

# **The American Recovery and Reinvestment Act: Stimulating Businesses or Bankruptcy Dockets?**

## **I. Introduction**

In 2008, the American economy was suffering in the midst of a severe global recession. On February 17, 2009, less than a month into his presidency, President Obama signed the American Recovery and Reinvestment Act into law in an effort to stimulate the still desolate national economy. The Act provides several tax incentives for businesses to assist in weathering the turbulent economy. However, many of these provisions must be utilized in lieu of filing bankruptcy. Corporations on the brink of insolvency in early 2009 were faced with difficult decisions between filing for Chapter 11 protection, arranging workouts with creditors to cancel or reduce portions of outstanding debt to increase liquidity, or attempting to use net operating costs to offset taxable income with net operating loss deductions. This paper will examine the consequences for businesses that elect for these tax incentives and those who elect to file bankruptcy and predict how corporations faced with these decisions might proceed given variations in circumstance. Additionally, it will attempt to determine if the enactment of the American Recovery and Reinvestment Act has increased, decreased, or had no effect on bankruptcy filings.

## **II. Debt Cancellation**

Many times, lenders may find it prudent to cancel or discharge debts owed to them at a discount. One situation that could provoke a lender to cancel a debt is When the value of future interest payments is less than the present value of partial payment at current interest rates, lenders may conclude cancellation of that debt is the prudent choice.. A second situation that may lead to

a cancellation of debt is a workout between a debtor and lender in an attempt by a debtor corporation to enhance liquidity. This transaction could take a variety of forms including a cash settlement, issuance of equity for debt, an exchange of debt, or modification of debt terms.<sup>1</sup> A third situation leading to cancellation of debt occurs when the debtor is financially troubled. The lender may decide that the best financial decision is to take what the lender has and not waste further resources on other remedies for repayment of the full debt. In any of these situations, the debtor must include the discount as taxable income under section 61(a)(12) of the Internal Revenue Code.<sup>2</sup>

A transaction to cancel debt often takes the form of a debt repurchase by the debtor corporation. The company will buy its own debt at the debt's adjusted issue price, and then realize income of the difference in original issue price and adjusted issue price, called the original issue discount, under §61(a)(12) of the Internal Revenue Code.<sup>3</sup> If the repurchase is done by a related party to the debtor corporation, such as a family member or related entity,<sup>4</sup> then the cancellation of debt income is realized and included in taxable income in the same manner as if the repurchase was done in the name of the corporation.<sup>5</sup> Even if the transaction appears on the surface to be internal (the corporation buying its own debt), the consequence of a debt repurchase is still a cancellation of debt. There are even instances when simply changing the terms of a debt instrument, for example extending a maturity rate, can give rise to cancellation of debt income,

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<sup>1</sup> Abahoonie, Edward, Van Tassel, Tami. Pricewaterhouse Coopers, Debt Restructurings and bankruptcy: Accounting, Tax, and FAS 109 Considerations, [http://www.pwc.com/en\\_US/us/tax-accounting-services/assets/debt-bankruptcy.pdf](http://www.pwc.com/en_US/us/tax-accounting-services/assets/debt-bankruptcy.pdf) (last visited April 17, 2009)

<sup>2</sup> 26 U.S.C. § 61(a)(12) (1984); I.R.C § 61(a)(12) (1984).

<sup>3</sup> Reilly, R, "Tax Planning Opportunities Related to the New COD Income-Deferral Election", American Bankruptcy Institute Journal, Feb. 2010, at 60-61.; 26 U.S.C. § 61(a)(12) (1984); I.R.C § 61(a)(12) (1984).

<sup>4</sup> 26 U.S.C. § 108(e)(4) (2009); I.R.C. § 108(e)(4) (2009). See 26 U.S.C. §§ 267(b)- and (c) (2009); I.R.C. §§ 267(b)-(c) (2009).

<sup>5</sup> Reilly, R, "Tax Planning Opportunities Related to the New COD Income-Deferral Election", American Bankruptcy Institute Journal, Feb. 2010, at 60-61..

and this cancellation of debt income must still be recognized under I.R.C. §61(a)(12) with the exception of certain exclusions provide for under §108 of the Internal Revenue Code.<sup>6</sup>

Not all debt transactions create cancellation of debt income despite the effect of the transaction being an actual cancellation or restructure of debt. A foreclosure on a non-recourse debt is not categorized as a cancellation of debt, but rather as a “taxable disposition of the collateral for an amount equal to the amount of the debt.”<sup>7</sup> In other words, this foreclosure is treated as income from a sale of property rather than income from the cancellation of a debt.<sup>8</sup> Also, a repurchase of debt that is predominately foreign currency does not create cancellation of debt income. Such a transaction would give rise to a foreign currency gain and be included in taxable income in that manner instead.

### **A. Bankruptcy Discharge as a Cancellation of Debt**

In a bankruptcy context, cancellation of debt is not only a possibility, it is a practical certainty. In a Chapter 7 filing, the debtor will be liquidating and paying creditors back to the extent possible given their current assets. While some secured creditors may get a full return on the debt, unsecured creditors will frequently be forced to take pennies on the dollar. Under the tax code however, the cancellation of any portion of the debt not repaid due to an inability to pay on the part of the debtor does not create taxable income.<sup>9</sup> This inability to pay is more important in a Chapter 11 filing. In a Chapter 11 filing, the debtor is trying to get back on its feet, and in the corporate context, continue to do business. If a debtor has gotten in over its head to the point

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<sup>6</sup> Cleary Gottlieb Steen & Hamilton LLP, American Bankruptcy Institute, Alert Memo of 19 February 2009, [www.abiworld.org](http://www.abiworld.org) (last visited April 17, 2010).

<sup>7</sup> Cleary Gottlieb Steen & Hamilton LLP, American Bankruptcy Institute, Alert Memo of 19 February 2009, [www.abiworld.org](http://www.abiworld.org) (last visited April 17, 2010).

<sup>8</sup> Cleary Gottlieb Steen & Hamilton LLP, American Bankruptcy Institute, Alert Memo of 19 February 2009, [www.abiworld.org](http://www.abiworld.org) (last visited April 17, 2010).

<sup>9</sup> 26 U.S.C. § 108(a)(1)(A) (2009); I.R.C. § 108(a)(1)(A) (2009).

where a bankruptcy filing is necessary, it is unlikely that the debtor will be able to continue to do business without the cancellation of some of its outstanding debt.

For creditors, a choice must be made: whether the company is worth more to them dead or alive. In other words, the creditors must decide whether they stand to make more money if the creditor liquidates or successfully reorganizes and continues to operate. Sometimes it is more profitable to cancel some of the debt at the outset of the case and take whatever pennies on the dollar are salvageable. Other times, creditors may find it more prudent to forgive a portion of the debt to help the debtor stay afloat until it can pull itself out of chapter 11 and back into profitability.

One mechanism creditor may employ to control the fate of the debtor and dictate how much debt it is willing to cancel is through approval of the Chapter 11 plan. A plan is the outline of how the debtor corporation will reorganize itself to emerge from Chapter 11 and become profitable. The debtor has 120 day exclusive period in which to file its plan for reorganization.<sup>10</sup> This time can be extended for cause up to 18 months after the order for relief,<sup>11</sup> normally requiring the debtor to show progress and potential for resolution on the horizon, but it is in the debtor's interest to confirm a plan within the exclusive period.<sup>12</sup> Each class of creditors has to approve the plan before it can be confirmed,<sup>13</sup> which gives the creditor leverage to cancel as little debt as possible. Creditors can contact other, similarly situated creditors who are forgiving debt to determine how much each creditor is willing to cancel in order to make an appropriate deal. Creditors can perform a due diligence investigation and determine how much money they can get

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<sup>10</sup> 11 U.S.C. § 1121(b) (2005).

<sup>11</sup> 11 U.S.C. § 1121(d)(2)(A) (2005).

<sup>12</sup> Scarberry, Mark S., Kenneth N. Klee, Grant W. Newton, Steve H. Nickles, *Business Reorganization in Bankruptcy* 634-644 (Thomson West 3rd ed. 2006).

<sup>13</sup> 11 U.S.C. § 1129(a) (2005).

out of the creditor. At that point a creditor can determine whether to agree to the plan, make a deal, and cancel some debt; or refuse to confirm the plan and hold out for payment in full.<sup>14</sup> The confirmation process for a reorganization plan greatly affects which creditors which cancel a portion of the debt and the amount each creditor will be willing to cancel for a debtor in a Chapter 11 case.

Once a reorganization plan has been confirmed, the debtor receives its fresh start. Section 1141 of the bankruptcy code provides that any debt that arose before the filing of the Chapter 11 petition is discharged upon the confirmation of the Chapter 11 plan.<sup>15</sup> Section 108(a)(1)(A) excludes this discharge from taxable income. There are, however, some debts that are not discharged at the confirmation of a Chapter 11 plan. If the plan substantially liquidates the debtor, the debtor fails to engage in business after confirmation, or the debt would not be discharged in a Chapter 7 case<sup>16</sup>, then the debtor does not receive a discharge from the confirmation of the Chapter 11 plan.<sup>17</sup> This discharge is effective against all future creditor attempts at recovery regardless of whether the creditor filed a claim in the case.<sup>18</sup> Therefore, a creditor cannot avoid cancelling a debt owed them by not filing a claim and staying out of the bankruptcy case.

## **B. Tax Treatment of Cancellation of Debt Income**

While §61 of the Internal Revenue Code treats the cancellation of debt as taxable income for the taxpayer, §108 of the Internal Revenue Code provides exceptions to including the discharge

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<sup>14</sup> Scarberry, Mark S., Kenneth N. Klee, Grant W. Newton, Steve H. Nickles, *Business Reorganization in Bankruptcy* 634-644 (Thomson West 3rd ed. 2006).

<sup>15</sup> 11 U.S.C. § 1141(d)(1) (2005).

<sup>16</sup> 11 U.S.C. § 727 (2005).

<sup>17</sup> 11 U.S.C. § 1141(d)(3) (2005).

<sup>18</sup> 11 U.S.C. § 1141(d)(1)(A)(i) (2005).

of debt in taxable income.<sup>19</sup> First, Section 108(a) provides that gross income does not include any amount which (but for this subsection) would be includible in gross income by reason of the discharge (in whole or in part) of indebtedness of the taxpayer if (A) the discharge occurs in a title 11 case.<sup>20</sup> This is an extremely important provision for chapter 11 debtors, who are trying to reorganize and recover from financial woes. Without section 108,<sup>21</sup> the debtor would be forced to pay what little working capital it still has to the government, and the likelihood of failure for the chapter 11 plan is significantly greater.

Even if a struggling debtor has not yet filed a chapter 11 bankruptcy petition, section 108 provides aid to insolvent debtors. The statute provides gross income does not include any amount which (but for this subsection) would be includible in gross income by reason of the discharge (in whole or in part) of indebtedness of the taxpayer if (B) the discharge occurs when the taxpayer is insolvent.<sup>22</sup> Section 108 defines insolvency as the excess of liabilities over the fair market value of assets,<sup>23</sup> commonly known as balance sheet insolvency. There are other approaches to declaring a debtor insolvent, but section 108 only applies to a debtor that is “balance sheet” insolvent. For instance, a debtor may not be able to pay its debts as they come due because of illiquidity rendering them equity insolvent, but without also being “balance sheet” insolvent, section 108 would not allow the debtor to exclude any cancellation of debt under the insolvency provision.

Section 108 further provides that gross income does not include any amount which (but for this subsection) would be includible in gross income by reason of the discharge (in whole or in

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<sup>19</sup> 26 U.S.C. § 61(a)(12) (1984); I.R.C. § 61(a)(12) (1984); 26 U.S.C. § 108(a) (2009); I.R.C. § 108(a) (2009).

<sup>20</sup> 26 U.S.C. § 108(a)(1)(A) (2009); I.R.C. § 108(a)(1)(A) (2009).

<sup>21</sup> 26 U.S.C. § 108(a) (2009); I.R.C. § 108(a) (2009).

<sup>22</sup> 26 U.S.C. § 108(a)(1)(B) (2009); I.R.C. § 108(a)(1)(B) (2009).

<sup>23</sup> 26 U.S.C. § 108(d)(3) (2009); I.R.C. § 108(d)(3) (2009).

part) of indebtedness of the taxpayer if (C) the indebtedness discharged is qualified farm indebtedness.<sup>24</sup> The statute continues “in the case of a taxpayer other than a C corporation, the indebtedness discharged is qualified real property business indebtedness.”<sup>25</sup> These provisions, while important provisions for solvent debtors, are less relevant to insolvent debtors and this paper. Subsections (C) and (D) are superseded by both the chapter 11 and insolvency exceptions, and therefore are inapplicable in this context.<sup>26</sup>

Subsection (E) was added to the code in 2007 by the Mortgage Forgiveness Debt Relief Act<sup>27</sup> and provides an exclusion from taxable income for qualified principal residence indebtedness discharged prior to January 1, 2013.<sup>28</sup> Section 108 goes on to define qualified principal residence indebtedness as “acquisition indebtedness<sup>29</sup> with respect to the principal resident of the taxpayer,”<sup>30</sup> which requires that the debt be incurred for buying, building, or significantly renovating the home and that the debt be secured by the home.<sup>31</sup> The exclusion is also limited to \$2 million of indebtedness.<sup>32</sup> Interestingly, this exclusion takes precedence over the insolvency exclusion unless the taxpayer elects to invoke the insolvency exclusion.<sup>33</sup> An insolvent, yet (formerly) wealthy individual debtor, needs to be mindful of §108(a)(2)(C) because she would

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<sup>24</sup> 26 U.S.C. § 108(a)(1)(C) (2009); I.R.C. § 108(a)(1)(C) (2009)..

<sup>25</sup> 26 U.S.C. § 108(a)(1)(D) (2009); I.R.C. § 108(a)(1)(D) (2009).

<sup>26</sup> 26 U.S.C. § 108(a)(2)(A) (2009); I.R.C. § 108(a)(2)(A) (2009); 26 U.S.C. § 108(a)(2)(B) (2009); I.R.C. § 108(a)(2)(B) (2009).

<sup>27</sup> Bankman, Griffith, and Pratt, *Examples and Explanations for Federal Income Tax*, 115 (5<sup>th</sup> ed. 2008).

<sup>28</sup> 26 U.S.C. § 108(a)(1)(E) (2009); I.R.C. § 108(a)(1)(E) (2009).

<sup>29</sup> Section 163(h)(3)(B) of the tax code defines acquisition indebtedness as “indebtedness which (I) is incurred in acquiring, construction, or substantially improving any qualified residence of the taxpayer, and (II) is secured by such residence.” It further provides that refinanced debt can still be acquisition debt to the extent that the refinancing does not exceed the amount of the refinanced indebtedness. 26 U.S.C. § 163(h)(3)(B) (2010); I.R.C. § 163(h)(3)(B) (2010).

<sup>30</sup> 26 U.S.C. § 108(h)(2) (2009); I.R.C. § 108(h)(2) (2009).

<sup>31</sup> 26 U.S.C. § 108(h)(2) (2009); I.R.C. § 108(h)(2) (2009); 26 U.S.C. § 163(h)(3)(B) (2010); I.R.C. § 163(h)(3)(B) (2010).

<sup>32</sup> 26 U.S.C. § 108(h)(2) (2009); I.R.C. § 108(h)(2) (2009).

<sup>33</sup> 26 U.S.C. § 108(a)(2)(C) (2009); I.R.C. § 108(a)(2)(C) (2009).

lose excludable discharge to the extent that her home was worth more than \$2 million if she failed to make the election. This election is obviously inapplicable to the corporate debtor.

Section 108 also provides a hierarchical structure dictating priorities within the exclusions for cancellation of debt income. The Title 11 exclusion takes precedence over all exclusions,<sup>34</sup> and the insolvency exclusion takes precedence over the qualified farm indebtedness and qualified real property business indebtedness exclusions,<sup>35</sup> so corporate insolvent debtors have little to worry about in this area.

Notwithstanding §108's treatment of cancellation of debt, American Jurisprudence synthesizes the holdings from *Howard Paper Co*<sup>36</sup>. and *Beacon Auto Stores*<sup>37</sup> cases and provides "the cancellation of a corporation's indebtedness by a creditor-shareholder which involves items previously deducted by the corporation causes the corporation to realize debt cancellation income if the cancellation was 'involuntary or non-gratuitous' and the deductions resulted in a tax benefit to the corporation."<sup>38</sup> This prevents corporations from taking on debt for tax deductions and then cancelling the debt to themselves and avoiding the recognition of taxable income.

**III.** One potential corporate strategy targeted by this statute that comes to mind is loaning the corporation money for a charitable contribution. If a principal in the company wanted to inject cash into an insolvent corporation, she could loan the corporation \$100,000 for a charitable contribution that they intended to make anyway. The company could then

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<sup>34</sup> 26 U.S.C. § 108(a)(2)(A) (2009); I.R.C. § 108(a)(2)(A) (2009).

<sup>35</sup> 26 U.S.C. § 108(a)(2)(B) (2009); I.R.C. § 108(a)(2)(B) (2009).

<sup>36</sup> *Howard Paper Co., Inc. v. C.I.R.*, 43 B.T.A. 545, 1941 WL 463 (B.T.A. 1941).

<sup>37</sup> *Beacon Auto Stores, Inc. v. C.I.R.*, 42 B.T.A. 703, 1940 WL 104 (B.T.A. 1940).

<sup>38</sup> 9 Am. Jur. 2d Bankruptcy §299. Citing *Howard Paper Co., Inc. v. C.I.R.*, 43 B.T.A. 545, 1941 WL 463 (B.T.A. 1941); *Beacon Auto Stores, Inc. v. C.I.R.*, 42 B.T.A. 703, 1940 WL 104 (B.T.A. 1940).



make the charitable donation in its name and deduct the \$100,000 from its gross income. The following year, the principal could simply cancel the debt and the corporation could exclude the cancellation from taxable income under the insolvency exclusion of section 108.<sup>39</sup> The corporation would be able to receive \$100,000 of tax-free cash if not for the *Howard Paper Co.*<sup>40</sup> and *Beacon Auto Stores*<sup>41</sup> cases. **Net Operating Losses**

Net Operating Losses are defined in the Internal Revenue Code as “the excess of the deductions allowed by this chapter over the gross income.”<sup>42</sup> Black’s Law Dictionary alternatively, and more comprehensibly, defines a net operating loss as “[t]he excess of operating expenses over revenues, the amount of which can be deducted from gross income if other deductions do not exceed gross income.”<sup>43</sup> Section 172 of the Internal Revenue Code provides for a deduction for net operating losses.<sup>44</sup> Section 172 further provides that the net operating loss deduction can be taken each year for “an amount equal to the aggregate of (1) the net operating loss carryovers to such year, plus (2) the net operating loss carrybacks to such year.”<sup>45</sup> Net Operating Losses are first applied to offset ordinary income from the prior year.<sup>46</sup> Those losses are then applied to the prior year’s capital gain. The net operating losses are then applied in this fashion on a year-to-year basis beginning with the earliest available year, which outside of the American Recovery and Reinvestment Act is two years prior to the year in which the losses were realized.

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<sup>39</sup> 26 U.S.C. § 108(a)(1)(B) (2009); I.R.C. § 108(a)(1)(B) (2009).

<sup>40</sup> *Howard Paper Co., Inc. v. C.I.R.*, 43 B.T.A. 545, 1941 WL 463 (B.T.A. 1941).

<sup>41</sup> *Beacon Auto Stores, Inc. v. C.I.R.*, 42 B.T.A. 703, 1940 WL 104 (B.T.A. 1940).

<sup>42</sup> 26 U.S.C. § 172(c) (2009); I.R.C. § 172(c) (2009).

<sup>43</sup> Black’s Law Dictionary (8th ed. 2004) (Within the definition of “loss”, “net operating loss” is defined).

<sup>44</sup> 26 U.S.C. § 172(a) (2009); I.R.C. § 172(a) (2009).

<sup>45</sup> 26 U.S.C. § 172(a) (2009); I.R.C. § 172(a) (2009).

<sup>46</sup> Dawson, Joseph P., American Bankruptcy Institute, Where’s My Cash Windfall? Tax Planning Opportunities from Recent Legislation, <http://www.abiworld.org/committees/newsletters/banktaxation/vol6num2/windfall.pdf> (last visited April 17, 2010).

Carrybacks and carryovers allow the taxpayer to use the net operating loss deduction in other taxable years when they could not use the full net operating loss deduction. A carryback is “an income-tax deduction (esp. for a net operating loss) that cannot be taken entirely in a given period but may be taken in an *earlier* period,”<sup>47</sup> and a carryover is just the opposite, “An income-tax deduction (esp. for a net operating loss) that cannot be taken entirely in a given period but may be taken in a *later* period.”<sup>48</sup> Section 172 further provides that carrybacks are limited to the two years preceding the year in which the loss was realized, while carryovers can span the twenty years following the years in which the loss was realized.<sup>49</sup> These carrybacks and carryovers must be applied in strict chronological order beginning with the earliest carryback year available.<sup>50</sup>

These provisions are crucial for businesses, especially in times of economic downturn. The deduction for net operating losses protects companies against a bad year, but the carryback and carryover provisions protect them against major economic downturns that can result in several unprofitable years. Since the deduction for net operating losses cannot exceed gross income in any given year, formerly profitable companies would struggle to survive several consecutive unprofitable years without carryback and carryover provisions. Section 172 allows these companies to redistribute some of these losses back to the years they were profitable (assuming they were profitable in the last two years) or forward to future years when they will hopefully realize profits again.

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<sup>47</sup> Black's Law Dictionary (8th ed. 2004).

<sup>48</sup> Black's Law Dictionary (8th ed. 2004).

<sup>49</sup> 26 U.S.C. § 172(b)(1)(A) (2009); I.R.C. § 172(b)(1)(A) (2009). (Assuming years other than 2009 and 2010 in which the American Recovery and Reinvestment Act would change the number years of carryback and carryover).

<sup>50</sup> 26 U.S.C. § 172(b) (2009); I.R.C. § 172(b) (2009).

The carryback and carryover provisions also allow profitable businesses to acquire unprofitable businesses for tax purposes. Companies that realize huge profits and therefore are unable to capitalize on deductions for net operating losses acquire companies with plenty of losses to spare and carry the losses back and forward to get formerly unavailable tax deductions. When dealing with major corporations and billions of dollars, these deductions can turn into real money.

In a bankruptcy context, these provisions are a critical preventative measure. Companies that would be forced to file Chapter 11 in an effort to reorganize and ride out the storm without these provisions can use carrybacks and carryovers to spread their losses, get some tax breaks, and stay afloat until the economy turns around. The appeal of acquiring a debt ridden company for tax purposes also shaves down bankruptcy dockets. Companies can avoid Chapter 11 by marketing and availing themselves to acquisition by a more profitable company. In either situation, net operating loss deductions and the ability to carry them beyond the taxable year greatly reduces bankruptcy filings.

#### **IV. Economic Downturn**

The end of the last decade was a gloomy time for the American, and world, economy. Many have described it as the worst financial crisis since the Great Depression.<sup>51</sup> Doves of individuals and companies have been forced to into bankruptcy after the economic prominence of the mid-2000s. By early 2010, the dollar to euro exchange rate had fallen to 1.5 to 1 and

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<sup>51</sup> Stephen C, Stapleton, Systemic Financial Failure: Can We Stop the Risk? in Bankruptcy and Financial Restructuring Law 2010: Top Lawyers on Trends and Key Strategies for the Upcoming Year at 1(Aspatore ed. 2010).

unemployment had risen to 9.8 percent and was expected to rise over 10 percent.<sup>52</sup> In 2009 alone, 99 banks failed, bringing the post-2007 total to 124 with more failures expected in the next couple years.<sup>53</sup> As 2010 began, one in six Americans was unemployed, and one of every eight American homes was in foreclosure.<sup>54</sup> The recession has hit every part of the economy.

Following the burst of the tech bubble in 2000, the Federal Reserve lowered interest rates in a historic fashion and kept them low to stimulate investment.<sup>55</sup> The strategy worked and the economy flourished. However, a foundation of this type was shaky at best since unqualified borrowers were more willing than ever to capitalize on low interest loans.<sup>56</sup> Initially, the mortgage market was stimulated by these changes, but with time the trend expanded beyond home mortgages and into the corporate world. Between 2005 and 2007, companies were leveraging deals as highly as possible, credit was abundant, and the economy was booming.<sup>57</sup> Once this bubble burst, bankruptcy became the only option for many corporations. Even businesses that were “too big to fail” were sinking quickly toward bankruptcy.

Business bankruptcy filings from March 2008 to March 2009 (the twelve month period preceding the enactment of the American Recovery and Reinvestment Act) totaled 49,091, a 59.7

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<sup>52</sup> Stephen C, Stapleton, Systemic Financial Failure: Can We Stop the Risk? in Bankruptcy and Financial Restructuring Law 2010: Top Lawyers on Trends and Key Strategies for the Upcoming Year at 3 (Aspatore ed. 2010).

<sup>53</sup> Stephen C, Stapleton, Systemic Financial Failure: Can We Stop the Risk? in Bankruptcy and Financial Restructuring Law 2010: Top Lawyers on Trends and Key Strategies for the Upcoming Year at 3 (Aspatore ed. 2010).

<sup>54</sup> Stephen C, Stapleton, Systemic Financial Failure: Can We Stop the Risk? in Bankruptcy and Financial Restructuring Law 2010: Top Lawyers on Trends and Key Strategies for the Upcoming Year at 3 (Aspatore ed. 2010).

<sup>55</sup> Stephen C, Stapleton, Systemic Financial Failure: Can We Stop the Risk? in Bankruptcy and Financial Restructuring Law 2010: Top Lawyers on Trends and Key Strategies for the Upcoming Year at 4 (Aspatore ed. 2010).

<sup>56</sup> Stephen C, Stapleton, Systemic Financial Failure: Can We Stop the Risk? in Bankruptcy and Financial Restructuring Law 2010: Top Lawyers on Trends and Key Strategies for the Upcoming Year at 4 (Aspatore ed. 2010).

<sup>57</sup> Drucker, Jesse and Peter Lattman, *Crisis on Wall Street: Harrah's Plans to Cut Debt, Benefiting From Tax Break*, The Wall Street Journal, March 2, 2009, at C2.

percent increase over the 30,741 petitions that were filed from March 2007 to March 2008.<sup>58</sup> Business filings for all of 2009 totaled 60,837, up from just 43,546 the previous year.<sup>59</sup> More specifically, Chapter 11 filings (business and individual combined) over the same periods rose 69.1 percent from 6,971 in 2007-2008 to 11,785 in 2008-2009.<sup>60</sup> The downturn is also evident in historical filings data on large public companies. These filings reached a low point in 2006 and 2007 with 14 and 13 filings in each year, respectively.<sup>61</sup>

## V. Harrah's Merger

Harrah's Entertainment, Inc. is the world's largest gambling company in terms of revenues.<sup>62</sup> It was founded in 1937 and owns and/or manages 36 casinos in the U.S., primarily in Las Vegas and Atlantic City.<sup>63</sup> It also has casinos on four continents,<sup>64</sup> including establishments in the U.K., Egypt, South Africa, Uruguay, and Canada.<sup>65</sup> Harrah's primary brands are Harrah's, Caesars, Horseshoe, and London Clubs International.<sup>66</sup> Harrah's recently hired a new President of

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<sup>58</sup> US Courts News Release, *Bankruptcy Filings Continue to Rise* (2009), [http://www.uscourts.gov/Press\\_Releases/2009/BankruptcyFilingsMar2009.cfm](http://www.uscourts.gov/Press_Releases/2009/BankruptcyFilingsMar2009.cfm).

<sup>59</sup> American Bankruptcy Institute, *Annual Business and Non-Business Filings by Year (1980-2009)*, <http://www.abiworld.org/AM/AMTemplate.cfm?Section=Home&CONTENTID=60229&TEMPLATE=/CM/ContentDisplay.cfm> (Last visited April 17, 2010).

<sup>60</sup> US Courts News Release, *Bankruptcy Filings Continue to Rise* (2009), [http://www.uscourts.gov/Press\\_Releases/2009/BankruptcyFilingsMar2009.cfm](http://www.uscourts.gov/Press_Releases/2009/BankruptcyFilingsMar2009.cfm).

<sup>61</sup> LoPucki, Lynn M., Lynn M. LoPucki's Bankruptcy Research Database, *Large Public Company Bankruptcies Filed in the United States, by year, 1990-2009*, (2010).

<sup>62</sup> Lattman, Peter, *A Buyout-Shop Breather --- Market Thaw Opens Door for Aid to Portfolio Firms*, Wall Street Journal, May 30, 2009, at B3.

<sup>63</sup> Audi, Tamara, Peter Lattman, and Jeff McCracken, *Harrah's Change's Its Game --- Tough Times for Gambling, Large Debt Force Shifts*, *The Wall Street Journal*, October 27, 2008, at C1.

<sup>64</sup> Harrah's Entertainment News Release, *Harrah's Entertainment, Inc. Announces Completion of Merger*, (2008) <http://investor.harrahs.com/phoenix.zhtml?c=84772&p=irol-newsArticle&ID=1100620&highlight>.

<sup>65</sup> Audi, Tamara, Peter Lattman, and Jeff McCracken, *Harrah's Change's Its Game --- Tough Times for Gambling, Large Debt Force Shifts*, *The Wall Street Journal*, October 27, 2008, at C1.

<sup>66</sup> Harrah's Entertainment News Release, *Harrah's Entertainment, Inc. Announces Completion of Merger*, (2008) <http://investor.harrahs.com/phoenix.zhtml?c=84772&p=irol-newsArticle&ID=1100620&highlight>.

Strategy and Development, Peter Murphy,<sup>67</sup> to further expand the company through joint ventures between its various brands in an international context.<sup>68</sup>

Harrah's entered an agreement and plan to merge with Hamlet Holdings, LLC/Hamlet Merger Inc. on December 19, 2006.<sup>69</sup> The stockholders approved the agreement and the merger on April 5, 2007 at a special stockholders meeting<sup>70</sup> giving shareholders a \$90 per share buyout.<sup>71</sup> The shareholders made a 36 percent premium on the transaction.<sup>72</sup> The deal was then completed on January 28, 2008,<sup>73</sup> leaving all outstanding shares in the control of Apollo Management LP and Texas Pacific Group ("TPG").<sup>74</sup> Apollo and TPG paid \$28.7 billion<sup>75</sup> for the company in a highly leveraged<sup>76</sup> deal, assuming \$10.7 billion in debt.<sup>77</sup> This deal was struck during the credit boom between 2005 and 2007 when firms were leveraging deals as highly as

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<sup>67</sup> Formerly of Disney, where he was very influential in international expansion. Then worked for Apollo, but not on the Harrah's deal. Berzon, Alexandra, *New Harrah's Executive to Focus on Overseas Growth*, The Wall Street Journal, October 22, 2009.

<sup>68</sup> Berzon, Alexandra, *New Harris Executive to Focus on Overseas Growth*, The Wall Street Journal, October 22, 2009.

<sup>69</sup> Harrah's Entertainment News Release, *Harrah's Entertainment, Inc. Announces Completion of Merger*, (2008) <http://investor.harrah.com/phoenix.zhtml?c=84772&p=irol-newsArticle&ID=1100620&highlight=>

<sup>70</sup> Harrah's Entertainment News Release, *Harrah's Entertainment, Inc. Announces Completion of Merger*, (2008) <http://investor.harrah.com/phoenix.zhtml?c=84772&p=irol-newsArticle&ID=1100620&highlight=>; *Harrah's Holders Back Private-Equity Buyout*, The Wall Street Journal, April 6, 2007 at B3.

<sup>71</sup> "Harrah's Entertainment, Inc. Announces Completion of Merger. Nevistas. January 28, 2008; "Harrah's Holders Back Private-Equity Buyout", The Wall Street Journal, April 6, 2007.

<sup>72</sup> Harrah's Entertainment News Release, *Harrah's Agrees to Be Acquired by Apollo and TPG*, (2006) <http://investor.harrah.com/phoenix.zhtml?c=84772&p=irol-newsArticleMedia&ID=943557&highlight=>.

<sup>73</sup> Harrah's Entertainment News Release, *Harrah's Entertainment, Inc. Announces Completion of Merger*, (2008) <http://investor.harrah.com/phoenix.zhtml?c=84772&p=irol-newsArticle&ID=1100620&highlight=>.

<sup>74</sup> Harrah's Entertainment News Release, *Harrah's Entertainment, Inc. Announces Completion of Merger*, (2008) <http://investor.harrah.com/phoenix.zhtml?c=84772&p=irol-newsArticle&ID=1100620&highlight=>.

<sup>75</sup> Harrah's Entertainment News Release, *Harrah's Agrees to Be Acquired by Apollo and TPG*, (2006) <http://investor.harrah.com/phoenix.zhtml?c=84772&p=irol-newsArticleMedia&ID=943557&highlight=>. (Some Report the deal at \$31 billion; *Harrah's Wins Relaxed Terms on \$5.5B In CMBS Debt*, Dow Jones News Service. March 8, 2010. Some report the deal at \$17.3 billion; *Harrah's Holders Back Private-Equity Buyout*, The Wall Street Journal, April 6, 2007 at B3; Cimilluca, Dana, *Ahead of the Tape*, The Wall Street Journal, January 8, 2008.).

<sup>76</sup> "Highly Leveraged" indicates that the deal was financed with debt. This most basically means that most of the money used for the purchase was borrowed.

<sup>77</sup> *Harrah's Holders Back Private-Equity Buyout*, The Wall Street Journal, April 6, 2007 at B3; Cimilluca, Dana, *Ahead of the Tape*, The Wall Street Journal, January 8, 2008; Harrah's Entertainment News Release, *Harrah's Agrees to Be Acquired by Apollo and TPG*, (2006) <http://investor.harrah.com/phoenix.zhtml?c=84772&p=irol-newsArticleMedia&ID=943557&highlight=>.

possible.<sup>78</sup> By the time the deal was finalized, the economy had changed drastically, and Apollo and TPG knew they were getting a different deal than they believed they had originally negotiated.

As the economy continued to weaken, the fiscal effects on the gambling industry were evident. Gambling and travel are, at least for most Americans, leisure activities and are subsequently one of the first things to get cut from most people's budgets. In these tough financial times, Harrah's tried to deleverage itself and increase liquidity. There are two primary methods for deleveraging a company: exchange offers and debt repurchases.<sup>79</sup> In early 2009, Harrah's completed two distressed-debt exchanges to reduce its debt load by \$3.4 billion. But even with this reduction it still maintained a debt load of about \$24 billion, \$500 million of which matures in 2010.<sup>80</sup> These moves were made among fears of bankruptcy, but are not indicative of the company's overall strategy under the American Recovery and Reinvestment Act.

## **VI. ARRA**

On February 17, 2009, President Obama signed a stimulus package, the American Recovery and Reinvestment Act, into law.<sup>81</sup> The package was designed with several stated purposes including creating jobs, stimulating economic recovery, and assisting those most impacted by the

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<sup>78</sup> Drucker, Jesse and Peter Lattman, *Crisis on Wall Street: Harrah's Plans to Cut Debt, Benefiting From Tax Break*, The Wall Street Journal, March 2, 2009, at C2.

<sup>79</sup> Lattman, Peter, *A Buyout-Shop Breather --- Market Thaw Opens door for Aid to Portfolio Firms*, The Wall Street Journal, May 30, 2009, at B3.

<sup>80</sup> Lattman, Peter, *A Buyout-Shop Breather --- Market Thaw Opens door for Aid to Portfolio Firms*, The Wall Street Journal, May 30, 2009, at B3.

<sup>81</sup> American Bankruptcy Institute Editor's Note, *Provisions of the American Recovery and Reinvestment Act Relating to Deferral of Cancellation of Debt Income*, March 2010, [www.abiworld.org](http://www.abiworld.org).

recession.<sup>82</sup> One vehicle through which the Act accomplishes its stated purposes is through the implementation of tax incentives for both individuals and businesses.

Of the \$787 billion in total disbursements from the act, \$288 billion are allocated to lost revenue from tax incentives.<sup>83</sup> As of March 2010, \$99.1 billion of this \$288 billion have been disbursed.<sup>84</sup> Corporate tax breaks are scheduled to total between \$75 billion and \$80 billion over the duration of the Act's disbursements.<sup>85</sup> To date, roughly \$30 billion of these tax breaks have been disbursed.<sup>86</sup> Businesses specifically get an extension of bonus depreciation, an extension of I.R.C. §179 expensing limits, a Work Opportunity Tax Credit, and a New-Markets Tax Credit.<sup>87</sup>

There are two additional business-oriented tax provisions that are relevant to this discussion and deserve more in-depth explanation. One is the addition of a five-year carryback for net operating losses for small businesses to §172 of the Internal Revenue Code.<sup>88</sup> Previously, companies could only carry such losses back two years prior to the year in which the loss was realized.<sup>89</sup> Now any business with average gross receipts of \$15 million or less for the three-year period prior to the year in which the loss arose can elect to carry net operating losses back three,

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<sup>82</sup> American Recovery and Reinvestment Act of 2009, Pub. L. No.111-5 §3(a) (2009).

<sup>83</sup> U.S. Government, *Overview of Funding*, (2010) <http://www.recovery.gov/Pages/home.aspx> (Follow Overview of Funding link on homepage) (Last visited April 17, 2010).

<sup>84</sup> U.S. Government, *Overview of Funding*, (2010) <http://www.recovery.gov/Pages/home.aspx> (Follow Overview of Funding link on homepage) (Last visited April 17, 2010).

<sup>85</sup> The Committee for a Responsible Federal Budget, *Happy Birthday ARRA: The American Recovery and Reinvestment Act Once Year Later*, (2010) <http://crfb.org/document/happy-birthday-arra-american-recovery-and-reinvestment-act-one-year-later>.

<sup>86</sup> The Committee for a Responsible Federal Budget, *Happy Birthday ARRA: The American Recovery and Reinvestment Act Once Year Later*, (2010) <http://crfb.org/document/happy-birthday-arra-american-recovery-and-reinvestment-act-one-year-later>.

<sup>87</sup> Rappis, Jamey G, "Tax Aspects of the American Recovery and Reinvestment Act of 2009: On the Road to Recovery?", Wisconsin Lawyer, April 2009.

<sup>88</sup> American Recovery and Reinvestment Act of 2009, Pub. L. No.111-5 §1211 (2009); 26 U.S.C. § 172 (2009); I.R.C. § 172 (2009); Rappis, Jamey G, "Tax Aspects of the American Recovery and Reinvestment Act of 2009: On the Road to Recovery?", Wisconsin Lawyer, April 2009.

<sup>89</sup> Rappis, Jamey G, "Tax Aspects of the American Recovery and Reinvestment Act of 2009: On the Road to Recovery?", Wisconsin Lawyer, April 2009.



four, or five years prior to when the loss occurred.<sup>90</sup> The statute specifically provides “If an eligible small business elects the application of this subparagraph with respect to an applicable 2008 net operating loss (I) subparagraph (A)(i) shall be applied by substituting any whole number elected by the taxpayer which is more than 2 and less than 6 for ‘2’.”<sup>91</sup> The phrasing of the statute gives the taxpayer the freedom to choose any year between two and six, and therefore, gives it lots of room for strategic planning.

The second is the deferral of tax consequences for cancellation of debt. The Act allows a taxpayer to elect to defer taxation on cancellation of debt until 2014 and then pay the tax ratably over a five-year period.<sup>92</sup> The act specifically provides that “at the election of the taxpayer, income from the discharge of indebtedness in connection with the reacquisition after December 31, 2008, and before January 1, 2011, of an applicable debt instrument shall be includible in gross income ratably over the 5-taxable-year period beginning with (A) in the case of a reacquisition occurring in 2009, the fifth taxable year following the taxable year in which the reacquisition occurs, and (B) in the case of a reacquisition occurring in 2010, the fourth taxable year following the taxable year in which the reacquisition occurs.”<sup>93</sup>

This extension can be invoked on a debt-by-debt basis, giving a corporation the additional benefit of mixing-and-matching strategies as needed.<sup>94</sup> However, corporations must consider that the election, while made on the tax return for the taxable year in which the income is realized, is

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<sup>90</sup> American Recovery and Reinvestment Act of 2009, Pub. L. No.111-5 §1211 (2009); Rappis, Jamey G, “Tax Aspects of the American Recovery and Reinvestment Act of 2009: On the Road to Recovery?”, Wisconsin Lawyer, April 2009; Vincent, Scott E., “American Recovery and Reinvestment Act of 2009 – Multiple Provisions for Business and Individual Taxpayers”, Journal of the Missouri Bar, March-April 2009.

<sup>91</sup> American Recovery and Reinvestment Act of 2009, Pub. L. No.111-5 §1211(a) (2009). [Amending 26 U.S.C. § 172(b)(1)(H) (2009)].

<sup>92</sup> American Recovery and Reinvestment Act of 2009, Pub. L. No.111-5 §1231 (2009).

<sup>93</sup> American Recovery and Reinvestment Act of 2009, Pub. L. No.111-5 §1231 (2009).

<sup>94</sup> Kraft, Todd A., *Tax Breaks for Business in the Stimulus Legislation*, Texas Lawyer, July 2009.

irrevocable.<sup>95</sup> The corporation, therefore, cannot change its mind in the five years between election and payment.<sup>96</sup> For all practical purposes, this gives the taxpayer a five-year, interest-free loan from the federal government in the amount of the cancellation of debt tax liability.

A year after the passage of the American Recovery and Reinvestment Act, the effectiveness of the package is still in question. The Congressional Budget Office predicted that the package would increase gross domestic product by between 1.4 and 3.8 percent by the end of 2009.<sup>97</sup> The Congressional Budget Office also predicted it would create or save between 800,000 and 2,300,000 jobs by the end of 2009.<sup>98</sup> However, the economy has failed to meet these predictions. Unemployment has also increased more rapidly than the Congressional Budget Office predicted.<sup>99</sup> All economic indicators point to failure, or at least only mitigated success, of the package a year after enactment. Both the Congressional Budget Office and the President's Council for Economic Advisers maintain that the package is working, but the original state of the economy was worse than they realized.<sup>100</sup> Those characterizations of success or failure, however, are measured on a macroeconomic level, which is irrelevant in the analysis of how the aforementioned provisions may still be used successfully by corporations to stay afloat in rough economic waters.

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<sup>95</sup> American Recovery and Reinvestment Act of 2009, Pub. L. No.111-5 §1231 (2009); Cleary Gottlieb Steen & Hamilton LLP, American Bankruptcy Institute, Alert Memo of 19 February 2009, [www.abiworld.org](http://www.abiworld.org) (last visited April 17, 2010).

<sup>96</sup> Cleary Gottlieb Steen & Hamilton LLP, American Bankruptcy Institute, Alert Memo of 19 February 2009, [www.abiworld.org](http://www.abiworld.org) (last visited April 17, 2010).

<sup>97</sup> The Committee for a Responsible Federal Budget, *Happy Birthday ARRA: The American Recovery and Reinvestment Act Once Year Later*, (2010) <http://crfb.org/document/happy-birthday-arra-american-recovery-and-reinvestment-act-one-year-later>.

<sup>98</sup> The Committee for a Responsible Federal Budget, *Happy Birthday ARRA: The American Recovery and Reinvestment Act Once Year Later*, (2010) <http://crfb.org/document/happy-birthday-arra-american-recovery-and-reinvestment-act-one-year-later>.

<sup>99</sup> The Committee for a Responsible Federal Budget, *Happy Birthday ARRA: The American Recovery and Reinvestment Act Once Year Later*, (2010) <http://crfb.org/document/happy-birthday-arra-american-recovery-and-reinvestment-act-one-year-later>.

<sup>100</sup> The Committee for a Responsible Federal Budget, *Happy Birthday ARRA: The American Recovery and Reinvestment Act Once Year Later*, (2010) <http://crfb.org/document/happy-birthday-arra-american-recovery-and-reinvestment-act-one-year-later>.

## VII. Strategic Considerations Under New Provisions

“Election” is arguably the most important word in the previously discussed sections of the American Recovery and Reinvestment Act. “At the election of the taxpayer”<sup>101</sup> in section 1231 gives the debtor a chance to strategically use or neglect to use the 5-year extension of cancellation of debt income. The net operating debt provisions of the American Recovery and Reinvestment Act are also at the election of the taxpayer.<sup>102</sup> The flexibility in this statute leaves corporations which may be considering utilizing the provisions of the American Recovery and Reinvestment Act with a number of choices.

When a debtor corporation looks at balance sheets, cash flow charts, and the like, it is always faced with a number of strategic options, but the American Recovery and Reinvestment Act has put a couple extra strategies at its disposal.. A board of directors or officers of a corporation could choose to pay off debts now, but this may not always be the prudent, or even an available, option. The board or officers could also decide to file for Chapter 11 and utilize all of the protections it offers. Under the American Recovery and Reinvestment Act, the board or officers of a small company<sup>103</sup> could choose to utilize the extension of net operating loss deduction carrybacks and carryovers.<sup>104</sup> By spreading the losses across more years and getting deductions, the company may be able to stave off bankruptcy and stay afloat. The board or officers may also choose to attempt a renegotiation with creditors to cancel some of its debt. Now that they can defer the taxation on the cancelled debt, deals can be restructured to cancel some of the debt and the company can stay afloat and avoid taxation on that income until 2014 and even then spread

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<sup>101</sup> American Recovery and Reinvestment Act of 2009, Pub. L. No.111-5 §1231 (2009).

<sup>102</sup> American Recovery and Reinvestment Act of 2009, Pub. L. No.111-5 §1211 (2009).

<sup>103</sup> \$15 million or less in gross receipts. American Recovery and Reinvestment Act of 2009, Pub. L. No.111-5 §1211(a)(iv) (2009).

<sup>104</sup> American Recovery and Reinvestment Act of 2009, Pub. L. No.111-5 §1211(a) (2009).

the debt ratably across another five years.<sup>105</sup> Obviously, any board or group of officers has a number of options on the table; each with advantages, disadvantages, and a proper strategic application.

If corporations cancel debt through any of the aforementioned mechanisms, it may be possible to avoid bankruptcy without exercising any of the elections in the American Recovery and Reinvestment Act. Some companies may find it advantageous to claim the cancellation of debt income now and pay the tax. One situation where this may be a prudent strategy is a company that has net operating losses that can be carried forward.<sup>106</sup> Such a company should at least consider claiming the income in the current taxable year so it won't lose any permanent benefits from the carryforward provisions.<sup>107</sup> Even with this strategy, the extension of the carryforward provisions for net operating losses in the American Recovery and Reinvestment Act could still come into play if the corporation was small enough<sup>108</sup> and had enough losses to carry out over the extended time. But whether invoking the net operating loss provisions of the American Recovery and Reinvestment Act or not, paying the taxes on the cancellation of debt now rather than later may be a prudent decision for a corporation.

When a corporation finds itself facing a huge debtload, even before the enactment of the American Recovery and Reinvestment Act, bankruptcy is always a consideration. Bankruptcy offers several protections to debtor. Section 362 of the bankruptcy code gives the debtor the protection of the automatic stay, immediately preventing creditors from seeking to collect debts

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<sup>105</sup> American Recovery and Reinvestment Act of 2009, Pub. L. No.111-5 §1231 (2009).

<sup>106</sup> Whitehouse, Tammy, *Tax Compliance Changes Under the Recovery Act*, Compliance Week, May 2009, at 34, 72. (Quoting Scott Vance, a tax principal at KPMG)

<sup>107</sup> Whitehouse, Tammy, *Tax Compliance Changes Under the Recovery Act*, Compliance Week, May 2009, at 34, 72. (Quoting Scott Vance, a tax principal at KPMG)

<sup>108</sup> Gross Receipts are limited to \$15 million average over the three preceding yeats to qualify as a "small business" and get the extension. American Recovery and Reinvestment Act of 2009, Pub. L. No.111-5 §1211 (2009).

outside of the bankruptcy proceeding.<sup>109</sup> The debtor is also able to stop making payments on pre-petition debts.<sup>110</sup> And most importantly, the debtor is able to receive a discharge of much of its debt at the end of the proceeding, whether liquidated in Chapter 7 or reorganized in Chapter 11. For purposes of this discussion, Chapter 7 debtors are not relevant to this discussion since they are liquidated and dead and therefore will not incur future tax liabilities. Chapter 11 debtors, however, will emerge from bankruptcy reorganized and much less debt ridden.

The discharge that a Chapter 11 debtor receives is a cancellation of debt. Section 61(a)(12) of the Internal Revenue Code requires that cancellation of debt income be included in gross income, however, §108(a) provides for an exclusion of bankruptcy discharges from cancellation of debt income.<sup>111</sup> Since §108 excludes the cancellation income anyway, §1231 of the American Recovery and Reinvestment Act, which extends the time for payment of taxes on cancellation of debt, is not helpful to a debtor emerging from bankruptcy. This leaves a debtor with a decision between the utilizing the cancellation of debt provision and avoiding Chapter 11 or using Chapter 11 to escort it to the other side of the recession.

If a debtor corporation files a Chapter 7 or Chapter 11 petition, the debtor may elect to treat the year in which the petition is filed as two distinct taxable years.<sup>112</sup> One year ends the day before the commencement date, and another begins on the commencement date.<sup>113</sup> If the debtor makes the election under §1398(d)(2), the taxable year ending at the commencement date becomes part of the bankruptcy estate. If the taxpayer refuses the election, the entire calendar

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<sup>109</sup> 11 U.S.C. § 362 (2006).

<sup>110</sup> 11 U.S.C. §362 (2006).

<sup>111</sup> 26 U.S.C. § 61(a)(12) (1984); I.R.C. § 61(a)(12) (1984); 26 U.S.C. § 108(a) (2009); I.R.C. § 108(a) (2009).

<sup>112</sup> 26 U.S.C. § 1398(d)(2) (1986); I.R.C. § 1398(d)(2) (1986); Dawson, Joseph P., American Bankruptcy Institute, Where's My Cash Windfall? Tax Planning Opportunities from Recent Legislation, <http://www.abiworld.org/committees/newsletters/banktaxation/vol6num2/windfall.pdf> (last visited April 17, 2010)

<sup>113</sup> 26 U.S.C. § 1398(d)(2)(A) (1986); I.R.C. § 1398(d)(2)(A) (1986); Dawson, Joseph P., American Bankruptcy Institute, Where's My Cash Windfall? Tax Planning Opportunities from Recent Legislation, <http://www.abiworld.org/committees/newsletters/banktaxation/vol6num2/windfall.pdf> (last visited April 17, 2010)

year in which the petition is filed is taxed in that year, with no portion entering the bankruptcy estate.

One consideration when contemplating filing for Chapter 11 protection, as opposed to utilizing one of the other aforementioned strategies, is I.R.C. §1017. Section 1017 provides that if a debt is discharged in a bankruptcy case and therefore excluded from taxable income under §108(a), and the taxpayer is subsequently entitled to a reduction in basis of depreciable property, then the reduction can be applied to any property still held by the taxpayer at the beginning of the taxable year after the year of discharge.<sup>114</sup> Subsection (b)(2) of section 1017, however, limits this reduction in basis for insolvent and bankruptcy corporations.<sup>115</sup> For a bankrupt or insolvent debtor, the reduction is limited to the aggregate bases of property held by the debtor immediately following discharge over the aggregate of the liabilities held by the debtor immediately after discharge.<sup>116</sup> Obviously, a debtor's post-discharge liabilities are going to be small to none since one of the fundamental purposes of bankruptcy is to get the debtor back on its feet with a clean slate. So in practice, the limit will be very close to the aggregate bases immediately following discharge in most cases.

Section 1017 could be an important provision for a debtor considering whether to file bankruptcy or try to stay afloat utilizing one of the new extensions of the American Recovery and Reinvestment Act. In a situation where the debtor has a large discrepancy in post-bankruptcy liabilities and depreciable assets (likely given that bankruptcy generally wipes the slate clean),

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<sup>114</sup> 26 U.S.C. § 1017(a) (1999); I.R.C. § 1017(a) (1999). (“If (1) an amount is excluded from gross income under subsection (a) of section 108 (relating to discharge of indebtedness), and (2) under subsection (b)(2)(E), (b)(5), or (c)(1) of section 108, any portion of such amount is to be applied to reduce basis, then such portion shall be applied in reduction of the basis of any property held by the taxpayer at the beginning of the taxable year following the taxable year in which the discharge occurs.”)

<sup>115</sup> Reilly, R, “Tax Planning Opportunities Related to the New COD Income-Deferral Election”, American Bankruptcy Institute Journal, Feb. 2010, at 60-61..

<sup>116</sup> 26 U.S.C. § 1017(b)(2) (1999); I.R.C. § 1017(b)(2) (1999).

the debtor could be forced to greatly reduce basis without getting a large cancellation of debt if the bankruptcy cancellation was small. The debtor must consider its predicted post-bankruptcy state and keep this in mind when deciding whether filing a Chapter 11 petition is the most prudent course of action.

The debtor also gains certain tax attributes in bankruptcy not available outside of bankruptcy. Section 1398(h) allows a deduction for administrative expenses<sup>117</sup> incurred throughout the bankruptcy proceeding, where as outside of bankruptcy, the debtor would not get a deduction for paying its accountants and lawyers.<sup>118</sup> This deduction can also be carried back and forward in the same fashion as net operating losses.<sup>119</sup> Administrative expense deductions can be carried back three years and forward seven years, and these limits are unaffected by the American Recovery and Reinvestment Act.<sup>120</sup> There are, however, two limitations to administrative expense deductions: the carryback and carryforward provisions are only applicable to the years the corporation is in bankruptcy and net operating loss deductions must be used first.<sup>121</sup>

Despite the immediate fresh start of the debtor emerging from Chapter 11, there are future disadvantages to filing for bankruptcy. If cancellation of debt income is discharged in bankruptcy under §108(a)(1)(A), the debtor will be forced to reduce certain tax attributes including net operating losses to the extent of the discharged cancellation of debt income. However, the

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<sup>117</sup> Administrative Expenses are determined by Section 503 of the bankruptcy code. 11 U.S.C. § 503 (2005).

<sup>118</sup> 26 U.S.C. § 1398(h) (1986); I.R.C. § 1398(h) (1986); Dawson, Joseph P., American Bankruptcy Institute, Where's My Cash Windfall? Tax Planning Opportunities from Recent Legislation, <http://www.abiworld.org/committees/newsletters/banktaxation/vol6num2/windfall.pdf> (last visited April 17, 2010)

<sup>119</sup> 26 U.S.C. § 1398(h)(2)(C) (1986); I.R.C. § 1398(h)(2)(C) (1986). (Section 172 of the tax code governs both net operating losses and administrative expense deductions.)

<sup>120</sup> Dawson, Joseph P., American Bankruptcy Institute, Where's My Cash Windfall? Tax Planning Opportunities from Recent Legislation, <http://www.abiworld.org/committees/newsletters/banktaxation/vol6num2/windfall.pdf> (last visited April 17, 2010)

<sup>121</sup> 26 U.S.C. § 1398(h)(2) (1986); I.R.C. § 1398(h)(2) (1986).

cancellation of debt deferral has no net operating loss reduction, or any other tax attribute reduction for that matter. Therefore the debtor may still utilize net operating loss deductions against future taxable income if it makes the election for a deferral of cancellation of debt income. Given this, the real decision for the debtor in this instance is whether to enter Chapter 11 and exclude the cancellation of debt income permanently while reducing future tax attributes or defer payment on the cancellation of debt income and keep the future tax attributes in its back pocket.

In Robert Reilly's 2010 article on the cancellation of debt extension in the American Recovery and Reinvestment Act, he lays out a great example of how §1017 works in a bankruptcy context. His debtor corporation is in bankruptcy in 2009 and receives a discharge of \$10 million in debt. The example assumes the debtor corporation declines to utilize the cancellation of debt extension. The corporation makes an additional \$5 million in non-discharge income and has a net operating loss carryover of \$6 million. The corporation is left with \$6 million in depreciable assets and \$5.5 million in liabilities immediately following discharge. The company will reduce its net operating loss by \$1 million, a taxable event. Then at the beginning of 2010, the corporation will be forced to reduce its remaining asset basis by \$500,000, which is now taxable income. In this example, the debtor corporation was able to cancel \$10 million of debt tax-free and only recognize \$1.5 million in taxable income to complete the transaction.<sup>122</sup> Clearly, this strategy was beneficial to the debtor, but it is only one of many options the debtor could have considered under the circumstances.

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<sup>122</sup> Reilly, R, "Tax Planning Opportunities Related to the New COD Income-Deferral Election", American Bankruptcy Institute Journal, Feb. 2010, at 60-61..



There are times when the debtor's financial situation or the market conditions may create circumstances where the debtor should try to avoid filing bankruptcy. In these situations, the American Recovery and Reinvestment Act may become crucial by offering extensions to the carryovers of net operating loss deduction and cancellation of debt exclusion.

Currently, under the American Recovery and Reinvestment Act, debtors can attempt to workout debt reductions outside of the context of bankruptcy without incurring any immediate tax liability. This provision is designed to help indebted corporations in this struggling economy avoid bankruptcy and not have to pay tax liabilities until after the recession has passed. In effect, the debtor is provided with a 5-year, tax-free loan from the federal government. Debtors may attempt to use debt repurchases or debt exchange offers, in which the debtor corporation offers a higher interest rate or higher priority in a bankruptcy filing to get a reduction in the total debt or delayed maturity dates.

For instance, if a highly leveraged company needed to reduce its debt level, it could offer its bondholders an increase from 1.2% interest to 3.2% interest on the bonds. In exchange, the bondholders would accept a reduction in value of their bonds from \$6 billion to \$4 billion. Prior to the American Recovery and Reinvestment Act, the corporation would have made \$2 billion in taxable income, however, under the Act the payment of these taxes can be deferred until 2014 and paid over the course of five years. When dealing with such a large volume of money, this can easily be the difference in filing for Chapter 11 protection and being able to ride out the recession without the input of creditors and a bankruptcy court.

However, not all transactions that appear to create cancellation of debt income are actually covered under the American Recovery and Reinvestment Act and corporations should be

cognizant of this when strategizing. For example, if the repurchase is of a foreign currency denominated debt, the gain will be foreign currency gain rather than cancellation of debt income and the extension will not be available.<sup>123</sup> Corporations involved in the world debt market must be wary of this distinction.

Additionally, foreclosures on recourse and non-recourse debts are treated as a disposition of property on the sale of the collateral rather than a cancellation of the debt.<sup>124</sup> Since it is not a cancellation of debt, it is not covered by the election, and corporations will not be able to defer payment on that income. Boards of Directors and Management teams must keep all of these deceiving situations in mind when determining whether or not to make the cancellation of debt election.

Debtor corporations contemplating the election should also keep in mind that the original issue discount deductions on the new debt must also be deferred along with the cancellation of debt income.<sup>125</sup> Corporations must be sure not to factor normal yearly original issue discount deductions in their five-year projections when considering making the election. The original issue discount deductions instead will be applied ratably over the five-year inclusion period from 2014 to 2018.<sup>126</sup> This provision prevents the taxpayer from being able to take the deduction in

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<sup>123</sup> Cleary Gottlieb Steen & Hamilton LLP, Alert Memo of 19 February 2009, American Bankruptcy Institute, retrieved from [www.abiworld.org](http://www.abiworld.org).

<sup>124</sup> Holman, Kelly, *A Stimulus for Private Equity?; New Tax Law Could Help Stave Off Painful Restructurings, or Worse*, The Investment Dealer's Digest: IDD., March 2009, at 1 (citing Joseph Opich, a tax partner at Paul, Hastings, Janofsky & Walker); Cleary Gottlieb Steen & Hamilton LLP, American Bankruptcy Institute, Alert Memo of 19 February 2009, [www.abiworld.org](http://www.abiworld.org) (last visited April 17, 2010).

<sup>125</sup> American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5 §1231(a)(i)(2) (2009); Cleary Gottlieb Steen & Hamilton LLP, American Bankruptcy Institute, Alert Memo of 19 February 2009, [www.abiworld.org](http://www.abiworld.org) (last visited April 17, 2010).

<sup>126</sup> American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5 §1231(a)(i)(2) (2009); Cleary Gottlieb Steen & Hamilton LLP, American Bankruptcy Institute, Alert Memo of 19 February 2009, [www.abiworld.org](http://www.abiworld.org) (last visited April 17, 2010).

years before they are taxed on the related income, which is logical and fair, but companies must not forget to consider this deferral also when considering the cancellation of debt election.

The cancellation of debt income deferral can be strategically used in harmony with the net operating loss deductions. The net operating loss carry forward provisions will allow the debtor to carry losses incurred during the recession forward to 2014 and then use the deduction to offset the inclusion of the cancellation of debt income.<sup>127</sup> This allows the corporation not only net operating losses from the year of the repurchase, but also losses from the years following the repurchase and losses stemming from deductible original issue discount generated in debt-for-debt exchanges.<sup>128</sup>

However, corporations with current net operating losses or carryforwards may benefit from not making the cancellation of debt election and offsetting the income from a debt exchange with those net operating losses. One instance where this may be the prudent course of action is when the net operating losses expire prior to the inclusion of the cancellation of debt income between 2014 and 2018.<sup>129</sup> This can be the preferred course of action for both insolvent and solvent debtors if there are enough net operating loss deductions to completely offset the cancellation of debt income. Since there would be no tax liability, the insolvent debtor could get the liquidity boost from the debt exchange without pushing itself into bankruptcy with a huge bill from the Internal Revenue Service. If there is a change in ownership on the horizon, §382<sup>130</sup> of the tax

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<sup>127</sup> Cleary Gottlieb Steen & Hamilton LLP, American Bankruptcy Institute, Alert Memo of 19 February 2009, [www.abiworld.org](http://www.abiworld.org) (last visited April 17, 2010).

<sup>128</sup> Cleary Gottlieb Steen & Hamilton LLP, American Bankruptcy Institute, Alert Memo of 19 February 2009, [www.abiworld.org](http://www.abiworld.org) (last visited April 17, 2010).

<sup>129</sup> Cleary Gottlieb Steen & Hamilton LLP, American Bankruptcy Institute, Alert Memo of 19 February 2009, [www.abiworld.org](http://www.abiworld.org) (last visited April 17, 2010).

<sup>130</sup> 26 U.S.C. §382 (2009). (Subsection (a): “The amount of the taxable income of any new loss corporation for any post-change year which may be offset by pre-change losses shall not exceed the section 382 limitation for such year.” Subsection (b)(1): “The section 382 limitation for any post-change year is an amount equal to (A) the value of the old loss corporation, multiplied by (B) the long term tax-exempt rate.”)

code may limit the use of net operating losses to offset cancellation of debt income in the future making it more prudent to pay the tax now.<sup>131</sup> There are also situations where a financial accounting benefit is derived from using the net operating loss deductions to offset the cancellation of debt income now rather than later.

Section 1017 of the Internal Revenue Code, previously discussed in the context of filing bankruptcy, must also be considered when deciding whether electing for cancellation of debt provisions is the most prudent course of action. Unlike the bankrupt debtor, a solvent debtor may work out a debt repurchase with a creditor and still have significant assets and liabilities immediately following the discharge. The application of §1017 then may require only a small reduction in basis for the taxpayer's post-discharge assets.

While all of these provisions have their strategic place in any business and tax plan, the best option is likely to mix-and-match them. A small business may feel the need to enter bankruptcy and protect itself from creditors, while still having net operating losses to carry forward, and then elect to pay the cancellation of debt income ratably from 2014 to 2018. Another corporation may be too large to carry its net operating debts back five years, but still finds it prudent to file Chapter 11 and then pay the cancellation of debt income down the road. These provisions can best be looked at like puzzle pieces for executives and board members to arrange. Each company has a different size puzzle and differently shaped pieces to arrange, but there is a way to piece each one together and create a picture for the future of each unique company.

## **VIII. Harrah's Reaction to ARRA**

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<sup>131</sup> Cleary Gottlieb Steen & Hamilton LLP, American Bankruptcy Institute, Alert Memo of 19 February 2009, [www.abiworld.org](http://www.abiworld.org) (last visited April 17, 2010).

When President Obama signed the American Recovery and Reinvestment Act in early 2009, highly leveraged companies including Harrah's honed in on an opportunity to exploit the new cancellation of debt income deferrals. Just before the President signed the stimulus package into law, Harrah's drew the last \$740 million on its \$2 billion revolving credit line to increase its liquidity.<sup>132</sup> Then within two weeks of the enactment of the American Recovery and Reinvestment Act, Harrah's formulated a plan to get rid of \$23 billion of debt.<sup>133</sup> News of Harrah's quick draw on capitalizing on the new tax break was not surprising, however, because Harrah's, among others, had been lobbying for such an extension.<sup>134</sup> Private-equity firms, like Apollo and TPG that own Harrah's, desperately need this provision to float through the current recession.

There are several techniques currently in use by many private-equity firms to deleverage themselves. For one, they are structuring new deals with more equity.<sup>135</sup> For already over-leveraged deals, some firms are creating annex funds to ask investors for more money to inject into the company. Harrah's plan, utilizing a third technique, is to execute a debt-exchange offer, which has become an extremely popular transaction among private-equity firms in an effort to avoid bankruptcy during the current recession.<sup>136</sup> The way this transaction works is that companies ask their bondholders to exchange their debt for discounted debt with a later maturity date. The incentive for bondholders to agree to such a transaction is normally either a higher

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<sup>132</sup> Drucker, Jesse and Peter Lattman, *Crisis on Wall Street: Harrah's Plans to Cut Debt, Benefiting From Tax Break*, The Wall Street Journal, March 2, 2009, at C2.

<sup>133</sup> Drucker, Jesse and Peter Lattman, *Crisis on Wall Street: Harrah's Plans to Cut Debt, Benefiting From Tax Break*, The Wall Street Journal, March 2, 2009, at C2.

<sup>134</sup> Drucker, Jesse and Peter Lattman, *Crisis on Wall Street: Harrah's Plans to Cut Debt, Benefiting From Tax Break*, The Wall Street Journal, March 2, 2009, at C2.

<sup>135</sup> Lattman, Peter, *A Buyout-Shop Breather – Market Thaw Opens Door for Aid to Portfolio Firms*, The Wall Street Journal, May 30, 2009, at B3.

<sup>136</sup> Drucker, Jesse and Peter Lattman, *Crisis on Wall Street: Harrah's Plans to Cut Debt, Benefiting From Tax Break*, The Wall Street Journal, March 2, 2009, at C2.

interest rate, a more senior position in the capital structure, or both.<sup>137</sup> If bondholders receive a higher position in the capital structure, it can increase their return in a bankruptcy filing. Given the current economy and the increased possibility of bankruptcy filings, this can make the deal very attractive to debt holders despite cancellation of some portion of the debt.

In late 2008, prior to President Obama or the 111<sup>th</sup> Congress taking office, Harrah's executed a debt exchange offer.<sup>138</sup> The highly leveraged company was already in over its head in the recession and was attempting to stave off bankruptcy. The repurchase was not as successful as executives had hoped, and only reduced the company's debt by about \$1 billion.<sup>139</sup> It also pushed the maturity on other debts back to buy time for the economy to turn around.<sup>140</sup> Under these circumstances, it should not be surprising that Harrah's was lobbying for a debt cancellation income deferral, nor should their attempt to execute another debt repurchase as soon as the provisions were enacted.

Harrah's intends to utilize a delayed tax bill on the cancellation of debt income under the American Recovery and Reinvestment Act to make it through the recession and will worry about the consequences further down the road. Many private-equity executives believed Harrahs may default on all of the debt incurred in the merger.<sup>141</sup> When these provisions were enacted, Harrah's debt was trading at 58 cents on the dollar and its high-yield bonds were trading as low

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<sup>137</sup> Drucker, Jesse and Peter Lattman, *Crisis on Wall Street: Harrah's Plans to Cut Debt, Benefiting From Tax Break*, The Wall Street Journal, March 2, 2009, at C2.

<sup>138</sup> Drucker, Jesse and Peter Lattman, *Crisis on Wall Street: Harrah's Plans to Cut Debt, Benefiting From Tax Break*, The Wall Street Journal, March 2, 2009, at C2.

<sup>139</sup> Drucker, Jesse and Peter Lattman, *Crisis on Wall Street: Harrah's Plans to Cut Debt, Benefiting From Tax Break*, The Wall Street Journal, March 2, 2009, at C2.

<sup>140</sup> Drucker, Jesse and Peter Lattman, *Crisis on Wall Street: Harrah's Plans to Cut Debt, Benefiting From Tax Break*, The Wall Street Journal, March 2, 2009, at C2.

<sup>141</sup> Drucker, Jesse and Peter Lattman, *Crisis on Wall Street: Harrah's Plans to Cut Debt, Benefiting From Tax Break*, The Wall Street Journal, March 2, 2009, at C2.

as 6 cents on the dollar.<sup>142</sup> On the horizon, Harrah's has \$710 million in debt maturing in 2010, and another \$308 million in 2011.<sup>143</sup> However, repurchasing the debt and deferring the tax consequence may be enough to keep Harrah's out of bankruptcy.<sup>144</sup>

Interestingly, in September 2009, Harrah's bought \$140 million of Planet Hollywood Resort & Casino's debt from Goldman Sachs Mortgage Company.<sup>145</sup> While the debt was undoubtedly bought at a large discount, it still is an interesting move by a company with major liquidity problems. The mortgage that Harrah's bought is also the junior-most debt in the capital structure leaving Harrah's at the bottom of the pecking order should Planet Hollywood be forced into bankruptcy.<sup>146</sup> While this move appears to contradict efforts to increase liquidity, it gives Harrah's a say in any restructuring of Planet Hollywood, and therefore may offer a competitive advantage well worth the loss of liquidity.

In the fourth quarter of 2009, Harrah's showed a profit despite still depressed revenues showing signs of economic recovery and future prosperity, or at least continued existence, for Harrah's.<sup>147</sup> Then in March 2010, Harrah's announced a debt reduction of \$4 billion and a maturity extension on some loans until 2015.<sup>148</sup> While Harrah's is far from out of the woods with plenty of debt still on its books and luxury and leisure markets being the slowest to rebound, the

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<sup>142</sup> Drucker, Jesse and Peter Lattman, *Crisis on Wall Street: Harrah's Plans to Cut Debt, Benefiting From Tax Break*, The Wall Street Journal, March 2, 2009, at C2. (Citing research by KDP Investment Advisors).

<sup>143</sup> Drucker, Jesse and Peter Lattman, *Crisis on Wall Street: Harrah's Plans to Cut Debt, Benefiting From Tax Break*, The Wall Street Journal, March 2, 2009, at C2. (Citing research by KDP Investment Advisors).

<sup>144</sup> Drucker, Jesse and Peter Lattman, *Crisis on Wall Street: Harrah's Plans to Cut Debt, Benefiting From Tax Break*, The Wall Street Journal, March 2, 2009, at C2.

<sup>145</sup> Berzon, Alexandra and Kris Hudson, *Harrah's Buys Casino's Debt*, The Wall Street Journal, September 16, 2009, at C9.

<sup>146</sup> Berzon, Alexandra and Kris Hudson, *Harrah's Buys Casino's Debt*, The Wall Street Journal, September 16, 2009, at C9.

<sup>147</sup> *Harrah's Wins Relaxed Terms on \$5.5B in CMBS Debt*, Dow Jones News Service, March 8, 2010.

<sup>148</sup> *Harrah's Wins Relaxed Terms on \$5.5B in CMBS Debt*, Dow Jones News Service, March 8, 2010.

American Recovery and Reinvestment Act provisions have been extremely helpful in staving off bankruptcy through the continuing recession.

## **IX. Effect of the ARRA on Bankruptcy Filings**

It is hard to know what businesses are strategically planning or even what the actual rationale for any decision made by management was because our government does not require companies to divulge such information to the public. Whether a debtor corporation decided that bankruptcy was a better course of action than deferring certain tax liabilities or utilizing net operating loss deductions is something that cannot easily be determined by an outsider.

However, it can be assumed that most, if not all, corporations entering bankruptcy did their due diligence and were aware of all available strategies. Even though the American Recovery and Reinvestment Act was not passed until February 2009, comparison between 2008 and 2009 filing statistics can give some insight into how business are reacting to the act. Business bankruptcy filings increased from 43,546 to 60,837 from 2008 to 2009.<sup>149</sup> Non-Business bankruptcy filings for the same period increased from 1,074,225 in 2008 to 1,412,838 in 2009.<sup>150</sup> Therefore business filings increased 39 percent, while non-business filings only increased 31 percent in 2009. This may mean that more companies are electing to take advantage of the protections of bankruptcy rather than weather the storm utilizing the amended net operating loss and cancellation of debt provisions.

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<sup>149</sup> American Bankruptcy Institute, *Annual Business and Non-Business Filings by Year (1980-2009)*, (2010) <http://www.abiworld.org/AM/AMTemplate.cfm?Section=Home&CONTENTID=60229&TEMPLATE=/CM/ContentDisplay.cfm> .

<sup>150</sup> American Bankruptcy Institute, *Annual Business and Non-Business Filings by Year (1980-2009)*, (2010) <http://www.abiworld.org/AM/AMTemplate.cfm?Section=Home&CONTENTID=60229&TEMPLATE=/CM/ContentDisplay.cfm> .



Analyzing year-to-year trends in bankruptcy filings can also provide insight into whether companies are reacting to the enactment of the American Recovery and Reinvestment Act. In 2006, business bankruptcy filings reached a 20-year low with only 19,695 filings.<sup>151</sup> As one would expect, this correlated with a peak in the prominence of the American economy, and as the economy turned southward, bankruptcy filing rates headed north. In 2007, bankruptcy filings increased 28,322, a 44 percent increase over the previous year. This was followed by a 54 percent increase in 2008 filings, with the number jumping to 43,546 filings.<sup>152</sup> Then in early 2009, the American Recovery and Reinvestment Act was passed, and corporations were given new strategies for avoiding bankruptcy. However, bankruptcy filings continued to rise, but at a slower pace. 2009 saw 60,837 businesses file bankruptcy, marking a 39 percent increase from 2008 business filings.<sup>153</sup>

Since the enactment of the American Recovery and Reinvestment Act, the gross domestic product has seen steady growth. Estimates show a steady quarterly increase between two and three percent through 2009.<sup>154</sup> Employment is rising at an even faster pace with estimates that 1.5 to 2 million jobs were created or saved over the last three quarters of 2009.<sup>155</sup> In total, it

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<sup>151</sup> American Bankruptcy Institute, *Annual Business and Non-Business Filings by Year (1980-2009)*, (2010) <http://www.abiworld.org/AM/AMTemplate.cfm?Section=Home&CONTENTID=60229&TEMPLATE=/CM/ContentDisplay.cfm>.

<sup>152</sup> American Bankruptcy Institute, *Annual Business and Non-Business Filings by Year (1980-2009)*, (2010) <http://www.abiworld.org/AM/AMTemplate.cfm?Section=Home&CONTENTID=60229&TEMPLATE=/CM/ContentDisplay.cfm>.

<sup>153</sup> American Bankruptcy Institute, *Annual Business and Non-Business Filings by Year (1980-2009)*, (2010) <http://www.abiworld.org/AM/AMTemplate.cfm?Section=Home&CONTENTID=60229&TEMPLATE=/CM/ContentDisplay.cfm>.

<sup>154</sup> The Committee for a Responsible Federal Budget, *Happy Birthday ARRA: The American Recovery and Reinvestment Act Once Year Later*, (2010) <http://crfb.org/document/happy-birthday-arra-american-recovery-and-reinvestment-act-one-year-later>. (Various estimates from the President's Council for Economic Advisers, the Congressional Budget Office, Goldman Sachs, J.P Morgan Chase, among others).

<sup>155</sup> The Committee for a Responsible Federal Budget, *Happy Birthday ARRA: The American Recovery and Reinvestment Act Once Year Later*, (2010) <http://crfb.org/document/happy-birthday-arra-american-recovery-and-reinvestment-act-one-year-later>. (Various estimates from the President's Council for Economic Advisers, the Congressional Budget Office, Goldman Sachs, J.P Morgan Chase, among others).

appears the economy is turning around. Not only are corporations failing at a slower rate, but they are clearly generating more revenue and hiring new employees.

So what does this say about the effect of the American Recovery and Reinvestment Act? It could indicate that more companies are able to keep themselves out of bankruptcy by utilizing the debt cancellation and net operating loss extensions discussed in this paper. It could simply indicate an overall economic upswing spawned by the enactment of this law and the \$300 billion it has injected into the American economy to date. It could also show no relationship whatsoever to the beneficial provisions for businesses in the Act and just represent a general change in consumer behavior in a cyclical economy. However, given that bankruptcy filings are increasing, even if at a reduced rate, while the other economic indicators are showing overall economic improvement, the American Recovery and Reinvestment Act likely has not assisted many companies in staving off bankruptcy. The Act's total economic effect clearly has helped businesses generally, but those on the brink of bankruptcy still appear to be filing more and more petitions every day.

## **X. Conclusion**

The American Recovery and Reinvestment Act was enacted in early 2009 to stimulate the struggling American economy. Many economic indicators show progress since the law's enactment. Gross domestic product is on the rise, the job market is improving, and the general economic climate appears to be better today than a year ago. However, bankruptcy filings are still on the rise. The American Recovery and Reinvestment Act offered businesses a deferral of tax liability for cancellation of debt income<sup>156</sup> and extended carryback and carryforward

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<sup>156</sup> American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5 §1231 (2009).

provisions for net operating loss deductions.<sup>157</sup> Both of these tax incentives were designed to assist debtor corporations in weathering the recession. Helping companies stay out of bankruptcy court is obviously part of that objective, so naturally you would expect filing rates to go down. While business bankruptcy filings are increasing at a reduced rate, there was still a 39 percent increase in bankruptcy filings from 2008 to 2009.<sup>158</sup> Many businesses still clearly find bankruptcy a safer environment in which to wait out the recession than utilizing the new provisions of the American Recovery and Reinvestment Act in the open market. So to answer the initial question “stimulating businesses or bankruptcy dockets?”, it appears the bankruptcy dockets have it.

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<sup>157</sup> American Recovery and Reinvestment Act of 2009, Pub. L. No.111-5 §1211 (2009).

<sup>158</sup> American Bankruptcy Institute, *Annual Business and Non-Business Filings by Year (1980-2009)*, (2010) <http://www.abiworld.org/AM/AMTemplate.cfm?Section=Home&CONTENTID=60229&TEMPLATE=/CM/ContentDisplay.cfm> .