IV. Restrictions on Trading Claims in Bankruptcy: Preservation of the Debtor's NOLs

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Accompanying the filing of a chapter 11 bankruptcy petition is the customary slew of first-day motions necessary to aid the debtor with the administration of its reorganization proceedings. Bankruptcy practitioners are all too familiar with the usual cast of first day motions: retention and wage motions, borrowing and/or cash collateral motions, approval of cash management, motions to honor certain pre-petition obligations, motions to establish case management procedures, and others. Frequently, first day motions also include a request by the debtor for entry of an order either prohibiting the trading of claims or equity interests, or instituting procedures to restrict the trading of claims or interests, of the debtor. Such "claims trading motions" can affect claimants at all levels of the debtor's capital structure and parties must be careful to respond and/or object to such motions in order to retain their rights to buy and sell claims against the debtor during the bankruptcy proceedings. Otherwise, they may be left holding illiquid claims that must await a distribution under a confirmed plan of reorganization before they can realize value.

Net Operating Losses

Motions seeking to restrict the trading of claims and interests arise in cases where the debtor is seeking to protect its net operating losses ("NOLs"). NOLs can be used as either "carrybacks" in which the corporation uses the NOLs to offset taxable income for up to two previous taxable years, or as "carryovers" in which the corporation uses NOLs to offset taxable income into the future. 26 USC §172. As such, for a company in chapter 11, NOLs can be extremely valuable as a mechanic in saving cash and implementing a reorganization plan, because it allows a company to save cash by using NOLs to offset future income, thereby reducing federal income tax liability on that

future income. The use of NOLs, however, is subject to certain statutory limitations. Section 382 of the Internal Revenue Code, for example, provides that a corporation's ability to use its NOLs is effectively eliminated if a corporate ownership change occurs. The limitations imposed by Section 382 limitation are far more relaxed, however, if the ownership change occurs pursuant to a confirmed chapter 11 plan of reorganization. Accordingly, debtors have implored the Bankruptcy Court to enter orders that will assist them in preserving their NOLs by preventing an ownership change before plan confirmation.

Exceptions to the NOL Limitation

As stated above, the limitations imposed on the use of NOLs are relaxed if an ownership change occurs in the context of a plan of reorganization. 26 USC § 382 ("Section 382"). Two alternative forms of relief are available under Section 382 to protect the NOL; Section 382(l) (5) and (6). Under Section 382(l)(5), a corporation will not be subject to the Section 382 limitation if an ownership change results from consummation of a chapter 11 plan, provided that four conditions are met: (i) under the plan, the historic shareholders and "qualified creditors" own at least 50% of the value and voting power of the debtor after the ownership change; (ii) the debtor does not undergo a subsequent ownership change during the two years following consummation of the plan; (iii) the debtor does not take a tax deduction for any interest paid or accrued during a period ranging from 3 to 4 years immediately preceding the consummation of the plan in respect of debt that is later converted into stock pursuant to the plan; and (iv) the debtor elects to rely on Section 382(l)(5).

The safe harbor provision under Section 382(l) (5) provides that a creditor who exchanges its claim for stock under a plan of reorganization is a "qualified creditor" if the claim (i) has been owned by such creditor for 18 months or more before the commencement of the case, or (ii) arose in the ordinary course of business and was at all times beneficially owned by such creditor. In addition, creditors may be "qualified creditors" even if they cannot satisfy the continuous ownership rule with respect to such claim provided they meet the *de minimus* rule. The *de minimus* rule states that the debtor may, for purposes of the safe harbor, treat indebtedness as always having been owned by the beneficial owner of the indebtedness immediately before the ownership change if the beneficial owner is not, immediately after the ownership change, either a 5% shareholder or an entity through which a 5% shareholder owns an indirect ownership interest in the corporation. Accordingly, as long as the holder will own less than 5% of the reorganized entity, such a claimholder will always be a "qualified creditor" unless the particular claim both did not arise in the ordinary course of the debtor's business or was not in existence 18 months before the filing of the bankruptcy petition. Section 382(l) (5).

Under the alternative rule of Section 382(l) (6), there are no ownership requirements that must be met. Instead, the ability to use the NOL must be calculated under a formula that looks to the value of the company's stock immediately after the ownership change (and includes stock issued to creditors in exchange for cancelling debt and stock issued to new investors in connection with the reorganization). That value is capped by the value of the corporation's assets immediately prior to the

ownership change, excluding recent capital contributions and certain excess non-business assets.

Preserving the NOL: The Bankruptcy Predicates

NOLs constitute property of the estate under Section 541 of the Bankruptcy Code, and are protected by Section 362's automatic stay provisions of the Bankruptcpy Code. *Official Comm. Of Unsecured Creditors v. PSS S.S. Co., Inc. (In re Prudential Lines, Inc.)*, 107 B.R. 832 (Bankr. S.D.N.Y. 1989), *aff'd*, 119 B.R. 430 (S.D.N.Y. 1990), *aff'd* 928 F. 2d 565 (2d Cir. 1991) *cert. denied* 502 U.S. 821 (1991). *See also Nisselson v. Drew Indus., Inc., (In re White Metal Rolling & Stamping Corp.)*, 222 B.R. 417-24 (Bankr. S.D.N.Y. 1998) (NOL carrybacks and carryovers are property of the estate of the corporation that generated them). Having determined that NOLs are property of the estate, bankruptcy courts have applied the automatic stay of Section 362(a) (3) to enjoin efforts of others to obtain possession or control over such property of the estate.

In the seminal case of *Prudential Lines*, the Second Circuit upheld the injunction issued by the Bankruptcy Court, and the use of the automatic stay[46], to protect the NOL as a valuable estate asset, and agreed with the bankruptcy court's finding that the elimination of the right to apply its NOL to offset future income would impede the debtor's reorganization efforts *Prudential Lines*, 928 F.2d at 574. In *Prudential Lines*, a creditors' committee sought to restrain the debtor's parent from taking a worthless stock deduction on the parent's tax return, which would have eliminated the value of the debtor's NOL carryforward. *Prudential Lines*, 928 F.2d at 574. The creditors' committee

[46] The Second Circuit also found that the injunction was supported by the equitable powers of the bankruptcy court under Section 105, which provides that the court may "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title." 11 USC §105(a).

had filed a competing plan that would use the NOLs, necessitating its preservation under Section 382. The debtor's plan proposed use of the NOL, but also that an insider of the parent would retain a 75% ownership interest in the reorganized debtor. When the committee objected to the debtor's plan, the parent stated that it intended to take the worthless stock deduction, thereby destroying the NOL (and the committee plan). With an immediate threat to the NOL, the committee commenced an adversary proceeding to enjoin the parent from taking the worthless stock deduction, and an injunction issued by the court.

Other courts have followed. One bankruptcy court stated "[What is certain is that the NOL has a potential value, as yet undetermined, which will be of benefit to creditors and will assist [the debtors] in their reorganization process. This asset is entitled to protection while [the debtors] move forward toward their reorganization." *In re Phar-Mor, Inc.*, 152 B.R. 924, 927 (Bankr. N.D. Ohio 1993). *See also, In re Southeast Banking Corp.,* Case No. 91-14561 (S.D. Fla., July 21, 1994) (debtor's NOLs "constitutes property of the estate ... and is entitled to the protections of the automatic stay"); *In re Grossman's, Inc.*, Case No. 97-695 (Bankr. D. Del. October 9, 1997 (debtors' net operating loss is property of the estates and is protected by automatic stay).

The extension of the *Prudential Lines* decision to defeat the trading of claims and interests has also been criticized. For example, creditors have argued that, unlike *Prudential Lines,* there is no similar immediate threat to an NOL when two creditors or equity holders seek to transfer claims or equity interests in the debtor. *In re UAL Corp.*, 412 F.3d 775 (7th Cir. 2005). Rather, the Seventh Circuit held that "there is no

equivalent example of control (or consumption) of a loss carry-forward in an investor's simple sale of stock." *In re UAL Corp.*, 412 F.3d at 778. The Seventh Circuit found that issuance of an injunction by the bankruptcy court was wrong:

> The bankruptcy court relied on 11 U.S.C. § 105(a) plus § 362, the automatic-stay provision. The former is a means to enforce the Code rather than an independent source of substantive authority, see *Kmart*, 359 F.3d 871 (citing cases), and the latter speaks to the matter indirectly if at all. Section 362(a) (3), the only arguably pertinent provision, blocks "any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate." Whether or not tax benefits are "property" under the Bankruptcy Code's capacious definition, see *In re Prudential Lines, Inc.*, 928 F.2d 565, 571-73 (2d Cir. 1991), an ESOP's sale of stock does not "obtain *possession* . . . or exercise *control*" (emphasis added) over that interest.

UAL, 412 F.3d at 778. When two parties decide to trade claims or interests, they are transferring rights that they own and control, without seeking to exercise control over the debtor's NOL.

Given the tensions between protecting a debtor's ability to preserve its NOLs and the need for liquidity, courts have been willing to enter procedures that will balance the rights of parties to buy and sell claims and interests and the debtor's rights to preserve its NOLs. The cases are numerous. *See, e.g., In re DJK Residential LLC, et al. (SIRVA, Inc.)*, Case No. 08-10375 (JMP) (Bankr. S.D.N.Y. Feb. 5, 2008) (interim order approving notification procedures and restricting certain transfers of equity interests); *In re Dura Auto. Sys., Inc.*, Case No. 06-11202 (Bankr. D. Del. Nov. 20, 2006) (same); *In re Calpine Corp.*, Case No. 05-60200 (BRL) (Bankr. S.D.N.Y. Dec. 21, 2005) (advance notice and 30 day objection period for transfers by substantial equity holders); *In re Delta Air Lines, Inc.*, Case No. 05-17923 (Bankr. S.D.N.Y. Sept. 16, 2005) (notice of substantial claimholder or equity holder status and advance notice of transfers); *In re*

Northwest Airlines Corporation, Case No. 05-17930 (Bankr. S.D. N.Y. Oct. 28, 2005) (enjoining certain transfers and providing advance notice and opt-out procedures); *In re WorldCom, Inc.*, Case No. 02-13533 (Bankr. S.D.N.Y. March 5, 2003) (enjoining certain stock transfers and providing advance notice to debtors to object to claims transfers); *In re Adelphia Communications Corp.*, Case No 02-41729 (Bankr. S.D.N.Y. Sept. 27 2002) (30 day objection period for proposed equity transfers by large holders); *In re Williams Communications Group, Inc.*, Case No 02-11957 (Bank. S.D.N.Y. July 24, 2002) (30 day advance notice period for acquiring claims that would bring holdings above $200 million); *In re US Airways, Inc.*, Case No. 04-13819 (SSM) (Bankr. E.D. Va. Apr. 1, 2005) (same); *In re W.R. Grace & Co.*, Case No. 01-01139 (Bankr. D. Del. Jan. 24, 2005) (approving notification procedures and restricting certain transfers of equity interests).

Narrowing the Requested Claims Order

As set forth above, a debtor needs only the ability to monitor and, if necessary, object, to the changes in the ownership of stock and claims to make sure that a 50% ownership change does not occur in advance of a plan, and that the ownership change that might occur under a plan will qualify under the safe harbor provisions of Section 382. In responding to first day motions seeking to impose broad restrictions and limitations on the trading of claims and interests, interest parties should make sure that the restrictions are narrowly crafted so that trading can occur without jeopardizing the debtor's ability to effectively preserve its NOLs to offset future income. Some of the evidentiary and other issues are as follows:

1. The imposition of claims trading restrictions should be commenced by the filing of a complaint, and standards applicable to the granting of an injunction ought to apply. *In re UAL Corp.*, 412 F.3d 775 (7th Cir. 2005). Some creditors have argued that because the relief requested in a claims trading motion seeks the entry of an order restricting or potentially prohibiting transfers of claims, such relief is injunctive in nature and a debtor must demonstrate irreparable harm and either the likelihood of success on the merits or a balancing of the hardships in favor of the debtor. Whether or not there is irreparable harm to the debtor or a balance of harms in favor of the debtor is speculative at best, particularly at the outset of the case. In fact, there may be little evidence on the commencement of the bankruptcy case that the debtor's plan will seek to satisfy pre-petition claims with equity of the debtor that will affect the debtor's NOLs. Further, the use of a sell-down notice (described below) can be an effective tool to prevent irreparable harm to a debtor. To the extent that a debtor in fact determines that its plan

of reorganization will equitize existing claimholders, the debtor can insist that such claim holders reduce their holdings so that each holder will be a qualified creditor under the *de minimus* standard.

2. The threshold amount sought by a debtor in defining who may be a substantial claim holder or substantial interest holder must be scrutinized to provide a realistic limit on trading transactions. The amounts offered by debtors, predictably, are on the low side in first day motions. Parties in interest should require that the debtor provide some evidence of the level of claims that will equate to a percentage of stock ownership upon a conversion of the debt to equity. For example, the claim threshold sought in the Northwest Airlines case for defining a substantial claimholder was initially $120 million; the implemented sell down notice near confirmation set that level at $400 million. *In re Northwest Airlines Corporation,* Case No. 05-17930 (Bankr. S.D. N.Y. Oct. 28, 2005).

3. The threshold amount likewise ought to account for the value of any collateral held by creditors. It is unlikely that secured creditors will receive equity in the reorganized debtor under a plan, at least for the secured portion of such claims. Under a plan of reorganization, a secured creditor must either retain its liens and receive the present value of its claims in deferred cash payments, or receive the proceeds of the collateral, to the extent such collateral is sold, or receive the "indubitable equivalent" of its claims. 11 USC §1129(b) (2) (a) (iii). Equity in the reorganized debtor is not the indubitable equivalent. See, 124 Cong. Rec. H 11, 103 (Sept. 28, 1978); S 17,420 (Oct.6, 1978) (equity securities of the debtor would not be the indubitable equivalent). As such, the debtor should distinguish between the face amount of a secured claim and

a likely deficiency, so that secured creditors will not be unduly burdened by restrictions on the sale of their claims in the aggregate.

4. Notice and objection periods for transfers of claims and interests should be kept to a minimum. General trading guidelines call for closings to occur within three business days of the agreement to buy or sell. Imposition of a lengthy waiting period, with the potential for litigation if an objection to the transfer is filed, will likely serve to dissuade buyers from entering the market and will be an impediment to customary market performance.

5. The debtor should demonstrate if less onerous methods than advance notice can serve to protect the NOL, such as the imposition of sell down procedures upon notice from a debtor that it will seek to use the Section 382 safe harbor rules. In these circumstances, holders can elect to opt out of the restrictions that impose advance notice requirements of the transfer of claims or interests, provided they agree to be subject to a sell down notice to be issued by the debtor in contemplation of its plan of reorganization, directing that the holders sell their interests below a certain level so as to not jeopardize the *de minimus rule*. Such a sell down mechanism is also included in the Model NOL Order issued by The Bond Market Association/Loan Syndication and Trading Association.[47]

6. The information required to be given in notices provided to the debtor must be kept confidential and not used for any purpose other than protection of the NOL. For example, information provided as to name and holdings of institutions can be wrongfully used by debtors to thwart unwanted investors or suitors, and generally chill

[47] A copy of the Model NOL Order is attached hereto.

the interests of outside investors. There is good reason to require that all such information be forwarded only to a select few individuals on behalf of a debtor, who agree to retain the confidentiality of that information.