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Issues and Information for the Insolvency Professional

Protecting Trading Markets and NOLs in Chapter 11

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The Bond Market Association (BMA) and the Loan Syndications and Trading Association (LSTA) have jointly drafted a model order for use in chapter 11 proceedings to protect a debtor's net operating losses (NOLs) without unduly restricting trading in unsecured claims during the pendency of a company's bankruptcy case (Model NOL Order). The project was motivated by the disruptions to the debt-trading markets that have been increasingly caused by restrictive NOL orders entered by bankruptcy courts at the request of debtor corporations in large chapter 11 cases. Recent examples of large cases where such orders have been entered are *UAL*, *US Airways*, *Mirant*, *Conseco* and *WorldCom*. These orders are intended to protect the debtors' ability to utilize NOL carryovers to offset future tax liability. In many instances, however, the effect of the orders has been to halt or seriously restrict trading in the corporations' debt and to require investors to expend significant time in an effort to understand and negotiate the scope of the restrictions.

Some creditors consider these restrictive trading orders an impermissible exercise of bankruptcy court power since the unsecured claims that are subject to restriction are not

themselves property of the bankruptcy estate. To date, none of these restrictive trading orders has been tested on appeal.

Nonetheless, the pattern emerging in recent cases is that some bankruptcy courts have broadly restricted trading in unsecured claims during bankruptcy proceedings based on a debtor's assertion that such a restriction is necessary to avoid possible impairment of a debtor's NOLs. In response to these broad restrictive orders, investors and broker-dealers have been compelled to engage counsel in order to object and in an attempt to restore liquidity in the debt-trading market, resulting in the expenditure of substantial time and effort, by both sides, for purposes of fine-tuning the breadth of the orders and putting in place *ad hoc* procedures to ensure compliance.



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The Model NOL Order reduces the disruption and expense resulting from NOL orders by creating a standard and less restrictive mechanism for dealing with the tax issues raised by debt trading during a bankruptcy. In producing the Model NOL Order, the BMA and LSTA consulted extensively with representatives of the debt-trading community as well as leading bankruptcy counsel for both debtors and creditors. The objective was to create a Model NOL Order that strikes an appropriate balance between the interests of the markets and the interest in maximizing the value of the bankruptcy estate for the benefit of all parties.

Background on NOL Orders

NOL trading orders are motivated by certain provisions of the IRC that are intended to prevent trafficking in NOL carryovers and other tax attributes. In general, a loss corporation's NOLs will be subject to severe limitation upon a change in control, which generally occurs under IRC §382 if the percentage of the stock of the loss corporation that is owned by 5 percent of shareholders increases by more than 50 percentage points over a three-year testing

period. If the ownership change occurs in a bankruptcy proceeding, however, special rules may apply.

Under one of these special rules, known as §382(1)(5), a partial exemption from the change in control limitation is available for an ownership change pursuant to a bankruptcy reorganization, so long as the historic shareholders and "qualified creditors" of the debtor corporation own at least 50 percent of the value and voting power of its stock after the change. In most cases, a debtor corporation may treat a creditor as qualified under §382(1)(5) if, immediately after the bankruptcy reorganization, that person owns less than 5 percent of the debtor corporation's equity.

Pursuant to the basic §382 rule, normal trading in a debtor corporation's equity can directly result in significant limitations on future use of NOL carryovers, regardless of the value of that equity. For this reason, NOL trading orders uniformly place significant restrictions on equity trading during the course of a bankruptcy. Although trading in debt cannot directly result in a limitation under §382, restricting trade in debt is premised on the debtor's potential conversion of unsecured debt into equity as part of an eventual reorganization plan, which could result in a NOL limitation absent the availability of the §382(1)(5) exception. The restrictions on debt trading imposed by NOL orders (particularly with respect to large holders) are intended to preserve a debtor's ability to benefit from the favorable presumption that small debt-holders are qualified for purposes of the §382(1)(5) exception.

For this reason, although the debt provisions of NOL trading orders vary, they most frequently prohibit large holders of debt from acquiring any additional claims. At early stages of a bankruptcy, these NOL trading orders have also sometimes prohibited all purchases and sales of a corporation's debt. These broad restrictions are very disruptive to trading markets and are often imposed without meaningful notice to the markets, leaving market participants in considerable doubt regarding the status of pending trades. Moreover, by preventing

large creditors from increasing their holdings of unsecured claims during the pendency of a proceeding, NOL trading orders may have a secondary effect of enabling a debtor to retain control of its reorganization by prohibiting parties from acquiring a blocking position with respect to a plan.

Approach Adopted in the Model NOL Order

The Model NOL Order is designed to put sufficient trading restrictions in place to achieve a reasonable degree of protection for a debtor corporation's NOL carryovers, while at the same time avoiding unnecessary disruptions to trading markets or providing a de facto takeover defense for a debtor-in-possession (DIP).

With respect to debt trading, the Model NOL Order functions by way of a "sell-down" mechanism. Under the Model NOL Order, creditors remain free to buy and sell debt throughout the course of a bankruptcy proceeding, unless and until the debtor proposes a reorganization plan that relies on the §382(1)(5) exception. In that event, the Model NOL Order would then require large debt-holders to sell claims to the extent necessary to preserve the qualified creditor presumption, but in no case below the level that they held when the Order was originally entered. If such a reorganization plan is confirmed, failure to comply with the sell-down requirement would result in a large debt-holder forfeiting its rights to receive a distribution with respect to the portion of its claims subject to the sell-down notice; however, non-compliance would impose no other penalty, including providing no basis for a designation of such debt-holder's claims in connection with voting on the reorganization plan. In that respect, the Model NOL Order seeks to preserve a level playing field among the debtor and creditors in the plan process.

The Model NOL Order is also designed to minimize market disruption by ensuring adequate notice to market participants. Under the Order, notice must be given via the Bloomberg newswire service before the trading restrictions become effective. The BMA and LSTA believe this will protect buyers, sellers and brokers from the risk of transactions being found *void ab initio*, which may result from an inadvertent violation of the bankruptcy court's trading order.

NOLs and Reorganization of Privately Held Debtors¹

While the problem of trading in a debtor's equity is primarily applicable to public debtors, the use of NOLs can be vital to privately held corporate debtors as well.

¹ **Editor's Note:** This section was written by Prof. Jeff Morris, ABI's Robert M. Zinman Resident Scholar for spring 2005.

The value of the NOL to the future profitability of a reorganized debtor does not turn on whether the debtor is publicly or privately held. It depends instead on the future profitability of the entity. Consequently, a privately held company that anticipates a successful reorganization and future profitability likewise needs to take steps to protect the availability of the NOLs. This is typically not a problem when the debtor is privately held because the owner of the debtor probably wants to maintain the NOLs for the debtor. Nonetheless, situations can arise where the owner of the business has other interests that override the interest in maintaining the debtor's NOLs.

In *In re Prudential Lines Inc.*,² the debtor was a wholly owned subsidiary of another corporation. The parent company attempted to take a worthless stock deduction for its interest in the debtor, an action that would have wiped out the debtor's ability to carry forward its NOLs. The Second Circuit held that the parent company's action violated the automatic stay in that the parent company's actions constituted "control over property of the estate." The property was the debtor's right to claim NOLs in the future. The ability to use the NOLs is dependent, of course, on the debtor having future income against which to make the claim. In a sense, it is comparable to a contingent future interest under which the debtor may become entitled to property should the specific contingency occur. The interest certainly is property of the estate under §541(a)(1) of the Bankruptcy Code, even though its value may be relatively low depending on the likely occurrence of the contingency.

There will not usually be a battle over a privately held debtor's NOLs because the owner of the entity is the person who believes the debtor will be profitable in the future and will want to maintain the NOLs to protect that future income. As *Prudential Lines* shows, however, if the owner of the entity has a stronger interest in its own tax benefits, the NOLs of even privately held debtors can be at risk. Creditors' committees in these cases would be well advised to consider seeking limits on the actions of the owner that might imperil the availability of those NOLs. In these cases, restrictions on the actions of the owner may be just as important as the restrictions on claims and equity trading addresses in the Model NOL Order.³ The full text of the Model NOL Order can be found on ABI World at www.abiworld.org/pdfs/lsta.swf. ■

² 928 F.2d 565 (2d Cir.), cert. denied, 502 U.S. 821 (1991).

³ For a more thorough discussion of these issues, see Morris, Jean, "Imposition of Transfer Limitations on Claims and Equity Interests During Corporate Debtor's Chapter 11 Case to Preserve the Debtor's Net Operating Loss Carryforward: Examining the Emerging Trend," 77 Amer. Bankr. L.J. 285 (2003).

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