Consent Solicitations

A company that is not seeking broad changes to its debt instruments may seek to amend or waive the terms of its indenture through a "free-standing" consent solicitation (*i.e.*, a consent solicitation that is not made in conjunction with a tender offer or an exchange offer). These amendments and waivers tend to be more limited in scope than those amendments and waivers sought in a consent solicitation that is conducted in conjunction with a tender offer or an exchange offer, in light of the fact that the consenting bondholders will themselves be bound by the terms of any amendments or waivers provided (as opposed to the situation in which a consent solicitation is made in conjunction with a tender offer or exchange offer, and the consenting bondholders amend or waive provisions of an indenture to which they will no longer be bound following the consummation of the tender offer, thus binding only the non-consenting bondholders to the amendment or waiver provided). Such consent solicitations are frequently open for a minimum period of 10 business days, but may be implemented as soon as the consents from requisite number of bondholders are obtained.

As was the case with amendments to syndicated credit facilities, certain provisions of an indenture may be amended by majority approval, whereas other provisions require the consent of each affected bondholder. Although amendments and waivers found in "free-standing" consent solicitations tend to be less broad than those contained in exit consents, it is important to keep in mind that even amendments contained in "free-standing" consent solicitations can result in the amended bonds being deemed a "new security" (which would then require that the "new securities" be registered under the Securities Act of 1933, as amended (the "Securities Act") or be subject to an exemption from registration). Amendments to payment features, maturity dates, redemption rights, collateral provisions and guaranty provisions often result in securities being deemed to be "new securities." Amendments to specific covenants (*e.g.*, limitations on indebtedness, restricted payments, asset sales, etc.) must be evaluated on an individual basis with respect to whether the amendments result in a significant change either to the nature of the investment or the level of risk protection

provided to the holders in order to determine whether the amended bonds are likely to be deemed a “new security”.

G. Exchange Offers

As described above, a company that has sufficient cash to repurchase its debt at a discount, either through private purchases or a tender offer, can significantly reduce its leverage. However, a company that does not have access to sufficient amounts of cash may reduce its leverage via an exchange offer pursuant to which the company offers to issue new debt or equity securities (containing new agreed terms) to the existing holders in exchange for cancellation of such holders' existing debt. Exchange offers can be structured in many ways, but are most commonly divided between “coercive” or “non-coercive” offers.

Because out-of-court exchanges are based on voluntary participation, they can only be successful to the extent that the bondholders elect to cooperate. This is referred to as the “holdout” problem or a “prisoner’s dilemma” (*i.e.*, those not participating in the exchange may be better off than those that do, but if too many hold out, all will be worse off). If the restructuring is successful despite a few holdouts, the holdouts will retain the full amount of their original claim (essentially, having gotten a better “deal” than the consenting bondholders). But if there are too many holdouts, the voluntary restructuring may not be successful and the company may be required to file for bankruptcy, which will likely reduce recoveries, leaving everyone significantly worse off. To manage the holdout problem, coercive exchange offers are often employed.

Exchange offers are deemed to be “coercive” when they compel the holders to consent to the exchange by exposing the non-consenting holders to the risk of being made worse off. The most common type of coercive exchange offer involves “stripping the bonds” (*i.e.*, including a provision in the exchange offer that the tendering bonds will be deemed to have voted to authorize an amendment to the indenture of the original bonds, to delete all protective covenants, and, to the extent applicable, to release all liens securing the payment of the bonds). Thus, if a majority of the bondholders tender their existing bonds, the non-consenting bondholders (*i.e.*, the “holdouts”) will be left with a significantly different (and much less attractive) bond following the exchange.

Another type of coercive exchange offer involves combining an exchange offer with a solicitation of support for a prepackaged Chapter 11 bankruptcy filing. This indicates to any potential holdouts that should the exchange offer fail, a bankruptcy proceeding will follow, which may result in the holdouts receiving the same, or potential less favorable, treatment as they would have received had they accepted the exchange offer.

In addition, many exchange offers contain a provision that no tendered bonds will be accepted for exchange unless at least 90% of all bonds tender. This provision provides some comfort to the bondholders that the exchange will occur only if a large percentage of the bonds are exchanged, a fact which increases the odds that the restructuring will be successful in remedying the financial distress, and that the number of “holdouts” that disproportionately benefit will be limited. In addition, it pressures all holders to participate in the exchange, since even a relatively small amount of nonparticipation will result in the exchange failing and all likely being worse off. (However, it should be noted that the company usually retains the right to waive the minimum participation requirement without notice, except as required by applicable law.)

A noncoercive exchange offer does not “threaten” to make the nonparticipant worse off as a result of nonparticipation, but instead attempts to present a comparatively attractive opportunity in order to induce participation.

1. Debt-to-Equity Conversion

In a debt-to-equity conversion, a company’s creditors agree to cancel some or all of the debt owed to them by the company in exchange for equity in the company. These transactions often result in the company being owned (whether in whole or in substantial part), by its principal

creditors, with the ownership of the original shareholders being dramatically reduced or even eliminated entirely.

A debt-to-equity conversion might be appropriate if:

- (a) Both the debt and the remaining assets in the company are substantial.
- (b) The company is believed to have a greater value as a going concern than in a liquidation.
- (c) The creditors believe the company is a good candidate for restructuring, with certain key management agreeing to remain employed for an agreed period of time following the conversion.
- (d) The original shareholders are willing to agree to the dilution (or elimination) of their shareholdings in the company, frequently in exchange for liability releases.
- (e) The transaction will not breach the company's material contractual obligations as a result of the change of control or otherwise.
- (f) The creditors can reach agreement among themselves (and with the existing equityholders, if they continue to participate after the exchange) as to certain corporate governance issues, such as:
 - (i) Composition of the board of directors (managers) and designation rights for major creditors (board observation rights for minority creditors).
 - (ii) Equityholder protections, e.g., drag along/tag along rights, rights of first refusal (or first offer), buy/sell agreements, preemptive rights, registration rights (including the right to force an initial public offering if the company is not already public), consent/veto rights and protective covenants, etc.
 - (iii) Compliance with listing standards of any applicable stock exchange, if the company is to continue to be publicly traded.
 - (iv) Transfer restrictions on newly issued equity securities.

From the creditor's point of view this conversion is likely to memorialize what the liquidation analysis of the company has already suggested (*i.e.*, that the debt was unlikely to be repaid in full). The exchange of the remaining part of the debt through the issue of shares will be reflected in the accounts of the creditor by the removal of the debtor balance and the inclusion of the shares as the creditor's assets.

From the company's point of view, the debt has been replaced by equity, and the company's capital structure has been reorganized, which may enable the company to raise additional capital in the future.

III. Tax Matters

There are significant tax matters that arise in connection with out-of-court debt restructurings, including the following:

A. Cancellation of Indebtedness

Subject to certain exemptions, if a company reacquires its debt for an amount less than the face amount of that debt, the company may have to recognize cancellation of indebtedness income, in an amount equal to the difference between the principal amount of debt repurchased and the repurchase price.

Where debt is repurchased for cash or for publicly traded property it is relatively easy to determine how much cancellation of indebtedness income is realized. Similarly where public debt is outstanding and its value can be ascertained by the public trading quotations, the difference between that public trading value and the face amount of the debt is generally the measure of the cancellation of indebtedness income.

However, where non-publicly traded debt is repurchased in exchange for new non-publicly traded debt (or other non-publicly traded property such as warrants) numerous issues arise in trying to determine the amount of cancellation of indebtedness income, if any, created by the exchange. In certain cases, where newly issued debt is used as the medium of exchange for outstanding indebtedness the face amount of the new debt (as opposed to the fair market value of the new debt) may be used to measure the amount of debt relief. In such a case a substantial amount of taxable income may be avoided as compared to an exchange based on fair value. In many cases the ability to utilize such strategy is dependent on being able to make a determination that neither the existing debt being retired nor the new debt being issued are “publicly traded” within the meaning of the applicable tax regulations which date back to the late 80’s and early 90’s and which fail to take account of new liquidity mechanisms in the market place. For example, are privately issued debt securities “publicly traded” merely because quotations for such securities can be found on the NASDAQ Portal 144A Trading system? What if there is very little trading volume or the quotations are old, does this change the result? At stake can be the requirement to recognize substantial amounts of taxable income. These and similar issues require careful planning and consultation with tax counsel in order to ensure a degree of certainty of the tax consequences from the debt exchange.

B. Creation of New OID

If cancellation of indebtedness income is created on a debt-for-debt exchange then, in general, an equivalent amount of new original issue discount (“OID”) would be created. This creation of OID sets up a stream of tax deductions to the issuer over the term of the new debt issued. Given that cancellation of indebtedness income may often be excluded from the issuer’s gross income, this creates a potentially valuable arbitrage where the taxable income is eliminated in the year of exchange and a stream of available deductions is created which can provide valuable tax benefits to the issuer as it turns the corner on profitability and starts generating taxable income. Unfortunately, such creation of OID can have a nasty consequence to any taxable holders of the newly issued debt, requiring them to recognize taxable OID income over the term of the newly issued debt. This divergence of tax interests will often play a significant role in the exchange offer negotiations and in the willingness of debt holders to participate in the exchange offer.

C. AHYDO and Loss of Interest Deduction

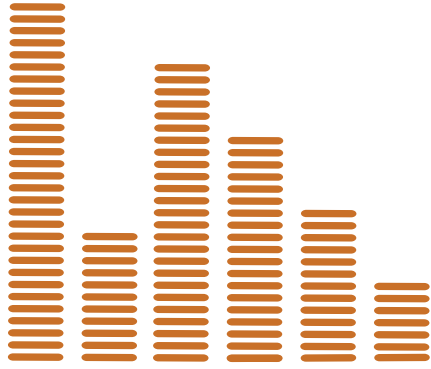
In general, the interest deduction on PIK notes and high-yield OID debt instruments with maturities in excess of five years are deferred until such interest is actually paid in cash, and interest paid on yields in excess of a specified amount which are deemed to be a non-deductible dividend. As such, new debt instruments with high rates of non-current pay interest (known as an Applicable High Yield Debt Instruments or “AHYDO”) issued in exchange offers may not permit the issuer to obtain current interest deductions with respect to such instruments. Legislation enacted in 2009 has suspended the impact of the AHYDO rules in certain exchange offers where the old outstanding debt instrument was not itself an AHYDO. This relaxation of the application of the AHYDO rules was enacted in order to encourage debt exchanges in response to the current credit crisis, but the rules will only apply to exchange offers completed before December 31, 2009.

D. Limitation on Net Operating Loss Carryforwards

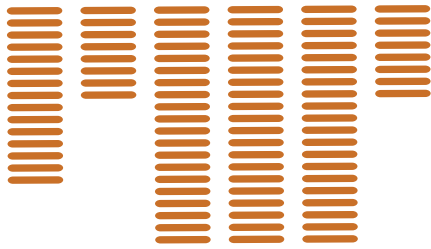
If equity or equity-linked securities are offered in exchange for debt securities, an analysis must be conducted to determine whether an ownership change under Section 382 of the Internal Revenue Code of 1986 would occur, limiting the company’s future use of net operating loss carryovers after the occurrence of such change.

E. Deemed Exchanges from Substantial Modification of Debt

As if this area was not already laden with traps for the unwary, stealth debt exchanges can occur for tax purposes creating cancellation of indebtedness income and OID to the participants. The applicable tax rules provide that a “significant modification” of a debt instrument will—in most circumstances—be treated as the issuance of a new debt instrument (with the new modified terms) in exchange for the old unmodified outstanding debt instrument. Accordingly, even though no actual exchange has occurred the same tax consequences arising from an actual exchange can arise. This may be used aggressively in connection with an exchange offer to try to limit the “holdout” problem. Where an exchange offer is coupled with a consent solicitation modifying the terms of the debt that may be left in the hands of the holdouts who do not participate in the exchange, the holdouts may be forced to treat the transaction (even though they do not participate in it) as a taxable exchange. This may help reduce some of the incentives for the debt-holders who refuse to participate in the exchange and can encourage greater participation from the debt-holders. Whether a modification of the terms of a debt instrument are sufficiently significant to warrant “deemed exchange” treatment is a complex question of fact and law. Examples of significant modifications which will give rise to exchange treatment include changes in yield, in timing of payments, in priority, in collateral and in recourse nature of the instrument. As a fact-intensive test, care should be taken to tightly integrate the planning of an exchange transaction with tax advice.



III. 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)

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

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.

- 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.

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.

- (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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