

## State Court reorganisation proceedings: statutory relics or viable alternatives to Chapter 11?

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### Introduction

Companies in financial distress typically are told by their advisors that they have two options: a risky out-of-court workout (which requires the near unanimous support of affected creditors) or an even more risky, costly and protracted insolvency proceeding. In the United States, state court reorganisation proceedings may provide troubled companies with a promising alternative approach. Consider the following scenario:

A company prepares and files a plan of reorganisation with the consent of a majority of the affected creditors whose claims represent three-fourths of the value of the corporation. Within a week, the proceedings are concluded and the court approves the plan, which binds the corporation and all of its creditors and stockholders. Moreover, all of this is accomplished without the expense, risk and delay associated with a Chapter 11 filing in a federal bankruptcy court.

The above fact pattern, with the addition of substantial pre-filing "packaging," reflects the statutory remedy provided under sections 102 and 302 of the Delaware General Corporation Law (the "DGCL") and its sister statutes around the country.<sup>1</sup> Recently, corporations have begun to explore and utilise the section 302 proceedings because it provides a quicker, more efficient alternative to Chapter 11 without the attendant cost, risk, and stigma. Combine those benefits with the likelihood that such a proceeding will constitute a "title 11 or similar case" under Section 382 of the Internal Revenue Code (the "IRC") (such that it is possible to preserve the corporation's net operating losses ("NOLs")) for carryforward purposes), and the state court proceeding becomes a viable alternative in the United States to the federal reorganisation procedures set forth in Chapter 11. This article analyses the paradigmatic Delaware insolvency law and explores whether a corporation in the state

court restructuring process can preserve its NOLs.

### Delaware General Corporation Law Sections 102(b)(2) and 302

A Delaware corporation may include a provision in its certificate of incorporation that permits a court-supervised compromise between the corporation and its creditors and/or its stockholders pursuant to DGCL § 102(b)(2).<sup>2</sup> With the inclusion of this provision, the corporation, a creditor, or a stockholder may bring an action in state court to reorganise the corporation.<sup>3</sup> If the corporation and a majority in number (representing three-fourths in value) of the affected creditors and/or the stockholders agree to the reorganisation and the court approves the plan, then the statute provides that the reorganisation is binding on the corporation and all creditors and/or stockholders.<sup>4</sup>

Once DGCL § 102(b)(2) is included in a corporation's certificate of incorporation, whether initially or following an amendment thereto, the provision binds persons who later become creditors or stockholders of the corporation. DGCL § 302(b) then grants the Delaware Court of Chancery jurisdiction over any compromise or arrangement made pursuant to DGCL § 102(b)(2)<sup>5</sup> as well as the power to "restrain, *pendente lite*, all actions and proceedings against any corporation with respect to which the court shall have begun the administration and enforcement of [the § 102] provision."<sup>6</sup>

Thus, so long as a Delaware corporation has drafted its certificate of incorporation to include DGCL § 102(b)(2), it has preserved the ability to utilise the state court reorganisation procedure, which provides a less expensive and less stigmatised alternative to a Chapter 11 filing. However, the attractiveness of the state court procedure also hinges upon whether the company will be able to preserve the tax benefit of its NOLs.

Will the restructuring of debt pursuant to DGCL § 102(b)(2) qualify as a "title 11 or similar case" as required by IRC § 382?

As a general matter, upon a change of control, a corporation's ability to use existing NOLs may be significantly reduced or eliminated pursuant to IRC § 382. IRC § 382(i)(5)(A), however, provides an exception to that general rule if the corporation satisfies two criteria: (i) the corporation is under the jurisdiction of a court in "a title 11 or similar case" immediately prior to the ownership change; and (ii) the former stockholders and creditors of the corporation own fifty percent or more of the stock of the surviving corporation after the ownership change.<sup>7</sup> If the state court proceeding qualifies as a "title 11 or similar case" under IRC § 382(7), thereby allowing a corporation to avoid the stringent NOL transfer limitations set forth in IRC § 382, then it should provide an effective vehicle for a workout because it is more expedient than proceeding through bankruptcy.<sup>8</sup>

IRC § 382(i)(5)(G) defines the phrase "title 11 or similar case" by reference to IRC § 368. IRC § 368(a)(3)(A) defines the phrase "title 11 or similar case" as:

- (i) a case under title 11 of the United States Code; or
- (ii) a receivership, foreclosure, or similar proceeding in a Federal or State court.<sup>9</sup>

While the definition provided in IRC § 368(a)(3)(A) is widely quoted, neither the Treasury regulations promulgated thereunder nor case law provides a further explanation of the phrase "title 11 or similar case."<sup>10</sup> The legislative history of IRC § 368, adopted in 1980, indicates that "the definition of a receivership, foreclosure, or similar proceeding is the same as under present section 371 of the Code."<sup>11</sup> Although IRC § 371 was repealed in 1990, the Treasury regula- ➤

tions thereunder required the contemplated transaction to include "a bona fide plan of reorganization approved by the court having jurisdiction of the proceeding and the transfer of the property of the insolvent corporation . . . made pursuant to such plan."<sup>12</sup> The Treasury regulations further required that the component steps of the transaction "must be embraced within the plan of reorganization and must be undertaken for reasons germane to the plan."<sup>13</sup> Thus, while the IRC fails to specifically explain the phrase "title 11 or similar case", the legislative history and Treasury regulations support the conclusion that a state court restructuring under the DGCL qualifies

A General Counsel Memorandum (the "GCM")<sup>14</sup> issued by the Internal Revenue Service (the "Service") provides further support for the conclusion that the state court proceeding described herein qualifies as a "similar case." In the GCM, the Service discussed the types of proceedings that qualified under IRC § 371 and suggested that IRC § 371 would apply to judicial proceedings where proprietary interests of the business are, at least to some extent, assumed by those who were creditors at the time of insolvency.<sup>15</sup> A restructuring commenced in the Delaware Court of Chancery effects the consensual restructuring of the debt and equity of a corporation by allowing the former creditors an equity interest in the corporation. Because the restructuring is subject to the court's approval, such proceeding should be encompassed within the meaning of "title 11 or similar case" provided by IRC § 382.

Finally, the definitions of "receivership" and "foreclosure" support the proposition that a DGCL insolvency proceeding qualifies as a "receivership, foreclosure, or similar proceeding."<sup>16</sup> A DGCL section 302 proceeding is an equitable proceeding intended to preserve corporate assets for the benefit of the corporation's equity holders and creditors by allowing any combination of the corporation itself, its stockholders or its creditors to reach a compromise to restructure the debt and equity of the corporation, provided a statutorily-prescribed level of consent is obtained. The language of DGCL § 302 explicitly acknowledges and permits the appointment of a receiver by the court as

deemed necessary to enforce a compromise reached by the parties. Similarly, if a DGCL section 302 proceeding is commenced by creditors to recover payment from a failing corporation, the proceeding would be analogous to a foreclosure because the creditors are effectively enforcing their rights to payment by seizure of an interest in the equity of the corporation.

### Conclusion

Based upon the language of the GCM and the Treasury regulations promulgated under former IRC § 371, as well as the language of DGCL § 302, which expressly permits the appointment of a receiver, and the potential for the commencement of a DGCL section 302 proceeding by creditors, a section 302 proceeding should qualify as a "receivership, foreclosure, or similar proceeding" as that phrase appears in IRC § 368. Accordingly, provided that the change in ownership falls within the ownership requirements set forth in IRC § 382(i)(5)(A)(ii), the NOL carryforward limitation imposed by IRC § 382 should not apply to the reorganized entity. Thus, a section 302 proceeding may well be the best, most cost effective choice for restructuring the corporation – a reduction of corporate debts in exchange for adjustments to the equity structure in a relatively short-lived, court-sanctioned proceeding that will likely qualify for the preservation of NOLs under the Internal Revenue Code, and all without the harsh market realities of Chapter 11. ■

<sup>1</sup> This article will focus on the provisions of the DGCL. However, several states provide similar statutory relief. See, e.g., Kan. Stat. Ann. § 17-6002(b)(2), 17-6912(a) (2003); La. Rev. Stat. § 12:161C (2004); Mich. Comp. Laws §§ 450.1204, 450.1205 (2004); Ohio Stat. tit. 18, § 1006B.2, 1117 (2004); Mo. Rev. Stat. § 371.210 (2004) (relating to Development Finance Corporations); N.Y. Banking Law § 219 (Consol. 2004) (relating to New York Business Development Corporations); W.Va. Code § 31-14-2(f) (2004) (relating to West Virginia Business Development Corporations).

<sup>2</sup> Section 102(b)(2) of the DGCL permits the inclusion of the following provision in hoc verbor:

Whenever a compromise or arrangement is proposed between this corporation and its creditors or any class of them and/or between this corporation and its stockholders or any class of them, any court of equitable jurisdiction within the State of Delaware may, on the application in a summary way of this corporation or of any creditor or stockholder thereof or on the application of any receiver or receivers appointed for this corporation under the provisions of § 291 of Title 8 of the Delaware Code or on the application of trustees in dissolution or of any receiver or receivers appointed for this corporation under § 229 of Title 8 of the Delaware Code under a meeting of the creditors or class of creditors, and/or of the stockholders or class of stockholders of this corporation, as

the case may be to be summoned in such manner as the said court directs, if a majority in number representing three fourths in value of the creditors or class of creditors and/or of the stockholders or class of stockholders of this corporation, as the case may be, agree to any compromise or arrangement and to any reorganization of this corporation as a consequence of such compromise or arrangement, the said compromise or arrangement and the said reorganization shall, if sanctioned by the court to which the said application has been made be binding on all the creditors or class of creditors, and/or on all the stockholders or class of stockholders of this corporation, as the case may be, and also on this corporation[.]

<sup>3</sup> 8 Del. C. § 302(a) (2004).

<sup>4</sup> *Id.* While a proceeding using DGCL §§ 102 and 302 may preserve certain tax attributes of the corporation, there remains some question as to whether a decree from the Court of Chancery enforcing a compromise between the corporation, its creditors and its stockholders pursuant to section 102(b)(2) will be binding on non-consenting, non-resident stockholders or creditors absent other ties between Delaware and the non-consenting stockholders or creditors. See, e.g., MARTIN D. GINSBURG & JACK S. LEVIN, *Mergers, Acquisitions and Buyouts* § 1208.2.1.5(3) (2003) (acknowledging potential due process and federal pre-emption issues arising through the use of DGCL §§ 102/302); Jerry Davidson, Inc. v. Michigan Nat'l Bank, 220 N.W.2d 714 (1974) (holding that a state court's order approving a consensual arrangement pursuant to a statute similar to DGCL §§ 102 and 302 was preempted by federal bankruptcy law and thus unenforceable against non-consenting creditors). The constitutional issues surrounding the enforceability of a state court decree upon non-consenting creditors are beyond the scope of this article and depend, in large part, upon who has consented to the proposed transaction. Nevertheless, in many cases involving a restructuring with the bondholders and stockholders, the affected parties will have sufficient contacts with Delaware to meet these constitutional problems.

<sup>5</sup> 8 Del. C. § 302(b).

<sup>6</sup> *Id.*

<sup>7</sup> IRC § 382(i)(5)(A) (2004).

<sup>8</sup> Gordon D. Henderson & Stuart J. Goldring, *Tax Planning for Troubled Corporations* § 508.4.2 n. 199 (2003); Martin D. Ginsburg & Jack S. Levin, *Mergers, Acquisitions and Buyouts* § 1208.2.1.5(3) (2003).

<sup>9</sup> IRC § 368(a)(3)(A).

<sup>10</sup> See, e.g., Boris I. Bliker & James S. Eustice, *Federal Income Taxation of Corporations & Shareholders* §§ 12.30(2)(a) (2003); Gregory E. Stern, 541-3rd T.M., *Tax Aspects of Restructuring Financially Troubled Businesses* § VII B 2 (2003); William Tallock, 540-2d T.M., *Discharge of Indebtedness, Bankruptcy and Insolvency Taxation* § IV B.2.b.2 (2003).

<sup>11</sup> S. REP. NO. 95-1035, H.R. 5013 (1980).

<sup>12</sup> Treas. Reg. § 1.371-1(a)(2) (1969).

<sup>13</sup> Treas. Reg. § 1.371-2 (1989).

<sup>14</sup> Gen. Coun. Mem. 34210 (Nov. 28, 1989).

<sup>15</sup> *Id.* In the GCM, the Service determined that a Plan of Arrangement approved by the U.S. Bankruptcy Court under Chapter XI of the Bankruptcy Act would not qualify as a "receivership, foreclosure, or similar proceeding," because the plan in question under Chapter XI did not effect a reorganization or a "substantive modification or alteration of the proprietary interest in the corporate enterprise." While a GCM cannot be relied on as precedent because it applies only to the taxpayer who requested the ruling, it is an indication of the Service's thinking with respect to a particular case at a particular time.

<sup>16</sup> Black's Law Dictionary defines receivership as "A legal or equitable proceeding in which a receiver is appointed for an insolvent corporation, partnership or individual to preserve its assets for benefit of affected parties." Black's Law Dictionary 1269 (6th ed. 1990).

Foreclosure is defined as: — The process by which — [an] owner of property subject to a lien, is deprived of his interest therein. A proceeding in equity whereby a mortgagee either takes title to or forces the sale of the mortgagor's property in satisfaction of a debt. A default under a security interest in personal property can be foreclosed by a judicial sale of collateral. In common usage, refers to enforcement of a lien, trust deed or mortgage in any method provided by law.

Black's Law Dictionary 646 (6th ed. 1990) (emphasis added)

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