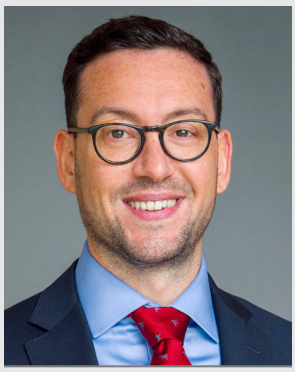
Evaluating Creditor Continuity of Interest: A 10-Step Process

by Alex Marcellesi



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In this report, Marcellesi outlines a 10-step process for analyzing and applying the creditor continuity of interest regulations, which he illustrates with examples drawn from fact patterns typically found in restructuring transactions.

The views expressed in this report, and any errors, are solely the author's.

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I. Introduction

The COVID-19 pandemic has thrown many struggling businesses into bankruptcy, especially in the retail and hospitality industries. The record amounts of new debt issued to survive the pandemic also created many corporate zombies — that is, companies in which interest paid exceeds profits for at least three years.[1] These corporate zombies are at a greater risk of defaulting on their obligations in the next downturn and being forced to restructure their debt.

From a tax standpoint, distressed corporations generally have valuable tax attributes such as net operating loss carryovers, carryforwards of disallowed business interest expense, or carryforwards of general business credits. Although these attributes may not be immediately valuable to a distressed corporation (T) that does not generate taxable income, they may be valuable to a prospective corporate acquirer (P).

P may be a third-party financial or strategic buyer. In many cases, however, P is a corporation newly formed by T's secured creditors (or by T on their behalf) to acquire T's assets. Forming P to acquire T's assets and having T's creditors exchange their debt claims for P stock (and often new P debt) is an alternative to recapitalizing T itself. Creditors sometimes prefer this alternative to ensure a fresh start for T's business and to leave behind all or a portion of T's legal, accounting, or regulatory history.

Structuring an acquisition of T's assets as a reorganization will allow P to inherit T's tax attributes.[2] Although P's ability to use these attributes to offset its taxable income will often be limited by sections 382 and 383, the effect of those provisions may be softened if T has filed for bankruptcy.[3] Further, a net built-in gain (NUBIG) in T's assets at the time of their acquisition will

[1] *See, e.g.*, Joe Rennison, "Pandemic Debt Binge Creates New Generation of 'Zombie' Companies," *Financial Times*, Sept. 13, 2020.

[2] Section 381(a)(2) and (c).

[3] Section 382(l)(5) and (6). The rules governing the application of sections 382 and 383 to an asset transfer that qualifies as a reorganization are in reg. section 1.382-2(a)(1)(ii).

increase the extent to which P can use T's pre-acquisition tax attributes.[4]

Structuring P's acquisition of T's assets as a reorganization will also cause holders of T stock or securities to defer the recognition of gain or loss realized on the exchange of their interests in T for P stock or securities, subject to some limits.[5] This consideration, however, is typically less important in practice (or may even weigh against a reorganization) when T is in financial distress and many of its shareholders and security holders are in a loss position.[6] More importantly, reorganization treatment will cause T not to recognize gain or loss on the disposition of its assets, which is particularly desirable when T has a NUBIG.[7]

To prevent T's shareholders and security holders from entirely exiting their investment in T without recognizing gain or loss, the regulations require that, in substance, a substantial part of the value of the proprietary interests in T be preserved in a reorganization.[8] This continuity of interest (COI) requirement is generally met if proprietary interests in P represent at least 40 percent of the consideration received in exchange for proprietary interests in T.[9]

Although neither the code nor the regulations define the term "proprietary interest," the courts have held that only equity interests are proprietary interests.[10] In particular, an interest as a creditor (whether secured or unsecured) is not a proprietary interest.[11] This raises an immediate issue when T is in so much financial distress that its equity interests are all but worthless and only T's creditors receive consideration in the exchange with P. Without some exception, no such exchange could qualify as a reorganization.

To remedy this situation, Treasury and the IRS issued regulations under which an interest in T solely as a creditor can, under some circumstances and to a specified extent, qualify as a proprietary interest in T for purposes of the COI requirement.[12] These creditor COI regulations, finalized in 2008, adopt the view long held by the courts and the IRS itself that when a corporation is in such financial distress that its equity interests become worthless, the corporation's creditors become its de facto shareholders.[13] These regulations also accord with the view that debt of a distressed company behaves in an equity-like fashion.[14]

The reasoning underpinning the courts' view that creditors of a distressed company are its de facto shareholders is based on the "absolute priority" rule of bankruptcy law. Simplifying somewhat, this rule requires that T's senior creditors be paid in full before T's junior creditors and shareholders can receive any recovery, unless

[4] Section 382(h)(1)(i) and (h)(6)(A); and Notice 2003-65, 2003-2 C.B. 747. *But see* REG-125710-18 (the section 382(h) regulations proposed September 10, 2019).

[5] *See* section 354(a)(2)(A).

[6] This is why this report focuses on the continuity of interest (COI) requirement as it applies to asset acquisitions. Even though a recapitalization of T may qualify as a section 368(a)(1)(E) reorganization, the stakes are typically lower, and it is less common for parties to explicitly structure a recapitalization so that it qualifies as a reorganization.

[7] Section 361(a). T may be distressed in that its cash flow is insufficient to service its existing debt and yet have a large NUBIG.

[8] Reg. section 1.368-1(e)(1)(i).

[9] Reg. section 1.368-1(e)(2)(v), Example 1.

[10] *See, e.g.*, *Helvering v. Minnesota Tea*, 296 U.S. 378 (1935).

[11] *LeTulle v. Scofield*, 308 U.S. 415, 420 (1940) ("Where the consideration is wholly in the transferee's bonds, or part cash and part such bonds, we think it cannot be said that the transferor retains any proprietary interest in the enterprise. On the contrary, he becomes a creditor of the transferee; and we do not think that the fact referred to by the Circuit Court of Appeals, that the bonds were secured solely by the assets transferred and that, upon default, the bondholder would retake only the property sold, changes his status from that of a creditor to one having a proprietary stake, within the purview of the statute.").

[12] T.D. 9434.

[13] *Helvering v. Alabama Asphaltic Limestone Co.*, 315 U.S. 179, 184 (1942) ("When the equity owners are excluded and the old creditors become the stockholders of the new corporation, it conforms to realities to date their equity ownership from the time when they invoked the processes of the law to enforce their rights of full priority. At that time they stepped into the shoes of the old stockholders. The sale did nothing but recognize officially what had before been true in fact."); and Rev. Rul. 59-222, 1959-1 C.B. 80.

[14] *See, e.g.*, Deborah H. Paul, "The Taxation of Distressed Debt Instruments: Taking Stock," 64 *Tax Law.* 37, 68 (2011) ("When distressed debt is exchanged for equity, it merely formalizes the pre-existing equity-like nature of the distressed debt.").

T's senior creditors agree otherwise.[15] The effect of this rule is to give T's creditors "the right to exclude [T's] stockholders" and "effective command over the disposition" of T's property to the extent that T is insolvent.[16] As explained later, however, only some of T's creditors are treated as stepping into the shoes of T's shareholders under the COI regulations.

This report describes the creditor COI regulations and their application as a 10-step process.[17] It addresses several ambiguities in those regulations, and illustrates their rules using some fact patterns that are common in restructuring transactions.

COI is only one of the many conditions required to be met for a transaction to qualify as a reorganization. Another key consideration is whether the existing T debt is a security. The mechanics of the exchange between P, T, and T's creditors and shareholders also matter greatly in a purported G reorganization.[18] Those considerations, as well as other statutory, regulatory, or judicial requirements, are beyond the scope of this report.

II. Creditor COI: A 10-Step Process

Step 1: Determine whether T is in a title 11 case or is balance sheet insolvent.

The creditor COI regulations apply only if (1) T is in a title 11 case (or a receivership, foreclosure, or similar court proceeding) or (2) T is balance sheet insolvent (that is, the amount of T's liabilities exceeds the fair market value of its assets immediately before the transaction).[19]

The FMV of T's assets can fluctuate unpredictably, and as a result, it can be difficult to determine whether T is balance sheet insolvent at the time its assets are acquired by P. Consider, for instance, recent fluctuations in the value of commercial real estate in New York City at the height of the COVID-19 lockdown and now that effective vaccines are being rolled out.

For this reason, it is typically easier to rely on the creditor COI regulations when T has filed for bankruptcy. Moreover, for an asset acquisition to qualify as a G reorganization, at least one of P or T must be under the jurisdiction of a court in a title 11 or similar case.[20] G reorganizations are particularly flexible, and it is common for reorganizations involving bankrupt corporations to be structured as G reorganizations.

If T is balance sheet solvent and is not in a title 11 or similar case, the regular COI rules apply.

Step 2: Identify the debt claims against T.

Under the creditor COI regulations, any debt claim against T can be a proprietary interest in T. There is no particular requirement that a debt claim against T be a security within the meaning of section 354. This can lead to cases in which non-security debt claims against T are treated as proprietary interests for purposes of qualifying an exchange of those claims for P stock and securities as a reorganization and yet the exchange is entirely taxable to holders of those non-security debt claims.[21]

The IRS's stance regarding T claims that are acquired shortly before, or with a view to, being exchanged for P stock is unclear. In a field service advice dated September 22, 1993, the IRS examined the case of a creditor who acquired T claims "as part of an integrated plan" to acquire P stock, and it concluded that claims held by that creditor should be disregarded for COI purposes.[22] As a result, the transaction did not meet the COI requirement and failed to qualify as a G reorganization.[23] The IRS's conclusion was based on step transaction principles and in

[15] Under the original version of the absolute priority rule, junior creditors and shareholders could not receive any recovery (even with the consent of senior creditors) until senior creditors had been paid in full. Under the relaxed version of the absolute priority rule codified in the current Bankruptcy Code at 11 U.S.C. section 1129(b)(2), senior creditors can consent to recoveries by junior creditors and shareholders even if they are not repaid in full.

[16] *Alabama Asphaltic*, 315 U.S. at 183-184.

[17] Although 10 steps may seem like a lot, I promise that these 10 steps are nothing like the 11 steps in reg. section 1.163(j)-6(f) for allocating section 163(j) items among partners in a partnership.

[18] Section 368(a)(1)(G).

[19] Reg. section 1.368-1(e)(6)(i) and section 368(a)(3).

[20] Section 368(a)(3)(b)(i).

[21] Section 354(a)(2)(A)(ii). *See also* S. Rep. No. 96-1035, at 37 (1980) ("Short-term creditors who receive stock for their claims may be counted toward satisfying the continuity of interest rule, although any gain or loss realized by such creditors will be recognized for income tax purposes."). Note that, in such a case, the reorganization could not be a G reorganization. Sections 368(a)(1)(G) and 354(a)(1).

[22] FSA 1993-1029.

[23] There were other reasons why the transaction failed to qualify as a G reorganization (*e.g.*, none of the debt claims against the bankrupt company were "securities").

particular on the "end result" and "mutual interdependence" tests.[24]

However, that field service advice predates the 1998 modification of the general COI regulations, which now provide that pre-reorganization sales of T stock to persons that are not related to either P or T are disregarded for COI purposes.[25] It also predates the 2008 creditor COI regulations, which do not impose any historic claimholder requirement. It is therefore unclear whether the 1993 field service advice reflects the IRS's current view on the issue.[26]

Step 3: Classify the debt claims against T.

The creditor COI regulations refer to "classes" of debt claims against T. Although not explicit in these regulations, this reference is to section 1123 of the Bankruptcy Code, which requires that a bankruptcy plan designate classes of claims and identify the consideration to be received (if any) by holders of claims in each class.[27]

Classifying claims for purposes of the COI regulations is therefore easy if T is in a title 11 case: Just look at Article III (typically) of the plan drafted by T's bankruptcy counsel. The process may be somewhat more complex if T is not in a title 11 case, although tax advisers should presumably be able to rely on information regarding T's capital structure obtained from T or its financial advisers.

The creditor COI regulations also provide that if a debt claim against T is bifurcated into a secured claim and an unsecured claim, either by court order or by agreement between T and its creditors, this bifurcated claim will be treated as two distinct claims for COI purposes.[28] The same principle presumably should apply if a debt claim against T is bifurcated into several secured claims of varying levels of seniority.

Step 4: Identify the highest class of debt claims to receive P stock.

Once the debt claims against T have been classified, one must identify the highest class of claims such that *any* claim in this class is actually exchanged for P stock. Every claim in this class — regardless of whether it is itself exchanged for P stock — is a proprietary interest in T.[29] If, for instance, holders of first-lien (1L) claims against T are given the option to exchange their claims for either P stock and new P debt or cash, and exactly one holder exercises its option to receive P stock and new P debt, all 1L claims are proprietary interests in T, even though all but one of them were exchanged for cash.[30] By contrast, claims in more senior classes are not proprietary interests in T. Debt claims in junior classes and equity claims may be proprietary interests, as explained in steps 6 and 7.

The creditor COI regulations further provide that every claim in a class that is equal to the highest class of claims to receive P stock is also a proprietary interest in T. Consider the case in which the claims of T's 1L term lenders and those of T's 1L revolving lenders are treated as belonging to equal classes of claims. In that case, all 1L debt claims against T will be treated as proprietary interests in T to the same extent, even if only T's 1L term lenders receive P stock and T's 1L revolving lenders are repaid in full in cash.[31]

One might think that claims that are senior to claims in the highest class of claims to receive P stock should also be treated as proprietary interests in T. After all, if T's creditors are its de facto shareholders because they have the effective power to dispose of T's assets, shouldn't T's most senior creditors — who are first in line to recover from T's assets — be treated as holding proprietary interests in T as well? To the extent that holders of those senior claims receive full recoveries in cash or P debt, however, their claims

[24] The IRS's reasoning relied in particular on *Yoc Heating Corp. v. Commissioner*, 61 T.C. 168 (1973), and *Security Industrial Insurance Co. v. United States*, 702 F.2d 1234 (5th Cir. 1983).

[25] Reg. section 1.368-1(e)(6)(i) and T.D. 8783. *See also J.E. Seagram Corp. v. Commissioner*, 104 T.C. 75 (1995).

[26] One possibility would be for the IRS to adopt a rule akin to the "5/14 rule" that applies to intermediating banks in the context of section 355 (*see, e.g.*, LTR 201123030 and LTR 200808006) and bless situations in which a "transitory" claimholder holds its claims for a material amount of time before entering into the restructuring agreement and therefore bears actual economic risk.

[27] 11 U.S.C. section 1123(a)(1) and (3).

[28] Reg. section 1.368-1(e)(6)(iii).

[29] Reg. section 1.368-1(e)(6)(i).

[30] This example assumes that no claims that are senior to 1L claims are exchanged for P stock.

[31] Again, this example assumes that no claims that are senior to 1L claims are exchanged for P stock. For simplicity, I will generally omit references to classes that are equal to the highest class of claims to be exchanged for P stock in the rest of this report, except when relevant. All the rules described later in the text that apply to the highest class of claims to be exchanged for P stock should be read as also applying to equal classes.

bear no similarity to T equity (unlike claims in junior classes) and should not be treated as proprietary interests in T.

The creditor COI regulations follow this principle and partially adopt the relation-back approach of *Atlas Oil* to determine which classes of debt claims against T constitute proprietary interests.[32] Under that approach, only classes of claims that are exchanged for P stock, and thus entitle their holders to a continuing interest in T through their ownership of P stock, constitute proprietary interests in T.[33] This approach therefore dictates ignoring classes of claims that are exchanged for P debt in the same principal amount (plus accrued but unpaid interest on the T debt) rather than T stock.[34] It also dictates ignoring classes of claims that must be fully repaid in cash upon the closing of the transaction (for example, administrative expense claims).[35]

The creditor COI regulations only partially adopt the relation-back approach of *Atlas Oil* because, as explained earlier regarding equal classes and later (in step 6) regarding junior classes, they treat some debt claims as proprietary interests in T regardless of whether they are exchanged for P stock.[36]

Step 5: Determine the extent to which claims in the highest class to receive P stock are proprietary interests in T.

A key provision of the creditor COI regulations is the COI formula below, which determines the value of the proprietary interests in T represented by claims in the highest class of claims to receive P stock.

$$\textit{FMV of claim} * \frac{\textit{Aggregate FMV of P stock received for claims in the highest class of T claims to receive P stock (and all equal classes)}}{\textit{Aggregate FMV of all consideration received for claims in the highest class of T claims to receive P stock (and all equal classes)}}$$

The left side of the COI formula caps the value of the proprietary interest in T represented by a claim in the highest class of claims to receive P stock at this claim's FMV, regardless of its face value. As we will see in step 6, the creditor COI regulations adopt the same approach for junior claims. This is advantageous for taxpayers that seek reorganization treatment because (1) the FMV of debt of a distressed issuer generally is significantly lower than its face value, and (2) all else being equal, the lower the aggregate value of the proprietary interests in T, the more likely COI is to be satisfied.

In the case of claims in the highest class to receive P stock, however, the right side of the COI formula further limits the value taken into account for COI purposes. Consider, for instance, a case in which every claim in that highest class has a face value of $200 but is worth only $100 and is exchanged for P stock worth $75, new P debt worth $20, and $5 of cash. The value of the proprietary interest represented by each of those claims for COI purposes is $100 * ($75/$100) = $75. As illustrated by this example, the denominator in the COI formula takes into account the FMV of *all* the consideration received in exchange for debt claims in the highest class, regardless of its form.

As an alternative to the example in the preceding paragraph, consider a case in which the claims of 1L term lenders and 1L revolving lenders are treated as belonging to equal classes, and assume for simplicity that all 1L claims are worth $100. Assume also that 1L term lenders are entitled to receive P stock worth $100 and that 1L

[32] *Atlas Oil and Refining Corp. v. Commissioner*, 36 T.C. 675 (1961).

[33] *Id.* at 688 ("The effect of the [*Alabama Asphaltic*] rule is merely that creditors who have a bona fide interest remaining who in fact receive stock in the new corporation, by relation back, can be deemed to have been equity owners at the time of the transfer, so as to be capable of satisfying the continuity-of-interest requirement that stock go to former owners."). In *Atlas Oil*, the IRS argued that *Alabama Asphaltic* mandated treating *all* creditors as de facto shareholders of T, which would have caused COI to fail. The Tax Court, however, adopted a narrower reading of the *Alabama Asphaltic* rule. *Id.*

[34] *Id.* at 687 ("The protected bondholders who maintain their status in the new corporation are not deemed 'former owners' and thus, need not participate in the equity distribution of the new company.").

[35] *See* S. Rep. No. 96-1035, at 33, 37 n.7 (1980). *See also* New York State Bar Association Tax Section, "Report on Statutory Provisions Regarding the Importation and Duplication of Tax Losses," Report No. 1102, at 32 (Jan. 20, 2006) (arguing that unsecured claims that are treated as priority claims and must be repaid in cash should be ignored for COI purposes).

[36] In *Atlas Oil*, the Tax Court ignored the claims of junior creditors that "were to receive ten cents on the dollar in cash in payment of their claims as proven and allowed by the court, without interest" in its COI analysis and therefore did not, in effect, consider those claims to be proprietary interests in T. *Atlas Oil*, 36 T.C. at 678. Henderson and Goldring adopt a slightly different interpretation of *Atlas Oil* and read the Tax Court as having adopted the same view as the COI regulations — namely, that all senior claims to receive P stock *and* all equal and junior claims to receive some consideration are proprietary interests in T. Henderson and Goldring, *supra* note 22, at sections 510.3 and 605.1.4.

revolving lenders are entitled to receive $100 in cash. In this case, the value of the proprietary interest represented by each 1L claim — regardless of whether it is a term loan claim or a revolving loan claim — for COI purposes is $100 * ($100/$200) = $50. As illustrated by this example, and as the preamble to the proposed version of the creditor COI regulations puts it, "the determination of what part of a senior claim is a proprietary interest in the target corporation is made by calculating the average treatment for all senior claims."[37]

As mentioned earlier, the COI formula is advantageous for taxpayers that seek reorganization treatment because it makes it more likely that the COI requirement will be met. This is consistent with Congress's purpose in creating the G reorganization, which was to "facilitate the rehabilitation of corporate debtors in bankruptcy" and "eliminate many requirements which have effectively precluded financially troubled companies from utilizing the generally applicable tax-free reorganization provisions."[38] This also means, however, that taxpayers that wish to avoid reorganization treatment (for example, because a step-up in the bases of T's assets is more valuable than T's tax attributes) should ensure that other G reorganization requirements are not satisfied (for example, by transferring T's assets to a lower-tier subsidiary of P rather than to P itself).

A straightforward effect of the COI formula is that if (1) there is only one class of T creditors, (2) any creditor in this class receives any P stock, and (3) T's existing stock is canceled, there will always be 100 percent COI (subject to the de minimis rule discussed in step 8). In the first example above, assuming there is only one class of T creditors and T's stock is canceled, T's creditors would be exchanging proprietary interests in T that are worth $75 for proprietary interests in P that are also worth $75. In other words, proprietary interests in P would represent 100 percent of the consideration received in exchange for proprietary interests in T. Of course, T will systematically have several classes of creditors, in addition to shareholders, and steps 6 and 7 address the treatment of junior classes of debt claims and equity claims under the creditor COI regulations.

Step 6: Determine the extent to which junior claims are proprietary interests in T.

The creditor COI regulations state that "every claim of all . . . junior classes of creditors," that is, classes of creditors that are junior to the highest class of claims to receive P stock, is a proprietary interest in T "immediately prior to the potential reorganization."[39] It does not matter whether any claim in any of these junior classes is exchanged for P stock.[40] The creditor COI regulations further provide that the value of the proprietary interest represented by a claim in a junior class that is taken into account for COI purposes is the FMV of that claim, regardless of its face value.[41]

Combining this rule treating all junior claims as proprietary interests with the COI formula described in step 5 has the effect that "there is 100 percent continuity of interest if each senior claim is satisfied with the same ratio of stock to nonstock consideration and no junior claim is satisfied with nonstock consideration."[42]

The creditor COI regulations do not indicate how to determine the FMV of a claim (whether junior or senior) for COI purposes. The preamble to the proposed version of these regulations, however, states that the value of a claim is "generally determined by reference to the amount of money and the fair market value of the consideration received in exchange therefor."[43] This approach is consistent with common law tax principles.[44] It also makes sense for claims that are canceled: Because no consideration is received in exchange for these claims, their value at closing should be zero.

Consider, however, the case of claims that are reinstated by the bankruptcy court. These are claims on which T defaulted pre-bankruptcy but that can remain in place — with their original

[37] Preamble to REG-163314-03, 70 F.R. 11903, 11907 (Mar. 10, 2005).

[38] *See* S. Rep. No. 96-1035, at 35 (1980).

[39] Reg. section 1.368-1(e)(6)(i).

[40] *See* S. Rep. No. 96-1035, at 36-37 (1980); and T.D. 9434.

[41] Reg. section 1.368-1(e)(6)(ii)(B).

[42] T.D. 9434.

[43] Preamble to REG-163314-03, 70 F.R. at 11907.

[44] *See, e.g.*, *Philadelphia Park Amusement v. United States*, 130 Ct. Cl. 166 (1954).

terms — post-bankruptcy if T meets specified conditions (including curing the default).[45] Reinstated claims may be proprietary interests under the creditor COI regulations if they are in a junior class. Their FMV at closing should normally be positive, so that these claims will have an actual effect on COI computations. Unless reinstated claims are publicly traded, however, it may be challenging to determine their FMV at closing.

Step 7: Determine the extent to which equity claims are proprietary interests in T.

In addition to some debt claims against T, the creditor COI regulations also treat T stock as proprietary interests in T.[46] Although the regulations do not explicitly say so, T stock, much like junior debt claims against T, should be treated as a proprietary interest in T to the extent of its FMV. In many restructurings, T stock is treated as worthless and its holders are not entitled to receive any consideration. In those cases, the FMV of T stock at closing should be zero, so T stock should be, in effect, disregarded for COI purposes.[47]

Consider, however, a case in which T's shareholders agree to contribute additional capital to T (which cash will then be transferred to P) in exchange for the right to receive a small percentage of the P stock being exchanged for T's assets. T's shareholders may prefer this alternative, and the hope of an increase in the value of the P stock, to seeing their T stock become entirely worthless. Should the T stock exchanged for P stock in this scenario be considered a proprietary interest in T?

Courts have held that the answer should be no when T is insolvent.[48] Their reasoning is based on the absolute priority rule described earlier. If T is insolvent and cannot repay its creditors in full, T's filing for bankruptcy will have the practical effect of extinguishing the equity interests in T. Under the absolutely priority rule, T's creditors will have the right to exclude T's shareholders from any recovery. On this basis, courts have held that any P stock received by T's shareholders in the scenario posited here must have been received on account of their new capital investment in T, and not on account of the equity interest they held in T beforehand.[49] In other words, the courts would treat the P stock as, in substance, received in exchange for cash rather than in exchange for T stock.

Step 8: If only one class of claims is exchanged for P stock, apply the de minimis rule.

The creditor COI regulations contain a rule providing that if only one class of T creditors receives P stock, that P stock is taken into account for COI purposes only if it "is not de minimis in relation to the total consideration received by the insolvent target corporation, its shareholders, and its creditors."[50] This rule is designed to prevent a scenario in which a class of T creditors receives $99 of cash and P stock worth $1 and yet the COI formula yields the result that there is 100 percent COI simply because T's other creditors and T's shareholders do not receive any consideration.[51]

Unfortunately, the creditor COI regulations do not define de minimis, and the lone example illustrating the rule is unhelpful.[52] That example provides that P stock representing 25 percent of the total consideration received by T's creditors and shareholders is not de minimis.[53] This leaves tax advisers, none of whom would have thought of 25 percent as de minimis in the first place, scratching their heads over how to apply the rule.

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[45] 11 U.S.C. section 1124.

[46] Reg. section 1.368-1(e)(6)(iv).

[47] Reg. section 1.368-1(e)(8), Example 10(i).

[48] *See, e.g.*, *Mascot Stove Co. v. Commissioner*, 120 F.2d 153 (6th Cir. 1941); and *Templeton's Jewelers Inc. v. United States*, 126 F.2d 251 (6th Cir. 1942). *See also* NYSBA Tax Section, "Report on Reorganizations Under Section 368(a)(1)(G) of the Code," Report No. 508 (Oct. 30, 1985).

[49] *See, e.g.*, *Mascot Stove*, 120 F.2d at 155-156 ("It is true that the old stockholders were permitted to become stockholders in the new company, but by virtue of the adjudication in bankruptcy the old stockholders had nothing to transfer, and the old company being insolvent and unable to pay its debts, neither it nor its stockholders could receive anything. There was, therefore, no exchange of stock for stock, or property for stock, and the interest the stockholders acquired in the new company was not, either in legal contemplation or as an economic concept, an acquisition in exchange for their stock in the old company, or by virtue of their ownership of it.").

[50] Reg. section 1.368-1(e)(6)(II)(A).

[51] The COI formula would yield the result that the value of the proprietary interest represented by claims in that class of T creditors is $100 * ($1/$100) = $1, and there would be 100 percent COI because those creditors would be exchanging a proprietary interest in T with a value of $1 for a proprietary interest in P with the same value.

[52] Moreover, there is as of yet no IRS guidance or case law applying this de minimis rule.

[53] Reg. section 1.368-1(e)(8), Example 10(ii).

The New York State Bar Association Tax Section, in its report on the proposed version of the creditor COI regulations, asked Treasury and the IRS to "consider creating a fixed standard for de minimis consideration, perhaps one percent or two percent of the fair market value of all of the consideration received in the transaction."[54] This suggested threshold is consistent with the *Black's Law Dictionary* (2019) definition of de minimis as meaning "trifling, negligible." It is also consistent with many de minimis thresholds found in the code and the regulations.[55]

The creditor COI regulations appear to permit circumventing the de minimis rule by having T's junior creditors or shareholders receive any amount of P stock — so that it's no longer the case that only one class of T creditors receives P stock. Those issuances, however, may be challenged by the IRS under various judicial doctrines (for example, economic substance) if they are themselves de minimis and their sole purpose is to ensure that COI is satisfied.

Step 9: Determine the issue price of any P debt received by T's creditors.

The consideration received by T's creditors for their existing debt claims against T often includes new P debt. The creditor COI regulations seem to indicate that the amount to be taken into account for COI purposes is the FMV of this P debt — not its face value or its issue price.[56] Because the new P debt is issued in exchange for property, however, the amount taken into account for COI purposes presumably should be the amount realized by T's creditors on receipt of the P debt, which generally will be the issue price of the P debt.[57]

Although the issue price rules are beyond the scope of this report, the issue price of the P debt generally will depend on whether the P debt itself or the T debt for which it is exchanged is treated as "traded on an established market" under the section 1273 regulations.[58] As many commentators have pointed out, those regulations treat many debt instruments that are not actually traded — let alone traded on an established market — as traded on an establish market, which can lead to surprising consequences.[59]

Consider an example in which the T debt and the new P debt issued in exchange both have a face value of $100, the T debt is treated as traded on an established market but the P debt is not, and the FMV of the T debt is only $50 given T's distressed financial situation. In that case, the issue price of the new P debt would be $50, even if P is expected to repay this debt in full and has the ability to do so.[60]

Although this rule may be counterintuitive and will tend to increase the amount of cancellation of debt income realized by T, it is actually advantageous for COI purposes. Because P debt is not a proprietary interest in P, any rule that tends to reduce the amount that is taken into account with respect to P debt for COI purposes will also tend to make it easier for COI to be satisfied.

[54] NYSBA Tax Section Report No. 1102, *supra* note 35, at 35.

[55] *See, e.g.*, section 265(b)(7) (2 percent); section 831(b)(2)(B)(iv)(IV) (2 percent); section 851(d)(2)(B) (1 percent); section 856(d)(7)(B) (1 percent); section 857(b)(7)(B)(ii) (1 percent); section 4943(c)(2)(C) (2 percent); reg. section 1.860D-1(b)(3)(ii) (1 percent); and reg. section 1.6031(a)-1(b)(2) (1 percent). The code and the regulations also contain several de minimis thresholds that are lower than 1 to 2 percent, *e.g.*, the threshold for de minimis original issue discount (0.0025 * (stated redemption price at maturity * number of complete years to maturity from the issue date)). Section 1273(a)(3) and reg. section 1.1273-1(d)(2).

[56] Reg. section 1.368-1(e)(6)(ii)(A) (describing the COI formula as a fraction "the denominator of which is the sum of the amount of money and the *fair market value* of all other consideration (including the proprietary interests in the issuing corporation) received in the aggregate in exchange for such claims."). (Emphasis added.)

[57] Reg. section 1.1001-1(g)(1). The amount realized on receipt of the P debt may diverge from its issue price, for instance, if the P debt is a cash-method contingent payment debt instrument governed by reg. section 1.1275-4(c). Reg. section 1.1001-1(g)(2). In that case, the amount realized on receipt of the P debt — not the issue price of the P debt — should be taken into account for COI purposes.

[58] Reg. section 1.1273-2(f).

[59] *See, e.g.*, NYSBA Tax Section, "Report on Definition of 'Traded on an Established Market' Within the Meaning of Section 1273 and Related Issuers," Report No. 1209 (Mar. 10, 2010). Obtaining a Committee on Uniform Security Identification Procedures number for a debt instrument may be enough to cause a service such as the Bloomberg Valuation Service or Markit to produce an "indicative quote" for the instrument, which in turn could cause it to be "traded on an established market" for purposes of the section 1273 regulations, even if this instrument is never actually traded. Reg. section 1.1273-2(f)(1)(iii).

[60] Reg. section 1.1273-2(c)(1).

Step 10: Compare the value of the proprietary interests in T with the value of the P stock received in exchange to determine whether COI is satisfied.

Once one has identified and valued the proprietary interests in T represented by debt and equity claims against T, determining whether COI is satisfied should be simple. COI is satisfied if and only if the value of the P stock received by T's creditors and shareholders represents at least 40 percent of the value of the proprietary interests in T surrendered in the exchange.[61] The examples in the following section are intended to illustrate how to apply this rule and steps 1 through 9 above.

III. Examples

In every example that follows, I assume that T is in a title 11 case or is balance sheet insolvent (step 1), that the debt claims against T have been identified (step 2), and that these debt claims have been classified (step 3). The analysis therefore starts on step 4.

Although examples 1 through 6 assume that T's creditors' non-P stock recovery takes the form of cash rather than new P debt (as would be more common), the outcome of each example would be the same if one assumes instead that T's creditors receive P debt with an issue price equal to the amount of cash posited by the example.

A. Example 1

All senior T creditors receive the same mix of P stock and cash; junior T creditors receive a mix of cash and P stock; and T's stock is canceled.[62]

1. Fact pattern.

- T has assets with an FMV of $150 and has debt with a face value of $200.
- T has two classes of creditors (in order of priority):
  - Class 1: T's class 1 creditors hold claims with an aggregate face value of $50.
  - Class 2: T's class 2 creditors hold claims with an aggregate face value of $150.
- T transfers its assets to P in exchange for $95 of cash and P stock with an FMV of $55.
  - T's class 1 creditors receive, in the aggregate, $40 of cash and P stock with an FMV of $10.
  - T's class 2 creditors receive, in the aggregate, $55 of cash and P stock with an FMV of $45.[63]
- T's stock is canceled, and T's existing shareholders receive no consideration.

2. Analysis.

- *Step 4*: Class 1 is the highest class of debt claims to receive P stock, so class 1 claims and class 2 claims are proprietary interests in T.
- *Step 5*: Under the COI formula, the value of the proprietary interests represented by class 1 claims is, in the aggregate, $50 * ($10/$50) = $10.
- *Step 6*: The value of the proprietary interests represented by class 2 claims is, in the aggregate, $100.
- *Step 7*: Because existing T stock is canceled in the restructuring, it is disregarded for COI purposes.
- *Step 8*: Because more than one class of claims is exchanged for P stock, the de minimis rule does not apply.
- *Step 9*: T's creditors do not receive any P debt.
- *Step 10*: In the aggregate, T's creditors exchange proprietary interests in T with an FMV = $10 + $100 = $110, for P stock with an FMV = $10 + $45 = $55, so there is $55/$110 = 50 percent COI.

B. Example 2

All senior T creditors receive the same mix of P stock and cash; junior T creditors receive P stock only; and T's stock is canceled.

1. Fact pattern.

- T has assets with an FMV of $150 and debt with a face value of $200.
- T has two classes of creditors (in order of priority):

[61] Reg. section 1.368-1(e)(2)(v), Example 1.

[62] This example is based on reg. section 1.368-1(e)(8), Example 10(i).

[63] In other words, class 2 debt claims against T "trade" at a 33 percent discount to their face value of $150 and have an FMV of $100.

- Class 1: T's class 1 creditors hold claims with an aggregate face value of $50.
- Class 2: T's class 2 creditors hold claims with an aggregate face value of $150.

- T transfers its assets to P in exchange for $40 of cash and P stock with an FMV of $110.
  - T's class 1 creditors receive, in the aggregate, $40 of cash and P stock with an FMV of $10.
  - T's class 2 creditors receive, in the aggregate, P stock with an FMV of $100.
- T's stock is canceled, and T's existing shareholders receive no consideration.

2. Analysis.

- *Step 4*: Class 1 is the highest class of debt claims to receive P stock, so class 1 claims and class 2 claims are proprietary interests in T.
- *Step 5*: Under the COI formula, the value of the proprietary interests represented by class 1 claims is, in the aggregate, $50 * ($10/$50) = $10.
- *Step 6*: The value of the proprietary interests represented by class 2 claims is, in the aggregate, $100.
- *Step 7*: Because existing T stock is canceled in the restructuring, it is disregarded for COI purposes.
- *Step 8*: Because more than one class of claims is exchanged for P stock, the de minimis rule does not apply.
- *Step 9*: T's creditors do not receive any P debt.
- *Step 10*: In the aggregate, T's creditors exchange proprietary interests in T with an FMV = $10 + $100 = $110 for P stock with an FMV = $10 + $100 = $110, so there is $110/$110 = 100 percent COI.

3. Comments.

Example 2 illustrates the fact that "there is 100 percent continuity of interest if each senior claim is satisfied with the same ratio of stock to nonstock consideration and no junior claim is satisfied with nonstock consideration."[64]

C. Example 3

T has co-equal senior classes of creditors, only one of which receives P stock; junior T creditors receive only P stock; and T's stock is canceled.

1. Fact pattern.

- T has assets with an FMV of $150 and debt with a face value of $200.
- T has two classes of creditors (in order of priority, except that classes 1A and 1B are co-equal):
  - Class 1A: T's class 1A creditors hold claims with an aggregate face value of $30.
  - Class 1B: T's class 1B creditors hold claims with an aggregate face value of $20.
  - Class 2: T's class 2 creditors hold claims with an aggregate face value of $150.

- T transfers its assets to P in exchange for $95 of cash and P stock with an FMV of $55.
  - In the aggregate, T's class 1A creditors receive $20 of cash and P stock with an FMV of $10.
  - T's class 1B creditors receive, in the aggregate, $20 of cash.
  - T's class 2 creditors receive, in the aggregate, $55 of cash and P stock with an FMV of $45.

- T's stock is canceled, and T's existing shareholders receive no consideration.

2. Analysis.

- *Step 4*: Class 1A is the highest class of debt claims to receive P stock, so class 1A claims, class 1B claims, and class 2 claims are proprietary interests in T.
- *Step 5*: Under the COI formula, the value of the proprietary interests represented by class 1A claims is, in the aggregate, $30 * [$10/($30 + $20)] = $6, and the value of the proprietary interests represented by class 1B claims is, in the aggregate, $20 * [$10/($30 + $20)] = $4.
- *Step 6*: The value of the proprietary interests represented by class 2 claims is, in the aggregate, $100.
- *Step 7*: Because existing T stock is canceled in the restructuring, it is disregarded for COI purposes.

[64] T.D. 9434.

- *Step 8*: Because more than one class of claims is exchanged for P stock, the de minimis rule does not apply.
- *Step 9*: T's creditors do not receive any P debt.
- *Step 10*: In the aggregate, T's creditors exchange proprietary interests in T with an FMV = $6 + $4 + $100 = $110 for P stock with an FMV = $10 + $45 = $55, so there is $55/$110 = 50 percent COI.

3. Comments.

Example 3, which yields the same outcome as Example 1, illustrates that the mix of P stock and cash received by different co-equal senior classes of creditors does not matter for COI purposes. The same is true when different creditors within the same senior class receive different mixes of P stock and cash.[65] Rather, in both cases, "the determination of what part of a senior claim is a proprietary interest in the target corporation is made by calculating the *average treatment for all senior claims*."[66] (Emphasis added.)

D. Example 4

Senior T creditors receive P stock only; junior T creditors receive cash only; and T's stock is canceled.

1. Fact pattern.

- T has assets with an FMV of $150 and debt with a face value of $200.
- T has two classes of creditors (in order of priority):
  - Class 1: T's class 1 creditors hold claims with an aggregate face value of $50.
  - Class 2: T's class 2 creditors hold claims with an aggregate face value of $150.
- T transfers its assets to P in exchange for $100 of cash and P stock with an FMV of $50.
  - T's class 1 creditors receive, in the aggregate, P stock with an FMV of $50.
  - T's class 2 creditors receive, in the aggregate, $100 of cash.
- T's stock is canceled, and T's existing shareholders receive no consideration.

2. Analysis.

- *Step 4*: Class 1 is the highest class of debt claims to receive P stock, so class 1 and class 2 claims are proprietary interests in T.
- *Step 5*: Under the COI formula, the value of the proprietary interests represented by class 1 claims is, in the aggregate, $50 * ($50/$50) = $50.
- *Step 6*: The value of the proprietary interests represented by class 2 claims is, in the aggregate, $100.
- *Step 7*: Because existing T stock is canceled in the restructuring, it is disregarded for COI purposes.
- *Step 8*: Because class 1 is the only class to receive P stock, the de minimis rule may apply. This P stock will be taken into account for COI purposes only if it is not de minimis "in relation to the total consideration received by the insolvent target corporation, its shareholders, and its creditors."[67] Here, the P stock represents $50/$150 = 33 percent of the total consideration received by T, T's shareholders, and T's creditors. This amount of P stock is not de minimis.[68]
- *Step 9*: T's creditors do not receive any P debt.
- *Step 10*: In the aggregate, T's creditors exchange proprietary interests in T with an FMV = $50 + $100 = $150 for P stock with an FMV = $50, so there is $50/$150 = 33 percent COI. As a result, the COI requirement is not satisfied, and the acquisition of T's assets by P cannot qualify as a reorganization.

E. Example 5

T's priority creditors receive cash only; all senior T creditors receive the same mix of P stock and cash; T has no junior creditors; and T's stock is canceled.

1. Fact pattern.

- T has assets with an FMV of $150 and debt with a face value of $200.
- T has two classes of creditors (in order of priority):

[65] As illustrated by reg. section 1.368-1(e)(8), Example 10(ii).

[66] Preamble to REG-163314-03, 70 F.R. at 11907.

[67] Reg. section 1.368-1(e)(6)(ii)(A).

[68] Reg. section 1.368-1(e)(8), Example 10(ii).

- Class 1: T's class 1 creditors hold claims with an aggregate face value of $50.
- Class 2: T's class 2 creditors hold claims with an aggregate face value of $150.

- T transfers its assets to P in exchange for $138 of cash and P stock with an FMV of $12.
  - T's class 1 creditors receive, in the aggregate, $50 of cash.
  - T's class 2 creditors receive, in the aggregate, $88 of cash and P stock with an FMV of $12.

- T's stock is canceled, and T's existing shareholders receive no consideration.

2. Analysis.

- *Step 4*: Class 2 is the highest class of debt claims to receive P stock, so class 2 claims are proprietary interests in T. Despite having priority over class 2 claims, class 1 claims are not proprietary interests in T.
- *Step 5*: Under the COI formula, the value of the proprietary interests represented by class 2 claims is, in the aggregate, $100 * ($12/$100) = $12.
- *Step 6*: There are no T debt claims that are junior to the class 2 claims.
- *Step 7*: Because existing T stock is canceled in the restructuring, it is disregarded for COI purposes.
- *Step 8*: Because class 2 is the only class to receive P stock, the de minimis rule may apply. This P stock will be taken into account for COI purposes only if it is not de minimis "in relation to the total consideration received by the insolvent target corporation, its shareholders, and its creditors."[69] Here, the P stock represents $12/$150 = 8 percent of the total consideration received by T, T's shareholders, and T's creditors. Although not entirely free from doubt, this amount of P stock arguably should not be treated as de minimis and thus should be taken into account for COI purposes.
- *Step 9*: T's creditors do not receive any P debt.
- *Step 10*: In the aggregate, T's creditors exchange proprietary interests in T with an FMV = $12 for P stock with an FMV = $12, so there will be $12/$12 = 100 percent COI, assuming the P stock received by class 2 is not de minimis. If this P stock was de minimis and therefore disregarded, there would be 0 percent COI.

3. Comments.

The outcome would be the same if T had creditors junior to class 2 but those creditors were not entitled to any consideration for their claims, because the FMV of those claims would then be zero at closing.[70]

F. Example 6

All senior T creditors receive the same mix of P stock and cash; claims of junior T creditors are reinstated; and T's stock is canceled.

1. Fact pattern.

- T has assets with an FMV of $150 and debt with a face value of $150.
- T has two classes of creditors (in order of priority):
  - Class 1: T's class 1 creditors hold claims with an aggregate face value of $50.
  - Class 2: T's class 2 creditors hold claims with an aggregate face value of $100.

- T transfers its assets to P in exchange for $10 of cash, P stock with an FMV of $40, and the assumption of the class 2 liability of $100 (see below).
  - T's class 1 creditors receive, in the aggregate, $10 of cash and P stock with an FMV of $40.
  - The claims of T's class 2 creditors are reinstated by the bankruptcy court.

- T's stock is canceled, and T's existing shareholders receive no consideration.

2. Analysis.

- *Step 4*: Class 1 is the highest class of debt claims to receive P stock, so class 1 claims and class 2 claims are proprietary interests in T.
- *Step 5*: Under the COI formula, the value of the proprietary interests represented by

[69] Reg. section 1.368-1(e)(6)(ii)(A).

[70] Preamble to REG-163314-03, 70 F.R. at 11907.

class 1 claims is, in the aggregate, $50 * ($40/$50) = $40.

- *Step 6*: The value of the proprietary interests represented by class 2 claims is their FMV, which cannot be determined based on consideration received in exchange for those claims. Let's assume that class 2 claims have an FMV of $80.
- *Step 7*: Because existing T stock is canceled in the restructuring, it is disregarded for COI purposes.
- *Step 8*: Because class 1 is the only class to receive P stock, the de minimis rule may apply. Here, the P stock represents $40/$150 = 26.7 percent of the total consideration received by T, T's shareholders, and T's creditors (including the assumption of the $100 reinstated liability). This amount of P stock is not de minimis.[71]
- *Step 9*: T's creditors do not receive any P debt.
- *Step 10*: In the aggregate, T's creditors exchange proprietary interests in T with an FMV = $40 + $80 = $120 for P stock with an FMV of $40, so there is $40/$120 = 33.3 percent COI. As a result, the COI requirement is not satisfied, and the acquisition of T's assets by P cannot qualify as a reorganization.

G. Example 7

T's priority creditors receive cash only; all senior T creditors receive the same mix of P stock and P debt; T's junior creditors receive P warrants; and T's stock is canceled.

1. Fact pattern.

- T has assets with an FMV of $150 and debt with a face value of $200.
- T has three classes of creditors (in order of priority):
  - Class 1: T's class 1 creditors hold claims with an aggregate face value of $20.
  - Class 2: T's class 2 creditors hold claims with an aggregate face value of $150.
  - Class 3: T's class 3 creditors hold claims with an aggregate face value of $30.
- T transfers its assets to P in exchange for $20 of cash, P debt with an issue price of $100, P stock with an FMV of $20, and P warrants with an FMV of $10.
  - T's class 1 creditors receive, in the aggregate, $20 of cash.
  - T's class 2 creditors receive, in the aggregate, P debt with an issue price of $100 and P stock with an FMV of $20.
  - T's class 3 creditors receive, in the aggregate, P warrants with an FMV of $10.
- T's stock is canceled, and T's existing shareholders receive no consideration.

2. Analysis.

- *Step 4*: Class 2 is the highest class of debt claims to receive P stock, so class 2 and class 3 claims are proprietary interests in T. Despite having priority over class 2 claims, class 1 claims are not proprietary interests in T.
- *Step 5*: Under the COI formula, the value of the proprietary interests represented by class 2 claims is, in the aggregate, $120 * ($20/$120) = $20.[72]
- *Step 6*: The value of the proprietary interests represented by class 3 claims is, in the aggregate, $10.
- *Step 7*: Because existing T stock is canceled in the restructuring, it is disregarded for COI purposes.
- *Step 8*: Warrants to acquire P stock are treated as zero-principal amount securities for purposes of the reorganization provisions.[73] However, they are generally not treated as P stock or any other kind of proprietary interest in P.[74] As a result, class 2 is the only class to receive P stock, which means that the de minimis rule may apply. Here, the P stock represents $20/$150 ≈ 13 percent of the total consideration received

[71] Reg. section 1.368-1(e)(8), Example 10(ii).

[72] Even though the creditor COI regulations treat some debt claims against T as proprietary interests in T, debt issued by P is not a proprietary interest in P (regardless of whether it's a security). *LeTulle*, 308 U.S. at 420.

[73] Reg. section 1.354-1(e).

[74] *Cf. Helvering v. Southwest Consolidated Corp.*, 315 U.S. 194, 200-201 (1942). The only exception is for "penny" warrants, *i.e.*, warrants that are deep in the money and are virtually certain to be exercised. *Cf.* Rev. Rul. 82-150, 1982-2 C.B. 110; and Rev. Rul. 85-87, 1985-1 C.B. 268.

by T, T's shareholders, and T's creditors. Although not entirely free from doubt, this amount of P stock arguably should not be treated as de minimis and thus should be taken into account for COI purposes.

- *Step 9*: I have assumed that the issue price of the P debt to be received by T's class 2 creditors is $100. In practice, one would have to determine this issue price under the rules of sections 1273 and 1274.[75]
- *Step 10*: In the aggregate, T's creditors exchange proprietary interests in T with an FMV = $20 + $10 for P stock with an FMV = $20, so there will be $20/$30 ≈ 66 percent COI.

3. Comments.

This fact pattern is typical of restructuring transactions. In the typical case, and simplifying somewhat, class 1 creditors will be holders of administrative expense claims, class 2 creditors will be secured lenders, and class 3 creditors will be unsecured creditors who receive a "tip" (whether in the form of P warrants or a small percentage of P stock) in exchange for their agreeing to the restructuring plan. T's shareholders may also receive such a tip from first-secured lenders, in which case that tip must be taken into account in the COI analysis.

IV. Conclusion

As illustrated by examples 1 through 7, COI is most at risk when junior creditors and shareholders receive recoveries in a form other than P stock and those recoveries are large relative to the total consideration received by holders of proprietary interests in T. This is unlikely to be the case in typical restructuring transactions, so the COI requirement should often be met. This provides an opportunity when T has valuable tax attributes but a recapitalization of T or an acquisition of its stock are unappealing for nontax reasons. If reports warning about hordes of corporate zombies falling into bankruptcy in the next downturn are to be believed, these COI regulations may see plenty of use soon. ■

[75] Any portion of the P debt that is issued for new money (*i.e.*, new cash advances to P by T's (soon-to-be former) creditors) should be disregarded for COI purposes.