

## GUEST COLUMN

### Restrictions On Trading Debt In Chapter 11

In recent years, bankruptcy courts have entered restrictive trading orders in a number of large recent Chapter 11 cases, including UAL, US Airways, Mirant, Consec and Worldcom. These orders restrict trading in their debt securities and other unsecured claims during the course of their bankruptcy proceedings. In response to these recurring disruptions, The Bond Market Association and the Loan Syndications and Trading Association have put together a model order for use in Chapter 11 proceedings to protect a debtor's net operating loss (NOL) without unduly restricting trading in unsecured claims during the pendency of a company's bankruptcy case. Representatives from the trading community and the bankruptcy bar agree the Model NOL Order strikes an appropriate balance between the interests of market participants and that of maximizing the value of the bankruptcy estate.

#### Background on NOL Orders



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NOL trading orders are motivated by certain provisions of the Internal Revenue Code 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% 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(l)(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% of the value and voting power of its stock after the change.

Pursuant to the basic § 382 rule, normal trading in a debtor corporation's equity can directly result in significant



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limitations on future use of NOL carryovers. 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 an NOL limitation absent the availability of the § 382(l)(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(l)(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



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early stages of a bankruptcy, these NOL trading orders have also sometimes prohibited all purchases and sales of a corporation's debt. As noted above, such 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.

### **Approach Adopted in the Model NOL Order**

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 plan of reorganization that relies on the § 382(l)(5) exception. In such case, the Model NOL Order would require large debt holders to sell claims to the extent necessary to preserve the qualified creditor presumption, but in no case below the level they held when the Order was originally entered. In the event any such 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. 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.

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.

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*This guest column was written by James Bromley, Kristofer Hess and Joe Lamport of Cleary Gottlieb Steen & Hamilton LLP.*