CLAIMS TRADING AND THE AUTOMATIC STAY: REVISITING *IN RE PRUDENTIAL LINES* AND THE IMPLICATIONS FOR CURRENT PRACTICE

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INTRODUCTION

The growing trend of debtors seeking first day orders pursuant to sections 105(a) and 362(a)(3) restricting trading in claims has added yet another motion to present to the bankruptcy judge on the first day of a new case. In support of these motions, debtors argue that claims trading among creditors during bankruptcy violates the automatic stay and threatens their ability to preserve net operating loss ("NOL") tax attributes. In response, creditors acknowledge that claims trading puts the NOLs at risk, but argue that the automatic stay provision of the Bankruptcy Code[1] cannot be interpreted to restrict their ability to freely trade their claims against the debtor. Appellate courts have yet to step fully into the fray, but when they have considered the bankruptcy court's power to limit claims trading, the disagreement among judges has been sharp. The issue remains a point of vigorous disagreement in chapter 11 reorganizations.[2]

Because the ability of a bankruptcy court to restrict claims trading remains an unsettled question that arises routinely, this paper examines the intersection of tax and bankruptcy law that creates the conflict. Part I provides an overview of the relevant bankruptcy and tax code provisions. Part II considers several questions animating the debate over whether the automatic stay should be interpreted to prevent claims trading by creditors by analyzing different possible frameworks for deciding what actions constitute exercising control over property of the estate. Part III discusses the implications of judicial decisions restricting claims trading and compares the operation of the automatic stay as a mechanism for restricting claims trading to injunctive relief as a separate source for the same relief.

I. BACKGROUND LAW

Two statutory schemes are implicated by a debtor's request to restrict trading in claims against the estate in order to preserve the value of the debtor's NOL carryforwards: the Internal Revenue Code and the Bankruptcy Code.

A. Internal Revenue Code Provisions Relating To NOLs

The Internal Revenue Code ("IRC")[3] generally allows taxpayers to use operating losses to offset prior or future taxable income, which reduces the taxpayer's bill. A corporation with a net loss during a taxable year may carry back the

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1. 11 U.S.C. §§ 101 *et seq.*

2. The Bond Market Association and Loan Syndications and Trading Association have attempted to reshape the debate by promulgating a Model NOL Order that seeks to achieve balance between debtor and creditor interests. The order is available at <http://www.abiworld.org/pdfs/lsta.swf> (last visited May 11, 2009). A critique of the BMA-LSTA's Model NOL Order is beyond the scope of this article. It is enough to say that the order creates an environment of uncertainty that only a lawyer could appreciate.

3. 26 U.S.C. §§ 1 *et seq.*

NOL to each of the two prior taxable years, entitling the corporation to a current refund.[4] If the corporation still has unused NOLs after offsetting all taxable income during the prior two taxable years, or if the corporation elects, it may carry the NOL forward to offset taxable income during the next twenty years. The use of the NOL in this situation is referred to as an NOL carryforward or carryover.[5] A corporation's ability to use prior losses to offset future taxable income can be impaired when the corporation undergoes a sizeable change in equity ownership, although the IRC provides some special rules for corporations that issue equity in exchange for canceling debt obligations in a court approved bankruptcy reorganization.

1. IRC Section 382

IRC section 382 limits the use of net operating losses to offset taxable income after a change in corporate ownership.[6] A change in corporate ownership occurs when a shareholder or coordinated group of shareholders increase their stake in the corporation by more than fifty percentage points.[7] After the ownership change occurs, the corporation can only deduct a portion of its NOL carryforwards annually.[8] Thus, although section 382 does not prohibit a corporation from utilizing its NOLs after an ownership change, it may significantly limit the use of NOLs to offset future income.

Section 382 is intended to prevent companies from trafficking in tax attributes. Absent section 382, operating losses could be claimed on an acquirer's tax return, a transaction that, in essence, would permit the acquirer to purchase a reduction of its tax bill from the owners of the acquired corporation.

2. The (L)(5) Exception

In a plain-vanilla bankruptcy reorganization, the equity and debt of the old corporation is canceled and the debt holders receive equity interests. Such reorganizations would seem to trigger section 382's ownership change provision, but Congress provided a bankruptcy exception—found in section 382(l)(5) (the "(L)(5) Exception") —allowing a corporate debtor to use its NOLs without being subject to the annual limitation as long as the reorganization meets several requirements.

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4. The use of the NOL in this situation is referred to as an NOL carryback. *See* 26 U.S.C. § 172.

5. This article examines chapter 11 debtors' uses of NOL carryforwards, and refers to "NOLs" and "NOL carryforwards" interchangeably.

6. 26 U.S.C. § 382(a)-(b).

7. 26 U.S.C. § 382(g). For example, an ownership change for §382 purposes would occur if a shareholder who owns 7.5% of the outstanding shares of a corporation were to purchase additional shares increasing the shareholder's ownership stake to 57.6%.

8. 26 U.S.C. § 382(b). The amount of NOL carryforwards available to offset a corporation's taxable income is equal to the value of the corporation prior to the ownership change multiplied by a "long-term tax-exempt rate" determined monthly by the IRS. In April 2009, the long-term tax exempt rate was 4.61%. Rev. Rul. 2009-12 Table 3, available at <http://www.irs.gov/pub/irs-drop/rr-09-12.pdf> (last visited May 7, 2009). The value of the corporation is the value of the equity of the corporation immediately prior to the ownership change. 26 U.S.C. § 382(e). Thus, if an ownership change occurred in a corporation on April 15, 2010, and the equity of the corporation had a value of $100 million immediately prior to the ownership change, then the corporation would be able to offset up to $4.61 million in income on its 2009 tax return.

The first requirement is that the debtor actually file for bankruptcy. Informal workouts do not qualify for the exception, even if the debtor was insolvent. The reorganization must occur in a chapter 11 (or similar) proceeding and must have resulted in a confirmed plan of reorganization.[9] Second, at least fifty percent of the equity of the reorganized firm must be owned by the debtor's former shareholders and creditors, as long as those creditors held "qualified indebtedness" of the debtor.[10] Qualified indebtedness is limited to (i) debt that has been continuously held by the same beneficial owner for the 18 months prior to the bankruptcy reorganization or (ii) debts that arose in the ordinary course of the debtor's business and have been held by the same beneficial owner. Treasury regulations allow a reorganized debtor to treat any creditor who receives less than five percent of the reorganized firm's equity as having held qualified indebtedness for the (L)(5) test.[11] Third, the debtor must reduce its NOL carryforwards by the amount of deductible interest paid or accrued on debt converted to equity through the reorganization during the three taxable years prior to the reorganization as well as any interest paid or accrued during the taxable year in which the reorganization takes place.[12] This is commonly referred to as the "bankruptcy toll charge." Finally, there must be no section 382 ownership change within two years after the reorganization.[13] If such a change occurs, the NOLs will be forfeited.

3. The (L)(6) Special Valuation Rule

If the reorganized firm fails to qualify for the (L)(5) Exception, the firm's ability to use its NOLs will be limited, but not destroyed. Section 382(l)(6) allows the firm to use a special valuation rule (the "(L)(6) Special Valuation Rule") to determine the amount of NOLs the firm may use annually. Under normal circumstances, the annual NOL offset a firm may use after an ownership change occurs is determined by the value of the firm's equity immediately *prior* to the ownership change multiplied by the long-term tax-exempt rate. By comparison, the (L)(6) Special Valuation Rule computes the annual NOL offset available to the reorganized firm by multiplying the value of the firm's equity *after* the reorganization by the applicable long-term tax-exempt rate. This generally yields a higher amount, because the equity value of a firm after reorganization is greater than the equity value of a firm in financial distress. This rule also benefits the debtor because it does not apply the (L)(5) "toll charge" to reduce the debtor's NOLs.

4. Section 382(g)(4)(D) Worthless Stock Deduction Rule

When a debtor's majority stockholder treats its stock as worthless, for example, by taking a section 165(g) deduction for worthless securities, section 382(g)(4)(D) treats the majority stockholder as "having acquired such stock on the 1st day of his 1st succeeding taxable year", and as "not … having owned such stock during any prior period."[14] This construc-

9. 26 U.S.C. § 382(l)(5)(A)(i).

10. 26 U.S.C. § 382(l)(5)(A)(ii).

11. Orders restricting claims trading generally aim to take advantage of this regulation by prohibiting creditors and other investors from acquiring claims that would lead to the receipt by the creditor or investor of 5% or more of the reorganized firm's equity.

12. 26 U.S.C. § 382(l)(5)(B).

13. 26 U.S.C. § 382(l)(5)(D).

14. 26 U.S.C. § 382(g)(4)(D).

tive ownership change triggers the section 382 limitation.[15] Further, because the shares of the debtor firm are considered worthless, the section 382 limitation could completely bar the debtor from using its NOLs to offset future income.[16]

B. Bankruptcy Code Provisions Relating To NOLs

Two issues arising in the context of claims trading restrictions in bankruptcy are (i) whether NOLs should be considered property of the estate and (ii) whether the automatic stay applies to claims trading. This section will briefly review the statutory provisions relevant to these issues.

1. Section 541 Property Of The Estate

The filing of a bankruptcy petition creates an estate that is comprised of "all legal or equitable interests of the debtor in property as of the commencement of the case."[17] This provision is broadly construed and includes interests that are contingent or of uncertain value as of the commencement of the bankruptcy case[18] as well as intangible interests.

The Supreme Court of the United States held in *Segal v. Rochelle* that an individual debtor's NOL carryback resulting in a tax refund to the debtor was property of the individual debtor's estate.[19] The Court expressed concern that including an NOL carryforward in the property of individual debtor's estate would be inapposite to the Bankruptcy Code's fresh start policy, but it did not decide the issue.[20]

2. Section 362 Automatic Stay

When individual creditors race to foreclose on a debtor's limited assets, they threaten to destroy any going concern value created by the firm. To prevent this destructive race, the Bankruptcy Code imposes an automatic stay on certain actions against parties that have petitioned for bankruptcy relief.[21] The automatic stay prevents creditors from foreclosing on the debtor's assets, stops other parties from commencing or continuing lawsuits against the debtor, and prohibits other actions that could be detrimental to the debtor's value as a going concern. The automatic stay also applies

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15. Curiously, § 382(g)(4)(D) only applies when the majority stockholder who treated the stock as worthless still holds the stock as of the close of the majority stockholder's taxable year. This section is intended to prevent taxpayers from taking a "double deduction" for the same economic loss. The double deduction would occur because the majority stockholder would be entitled to a worthless securities deduction under 26 U.S.C. § 165(g) and the debtor firm would be entitled to offset its income by its NOLs.

16. The IRS will likely argue that the shares are worthless given the majority shareholder's treatment of the stock as such. The § 382(b) limitation is calculated by multiplying the equity of the debtor corporation—in cases of worthless stock, the equity value is 0—by the long-term tax-exempt rate, preventing the debtor from using any amount of its NOLs.

17. 11 U.S.C. § 541(a)(1).

18. A good example is a chose in action. The debtor's ability to bring a lawsuit is property of the estate despite the uncertain value of the interest. The debtor's interest is not contingent (it can bring the lawsuit now if it desires), but the value of the interest is contingent upon the debtor's success in court and upon the damages awarded.

19. 382 U.S. 375, 380 (1966).

20. *Id.* at 381.

21. 11 U.S.C. § 362.

to "any act to obtain possession of property of the estate or property from the estate or to exercise control over property of the estate."[22]

Accordingly, if NOLs are considered property of the estate under section 541, then the automatic stay prevents any party from engaging in "any act to obtain possession" of these NOLs or any act "to exercise control over" the NOLs, providing a justification for orders preventing claims trading.

C. Case Law Treatment of NOLs in Bankruptcy

Appellate court decisions examining the treatment and status of NOLs in chapter 11 reorganizations are scarce. Two cases, a 1990's era case from the United States Court of Appeals for Second Circuit and a case of relatively recent vintage from the United States Court of Appeals for the Seventh Circuit, have become the seminal cases for parties litigating restrictions on claims trading—which is occurring more and more often in bankruptcy courts—and provide opposing views of the issue.

1. *Prudential Lines*

The Second Circuit's seminal case treating NOLs as property of the estate subject to the automatic stay is *In re Prudential Lines, Inc*.[23] Prudential Lines, Inc. ("PLI") was the wholly-owned subsidiary of PSS Steamship Company, Inc. ("PSS"). The two companies filed a consolidated tax return and were jointly managed by the Skouras family. PLI became the subject of an involuntary petition for reorganization, and the Skourases, as managers of PLI, presented a plan to creditors allowing the Skouras family to retain control of PLI and leaving the reorganized company a $74 million NOL carryforward available to offset future income.[24] The plan did not garner creditor support. The creditor's committee formulated its own plan to cancel the Skouras family's PLI stock and remove the Skouras family from PLI management, yet to retain the availability of PLI's NOL to offset future income.[25] PLI's parent company, PSS, also controlled by the Skouras family, rejected the creditor's plan and announced its intention to take a worthless stock deduction on its PLI stock. At the same time, PLI management (again the Skouras family) met with PLI's largest unsecured creditor and urged it to support PLI's plan, telling the creditor that the NOL carryforward would be preserved under PLI's plan but would be uncertain under the creditor's committee's plan.[26] The Skourases and creditors attempted to negotiate an acceptable resolution to the battle of the plans. After negotiations failed, the creditor's committee asked the bankruptcy court to enjoin PSS from taking a worthless stock deduction on its PLI stock.[27] The bankruptcy court granted the injunction, holding (i) that the NOL constituted property of PLI's estate and (ii) that PSS's worthless stock deduction would violate the automatic stay as an attempt to exercise control over PLI's property.[28] The district court affirmed the bankruptcy court's decision.[29]

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22. 11 U.S.C. § 362(a)(3).

23. 928 F.2d 565 (2d Cir. 1991).

24. *Id.* at 567.

25. *Id.*

26. *Id.*

27. *Id.*

28. In re Prudential Lines, Inc., 114 B.R. 27 (Bankr. S.D.N.Y. 1989).

29. In re Prudential Lines, Inc., 119 B.R. 430 (S.D.N.Y. 1990).

The court of appeals agreed with the lower courts' decisions and ruled unanimously that PLI's NOLs constituted property of the estate under section 541, noting Congress's intent that the term be interpreted broadly.[30] The court then determined that the injunction was proper, reasoning that PSS's worthless stock deduction would effectively eliminate PLI's NOL carryforwards, that "PSS's interest in its worthless stock deduction [was] intertwined with PLI's NOL," and that taking the worthless stock deduction would be an attempt to exercise control over property of the estate in violation of the automatic stay.[31] In other words, "where a non-debtor's action with respect to an interest that is intertwined with that of a bankrupt debtor would have the legal effect of diminishing or eliminating property of the bankrupt estate, such action is barred by the automatic stay."[32]

2. *United Airlines*

When United Airlines ("United") declared bankruptcy in December 2002, more than half of its stock was held by its Employee Stock Ownership Program (ESOP).[33] United feared that the ESOP would sell its stock, triggering a section 382 ownership change that would limit its ability to use its NOLs to offset future income. Accordingly, United sought and obtained a first day order prohibiting the ESOP from selling its stock. A final injunction was issued two months later. The bankruptcy court did not require United to post a bond to protect the ESOP against loss or direct United otherwise to provide "adequate protection" of the ESOP's interests under section 362(d)(1).[34] The ESOP's trustee appealed the injunction, but it did not ask the district court to require a bond or adequate protection.[35] While the appeal was pending, United terminated the ESOP, which distributed the shares to United's employees. The decision to terminate was made after the Internal Revenue Service ("IRS") issued a regulation permitting ESOPs to distribute shares to employees without triggering an ownership change that would jeopardize the corporation's ability to use its NOLs. Thus, United asked the district court to dismiss the appeal as moot.[36] The district court, however, continued with the appeal and affirmed the bankruptcy court's ruling on the merits. The trustee filed an appeal in the Seventh Circuit.

In the court of appeals, Judge Easterbrook vacated the district court's judgment and remanded the case to the bankruptcy court, with instructions to dismiss the appeal as moot to the extent that it blocked a sale of shares by the defunct ESOP or any of the investors who obtained stock via the ESOP.[37]

In dicta, the court chastised the bankruptcy judge for not having required adequate protection or an injunction bond, noting that United workers were left bearing illiquid securities and uncompensated risk because the injunction

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30. 928 F.2d at 569-73.

31. *Id.* at 574.

32. *Id.*

33. In re UAL Corp., 412 F.3d 775, 777 (7th Cir. 2005).

34. *Id*.

35. *Id*.

36. United's stock price decreased from $1.06 on the day of the bankruptcy court's order to $0.76 at the time the ESOP was dissolved. *See* 412 F.3d at 777.

37. *Id*. at 780.

required their holdings to be undiversified.[38] The court conceded that a stock sale could have affected United's interest in its NOL carryforwards, but added that "this would not occur because of anything the ESOP possessed or controlled."[39] The court distinguished *Prudential Lines* on this basis, noting that in the *Prudential Lines* case, the corporate parent's tax benefit "would have come in lieu of the corporate family's accumulated operating losses," and "taking the deduction would have exercised control over the debtor's operating losses."[40] In other words, apportioning the benefit was a zero-sum game. The deduction could have benefitted the debtor or its parent, but the parent controlled the choice and was entitled to capture the tax benefit for its own use by taking a worthless stock deduction.

The court remarked that in United's case "there [was] no equivalent example of control (or consumption) of a loss carry-forward in an investor's simple sale of stock."[41] Judge Easterbrook concluded that section 105(a) and section 362(a)(3) did not justify an injunction absent a bond or other adequate protection.[42]

II. DISCUSSION

Orders restricting claims trading in bankruptcy, like the orders at issue in *Prudential Lines* and *United Airlines*, raise a number of questions at the intersection of tax and bankruptcy law. This section will explore those fundamental questions before considering the implications.

A. Are NOL Carryforwards Property Of The Estate?

Although the question of whether NOL carryforwards are property of the estate was once the subject of vigorous debate,[43] creditors now generally accept the proposition without controversy.[44] NOL carryforwards are current, intangible interests. The right to use an NOL carryforward is not contingent upon the occurrence of any event, although the debtor's right may be limited in the event of an ownership change or worthless stock deduction. The tax savings available because of the NOL carryforward is contingent upon the debtor's ability to generate future income. The future tax savings are uncertain, and they depend upon the amount of future taxable income generated, the tax character of that income, and the tax rates applicable to that income.

These qualities make a debtor's NOL carryforwards similar to a debtor's chose in action, which is property of the estate. The chose in action is a current right possessed by the debtor, notwithstanding that its value is contingent upon the debtor's success in court and is uncertain, because the debtor does not know in advance the amount of the judgment that may be awarded. A modern bankruptcy judge comfortable with uncertain valuations of current property interests should have little problem finding a debtor's NOL carryforward to constitute property of the estate, especially if creditors do not contest the issue.

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38. 412 F.3d at 777–78.

39. *Id.* at 778.

40. *Id.* at 779.

41. *Id.*

42. *Id.*

43. *See, e.g., In re Prudential Lines*, 928 F.2d at 569-73.

44. *See, e.g.,* Objection of Wells Fargo Foothill, LLC, dated Mar. 31, 2009, ¶ 16, *In re Foothills Texas, Inc.*, No. 09-10452 (Bankr. D. Del. 2009).

But what does it mean to say that the NOL is estate property pursuant to section 541? Nothing in the canon of non-bankruptcy law prevents parties from taking actions that could destroy NOL value, and neither shareholders nor creditors have fiduciary duties to preserve a corporation's NOL value. Accordingly, we must ask what code provision or policy justifies expanding the debtor's interest in its NOL carryforwards within bankruptcy.[45] Many people argue that one purpose of bankruptcy is to ease a debtor's burden, but it is difficult to see the relevance of this argument. Restrictions on claims trading operate on the assumption that after the reorganization, the creditors will own at least fifty percent of the reorganized firm's equity. Given that creditors will own the firm upon reorganization in any event, restricting creditors' ability to trade claims on the front end in order to benefit them on the back end is an odd manner in which to preserve the creditors' interests. Nevertheless, this is par for the course in bankruptcy. One purpose of the automatic stay is to provide breathing room to the debtor to prevent a "tragedy of the commons" situation. Arguing that debtors' rights are not necessarily expanded based upon the filing of a bankruptcy petition might beg the question: If claims trading constitutes exercising control over property of the estate, then it violates the automatic stay, which authorizes departure from the non-bankruptcy baseline.[46] The key issue is whether claims trading constitutes "exercising control" as prohibited by section 362(a)(3).

But this is not the only way to think about the extent of a debtor's right to use NOLs to offset future income. We could differentiate between property rights that contain inherent limitations and property rights that continue until a superior right is asserted. For instance, if a debtor acquires equipment that it later pledges to secure a loan, the debtor's property right can be extinguished by the creditor's right to foreclose on the equipment in the event of a default. The security interest acts as a limitation on the debtor's interest in the equipment, but only because the creditor's adverse interest is superior to the debtor's interest. If the debtor were to file for chapter 11 relief, the automatic stay would prevent the creditor from foreclosing on the collateral. The creditor would have to petition the bankruptcy court to lift the stay and allow the creditor to seize the equipment.

Contrast the debtor's interest in the equipment with the debtor's interest in a leased warehouse. In the latter case, the right that the debtor acquires is limited. The debtor's interest in the leased warehouse ends upon expiration of the lease, and the automatic stay provides no holdover rights if the debtor refuses the vacate the premises at the end of the lease. Similarly, a debtor's insurer could not cancel an insurance policy upon the debtor's bankruptcy filing, but the automatic stay does not give the debtor the ability to force the insurer to renew the policy after it expires. These interests have inherent limitations that define the extent of the property interest conveyed to the debtor.

Is the debtor's interest in NOL carryforwards more similar to its interest in equipment subject to a security interest or its interest in a leased warehouse or an insurance contract? Because the IRC permits the unrestricted use of NOL carryforwards to offset future income until an ownership change occurs, we could view the NOL interest as having a natural expiration date akin to the leased warehouse and insurance contract, namely, the date of an ownership change. As with the lease and insurance contract, the debtor knows that the day an ownership change occurs is its day of reckoning – the day when its ability to realize fully its NOL benefits will be impaired in accordance with the terms set forth in the IRC.

Accepting this view requires accepting that the actions of other parties will determine the debtor's NOL rights. In other words, the debtor's ability to use its NOL carryforwards can be impaired by the actions of other parties, as is

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45. Butner v. U.S., 440 U.S. 48 (1979).

46. However, determining that § 382 cannot restrict a debtor's ability to use its NOL carryforwards would violate the *Butner* principle that, unless otherwise expressly provided in the Bankruptcy Code, property rights in bankruptcy are defined by non-bankruptcy law. *See id.* at 55.

the case where a secured creditor seizes pledged equipment. We might respond, however, that the debtor's NOL interest is impaired not because a creditor asserts a priming interest in the NOL, but because of the natural limitation built into the NOL right. But section 362(a)(3) reaches "*any act* … to exercise control over property of the estate," and the natural limitation of NOL rights could be triggered by creditor actions.

B. What Does It Mean To Exercise Control Over An NOL?

If the debtor's NOLs are not property of the estate, then the automatic stay does not apply to claims trading in bankruptcy. But this debate is over; NOL carryforwards are likely (and appropriately) to be viewed as property of the estate. Thus, we must next consider what actions would constitute an attempt to obtain possession or exercise control over the NOL.

1. Differing Views Of Control

We can imagine two different views of "control" over a debtor's property rights: (i) any action affecting the value of a property right constitutes control, or (ii) only actions that affect the existence of the right itself constitute control.

Debtors seeking restrictions on claims trading may advocate that actions affecting the value of the property right constitute control. This argument proves too much. If this were accepted as the governing principle, the automatic stay would reach actions by a party that reduce the value of the debtor's estate. Consider again the chose in action. If the debtor were to bring a lawsuit against the counterparty, the counterparty could respond by asserting a legal defense. The value of the debtor's claim is uncertain and depends upon the likelihood that the debtor will succeed in court. But it would be absurd to argue that the counterparty violates the automatic stay by defending itself against the claim, although its defense arguably decreases the debtor's likelihood of success and, therefore, decreases the value of the chose in action. Surely asserting a legal defense would not be considered an action to exercise control over the property of the estate.[47]

The alternative view, limiting the definition of control to acts that effectively eliminate the existence of the right itself, may be more consistent with the *Prudential Lines* decision. There, the managers of the debtor and the debtor's corporate parent threatened to take an action that would have completely eliminated the value of the debtor's NOL carryforwards.[48] This view of control is more consistent with the traditional understanding of the word, especially given that section 362(a)(3) contemplates actions "to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate."

"Obtain possession" indicates taking the whole of the property. If we were to interpret the term "exercise control" in light of the term "obtain possession," then we might define "control" as an instance where another party prevents the

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47. An opponent of this example may object that defending against a lawsuit brought by the debtor merely reduces the *expected* value of the chose in action. But when dealing with property of uncertain value, expected value is the best one can do without reliable methods for peering into the future (which itself could turn the operation of a bankruptcy proceeding on its head). In fact, the value of the debtor's NOL carryforward is itself an expected value, which must account for the likelihood of future profit, the distribution of future profit and loss, and the possibility that an ownership change will occur in the future.

48. Of course, this result only follows if the parent corporation still holds stock at the end of the parent's taxable year under a literal reading of 11 U.S.C. § 382(g)(4)(D). It appears that the parent corporation's equity interest would have been eliminated in the creditor's plan, and if the plan were confirmed before the end of the parent's taxable year, the parent would not have held any stock in PLI, potentially rendering § 382(g)(4)(D) inapplicable. As interesting as this line of thinking is, it is a difficult tax question best left for another author.

debtor from benefiting from a property interest at all. The drafters of section 362(a)(3) could easily have used the phrase "impair the value of property of the estate," but they chose to limit the stay to actions to "obtain possession" or "exercise control." Of the two views of control, this interpretation is superior because it avoids the absurdity created by an automatic stay that prevents any party from doing anything that might impair the value of the debtor's property.

2. Considering Individual And Aggregate Claims

In defining what it means to "exercise control" over property, we could make a distinction between trades or traders that could threaten the NOL benefit by themselves and those that could not. In other words, "control" could become a proxy for "autonomy", which, in turn, would preclude claims trading only where it involves large claimholders that could independently threaten the debtor's NOLs.[49]

But if the automatic stay applies to claims trading, should it not apply to all parties, regardless of the size of their interests?[50] Not necessarily, as the relevant provision refers to actions "to exercise control over property of the estate." Accordingly, by limiting the concept of control, we limit the applicability of the automatic stay to parties capable of exercising such control. One problem here is that the automatic stay would not be "automatic"—the bankruptcy court would have to define who is a "large" claimholder and what constitutes a "large" claim sufficient to satisfy the meaning of control. Admittedly, this might be a simple process, but requiring a first day order to define the scope of the automatic stay may make some judges and practitioners uncomfortable. Declining to define control in terms of large trades or large claimholders avoids these issues, for better or worse.

3. Is It Impossible For Claims Trading To Violate The Automatic Stay?

Technically, trading in equity sufficient to constitute an ownership change triggers a section 382 NOL limitation, but trading debt does not. It is the subsequent exchange of debt for equity pursuant to a plan of reorganization that triggers the section 382 limitation, and claims trading merely eliminates the possibility of qualifying for the (L)(5) Exemption. It may be more accurate to think of claims trading as limiting the reorganization options available for the managers of the debtor rather than as impairing the value of the debtor's NOLs.[51]

This understanding would imply that claims trading does not violate the automatic stay unless actions limiting the debtor's ability to propose a plan of reorganization constitutes an act of control over property of the estate. Here, the only way to justify the stay would be to conclude that the debtor's exclusive ability to propose a plan of reorganization

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49. This author uses the term "controlling shareholders" to refer to shareholders who hold enough stock to independently dictate the management of a company. The relationship between the parent and the wholly-owned subsidiary in *Prudential Lines* fits this model of control. One normally does not consider minority shareholders to exercise control when they vote their shares independently. Although minority shareholders can influence the outcome of a shareholder election if enough of them vote similarly, absent coordination, the law does not consider such shareholders to "control" the corporation.

50. In fact, it is difficult to classify many orders restricting claims trading as orders enforcing the automatic stay. To the extent that the orders allow for some trades to be completed, the orders may be thought of as partially lifting the automatic stay. The BMA-LSTA Model NOL Order adopts a "sell down" approach, requiring claims traders to unwind certain trades if and when the debtor proposes a plan of reorganization relying upon the bankruptcy exception to the NOL limitation rule. This approach tentatively and partially lifts the automatic stay to allow trades that would otherwise have been prohibited by the stay.

51. That is, the debtor is unable to propose a plan that contemplates the unrestricted ability of the reorganized debtor to use NOL carryforwards to offset future income.

pursuant to section 1121(b) is itself a property right of the debtor and that claims trading would deprive the debtor of this right. Thus, we must examine whether the section 1121(b) right constitutes "property of the estate" as defined by section 541.[52]

By its nature, the section 1121(b) right is one conferred by statute and held by the debtor upon the filing of a chapter 11 case. Thus, it may be appropriate to consider the section 1121(b) right as property of the estate. But even assuming that the right constitutes property of the estate, the relevant question is whether an act that limits the debtor's options when proposing a plan would constitute exercising control over the section 1121(b) right for purposes of section 362(a)(3). Federal Rule of Bankruptcy Procedure 3001 suggests that it would not.

Given that Rule 3001(e) contemplates a limited role for judicial involvement in claims transfers, it would be odd if the drafters of the Rule considered claims trading to be a violation of the automatic stay. Rule 3001(e) was last amended on April 30, 1991, just over one month after *Prudential Lines* was decided. It is thus very likely that the drafters of the amended Rule failed to consider the reasoning in that case. It would be premature to reject restrictions on claims trading by arguing that such restrictions are incompatible with Rule 3001(e). Such an argument on its own would be insufficient to support that conclusion. But the existence of Rule 3001(e), and the fact that it has not been amended to allow for greater judicial involvement in claims trading, does lend some support to the argument that claims trading should not be considered a violation of the automatic stay.

Although the preceding analysis does not present any clear answer, it would appear that, on the whole, claims trading should not be considered an activity that rises to the level of exercising control over the debtor's NOL carryforwards, and the automatic stay should not inhibit creditors' ability to trade claims in bankruptcy.

C. Is It Possible To Reconcile *Prudential Lines* With The View That The Automatic Stay Does Not Apply To Claims Trading?

Creditors and judges who are satisfied that claims trading does not violate the automatic stay should consider whether that conclusion is reconcilable with the Second Circuit's *Prudential Lines* decision, which governs all cases in the Second Circuit, including those in the Southern District of New York, one of the nation's busiest bankruptcy venues.

1. Limiting *Prudential Lines* To Its Facts

Prudential Lines does rest on a unique set of facts giving rise to a unique problem. The subsidiary was wholly-owned by the parent. Both the parent and subsidiary were managed and controlled by one family. The parent threatened to take a worthless stock deduction in the context of competing battle plans between management and the creditor's committee, with the relevant IRC provision, section 382(g)(4)(D), used as a weapon in that battle. The tax benefit was a binary option that would either allow the parent to use the worthless stock deduction to decrease its tax bill or allow the debtor subsidiary to use the NOL to offset future income. Thus, *Prudential Lines* could be limited to its facts. But analyzing the case with an eye upon the interplay among insiders, creditors, and leverage in the reorganization process may reveal a better reason for limiting the reach of *Prudential Lines*.

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52. The Supreme Court has stated that the § 1121(b) exclusivity rule is not property for purposes of § 1129(b)(2)(B)(ii). *See* Bank of Am. Nat'l Trust and Sav. Ass'n v. 203 N. LaSalle St. P'ship, 526 U.S. 434, 454 (1999).

2. Creditor Protection Against Insiders

Prudential Lines can be viewed as a case where the court was driven by concerns about creditor protection in the face of insider-shareholders seeking to retain control after the reorganization. In *Prudential Lines*, the insider-shareholders' threat to take the worthless stock deduction appeared to be an attempt to pressure creditors into accepting management's plan, which would have allowed the controlling family to retain control of the debtor corporation. Allowing the corporate parent to take the worthless stock deduction would have increased management's negotiating leverage and helped management retain control of the corporation after driving it into bankruptcy. Modern cases authorizing restrictions on claims trading do not operate for the protection of the creditors, but, rather, permit management to retain control of the reorganization process. Specifically, claims trading prevents outside investors and large claimholders from increasing their leverage in the reorganization process vis-à-vis management by "voting with their feet" or by meaningfully increasing their participation within a class of claims by increasing their holdings. This outcome is in direct conflict with the result in *Prudential Lines*, where the court prevented management from using the NOL as a trading chip in reorganization negotiations.

If we read the underlying theme in *Prudential Lines* as one of viewing insiders' actions with skepticism and suspicion, the case becomes consistent with other aspects of bankruptcy law. For example, the policy debate and case law developments that ultimately led courts to adopt the absolute priority rule over relative priority was driven by the mistrust of managers who drove their firms into bankruptcy.[53] In addition, the Bankruptcy Code itself treats insiders with suspicion, providing lesser protections for employee bonuses and transfers to insiders.[54] Regardless of whether the automatic stay was the best tool for the Second Circuit to use to protect creditors, courts could certainly read *Prudential Lines* as an equity-based decision, designed to prevent insiders from using coercive tactics in the reorganization process and not as justification for restricting claims trading.

III. IMPLICATIONS

The decision whether to restrict claims trading or to allow for the free transfer of claims against debtors has broad implications for the entire field of corporate reorganizations and distressed debt investors.

A. Preserving Asset Value

We might ask whether claims trading is the kind of destructive race to the debtor's assets that the automatic stay seeks to prevent. The threat to NOL value posed by the collective action problem is at least similar to such a race. Prohibiting claims trading may preserve the size of the pie available to creditors to distribute in the reorganization plan, but it is certainly different from foreclosing on collateral. Collateral provides immediately ascertainable value to the estate, whereas NOLs carry value that is both uncertain and contingent. Additionally, we may presume that collateral has synergy value in the hands of the debtor. Although NOLs do not have synergistic value in the traditional sense—that is, NOL value is not dependent upon the debtor firm possessing a unique collection of assets and skills—NOL carryforwards do have going concern value in that they have no value once removed from the debtor corporation.[55]

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53. For an excellent discussion of the issue see Douglas G. Baird and Robert K. Rasmussen, *Boyd's Legacy and Blackstone's Ghost*, 1999 Sup. Ct. Rev. 393 (1999).

54. 11 U.S.C. §§ 547(b)(4)(B), 548(a)(1)(B)(IV).

55. The NOL tax attribute is unique to the taxpayer and is non-transferable.

Liquidity is also an important consideration. When one creditor trades its claim, that trade does not impair the value of the other creditors' claims. Rather, claims trading by one creditor probably increases the value of the other creditors' claims, because claims trading implies that claims are liquid assets. Investors are willing to pay more for liquid assets. Thus, claims trading by one creditor may make it easier for other creditors to also trade their claims. This is not the case where an unsecured creditor levies on certain assets of the debtor corporation; once one creditor has foreclosed on collateral, other creditors are unable to collect against that collateral. In the foreclosure realm, one creditor cannot do what it wants to do without making it harder for other creditors to take the same action. Accordingly, a decision to restrict claims trading represents a decision to put the long-term prospective value of the estate ahead of the ability of the creditors to realize short term gains.

But why force creditors to wait for a recovery that may or may not be increased by the NOL when their recovery can be maximized now? The automatic stay is part of a larger system designed to determine whether the greatest value may be realized by reorganizing or liquidating the debtor firm. One reason this is important is because it maximizes the value available to repay the debtor's many creditors. Restricting claims trading and forcing creditors to participate in the entire bankruptcy seems to be at odds with the purpose of preserving going concern value for the benefit of creditors. In the absence of trading restrictions, creditors can realize the value of their claims immediately by selling the claim to another party or can wait to receive consideration in a court approved reorganization. Restricting claims trading maximizes creditor value at the reorganization stage at the expense of creditor value in the early stages of the bankruptcy process.

B. Injunctive Relief As An Alternative

Even if the automatic stay does not prevent claims trading, however, creditors may face another obstacle. A bankruptcy court could issue an injunction restricting or prohibiting claims trading during the reorganization process.[56]

1. Full Consideration Of The Debtors' Options

There are several factors that a bankruptcy court should consider when assessing a motion to enjoin claims trading. The first is the value of the NOL. Bankruptcy courts should determine whether the debtor has fully considered and properly valued all of the debtors' options. Although debtors' motions and briefs speak of NOL tax benefits as though they were an all or nothing affair, this simply is not the case. And, if the court is going to require debtors to participate in the entire bankruptcy, it should require them to show that they have fully considered the effects and applicability of sections 382(l)(5) and (l)(6) of the IRC. Specifically, if the debtor fails to qualify for the (L)(5) Exception, how much of the NOL tax benefit would it lose under the section 382 limitation computed with the (L)(6) Special Valuation Rule?

In arriving at a valuation of the NOL tax benefits under the (L)(5) Exception and the (L)(6) Special Valuation Rule, debtors should consider the "bankruptcy toll charge",[57] the present value of future tax benefits, the likelihood and

56. Aside from the procedural differences between the automatic stay and injunctive relief, one difference resulting from requiring injunctive relief may be that the debtor's management may not bother petitioning for injunctive relief restricting claims trading if preliminary relief is not granted early in the bankruptcy proceeding. The debtor will presumably have to expend some non-negligible amount of time and effort in order to properly prepare the necessary showing of harm, and the debtor may rationally decide that the costs outweigh the benefits. Sufficient trading may have occurred by the time the parties have prepared for a hearing to make the issue moot. The numerous issues facing a court considering whether to grant an injunction against claims trading illustrates the substantive and procedural difficulties of the task.

57. Recall that § 382(l)(5)(B) requires the debtor using the (L)(5) Exception to reduce its NOL carryforwards by the amount of deductible interest paid or accrued on debt converted to equity through the reorganization during the three taxable years prior to the reorganization, as well as any interest paid or accrued during the taxable year in which the reorganization takes place. *See supra* note 12 and accompanying text.

timing of future profitability, and the likelihood that an ownership change will occur during the two years subsequent to the reorganization. If the interest toll charge is high, the debtor may be better off not making an (l)(5) election and instead relying on the (L)(6) Special Valuation Rule, which does not reduce the debtor's NOL carryforward.[58] The debtor's ability to use NOL carryforwards in a given taxable year is limited by section 382 or the amount of taxable income of the reorganized corporation. It may not matter that the debtor fails to qualify for the (L)(5) Exception if future annual profits are not expected to be greater than the amount of the section 382 limitation under the (L)(6) Special Valuation Rule.[59] Additionally, if there is an ownership change during the two years after a reorganization that qualifies for the (L)(5) Exception, the reorganized debtor will forfeit its ability to carryforward its pre-reorganization NOLs. However, the same ownership change occurring after a reorganization that fails to qualify for the (L)(5) Exception but that uses the (L)(6) Special Valuation Rule will not cause the debtor to lose its ability to use pre-reorganization NOL carryforwards to offset future income.[60]

Although this analysis relies on financial forecasts and the expected outcome of the reorganization, at the very least, it provides a check on the increasingly routine impulse to restrict claims trading, and the analysis may reveal that the effect is not always as drastic as the debtor claims.

2. Balancing Harms

Once the court is aware of how much money is at stake if the debtor fails to qualify for the (L)(5) Exception, the court will be better able to balance the harms that may result from issuing or declining to issue an injunction restricting claims trading.[61] We might ask whether the gains from preserving the (L)(5) Exception outweigh the losses from illiquidity suffered by the claims holders. If the benefit of restricting claims trading to permit the debtor to qualify for the (L)(5) Exception outweighs the creditors' losses due to illiquidity, then the court might ask the debtor to "put its money where its mouth is" and post an injunction bond to compensate the creditors for the devaluation of their claims.[62] If the injunc-

58. Assume the debtor has an unexpired $100 million NOL carryforward, but if § 382(l)(6) applies (because the (L)(5) exception is unavailable), the debtor would only be able to use the NOL to offset $20 million in income per year for the next five years. If the debtor paid $25 million in interest per year for each of the past three years to creditors who become equity holders in the reorganization, the debtor's NOL would be reduced to $25 million. If the debtor qualifies for the (L)(5) Exception, it could use all $25 million to offset income in its first year. This benefit may be less valuable than the ability to deduct up to $20 million per year for the next five years under § 382(l)(6).

59. Assume that a reorganized debtor will have a $50 million NOL if it qualifies for the (L)(5) Exception, but would be limited to $10 million per year for the next 10 years if it fails to qualify for the (L)(5) Exception. If the expected taxable income of the debtor is between $8 million and $10 million for each of the next five years, then the (L)(5) Exception reduces the value of the debtor's NOL tax benefit.

60. However, a change in ownership would still trigger the usual § 382 limitation.

61. Whether the harm to the debtor would be irreparable is an interesting question. Any harm would be monetary (the loss of a tax benefit), but courts would run into real trouble apportioning blame among creditors. Any exercise in attempting to do so may be futile, because the reorganized firm, owned by the former creditors and investors who purchased claims, would be collecting any judgment from the former creditors. Furthermore, would the reorganized debtor, owned by the former creditors, bring a cause of action suing for lost NOL tax benefits? Does a corporation even have standing to sue creditors for a lost NOL tax benefit? And, if the corporation does not have that right, why should a court issue an injunction in the first instance?

62. The Model NOL Order and other recent orders generally do not impose a flat prohibition on all claims trading. The orders often contemplate a "sell down" mechanism or advance notice procedure that technically permits claims trading to continue, although with a much later and riskier close. If there is a market for claims against the debtor, the court could compare the price of the claims before the injunction to the post-injunction price as a very rough proxy for a liquidity premium.

tion is Kaldor-Hicks efficient, then a bond would be an effective mechanism for the winners to compensate the losers in a transaction that would approximate what we would expect outside of bankruptcy.[63]

C. Creating Robust Markets For Claims Trading

A robust market for claims trading can efficiently move claims from creditors to parties who place higher values on the claim. Such markets give creditors the ability to opt out of the uncertainty and expense of a bankruptcy proceeding and receive cash more quickly. Claims trading allows creditors to shift the risk associated with holding distressed debt to firms and investors who are better able to manage the risk. Liquid claims markets not only benefit creditors and distressed debt investors, but should also benefit debtors. Sophisticated creditors who realize that their claims will be illiquid in bankruptcy will charge higher interest rates on loans.

Prohibitions on claims trading obviously decrease the robustness of distressed debt markets, but prohibitions are not the only judicial actions that could impair liquidity. Restrictions short of prohibition, such as orders that contemplate requiring "sell-downs" in the event that the debtor proposes a plan relying on the (L)(5) Exception or requiring lengthy notice, can also introduce a great deal of uncertainty into the market for a debtor's claims. It is possible that such restrictions could operate as *de facto* prohibitions that freeze claims trading markets. Sophisticated parties will generally be able to order their affairs if given clear rules in advance, but courts should be aware of how the rules they set will reorder the behavior of market participants.

IV. CONCLUSION

Bankruptcy judges are likely to see a growing number of debtor motions seeking to restrict claims trading to preserve NOL value during the next large wave of chapter 11 filings. Although a debtor's interest in NOL carryforwards should be considered property of the estate under section 541's expansive definition, the concept of exercising control under section 362(a)(3) should not be extended to apply to claims trading. A broad reading that applies section 362(a)(3) to any action that could affect the expected value of property of the bankruptcy estate would expand non-bankruptcy rights in a manner inconsistent with the Bankruptcy Code. Courts should reject this interpretation and deny debtor motions to restrict claims trading in order to preserve NOL value. Courts should limit the scope of the *Prudential Lines* decision to situations where insider-shareholders threaten NOL value in order to improve negotiating leverage vis-à-vis creditors in a bankruptcy proceeding.

Declining to extend the operation of the automatic stay has several benefits. It serves to protect a robust market for claims trading, which allows creditors to effectively opt out of the bankruptcy process and shift the risk of holding claims against a debtor in a chapter 11 proceeding to parties that are better able to bear the risk. Because claims trading does not create the same collective action problem brought about by the traditional creditors' race to the debtor's assets, the automatic stay is not needed to preserve the debtor's synergy value. Where restricting claims trading is desirable,

63. *In re UAL*, 412 F.3d at 778. An action may be described as "Kaldor-Hicks efficient" if "the winners from a possible policy change could [(hypothetically; actual compensation is not required)] compensate the losers from the change enough so that the losers would be indifferent between the status quo, on one hand, and the world of the new policy plus the compensation, on the other, while leaving the winners enough benefits left over that they still prefer their new (winning) status." David A. Hoffman & Michael P. O'Shea, *Can Law and Economics Be Both Practical and Principled?*, 53 Ala. L. Rev. 335, 358 (citing Herbert Hovenkamp, *Legislation, Well-Being, and Public Choice*, 57 U. Chi. L. Rev. 63, 64-67 (1990) and Matthew D. Adler & Eric A. Posner, *Rethinking Cost-Benefit Analysis*, 109 Yale L.J. 165, 190-91 (1999)).

injunctive relief provides a better mechanism for implementing restrictions because it requires and allows for a fuller examination of the value of the debtor's various options, including the special valuation rule of section 382(l)(6) of the Internal Revenue Code.