The Poison Pill Alternative to
Stock Trading Injunctions in Chapter 11

January/February 2007

Brad B. Erens
Mark G. Douglas

The implementation of restrictions on stock and/or claims trading has become almost routine in large chapter 11 cases involving public companies on the basis that such restrictions are vital to prevent forfeiture of favorable tax attributes that can be triggered by a change in control. Continued reliance on stock trading injunctions as a means of preserving net operating loss carry forwards, however, may be problematic, after the controversial ruling handed down in 2005 by the Seventh Circuit Court of Appeals in *In re UAL Corp*. In that case, the Court sharply criticized stock trading freezes and suggested that the *quid pro quo* for preventing trading should be a bond or some other form of security posted by the chapter 11 debtor to compensate stockholders for any losses sustained as a consequence of their inability to trade. Although courts continue to impose stock and claims trading restrictions as part of customary "first day" orders in chapter 11 cases filed by publicly-traded companies, the possibility that trading injunctions will be harder to obtain begs the question whether other means of preventing significant shifts in equity ownership are available. Carefully-tailored measures implemented by a debtor-corporation's board of directors, such as "poison pills," may be one option.

Tax Attributes and Changes in Control

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 can generally 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.

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 multiplied by 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.

Under certain limited circumstances, a debtor can undergo a change of ownership under a chapter 11 plan 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.

A significant volume of stock transfers prior to confirmation of a plan of reorganization can jeopardize the debtor-company's ability to retain the full benefit of its NOLs under that plan. Some 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 *Official Committee Of Unsecured Creditors v. PSS Steamship Co.* (*In re Prudential Lines, Inc.)*. In that case, the Second Circuit Court of Appeals upheld a bankruptcy court's ruling, based upon sections 362(a)(3) and 105(a) of the Bankruptcy Code, that an NOL is property of the debtor's bankruptcy estate and that the efforts of the debtor's non-bankrupt 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. Adopting the approach articulated in *Prudential,* many courts have ruled that stock trading may be prohibited under section 362(a)(3), as an exercise of control over NOLs, which are property of the debtor's bankruptcy estate.

Debtors have been swift to seek court intervention in cases that have the potential for a significant volume of stock trading. Companies such as First Merchants Acceptance Corporation, Service Merchandise Company, Phar-Mor, Inc. and Southeast Banking Corp. and, more recently, Conseco, Williams Communications Group, United Airlines, Owens Corning, Foamex International, Inc., FLYi, Inc., Dana Corporation and Dura Corporation have sought court approval at the outset of a chapter 11 case to implement procedures designed to monitor trading and to prevent trading if it threatens important tax attributes. Typical stock trading injunctions protect against ownership changes prior to the effective date of a chapter 11 plan and are generally designed to limit trading by any entity holding five percent or more of the debtor's stock.

A Wrench in the Works? The Seventh Circuit's Ruling in *UAL*

The prevalence of routine stock trading injunctions in large chapter 11 cases was challenged in 2005 by the Seventh Circuit Court of Appeals in *In re UAL Corp.* 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 obtained an injunction forbidding any stock sales by the ESOP. The ESOP did not 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. 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. 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 they never obtained a bond or other equivalent means of protection to safeguard against any diminution in value in the stock caused by the trading freeze. Even so, 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.

At least one bankruptcy court has interpreted *UAL* as a mandate for refusing to impose stock trading restrictions in a chapter 11 case. On March 3, 2006, Judge Jerry W. Venters of the Bankruptcy Court for the Western District of Missouri, relying upon *UAL*, denied a motion to implement equity trading restrictions filed by chapter 11 debtors Interstate Bakeries Corp. and its affiliates. According to Judge Venters, the requested relief, which the debtors sought eighteen months after filing for chapter 11, when it first appeared that they might have tax attributes to protect, was a procedurally improper request for injunctive relief and, moreover, was unjustified because equity securities are not property of a debtor’s estate. Similar objections were raised to equity trading orders requested in the chapter 11 cases of Dana Corporation and Foamex International, Inc., although the bankruptcy courts involved ultimately approved the restrictions.

A Way Forward: The Poison Pill?

Devised in the early 1980s, shareholder rights plans, or "poison pills," are a commonplace takeover defense. According to recent estimates, approximately 46% of the S&P 500 companies had a rights plan in place at the end of 2005. A rights plan can be quickly implemented by action of a company's board of directors, and most importantly, shareholder approval is generally not required. In the most common form, the board of directors declares a dividend of share purchase rights and enters into a shareholder rights agreement with a rights agent (typically the transfer agent for the company's common stock). The purchase rights attach to the company's common stock and remain inactive and unexercisable until a shareholder acquires more than a certain percentage of the company's outstanding stock — typically ten to twenty percent — triggering detachment and exercisability of the purchase rights. All other shareholders then have the right to purchase newly-issued shares of the company's common stock at a 50% discount to the current market price, thereby significantly diluting the acquiring shareholder's equity holdings. The existence of a poison pill generally forces potential acquirors to negotiate with the target's management and board before consummating an offer. There are ways to defeat a pill, but they are difficult, costly and time consuming.

Under the right circumstances, the poison pill may be an attractive alternative to a traditional stock trading order given the uncertainty in obtaining such an order after the *UAL* decision. This may entail amending the pill to make it more restrictive — the typical ten to twenty percent threshold likely would need to be dropped to five percent to protect forfeiture of a chapter 11 debtor's tax attributes. Court approval may not even be necessary to adopt a poison pill or to make an existing provision more restrictive. As a general rule, although chapter 11 shifts the fiduciary paradigm of a company's directors to account for creditor and estate interests, a chapter

11 filing does not intrude upon the corporate governance of the debtor-in-possession. Bankruptcy courts are reluctant to interfere with a debtor's management of its business. Further, under the Bankruptcy Code, a debtor's management decisions are entitled to a presumption of reasonableness.

The Bankruptcy Code provides that a debtor-in-possession or bankruptcy trustee may enter into transactions in the ordinary course of business without court approval. Although court approval is required for any use, sale or lease of estate property that is outside of the ordinary course of the debtor's business, a debtor's stock is not considered property of its bankruptcy estate. As a consequence, a chapter 11 debtor-in-possession arguably can rely upon its general mandate to continue operating the debtor's business as authority for implementing or amending a poison pill. For example, shortly after filing for chapter 11 protection in March of 2006, Dana Corporation extended the duration of a poison pill provision that would otherwise have expired on July 25, 2006, without the need for bankruptcy court approval. In addition, on January 30, 2006, chapter 11 debtor USG Corporation announced that it was adopting a revised shareholder rights plan. Under the revised plan, which expired on December 31, 2006, if any person acquired beneficial ownership of five percent or more of USG's voting stock, other shareholders had the right to purchase additional USG common stock at half the market price. After emerging from chapter 11 protection, USG implemented a new plan, effective January 1, 2007, which reinstitutes the fifteen-percent threshold.

The practical utility of implementing a poison pill or beefing up an existing provision as a way to prevent forfeiture of NOLs may be limited — merely giving other stockholders the right to acquire stock at a discount may not prevent a “change in control” if the rights are not timely exercised in sufficient quantity. Still, the threat of significant dilution could be adequate to ward off a substantial equity ownership shift and provide the debtor with enough time to seek court intervention under circumstances that may be more likely to pass muster under the restrictive approach suggested by the Seventh Circuit in *UAL*.

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

Official Committee Of Unsecured Creditors v. PSS Steamship Co. (*In re Prudential Lines, Inc.)*, 928 F.2d 565 (2d Cir. 1991).

In re Interstate Bakeries Corp., Case No. 04-45814 (JWV) (Bankr. W.D. Mo. Mar. 3, 2006) (unpublished ruling).

Jones Day acted as debtor’s counsel in the chapter 11 cases of Williams Communications Group, FLYi, Inc., Dana Corporation and USG Corporation.

A version of this article appears in the February 2007 edition of the *Bankruptcy Strategist*. It appears here with permission.