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Bankruptcy Court Approves Innovative Plan Preserving Solyndra's Valuable Tax Attributes Over DOJ Objections

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A bankruptcy court has approved the reorganization plan of solar cell manufacturer Solyndra despite government objections that the plan's principal purpose was "tax avoidance" through the preservation of net operating losses. There are very few decided cases addressing this issue, and Solyndra's is worth following as any appeal proceeds.

On October 22, 2012, the U.S. Bankruptcy Court for the District of Delaware confirmed the Debtors' Amended Joint Chapter 11 Plan (the Plan) of photovoltaic cell manufacturer Solyndra, LLC (Solyndra LLC), and its owner, 360 Degree Solar Holdings, Inc. (Solyndra Corp.).[1] Under the Plan, the historic shareholders of Solyndra Corp. retain their ownership interests so that the valuable tax attributes of Solyndra Corp., including significant net operating losses (NOLs), are preserved on emergence. Judge Walrath confirmed the Plan over the objection of the Department of Justice (the DOJ), on behalf of the Internal Revenue Service (the IRS), which argued that the Plan could not be confirmed because its principal purpose was tax avoidance. The DOJ's theory was that a shell company with no employees, assets, or business activity should not be permitted to retain its NOLs, especially where, the DOJ asserted, the value of the attributes far exceeded the payments the Plan proposed to make to unsecured creditors. Judge Walrath granted a 10-day stay of the confirmation order so as to permit appeal.

Background

Solyndra manufactured photovoltaic cells affixed to cylindrical tubes. In September 2009, the U.S. Department of Energy (the DOE) agreed to guarantee a $535 million loan from the U.S. Federal Financing Bank to Solyndra. By early 2011, however, a variety of industry factors had forced Solyndra's two principal shareholders (the Principal Shareholders) to secure additional financing and to restructure Solyndra's outstanding debt. In February 2011, Solyndra's investors and creditors, including the DOE, agreed to an out-of-court restructuring (the 2011 Debt Restructuring). Pursuant to the 2011 Debt Restructuring, among other things, the Principal Shareholders and other investors extended to Solyndra a loan of $75 million (the Tranche A Facility), which was secured by one of Solyndra's manufacturing plants and ranked senior to all other debt, including the DOE's loan guarantee. Further negotiations in August 2011 to again restructure Solyndra's debt failed. Thereafter, Solyndra ceased manufacturing, laid off most of its workforce, and filed for bankruptcy under Chapter 11. Solyndra's NOLs[2] are estimated to total between $875 million and $975 million, and it also has $12 million in research and development tax credits. Pursuant to the Plan, however, Solyndra will recognize between $600 million and $700 million of cancellation of debt income that would appear to reduce its NOLs.

1 Unless the context indicates otherwise, we use "Solyndra" to refer to Solyndra LLC and Solyndra Corp. together.

2 For U.S. federal income tax purposes, Solyndra Corp. is classified as a corporation, and Solyndra LLC as a disregarded entity. Accordingly, the NOLs are tax attributes of Solyndra Corp.

After filing for bankruptcy, Solyndra sold most of its assets in sales pursuant to Section 363 of the Bankruptcy Code, which yielded approximately $100 million to be paid to creditors. In addition to the sale proceeds, Solyndra's Principal Shareholders agreed to contribute approximately $10 million that would also be distributed to Solyndra's creditors. The characterization of this contribution for tax purposes is somewhat uncertain, but the agreement to distribute the proceeds of such contribution presumably was intended to bolster support for the Plan among the creditors. The Plan would dissolve Solyndra LLC but would leave Solyndra Corp. intact, without substantially changing the ownership of Solyndra Corp. Notwithstanding that the Principal Shareholders' ownership of Solyndra Corp. would emerge from bankruptcy undiluted, the only creditor to oppose the Plan was the DOE; the DOJ also objected to the Plan, on behalf of the IRS, on the basis that the Plan's principal purpose was tax avoidance.

Certain U.S. Federal Income Tax Consequences of the Plan

For U.S. federal income tax purposes, the Plan may permit Solyndra Corp. to avoid adverse consequences under Sections 382 and 269 of the Internal Revenue Code and thus to emerge from bankruptcy with its valuable tax attributes (including its NOLs) intact. Thereafter, Solyndra Corp.'s Principal Shareholders could contribute cash or property to Solyndra Corp., the income of which would be offset by the NOLs.

Because Solyndra Corp.'s Principal Shareholders owned more than 50 percent of Solyndra's shares prior to the bankruptcy and Solyndra Corp. will emerge from bankruptcy with its Principal Shareholders continuing to hold a substantial majority of its shares, Solyndra Corp. will apparently not experience an ownership change under Section 382.[3] The ability of a loss corporation (*i.e.*, a corporation with an NOL carryforward or that has an NOL for the taxable year of an ownership change) that experiences an ownership change to offset its NOLs against its post-change taxable income generally is severely limited. If the loss corporation does not continue its historic business, however, its NOLs generally are reduced to zero. Because Solyndra sold all of its assets and exited its manufacturing business, Solyndra Corp.'s NOLs would have been eliminated had it experienced an ownership change.

Under the Plan, moreover, there will not be an acquisition of control of Solyndra Corp. under Section 269. In relevant part, Section 269 provides that, if any person acquires control of a corporation for the principal purpose of evading or avoiding U.S. federal income tax by securing a deduction, credit or other allowance not otherwise available to the person or corporation, the IRS may disallow the deduction, credit or other allowance. Generally, an acquisition of control occurs if a person acquires ownership of stock representing at least 50 percent of either the total combined voting power or the total value of a corporation's stock. Here, because there has been no acquisition of control of Solyndra Corp., Section 269 cannot apply.

The DOJ's Objection to the Plan and the Principal Shareholder's Response

The DOJ objected to the confirmation of the Plan under Section 1129(d) of the Bankruptcy Code, claiming that the Plan's principal purpose is tax avoidance. Section 1129(d) provides that the bankruptcy court may not confirm a plan if the principal purpose (*i.e.*, the most important purpose) of the plan is the avoidance of taxes. Few reported cases have applied Section 1129(d). Those cases, however, indicate that Section 1129(d) requires a finding that a tax avoidance purpose exceeded all other motivations for

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3 Generally, an ownership change occurs under Section 382 if the percentage of stock of a loss corporation owned by one or more 5-percent shareholders has increased by more than 50 percentage points over the lowest percentage of stock of the loss corporation (or a predecessor corporation) owned by such shareholders at any time during the testing period. Some uncertainty is introduced here by the $10 million contribution made by the Principal Shareholders, discussed below.

the plan.[4] According to the DOJ, the Plan seeks to reorganize Solyndra Corp. to emerge from bankruptcy as a shell corporation — with no employees or active business, but with its Principal Shareholders' retaining their equity and control over Solyndra Corp.'s significant tax attributes. In support of this assertion, the DOJ pointed to evidence (including numerous emails between the Principal Shareholders and their advisors) that Solyndra's Principal Shareholders and their representatives consistently had focused on and revisited ways in which Solyndra Corp. could preserve its NOLs should bankruptcy occur. The DOJ viewed the 2011 Debt Restructuring as a part of Solyndra's efforts to ensure that the Principal Shareholders maintained control of Solyndra Corp. without limiting its NOLs.

One of the Principal Shareholders filed a response to the IRS's objection. The Principal Shareholder argued that all of Solyndra's creditors (except the DOE) had approved the Plan, and further, that Solyndra's efforts to preserve its NOLs were secondary to Solyndra's efforts to reorganize. This was evident by the fact that Solyndra's owners had invested an additional $125 million in Solyndra (including the Tranche A Facility) after it received the DOE loan guarantee. The Principal Shareholders had been advised that the value of the assets recovered in a Chapter 11 reorganization would be substantially higher than the assets' value in a Chapter 7 liquidation. The response asserted that the Principal Shareholders' principal purpose for the Plan was to provide a mechanism (viz., through Chapter 11 reorganization) that would permit them to extend, in a secure manner, the Tranche A Facility — which in turn would allow Solyndra to maximize the value of its remaining assets.

The Bankruptcy Court Opinion

The bankruptcy court held for Solyndra, finding that the Plan complied with the requirements of Section 1129 of the Bankruptcy Code. The court noted the evidence that the Principal Shareholders were likely to contribute profitable businesses to Solyndra Corp. in the future. Given that Solyndra Corp. was a holding company, intended to hold investments in other businesses, the court appeared to find that the future stuffing supported a business sufficient to justify a Chapter 11 reorganization of Solyndra Corp. Further, based on the evidentiary record presented at the hearing held to consider the Plan, and the court's findings, the court concluded that the principal purpose of the Plan was not tax avoidance. The court did not distinguish or otherwise address the cases, described above, that have applied Section 1129(d). The court offered no analysis or express finding to support its conclusion that the principal purpose of the Plan was not tax avoidance; it never compared the value of the tax savings delivered indirectly to the Principal Shareholders with any other value of the Plan. Questions remain, therefore, about the manner in which a court is to scrutinize a plan for purposes of Section 1129(d). For example, does Section 1129(d) require a court to conclude that the prohibited tax avoidance purpose exists as to the plan as a whole, or is it sufficient that the court determine that the principal purpose for one or more elements of the plan is tax avoidance? Thus, even if the principal purpose of the Plan as an entirety was to maximize the recoveries for Solyndra's estate, it is unclear whether the preservation of the value of Solyndra's NOLs for the benefit of the shareholders would be beyond the reach of Section 1129(d). Although the court stayed its order to allow the IRS to appeal the decision, the highly factual nature of the finding under Section 1129(d) may make any such appeal difficult.

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4 In two of those cases the debtor was an empty shell with significant NOLs. In one case, the court rejected the plan pursuant to Section 1129(d). *In re S. Beach Sec., Inc.*, 367 B.R. 881 (Bank. N.D. Ill. 2007), *aff'd*, 606 F.3d 366, 2010-1 U.S.T.C. ¶ 50,421 (7th Cir. 2010) (in which the debtor's disclosure statement indicated that the purpose for its plan was to shift equity in the debtor to a related creditor, relying on Section 382(l)(5) to avoid an ownership change that would impair the debtor's NOLs). In the other case, the court confirmed the plan because it found there to be a non-tax purpose for the plan that was equally important as preserving the debtor's NOLs. *In re Rath Packing Co.*, 55 B.R. 528 (Bankr. N.D. Iowa 1985) (ruling that tax avoidance was not the primary purpose for the plan because preserving the debtor's publicly-held shell was "as important as the tax loss"). The court in the only other case applying Section 1129(d) rejected the debtor's plan to sell its assets in a manner that purportedly would have prevented the taxes payable on the sale from qualifying as an administrative expense of the bankruptcy case. *In re Scott Cable Commc'ns, Inc.*, 227 B.R. 596 (Bank. D. Conn. 1998).

Observations

Solyndra's Plan, if ultimately sustained, appears to be a creative strategy for preserving a debtor's NOLs intact, even when it sells all of its assets and exits its failed business. The two principal questions that *Solyndra* presents for bankruptcy and tax professionals are whether it can be easily replicated and whether it represents a planning technique that delivers potential tax savings otherwise unavailable.

One key element of the strategy in *Solyndra* is that it requires a plan of reorganization with a very limited number of continuing equity owners who anticipate having future income-producing opportunities that can be contributed to the loss corporation and will generate taxable income to absorb the NOLs carried forward. Thus, a stuffing strategy like that in *Solyndra* will generally be practicable only in private equity or hedge fund situations, or in the less typical situation in which a parent retains control of a bankrupt subsidiary. Moreover, such a strategy will typically work only in a situation with an almost pure holding company that has not incurred significant debt. Otherwise, such creditors would typically take control of the debtor, or insist upon a sale to a third party.

The second question is whether the strategy in *Solyndra* offers a benefit not otherwise obtainable from a more traditional stuffing strategy. It has long been recognized that existing equity owners of a loss corporation can secure the indirect benefit of those losses by contributing income producing assets and opportunities to the loss corporation in the same proportion as their existing ownership. In a sense, *Solyndra* simply combines that classic strategy with bankruptcy. That innovation is not insignificant because the bankruptcy process cleanses the loss corporation of both fixed and contingent potential liabilities. As a result, such stuffing strategies may be more attractive.

One final question is whether Solyndra Corp. actually will realize the anticipated results under Section 382. The Principal Shareholders contributed $10 million to Solyndra pursuant to the Plan. That contribution, the proceeds of which were distributed to creditors pursuant to the plan, may raise questions as to whether there was an owner shift from creditors, whose debt would have been properly characterized as stock, to the Principal Shareholders. That question is complex, uncertain and highly factual.