

UNITED STATES

**Your loss is someone else's gain**

by Deborah Hicks Midanek

On 18 January 2010, five plan proponents were striving to control the emergence from bankruptcy of Fremont General Corporation. FGC, a public company which filed in Santa Ana, CA, in 2008, had been among the top five subprime originators in the US, and had also been involved in insurance and banking. By the time the competing plans were being promulgated, however, operations had largely ceased, and remaining tangible assets included roughly \$300m in cash, a handful of remaining mortgage loans and some real estate.

So what was attracting what was alleged to be the highest number of competing plans yet seen in a US bankruptcy court? All eyes were on the possibility of capturing the benefits of the estate's tax loss carryforward, otherwise known as the NOL, estimated to range from \$200m to \$800m. The NOL, which arises when a taxpayer incurs a net loss in a tax year, is valuable because, subject to certain limitations, they can be carried back to offset taxable income for the two prior tax years, and they can be carried forward for the 20 subsequent years to shelter future taxable income of the company that generated such losses (the 'loss corporation').

It seems that opinion in the legal and accounting community is split as to whether and under what conditions a new owner can benefit from losses incurred by a predecessor, and likely many more possible buyers looked at the Fremont possibilities and did not gain confidence that they could reliably capture the benefits of shelter from future taxes. Under what circumstances, then, can a buyer most likely get that confidence when buying distressed assets which include tax loss carry forwards?

It was once commonplace to buy shells of companies of which little remained but losses. To prevent the acquisition of a loss corporation solely to exploit its NOLs, Congress enacted Section 382 of the IRC. Specifically, if an entity has undergone an 'ownership change', §382(g) limits a corporation's ability to use 'pre-change' NOLs. Though the regulations are somewhat complex, generally an ownership change occurs if the percentage of the corporation's stock held by one or more shareholders owning at least 5 percent of the corporation's equity increases by more than 50 percentage points over a three year period. For example, if a shareholder owns 10 percent of a corporation's stock and, within three years, acquires additional shares such that he now owns 61 percent of the corporation's outstanding stock, an ownership change will be deemed to have occurred.

Once an ownership change has occurred, a corporation's ability to use its pre-change NOLs to offset future income is subject to an annual limit, calculated by multiplying the value of the corporation's stock immediately before the ownership change by a statutorily prescribed long-term interest rate, which generally reduces the amount of post-change income to which the pre-change NOLs can be applied. In distressed situations where the value of the corporation's stock is likely quite low, an ownership change renders any NOLs valueless, in that the amount of NOLs permitted to be used to offset taxable income will shelter only a negligible amount of income.

In distressed situations operating under Chapter 11, however, the calculations become more complex, and not only the value of the stock must be considered, but so must other forms of plan consideration, such as bonds or other debt used in debt for equity exchanges. Section 382 addresses this in IRC §§382(l)(5) ('L5') and 382(l)(6) ('L6'), which serve as potential 'safe harbours' for companies seeking to preserve NOLs in bankruptcy.

L5 exempts the loss corporation from the annual limit if: (i) the corporation was under a bankruptcy court's jurisdiction immediately before the ownership change; (ii) the bankruptcy court approved the ownership change pursuant to a confirmed reorganisation plan; and (iii) the corporation's pre-reorganisation shareholders and 'qualified creditors' own at least 50 percent of the restructured corporation's stock following the consummation of the plan of reorganisation.

Generally a 'qualified creditor' is a creditor of the debtor that, immediately before the ownership change, either: (i) had been a creditor for at least 18 months before the bankruptcy filing; or (ii) became a creditor in the ordinary course of the debtor's business and had not acquired the debt from another creditor.

Importantly, L5 will not apply if a reorganised corporation does not conduct meaningful business activity following the ownership change or if the corporation undergoes a second ownership change within two years of the initial one. In either scenario, it would be unable to use any of the pre-change NOLs to offset its taxable income. In addition, NOLs that may be carried forward under the L5 exception will be reduced by any cancellation of indebtedness (COD) income recognised by the debtor in the reorganisation.

The debtor may instead choose the L6 exception, which does not exempt a debtor from the annual limit of §382, but may enable the debtor to increase the amount of that annual limit, rendering the NOLs more valuable than they would be outside of the bankruptcy context. Under L6, the value of the reorganised corporation for purposes of calculating the §382 annual limit is the lesser of the value of the stock of the reorganised debtor immediately after the reorganisation and the value of the reorganised debtor's assets. In each case, such valuation reflects the cancellation of creditors' claims in the reorganisation.

Corporate debtors frequently file motions requesting the bankruptcy court to restrict the trading of equity interests and claims to avoid triggering the NOL limitations associated with an ownership change. These 'claims trading motions' reflect the view that NOLs are property of the debtor's estate which may have significant value, and, as such, are entitled to the protection of the automatic stay.

Although not without controversy and a strong reaction from the debt trading community, such a motion was filed early in the Fremont case. The order was granted, imposing restrictions on the trading of Fremont equity interests, with an eye on preserving the possible value of the NOLs in a plan of reorganisation. In the Fremont case, as distinct from many Chapter 11 cases, the business plans of the plan proponents were of critical importance, as in essence they were restarting the operations of the company, rather than simply restructuring the company's balance sheet.

Certain of the five Fremont plan proponents emphasised how their respective plans were tailored to maximise the likely benefits from applying the NOLs. One proponent, Signature Capital Group, described its 'business model' for Fremont as "one that generates a predictable, growing, and recurring earnings stream..." and asserted that such "stable earnings...are ideally suited to utilize the net operating loss tax carry forwards for the benefit of Fremont's shareholders". Ultimately, Signature's plan, which they assert is designed specifically to address preservation of the NOLs, was confirmed.

While clearly much attention has been focused on the use of and protection of NOLs in debtor's estates, it remains rare to see a new entity take control of the estate of the loss corporation in a confirmed Chapter 11 plan and benefit from the NOLs, and in fact many players in the Fremont case and outside of it were convinced it could not happen. Now that it has, the progress of the new operation will likely be watched very closely by others who would like to find a way to secure similar benefits.

If economic conditions improve for entities undergoing Chapter 11 restructurings in 2011 and beyond, there will likely be a renewed emphasis on the preservation of value, business continuity and the use of NOLs by reorganising debtors, and these techniques may be more widely implemented.

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