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Are Trading Orders Unconstitutional?

Fifth Amendment takings argument faces hurdles.

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TRADING ORDERS in large Chapter 11 cases have become routine.¹ Few reported decisions, however, address their legality, including their constitutionality.² Trading orders further the preservation of a debtor's net operating losses (NOLs) and other tax attributes by enjoining third parties from trading in the debtor's securities, absent compliance with a series of procedures.

Objections to trading orders often recite without much more that they violate the Fifth Amendment "takings" clause as a taking by the government (the bankruptcy court) of the investor's property (the ability to dispose of securities) for public use (protecting the debtor's estate and the public policy of promoting reorganization) without any compensation for possible losses. Is there anything to this argument?

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An Overview

At stake are a debtor's tax attributes: carrybacks and carryforwards often worth millions of dollars. Unrestricted trading of a debtor's securities can eliminate or reduce these tax attributes if the trading effects an "ownership change" under the Internal Revenue Code of 1986, as amended, (the Tax Code). Specifically, §382 of the Tax Code limits—and in some cases, eliminates—a corporate taxpayer's utilization of NOLs following a "50-percent ownership change" of the debtor.³

Broadly speaking, a "50-percent ownership change" occurs when a more than 50-percent change occurs in the ownership of the company by shareholders owning at least 5 percent of the company's stock.⁴ Trading orders impose notice requirements that enable a debtor to object—and presumably block—any trade that would result in such a change. Typical trading orders require that: (a) substantial equity holders must identify themselves to the debtor and the court; (b) third parties must notify the debtor of any trade that potentially renders them a substantial equity holder, or if already a substantial equity holder, of any trade that increases current holdings; (c) third parties must notify the debtor of any trade that, conversely, decreases their equity holdings

if they are substantial equity holders, and of any trade that would render them no longer substantial equity holders; and most significantly, (d) the debtor has several days following receipt of such notices to object to any proposed trade if it would adversely affect its NOLs. A trading order also provides that trades violating its terms are void.

Courts rely on the automatic stay and property of the estate provisions of the Bankruptcy Code, as well as the *Prudential Lines* decision, when entering trading orders.⁵ In *Prudential Lines*, the U.S. Court of Appeals for the Second Circuit extended the automatic stay to block the debtor's parent—itsself a non-debtor—from taking a worthless stock deduction that would have eliminated the debtor's NOLs. The court held that in impairing the NOLs, the parent's action was "an attempt to exercise control over property of the estate" prohibited by the automatic stay.⁶

An Intersection

Because trading orders frustrate a non-debtor's ability to transfer its property freely in favor of a perceived greater good (protecting the NOLs), a "takings" argument comes as no surprise. The Fifth Amendment provides that "private property [shall not] be taken for public use, without just compensation."⁷ The takings clause applies to the regulation of

property, and courts will find a non-possessory taking when the government “takes” a protected property interest for public use via legislative enactment.⁸

The Constitution also vests Congress with the power “to establish...uniform Laws on the subject of Bankruptcies throughout the United States.”⁹ Courts have construed the Bankruptcy Clause broadly and flexibly, affording Congress far-reaching discretion to modify contractual and property rights.¹⁰ In 1935, the U.S. Supreme Court stated that the Bankruptcy Power “like the other great substantive powers of Congress, is subject to the Fifth Amendment.”¹¹ Since then, perhaps “more by dint of repetition than by analysis,”¹² courts accept the notion that the Bankruptcy Power—and consequently, the Bankruptcy Code—in some measure remain subject to the prohibition against taking private property without just compensation.¹³

Congress heeded these constitutional limits when it enacted the Bankruptcy Code.¹⁴ Adequate protection, for example, has its roots in the constitutional theory that any impairment of the liquidation value of a secured creditor’s collateral attributable to the exercise of judicial powers conferred by bankruptcy legislation, in the absence of just compensation, violates the Fifth Amendment.¹⁵

Takings?

A Fifth Amendment challenge to a trading order goes as follows: (a) Investors have an ownership interest in the debtor’s securities which (b) is entitled to constitutional protection from a “taking”; (c) a trading order constitutes a governmental act through the bankruptcy court as well as (d) a “taking” since it impairs the investors’ ownership interest without just compensation. Let us consider each element.

The debtor’s securities held by third parties constitute protected ownership interests. If the Fifth Amendment entitles secured creditors to adequate protection of their liens—a fractional ownership interest in property—investors with full ownership of property arguably should receive similar protection. Because a corporation does not have any ownership interest in its own securities held by third parties,¹⁶ securities owners would seem to deserve constitutional

protection of their interests at least to the same degree as secured creditors.¹⁷

Does the court’s entry of a trading order constitute a governmental act? To constitute a taking, the bankruptcy court’s entry of a trading order must amount to a “governmental act” under the Fifth Amendment. Whether a court action constitutes a “governmental act” for Fifth Amendment purposes raises a number of challenging, and in some instances, unsettled questions.

The law is unsettled whether a judicial act can ever constitute an unconstitutional ‘taking.’ Even if a judicial taking could exist, it remains uncertain whether a trading order presents such a radical departure from existing precedent as to violate the Fifth Amendment.

An act of Congress can clearly result in a Fifth Amendment taking. Thus, a Bankruptcy Code provision may be unconstitutional if it results in an uncompensated taking.¹⁸ Similarly, a bankruptcy court’s enforcement of an unconstitutional Bankruptcy Code provision would also be unconstitutional.¹⁹ Trading orders, though, derive from §§105, 362 and 541 of the Bankruptcy Code, indisputably constitutional provisions within the scope of the Bankruptcy Clause.²⁰ Moreover, cases which stand for the principle that congressional acts can result in a Fifth Amendment taking do not find that a taking results from the authorized acts of a judicial officer.²¹ Thus, a constitutional challenge to a trading order must rest on something more than an argument that the underlying statutes (§§105, 362 and 541 of the Bankruptcy Code) are facially unconstitutional.

This need raises the question of whether courts, as opposed to legislative bodies, can ever “take” property in violation of the Fifth Amendment. The U.S. Supreme Court has yet to address directly whether “judicial takings” can occur.²² Courts generally have not viewed judicial orders as independently giving rise to a taking, in part because they

do not see courts as creating or changing the law. Rather, courts merely interpret and administer existing law, as declared by the Constitution, legislature and common law.²³ Because existing law defines property rights, no “taking” occurs when all a court does is apply existing law.²⁴

Supreme Court dicta, however, has suggested that courts may effect an unconstitutional taking if the court’s decision causes an “unpredictable,” “unforeseeable” or “sudden” change in the law that transfers private property to the state without just compensation.²⁵ Presumably, in such cases a taking occurs because the court’s actions go beyond the mere application of existing law.

Assuming a viable theory of judicial taking, a constitutional challenge to a trading order would need to establish that the order causes an “unpredictable,” “unforeseeable” or “sudden” change in the law that results in the transfer of private property for the benefit of some public use.²⁶ This may prove difficult: Bankruptcy courts routinely extend the scope of the automatic stay to non-debtor entities and non-debtor property in connection with other matters, such as third-party litigation, that may adversely impact the debtor’s estate.²⁷ Precedent exists, therefore, for extension of the automatic stay to restrict wholesale trading of the debtor’s stock if such trading would impair the debtor’s NOLs.

Would a trading order otherwise amount to a taking? Putting aside the question of whether a judicial act can ever constitute a taking, a constitutional challenge to a trading order must also establish that the order effects a non-possessory taking under the standards that the Supreme Court promulgated for regulatory takings in *Penn Central Transp. Co. v. City of New York*.²⁸ These factors include: (1) the “character” of the governmental action (whether the action constitutes a complete destruction, extinction or invasion of a property right rather than a mere diminution in value), (2) the economic impact of the regulation, and (3) the extent to which the regulation interferes with “reasonable investment-backed expectations.”²⁹ These criteria pose several difficulties.

First, trading orders generally do not

completely abrogate an investor's right to sell its securities. Since trading orders impose only limited restrictions on trading if certain conditions exist, they do not resemble the sort of wholesale government interference with property rights that courts typically deem a Fifth Amendment "taking."³⁰ But an investor might argue that a particular trading order, as applied under the facts of a specific case, destroys the entire economic value of its securities. Such an argument might prove more tenable.³¹

Second, investors may have a hard time proving the economic impact of a trading order. Markets can rise, as well as fall, during the freeze on sales. Moreover, they may respond favorably to trading orders, particularly if the debtor has valuable NOLs, since presumably restricting trading will ultimately benefit the debtor's estate.³²

Finally, courts have an established history of enjoining non-debtors from taking actions that adversely impact the debtor's estate, even if such action involves only non-debtor property.³³ That history makes difficult establishing that trading orders interfere with "reasonable investment-backed expectations."³⁴

The "public use" and "without just compensation" factors. Under the Fifth Amendment, the state may not take the property of one person for the sole purpose of transferring it to another private party, even if the first person is paid just compensation.³⁵ There must be a "public use." Governmental action is for public rather than private use if the government has rationally determined that the legislation causing an alleged taking serves a conceivable public purpose.³⁶ Courts construe this requirement broadly: "Public use" is coterminous with the scope of the government's police power,³⁷ and presumably, with the Bankruptcy Power as well.³⁸

Since trading orders restrict the sale of stock to foster the public policy of promoting reorganization, they likely satisfy the "public use" requirement. One could argue, however, that a trading order only remotely relates to the public use of promoting reorganization, since in practice, it effectively takes property from investors to benefit the debtor and its existing creditors, private parties.³⁹ Given the Supreme Court's recent emphasis on the takings' purpose (for trading orders,

promoting a debtor's rehabilitation) rather than its mechanics (arguably redistributing the investors' wealth to the debtor's estate) as determinative of "public use,"⁴⁰ such an argument may not prevail.

Finally, trading orders appear to satisfy the last element needed for an unconstitutional "taking"—a lack of just compensation—since bankruptcy courts rarely enter them with any protection against an erosion of investors' security positions.⁴¹ Were courts to enter trading orders with adequate protection provisions like those for secured creditors, no constitutional issue should arise.⁴²

Conclusion

An argument that trading orders violate the Fifth Amendment, while appealing, faces many hurdles. The law is unsettled whether a judicial act can ever constitute an unconstitutional "taking." Even if a judicial taking could exist, it remains uncertain whether a trading order presents such a radical departure from existing precedent as to violate the Fifth Amendment. Finally, putting aside the question of whether the bankruptcy court's action could amount to a judicial taking, the restrictions that trading orders impose may not satisfy the Supreme Court's requirements for a non-possessory taking. As a result, trading orders, while perhaps vulnerable on other grounds, may withstand a Fifth Amendment challenge.

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1. Trading orders exist in the following representative cases: Foamex International Inc., Calpine Corp., Dana Corporation, Silicon Graphics, Inc., Mirant Corporation, U.S. Airways Group, Inc., Solutia Inc., Delta Air Lines, Inc., Delphi Corporation and Northwest Airlines Corporation.

2. Numerous non-constitutional challenges to trading orders exist, including that trading orders: (i) constitute de facto injunctive relief which are only available by filing a full-fledged adversary proceeding; (ii) are beyond a bankruptcy court's jurisdiction; (iii) lack any statutory authority, since the automatic stay provisions of §362 of the Bankruptcy Code does not reach non-debtor property, and §105 of the Bankruptcy Code does not independently provide substantive relief; (iv) disrupt market efficiency and impose unfair burdens on market participants relying on prompt settlements; and (v) constitute impermissible anti-takeover tools that entrench management and chill outside investors' interest.

3. I.R.C. §382(g) (2005); Mark A. Speiser et al., "NOLs: The Policy Conflicts Created by Trading Orders," Commercial Lending Review, May-June 2005, at 28.

4. I.R.C. §382(g) (2005); Speiser, supra note 3, at 28.
5. 11 U.S.C. §§105, 362(a), 541 (West 2006); *Official Committee of Unsecured Creditors v. PSS S.S. Co., Inc.* (In re Prudential Lines Inc.), 928 F.2d 565 (2d Cir. 1991).

6. *Prudential Lines*, 928 F.2d at 574.

7. U.S. Const. amend. V.

8. *Penn Central Transp. Co. v. City of New York*, 438 U.S. 104, 130-31 (1978); Julia Patterson Forrester, "Bankruptcy Takings," 51 FLA. L. REV. 851, 864-65 (1999); Ralph R. Mabey & Jamie Andra Gavrin, "Constitutional Limitations

on the Discharge of Future Claims in Bankruptcy," 44 S.C. L. REV. 745, 763 (1993).

9. U.S. Const. art. I, §8, cl. 4.

10. Mabey, supra note 8, at 760 (citing cases); James Steven Rogers, "The Impairment of Secured Creditors' Rights in Reorganization: A Study of the Relationship Between the Fifth Amendment and the Bankruptcy Clause," 96 HARV. L. REV. 973, 973-74 (1983).

11. *Louisville Joint Stock Land Bank v. Radford*, 295 U.S. 555, 589 (1935).

12. Rogers, supra note 10, at 977.

13. E.g., *United States v. Sec. Indus. Bank*, 459 U.S. 70, 75 (1982).

14. See, e.g., 11 U.S.C. §§361-364; S. Rep. No. 95-989, at 49 (1978), as reprinted in 1978 U.S.C.C.A.N. 5787; H.R. Rep. No. 95-595, at 339 (1978), as reprinted in 1978 U.S.C.C.A.N. 5963, 6295 (indicating that adequate protection was based on Fifth Amendment constitutional requirements).

15. Rogers, supra note 10, at 977.

16. E.g., *First Southwest Corp. v. Tex. Consumer Fin. Corp.* (In re *Tex. Consumer Fin. Corp.*), 480 F.2d 1261, 1266 (5th Cir. 1973).

17. In re *UAL Corp.*, 412 F.3d 775, 779 (7th Cir. 2005).

18. E.g., *Sec. Indus. Bank*, 459 U.S. at 78.

19. E.g., *Sec. Indus. Bank*, 459 U.S. at 78; *Ry. Labor Executives' Ass'n v. United States* (In re *Chicago, Milwaukee, St. Paul & Pac. R.R. Co.*), 799 F.2d 317, 324 (7th Cir. 1986); Note, "Constitutionality of Retroactive Lien Avoidance Under Bankruptcy Code Section 522(f)," 94 HARV. L. REV. 1616, 1620 (1981).

20. E.g., *Kalb v. Feuerstein*, 308 U.S. 433, 439 (1940) (noting, in upholding the constitutionality of the stay under the Bankruptcy Act, that "[t]he Constitution grants Congress exclusive power to regulate bankruptcy and under this power Congress can limit that jurisdiction which courts, State or Federal, can exercise over the person and property of a debtor who duly invokes the bankruptcy law.").

21. E.g., *Allustiarte v. United States*, 46 Fed. Cl. 713, 717 (Fed. Cl. 2000), aff'd, 256 F.3d 1349 (Fed. Cir. 2001).

22. *SEC v. Credit Bancorp, Ltd.*, 290 F.3d 80, 91 (2d Cir. 2002); *Williams v. Adkinson*, 792 F.Supp. 755, 764 n.15 (M.D. Ala. 1992), aff'd, 987 F.2d 774 (11th Cir. 1993).

23. *Brace v. United States*, 72 Fed. Cl. 337, 358-59 (Fed. Cl. 2006).

24. See Rogers, supra note 10, at 987-88.

25. See *Williams*, 792 F.Supp. at 764 n.15 (citing *Bonelli Cattle Co. v. Arizona*, 414 U.S. 313, 331 (1973), overruled on other grounds sub nom. *Oregon v. Corvallis Sand & Gravel Co.*, 429 U.S. 363 (1977); *Hughes v. State of Washington*, 389 U.S. 290, 297-98 (1967) (Stewart, J., concurring)).

26. *Brace*, 72 Fed. Cl. at 359; *Williams*, 792 F.Supp. at 764 n.15; *Public Access Shoreline Hawaii v. Hawaii County Planning Comm'n*, 903 P.2d 1246, 1272-73 (Haw. 1995).

27. E.g., *Prudential Lines*, 928 F.2d at 574; 48th Street Steakhouse, Inc. v. Rockefeller Group, Inc. (In re 48th Street Steakhouse, Inc.), 835 F.2d 427, 431 (2d Cir. 1987) ("If action taken against the non-bankrupt party would inevitably have an adverse impact on property of the bankrupt estate, then such action should be barred by the automatic stay.").

28. 438 U.S. 104 (1978).

29. See *Penn Central*, 438 U.S. at 124.

30. E.g., id., 438 U.S. at 130-31.

31. See, e.g., *Sec. Indus. Bank*, 459 U.S. at 77.

32. See In re *UAL*, 412 F.3d at 777-78.

33. E.g., 48th St. Steakhouse, 835 F.2d at 431.

34. See *Penn Central*, 438 U.S. at 124.

35. *Kelo v. City of New London, Connecticut*, 125 S.Ct. 2655, 2661 (2005).

36. *Kelo*, 125 S.Ct. at 2664; *Midkiff*, 467 U.S. at 240-41.

37. *Midkiff*, 467 U.S. at 240; but see *Kelo*, 125 S.Ct. at 2676 (arguing that "the police power and 'public use' cannot always be equated.") (O'Connor, J., dissenting).

38. Mabey, supra note 8, at 770-71.

39. In re *UAL Corp.*, 412 F.3d at 778.

40. *Kelo*, 125 S.Ct. at 2664.

41. See In re *UAL Corp.*, 412 F.3d at 778.

42. See id. at 779.

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