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EDITOR'S NOTE: DECISIONS, AND MORE . . .
Victoria Prussen Spears

SECOND CIRCUIT COURT OF APPEALS PARTIALLY RESUSCITATES TRIBUNE LEVERAGED BUYOUT LITIGATION
Benjamin Mintz and Justin Imperato

A WARNING TO CONTRACT COUNTERPARTIES: A DEBTOR CAN SELL YOUR FULLY PERFORMED CONTRACT WITHOUT CURING DEFAULTS AND PAYING YOUR CLAIM IN FULL
Andrew M. Troop and Andrew V. Alfano

"TAKE THIS PILL, IT'S GOOD FOR YOU": FIFTH CIRCUIT CONCLUDES THAT FORCED CHANGE OF CONTROL WAS NOT THE PRODUCT OF DURESS
Arthur J. Steinberg, Jonathan W. Jordan, and Sarah L. Primrose

CONTRACTUALLY REIMPOSING FIDUCIARY DUTIES IN AN LLC OPERATING AGREEMENT DESPITE CLAUSE WAIVING FIDUCIARY DUTIES
Glenn D. West

TRIMARK: ARE "SACRED RIGHTS" STILL SACROSANCT?
Jonathan T. Edwards, Michael G. Parisi, C. Jordan Myers, and Adam R. Monich

PROTECTING NET OPERATING LOSSES IN DISTRESSED INVESTMENTS
Matt Ehinger and Michael Ott

DELAWARE BANKRUPTCY COURT REBUFFS U.S. TRUSTEE EFFORT TO COLLECT STATUTORY FEES FROM LITIGATION TRUST DISTRIBUTIONS
Jacob A. Adlerstein, Robert A. Britton, Claudia R. Tobler, and Miriam M. Levi

ENGLISH COURT REFUSES TO APPROVE RESTRUCTURING PLAN BASED ON CROSS-CLASS CRAMDOWN
Philip Hertz, Lewis Cymbal, Gabrielle Ruiz, and Douglas Deutsch

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VOLUME 17 NUMBER 8 Nov./Dec. 2021

Editor's Note: Decisions, and More . . .
Victoria Prussen Spears 395

Second Circuit Court of Appeals Partially Resuscitates Tribune Leveraged Buyout Litigation
Benjamin Mintz and Justin Imperato 398

A Warning to Contract Counterparties: A Debtor Can Sell Your Fully Performed Contract Without Curing Defaults and Paying Your Claim in Full
Andrew M. Troop and Andrew V. Alfano 405

"Take This Pill, It's Good for You": Fifth Circuit Concludes That Forced Change of Control Was Not the Product of Duress
Arthur J. Steinberg, Jonathan W. Jordan, and Sarah L. Primrose 410

Contractually Reimposing Fiduciary Duties in an LLC Operating Agreement Despite Clause Waiving Fiduciary Duties
Glenn D. West 413

***TriMark*: Are "Sacred Rights" Still Sacrosanct?**
Jonathan T. Edwards, Michael G. Parisi, C. Jordan Myers, and Adam R. Monich 419

Protecting Net Operating Losses in Distressed Investments
Matt Ehinger and Michael Ott 425

Delaware Bankruptcy Court Rebuffs U.S. Trustee Effort to Collect Statutory Fees from Litigation Trust Distributions
Jacob A. Adlerstein, Robert A. Britton, Claudia R. Tobler, and Miriam M. Levi 429

English Court Refuses to Approve Restructuring Plan Based on Cross-Class Cramdown
Philip Hertz, Lewis Cymbal, Gabrielle Ruiz, and Douglas Deutsch 433

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Protecting Net Operating Losses in Distressed Investments

By Matt Ehinger and Michael Ott*

The authors of this article provide an overview of the rules pertaining to net operating losses in bankruptcy.

Many businesses recognized significant net operating losses or "NOLs" as a result of the COVID-19 pandemic. The Internal Revenue Code of 1986, as amended (the "Code"), generally allows many types of taxpayers (including individuals, estates and trusts, exempt organizations, and most C corporations) to utilize NOLs to offset taxable income in other tax years, subject to certain limitations. In fact, the CARES Act, as part of COVID-19 relief legislation, relaxed the limitation on carrying back NOLs for the 2018 through 2020 tax years, generally allowing NOLs to be carried back to each of the five taxable years preceding the loss year, in addition to the general rule allowing NOLs to be carried forward indefinitely following the loss year. As a result, NOLs can be valuable tax tool for a loss-recognizing corporation (the "Loss Corporation").

However, NOLs are not freely transferable. The Code places limits on the extent to which a Loss Corporation may utilize an NOL following a change in ownership. While these limitations can be significant, importantly, there are exceptions for restructuring transactions completed through a bankruptcy proceeding. Accordingly, as with many other aspects of distressed investing, a bankruptcy proceeding may provide a valuable avenue for maximizing and preserving the value of NOLs.

OWNERSHIP CHANGES

Section 382 of the Internal Revenue Code provides that if a Loss Corporation undergoes an "ownership" change, its NOLs are limited on a go forward basis. These rules generally provide that the Loss Corporation may only utilize NOLs generated prior to the change in ownership in any post-ownership change year up to a cap calculated initially by multiplying the equity value of the pre-ownership change corporation by the long-term tax-exempt rate (1.64

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percent as of May 2021). To the extent there are unused NOLs under the cap in any one year, such amounts are carried over to the next year.

For purposes of Code Section 382, an ownership change generally will be deemed to have occurred if any five percent owner of the corporation increased its ownership stake in the company by more than 50 percent in the prior three years.[1] These rules take into account any equity shifts as a result of most tax-free reorganizations under Code Section 368.

These limitations can always be burdensome, but the impact could be even greater for businesses undergoing ownership changes during the COVID-19 era. As detailed above, the mathematical cap (which determines the amount of NOLs that can be used on a go-forward basis) is determined in part by the valuation of the business prior to the ownership change. COVID-19 and the related fallout from the pandemic could have a significant impact on valuations of businesses. These circumstances combined with the low tax-exempt rate (which the second part of the Code Section 382 calculation), could greatly limit the amount of NOLs that can be used on a go-forward basis.

BANKRUPTCY EXCEPTIONS FOR LOSS CORPORATIONS

While the Code Section 382 NOL limitations could have a significant impact on a Loss Corporation, there are exceptions to the application of these rules. A principal exception is extended to Loss Corporations that are subject to bankruptcy proceedings. Specifically, Code Section 382 contains two separate exceptions for bankruptcy restructuring transactions.

First, there is no cap on the utilization of NOLs following a restructuring through a bankruptcy case of the Loss Corporation if the shareholders and qualified creditors of the Loss Corporation (as determined prior to bankruptcy restructuring), own 50 percent of the stock of the corporation (i.e., retain 50 percent of the voting power and 50 percent of the economic value), after the restructuring.[2] As suggested, two primary requirements must be satisfied for this so-called "bankruptcy exception" to apply:

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[1] The specifics of the Internal Revenue Code Section 382 cap calculation and the ownership change test are highly technical and contain numerous exceptions and special rules. All taxpayers should consult with their tax professional to determine the application of and implications of the Code Section 382 to their specific situation.

[2] Specifically, 26 U.S.C. § 382(*l*)(5)(A)(ii) provides that the cap shall not apply if:

> the shareholders and creditors of the old loss corporation (determined immediately before such ownership change) own (after such ownership change and as a result of being shareholders and creditors immediately before such change) stock of the new loss corporation (or stock of a controlling corporation if also in bankruptcy) which meets the requirements of section 1504(a)(2) (determined by substituting "50 percent" for "80

- First, the Loss Corporation must have been under the jurisdiction of a court immediately before the ownership change in a Title 11 or similar case.
- Second, the former shareholders and qualified creditors of the bankrupt corporation must retain "control" after the ownership change.[3]

With respect to the second requirement, stock transferred to a creditor only counts towards the 50 percent threshold if the stock was transferred in satisfaction of indebtedness held by the creditor for at least 18 months prior to the filing of the bankruptcy case, or if the indebtedness arose in the ordinary course of business of the Loss Corporation and continued to be held by the original creditor.[4] To the extent these requirements are satisfied, this allows the NOLs to be used going forward without the limitations imposed by the general Code Section 382 rules.

While valuable, this exception will be lost (and the cap will be set to zero) if there is a second ownership change within two years after the bankruptcy restructuring transaction.[5] Additionally, while this bankruptcy exception contained within Code Section 382 eliminates the cap on the utilization of post-restructuring NOLs, the NOLs that can be utilized going forward will be reduced by the amount of any deductions that the Loss Corporation took within the prior three years with respect to interest payments made to creditors that received stock in the restructuring transaction.[6] These are some of the considerations that must be taken into account when evaluating the viability of the "bankruptcy exception" to Code Section 382.

Additionally, to the extent that the Loss Corporation does not qualify for the bankruptcy exception (or elects not to utilize the exception), then under Code Section 382(*l*)(6), following a bankruptcy restructuring, the Code Section 382 cap is calculated to account for any increase in value of the corporation resulting from any surrender or cancellation of creditor's claims in the restructuring. The

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percent" each place it appears). Section 1504(a)(2) provides that corporations will be considered part of an affiliated group either entity (or a common parent) owns at least 80 percent of the total voting power and 80 percent of the total value of the other entity.

[3] This article is designed to provide an overview of these rules. As one might expect, there is a great amount of detail to these rules that must be satisfied to take advantage of the exceptions discussed herein. Additionally, the Internal Revenue Service has challenged taxpayer's claiming these exceptions to the extent that restructurings are undertaken principally for tax avoidance purposes.

[4] 26 U.S.C. § 382(*l*)(5)(E).

[5] *Id.* § 382(*l*)(5)(D).

[6] *Id.* § 382(*l*)(5)(B).

valuation of a business could be increased substantially as a result of such claims being mitigated, which could have a corresponding positive impact on the cap for calculating the NOLs going forward.[7]

These specialized NOLs rules related to bankruptcy proceedings provide potentially valuable planning considerations. For example, a corporation with a large NOL may find bankruptcy as an attractive avenue for obtaining an equity infusion. Under the bankruptcy exception to the NOL limitations, a new investor could potentially obtain up to 50 percent of the Loss Corporation's equity, without effecting the value of the NOL, provided that the Loss Corporation's existing shareholders and qualified creditors retain the remaining 50 percent equity.

OTHER BANKRUPTCY ADVANTAGE

Reorganizing through a bankruptcy proceeding has another advantage when it comes to preserving and maximizing the value of NOLs. A debtor with significant NOLs can typically obtain an order from the bankruptcy court early in its bankruptcy case requiring large shareholders of the corporation to notify the debtor before engaging in any material trading of the debtor's equity, and voiding any transfers made without notice. Such an order provides some protections against the debtor-taxpayer losing its NOLs based upon actions of its shareholders that would normally be outside of a taxpayer's control.

CONCLUSION

Given the scale of the COVID-19 downturn, NOLs generated could be a valuable asset for some time. Preserving and protecting their value will be critically important in the coming years and require careful planning that all Loss Corporations should evaluate and consider.

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[7] A taxpayer may elect to apply the cap under Section 382(*l*)(6) rather than utilize the bankruptcy exception under Section 382(*l*)(5). This may be useful if the taxpayer anticipates that a subsequent sale will occur within two years after the restructuring.