Successful Debt Restructuring

By Richard C. Morris • Wood & Porter • San Francisco

On July 28, 2006, the IRS issued LTR 200630002 in which it ruled that the conversion of a parent company into a limited liability company would not result in a deemed exchange of the company's debt pursuant to Code Sec. 1001 and the regulations thereunder. In particular, the IRS ruled that the internal restructuring did not produce a significant modification of the debt. Given the inversion-like nature of the exchange, and the potentially significant reduction in exposure to creditors, this ruling may open a new avenue of planning.

Layers of Debt

Parent was a publicly traded corporation, the common parent of an affiliated group of corporations filing a consolidated return. Parent and its subsidiaries engaged in several businesses both domestically and internationally. Parent had outstanding publicly traded debt consisting of seven series of senior notes and five series of exchangeable debentures (collectively referred to as the "Debt").

The senior notes were typical debt, paying market interest semi-annually and maturing at various times. Similarly, the exchangeable debentures paid market interest semi-annually and matured at various times. The debentures were generally exchangeable for the cash value of a specified number of shares of portfolio stock in one or more companies. The ruling does not indicate the particular company's stock the debenture holder would receive. Thus, we don't know if the stock would be publicly traded, or even have a market for resale.

In certain instances, Parent was able to satisfy the exercise of a debenture holder's exchange right by paying the exchange value in cash, in shares of the referenced portfolio stock or some combination thereof. In certain circumstances, Parent could issue its own shares. The current trading price of one or more series of the Debt was substantially less than its respective adjusted issue price. The Debt was *recourse* to Parent, and none of Parent's assets were subject to any perfected or unperfected security interest benefitting any of the holders of any series of the Debt. Yet, there were no provisions in the terms of the Debt restricting Parent's ability to acquire and dispose of assets in the ordinary course of its business.

Internal Reshuffling

Parent proposed to restructure as follows. First, Parent would form a wholly owned holding corporation ("New Parent"). New Parent would then form a wholly owned subsidiary. This new third-tier subsidiary would merge with and into Parent, with Parent surviving as the wholly owned subsidiary of New Parent. Parent would then convert into a single-member limited liability company ("SMLLC"). The restructuring is intended to qualify as an F reorganization, and it looks a lot like an inversion.

After the restructuring, New Parent would hold all of the membership interests in SMLLC, a limited liability company that would be disregarded as separate from its owner. In addition, immediately after the restructuring, the assets and liabilities of SMLLC would be identical to the assets and liabilities of Parent immediately prior to the restructuring, except for cash issued in lieu of fractional shares and cash used to pay expenses incurred in connection with the restructuring.

Under the applicable state law (which appears to be Delaware), none of the Debt holders' rights against Parent, including with respect to payments and remedies, and none of Parent's obligations and covenants to the Debt holders would be altered in any manner by the restructuring. Following the restructuring, the Debt holders would continue to have exactly the same legal relationship with SMLLC they previously had with Parent, *viz.,* as general unsecured recourse claimants having no greater preference than any other creditor. Of course, the Debt holders' relationship would no longer be with the publicly-traded top tier entity of the group.

Additionally, under state law, the restructuring would not result in the creation of any new legal rights or obligations between

the Debt holders and New Parent. There are no provisions in the original terms of the Debt that require the consent or approval of any holder of any series of the Debt in order for Parent to effectuate the restructuring.

Exchange of Debt?

Companies undergoing internal restructuring need to be keenly aware of the debt modification rules. These rules can cause debt to be treated as sold or exchanged when restructuring, effectively creating a tax liability when, from the company's perspective, nothing has changed. Given the amount of debt involved here (seven series of senior debt and five series of exchangeable debentures), it is hardly surprising that the taxpayer asked for a ruling.

The analysis of whether an internal restructuring causes debt to be treated as sold or exchanged (thus creating a tax liability) begins like all other sale or exchange analyses. M&A TAX REPORT readers know that Code Sec. 1001 provides for the recognition of gain or loss on the sale or exchange of property. The regulations clarify that gain or loss is realized from the exchange of property for other property differing materially either in kind or in extent. [Reg. §1.1001-1(a).] Of course, this begs the question of whether the Debt (which is property) will differ materially in kind or extent if, for tax purposes, it is owned by a new legal entity.

Sales and exchanges of debt are hardly uncommon, and the regulations provide specific rules for determining when debt has been sold or exchanged. Indeed, the touchstone for determining whether a debt instrument differs materially in kind or in extent is if it has undergone a "significant modification." [Reg. §1.1001-3(b).] A significant modification of a debt instrument results in a "new" debt instrument that is deemed to be exchanged for the unmodified debt instrument.

The debt rules can be broken down into two parts: rules relating to "modifications" and rules to determine if a modification is "significant." On the former, the regulations provide rules for determining whether a change in the legal rights or obligations of a debt instrument is a modification. [Reg. §1.1001-3(c).] A modification is any alteration, including any deletion or addition, in whole or in part, of a legal right or obligation of the issuer or a holder of a debt instrument. It does not matter whether the alteration is evidenced by an express agreement (oral or written), by conduct of the parties or otherwise. That is a fairly broad definition.

An alteration of a legal right or obligation that occurs by operation of the terms of a debt instrument is generally not a modification. However, an alteration that results in the substitution of a new obligor, the addition or deletion of a co-obligor or a change (in whole or in part) in the recourse nature of a debt instrument (from recourse to nonrecourse or *vice versa*) is a modification, even if the alteration occurs by operation of the terms of a debt instrument.

The regulations also provide rules for determining whether a modification is significant. As a general rule, the substitution of a new obligor on a recourse debt instrument is a significant modification.

State Law

Whether the internal restructuring creates a significant modification (and thus a taxable event) will depend on state law. Here, the applicable state law provided that the conversion of a corporation into a limited liability company does not affect any obligations or liabilities of the corporation incurred prior to its conversion to a limited liability company, or the personal liability of any person incurred prior to such conversion. Moreover, state law provided that for all purposes, all rights of creditors and all liens upon any property of the converted corporation shall be preserved unimpaired, and all debts, liabilities and duties of the converted corporation shall thenceforth attach to the limited liability company and may be enforced against it to the same extent as if the debts, liabilities and duties had been incurred or contracted by it. Essentially, the new limited liability company steps into the shoes of the converted corporation.

The federal tax law generally looks to state law to determine legal entitlements in property. [*R. Aquilino,* SCt, 60-2 USTC ¶9538, 363 US 509, 513, 80 SCt 1277 (1960); *J.E. Morgan,* SCt, 40-1 USTC ¶9210, 309 US 78, 82

(1940).] Pursuant to the particular state law here, the conversion of Parent into SMLLC will not affect the legal rights or obligations between the Debt holders. The Debt holders will continue to have exactly the same legal relationship with SMLLC that they previously had with Parent, *viz.*, as general unsecured recourse claimants having no greater preference than any other creditor.

Additionally, the Debt holders' legal rights against SMLLC with respect to payments and remedies will be the same legal rights that the Debt holders had against Parent. The obligations and covenants from SMLLC to the Debt holders will be the same as the obligations and covenants from Parent to the Debt holders.

New Avenues?

Since state law specifically provides for the retention of the legal rights and obligations between Parent (in its new limited liability company form) and the Debt holders, and since there were no legal rights or obligations between the Debt holders and New Parent prior to the restructuring, the restructuring cannot result in the creation of any new legal rights or obligations between the Debt holders and New Parent. Thus, the restructuring does not result in a change in the recourse nature of the Debt. Accordingly, the IRS ruled that the conversion of Parent into SMLLC as part of the restructuring does not result in a significant modification of the Debt for tax purposes, and hence, no sale or exchange of Debt is incurred.

This innocuous ruling produces a substantially favorable result for debtors. After the inversion and conversion to a limited liability company, SMLLC could distribute assets to New Parent. This would enable Parent to isolate the recourse nature of its debts. At best, this should prohibit the lenders from having recourse to any assets of the group, and lenders may not be happy with this result.

At worst, it may limit the lender's recourse to assets owned pre-restructuring, as a court in equity could find the shuffling to have been unfair. In any event, the ruling could open up significant planning opportunities for debtors whose recourse debt instruments do not prohibit distributions.

Afterthoughts

As the M&A TAX REPORT was going to press, the IRS released yet another ruling along the lines of LTR 200630002. In LTR 200633008 [May 10, 2006], Oldco, an S corporation that had C corporation earnings and profits ("E&P"), wanted to sell its present business ("Business A"). Oldco was a holding company that wholly owned two limited liability companies ("LLCs"), which were disregarded for federal income tax purposes. Oldco also owned, directly and indirectly, interests in several qualified subchapter S subsidiaries ("Qsubs"), other LLCs and a partnership interest in an inactive partnership.

Oldco shareholders sought to dispose of Business A, which was engaged in by only some of the entities in the group. The shareholders wanted to accomplish this goal by selling their stock in Oldco. The potential buyers, however, raised concerns about certain contingent and remote liabilities related to Business B formerly conducted by the Oldco group. To mitigate the buyer's concerns, Oldco proposed a series of transactions to remove the Business B liabilities from the group prior to sale.

To start the proposed transaction, Oldco's shareholders will form a corporation ("Newco") and Newco will form a new limited liability company ("NewLLC"), which will be disregarded for federal income tax purposes. Next, Oldco will merge with and into NewLLC. In the merger, each whole or fractional share of Oldco stock will be converted into one whole or fractional share of Newco stock, and immediately following the merger, the Oldco shareholders will own Newco in the same proportions as they owned Oldco. Under state law, NewLLC will succeed to all of the assets and liabilities of Oldco.

Following the merger, NewLLC will distribute to Newco all of its interests in the entities that conduct Business A ("the Transfers"). Notably, Oldco's shareholders have entered into a contract to sell the stock of Newco. After the merger and before such sale is consummated, Newco will make a pro rata distribution of the assets of NewLLC to its shareholders ("the Distribution").

The IRS made several rulings in LTR 200633008, all of which were favorable to

Oldco. First, it ruled that the transfer of assets and liabilities from Oldco to NewLLC would qualify as an F reorganization. Moreover, the Distribution will not prevent the transfer from so qualifying. Indeed, the Distribution will be treated as a distribution of property from Newco to the Oldco shareholders separate from the reorganization. [*See* Rev. Rul. 96-29, 1996-1 CB 50, and Reg. §1.301-1(l).]

Second, Oldco's S election will not terminate as a result of the reorganization and will continue (for Newco) provided Newco meets the eligibility requirements for a small business corporation. [*See* Rev. Rul. 64-250, 1964-2 CB 333.] Furthermore, the QSub elections will not terminate and will remain in effect for Newco. However, the Distribution will terminate the QSub elections of the QSubs, which will then be owned directly by the shareholders. [*See* Rev. Rul. 2004-85, IRB 2004-33, 189.] Finally, Newco will succeed to Oldco's accumulated adjustments account, and it will not recognize any built-in gain under Code Sec. 1374.

LTR 200633008 has some striking similarities to LTR 200630002 in that both taxpayers underwent internal restructuring to isolate various liabilities. In the former, the liabilities were contingent and remote. In the latter, the liabilities were not contingent or remote, but these differences do not appear material. In LTR 200633008, the company underwent a quasi-spin off of the assets that the buyer did not want.

Perhaps the most important result of LTR 200633008 is that Oldco's creditors may have lost the assets to which they would have otherwise looked for payment. These assets are now owned by the buyer (*i.e.*, Business A) and by the shareholders (*i.e.*, Business B). Newco has no assets remaining. Assuming that state law would uphold the isolation of the contingent and remote liabilities, the transaction described in LTR 200633008, like the transaction described in LTR 200630002 above, could open up new avenues of planning for both tax and non-tax purposes.

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