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SELECTED SECURITIES ISSUES FOR PUBLICLY HELD DEBTORS

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I. INTRODUCTION

The vast majority of time and effort in a Chapter 11 case is spent negotiating a financially viable debt structure, rationalizing operations by jettisoning unprofitable assets and businesses, rejecting disadvantageous contracts and leases, and confirming and consummating a plan incorporating these business decisions and strategies. Title 11 of the United States Code provides the bulk of the legal framework for this process. However, debtors whose debt and/or equity securities are publicly held (or who plan to issue such securities as part of their reorganizations) also must be conversant with (i) the financial and tax impact of continued postpetition trading in their securities and (ii) the requirements of the U.S. securities laws and the extent to which they are applicable notwithstanding the filing of a Chapter 11 case.

The purpose of this outline is to flag for restructuring lawyers selected securities-related issues that may arise in a Chapter 11 case involving a debtor with publicly-held securities so that they can consult with appropriate legal experts if need be. This outline is *not* a substitute for consultation with attorneys whose expertise is in the area of securities or tax law.

II. DISCLOSURE OBLIGATIONS

A. Disclosure Duties of Public Companies Contemplating Filing for Chapter 11

1. Financially troubled public companies[1] face an inherent tension between complying with the securities laws' disclosure and reporting requirements and avoiding disclosure of information that may result in suppliers withholding credit or customers delaying ordinary course payments, thereby aggravating the company's financial distress and impeding its ability to effectuate an out-of-court workout or a controlled descent into Chapter 11.[2]

2. Nevertheless, such companies must continue to comply with the securities laws' disclosure and reporting requirements.[3] Failure to comply can subject a public company to an investigation by the U.S. Securities and

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[1] "Public companies" means companies that are required to file current and periodic reports with the U.S. Securities and Exchange Commission pursuant to Sections 13(a) or 15(d) of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a to 78oo, because they have (i) securities listed on a national securities exchange, (ii) securities registered under Section 12(g) of the Securities Exchange Act of 1934, 15 U.S.C. § 78*l*(g), or (iii) a registration statement that has become effective under the Securities Act of 1933, 15 U.S.C. §§ 77a to 77aa. *See* 15 U.S.C. §§ 78m(a) (Section 13(a)), 78o(d) (Section 15(d)).

[2] *See A Practical Guide to Out-of-Court Restructurings and Prepackaged Plans of Reorganization* § 2.06, at 2-20 to 2-21 (Nicholas P. Saggese & Alesia Ranney-Marinelli eds., 2d ed. Supp. 2000) [hereinafter Saggese & Ranney-Marinelli].

[3] R. Scott Falk et al., *Chapter 11 and Securities Laws*, Am. Bankr. Inst. J., Dec./Jan. 2007, at 36.

Exchange Commission (the "SEC"), resulting in civil or criminal penalties, thereby aggravating the Company's liquidity and other problems.[4]

3. The Securities Exchange Act of 1934 (including rules and regulations promulgated thereunder, the "Exchange Act")[5] requires public companies to file with the SEC periodic and special event reports on a timely basis (*i.e.*, 10-Ks, 10-Qs, and 8-Ks).[6]

4. The SEC attempts to assure accuracy, completeness, and uniformity by requiring that reported data be provided on specific forms, including:[7]

    - Form 10-K for annual reports
    - Form 10-Q for quarterly reports
    - Form 8-K for reporting of significant events occurring between the periodic reports.

5. The narrative sections of Form 10-K and Form 10-Q require disclosure of specified facts, events, or trends as described in detail by Regulation S-K.[8] Regulation S-K (17 C.F.R. Part 229) provides instructions for filing forms under the Exchange Act.[9]

6. A critical part of the SEC periodic filings is "Management's Discussion and Analysis of Financial Condition and Results of Operation" ("MD&A"), a section of both Form 10-K annual reports and Form 10-Q quarterly reports mandated by Item 303 of Regulation S-K.[10]

    (a) The purpose of MD&A is to provide investors with information relevant to an assessment of the financial condition and results of operations of the filing company.[11] The SEC has stated that "'MD&A is intended to give the investor an opportunity to look at

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4 *Id.*

5 15 U.S.C. §§ 78a to 78oo.

6 *See* 15 U.S.C. §§ 78m, 78o(d).

7 SEC public forms and many of the rules, regulations, and schedules associated with these forms can be viewed in PDF format through the links provided in the SEC's Forms List, available on the SEC's website at http://www.sec.gov/about/forms/secforms.htm.

8 Falk et al., *supra* note 3, at 36.

9 *See* 17 C.F.R. §§ 229.10 to 229.1123 (Part 229–Regulation S-K). Regulation S-K may be accessed on the SEC's website at http://www.sec.gov/divisions/corpfin/ecfrlinks.shtml.

10 17 C.F.R. § 229.303; *see also* Falk et al., *supra* note 3, at 36.

11 17 C.F.R. § 229.303(a) Instructions to paragraph 303(a), ¶ 2.

the company through the eyes of management by providing both a short and long-term analysis of the business of the company.'"[12]

(b) Paragraph (a) of Item 303 of Regulation S-K sets forth the paramount disclosure requirement of MD&A: to "provide such other information that the registrant believes to be necessary to an understanding of its financial condition, changes in financial condition and results of operations," which is in addition to detailed disclosure on the company's liquidity, capital resources, results of operations, off-balance sheet arrangements, and contractual obligations.[13] The SEC has stated that particular emphasis should be placed on disclosure regarding the company's future prospects.[14]

7. Disclosure is mandatory where a known trend or uncertainty is "reasonably likely to have a material effect" on the company's financial condition or results of operations.[15]

(a) Paragraph (a)(1) of Item 303 of Regulation S-K requires management to identify "any known trends or any known demands, commitments, events, or uncertainties" that are reasonably likely to result in the company's liquidity increasing or decreasing in a material way.[16] The "reasonably likely" standard is a lower threshold than a "more likely than not" standard. Thus, disclosure could be required even if the likelihood of a material adverse liquidity change is less than 50 percent.[17] If a material liquidity deficiency is identified, management also must disclose its proposed course of action to remedy the situation. This disclosure obligation can potentially prejudice the company's restructuring negotiating strategy with its creditors.[18]

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[12] Commission Statement About Management's Discussion and Analysis of Financial Condition and Results of Operations, Securities Act Release No. 8056, Exchange Act Release No. 45,321, 67 Fed. Reg. 3746, 3747 (Jan. 25, 2002) [hereinafter Commission Statement About MD&A] (quoting Concept Release on Management's Discussion and Analysis of Financial Condition and Results of Operations, Securities Act Release No. 6711, Exchange Act Release No. 24,356, 52 Fed. Reg. 13,715, 13,717 (Apr. 17, 1987)).

[13] 17 C.F.R. § 229.303(a).

[14] Commission Statement About MD&A, 67 Fed. Reg. at 3747.

[15] *Id.*

[16] 17 C.F.R. § 229.303(a)(1).

[17] Commission Statement About MD&A, 67 Fed. Reg. at 3748; Falk et al., *supra* note 3, at 36.

[18] Falk et al., *supra* note 3, at 36.

(b) Paragraph (a)(2) of Item 303 of Regulation S-K requires management to describe any known material trends, favorable or unfavorable, in the company's capital resources, including any expected material changes between equity, debt, and any off-balance sheet financing arrangements.[19] One commentator has noted that "[t]hese changes can include not only additional borrowings but also changes in debt equivalents, such as increases in accounts payable, a short-term financing technique frequently utilized by financially distressed companies."[20]

(c) For companies that are, or are reasonably likely to be, in breach of debt covenants, management also must disclose material information about the breach and analyze the impact on the company if material.[21] This analysis should include the steps the company is taking either to avoid or cure the breach, the reasonably likely impact of the breach (including the effects of any cross-default or cross-acceleration) on financial condition or operations, and alternative sources of funding.[22] In addition, if existing debt covenants limit, or are reasonably likely to limit, a company's ability to undertake additional debt or equity financing to a material extent, the company must discuss the covenants and the consequences of such limitation to the company's financial condition and operating performance.[23]

(d) The company must file a Form 8-K within four days following the occurrence of a triggering event that causes an increase or acceleration of a direct financial obligation and the consequences of the event are material to the company.[24] The company must disclose as described in Item 2.04 of Form 8-K the triggering event, the increase in such obligation, and any other obligation that may

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[19] 17 C.F.R. § 229.303(a)(2)(ii).

[20] Falk et al., *supra* note 3, at 94.

[21] Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations, Securities Act Release No. 8350, Exchange Act Release No. 48,960, 68 Fed. Reg. 75,056, 75,064 (Dec. 29, 2003).

[22] *Id.*

[23] *Id.*

[24] *See* SEC Form 8-K, Current Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934, General Instructions para. B(1), *available at* http://www.sec.gov/about/forms/form8-k.pdf. Forms 10-K are required to be filed 90 days after the end of the fiscal year covered by the report, except for large accelerated filers and accelerated filers (as such terms are defined in Rule 12b-2 of the Exchange Act, 17 C.F.R. § 240.12b-2), in which case Forms 10-K are required to be filed 60 and 75 days, respectively, after the end of the fiscal year covered by the report. *See* 17 C.F.R. § 249.310(b).

arise, increase, or be accelerated as a result of the triggering event.[25]

8. Companies that fail to meet their disclosure obligations risk enforcement action by the SEC.[26] Thus, while distressed companies may be wary of causing suppliers and other vendors to cease providing credit, they must continue to meet disclosure obligations under the Exchange Act.

B. Disclosure Obligations for Public Companies in Chapter 11

1. SEC Reporting Requirements

Public companies that file for Chapter 11 must continue to comply with all reporting obligations under the Exchange Act.[27] "Neither the United States Bankruptcy Code nor the federal securities laws provide an exemption from Exchange Act periodic reporting for issuers that have filed for bankruptcy."[28] Thus, absent the granting of a modification or waiver of the Exchange Act reporting requirements by the SEC (s*ee* Part II.B.3. *infra*), a public company in Chapter 11 must continue to file Forms 10-K, 10-Q, and 8-K on a timely basis.

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[25] *See* Form 8-K, Current Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934, Information to Be Included in the Report, Item 2.04(a), *available at* http://www.sec.gov/about/forms/form8-k.pdf; Falk et al., *supra* note 3, at 94.

[26] The SEC may (i) initiate a judicial proceeding to impose civil penalties against the violating company or its officers and (ii) seek to bar individual executives who have violated certain sections of the Exchange Act from ever again acting as officers or directors of a public company. *See* 15 U.S.C. § 78u. For example, in 2005, as a result of misleading explanations in the MD&A section of the company's Form 10-Q filing, the SEC initiated proceedings against the former CEO and CFO of Kmart Corp., requesting permanent injunctions, disgorgement with prejudgment interest, civil penalties and a bar on the pair ever again serving as officers or directors of a public company. *See* Press Release, SEC, SEC Charges Kmart's Former CEO and CFO with Financial Fraud (Aug. 23, 2005), *available at* http://www.sec.gov/news/press/2005-119.htm. In 2006, the district court denied the defendants' motion to dismiss the SEC complaint. *SEC v. Conaway*, No. 05-40263, 2006 WL 2828569 (E.D. Mich. Sept. 29, 2006). Based on the court docket, the case remains open.

The new head of the SEC, Mary Schapiro, has vowed to revitalize the SEC's enforcement efforts and to bolster investor protection by removing barriers to initiating proceedings. In her first public address as SEC chairman, Schapiro stated that she was ending (i) a two-year policy requiring agency enforcement attorneys to obtain approval from the commissioners before negotiating fines and penalties with companies accused of securities fraud and (ii) full review at a meeting by all commissioners of formal orders of investigation. *See* Mary L. Schapiro, Chairman, SEC, Address at PLI's "SEC Speaks in 2009" Program (Feb. 6, 2009), *available at* http://www.sec.gov/news/speech/2009/spch020609mls.htm.

[27] *See* SEC Staff Legal Bulletin No. 2, 1997 SEC No-Act. LEXIS 538, at *2-3 (Apr. 15, 1997) [hereinafter Staff Legal Bulletin No. 2].

[28] Staff Legal Bulletin No. 2, 1997 SEC No-Act. LEXIS 538, at *2-3 (footnote omitted).

2. Events Triggering SEC Reporting Requirements During a Chapter 11 Case

(a) Within four business days after filing a bankruptcy petition, a company must file a Form 8-K with the SEC, disclosing basic information about the case (*i.e.*, case number, court, filing date, officers appointed).[29] Public companies usually issue a press release containing that information simultaneously with the bankruptcy filing, and then attach the press release as an exhibit to the Form 8-K.[30]

(b) Other triggering events that will require filing of a Form 8-K during the course of a Chapter 11 case include events such as the disposition of a significant percentage of assets, the departure of directors or principal officers, the election of new directors, the appointment of new principal officers, appointment of a trustee or examiner, the taking of an accounting charge for the impairment of assets, or the receipt of a notice of a delisting.[31] A Form 8-K must be filed within four business days after the occurrence of any of these events.[32]

(c) Within four days after entry of an order confirming a plan of reorganization (a "Chapter 11 plan"), the company must file a Form 8-K setting forth (1) the identity of the court; (2) the date the confirmation order was entered; (3) a summary of material terms of the Chapter 11 plan, together with a copy of the Chapter 11 plan as confirmed; (4) the number of shares or units of the debtor or its

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[29] *See* SEC Form 8-K, General Instructions, *supra* note 24, para. B(1); SEC Form 8-K, Information to Be Included in the Report, *supra* note 25, Item 1.03(a); *see also* David J. Barton, *SEC Disclosure, Filing Requirements for Public Companies in Chapter 11*, J. Corp. Renewal, Jan. 2009, at 12, *available at* http://www.turnaround.org/Publications/Articles.aspx?objectID=10450.

[30] Barton, *supra* note 29, at 12.

[31] *See id*. at 13; *see also* SEC Form 8-K, Information to Be Included in the Report, *supra* note 25, Items 2.01, 2.06, 3.01, 5.02. Under Item 8.01 of Form 8-K, the company may, at its option, disclose any events, with respect to which information is not otherwise called for by Form 8-K, that the company deems of importance to securityholders. *See* SEC Form 8-K, Information to Be Included in the Report, *supra* note 25, Item 8.01. The filing of a motion to appoint a trustee or an examiner or court approval of a debtor's disclosure statement may be such events. Because the disclosure statement may contain newer and/or updated information than that contained in previous SEC filings, a debtor would be well advised to file the court-approved disclosure statement with the SEC in a Form 8-K upon approval of the disclosure statement by the bankruptcy court and before beginning solicitation. Barton, *supra* note 29, at 13.

[32] *See* SEC Form 8-K, General Instructions, *supra* note 24, para. B(1). All mandatory Form 8-K filings must be made within four business days of the triggering event, with the exception of those filed in order to disclose nonpublic information required by Regulation FD (17 C.F.R. Part 243), 17 C.F.R. §§ 243.100 to 243.103. *See* Part II.C. *infra* for a discussion of Regulation FD.

parent issued and outstanding, the number reserved for future issuance in respect of allowed claims and interests, and the aggregate total of such numbers; and (5) information as to the assets and liabilities of the debtor or its parent as of the date that the order confirming the Chapter 11 plan was entered, or a date as close thereto as practicable.[33]

3. Request for Waiver or Modification of SEC Reporting Requirements

(a) Neither federal securities laws nor the Bankruptcy Code provide an exemption from the Exchange Act reporting requirements for public companies in Chapter 11. Moreover, the SEC has emphasized the importance of Exchange Act reporting in preserving free, fair, and informed securities markets. However, under certain limited circumstances, the SEC permits companies that are subject to the jurisdiction of the bankruptcy court to file reports that differ in form or content from those normally required to be filed under the Exchange Act.[34] Before adopting these modified reporting requirements, the company must first submit a no-action request to the SEC. In the request, the debtor must "present a clear demonstration of its inability to continue reporting, its efforts to inform its security holders and the market, and the absence of a market in its securities."[35] The request must be filed "promptly" after the filing of the bankruptcy petition – *i.e.*, before the date the debtor's first periodic report is due following the debtor's bankruptcy filing.[36]

(b) In deciding whether to accept modified Exchange Act reports, the SEC considers the following four criteria: (1) the issuer's difficulty in obtaining the information necessary to complete the reports; (2) the issuer's financial condition; (3) the issuer's efforts to advise its security holders and the public of its financial condition and activities (including its prior record of Exchange Act filings and whether it timely filed a Form 8-K announcing the bankruptcy

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[33] *See* SEC Form 8-K, General Instructions, *supra* note 24, para. B(1); SEC Form 8-K, Information to Be Included in the Report, *supra* note 25, Item 1.03(b).

[34] Application of the Reporting Provisions of the Securities Exchange Act of 1934 to Issuers Which Have Ceased or Severely Curtailed Their Operations, Exchange Act Release No. 9660 (June 30, 1972); Staff Legal Bulletin No. 2, 1997 SEC No-Act. LEXIS 538, at *2-3.

[35] Staff Legal Bulletin No. 2, 1997 SEC No-Act. LEXIS 538, at *4.

[36] *Id.* at *9.

filing); and (4) the nature and extent of trading in the issuer's securities.[37]

(c) If no-action relief is granted, the SEC usually will accept in lieu of Form 10-K and Form 10-Q filings the monthly operating reports that debtors are required to file with the bankruptcy court under Rule 2015 of the Federal Rules of Bankruptcy Procedure.[38] Generally, the debtor must file each monthly operating report with the SEC on a Form 8-K within 15 calendar days after the date the monthly report must be filed with the bankruptcy court. It is important to note that the relief given by the SEC only applies to the filing of Forms 10-K and Form 10-Q. The debtor still must comply with all of its other obligations under the Exchange Act, including the filing of Forms 8-K with respect to any material events that occur during the Chapter 11 case.[39]

(d) Based on the restrictive criteria for modified reporting, relief generally is limited to a company that either is liquidating its operations as part of the bankruptcy case or has an extremely limited market for its securities. A company that has significant ongoing operations with prospects of reorganizing is unlikely to be granted modified reporting relief.[40]

(e) Illustrative "No-Action" Responses by the SEC

(i) *Genesee Corporation*. SEC granted relief from periodic reporting requirements to Genesee Corporation ("Genesee"). In doing so, the SEC noted that (1) Genesee was current in its reporting obligations under the Exchange Act, (2) there was no trading in its securities, (3) its

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[37] *Id*. at *3. *See generally id.* at *4-9 (providing guidance with respect to each factor the SEC Staff considers in making its determination.) Whether there is an active market for the debtor's securities appears to be the factor given the most weight by the SEC. The SEC takes the position that if the debtor's securities trade on a national securities exchange or the Nasdaq stock market, that fact alone will cause the SEC to deny a debtor's request for modified reporting obligations. *See id.* at *7.

[38] *Id.* at *10; *see also See* Fed. R. Bankr. P. 2015(a) ("A trustee or debtor in possession shall . . . (5) in a Chapter 11 reorganization case, on or before the last day of the month after each calendar quarter during which there is a duty to pay fees under 28 U.S.C. § 1930(a)(6), file and transmit to the United States trustee a statement of any disbursements made during that quarter and of any fees payable under 28 U.S.C. § 1930(a)(6) for that quarter . . . .").

[39] Staff Legal Bulletin No. 2, 1997 SEC No-Act. LEXIS 538, at *10 (debtor also must satisfy the proxy, issuer tender offer, and going private provisions of Exchange Act); *see also* SEC's Compliance and Disclosure Interpretations, *available at* http://www.sec.gov/divisions/corpfin/guidance/exchangeactsections-interps.htm (last updated on Oct. 8, 2008).

[40] Barton, *supra* note 29, at 16.

stockholders had approved and adopted a Plan of Liquidation and Dissolution, (4) Genesee had filed a Certificate of Dissolution with the State of New York more than a year prior to the date of the no-action request letter, and (5) Genesee's transfer agent had closed Genesee's stock transfer books and discontinued recording transfers of Genesee's stock. Genesee was required to continue to file reports on Form 8-K to disclose any material events relating to its winding up and dissolution, including the amounts of any liquidation distributions, payments, and expenses, and to file a final report on Form 8-K upon completion of its dissolution.[41]

(ii) *Weirton Steel Corporation.* The SEC declined to provide the requested no-action relief to the debtor, Weirton Steel Corporation ("Weirton"), from Exchange Act reporting requirements, even though Weirton had (1) continued to file its required periodic and current reports after the bankruptcy filing, (2) filed monthly operating reports under cover of Form 8-K in a timely manner, (3) intended to liquidate by selling substantially all of its assets to a buyer, and (4) contended that the average daily trading price for its stock in the year prior to bankruptcy was at penny stock levels despite substantial volume of activity. The SEC, however, focused on the fact that Weirton's common stock had 17 active market makers and trading volume of hundreds of thousands to millions of shares per day during the months preceding the bankruptcy filing. Accordingly, the SEC determined that the company's emphasis on the "'minimal' market value of trading rather than the extensive nature and extent of trading . . . [was] inconsistent with the protection of investors, because it focuse[d] solely on market value rather than *market interest*."[42]

(iii) *Opticon Medical, Inc.* The SEC granted no-action relief to a Chapter 11 liquidating debtor which had an average daily trading volume of 162,323 shares in the two month post-bankruptcy period preceding the company's no-action request, down from an average daily trading volume of

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41 Genesee Corp., SEC No-Action Letter, 2007 WL 4328652 (Dec. 5, 2007).

42 Weirton Steel Corp., SEC No-Action Letter, 2004 WL 691776, at *1 (Mar. 23, 2004) (emphasis added).

1,396,800 shares in the three month period preceding the company's bankruptcy filing.[43]

C. Confidentiality Agreements and Selective Disclosure of Material Nonpublic Information During the Chapter 11 Case

1. Regulation FD Generally

(a) Regulation FD (Fair Disclosure) generally mandates that when a public company discloses any material nonpublic information[44] regarding the company or its securities to certain securities market professionals or to holders of the company's securities who may trade on the basis of that information, the company must make public disclosure of that information simultaneously (in the case of an intentional disclosure) or promptly (in the case of a non-intentional disclosure).[45] Public disclosure can be made by filing a Form 8-K or by disseminating the "information through another method (or combination of methods) of disclosure that is reasonably designed to provide broad, non-exclusionary distribution of the information to the public."[46] Other acceptable methods of public disclosure include press releases, press conferences, and conference calls.[47]

(b) Regulation FD is intended to prevent selective disclosure to those market participants and investors who can exploit an informational edge obtained from their access to corporate insiders.[48] The market participants covered by Regulation FD include brokers,

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[43] Opticon Medical, Inc., SEC No-Action Letter, 2002 WL 1423445 (June 28, 2002).

[44] Regulation FD does not define the phrase "material nonpublic information," but relies on the meanings ascribed to those terms by case law. Selective Disclosure and Insider Trading, Securities Act Release No. 7881, Exchange Act Release No. 43,154, Investment Company Act Release No. 24,599, 65 Fed. Reg. 51,716, 51,721 (Aug. 24, 2000). "Material information" is information for which there is a substantial likelihood that (i) "'a reasonable shareholder would consider it important' in making an investment decision" and (ii) "a fact 'would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.'" *Id.* (citations omitted). An issuer that discloses nonmaterial information to an analyst will not be in violation of Regulation FD if, unbeknownst to it, that information helps the analyst complete a "mosaic" of information that, taken together, is material. *Id.* at 51,722. Information is nonpublic if it has not been disseminated in a manner making it available to investors generally. *Id.* at 51,721.

[45] *See* 17 C.F.R. § 243.100(a); *see also* 17 C.F.R. § 243.101.

[46] 17 C.F.R. § 243.101(e).

[47] *See* Selective Disclosure and Insider Trading, 65 Fed. Reg. at 51,723-51,724; *see also* Securities Offering Reform, Securities Act Release No. 8591, Exchange Act Release No. 52,056, Investment Company Act Release No. 26,993, 70 Fed. Reg. 44,722, 44,731-44,760 (Aug. 3, 2005).

[48] *See* Selective Disclosure and Insider Trading, 65 Fed. Reg. at 51,716.

dealers, investment advisors, certain institutional investment managers, investment companies, hedge funds, and their associated or affiliated persons.[49] Also covered by Regulation FD is any holder of the company's securities, under circumstances in which it is reasonably foreseeable that the person will purchase or sell the company's securities on the basis of the information.[50]

(c) Regulation FD, however, contains certain important exclusions. Notably, Regulation FD does not apply to selective disclosure made to a "person who owes a duty of trust or confidence to the issuer (such as an attorney, investment banker, or accountant)" or "who expressly agrees to maintain the disclosed information in confidence."[51]

2. Regulation FD Concerns in Chapter 11

(a) Because a public company in Chapter 11 must comply with the requirements of Regulation FD, certain Chapter 11 disclosure requirements can trigger Regulation FD concerns. In a Chapter 11 case, a debtor typically discloses nonpublic information to its principal constituents in the case for a variety of reasons. Thus, for example, such information is disclosed to its existing or prospective lenders to secure debtor-in-possession financing and comply with its on-going contractual disclosure requirements during the term of the loan agreement. Similarly, the debtor regularly provides material nonpublic information to official creditors' and equity committees[52] during the Chapter 11 case to permit the committees to monitor the debtor's operations and participate in formulation of a Chapter 11 plan.[53] In many cases, members of those committees are holders of the debtor's securities

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[49] 17 C.F.R. § 243.100(b)(1)-(b)(1)(iii); Selective Disclosure and Insider Trading, 65 Fed. Reg. at 51,719.

[50] 17 C.F.R. § 243.100(b)(1)(iv); Selective Disclosure and Insider Trading, 65 Fed. Reg. at 51,719-51,720.

[51] 17 C.F.R. § 243.100(b)(2)(i), (ii). The confidentiality agreement must be express, but it need not be in writing. (The better, safer practice is to obtain it in writing.) The confidentiality agreement can be obtained after the disclosure is made, but it must be obtained before the recipient of confidential information discloses or trades on the basis of it. Thus, a company that inadvertently makes a selective disclosure should try to immediately obtain a confidentiality agreement from the recipient. Selective Disclosure and Insider Trading, 65 Fed. Reg. at 51,720 n.28.

[52] Section 1102(a)(1) of the Bankruptcy Code provides that "the United States trustee shall appoint a committee of creditors holding unsecured claims and may appoint additional committees of creditors or of equity security holders as the United States trustee deems appropriate." 11 U.S.C. § 1102(a)(1). A creditors' committee generally consists of "the persons, willing to serve, that hold the seven largest claims against the debtor of the kinds represented on such committee." 11 U.S.C. § 1102(b)(1).

[53] Brad B. Erens & Kelly M. Neff, *Confidentiality in Chapter 11*, 22 Emory Bankr. Dev. J. 47, 59 (2005).

who could be expected to trade such securities on the basis of such information.[54]

(b) The debtor should ensure that such disclosure falls within the exclusion under Regulation FD "for persons 'who expressly agree to maintain the disclosed information in confidence'"[55] by securing written confidentiality agreements from its lenders and members of statutory committees before providing material nonpublic information to them. Those agreements should provide that (i) confidential information includes both written and oral communication; (ii) if the committee or lender uses confidential information in a court filing or hearing, it should be under seal or made in camera; and (iii) the confidentiality restrictions continue for a specified period of time after plan confirmation. [56]

(c) The debtor's disclosures to statutory committees create particular concerns since the enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA"). BAPCPA added section 1102(b)(3)(A) to the Bankruptcy Code, which requires that statutorily appointed committees provide their constituents with access to information. Section 1102(b)(3)(A) delineates neither the means of providing access to such information nor, more importantly, the nature, scope or extent of the "information" that committees must provide.[57] Committees and debtors typically seek an order from the bankruptcy court at the beginning of the case delineating the committees' obligations

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[54] To encourage large holders of a debtor's debt securities to serve on creditors' committees, courts, with the support of the SEC, have allowed entities to serve on a creditors' committee and, at the same time, trade in the debtor's securities if that entity trades securities in its regular course of business and implements an effective "Chinese Wall." *See, e.g., In re Federated Dep't Stores, Inc.*, No. 1-90-00130, 1991 WL 79143, at *1 (Bankr. S.D. Ohio Mar. 7, 1991); *see* Part III.A.-B. *infra* and accompanying notes. Absent such judicial protection, certain types of debt holders decline committee service for fear of insider trading violations under the securities laws.

[55] Erens & Neff, *supra* note 53, at 59 (citation omitted). Committee members sometimes refuse to enter into confidentiality agreements; but, they agree, however, to sign the confidentiality provisions of the committee bylaws.

[56] *See id.* at 74. Some of the Chapter 11 cases in which the committee and its members entered into confidentiality agreements with the debtor include: *In re Sterling Chemicals Holdings, Inc.*, No. 01-37805-H4-11 (Bankr. S.D. Tex.); *In re Fibermark, Inc.*, No. 04-10463-CAB (Bankr. D. Vt.); *In re Interstate Bakeries Corp.*, No. 04-45814 (JWV) (Bankr. W.D. Mo.); *In re Eagle Food Centers, Inc.*, No. 03-15299 (PSH) (Bankr. N.D. Ill.); and *In re William James Del Biaggio, III,* No. 08-30991 TEC 11 (Bankr. N.D. Cal.).

[57] *See* Deborah L. Thorne, *Creditors' Committees: The Fallout from BAPCPA Changes to § 1102*, Am. Bankr. Inst. J., Apr. 2006, at 20, 70.

under section 1102(b)(3) and clarifying that material nonpublic information is not to be disclosed.[58]

(d) The SEC has not provided any guidance as to whether information disclosed in a bankruptcy court filing (such as the debtor's monthly operating reports) or at a bankruptcy court hearing might trigger Regulation FD concerns. It could be argued that such disclosure does not violate Regulation FD because such disclosure is made in a public proceeding, available to the public, and generally not made to those who could be reasonably expected to trade on the basis of it. One commentator has suggested, as the most conservative course of action, that a debtor avoid making public disclosure of any material nonpublic information in any court filings unless (i) the court filings are made under seal (and provided only to those parties who have entered into confidentiality agreements) or (ii) the court hearing is in camera.[59] Alternatively, the debtor may consider filing a Form 8-K and/or issuing a press release in conjunction with such disclosure.[60]

D. Disclosure Constituting "Adequate Information" Under Bankruptcy Code Section 1125

1. Once a company has filed for Chapter 11, it may not solicit votes on a Chapter 11 plan unless it transmits to each person from whom it solicits votes a court-approved disclosure statement containing "adequate information."[61] "Adequate information" is defined in section 1125(a) to mean information of a kind that would enable a reasonable investor typical

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[58] *See e.g.*, *In re Refco, Inc*., 336 B.R. 187, 197-98 (Bankr. S.D.N.Y. 2006). In *Refco*, the duties of the committee included disseminating case information via a webpage, preparing monthly written reports summarizing recent findings and public financial information, and providing a nonpublic forum to submit creditor questions and requests for access to information. The court noted the tension between (i) the committee's need to preserve its own access to nonpublic information, to protect attorney-client privilege, and to comply with the securities laws and (ii) the rights of unsecured creditors under section 1102(b)(3) to be informed of material developments in the Chapter 11 case. In balancing these interests, the court determined that the committee was not required, without further court order, to provide access to

> information (a) that could reasonably be determined to be confidential and non-public or proprietary, (b) the disclosure of which could reasonably be determined to result in a general waiver of the attorney-client [privilege] or other applicable privilege, or (c) whose disclosure could reasonably be determined to violate an agreement, order or law, including applicable securities laws.

Id.

[59] Erens & Neff, *supra* note 53, at 61.

[60] *Id.*

[61] 11 U.S.C. § 1125(a)(1), (b).

of holders of claims or interests of the relevant class to make an informed judgment about the Chapter 11 plan.[62] What constitutes adequate disclosure varies from case to case and, in a case involving a large, public company, more detailed information generally will be required.[63]

2. For traditional Chapter 11 cases – where plan votes are solicited postpetition – nonbankruptcy law is not applicable in determining whether the disclosure statement contains adequate information.[64] Thus, disclosure statements are excepted from the requirements of the securities laws (such as Section 14 of the Exchange Act and Section 5 of the Securities Act of 1933 (including rules and regulations promulgated thereunder, the "Securities Act")[65] and from similar state securities laws).[66]

3. However, for prepackaged Chapter 11 cases – where plan acceptances and rejections are solicited before filing for bankruptcy – such plan votes may be counted only if: (i) their solicitation was in compliance with any applicable nonbankruptcy law, rule, or regulation governing the adequacy of disclosure with respect to such solicitation; or (ii) if there is not any such law, rule, or regulation, there was disclosure prior to solicitation of "adequate information" as defined in section 1125(a).[67] Thus, public companies that solicit votes for a prepackaged Chapter 11 plan must comply with the disclosure requirements of the Exchange Act. At a minimum, this ensures that the holders of securities receive disclosure similar to that which they would have received had solicitation occurred during the Chapter 11 case.[68]

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62 11 U.S.C. § 1125(a)(1).

63 *See Collier on Postpetition Disclosure Requirements (Ch. 11)*, 2008 Emerging Issues 1294 (Dec. 4, 2007) (LEXIS).

64 Section 1125(d) provides: "Whether a disclosure statement required under subsection (b) of this section contains adequate information is not governed by any otherwise applicable nonbankruptcy law, rule, or regulation, but an agency or official whose duty is to administer or enforce such a law, rule, or regulation may be heard on the issue of whether a disclosure statement contains adequate information. Such an agency or official may not appeal from, or otherwise seek review of, an order approving a disclosure statement." 11 U.S.C. § 1125(d).

65 15 U.S.C. §§ 77a to 77aa.

66 *See* H.R. Rep. No. 95-595, at 408-10 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6364-66.

67 11 U.S.C. § 1126(b).

68 *Collier Lending Institutions & Bankruptcy Code* ¶ 4.14 (Alan N. Resnick & Henry J. Sommer eds., rev. 2008).

III. TRADING RESTRICTIONS

A. Trading Restrictions on Committee Members

1. Statutory committees of creditors or equity security holders are expressly authorized by the Bankruptcy Code to: (a) consult with the trustee or debtor-in-possession concerning the administration of the estate; (b) investigate the debtor's acts, conduct, assets, liabilities, and financial condition; (c) participate in the formulation of a Chapter 11 plan; (d) request the appointment of a trustee or examiner; and (e) perform "such other services" as are in the interest of those represented.[69] In order to discharge their duties, statutory committees need and are routinely granted access to material nonpublic information concerning the debtor and its affairs.

2. A statutory committee and its members will have a duty of confidence to the debtor resulting from their express agreement to maintain the material nonpublic information in confidence.[70] The committee and its members also will owe duties to their constituents, including the duties of good faith and loyalty, which prohibit them from using their positions to advance their own self-interests.[71] Thus membership on an official committee precludes trading in the debtor's securities.

3. The SEC takes the position that a committee member that trades on the basis of material nonpublic information obtained in its representative capacity would likely be liable for violating Section 10(b) and Rule 10b-5 of the Exchange Act under the misappropriation theory of insider trading.[72] Indeed, the SEC recently has brought actions seeking cease and desist orders, suspension from any broker or dealer associations, permanent injunctions against future participation on creditors' committees in bankruptcies of security issuers, disgorgement of profits and prejudgment interest thereon, and civil penalties against committee

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[69] 11 U.S.C. § 1103(c).

[70] *See supra* note 51.

[71] *In re Nationwide Sports Distribs., Inc.*, 227 B.R. 455, 463-64 (Bankr. E.D. Pa. 1998).

[72] *See* Selective Disclosure and Insider Trading, 65 Fed. Reg. at 51,720 (Regulation FD: Fair Disclosure). The misappropriation theory of insider trading provides that "a person commits fraud 'in connection with' a securities transaction, and thereby violates § 10(b) [of the Exchange Act] and Rule 10b-5 [thereunder], when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information . . . The misappropriation theory is thus designed to 'protec[t] the integrity of the securities markets against abuses by 'outsiders' to a corporation who have access to confidential information that will affect th[e] corporation's security price when revealed, but who owe no fiduciary or other duty to that corporation's shareholders.'" *United States v. O'Hagan*, 521 U.S. 642, 652-53 (1997) (fourth and fifth alterations in original) (citation omitted).

members and their representatives, alleging improper use of material nonpublic information received by such committee members.[73] In addition, since 2007, the SEC has included as part of its routine examinations of registered hedge fund advisors new information requests designed to assess the risk of insider trading based on nonpublic material information. The SEC has requested such advisors, among other things, to (i) provide a list of the companies as to which the advisors' employees or affiliates serve on a creditors' committee; (ii) identify all securities held in any client account during the past two years that were involved in a bankruptcy workout; and (iii) for each security identified, identify all accounts that held equity or fixed income positions in a debtor-issuer at the time of the bankruptcy filing and provide portfolio holdings reports for each of these accounts as of the bankruptcy filing date.[74]

B. "Ethical Walls" and Information Blocking Procedures

1. To protect themselves from SEC enforcement action and liability for breach of their fiduciary duties, committee members that hold the debtors' debt or equity securities often request the court to allow continued trading in those securities, subject to certain information blocking procedures and an "ethical wall" being implemented to limit (or prevent) communications between the individuals sitting on the committee and the individuals engaged in trading.[75] Such a procedure was approved by the Bankruptcy Court for the Southern District of Ohio in the seminal case of *In re Federated Department Stores, Inc.*[76]

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[73] *See* SEC v. Barclays Bank PLC, Litigation Release No. 20,132, 2007 WL 1559227, at *1 (May 30, 2007) (alleging that trader engaged in insider trading through use of material nonpublic information while simultaneously acting as committee representative and proprietary trader; enforcement action brought despite use of "Big Boy" letters); Van D. Greenfield, Exchange Act Release No. 52,744, 2005 WL 2978438, at *3-4 (Nov. 7, 2005) (alleging failure to maintain required information barriers to prevent misuse of nonpublic information received while serving on creditors' committee).

[74] *See* Form of examination request letter from the New York Regional Office of the Securities and Exchange Commission (August XX, 2007), *available at* http://nscp.org/media/sec_request_list-aug2k7.pdf; *see also* Kara Scannell, *SEC Pushes for Hedge Fund Disclosure*, Wall St. J., Sept. 19, 2007, at C3.

[75] Most institutional investors are unwilling to serve on a statutory committee without a trading order.

[76] *In re Federated Dep't Stores, Inc.*, 1991 WL 79143, at *1 ("[A creditor] will not be violating its fiduciary duties as a committee member and accordingly, will not be subjecting its claims to possible disallowance, subordination, or other adverse treatment, by trading in securities of the Debtors . . . during the pendency of these [c]ases, provided that [the creditor] employs an appropriate information blocking device or '[Screening] Wall' which is reasonably designed to prevent [that creditor's] trading personnel from receiving any nonpublic committee information through [that creditor's] committee personnel and to prevent [that creditor's] committee personnel from receiving information regarding [that creditor's] trading in securities of the Debtors . . . in advance of such trades . . . .").

2. An "ethical" or "screening" wall refers to a procedure established by an institution to isolate its trading activities from its activities as a member of a statutory committee in a Chapter 11 case. Screening wall and information blocking procedures typically --[77]

   (a) Require that each employee, representative or agent of the committee member performing activities related to the committee (the "Committee Personnel") sign a written acknowledgement that he or she (i) may receive nonpublic information in his or her capacity as a committee member, (ii) is aware of the information blocking procedures that are in effect, (iii) will follow these procedures, and (iv) will immediately inform committee counsel and the United States trustee if such procedures are materially breached;

   (b) Preclude Committee Personnel from sharing any nonpublic information relating to committee activities or membership (the "Information") with any other employees, representatives, or agents of the committee member and require the use of separate offices and access to separate telephone, facsimile lines, email and electronic messaging systems when appropriate;

   (c) Require that Committee Personnel maintain all hard copy files containing Information in secured cabinets inaccessible to other employees of the committee member;

   (d) Preclude Committee Personnel from having access to information regarding trades in the debtor's securities in advance of the execution of such trades; and

   (e) Require a compliance review process to ensure continued compliance with the information blocking procedures.[78]

3. Screening procedures resolve the inherent conflict between the duty of an institutional investor (a) as a committee member to the constituency represented by the committee and (b) to the clients for whom it trades securities. Ethical walls and related information blocking procedures also

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[77] The same procedures also would apply to the trading of claims.

[78] Screening walls and information blocking procedures have been implemented in many cases, including: *In re Delphi Corp.*, No. 05-44481 (RDD) (Bankr. S.D.N.Y. Feb. 15, 2007) (Docket No. 6976); *In re Calpine Corp.*, No. 05-60200 (BRL) (Bankr. S.D.N.Y. Jan. 25, 2006) (Docket No. 606); *In re Dana Corp.*, No. 06-10354 (BRL) (Bankr. S.D.N.Y. Apr. 27, 2006) (Docket No. 1013); *In re Mirant Corp.*, No. 03-46590 (DML) (Bankr. N.D. Tex. Sept. 15, 2004) (Docket No. 5462); and *In re Enron Corp.*, No. 01-16034 (AJG) (Bankr. S.D.N.Y. Feb. 27, 2002) (Docket No. 1753). Certain of these orders (*e.g.*, *Calpine, Dana,* and *Mirant*) permit the committee member not only to trade for its clients account, but also trade for its own account.

prevent the investor's trading desk from being tainted with insider information, thereby shielding the investor from insider trading claims under Section 10(b) and Rule 10b-5 of the Exchange Act.[79]

4. A disadvantage of screening walls and information blocking procedures is the inefficiency that arises as a consequence of the lack of communication between different groups of people at the same financial institution. In addition, the utility of screening walls and information blocking procedures is limited to large institutions able to implement them effectively.

C. "Big Boy" Letters

1. Market participants sometimes attempt to use "Big Boy" letters to mitigate or avoid litigation under the securities laws, disclosing to their trading counterparties that they have or may have, but cannot disclose, certain material nonpublic information.

2. A "Big Boy" letter involves a "representation by the buyer in a securities transaction that (a) the buyer is a sophisticated investor, (b) the buyer understands that the seller may possess material non-public information that will not be disclosed to the buyer, (c) the buyer is relying on its own research and analysis in entering into the transaction, and (d) the buyer effectively waives any claim it may have under the federal securities laws, including Section 10(b) or Rule l0b-5 of the [Exchange Act]."[80]

3. No court has yet to rule on the enforceability of "Big Boy" letters.

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[79] Section 10(b) of the Exchange Act prohibits the "use or employ, in connection with the purchase or sale of any security . . . , [of] any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe as necessary or appropriate in the public interest or the protection of investors." 15 U.S.C. § 78j(b). Rule 10b-5, which implements Section 10(b) of the Exchange Act, makes it unlawful for anyone engaged in the purchase or sale of a security:

> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5.

[80] Randolph W. Bodner et al., *Big Boy Letters in the Spotlight*, Insights: Corp. & Sec. L. Advisor, June 2007, at 2. A buyer may also want to obtain a "Big Boy" letter to show that it did not obtain any material nonpublic information.

(a) Courts, however, have addressed non-reliance provisions in the context of sale and purchase agreements. These decisions are instructive for "Big Boy" letters:

(i) The Ninth and Tenth Circuits have held that where one party explicitly informs the other of its non-disclosure of material information, an omission in a transaction between sophisticated investors is not misleading or manipulative under Rule 10b-5.[81]

(ii) The Third Circuit, however, has concluded that a non-reliance clause is factual evidence, but does not as a matter of law establish, that reliance was absent or unreasonable.[82] The court further concluded that enforcement of non-reliance clauses to shield the seller from Rule 10b-5 claims as a matter of law would be inconsistent with Section 29(a) of the Exchange Act.[83] Section 29(a) provides that "[a]ny condition, stipulation, or provision binding any person to waive compliance with any provision of [the Exchange Act] or of any rule or regulation thereunder . . . shall be void."[84] Thus, it remains questionable whether private parties can opt out of the safeguards of the federal securities laws.

(b) Even if "Big Boy" letters are enforceable in a civil action, they will not shield the parties from SEC investigation or enforcement action. The SEC's enforcement action against Barclays Bank (*see* Part III.A.3. *supra*) illustrates that "Big Boy" letters do not protect trading parties from government action given the established principle in securities law that a "corporate insider must abstain

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[81] *See McCormick v. Fund Am. Cos.*, 26 F.3d 869, 879-80 (9th Cir. 1994); *Jensen v. Kimble*, 1 F.3d 1073, 1078 (10th Cir. 1993); *see also Harborview Master Fund, LP v. Lightpath Techs., Inc.*, No. 07 Civ. 9228 (NRB), 2009 WL 249391, at *7 & n.8 (S.D.N.Y. Jan. 30, 2009) (relying on *Jensen* in addressing fraud claims based on material omissions in connection with a securities purchase agreement containing language similar to that of a "Big Boy" letter).

[82] *AES Corp. v. Dow Chem. Co*., 325 F.3d 174, 181-82 (3d Cir. 2003) ("to hold that a buyer is barred from relief under Rule 10b-5 solely by virtue of his contractual commitment not to rely would be fundamentally inconsistent with Section 29(a) [of the Exchange Act]"; "[w]e are unwilling . . . to hold that the extraction of a non-reliance clause, even from a sophisticated buyer, will always provide immunity from Rule 10b-5 fraud liability").

[83] *Id.* at 182.

[84] 15 U.S.C. § 78cc(a).

from trading in the shares of his corporation unless he has first disclosed all material inside information known to him."[85]

(c) Enforceability of "Big Boy" letters is even more uncertain in a securities transaction between a "Big Boy" letter signatory and an unsuspecting downstream purchaser.[86]

D. Preserving Net Operating Losses: Trading Restrictions on Holders of Stock or Claims

1. Chapter 11 debtor corporations often file motions to restrict trading in their stock or claims so as to prevent an inadvertent change of ownership that would cause them to lose the ability to offset future taxable income against accumulated net operating losses ("NOLs").[87]

2. Bankruptcy court orders restricting trading are driven by the Internal Revenue Code of 1986,[88] as amended (the "IRC"):

(a) Tax attributes associated with NOLs constitute a valuable asset of a debtor's estate as they can be carried back two years or forward twenty years to reduce future tax obligations of a reorganized company.[89] The value of NOLs is generally expressed as the net present value of the future taxes which the debtor will save as a result of its NOLs and other tax attributes.[90]

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[85] *Chiarella v. United States*, 445 U.S. 222, 227 (1980) (citing Cady, Roberts & Co., Exchange Act Release No. 6668, 40 S.E.C. 907 (Nov. 8, 1961)); *see also* SEC v. Barclays Bank PLC, 2007 WL 1559227; *see also supra* note 73.

[86] *See* R^2 *Invs. LDC v. Salomon Smith Barney*, No. 01-CV-03598 (S.D.N.Y. filed Apr. 27, 2001) (Jeffries & Company bought $20 million of junk bonds issued by World Access from Salomon Smith Barney using a "Big Boy" letter, and then resold the bonds to R^2 without disclosing to R^2 that it had bought the bonds under a "Big Boy" letter; settled in 2007); *see also* Jenny Anderson, *Buyer-Seller Agreements Not to Sue Raise Issues About Inside Information*, N.Y. Times, May 22, 2007, at C1 (it is prudent for a buyer who wishes to resell a security it bought under a "Big Boy" letter to enter into a "Big Boy" letter with the subsequent purchaser of that security); *When Creditors Are Traders, Gray Areas Arise*, Distressed Investing Report, Apr. 2008, at 16-17, *available at* http://www.turnaround.org/cmaextras/DI_report.FINAL.pdf (reselling "in effect, tainted" bonds into the market without disclosing that they were purchased under a "Big Boy" letter constitutes a fraud on the marketplace).

[87] *See* 26 U.S.C. § 172.

[88] *See* 26 U.S.C. §§ 172, 382.

[89] NOLs can be used as either "carrybacks" (in which the corporation uses the NOLs to offset taxable income for up to two preceding taxable years) or "carryovers" (in which the corporation uses the NOLs to offset taxable income for up to twenty years into the future). 26 U.S.C. § 172(b)(1)(A).

[90] *See* Sandra A. Riemer & Candice Frost, *Can They Really Do That ? ? ? Enforceability and Protection of NOL Injunctions and Third-Party Releases in Reorganization Plan*s, 7th Annual Am. Bankr. Inst. N.Y. City Bankr. Conference (May 9, 2005), *available at* 050905 ABI-CLE 375 (Westlaw).

(b) Generally, a corporation that undergoes a shift in beneficial ownership of more than 50 percentage points in any three-year period is treated as having undergone an ownership change for U.S. federal income tax purposes. For testing such shifts in ownership, very technical rules define the 5% shareholders whose ownership is taken into account. As a consequence of such ownership change, IRC section 382 generally limits the corporation's ability to use pre-change NOLs and certain other tax attributes to offset post-change income.[91] If a debtor undergoes an ownership change prior to consummation of a Chapter 11 plan, it will only be able to use NOLs to offset an annual amount of income equal to the value of the debtor's stock[92] prior to the ownership change multiplied by the long-term tax exempt rate.[93] Given that the value of the debtor's stock may be quite low and the long-term tax exempt rate is currently approximately 5.5%, the limitation on the use of the debtor's NOLs is significant. Thus, unrestricted trading of a debtor's stock prior to plan consummation could trigger a section 382 ownership change and significantly reduce or even eliminate the debtor's NOLs.

(c) In addition, any worthless stock deduction claimed during the bankruptcy case by a holder owning 50% or more of a debtor's stock could trigger a deemed section 382 ownership change at an implied zero value, thereby eliminating the use of NOLs and other tax attributes.[94]

(d) IRC section 382 provides for certain exceptions in the bankruptcy context. These exceptions serve as incentives to preserve the use of the debtor's NOLs after emergence pursuant to the Chapter 11 plan.

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[91] *See* 26 U.S.C. § 382(b)(1). The application of IRC section 382 is limited to "loss corporations." A "loss corporation" is defined in IRC section 382(k)(1) to mean "a corporation entitled to use a net operating loss carryover or having a net operating loss for the taxable year in which the ownership change occurs. Except to the extent provided in regulations, such term includes any corporation with a net unrealized built-in loss." 26 U.S.C. § 382(k)(1). Regulations make clear that built-in losses, capital losses, and a number of other tax attributes are generally sufficient to make a corporation a loss corporation.

[92] For the purposes of IRC section 382, the term "stock" does not include preferred stock which (i) is not entitled to vote, (ii) is limited and preferred as to dividends and does not participate in corporate growth to any significant extent, (iii) has redemption and liquidation rights which do not exceed the issue price of such stock (except for a reasonable redemption or liquidation premium), and (iv) is not convertible into another class of stock. *See* 26 U.S.C. §§ 382(k)(6)(A), 1504(a)(4).

[93] 26 U.S.C. § 382(b)(1).

[94] 26 U.S.C. § 382(g)(4)(D).

(i) Under IRC section 382(l)(5), if a debtor corporation undergoes an ownership change pursuant to a confirmed Chapter 11 plan, and existing stockholders or "qualified creditors" retain 50% or more of the reorganized company's stock, the reorganized company is not subject to an annual limitation on the use of its pre-change NOLs.[95] Instead, the tax attributes are subject to a one-time reduction to reflect the prior deduction by the debtor of certain interest expense in the preceding 3+ years. Built-in losses are not limited under this rule. However, a second ownership change within two years after this rule is employed will result in the elimination of all remaining NOLs and other favorable tax attributes.

(ii) IRC section 382(l)(6) is an alternative elective exception. Under IRC section 382(l)(6), if a debtor corporation undergoes an ownership change pursuant to a confirmed Chapter 11 plan, the section 382 limitation on the use of NOLs is not based on the pre-change value of the debtor's stock, but rather is based on the value of the reorganized company's stock immediately after consummation of the Chapter 11 plan.[96] Thus, the post-consummation value of the reorganized company's stock will be significantly higher than the debtor's pre-change stock value because it will include debt that has been converted to equity under the Chapter 11 plan.[97]

3. Three types of injunctions during the case are generally used to protect the debtor's tax attributes:

(a) Injunctions enjoining the sale or purchase of a debtor's stock prior to the effective date of a Chapter 11 plan;

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[95] 26 U.S.C. § 382(l)(5). A "qualified creditor" is "the beneficial owner, immediately before the ownership change, of qualified indebtedness of the loss corporation." 26 C.F.R. § 1.382-9(d)(1). "Qualified indebtedness" is indebtedness of a loss corporation if it – (i) has been owned by the same beneficial owner since the date that is 18 months before the date of the filing of the title 11 or similar case; or (ii) arose in the ordinary course of the trade or business of the loss corporation and has been owned at all times by the same beneficial owner. 26 C.F.R. § 1.382-9(d)(2).

[96] *See* 26 U.S.C. § 382(l)(6).

[97] *See id.*; *see also* Mark A. Speiser et al., *NOLs: The Policy Conflicts Created by Trading Orders*, Com. Lending Rev., May-June 2005, at 27, 28.

(b) Injunctions enjoining a major shareholder from claiming a worthless stock deduction prior to the effective date of a Chapter 11 plan; and

(c) Injunctions enjoining the sale or purchase of claims against a debtor prior to the effective date of a Chapter 11 plan.

4. Trading restrictions also may be required post-emergence pursuant to the debtor's articles of incorporation if the special rules under IRC section 382(l)(5) are used.

5. Trading injunctions generally are sought as a first-day order and establish notification and trading procedures that must be complied with before stock or claims are transferred or sold. The trading injunctions enable the debtor to monitor and object to any ownership changes that could negatively affect its ability to use NOLs or other favorable tax attributes during the case (to shelter asset sales) or post-emergence. Typical procedures include:[98]

(a) Requiring any holder beneficially owning a minimum threshold amount of stock or claims to file with the court and serve on the debtor a notice declaring such holder's status as a "Substantial Holder" and listing the stock or claims it beneficially owns;[99]

(b) Requiring that a notice be filed with the court and served on the debtor before (i) a Substantial Holder purchases additional stock or claims or sells stock or claims if such sale results in it no longer being a Substantial Holder or (ii) an investor purchases stock or

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[98] Trading injunctions have been issued in a number of cases, including: *Nortel Networks Inc*., No. 09-10138 (KG) (Bankr. Del. Feb. 5, 2009) (Docket No. 235); *In re Wellman, Inc*., No. 08-10595 (SMB) (Bankr. S.D.N.Y. Apr. 10, 2008) (Docket No. 191); *In re Dana Corp*., No. 06-10354 (BRL) (Bankr. S.D.N.Y. Aug. 9, 2006) (Docket No. 2772); *In re Delphi Corp*., No. 05-44481 (RDD) (Bankr. S.D.N.Y. Jan. 6, 2006) (Docket No. 1780); *In re Calpine Corp*., No. 05-60200 (BRL) (Bankr. S.D.N.Y. Dec. 21, 2005) (Docket No. 37); and *In re Mirant Corp*., No. 03-46590 (DML) (Bankr. N.D. Tex. Sept. 17, 2003) (Docket No. 830). *See* Model NOL Order, Bond Market Ass'n / Loan Syndications & Trading Ass'n (Nov. 2004), *available at* http://www.abiworld.org/pdfs/lsta.swf. The Model NOL Order also includes provisions that are intended to benefit the enjoined parties, such as (i) confidentiality provisions in favor of the equity security or claim holder; (ii) prohibition on the designation of votes for plan confirmation under section 1126(e) as a result of failure to comply with the order; and (iii) provisions conditioning the effectiveness of the order on publication in *The Wall Street Journal* or on the Bloomberg newswire service. A trading injunction that restricts the trading of claims also may permit claim holders to trade freely without notice to the debtor if they agree to sell to an unrelated party an amount of the claims that would not impede the formulation of a Chapter 11 plan utilizing IRC section 382(l)(5). *See* Riemer & Frost, *supra* note 90.

[99] The minimum threshold for stock generally is set at 4.75% of each class of specified stock, while the minimum threshold for claims generally is a specified dollar amount (including principal and accrued interest), both of which are periodically reviewed. These thresholds take advantage of the rules limiting the holders whose holding must be tracked to those holding at least 5% of the stock of the debtor.

claims that would cause such investor to become a Substantial Holder;

(c) Requiring an equity security holder that holds 50% or more of the debtor's stock (as defined above) to file with the court and serve on the debtor a notice of its intent to claim a worthless stock deduction; and

(d) Requiring court approval of any proposed purchase or sale transaction involving a Substantial Holder or a worthless stock deduction, if the debtor timely objects.

6. Numerous courts have approved trading injunctions to protect debtors' NOLs and other tax attributes.[100] A trading injunction on the debtor's stock prevents an ownership change from occurring prior to the consummation of the Chapter 11 plan, thereby preserving the availability of the exception under IRC section 382(l)(6). Investors, however, routinely object to trading injunctions on constitutional grounds, arguing that trading restrictions violate the Fifth Amendment takings clause, representing a government taking of private property for public use without just compensation. Objections also have been made with respect to restrictions on trading debt on the grounds that the debtor's use of the special rules under IRC section 382(l)(5) is speculative at the outset of a case. At least one appellate court has focused on the constitutional issues. In *In re UAL Corp.*, the Seventh Circuit Court of Appeals criticized a bankruptcy court order which had enjoined an Employee Stock Ownership Plan from selling its United Airlines stock because it failed to compensate the shareholders.[101] Following *UAL*, at least one bankruptcy court has denied a debtor's motion for a trading injunction restricting debt and equity trading.[102] Moreover, in *In re Remy Worldwide Holdings, Inc.,*[103]

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[100] In *Official Committee of Unsecured Creditors v. PSS Steamship Co.* (In re Prudential Lines Inc.), 928 F.2d 565 (2d Cir. 1991), the parent of a wholly-owned debtor was permanently enjoined from taking a worthless stock deduction with respect to its bankrupt subsidiary. In this seminal decision, the Second Circuit held that the right to an NOL carryforward constituted "property of the estate" under section 541 of the Bankruptcy Code. *Id.* at 571-73. The parent company's attempt to claim a worthless stock deduction would have resulted in the debtor's loss of its NOL-related tax benefits. The court held that the automatic stay barred the parent from this action as an exercise of control over the property of the estate. *Id.* at 574; *see also supra* note 98.

[101] *In re UAL Corp.*, 412 F.3d 775, 778 (7th Cir. 2005) ("[L]oss of liquidity is an immediate and independent injury . . . The injunction also left investors underdiversified, and thus bearing uncompensated risk. . . . Requiring investors to bear the costs of illiquidity and underdiversification was both imprudent and unnecessary. . . . There is no reason why investors who need liquidity should be sacrificed so that other investors (principally today's debt holders) that will own United after it emerges from bankruptcy can reap a benefit; bankruptcy is not supposed to appropriate some investors' wealth for distribution to others.").

[102] *See In re Interstate Bakeries Corp.*, No. 04-45814 (JWV), hr'g tr. at 65-66 (Bankr. W.D. Mo. Mar. 3, 2009) ("[W]e would be perhaps telling equity holders at least that they can't sell their property and it's not the

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the debtor's majority shareholder received compensation for its liquidity and diversification loss. In *Remy*, the Bankruptcy Court for the District of Delaware approved a settlement agreement between the debtor and its majority shareholder in which the shareholder agreed to refrain from trading in the debtor's equity interests and claiming a worthless stock deduction in exchange for a $4 million cash payment to avoid an "ownership change" of the debtors under IRC section 382(g). It is sometimes desirable to restrict trading only in equity securities and to permit claims trading unless the debtor believes that it may be desirable to use the special rules of IRC section 382(l)(5). An order enjoining trading of claims against the debtor may help ensure that the debtor qualifies for the exception under IRC section 382(l)(5).

7. In cases in which the debtor's tax attributes will be eliminated by cancellation of debt income or the debtor's assets are sold to the creditors or to a third party as part of the Chapter 11 plan, the preservation of NOLs and other tax attributes by a trading injunction generally will be less important. Finally, a trading injunction may come too late and offer little benefit to a debtor if the debtor has already experienced a recent ownership change such that its tax attributes have already been limited.

IV. REGISTRATION EXEMPTIONS AND SAFE HARBORS UNDER THE BANKRUPTCY CODE

A. Bankruptcy Exemptions and Safe Harbors Generally

A Chapter 11 plan may provide for the issuance of new debt or equity securities for cash, property, existing securities, or in exchange for claims against or interests in a debtor or for any other appropriate purpose.[104] Under the Securities Act, the offer or sale of securities by a company must be registered with the SEC, unless an exemption from the registration requirements is available.[105] As discussed below, section 1145 of the Bankruptcy Code affords a limited exemption from registration requirements for the offer or sale of certain securities issued under a Chapter 11 plan,[106] and section 1125(e) of the Bankruptcy Code provides a limited safe harbor from the anti-fraud provisions of the securities laws

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debtors' property that we're restricting usage of, but rather somebody else's property"; court also found that the effect of the debt or equity trading on debtor's use of NOLs was then too speculative.).

[103] *In re Remy Worldwide Holdings*, Inc., No. 07-11481 (KJC) (Bankr. D. Del. Nov. 7, 2007) (Carey, J.) (Docket No. 158).

[104] 11 U.S.C. § 1123(a)(5)(J).

[105] 15 U.S.C. § 77e(a), (c).

[106] *See* 11 U.S.C. § 1145(a). See Appendix *infra* for text of § 1145.

for good faith solicitation in connection with the Chapter 11 plan process.[107]

B. Registration Requirements of the Securities Act Generally

1. Section 5 of the Securities Act requires that a registration statement be filed with the SEC with respect to every offer to sell securities unless an exemption from registration is available.[108] Section 5 of the Securities Act also prohibits the sale (or resale) of securities until the registration statement is declared effective by the SEC.[109]

2. The filing of a registration statement with the SEC is a time-consuming and costly process which "may take six months or more and typically will cost an issuer several millions of dollars to complete."[110] A registration statement also requires audited financial statements,[111] which can be problematic for troubled companies.

C. Summary of Exemptions Under Section 1145 of the Bankruptcy Code

1. Section 1145(a)(1) of the Bankruptcy Code provides an exemption from federal and state registration requirements for the offer or sale of a security under a Chapter 11 plan *if*: (i) the security is issued by the debtor, an affiliate participating in a joint Chapter 11 plan with the debtor, or a successor of the debtor; (ii) each recipient of the security under the Chapter 11 plan is a holder of a prepetition or administrative claim against or an equity interest in the debtor; and (iii) the security is in exchange (1) entirely for such claim or interest or (2) principally for such claim or interest and partly for cash or property.[112] Section 1145(a)(1) exempts the solicitation of plan votes, which is the equivalent of an offer, and the initial issuance of the securities under the Chapter 11 plan. This exemption, however, is not available to the offer or sale of the security by or through an underwriter, as defined in section 1145(b)(1).

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[107] 11 U.S.C. § 1125(e).

[108] 15 U.S.C. § 77e(c); *see also* Gregory Fernicola & Richard Levin, Securities Laws Exemptions in the Purchase and Sale of Securities Issued Under a Chapter 11 Plan, Presentation to the Loan Syndications and Trading Ass'n, at 2 (Apr. 19, 2007); Saggese & Ranney-Marinelli, *supra* note 2, § 8.02[A], at 8-6 to 8-8.

[109] 15 U.S.C. § 77e(a).

[110] Corinne Ball, *Section 1145: Theory Versus Practice,* N.Y. L.J., Dec. 30, 2004, at 5; *see also* Falk et al., *supra* note 3, at 36, 94-95.

[111] *See* 15 U.S.C. §§ 77g(a), 77j, 77aa (Schedule A); Falk et al., *supra* note 3, at 95.

[112] 11 U.S.C. § 1145.

2. Section 1145(a)(2) also exempts from federal and state registration requirements both (i) the offer of a security through any warrant, option, right to subscribe, or conversion privilege that was sold under a Chapter 11 plan in accordance with section 1145(a)(1) and (ii) the sale of a security that occurs upon the exercise of such a warrant, option, right, or privilege.[113]

3. Section 1145(c) provides that an offer or sale of securities issued under a Chapter 11 plan in accordance with section 1145(a)(1) is deemed to be a public offering – which means that the securities are not "restricted securities" and are freely transferable (other than by an underwriter or the issuer's affiliate).[114]

4. Sections 1145(b)(1) and 1145(b)(3) together provide a special, more limited definition of "underwriter" than that set forth in section 2(a)(11) of the Securities Act. (*See* Part IV.G.2. *infra.*) An underwriter under the Securities Act is not an underwriter with respect to any securities offered or sold in a manner specified in section 1145(a)(1) other than an entity of the kind specified in section 1145(b)(1).[115]

5. Section 1145(a)(3) exempts the offer or sale during a pending Chapter 11 case of portfolio securities that were owned by the debtor on the filing date of the bankruptcy petition under certain limited circumstances.[116]

6. Section 1145(a)(4) provides that registration requirements do not apply to a "transaction by a stockbroker" in a security issued under section 1145(a)(1) or (2) within 40 days after the security was "bona fide offered to the public," if the stockbroker provides a court-approved disclosure statement and any court-ordered supplementary information.[117]

7. Section 1145(d) provides that the Trust Indenture Act of 1939 does not apply to a note issued under a Chapter 11 plan that "matures not later than one year after the effective date of the plan."[118]

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[113] 11 U.S.C. § 1145(a)(2).

[114] 11 U.S.C. § 1145(c); *see* Saggese & Ranney-Marinelli, *supra* note 2, § 8.02[F], at 8-36 to 8-37.

[115] 11 U.S.C. § 1145(b)(3).

[116] 11 U.S.C. § 1145(a)(3).

[117] 11 U.S.C. § 1145(a)(4).

[118] 11 U.S.C. § 1145(d).

D. No-Action Relief

Because it is not always clear if section 1145's requirements have been satisfied, debtors sometimes seek no-action relief from the SEC. Practitioners should be aware that in 1994 the SEC stated that no-action and interpretive advice concerning the applicability of section 1145(a) should be sought "no later than when the disclosure statement relating to the plan is filed with the court."[119]

E. Elements of Section 1145(a)(1)

1. Offer or Sale Under a Chapter 11 Plan

(a) Because the section 1145 exemption is available only for the offer or sale of a security "under a plan,"[120] the plan should (a) specifically describe each of the securities to be issued and exchanged for claims or equity interests (including the principal terms, amounts, and proposed allocations), (b) condition the issuance of the securities upon confirmation of the Chapter 11 plan, and (c) state that the securities are being offered, sold, and issued in reliance upon the section 1145(a) exemption.[121] Furthermore, the confirmation order should find that the section 1145 exemption is applicable to the securities offered, sold, and issued under the Chapter 11 plan and authorize the issuance of the securities.[122]

(b) The section 1145 exemption is not available for any securities that were not contemplated by the Chapter 11 plan.[123]

2. Of a Security

The definition of "security" found in section 101(49) of the Bankruptcy Code[124] is similar to the Securities Act definition. Included in both the Bankruptcy Code and Securities Act definitions of "security" are warrants or rights to subscribe to or purchase or sell a security.[125] Thus, the section 1145 exemption

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[119] Central and South West Corp., SEC No-Act. Letter, 1994 SEC No-Act. LEXIS 733, at *3 (Aug. 16, 1994).

[120] 11 U.S.C. § 1145(a)(1).

[121] *See* Falk et al., *supra* note 3, at 95; Fernicola & Levin, *supra* note 108, at 4; Saggese & Ranney-Marinelli, *supra* note 2, § 8.02[B], at 8-13, § 8.07[A], at 8-89.

[122] *See* Saggese & Ranney-Marinelli, *supra* note 2, § 8.07[B], at 8-96 to 8-97.

[123] *See* Falk et al., *supra* note 3, at 95.

[124] *See* 11 U.S.C. § 101(49).

[125] *See* 11 U.S.C. § 101(49); 15 U.S.C. § 77b(a)(1).

also applies to the right to purchase securities in the future[126] and exempts from registration the sale of the underlying security upon the exercise of any warrant, option, subscription right, or conversion privilege that was issued under a Chapter 11 plan.[127]

3. Of the Debtor, of an Affiliate Participating in a Joint Plan, of a Successor

(a) The section 1145(a)(1) exemption is only available if the security being offered or sold is a security of the debtor, an affiliate participating in a joint plan with the debtor, or a successor to the debtor under the plan.

(b) In a traditional Chapter 11 case, where votes on the plan are solicited after commencement of the case, both the "offer" and "sale" of the plan securities are made "under a plan" and both relate to a "security of a *debtor*" (or affiliate or successor of a *debtor*). However, with a prepackaged plan, the "offer" of the security is made prepetition, at a time when the troubled company is not yet a "debtor," as defined in the Bankruptcy Code.[128] Thus, although the *issuance* or *sale* of the prepackaged plan securities clearly is exempted from registration by section 1145(a), the SEC takes the position that the *offer* is not. This means that prior to soliciting acceptance of a prepackaged plan, the debtor must either comply with registration requirements or qualify for some other exemption from registration.

(c) The Bankruptcy Code defines "affiliate" in section 101(2),[129] but provides no definition of the phrase "participating in a joint plan with the debtor." The SEC has interpreted the term "affiliate" broadly.[130]

(d) Where the affiliate issuer is a proponent of a Chapter 11 plan, the affiliate clearly comes within the phrase an "affiliate participating in a joint plan with a debtor" and is thus entitled to the section

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[126] *See* Saggese & Ranney-Marinelli, *supra* note 2, § 8.02[E], at 8-27 to 8-28.

[127] 11 U.S.C. § 1145(a)(2).

[128] 11 U.S.C. § 101(13) ("'[D]ebtor' means person . . . concerning which a case under this title has been commenced.").

[129] *See* 11 U.S.C. § 101(2).

[130] *See* Fernicola & Levin, *supra* note 108, at 3 n.3; *see* Saggese & Ranney-Marinelli, *supra* note 2, § 8.02[C][1], at 8-17 to 8-18.

1145 exemption.[131] However, the SEC also has suggested that the affiliate issuer need not be an actual proponent or co-proponent of the Chapter 11 plan.[132]

(e) One of the more difficult determinations is what constitutes a "successor" to the debtor. The Bankruptcy Code does not define "successor" or the phrase "successor to the debtor under the plan." The term "successor" has been given a broad and pragmatic interpretation by the SEC. Entities that have purchased substantially all the assets of a debtor or merged with a debtor have been deemed to be successors to a debtor for purposes of section 1145.[133] In certain instances, liquidating litigation trusts also have been deemed to be successors to a debtor.[134]

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[131] *See In re Frontier Airlines, Inc.*, 93 B.R. 1014, 1020-22 (Bankr. D. Colo. 1988) (citing the lack of SEC guidance on definition of "affiliate participating in a joint plan with [a] debtor"; holding that issuance of securities under § 1145 exemption by wholly-owned subsidiary that was co-proponent of the plan was permissible); Elsinore Finance Corp., SEC No-Action Letter, 1988 SEC No-Act. LEXIS 469, at *3-7, *15-16 (Apr. 15, 1988) (no-action relief recommended where affiliate of debtor was "clearly participating in the Plan" as evidenced by the fact that "it [was] one of the named proponents"); Lezak Group, Inc., SEC No-Action Letter, 1985 SEC No-Act. LEXIS 2587, at *9-10 (Oct. 3, 1985) (no-action relief recommended where nondebtor parent was the proposed issuer and plan proponent under the Chapter 11 plan).

[132] Lomas Financial Corp., SEC No-Action Letter, 1992 WL 19998, at *13 (Jan. 29, 1992) ("[I]t is not necessary for an issuer to be a plan proponent in order to fall within Section 1145.").

[133] *See, e.g.*, Search Capital Group, Inc., SEC No-Action Letter, 1996 SEC No-Act. LEXIS 713, at *1-2, *18-19 (Aug. 30, 1996) (plan securities issued by parent company of buyer of substantially all of debtor's assets afforded § 1145 exemption); Hasbro, Inc., SEC No-Action Letter, 1989 SEC No-Act. LEXIS 988, at *1-2, *16-20 (Sept. 28, 1989) (no-action relief recommended where warrants issued to debtor as part of purchase price for debtor's assets pursuant to a preconfirmation § 363 sale would be distributed to creditors under Chapter 11 plan); Jet Florida System, Inc., SEC No-Action Letter, 1987 WL 107448, at *1-4, *7 (Jan. 12, 1987) (securities of survivor of merger with debtor to be issued under Chapter 11 plan and shares issued by acquirer of debtor's assets as part of purchase price under a § 363 sale to be distributed under Chapter 11 plan both afforded § 1145 exemption); Barry's Jewelers, Inc., SEC No-Action Letter, 1998 SEC No-Act. LEXIS 735, at *1-2, *21-22 (July 20, 1998) (no-action relief recommended where plan issuer was surviving entity of reincorporation merger between debtor and newly-formed wholly-owned subsidiary of debtor). *But see In re Stanley Hotel, Inc.*, 13 B.R. 926, 933 (Bankr. D. Colo. 1981) ("To be a successor, 'in all material respects the succeeding corporation should stand in the boots of the old one.'" (citation omitted)).

[134] *See* D.H. Baldwin Co., SEC No-Action Letter, 1986 WL 66903, at *5 (June 13, 1986) (beneficial interests in liquidating trust may be distributed without complying with the registration requirements based on representations that: (i) the beneficial interests in liquidating trust are not transferable except to entities over which the creditor beneficiaries exercise control or upon death or operation of law; (ii) the beneficial interests will not be evidenced by a certificate or be evidenced by any certificate that will bear a restrictive legend; (iii) the liquidating trust exists only to effect the liquidation and will terminate within a reasonable period of time; and (iv) the liquidating trust will issue to all beneficiaries annual reports containing audited financial statements reflecting the activities of the trust); Official Unsecured Creditor's Committee of American Freight Systems, Inc. and USA Western, Inc., SEC No-Action Letter, 1991 SEC No-Act. LEXIS 901, at *25-28 (July 15, 1991) (same).

(f) The affiliate or successor issuer need not be a debtor to be afforded the section 1145 exemption.[135]

(g) A debtor can have more than one successor.[136]

4. In Exchange for or Principally in Exchange for a Claim, Interest, or Administrative Expense Claim

(a) The section 1145(a)(1) exemption is available only if the offer or sale of the security is (A) in exchange for a prepetition or administrative claim against or an equity interest in the debtor or (B) principally in exchange for such claim or interest and partly for cash or property. It is not relevant under section 1145(a)(1) whether the claim to be exchanged is secured, unsecured, prepetition or postpetition, but the recipient of the security must be the holder of such claim or equity interest.[137]

(b) Situations where the offer and sale of the security are entirely in exchange for a claim or equity interest are straight-forward. However, the analysis is more difficult when cash or other property is transferred to the debtor by the claim or equity interest holder. In that case, the section 1145 exemption remains available only if the value of the cash or property transferred to the debtor by the holder of the claim or interest is less than the value of the claim or interest being surrendered. This limitation is commonly referred to as the "principally/partly" requirement. According to the SEC, "[t]he purpose of this requirement is to ensure that Section 1145 is used primarily as an exemption from registration for a transaction aimed at satisfying existing obligations and interests, and not as a means for avoiding the added protections afforded through the

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[135] Fernicola & Levin, *supra* note 108, at 3 n.3; *see also* U.S. Plastic Lumber Corp., SEC No-Action Letter, 1998 SEC No-Act. LEXIS 940, at *6, *15 (Oct. 23, 1998) (nondebtor purchaser of debtor's assets in a § 363 sale treated as successor to debtor, such that securities to be issued by purchaser under Chapter 11 plan would be exempt from registration under § 1145); TMI Growth Properties, SEC No-Action Letter, 1989 SEC No-Act. LEXIS 113, at *11-16 (Jan. 25, 1989) (securities of nondebtor affiliate-partnerships to be offered and sold under Chapter 11 plan without registration); Lezak Group, Inc., SEC No-Action Letter, 1985 SEC No-Act. LEXIS 2587, at *9-10 (Oct. 3, 1985) (§ 1145 exemption applied to nondebtor parent issuer); *In re Amarex*, *Inc*., 53 B.R. 12 (Bankr. W.D. Okla. 1985) (nondebtor corporation whose subsidiary would merge with debtor under Chapter 11 plan deemed to be successor to debtor).

[136] *See* Wickes Cos., Inc., SEC No-Action Letter, 1986 WL 67441, at *1 (Nov. 10, 1986) (issuer parent and acquirer subsidiary in a triangular acquisition deemed as successor to debtor); Search Capital Group, Inc., SEC No-Action Letter, 1996 SEC No-Act. LEXIS 713, at *1-2, *18-19 (Aug. 30, 1996) (parent company and wholly-owned subsidiary which acquired substantially all of debtors assets both viewed as successors to debtor); Oregon Steel Mills, Inc., SEC No-Action Letter, 1993 SEC No-Act. LEXIS 326, at *1-2 (Feb. 26, 1993) (same).

[137] *See* Fernicola & Levin, *supra* note 108, at 5; s*ee* 8 *Collier on Bankruptcy* ¶ 1145.02[1][a][iii] (Alan N. Resnick & Henry J. Sommer eds., 15th ed. rev. 2008); Saggese & Ranney-Marinelli, *supra* note 2, § 8.02[D], at 8-23.

registration requirements of the federal securities laws when raising fresh capital."[138] Thus, securities issued under a Chapter 11 plan by a debtor primarily to raise cash to facilitate an exit from bankruptcy are not accorded the section 1145(a) exemption.[139]

(c) Although there is little case law interpreting the "principally/partly" requirement, there are a number of no-action letters addressing it. In determining whether the "principally/partly" requirement is satisfied, the SEC takes into consideration the value of the claim or interest being surrendered as compared with the cash or property being contributed by the claim or interest holder. The SEC takes the position that the "burden of proof in obtaining an exemption from registration under Section 1145 should be on the Proponents, who must demonstrate the basis for concluding that the value of the securities being exchanged exceeds the value of the new funds being solicited."[140]

(d) The SEC has cited with approval one commentator's view that the value of the claim or interest surrendered should represent more than 50% of the value of the total consideration tendered, with the remaining portion comprising cash and other property.[141]

(e) The difficulty that generally confronts the plan proponent is establishing the value of the claims and interests that are being surrendered. Value can be established in a number of ways. Thus, the SEC has recommended no-action relief in connection with the issuance of securities pursuant to section 1145(a)(1) based on plan

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[138] Objection of the SEC to the First Amended Disclosure Statement Relating to the First Amended Joint Chapter 11 Plan of Reorganization and First Amended Joint Plan, Filed by Marvel Holdings Inc., et al., *In re Marvel Holdings Inc.*, No. 96-2066 (Bankr. D. Del. July 10, 1997), 1038 PLI/Corp 51, at *236 (Westlaw) [hereinafter Marvel Objection].

[139] *See id.* at *236 & n.11; *see also* Fernicola & Levin, *supra* note 108, at 3 n.2.

[140] Marvel Objection, *supra* note 138, at *237.

[141] *See* Objection of the SEC to Debtor's Application for Determination of Applicability of Bankruptcy Code Section 1145 to Debtor's Second Amended Plan of Reorganization, *In re Penn Pacific Corp.*, No. 94-00230 (Bankr. N.D. Okla. July 21, 1994), 882 PLI/Corp 47, at *107 n.3 (Westlaw) ("Section 1145 further restricts the new property component by requiring that the outstanding securities and claims be the 'principal' return consideration . . . debtors who wish to avoid SEC intervention should require that the return consideration constitute 51% outstanding claims and interests, at minimum, and 49% new property, at maximum." (alteration in original) (quoting Clyde Mitchell, *Securities Regulation in Bankruptcy Reorganizations*, 54 Am. Bankr. L.J. 101, 117-18 (1980)); *see also* 8 *Collier on Bankruptcy*, *supra* note 137, ¶ 1145.02[1][a][iii]; Fernicola & Levin, *supra* note 108, at 5 n.8.

valuation of claims,[142] market valuation of claims,[143] and a financial advisor's valuation of claims.[144]

F. Free Tradability of Securities Issued Under Section 1145(a)(1)

1. Section 1145(c) of the Bankruptcy Code provides that an offer or sale of a security under section 1145(a)(1) is "deemed to be a public offering."[145] This provision prevents the securities issued under a Chapter 11 plan in accordance with section 1145(a)(1) from being characterized as "restricted securities" under the Securities Act[146] or subject to the registration requirements or other restrictions on resale.[147] The SEC has issued a number of no-action letters providing reassurance that resales of securities issued in reliance on section 1145(a)(1) are exempt from registration under section 1145.[148]

2. Thus, a claim or equity interest holder that receives securities under a Chapter 11 plan in accordance with section 1145(a)(1) may trade those

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[142] *See* Jet Florida Systems, Inc., SEC No-Action Letter, 1987 WL 107448 (Jan. 12, 1987) (SEC recommended no-action relief where the debtor calculated value of claims to be exchanged for subscription rights by dividing the plan consideration for the claims by the face amount of the claims, then multiplied by $100 (the face amount of claims to be exchanged for a right to purchase one share of common stock) to reach a per-right value of $3.21 to $3.80, compared with the per-right value to the cash exercise price of $2.40, and concluded that the proposed exchange would be principally for a claim against the debtor and partly for cash or property).

[143] *See* Bennett Petroleum Corp., SEC No-Action Letter, 1983 SEC No-Act. LEXIS 3102, at *7, *19 (Dec. 27, 1983) (SEC recommended no-action relief where the stockholders that elected to exchange their existing common stock would be required to pay a per share cash price of 75% of the average bid price of debtor's common stock for the ten days prior to the plan confirmation date, thereby ensuring that the market value of the claims surrendered would exceed the amount of cash contributed by 25%).

[144] *See* Barry's Jewelers, Inc., SEC No-Action Letter, 1998 SEC No-Act. LEXIS 735, at *27-28 (July 20, 1998) (SEC recommended no-action relief where the financial advisor convincingly showed that the implied value of the bondholders' allowed claims was greater than the maximum cash contribution to be made by the bondholders).

[145] 11 U.S.C. § 1145(c).

[146] The term "restricted securities" is defined in Rule 144 under the Securities Act. *See* 17 C.F.R. § 230.144.

[147] H.R. Rep. No. 95-595, at 421, *reprinted in* 1978 U.S.C.C.A.N. at 6377 ("Subsection (c) makes an offer or sale of securities under the plan in an exempt transaction . . . a public offering, in order to prevent characterization of the distribution as a 'private placement' which would result in restrictions, under Rule 144 of the SEC, on the resale of the securities.").

[148] Mooney Aerospace Group, Ltd., SEC No-Action Letter, 2002 SEC No-Act. LEXIS 843, at *12-13 (Dec. 20, 2002) (SEC recommended no-action relief as to resale of warrants exempt from registration under § 1145 that were issued prior to plan confirmation for distribution under Chapter 11 plan); Search Capital Group, Inc., SEC No-Action Letter, 1996 SEC No-Act. LEXIS 713, at *1-2, *21-22 (Aug. 30, 1996) (securities of nondebtor successor to be issued under Chapter 11 plan deemed not to be "restricted securities"; resales without registration permitted as long as seller is not an "underwriter" as defined in § 1145(b)(1) or an affiliate of the issuer within the meaning of the Securities Act).

securities freely, provided that such holder is not an underwriter within the meaning of section 1145(b)(1)[149] or an affiliate of the issuer within the meaning of Rule 144 of the Securities Act.[150]

G. The Resale of Securities Issued Under Section 1145

1. An offer or sale of securities by an "underwriter," as defined in section 1145(b), is not afforded an exemption from the registration requirements of the Securities Act or state or local law under section 1145.[151]

   (a) Section 1145(b)'s definition of "underwriter" is more limited than the definition of "underwriter" under the Securities Act.[152] A non-bankruptcy underwriter is one who, *at the time when he purchased a security*: (i) intended to distribute it at a later date; (ii) was involved, directly or indirectly, in a purchase aimed at distribution; or (iii) who, either directly or indirectly, underwrote the purchase itself.[153]

   (b) Most creditors in a Chapter 11 case have little choice but to accept securities offered to them in exchange for their claims under a Chapter 11 plan, and many of them intend to resell the securities soon after they receive them.[154] The expansive Securities Act definition of "underwriter," "[i]f literally applied, . . . would prevent any creditor in a bankruptcy case from selling securities received without filing a registration statement or finding another exemption."[155] Thus, Congress tailored the bankruptcy definition of "underwriter" so as to permit most creditors to escape the restrictive label of "underwriter" and avail themselves of the

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149 *See* Part IV.G. *infra* for a discussion of § 1145(b)(1) of the Bankruptcy Code.

150 Securities Act Rule 144(a)(1) defines an "affiliate of an issuer" as "a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, such issuer." 17 C.F.R. § 230.144(a)(1). However, if the applicable conditions of Rule 144 are met – SEC reporting requirements have applied to the debtor for at least 90 days and the debtor is current on all reporting requirements – then affiliates of the issuer that received securities issued under section 1145(a) may sell such securities without filing a registration statement and without adhering to Rule 144's minimum holdings period requirement (although the affiliate will be subject to the volume limitations, and information and notice requirements of Rule 144). *See* Fernicola & Levin, *supra* note 108, at 6 n.9; Saggese & Ranney-Marinelli, *supra* note 2, § 8.03[C], at 8-65 to 8-66.

151 11 U.S.C. § 1145(a)(1), (b).

152 Fernicola & Levin, *supra* note 108, at 4.

153 *See* 15 U.S.C. § 77b(a)(11); *see also* Fernicola & Levin, *supra* note 108, at 4, 6-7.

154 Fernicola & Levin, *supra* note 108, at 6 n.10.

155 H.R. Rep. No. 95-595, at 421, *reprinted in* 1978 U.S.C.C.A.N. at 6377.

section 1145 exemption,[156] even though it is their intention when they vote on the plan and when they receive plan securities to sell them.

2. "Underwriter" for Bankruptcy Purposes

(a) Section 1145(b)(1) provides that an entity is an "underwriter" if such entity (A) purchases claims against or interests in the debtor with a view to distribution of any security received in exchange for such claim or interest; (B) offers to resell securities issued under a Chapter 11 plan for the holders of such securities; (C) offers to buy securities issued under a Chapter 11 plan with a view to distribution of such securities; or (D) is an issuer, as used in Section 2(a)(11) of the Securities Act,[157] with respect to such securities.[158]

(b) In contrast to the definition of "underwriter" in clauses (B) and (C), which focus on the entity's intent at the time of the purchase or sale of the plan securities, clause (A) focuses on whether the entity has a "view to distribution" at the time it acquires the underlying claims or interests that are ultimately exchanged for plan securities.[159] Thus, for example, a typical trade creditor that desires to resell the securities issued to it under a plan at the time it received them would not be an "underwriter" under clause (A) – and could therefore resell the securities without registration – if it acquired its claims against the debtor in the ordinary course of doing business with the debtor (*i.e.*, for providing goods or services).[160] By contrast, an entity that purchases claims with the intention of acquiring and reselling plan securities would not be afforded an exemption from registration by section 1145(a). The determination of whether an entity is an "underwriter" under section 1145(b)(1)(A) will depend on the facts and circumstances of the particular transaction.[161]

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[156] *See* Falk et al., *supra* note 3, at 95-96.

[157] 15 U.S.C. § 77b(a)(11).

[158] 11 U.S.C. § 1145(b)(1).

[159] 11 U.S.C. § 1145(b)(1)(A); *see also* Fernicola & Levin, *supra* note 108, at 6-8; Saggese & Ranney-Marinelli, *supra* note 2, § 8.03[A], at 8-58 to 8-59.

[160] *See* Falk et al., *supra* note 3, at 95; Fernicola & Levin, *supra* note 108, at 7-8.

[161] Fernicola & Levin, *supra* note 108, at 8.

(c) Unlike the definition of "underwriter" under the Securities Act, clause (D) of section 1145(b)(1) includes an "issuer," as such term is used in section 2(a)(11) of the Securities Act, as an "underwriter."[162] Section 2(a)(11) of the Securities Act provides that "the term 'issuer' shall include, in addition to an issuer, any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer."[163]

(i) If applied literally, a debtor-issuer would be an "underwriter" under section 1145, which would lead to the bizarre result that the debtor itself could not rely on the section 1145 exemption from registration with respect to securities issued under its own Chapter 11 plan. Courts and commentators alike, however, have construed the term "issuer" in this context narrowly, and have found that it is intended to include as underwriters only certain "control persons," as that term is used in the Securities Act, and not debtors or their affiliates.[164]

(ii) The determination of "control" is a fact specific inquiry and is based on the definition of "control" set forth in Rule 405 under the Securities Act.[165] An entity usually has "presumptive control" if it owns and controls more than 10% of the voting securities of an issuer.[166]

3. Exceptions to Underwriter Status Under The Bankruptcy Code

(a) Section 1145(b)(1) provides two important exceptions to the definition of "underwriter."

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[162] 11 U.S.C. § 1145(b)(1)(D); *see also* Fernicola & Levin, *supra* note 108, at 9; Saggese & Ranney-Marinelli, *supra* note 2, § 8.03[B], at 8-63 to 8-64.

[163] 15 U.S.C. § 77b(a)(11).

[164] *See In re Standard Oil & Exploration of Del., Inc.*, 136 B.R. 141, 148-50 (Bankr. W.D. Mich. 1992); *In re Amarex, Inc.* 53 B.R. at 13; *see also* Richard J. Morgan, *Application of the Securities Laws in Chapter 11 Reorganizations Under the Bankruptcy Reform Act of 1978*, 1983 U. Ill. L. Rev. 861, 877 (1983).

[165] Rule 405 provides: "The term control (including the terms controlling, controlled by and under common control with) means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise." 17 C.F.R. § 230.405.

[166] *See* Fernicola & Levin, *supra* note 108, at 4, 9; H.R. Rep. No. 95-595, at 238, *reprinted in* 1978 U.S.C.C.A.N. at 6197.

(b) *Ordinary Trading Transactions.* An entity that is not an issuer will not be deemed to be an underwriter with respect to "ordinary trading transactions."[167] Thus, even an "underwriter" under the Bankruptcy Code may resell plan securities without registering them as long as it does so through "ordinary trading transactions."[168]

(i) The phrase "ordinary trading transactions" is not defined in the Bankruptcy Code or the securities laws. SEC no-action letters have provided some guidance on the meaning by contrasting "ordinary trading transactions" with "distributions."[169] Thus, "ordinary trading transactions" are *unlike* "distributions," which are restricted by securities laws, and typically involve an unsolicited resale of a small number of securities that involves customary selling efforts and a typical compensation for brokers.[170]

(ii) Creditors or equityholders who received significant amounts of securities under a Chapter 11 plan and who use a broker to resell those securities must be careful to abide by the definitional parameters of an "ordinary trading transaction" to avoid running afoul of the section 1145 exemption and being deemed an "underwriter" under section 1145(b).[171]

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[167] 11 U.S.C. § 1145(b)(1).

[168] *See* Fernicola & Levin, *supra* note 108, at 10 & n.20.

[169] *See* Manville Corp. SEC No-Action Letter, 1986 WL 6834, at *5 (Sept. 29, 1986) (SEC permitted resales by accumulators and distributors without complying with the Securities Act's registration requirements so long as only ordinary trading transactions were conducted). The SEC based its no-action relief on the representation that the factors typically involved in traditional underwriting were not present: "(a) concerted action by recipients of Plan Securities in connection with the sale of Plan Securities, or concerted action on behalf of one or more such recipients in connection with such sales by distributors; (b) use of informational documents concerning Plan Securities prepared or used to assist in the resale of Plan Securities, other than the Disclosure Statement, supplements thereto, if any, and documents filed with the SEC . . . pursuant to the [Exchange] Act, such as annual and quarterly reports on Forms 10-K and 10-Q; and (c) special compensation to brokers and dealers in connection with the sale of Plan Securities designed as a special incentive to resell Plan Securities, other than the compensation that would be paid pursuant to arms-length negotiations between a seller and a broker or dealer, each acting unilaterally, not greater than the compensation that would be paid for a routine similar-sized sale of similar securities of a similar issuer.").

[170] *Id.*; *see also* Fernicola & Levin, *supra* note 108, at 11.

[171] *See* Falk et al., *supra* note 3, at 96.

(c) *Fractional Exception.* Section 1145(b)(2) excepts from the definition of "underwriter" parties to agreements for the purchase or offer of fractional interests.[172]

H. The Portfolio Securities Exemption Under Section 1145(a)(3)

1. Section 1145(a)(3) exempts the offer or sale of a security of an issuer other than the debtor or an affiliate if (i) the security was owned by the debtor on the filing date of the bankruptcy petition, (ii) the issuer is a reporting company under the Exchange Act, (iii) the issuer is in compliance with the disclosure and reporting requirements of the Exchange Act, and (iv) the offer or sale does not exceed certain maximum percentages of the class of such securities outstanding during specified time periods.

2. This limited exemption permits the debtor to sell during a Chapter 11 case portfolio securities it owns without filing a registration statement. This enables a debtor holding portfolio securities to liquidate them during the Chapter 11 case in order to raise cash.[173]

I. The Stockbroker Exemption Under Section 1145(a)(4)

1. Section 1145(a)(4) provides that registration requirements do not apply to a "transaction by a stockbroker"[174] in a security issued under section 1145(a)(1) or (2) within 40 days after the first date the security was "bona fide offered to the public" by the issuer, or by or through an underwriter, if the stockbroker provides a court-approved disclosure statement and any court-ordered supplementary information at the time of or before such transaction.[175]

2. Although the exemption is intended for the benefit of the stockbroker, the debtor-issuer may want to take steps to facilitate trading of securities that it issued under section 1145(a)(1) or (2).[176] If the securities have been listed on an exchange, the debtor-issuer will want to take steps to

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[172] *See* Saggese & Ranney-Marinelli, *supra* note 2, § 8.03[A][2], at 8-62 to 8-63; H.R. Rep. No. 95-595, at 420, *reprinted in* 1978 U.S.C.C.A.N. at 6376.

[173] *See* H.R. Rep. No. 95-595, at 420-21, *reprinted in* 1978 U.S.C.C.A.N. at 6376-77; S. Rep. No. 95-989, at 132 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5918.

[174] 11 U.S.C. § 1145(a)(4). The term "stockbroker" is defined in section 101(53A) of the Bankruptcy Code. *See* 11 U.S.C. § 101(53A).

[175] 11 U.S.C. § 1145(a)(4). Section 1145(a)(4) provides an exemption similar to the exemption provided to dealers under Section 4(3)(A) of the Securities Act. *See* 15 U.S.C. § 77d(3).

[176] *See* Saggese & Ranney-Marinelli, *supra* note 2, § 8.05[B], at 8-74.

encourage trading, such as making copies of the court-approved disclosure statement available to stockbrokers during the 40-day exemption period.[177] The debtor-issuer also may consider supplementing the disclosure statement as permitted by section 1145(a)(4) and disseminating the supplementary information if it becomes aware of any material omissions or misstatements in the disclosure statement, as approved by the bankruptcy court.[178]

J. Limited Exemption to the Trust Indenture Act

Section 1145(d) provides that the Trust Indenture Act of 1939 ("TIA") does not apply to a note issued under a Chapter 11 plan that "matures not later than one year after the effective date of the plan."[179] Subject to this limited exception, the TIA applies.

K. Exemption Under Section 364(f) of the Bankruptcy Code

1. Section 364(f) of the Bankruptcy Code facilitates postpetition debt financing by exempting it from the registration requirements of the Securities Act and state and local law, the TIA, and various other state and local licensure requirements.[180] Thus, section 364(f) permits a debtor to raise capital during its Chapter 11 case by taking on additional debt through the issuance of promissory notes or "certificates of indebtedness."[181]

2. Note, however, that the section 364(f) exemption is not available if the debtor-issuer (i) is an "underwriter" within the meaning of section 1145(b) or (ii) the securities to be issued are "equity securities."[182]

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[177] *See id.*

[178] *See id* § 8.05[B], at 8-75.

[179] 11 U.S.C. § 1145(d).

[180] Section 364(f) of the Bankruptcy Code provides:

> Except with respect to an entity that is an underwriter as defined in section 1145(b) of this title, section 5 of the Securities Act of 1933, the Trust Indenture Act of 1939, and any State or local law requiring registration for offer or sale of a security or registration or licensing of an issuer of, underwriter of, or broker or dealer in, a security does not apply to the offer or sale under this section of a security that is not an equity security.

11 U.S.C. § 364(f).

[181] *See In re Standard Oil & Exploration of Del., Inc.*, 136 B.R. at 146-148.

[182] The term "equity security" is defined in § 101(16) of the Bankruptcy Code. *See* 11 U.S.C. § 101(16).

L. Securities Fraud Liability

The securities laws' anti-fraud provisions make it unlawful to purchase or sell securities based on any material misrepresentation or omission of any material fact.[183] The registration exemptions under sections 364(f) and 1145 of the Bankruptcy Code do not provide a safe harbor from liability under the anti-fraud provisions of the securities laws.

M. Limited Safe Harbor Under Section 1125(e) of the Bankruptcy Code for Good Faith Solicitation Under a Chapter 11 Plan

1. The "Good Faith" Exemption Under Section 1125(e)

(a) Section 1125(e) of the Bankruptcy Code[184] provides a *limited* safe harbor from liability under the anti-fraud provisions of federal and state securities laws for persons that in good faith and in compliance with the applicable provisions of Chapter 11 (i) solicit votes on a Chapter 11 plan or (ii) participate in the offer, issuance, sale, or purchase of a security of a debtor, an affiliate participating in a joint plan with the debtor, or a newly organized successor to the debtor[185] offered or sold under a Chapter 11 plan. The intent of this safe harbor provision is to protect those involved in the plan solicitation process, such as the creditors, creditors' and other official committees and their professionals, as well as the debtor and its professionals, from potential liability under the securities laws for participating in the plan solicitation process in reliance on

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[183] See *supra* note 79 for the anti-fraud provisions of the Exchange Act.

[184] Section 1125(e) of the Bankruptcy Code provides:

> A person that solicits acceptance or rejection of a plan, in good faith and in compliance with the applicable provisions of this title, or that participates, in good faith and in compliance with the application provisions of this title, in the offer, issuance, sale, or purchase of a security, offered or sold under the plan, of the debtor, of an affiliate participating in a joint plan with the debtor, or of a newly organized successor to the debtor under the plan, is not liable, on account of such solicitation or participation, for violation of any applicable law, rule, or regulation governing solicitation of acceptance or rejection of a plan or the offer, issuance, sale or purchase of securities.

11 U.S.C. § 1125(e).

[185] By its terms, § 1125(e) shields from liability under the securities laws only *newly organized* successors to the debtor. This is in contrast to § 1145(a)(1), which protects *any* "successor to the debtor." The SEC, however, has recommended no-action relief even where the issuer was not a "newly organized successor." *See, e.g.*, Computer Input Services, Inc., SEC No-Action Letter, 1984 WL 45210, at *6 (May 4, 1984) (nondebtor parent company of prospective purchasers of substantially all of debtors' assets and proposed issuer of securities under debtors' Chapter 11 plan afforded § 1125(e) protection); Richard M. Cieri et al., *Safe Harbor in Unchartered Waters – Securities Law Exemptions Under Section 1125(e) of the Bankruptcy Code*, 51 Bus. Law. 379, 399 (1996).

a court-approved disclosure statement.[186] The safe harbor provision also encourages creditors to participate in the plan process by alleviating their fear of liability under the securities laws in connection with their good faith efforts to gain consensus on a Chapter 11 plan.[187]

(b) As discussed in paragraph II.D. above, section 1125(d) of the Bankruptcy Code provides that the adequacy of disclosure in a disclosure statement is not governed by any otherwise applicable nonbankruptcy law, such as the securities laws.[188] The legislative history notes that the safe harbor provided by section 1125(e) was necessary to give effect to the securities law exemption under section 1125(d).[189] Absent this safe harbor, the solicitation of plan votes and participation in the offer, sale, and issuance of securities under a Chapter 11 plan would be subject to the anti-fraud provisions of the securities laws, and a person that participated in the plan solicitation process would be potentially liable for any material omissions or misstatements in the disclosure statement or for any other violation of securities laws.[190]

2. Section 1125(e) Safe Harbor Limitations

(a) Good Faith Limitation

(i) The "safe harbor" under section 1125(e) by its terms is limited to acts taken in good faith and in compliance with applicable provisions of the Bankruptcy Code. The legislative history states that "[s]ub-section (e) does not affect civil or criminal liability for defects and inadequacies that are beyond the limits of the exoneration that good faith

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[186] H.R. Rep. No. 95-595, at 229, *reprinted in* 1978 U.S.C.C.A.N. at 6189. The term "participation" is broadly interpreted for the purposes of § 1125(e). The legislative history notes that the provision is intended "to protect creditors, creditors' committee, counsel for committees, and others involved in the case." *Id.* Such other parties also include the debtor, the debtors' professionals, and plan sponsors or investors. *See, e.g.*, *In re Apex Oil Co.*, 118 B.R. 683, 694 (Bankr. E.D. Mo. 1990) (court granted § 1125(e) protection to debtors, nondebtor affiliates and creditors' committee, and their respective officers, directors, shareholders, partners, employees, agents, professionals and representatives.); Cieri et al., *supra* note 185, at 416.

[187] Cieri et al., *supra* note 185, at 396; *see also* 7 *Collier on Bankruptcy* ¶ 1125.03[1][a] (Alan N. Resnick & Henry J. Sommer eds., 15th ed. rev. 2008) (discussing how free communication between parties in interest can help produce "the best result for all parties").

[188] 11 U.S.C. § 1125(d); *see also supra* note 64.

[189] H.R. Rep. No. 95-595, at 229, *reprinted in* 1978 U.S.C.C.A.N. at 6189.

[190] *Id.*; *see also* U.S. Plastic Lumber Corp., SEC No-Action Letter, 1998 SEC No-Act. LEXIS 940, at *11 (Oct. 23, 1998).

provides."[191] Thus, the section 1125(e) safe harbor does not shield a person from liability from securities fraud claims under Section 10(b) and Rule 10(b)-5 of the Exchange Act, because they require a showing of scienter – defined as "a mental state embracing intent to deceive, manipulate, or defraud."[192] If scienter exists, the good faith required by section 1125(e) obviously does not.

(ii) The legislative history notes that section 1125(e) codifies the U.S. Supreme Court's decision in *Ernst & Ernst v. Hochfelde*r, which held that liability under Section 10(b) and Rule 10(b)-5 of the Exchange Act cannot be based on negligent conduct alone; it requires a showing of scienter.[193] Thus, section 1125(e) will protect a person that participated in the plan solicitation process from liability based on negligent misstatements or omissions in a disclosure statement, but will not exonerate a person from intentionally wrongful conduct during that process.[194] While it is clear that parties will be protected from mere negligence – and will be liable for knowing, intentional, material misstatements or omissions in connection with the solicitation and plan process – it is not clear whether recklessness is protected by section 1125(e).

(iii) Moreover, the fact that a bankruptcy court finds that (A) a disclosure statement contains adequate information and (B) all parties acted in good faith in connection with the solicitation and plan process will not be an absolute bar to a postconfirmation suit alleging fraud. However, such suits are rare, and courts are reluctant to allow disgruntled parties to litigate issues and facts that were, or could have been, raised during the Chapter 11 case. Thus, some courts require the plaintiffs to establish a "true 'secret fraud' with regard to a topic that was not addressed, and normally

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[191] S. Rep. No. 95-989, at 122, *reprinted in* 1978 U.S.C.C.A.N. at 5908; *see also SEC v. Universal Express, Inc.*, 475 F. Supp. 2d 412, 425 (S.D.N.Y. 2007); Damson Oil Corp., SEC No-Action Letter, 1992 SEC No-Act. LEXIS 235, at *2 (Feb. 21, 1992) (SEC clarified that liability still exists for "civil and criminal penalties of the federal securities laws for disclosure inadequacies and other violations that are beyond the safe harbor provisions of Section 1125(e)").

[192] *Ernst & Ernst v. Hochfelder,* 425 U.S. 185, 193 n.12 (1976); Saggese & Ranney-Marinelli, *supra* note 2, § 8.06[A], at 8-82 to 8-83.

[193] *See* 425 U.S. 185; H.R. Rep. No. 95-595, at 230, *reprinted in* 1978 U.S.C.C.A.N. at 6189-90.

[194] Cieri et al., *supra* note 185, at 401 & n.86; 7 *Collier on Bankruptcy*, *supra* note 187, ¶ 1125.03[7]; Saggese & Ranney-Marinelli, *supra* note 2, § 8.06[A], at 8-82 to 8-84.

would *not* be addressed, during the course of the reorganization proceedings."[195]

(b) Courts have held that section 1125(e)'s safe harbor is available only during the limited period of the "disclosure and solicitation process" of a Chapter 11 case.[196] It is unclear whether persons involved in plan negotiations prior to the court's approval of a disclosure statement are protected by section 1125(e) or subject to the more stringent standards of the securities laws.[197]

(c) Persons participating in the offer or sale of securities not issued pursuant to a Chapter 11 plan, such as portfolio securities owned by the debtor, do not enjoy the protection of section 1125(e) because those securities (i) are not securities of a debtor, affiliate of the debtor, or newly formed successor to the debtor and/or (ii) are not offered or sold under a Chapter 11 plan.[198] The sale of portfolio securities owned by a debtor, however, enjoys a limited exemption from the registration requirements under section 1145(a) of the Bankruptcy Code.[199]

(d) It is unclear whether section 1125(e)'s protection is available to persons participating in a prepetition solicitation process in connection with a prepackaged Chapter 11 plan. Although section 1126(b) of the Bankruptcy Code provides for prepetition solicitation of votes, the legislative history of section 1125(e) suggests that the safe harbor of section 1125(e) was intended to protect solicitations made in reliance on a court-approved disclosure statement – which technically is not possible if the entity has yet to file a bankruptcy petition.[200] Commentators take different positions on the issue.[201]

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[195] *See Pub. Serv. Co. of N.H. v. Richards* (In re Pub. Serv. Co. of N.H.), 148 B.R. 702, 720 (Bankr. D.N.H. 1992) (suggesting that if a court could not make an informed judgment on whether the "unexpected fact" should be disclosed, then its adequate disclosure and good faith determinations should not be binding for § 1125(e) purposes).

[196] *Universal Express*, *Inc.*, 475 F. Supp. 2d at 425 (citing *Jacobson v. AEG Capital Corp.,* 50 F.3d 1493, 1496 (9th Cir. 1995)).

[197] *Century Glove, Inc. v. First Am. Bank of N.Y.*, 860 F.2d 94, 102 (3d Cir. 1988).

[198] Saggese & Ranney-Marinelli, *supra* note 2, § 8.06[B], at 8-86.

[199] *See* Part IV.H. *supra* for a discussion of portfolio securities.

[200] *See* H.R. Rep. No. 95-595, at 229, *reprinted in* 1978 U.S.C.C.A.N. at 6189.

[201] *See* Cieri et al., *supra* note 185, at 409-14.

V. NEW DEVELOPMENTS

No Shareholder Approval of Issuance of Securities by a Debtor-In-Possession – Change to NYSE Rule 312.03

1. On January 8, 2009, the SEC published notice of a proposed rule change to New York Stock Exchange ("NYSE") Rule 312.03[202] filed by the NYSE.[203] The rule change was effective immediately upon filing, although the SEC solicited comments from interested persons until February 6, 2009. The rule change codifies the NYSE's long-standing interpretation that a NYSE-listed company that is a debtor-in-possession under the Bankruptcy Code satisfies any applicable shareholder approval requirement under NYSE Rule 312.03 that might otherwise be required in connection with an issuance of common stock or a security convertible into or exercisable for common stock by obtaining bankruptcy court approval of the proposed issuance.[204]

2. Although the rule change was prompted by the conservatorship proceedings of Fannie Mae and Freddie Mac and the United States Treasury's purchase of senior preferred stock and common stock warrants representing a 79.9% ownership stake in each of them, the rule change is not specific to the Fannie Mae and Freddie Mac transactions.[205]

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[202] *See New York Stock Exchange Listed Company Manual* § 312.03(c) (last modified May 22, 2007), *available at* 2004 WL 1907812.

[203] *See* Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by New York Stock Exchange LLC to Memorialize an Interpretation of the Listed Company Manual Concerning Shareholder Approval Requirements and to Describe a Certain Application of Its Audit Committee Rule, Exchange Act Release No. 59,217, 74 Fed. Reg. 3117, 3117-18 (Jan. 16, 2009) [hereinafter Shareholder Approval Requirements Rule Change].

[204] Shareholder Approval Requirements Rule Change, 74 Fed. Reg. at 3118. Similarly, NASDAQ Rule 4350(i)(7) provides that shareholder approval is not required for any share issuance by a listed company if such issuance is part of a court-approved reorganization under the Bankruptcy Code or comparable foreign laws. NASDAQ Manual Rule 4350(i)(7).

[205] *See* Shareholder Approval Requirements Rule Change, 74 Fed. Reg. at 3118.

APPENDIX

11 U.S.C. § 1145. Exemption from Securities Laws.

(a) Except with respect to an entity that is an underwriter as defined in subsection (b) of this section, section 5 of the Securities Act of 1933 and any State or local law requiring registration for offer or sale of a security or registration or licensing of an issuer of, underwriter of, or broker or dealer in, a security do not apply to —

(1) the offer or sale under a plan of a security of the debtor, of an affiliate participating in a joint plan with the debtor, or of a successor to the debtor under the plan —

(A) in exchange for a claim against, an interest in, or a claim for an administrative expense in the case concerning, the debtor or such affiliate; or

(B) principally in such exchange and partly for cash or property;

(2) the offer of a security through any warrant, option, right to subscribe, or conversion privilege that was sold in the manner specified in paragraph (1) of this subsection, or the sale of a security upon the exercise of such a warrant, option, right, or privilege;

(3) the offer or sale, other than under a plan, of a security of an issuer other than the debtor or an affiliate, if —

(A) such security was owned by the debtor on the date of the filing of the petition;

(B) the issuer of such security is —

(i) required to file reports under section 13 or 15(d) of the Securities Exchange Act of 1934; and

(ii) in compliance with the disclosure and reporting provision of such applicable section; and

(C) such offer or sale is of securities that do not exceed —

(i) during the two-year period immediately following the date of the filing of the petition, four percent of the securities of such class outstanding on such date; and

(ii) during any 180-day period following such two-year period, one percent of the securities outstanding at the beginning of such 180-day period; or

(4) a transaction by a stockbroker in a security that is executed after a transaction of a kind specified in paragraph (1) or (2) of this subsection in such security and before the expiration of 40 days after the first date on which such security was bona fide offered to the public by the issuer or by or through an underwriter, if such stockbroker provides, at the time of or before such transaction by such stockbroker, a disclosure statement approved under section 1125 of this title, and, if the court orders, information supplementing such disclosure statement.

(b)(1) Except as provided in paragraph (2) of this subsection and except with respect to ordinary trading transactions of an entity that is not an issuer, an entity is an underwriter under section 2(11) of the Securities Act of 1933, if such entity —

(A) purchases a claim against, interest in, or claim for an administrative expense in the case concerning, the debtor, if such purchase is with a view to distribution of any security received or to be received in exchange for such a claim or interest;

(B) offers to sell securities offered or sold under the plan for the holders of such securities;

(C) offers to buy securities offered or sold under the plan from the holders of such securities, if such offer to buy is —

(i) with a view to distribution of such securities; and

(ii) under an agreement made in connection with the plan, with the consummation of the plan, or with the offer or sale of securities under the plan; or

(D) is an issuer, as used in such section 2(11), with respect to such securities.

(2) An entity is not an underwriter under section 2(11) of the Securities Act of 1933 or under paragraph (1) of this subsection with respect to an agreement that provides only for —

(A)(i) the matching or combining of fractional interests in securities offered or sold under the plan into whole interests; or

(ii) the purchase or sale of such fractional interests from or to entities receiving such fractional interests under the plan; or

(B) the purchase or sale for such entities of such fractional or whole interests as are necessary to adjust for any remaining fractional interests after such matching.

(3) An entity other than an entity of the kind specified in paragraph (1) of this subsection is not an underwriter under section 2(11) of the Securities Act of 1933 with respect to any securities offered or sold to such entity in the manner specified in subsection (a)(1) of this section.

(c) An offer or sale of securities of the kind and in the manner specified under subsection (a)(1) of this section is deemed to be a public offering.

(d) The Trust Indenture Act of 1939 does not apply to a note issued under the plan that matures not later than one year after the effective date of the plan.