Death and Taxes Assured: Confirmation of Shell Corporation's Tax-Avoidance Chapter 11 Plan Denied

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Preservation of favorable tax attributes, such as net operating losses that might otherwise be forfeited under applicable nonbankruptcy law, is an important component of a business debtor's chapter 11 strategy. However, if the principal purpose of a chapter 11 plan is to avoid paying taxes, rather than to effect a reorganization or the orderly liquidation of the debtor, the Bankruptcy Code contains a number of tools that can be wielded to thwart confirmation of the plan. The Seventh Circuit Court of Appeals was recently called upon to weigh in on this issue as an apparent matter of first impression in the circuit courts of appeal. In *In re South Beach Securities, Inc.*, a unanimous three-judge panel of the court affirmed an order denying confirmation of a chapter 11 plan proposed by a company whose sole asset consisted of tax attributes and whose only creditor was a related company attempting to acquire the attributes to avoid taxes.

Tax Attributes and Changes of Ownership

A critical feature of almost every chapter 11 case involving a business that is attempting to reorganize by reworking its capital structure is preserving to the fullest extent possible the company's ability to use its existing net operating losses ("NOLs") to offset future income of the reorganized or successor entity for tax purposes. NOLs are an excess of deductions over income in any given year. They can generally be carried back to use against taxable income in the two previous years and, to the extent not used, may be carried forward for 20 years. Losses remain

with the debtor during a bankruptcy case because a bankruptcy filing for a corporation does not create a new taxable entity.

Certain provisions in section 382 of the Internal Revenue Code ("IRC") significantly limit the company's ability to use its NOLs upon a more than 50 percent "change of ownership" of the company's stock owned by major shareholders. The vast majority of all corporate reorganizations under chapter 11 result in such a change of ownership under section 382. If the change occurs prior to the effective date of a chapter 11 plan, the standard NOL limitation of section 382 applies. This means that, on a going-forward basis, the company's allowed usage of prechange NOLs against future income will be capped at an annual rate equal to the equity value of the corporation immediately before the change of ownership multiplied by the long-term tax-exempt bond rate. Similarly, future use of built-in losses in assets (for example, through depreciation deductions) will be subject to the annual limitation. Because the equity value of the company while in bankruptcy prior to plan effectiveness typically will be *de minimis*, capping the NOLs at that value will most often prevent the company from using the NOLs thereafter.

Special rules apply for ownership changes occurring as a result of a debtor's emergence from bankruptcy. In general, if the ownership change occurs pursuant to the debtor's confirmed plan of reorganization, the debtor may use its postemergence equity value (after debt cancellation) instead of its equity value immediately before the change to calculate its annual limitation on the use of its prechange NOLs after emergence. For example, assuming a 4 percent long-term tax-exempt bond rate, a company having an equity value of $100 million immediately following

emergence could use $4 million of its prechange NOLs annually to offset its future taxable income.

Under certain limited circumstances, a debtor can undergo a change of ownership under a chapter 11 plan and emerge without any section 382 limitation on its NOLs and built-in losses. To qualify for this provision (contained in section 382(l)(5) of the IRC): (i) shareholders and creditors of the company must end up owning at least 50 percent of the reorganized debtor's stock (by vote and value); (ii) shareholders and creditors must receive their minimum 50 percent stock ownership in respect of their interests in and claims against the debtor; and (iii) stock received by creditors can be counted toward the 50 percent test only if it is received in satisfaction of debt that (a) had been held by the creditor for at least 18 months on the date of the bankruptcy filing (*i.e.*, was "old and cold") or (b) arose in the ordinary course of the debtor's business and is held by the person who at all times held the beneficial interest in that indebtedness. This "no limitation on future use of losses" result comes with two caveats: (i) the available losses are first reduced for the amount of interest deductions taken in the three or more years before emergence; and (ii) there can be no future ownership change within the two years following emergence without completely eliminating the ability to use the NOLs.

Both the IRC and the judge-made tax doctrine of "substance over form" may impose limitations on an acquired company's ability to use tax attributes to offset taxable income. These rules are designed to prevent "trafficking" in tax attributes via changes in corporate ownership, lest the change confer a tax benefit on an entity (the purchaser) other than the previous owner, which bore the economic brunt of the net operating losses. However, family members (*e.g.*, spouses,

children, grandchildren, and parents) are treated as a single owner, stock owned by a corporation is treated as being owned by its shareholders, stock owned by partnerships is deemed to be owned by the partners, and stock owned by a trust is deemed to be owned by its beneficiaries. Thus, transfers among such family members or between entities and their shareholders, partners, or beneficiaries do not trigger the NOL limitations.

Section 269(a)(1) of the IRC also imposes restrictions on obtaining tax benefits from NOLs beyond the restrictions imposed by section 382. It disallows deductions and other tax benefits, including the use of NOLs, when tax avoidance is the principal purpose of, among other things, acquiring control (at least 50 percent of vote or value) of a corporation providing tax benefits that would not otherwise be available.

The Bankruptcy Code's Prohibition of Tax-Avoidance Chapter 11 Plans

Section 1129(d) of the Bankruptcy Code provides as follows:

> Notwithstanding any other provision of this section, on request of a party in interest that is a governmental unit, the court may not confirm a plan if the principal purpose of the plan is the avoidance of taxes or the avoidance of the application of section 5 of the Securities Act of 1933. In any hearing under this subsection, the governmental unit has the burden of proof on the issue of avoidance.

One purpose of section 1129(d) is to codify the "substance over form" principle established by the U.S. Supreme Court's 1935 ruling in *Gregory v. Helvering*, which has also been incorporated into IRC section 269. Even if a bankruptcy court does not deny confirmation of a plan under section 1129(d), the Internal Revenue Service may deny claimed deductions based upon NOLs under IRC section 269, as previously described. The IRS has taken the position for many years that it has the independent power under section 269 to determine whether an acquisition pursuant

to a chapter 11 plan was made for the principal purpose of evasion or avoidance of federal income tax, and in making that determination, the fact that the IRS failed to invoke section 1129(d) or invoked it but failed to carry its burden of proof in bankruptcy court is not controlling. This position has been subject to criticism based upon, among other things, principles of res judicata.

The "governmental unit," which most (but not all) courts have construed to include the Office of the U.S. Trustee, bears the burden of proof on the issue of tax avoidance. That burden is to show that the *principal* purpose of the plan is tax or securities law avoidance. Under section 1129(d), a plan may be proposed that takes advantage of tax attributes of the estate, provided that it is not the principal purpose of the plan. If a chapter 11 debtor is insolvent or in need of financial reorganization, tax or securities law avoidance would rarely be the principal purpose of the debtor's plan. According to one bankruptcy court, "the principal purpose" in section 1129(d) "should be strictly construed and essentially means 'most important.' "

With respect to the Securities Act, the principal purpose of the provision is to ensure that a "shell" corporation whose primary asset is a registration on a national securities exchange does not use the exemption in section 1145 of the Bankruptcy Code from registering a securities transaction under the Securities Act of 1933 and applicable state or local law in order to confirm a chapter 11 plan that is essentially a "blind pool" investment.

The interplay between section 1129(d) of the Bankruptcy Code and sections 269 and 382 of the IRC was the subject of the Seventh Circuit's ruling in *South Beach Securities*.

South Beach Securities

South Beach Securities, Inc. ("South Beach"), was formerly a registered securities broker/dealer. South Beach is wholly owned by NOLA, LLC ("NOLA"), a limited liability company with three members. One is the father of Leon A. Greenblatt III ("Greenblatt"), who achieved notoriety in the late 1990s by instructing Scattered Corporation ("Scattered"), a company of which he is a director, to sell short more shares of LTV Corporation than actually existed—a feat that ultimately led to Scattered's censure and excommunication from the securities business. The other two members of NOLA are the fathers of Scattered's other officers and directors. NOLA is managed by a company named Teletech Systems, Inc., the president and sole employee of which is Greenblatt, who therefore effectively controlled South Beach.

South Beach's only creditor is Scattered, which asserted a claim in the amount of approximately $3.2 million. Scattered acquired the claim from another related company that had loaned money to South Beach in a convoluted and largely indecipherable series of transactions involving affiliated entities.

South Beach and NOLA filed for chapter 11 protection in Chicago on April 27, 2005. At the time of the filing, both companies were corporate shells with no business operations or income. The only assets of South Beach were NOLs. South Beach later proposed a chapter 11 plan under which the stock of South Beach held by NOLA would be canceled and new stock issued to Scattered. Scattered would then pay South Beach an amount sufficient to enable it to use up the NOLs, shielding the payment from taxes. The plan had only two classes, both of which contained

insiders: NOLA, in the single class of interest holders, and Scattered, in the single class of creditors.

After reviewing the petitions and schedules, the Illinois bankruptcy court, with the support of the U.S. Trustee, ruled that both cases should be dismissed under section 1112(b) of the Bankruptcy Code as having been filed in bad faith, neither case appearing to have any "legitimate reorganizational objective." South Beach (but not NOLA) appealed, and the district court reversed. The district court acknowledged that Scattered was "likely an insider vis-à-vis South Beach" but concluded that there is no "blanket prohibition on insider creditors collecting on their debts" in bankruptcy. Although there was "certainly a basis for concern" about South Beach's relationship with Scattered, the district court ruled, "more was needed" before the case could be dismissed. The district court accordingly remanded the case for further proceedings below in which the bad-faith question could be revisited.

On remand, however, the U.S. Trustee elected not to pursue dismissal, but instead objected to South Beach's plan on two grounds: (i) that no impaired, noninsider creditor class had accepted the plan, as required by section 1129(a)(10) of the Bankruptcy Code; and (ii) that the plan could not be confirmed in accordance with section 1129(d) because its principal purpose was avoidance of taxes. The bankruptcy court denied confirmation on these grounds, holding, moreover, that the U.S. Trustee had standing to object to confirmation under section 1129(d). The district court affirmed on appeal in July 2009.

The Seventh Circuit's Ruling

South Beach and Scattered fared no better in the Seventh Circuit. Writing for a unanimous three-judge panel, circuit judge Richard A. Posner initially addressed the U.S. Trustee's standing under section 1129(d), which by its terms can be invoked as a basis for denial of confirmation only by "a party in interest that is a governmental unit." Judge Posner acknowledged that a certain amount of inconsistency exists in both the Bankruptcy Code and case law on whether the U.S. Trustee qualifies as a "governmental unit" or a "party in interest." Even so, he discounted contrary court rulings on the role of the U.S. Trustee as a "governmental unit" and concluded that "the view that the U.S. Trustee can be a party in interest makes better sense," given the U.S. Trustee's important role as a watchdog in bankruptcy cases. Moreover, Judge Posner emphasized, a bankruptcy court has the power to consider issues of tax avoidance on its own initiative under section 105(a) of the Bankruptcy Code.

Addressing the merits of the controversy as an apparent matter of first impression in the circuits, Judge Posner reiterated and adopted the reasoning of the lower courts. He explained that, outside of bankruptcy, South Beach's NOLs could be used to obtain a tax benefit only if the company received a capital infusion that enabled it to obtain income against which to offset the losses, or if the assets were acquired by a company that had income or assets. However, he noted that a 1996 IRS private letter ruling lays out the general rule that taxpayers may not transfer NOLs to other taxpayers.

If the bankruptcy court had confirmed South Beach's proposed chapter 11 plan, Judge Posner observed, "[t]he result would be to shield income of Scattered from federal tax, because South Beach's income would be Scattered's income since Scattered would be South Beach's sole

owner." According to the judge, imposing limitations on using the purchase of a company as the basis for deducting the target company's NOLs from the purchaser's taxable income is consistent with the IRC and the judge-made tax doctrine of "substance over form."

Judge Posner expressed some doubts regarding whether the NOL preservation and transfer scheme proposed in South Beach's chapter 11 plan would pass muster under the tax laws, but he discounted this consideration in addressing the substance of the confirmation objection:

> So it looks as if the plan of reorganization, even if approved, wouldn't confer the tax benefit that Greenblatt sought. But that doesn't affect whether the plan was rightly rejected; for South Beach's disclosure statement suggests no purpose other than to beat taxes, and we know that a plan of reorganization may not be confirmed if that is its principal purpose, whether or not the purpose will actually be accomplished or will be nixed later by the Internal Revenue Service. The object of bankruptcy is to adjust the rights of the creditors of a bankrupt company; it is not to allow a solvent company to try to lighten its tax burden.

Judge Posner also ruled that the chapter 11 plan could not be confirmed under section 1129(a)(3) of the Bankruptcy Code on the "closely related ground that it hadn't been proposed in good faith." To be proposed in good faith, Judge Posner wrote, a chapter 11 plan must have "a true purpose and fact-based hope of either 'preserving [a] going concern' or 'maximizing property available to satisfy creditors.' " According to the judge, the absence of any real debt or outside creditors "shows that this case doesn't belong in bankruptcy court." Finally, Judge Posner dismissed as "bogus" Scattered's argument that a nontax motive for bankruptcy was to shield South Beach from lawsuits, remarking that "South Beach's bankruptcy schedule listed no claims other than Scattered's, and the deliberate omission of creditors from the list submitted by the debtor is unlawful and is ground for dismissal of the bankruptcy proceeding."

Outlook

South Beach Securities is an important development because it represents the first time that any of the federal circuit courts of appeal have weighed in on section 1129(d) of the Bankruptcy Code and, more specifically: (i) whether the U.S. Trustee has standing to raise an objection to confirmation based upon the provision; and (ii) under what circumstances the "principal purpose" of a chapter 11 plan will be deemed tax avoidance. The ruling also indicates that, even in cases where stakeholders do not object to a chapter 11 plan that violates the provisions of, and bedrock principles underlying, the Bankruptcy Code, the U.S. Trustee and, in the final instance, the bankruptcy court serve as gatekeepers to confirmation.

South Beach Securities, however, does not provide a great deal of guidance regarding the "principal purpose" test of section 1129(d). The Seventh Circuit had little difficulty concluding that the debtor's chapter 11 plan satisfied that test, based upon the utter absence of any plausible alternate motive. Other cases are likely to be more challenging on this issue. It is worth noting that the bankruptcy court's dismissal of the chapter 11 case *as having been filed in bad faith* was reversed on appeal, even though the reversing court was aware of all of the relevant facts and the plan proposed by the debtor. The entrance gate to chapter 11 is sometimes easier to navigate successfully than the exit.

In re South Beach Securities, Inc., 606 F.3d 366 (7th Cir. 2010).

Gregory v. Helvering, 293 U.S. 465 (1935).

In re Rath Packing Co., 55 B.R. 528 (Bankr. N.D. Iowa 1985).