Trading Restrictions in Bankruptcy: Did The Seventh Circuit Up the Ante for Stock Trading Injunctions?

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Although the outcome of a chapter 11 restructuring seldom can be predicted at the outset of a case with any degree of certainty, one thing is assured: the company will not have the same creditors and shareholders at the end of the case that it had at the beginning. The proliferation of vulture funds and other traders in distressed "securities" provides a ready market for creditors and shareholders who want to cut their losses without waiting until confirmation of a plan of reorganization that may not take place for several years.

Trading in public securities issued by a debtor is regulated by disclosure and other requirements contained in federal securities laws, although transfers of creditor claims are not subject to such regulation. Astute claims traders can profit considerably if claims acquired at a steep discount later reap significant recoveries. Whether such speculation turns a profit depends on the quality of an acquiror's investigation of the debtor company's affairs and an educated bet on the likely outcome of the case — information and expertise that few creditors have or are willing to develop.

The disparity in resources and expertise between creditors and sophisticated claims speculators has been perceived as creating a potential for abuse in an unregulated market. For this reason, bankruptcy courts have played a role in monitoring and sometimes preventing claims trading.

Court scrutiny also has been brought to bear because buying claims against a company may be a means of acquiring a controlling stake in the company if the company converts its debt to equity as part of a chapter 11 plan of reorganization. Creditors selling their claims against a bankrupt company in the early stages of a case do not have the benefit of the same disclosure to which they would be entitled in connection with the chapter 11 plan confirmation process.

Neither the Bankruptcy Code nor its accompanying procedural rules expressly give the bankruptcy courts the power to regulate trading once a company files for bankruptcy protection. Rule 3001(e) of the Federal Rules of Bankruptcy Procedure ("Bankruptcy Rules") merely contains certain notification requirements that vary depending upon when a claim is transferred to ensure that the court has an accurate record of the identity of the holder of the claim and, in a chapter 11 case, to ensure that the actual holder of the claim has an opportunity to vote to accept or reject a plan. It does not provide for any court involvement in the trading process.

The Old Rule

This was not always the case. Prior to 1991, Bankruptcy Rule 3001(e) invited relatively open-ended bankruptcy court scrutiny of the fairness of a pending trade. At that time the rule provided that substitution of the transferee as the holder of a claim after the filing of a proof of claim required court approval after notice and a hearing. Potential transferees typically provided notice not only to the transferor and the court, but to all other creditors and interested parties in the bankruptcy case. Third parties then had an opportunity to object to the transfer, the terms of which were disclosed to the court. Whether or not anyone objected, the bankruptcy court was in a position to determine whether the seller was sufficiently informed of the value of its claim or was susceptible to being misled.

Bankruptcy Rule 3001(e) was amended in 1991 with the express intention of curtailing judicial oversight of claims trading by limiting the requirement of court approval, minimizing what had to be disclosed to the court and eliminating third party involvement altogether. Under the present version of the rule, no notice of a transfer of a claim need be given to anyone other than the court (by filing a notice of such transfer) and the transferor. Moreover, the parties to the trade are not required to disclose the terms of transfer. If the transferor makes a timely objection to the transfer, the "court's role is to determine whether a transfer has been made that is enforceable under nonbankruptcy law."

Tax Attributes and Changes in Control

What rulemakers apparently overlooked when attempting to remove the bankruptcy courts from the process was the resulting potential for losing a sometimes significant asset in chapter 11 reorganizations involving companies with valuable tax attributes. An indispensable feature of almost every chapter 11 case involving a business that is attempting to reorganize by reworking its capital structure is the ability to preserve as much as possible existing net operating losses ("NOLs") to offset against future tax liabilities of the reorganized or successor entity. NOLs are an excess of deductions over income in any given year. They generally can be carried back to use against taxable income in the two previous years and, to the extent not used, may be carried forward for 20 years. Losses remain with the debtor during a bankruptcy case because a bankruptcy filing for a corporation does not create a new taxable entity.

The potential concern is that certain provisions in the Internal Revenue Code ("IRC") significantly limit the ability of a company to preserve its NOLs upon a "change in ownership."

The vast majority of all corporate reorganizations under chapter 11 result in a change of ownership under section 382 of the IRC. If the change occurs prior to confirmation of a chapter 11 plan, the standard NOL limitation of section 382 applies. This means that, on a going-forward basis, the company's allowed usage of NOLs against future income will be capped at an annual rate equal to the equity value of the corporation immediately before the change in ownership times the long-term tax exempt bond rate. Capping the NOLs will delay (or may even prevent) the company from using the NOLs, in either case often significantly reducing the present value of the tax savings. If, for example, an ownership change occurs because of a worthless stock deduction, the equity of the company is presumed to be worthless, thereby preventing the use of its NOLs to offset future income.

When a change of ownership takes place pursuant to a plan of reorganization, the tax attributes that remain after giving effect to other attribute reduction rules in the IRC generally — although not always — are subject to an annual limitation on future use. Under section 382(l)(6) of the IRC, that limitation is equal to the annual long-term tax-exempt bond rate times the value of the company's equity immediately after the change of ownership (and after giving effect to the reduction in liabilities occurring pursuant to the plan of reorganization).

Under certain limited circumstances, a debtor can undergo a change of ownership in bankruptcy and emerge without any section 382 limitation on its NOLs or built-in loss. To qualify for this provision (contained in section 382(l)(5) of the IRC): (i) shareholders and creditors of the company must end up owning at least 50 percent of the reorganized debtor's stock (by vote and value); (ii) shareholders and creditors must receive their minimum 50 percent stock ownership in discharge of their interest in and claims against the debtor; and (iii) stock received by creditors can only be counted toward the 50 percent test if it is received in satisfaction of debt that (a) had been held by the creditor for at least 18 months on the date of the bankruptcy filing (*i.e.*, was "old and cold") or (b) arose in the ordinary course of the debtor's business and is held by the person who at all times held the beneficial interest in that indebtedness.

Section 382(l)(5) of the IRC serves a valuable rehabilitative purpose by permitting bankrupt corporations that can qualify for that provision's treatment to restructure their finances and emerge from bankruptcy with a largely unfettered ability to use their NOLs to shelter income earned after an ownership change takes place as part of a chapter 11 plan of reorganization. Even that ability may be compromised in certain circumstances. Thus, if the company's business enterprise is not continued at all times during the two-year period beginning upon confirmation of a plan, or if a second change in ownership takes place within two years, the company will forfeit the right to benefit from the liberal rules of section 382(l)(5). Also, a debtor company making use of section 382(l)(5) must undergo a statutory NOL "haircut" whereby it loses certain interest deductions taken within the previous three tax years.

These rules place a heavy burden on the debtor to monitor the identity of its creditors and shareholders with fairly exacting precision. A significant volume of stock or claims transfers can jeopardize the debtor-company's ability to retain the full benefit of its NOLs. Bankruptcy courts recognized this potential risk relatively early on, finding that NOLs are property of a chapter 11 debtor's bankruptcy estate and enjoining any action that had the potential to adversely affect them. The seminal case in this area is *In re Prudential Lines, Inc.*, where the bankruptcy court found that an NOL was property of the debtor's bankruptcy estate and that the efforts of the debtor's corporate parent to claim a worthless stock deduction, which under then-existing law would have rendered the debtor's NOL useless, violated the automatic stay.

The court predicated its ruling, which subsequently was upheld on appeal by the Second Circuit, upon sections 362(a)(3) and 105(a) of the Bankruptcy Code. The former precludes "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." Section 105(a) gives a bankruptcy court broad equitable powers to issue any order "that is necessary or appropriate to carry out the provisions of" the Bankruptcy Code. Other courts have since followed suit, recognizing that preservation of a debtor's NOLs may be crucial to the success of the reorganization.

Debtors have been swift to seek court intervention in cases that have the potential for a significant volume of claim or stock trading. Companies such as First Merchants Acceptance Corporation, Service Merchandise Company, Phar-Mor, Inc. and South East Banking Corp. and, more recently, Conseco, Williams Communications Group, United Airlines and Owens Corning have sought at the outset of a bankruptcy case court approval of procedures designed to monitor trading and afford the debtor an opportunity to prevent trading if it threatens important tax attributes. Conseco obtained a bankruptcy court order blocking major shareholders from selling or transferring common stock as part of its first day chapter 11 filings. United Airlines successfully enjoined the trustee of its employee stock ownership plan from selling its majority stock holdings to preserve NOLs estimated to exceed $20 billion. In February of 2005, the Delaware bankruptcy judge presiding over Owens Corning's chapter 11 case issued an order requiring investors who own 4.75 percent or more of the company's 55 million shares to notify the company and give it an opportunity to object before engaging in further purchases or sales of stock. In fact, NOL preservation motions are becoming almost routine in large chapter 11 cases.

Typical Trading Injunctions

Three basic types of trading injunctions commonly are relied upon to protect NOLs. The first is an injunction enjoining the transfer of equity interests. Stock trading injunctions protect against ownership changes prior to the effective date of a chapter 11 plan and generally are designed to limit trading by any entity holding five percent or more of the debtor's stock. If there are multiple classes of stock with varying economic values, the injunction should be tailored to account for this, as the five percent holder threshold is determined by reference to value.

Another type of injunction prevents a stockholder from taking a worthless stock deduction. Generally, such an injunction would be necessary only where there has been a 50 percent shareholder during the three-year period ending on the last day of the taxable year. Any one-time 50 percent shareholder that sold enough stock to fall below the threshold during the relevant period is still treated as a 50 percent shareholder in determining whether a worthless stock deduction by that shareholder could trigger a reduction or forfeiture of a debtor's NOL carry-forwards.

Finally, claims trading injunctions commonly are issued to protect the debtor-company's ability to rely on section 382(l)(5) of the IRC as a means of preserving NOL carry-forwards. Such injunctions typically set a threshold dollar amount of trading in claims that will trigger the provisions of the trading prohibition.

Recent Ruling in United Airlines

A decision recently handed down by the Seventh Circuit Court of Appeals is emblematic of the types of problems that can arise in connection with trading restrictions in a bankruptcy case. When United Airlines sought chapter 11 protection in 2002, United's employees owned slightly more than one-half of the company's stock through an employee stock ownership plan ("ESOP"). Concerned that the ESOP might sell the stock, and thereby cause a change in control that would jeopardize its ability to preserve NOLs, United sought and obtained an injunction forbidding any stock sales by the ESOP. The ESOP failed to ask the bankruptcy court to require United to post a bond or implement other measures to protect the ESOP against losses occurring as a result of its inability to sell the United stock.

The trustees of the ESOP appealed the injunction. Nevertheless, before the appellate court could render a decision, the Internal Revenue Service issued a regulation permitting ESOPs to pass through shares to employee beneficiaries without jeopardizing the issuer's ability to preserve NOL carry-forwards. United terminated the ESOP, which distributed the stock it held to the employees, who were free to trade the shares if they wished. The ESOP having been dissolved, the injunction lapsed, although it was never formally vacated by the bankruptcy court. Even though United then asked the district court to dismiss the appeal as moot, the court affirmed the bankruptcy court's decision to enjoin the stock sales. The ESOP's trustees appealed that determination to the Seventh Circuit.

At the time that the bankruptcy court issued the injunction, United's stock was trading at $1.06 per share. When employees were again able to trade (upon dissolution of the ESOP), the stock price had fallen to $.76. On appeal to the Seventh Circuit, the trustees sought an award of damages to compensate for the decrease in the price of the stock during the trading freeze.

The Seventh Circuit denied the trustees' request for damages because the trustees failed to obtain a bond or other equivalent means of protection to safeguard against any diminution in value in the stock caused by the trading freeze. Still, the Court of Appeals vacated the district court's order affirming the injunction and remanded the case with instructions to enter an order formally dissolving the injunction. In doing so, the Seventh Circuit was highly critical of the bankruptcy court's decision to enjoin trading in the case:

> Requiring investors to bear the costs of illiquidity and underdiversification was both imprudent and unnecessary. United wants to preserve the value of tax deductions that, it contends, are worth more than $1 billion should it return to profitability. There is no reason why investors who need liquidity should be sacrificed so that other investors (principally, today's debt holders) can reap a benefit; bankruptcy is not supposed to appropriate some investors' wealth for distribution to others. United should have been told to back up its assertions with cash, so that put-upon shareholders could be made whole. If United's views are right, it would not have had any trouble borrowing to underwrite a bond or other form of protection; and if lenders would not make such loans, that would have implied to the court that United's contentions are hot air.

The Court of Appeals went on to characterize reliance on sections 105(a) and 362(a)(3) of the Bankruptcy Code as a basis for issuing a trading injunction as "weak enough to make a bond or adequate-protection undertaking obligatory before a bankruptcy judge may forbid investors to sell their stock on the market." According to the Seventh Circuit, a carefully drafted adequate protection agreement could have "protected stockholders against an erosion of their position while requiring them to indemnify United if the market price of the stock should rise, and the expense of a bond or other security turn out to have been unnecessary." Nevertheless, because no such protective measures were implemented at the time the trading freeze took place, the

Court of Appeals ruled that the employee shareholders were not entitled to damages for any diminution in United's stock value.

Outlook

Highly visible bankruptcy cases such as the chapter 11 cases filed by United Airlines, WorldCom, Enron, Global Crossing, Kmart and Owens Corning have focused attention on investing and trading in the securities of troubled companies and highlight the influential role played by distressed investment funds in large and medium-sized chapter 11 cases. These and many other cases also illustrate some of the challenges confronted by companies seeking to reorganize in bankruptcy. The practical challenge for debtors that possess sizeable NOLs is to safeguard these tax attributes by avoiding an ownership change (or excessive claims trading) until confirmation and consummation of a plan of reorganization. Notwithstanding rulemakers' efforts in 1991 to remove the bankruptcy court from regulating trading, recent developments indicate that the courts are still very much involved in regulating trading if the success of a debtor's reorganization is at stake.

These developments also suggest that as part of pre-bankruptcy strategic planning, potential debtors should determine whether they have any NOLs or other tax attributes (such as built-in losses) that require protection. The unwary debtor may find that it already has undergone an ownership change (or has lost its ability to qualify for section 382(l)(5) of the IRC) prior to filing or that it is dangerously close to the threshold. Swift action may be necessary given the robust market for trading in the claims and stock of financially troubled companies.

The impact of the Seventh Circuit's ruling in *United Airlines* is unclear. At a minimum, the decision suggests that shareholders and creditors alike should be vigilant to ensure that debtors seeking court approval of procedures restricting claim and equity trading show that the benefit to the estate through preserving tax attributes outweighs prejudice to creditors and shareholders who are being precluded from liquidating their holdings.

Because the specific issue before the Seventh Circuit in *United Airlines* was whether the ESOP trustees were entitled to money damages, the court's pronouncements concerning the legitimacy of trading injunctions may be regarded as *dicta*. Still, given widespread reliance among bankruptcy courts upon sections 362(a)(3) and 105(a) of the Bankruptcy Code as authority for regulating trading, the Seventh Circuit's criticism of this approach in cases distinguishable from the *Prudential* worthless stock deduction scenario should put bankruptcy advisors on notice. It remains to be seen whether the *quid pro quo* for implementing trading restrictions in the future will involve some type of bond or other equivalent means of economic protection for those parties prohibited from trading.

In re UAL Corp., 412 F.3d 775 (7th Cir. 2005).

Official Comm. of Unsecured Creditors v. PSS S.S. Co. (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).

First Merchants Acceptance Corp., 1998 Bankr. LEXIS 1816 (Bankr. D. Del. Jan. 20, 1998).

In re Service Merchandise Co., Inc., 2000 Bankr. LEXIS 1523 (M.D. Tenn. Dec. 2000).

In re Phar-Mor, Inc., 152 B.R. 924 (Bankr. N.D. Ohio 1993).

In re Southeast Banking Corp., 1994 WL 1893513 (Bankr. S.D. Fla. July 21, 1994).

In re Conseco Inc., Case No. 02-49671 (Bankr. N.D. Ill. Dec. 18, 2002).

In re Williams Communications Group Inc., Case No. 02-11957 (BRL) (Bankr. S.D.N.Y. July 24, 2002).

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