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

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The economic meltdown that devastated the financial markets during the 4th quarter of 2008 is predicted to continue throughout 2009 (possibly 2010) and the surge of bankruptcy and reorganization proceedings may engulf any number of businesses over the next several months, or years. Even those companies with healthy balance sheets may find that their contract partners, vendors, customers or suppliers are in bankruptcy, an event that historically meant uncertainty and one that may have left a significant hole on the balance sheet – at least until the conclusion of the bankruptcy case when creditor distributions could be made, and those typically at just cents on the dollar. The emergence, sophistication and market acceptance of distressed investors, however, now presents opportunities for creditors to extricate themselves from the bankruptcy proceeding and liquidate their claims for cash, well before confirmation of a plan of reorganization which may take place years after the commencement of a case.

Distressed investors bring a different dynamic to a reorganization proceeding. Historically, a company in chapter 11 would work with its trade creditors and lenders towards the goal of a successful turnaround. Trade creditors, for all practical purposes, were hostage to the proceeding and often would favor a plan that provided them a continued customer, even if the dividend was not as high as those produced by other scenarios, such as a sale or merger. Distressed investors are frequently less friendly – and less patient. Often, they have been labeled

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as "vulture funds" for their attempts to liquidate debtors for quick and prosperous returns on their capital. While not all distressed investors will seek such draconian results, they are generally less agreeable to lengthy stays in chapter 11 or long-term payouts. Consequently, distressed investors have encountered a number of obstacles to their active participation in chapter 11 proceedings.

For example, accompanying the filing of a chapter 11 bankruptcy petition, and now a regular "first day" motion, is a request by the debtor for the 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 orders" can affect claimants at all levels of the debtor's capital structure (secured lenders, bondholders, general unsecured creditors, trade claimants and shareholders). These parties must be quick to respond or object to such motions at the earliest stages of the case in order to retain their rights to buy and sell claims against the debtor during the bankruptcy. Otherwise, such creditors 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. In the chapter 11 context, the use of NOLs as carry-forwards is a critical mechanic in implementing a reorganization plan because it allows a company to preserve cash by using NOLs to offset future income, thereby reducing federal income tax liability. 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. There is an important exception, however; the limitations imposed by Section 382 are far more relaxed, and NOLs can be preserved, if the ownership change occurs pursuant to a confirmed chapter 11 plan of reorganization. Consequently, debtors have implored the bankruptcy courts to enter orders that will prohibit, or limit, the trading of claims and interests. If trading is limited or does not occur at all, no change of ownership can occur pre-confirmation and the debtor's NOLS will be preserved.

The Bankruptcy Exception to the NOL Limitation

The exceptions to the limitations imposed on the use of NOLs are found in Sections 382(l)(5) and (6), and are known as the safe harbor provisions. Under Section 382(l)(5), NOLs will not be lost as the result of an ownership change if that 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 criteria in (ii)–(iv) above are directly within the purview of, and presumably will be satisfied by, the debtor.[1] The first element, as to the existence of "qualified creditors", is not within the debtor's control and therefore the bankruptcy court's intervention is necessary to

[1] For example, it is unlikely that a debtor would have taken a deduction preceding the bankruptcy for interest paid on unsecured claims, which are the type of claims that are typically converted to equity under a plan. In addition, a debtor will generally seek to restrict substantial equity transfers for the requisite period post confirmation of its plan.

determine who is – and who should remain – a "qualified creditor".

Section 382(l)(5) defines who constitutes a "qualified creditor". That section 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 (colloquially referred to as "old and cold" creditors) or (ii) arose in the ordinary course of business and was at all times beneficially owned by such creditor. Importantly, 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 creditor will own less than 5% of the reorganized entity in exchange for its claims against the debtor, 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).[2]

Bankruptcy Court Intervention: The Statutory Predicates

Claims trading orders are premised on the theory that NOLs constitute property of the

[2] The less often used exception is the alternative rule of Section 382(l)(6), where 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.

debtor's estate under Section 541 of the Bankruptcy Code. Once that determination has been made, bankruptcy courts then apply the automatic stay provisions of Section 362(a)(3) to enjoin efforts of others to obtain possession or control over such property of the estate. *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, 424 (Bankr. S.D.N.Y. 1998) (NOL carrybacks and carryovers are property of the estate of the corporation that generated them).

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[3], 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 568. The creditors' committee had filed a competing plan that would use the NOL, necessitating its preservation under Section 382. *Id.* at 567. 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. *Id.* at 568.

Other courts have adopted the same analysis to protect a debtor's NOLs. One bankruptcy court stated "[w]hat is certain is that the NOL has a potential value, as yet undetermined, which

[3] 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).

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 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 NOL "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 is not uniformly accepted, however, and has been criticized. Creditors have argued that, unlike *Prudential Lines,* there is no immediate threat of loss of 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). In UAL, 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. Under this theory, when two parties decide to trade claims or interests, they are transferring rights that they own and control, they are not seeking to obtain possession

or exercise control over the debtor's NOL.

Narrowing the Requested Claims Order

When faced with a claims trading motion, bankruptcy courts should, appropriately, balance the interests of the debtor with market considerations and creditors' needs for liquidity. On the one hand, a debtor should only require procedures that enable it to monitor and, if necessary, object to transfers if those transfers will cause more than a 50% ownership change in advance of plan confirmation. On the other hand, creditors should respect procedures and restrictions that are narrowly crafted to permit trading without jeopardizing the debtor's ability to effectively preserve its NOLs to offset future income. 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 attempt to balance those rights. 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). With the rash of filings late in 2008 and early 2009, the entry of a substantial number of claims trading orders should be anticipated.

To achieve an appropriate balancing of interests, creditors will need to act quickly at the outset of the bankruptcy case. In lodging their objections to claims trading orders, creditors should consider raising a number of the evidentiary and practical issues, as follows:

1. Determine Whether Claim And Share Levels Are Realistic And Appropriate.

The claim and share levels proposed by a debtor for purposes of defining who may be a substantial claim holder or substantial interest holder must be scrutinized to provide a realistic limit on trading transactions. The levels proposed by debtors at the outset of a case are, customarily, cautiously low. Parties in interest should require that the debtor provide justification for the chosen levels, including some analysis for the debt to equity conversion rate. For example, the claim threshold sought in the Northwest Airlines case for defining a substantial claimholder was initially $120 million; the final order increased that level to $145 million, and this amount was again raised to $400 million at the time the disclosure statement was approved. Further, the final order excluded qualified market makers from the advance notice requirements (provided it made an election to be bound by be a subsequent sell-down procedure) and also excluded indenture trustees from the procedures and from liability to the extent they followed their standard practices in transferring debt securities. *In re Northwest Airlines Corporation,*

Case No. 05-17930 (Bankr. S.D. N.Y. Oct. 28, 2005).[4]

2. Carve-Out Collateral Value From Claim Threshold Of Secured Creditors.

Likewise, the threshold claim and share levels ought to include specific provisions relating to secured claims, and carve-out the value of any collateral held by an acquiring or selling creditor. 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). Accordingly, it is unlikely that secured creditors will receive equity in the reorganized debtor under a plan, at least for the secured portion of their claims. Therefore, 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.

3. Minimize Advance Notice And Objection Periods.

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 objection or 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.

4. Investigate Whether Less Onerous Procedures Will Suffice.

The debtor should be required to employ the least onerous restrictions to protect its

[4] Copies of the final trading order entered in the Northwest Airlines case, and the subsequent motion (without exhibits) for the entry of an order to authoring Northwest to implement the "sell-down" procedures, are attached hereto as Exhibits A and B, respectively.

NOLs, such as the imposition of “sell down” procedures once the debtor determines that it will seek to use the Section 382 safe harbor rules. Under these procedures, a debtor can agree that creditors can elect to “opt out” of the advance notice requirements for their transfers, provided they agree to be subject to a sell down notice to be issued by the debtor in contemplation of its plan of reorganization. Typically, such a notice provides that holders must either sell their claims to a level below the claim threshold, or forfeit distributions on account of claims in excess of the threshold, so as to not jeopardize the *de minimus rule*

5. Require Confidentiality.

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

6. Request Commencement Of Adversary Proceeding.

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). Creditors may argue 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 sell-down procedures (described above) can be an effective tool to prevent irreparable harm to a debtor.

Market Response

The Bond Market Association and the Loan Syndications and Trading Association have been actively involved in a number of claims trading issues, including trading restriction orders. In order to preserve liquidity in the debt markets, those groups released a comprehensive model NOL order in 2004 (since updated) that has been used by market participants to negotiate appropriate claims trading orders in a number of bankruptcy cases. In addition to many of the considerations set forth above, the model NOL order also includes provisions for offsetting acquisitions and dispositions (including day trading), short sales, and netting. It further provides for sanctions for failure to comply. For equity transfers, such transfers would be void; with respect to claim transfers, the sanction would be forfeiture of the excess equity in violation of the sell-down notice or restriction. Finally, as a result of orders entered in recent bankruptcy cases, the updated guidelines from the Bond Market Association and LSTA suggest that:

(1) first-day interim orders limiting trading restrictions should apply to equity transfers only, so that restrictions relating to the trading of claims are put in place only after a court hearing;

(2) parties should include detailed provisions relating to "sell down" procedures; and

(3) creditors should only provide a single consent evidencing their agreement to sell down, without disclosing information concerning the creditors' claims.[5]

[5] Copies of the updated model NOL order and guidelines are available to registrants on the LSTA website.