

Blog - **A LEG UP FOR EQUITY?**
Part II - Freeze Claims¹

Equity security holders² or investors³ (“Equity Holders”) in debtor entities are usually subordinated to creditors’ claims in bankruptcy cases.⁴ This need not always be so.

Two situations exist where Equity Holders’ claims may be equal or superior to general unsecured creditors’ claims. The first are claims based on “fraudulent retention” (“Fraudulent Retention Claims”). The second are claims based on debtors’ post-petition interfering with Equity Holder’s rights to sell their investment, to benefit the debtors’ reorganization effort (“Freeze Claims”).

Allowed⁵ Fraudulent Retention Claims are treated equally to general unsecured creditors’

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² See 11 U.S.C. § 101 (16) and (17)

(16) The term “equity security” means—

- A) share in a corporation, whether or not transferable or denominated “stock”, or similar security;
- B) interest of a limited partner in a limited partnership; or
- C) warrant or right, other than a right to convert, to purchase, sell, or subscribe to a share, security, or interest of a kind specified in subparagraph (A) or (B) of this paragraph.

(17) The term “equity security holder” means holder of an equity security of the debtor.

³ See, *In re Montgomery Ward Holding Corp.*, 272 B.R. 836, 842 (Bkrcty.D.Del.,2001).

⁴ See, 11 U.S.C. § 510(b)(Subordination) and 11 U.S.C. § 1129(b)(2)(B)’s “absolute priority rule” which “generally requires that all unsecured creditors be paid in full before equity security holders are allowed to retain any ownership interest in the debtor.” *In re Brotby*, 303 B.R. 177, 195 (9th Cir.BAP 2003).

⁵ Allowed claims give the creditor holding that claim a right to payment of a specified sum of money pursuant to 11 U.S.C. § 502(b), usually enforceable against the debtor’s bankruptcy estate. See, *In re Ayers Bath (U.S.A.), Co., Ltd.*, 2021 WL 4317321, at *41 (Bkrcty.C.D.Cal., 2021). A “claim becomes allowed in one of three ways: first, a proof of claim is filed or deemed filed and no party objects; second, a claim is allowed by the court after an objection is filed; and third, a claim is estimated by the Court under the provisions of section 502(c). *In re Rowe*, 342 B.R. 341, 348 (Bkrcty.D.Kan.,2006).

claims. Allowed⁶ Freeze Claims may receive an administration priority⁷ over general unsecured claims. Allowed Fraudulent Retention Claims get available “bankruptcy dollars⁸.” Allowed Freeze Claims are entitled to full payment, subject to the bankruptcy estate’s resources.⁹

This blog post is the second of two. The prior blog post discussed the subordination or not of Fraudulent Retention Claims, See. <https://www.bankruptcystrategies.com/a-leg-up-for-equity-fraudulent-retention-claims/>. This blog post concerns allowing Freeze Claims.

FREEZE CLAIMS **Preserving NOLs**

A debtor’s net operating losses (“NOLs”) are a valuable asset.¹⁰ The Internal Revenue Code § 172 provides that corporations may carry forward their NOLs to reduce federal income taxes on future income. However, that ability is significantly limited when by an “ownership change.”¹¹ Ownership changes result from transfers of corporations’ shares.

To preserve NOLs, debtors seek orders, restricting transfers of equity interests or institute notice procedures: Freeze Orders¹² Freeze Orders can be sought and entered as early as a case’s filing.¹³

⁶ See, *Id.*

⁷ 11 U.S.C. § 503(b).

⁸ “ Bankruptcy Dollars ” are the percentage recoveries by creditors holding unsecured claims. Paying 10¢ on the \$ 1.00 is probably above average in most chapter 7 cases. *In re Rappaport*, 517 B.R. 518, 538 (Bkrcty.D.N.J., 2014)

⁹ See 11 U.S.C. § 507. Priorities. Regulating the priorities in distributing the bankruptcy estate’s assets.

¹⁰ *In re Feiler*, 218 B.R. 957, 962 (Bkrcty.N.D.Cal.,1998), *In re Wilson-Seafresh, Inc.*, 263 B.R. 624, 629 (Bkrcty.N.D.Fla.,2001) First-Day Issues (Payment of Critical Vendors; Abuses of DIP Financing; Cash Management), 091203 ABI-CLE 23

¹¹*Id.*, IRC §§ 382 and 383

¹²See, *In re Intelsat S.A.*, No. 20-32299 (KLP) (Bankr. E.D. Va. June 9, 2020) (establishing notification and hearing procedures related to certain stock transfers and declarations of worthlessness); *In re Pier 1 Imports, Inc.*, No. 20-30805 (KRH) (Bankr. E.D. Va. Mar. 19, 2020) (same); *In re Toys “R” Us Inc.*, No. 17-34665 (KLP) (Bankr. E.D. Va. Oct. 25, 2017) (same); *In re Penn Virginia Corp.*, No. 16-32395 (KLP) (Bankr. E.D. Va. June 9, 2016) (same).

¹³First-Day Issues (Payment of Critical Vendors; Abuses of DIP Financing; Cash Management), 091203 ABI-CLE 23

Freeze Orders may restrict trading of all or portions of a debtor's equity. For example, Freeze Order can restrict trading by "(a) holders of the equivalent of more than 449,390 shares of Common Stock (e.g., 4.5 percent or more of outstanding Common Stock) and (b) parties who are interested in purchasing sufficient Common Stock to result in such party becoming a holder of 4.5 percent or more of outstanding Common Stock."¹⁴ That restriction can run while a plan of reorganization is being negotiated or confirmed.

During the Freeze Order's effective period, share prices routinely drop. That creates hardship enough when all equity security holders may not trade their shares. When the Freeze Order affects only a portion of the Debtor's shares, the harm is disproportionate. Then, Equity Holders with frozen shares must wait as the share price slides while unfrozen shares sell. It's like waiting to escape the Titanic after all the life boats are gone.

This blogticle sees Freeze Claims¹⁵ as "administration expenses."¹⁶ Claims for allowed administration expenses¹⁷ receive the second highest priority and seniority in distribution of payments to unsecured creditors¹⁸ in bankruptcy cases.¹⁹

Administration Claim Requirements

Bankruptcy Code § 503(b) ("§ 503(b)") identifies allowable administration claims.

¹⁴ See, *Ascena Retail Group, Inc., et al.*, Case No. 20-33113 (KRH), United States Bankruptcy Court For the Eastern District of Virginia, Richmond Division ("Ascena").

¹⁵ 11 U.S.C. § 101(5) defines a "claim" as a:

- (A) right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured; or
- (B) right to an equitable remedy for breach of performance if such breach gives rise to a right to payment, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured.

¹⁶ 11 U.S.C. § 503(b)(1)(A) defines administrative expenses as "the actual, necessary costs and expenses of preserving the estate. . ."

¹⁷ Administration claims become "allowed" through a "notice and a hearing," 11 U.S.C. § 503(b), which determines whether and how much that claim may receive from the bankruptcy estate. 11 U.S.C. § 541 (Defining bankruptcy estate.)

¹⁸ An secured creditor is a creditor whose claim lacks collateral to secure its payment.

¹⁹ See, 11 U.S.C. § 507(a)(2).

They include:

- (1) (A) the actual, necessary costs and expenses of preserving the estate . . . including—

- (D) a creditor, an indenture trustee, an equity security holder, or a committee representing creditors or equity security holders other than a committee appointed under section 1102 of this title, in making a substantial contribution in a case under chapter 9 or 11 of this title;

11 U.S.C. § 503(b)(1)(A) and (D)

Debtors' post-petition torts are allowable administration claims.²⁰

What's a Tort?

Torts are defined broadly as:

. . . .a civil wrong, other than breach of contract, for which the court will provide a remedy in the form of an action for damages.” ***Indeed, one of the hallmarks of traditional tort liability is the availability of a broad range of damages to compensate the plaintiff “fairly for injuries caused by the violation of his legal rights.” Carey v. Piphus, 435 U.S. 247, 257, 98 S.Ct. 1042, 1049, 55 L.Ed.2d 252 (1978).*** Although these damages often are described in compensatory terms,. . . . in many cases they are larger than the amount necessary to reimburse actual monetary loss sustained or even anticipated by the plaintiff, and thus redress intangible elements of injury that are “deemed important, even though not

²⁰ See, *In re Baseline Sports, Inc.*, 393 B.R. 105, 130 (Bkrcty.E.D.Va.,2008) (“*Baseline*”), ([*Reading Co. v. Brown*, 391 U.S. 471, 88 S.Ct. 1759, 20 L.Ed.2d 751 (1968), makes] post-petition torts committed by the debtor-in-possession while acting in the furtherance of the operation of the business satisfy the second or “burden” prong of the administrative expense test, and claims for such torts may be accorded priority as an administrative expense. See *id.* at 477–85, 88 S.Ct. 1759; *Pa. Dep't of Env'tl. Res. v. Tri-State Clinical Labs., Inc.*, 178 F.3d 685, 691 (3d Cir.1999) (“The Supreme Court held that the tort judgment was entitled to priority as an administrative expense under § 64a(1) of the Bankruptcy Act, even though the expense was not technically a cost of preserving the estate.”); *Ala. Surface Mining Comm. v. N.P. Mining Co.*, 963 F.2d 1449, 1453 (11th Cir.1992) (“Reading ... held that tort claims against a bankruptcy trustee were payable as administrative expenses even though they were not beneficial to the estate.”); *Kapernekas v. Continental Airlines, Inc. (In re Continental Airlines, Inc.)*, 148 B.R. 207, 213 (D.Del.1992) (stating that Reading held that certain costs may be treated as administrative expenses if those costs were incurred as a result of the debtor committing a post-petition tort); 4–503 Collier on Bankruptcy ¶ 503–06[2][c] [i]–[iv] (15th ed.2008). See also, *In re Krisu Hospitality, LLC*, 2021 WL 1186483, at *6 (Bkrcty.N.D.Tex., 2021), citing, *Baseline*

pecuniary in [their] immediate consequence[s].”²¹

***Interfering with
Equity Holders’ Legal Rights***

Equity Holders have a fundamental right to sell their shares.²² Freeze Orders interfere with that right by restricting and prohibiting the sale of equity security interests. Freeze Orders are premised on the representation that they preserve debtors’ NOLs benefits. Unfortunately for Equity Holders, once the freeze ends, the share price is reduced substantially. Hence, Equity Holders are injured by Freeze Orders.

***Post Petition Torts are Part of the
Debtors’ Post Petition Operations***

Whether post-petition torts occurred as part of debtors’ operations is sometimes considered in determining if there is an allowable administration claim.²³

Motions for Freeze Orders may represent:

“ Implementation of the Procedures is necessary and appropriate to enforce the automatic stay and, critically, to preserve the value of the Tax Attributes for the benefit of the Debtors’ estates. . . . For the reasons discussed herein, the relief requested is ***necessary in order for the Debtors to operate their businesses in the ordinary course*** and preserve the ongoing value of the Debtors’ operations and maximize the value of their estates for the benefit of all stakeholders.²⁴

The injuries to Equity Holders cause by Freeze Orders are foreseeable. This foreseeable injury is apparently incorporated into those debtors’ operations.

²¹ *U.S. v. Burke*, 112 S.Ct. 1867, 1870–71, 504 U.S. 229, 234–35 (1992) (Emphasis supplied).

²² *Williams Companies Stockholder Litigation*, 2021 WL 754593, at *20 (Del.Ch., 2021)(“Modern corporate law recognizes that stockholders have three fundamental, substantive rights: to vote, to sell, and to sue.”, citing, *Strougo v. Hollander*, 111 A.3d 590, 595 n.21 (Del. Ch. 2015), See also, J, Velesco, the Fundamental Rights of the Shareholder, 40 U.C. Davis Law Review 407.

²³ See, *Baseline* 393 B.R. at 130.

²⁴ See *Ascena* Freeze Order motion

Understandably, “if you want to make an omelet, you have to break some eggs.”²⁵

However, if you break someone else’s eggs to make your omelet, they are entitled to compensation for their loss.²⁶

Freeze Order Injuries Preserve Debtors’ Assets

Bankruptcy Code § 503 includes as administration expenses the “actual, necessary costs and expenses of preserving the estate.” Freeze Orders’ purpose is to preserve the debtor’s NOLS. Debtors’ NOL’s are property of their estates.²⁷

Motions seeking Freeze Orders may represent, among other things:

- Notably, the Debtors have limited the relief requested herein to the extent ***necessary to preserve estate value.***
- By establishing and implementing such Procedures, the Debtors will be in a position to object to “ownership changes” that threaten their ability to ***preserve the value of their Tax Attributes for the benefit of the estates.***
- The Procedures . . . ***ensure preservation of the Tax Attributes.***

. . . . Implementation of the Procedures is necessary and appropriate to enforce the automatic stay and, ***critically, to preserve the value of the Tax Attributes for the benefit of the Debtors’ estates.*** The termination or limitation of the Tax Attributes could be materially detrimental to all parties-in-interest. Thus, granting the relief ***requested herein will preserve the Debtors’ flexibility in operating their businesses*** during the pendency of these chapter 11 cases and also implementing an exit plan that makes full and efficient use of the Tax Attributes, maximizing the value of their estates.

- The Debtors seek to establish procedures . . . ***to preserve the Debtors’ ability to seek substantive relief if it appears that a proposed transfer could jeopardize the Debtors’ utilization of the Tax Attributes.*** . . .

²⁵ *Oregon Natural Resources Council v. Marsh*, 1986 WL 13440, at *4 (D.Or.,1986)(“Congress ordered the [Army Corps of Engineers] to make an omelet [build a dam]; Congress knew full well that one must break the eggs [harm the environment] to cook an omelet. *State v. Cummings*, 647 S.E.2d 869, 879, 220 W.Va. 433, 443 (W.Va.,2007)(The dissent’s “basic argument is that you have to break a few eggs to make an omelet. A few innocent people have to go to jail to make sure we get as many guilty people in there as possible”).

²⁶See, *Baseline* 393 B.R. at 130.

²⁷ See, *In re A.H. Robins Co., Inc.*, 251 B.R. 312, 315 (Bkrcty.E.D.Va.,2000).

- For the reasons discussed herein, the relief requested is necessary in order for the Debtors to operate their businesses in the ordinary course and ***preserve the ongoing value of the Debtors' operations and maximize the value of their estates for the benefit of all stakeholders.***

Disclosure statements for plans of reorganization, for cases using Freeze Orders may include NOLs among that debtor's tax attribute, discuss the importance of NOLs and the Freeze Order's role in preserving NOLs.²⁸

More importantly, the Freeze Orders will probably include a statement that:

. . . and this Court having found that the relief requested in the Motion is in the best interest of the Debtors' estates, their creditors, and other parties in interest; . . . ; ***and this Court having reviewed the Motion and having heard the statements in support of the relief requested therein at a hearing before the Court (the "Hearing"); and this Court having determined that the legal and factual bases set forth in the Motion and at the Hearing establish just cause for the relief granted herein . . .***²⁹

Thus, debtors getting Freeze Orders are "judicially estopped" from claiming the Freeze Order did not benefit the bankruptcy estate and case. They cannot backtrack from those representations.³⁰

Calculating the Allowable Claim

If the Freeze Claim is allowable, the amount of the allowed claim is determined next. If the basis for the claim being allowed is "post petition tort," determining the amount of the claim should follow tort law: dollar value of the injury.

The calculation is more complex for "substantial contribution" claims. The creditor must show the value the debtor received as the result of the creditor's injury.³¹ Calculating that figure

²⁸ See, *Ascena*, Disclosure Statement.

²⁹ See, *Ascena*, Freeze Order.

³⁰ *Bresler v. Wilmington Trust Company*, 348 F.Supp.3d 473, 490 (D.Md., 2018), citing *New Hampshire v. Maine*, 532 U.S. 742, 749, 121 S.Ct. 1808, 149 L.Ed.2d 968 (2001)(Judicial estoppel "generally prevents a party from prevailing in one phase of a case on an argument and then relying on a contradictory argument to prevail in another phase.").

³¹ See, *Ford Motor Credit Co. v. Dobbins*, 35 F.3d 860, 866 (C.A.4 (Va.), 1994)Dobbins, (4th Cir. 1994) ("[t]he court's administrative expense inquiry centers upon whether the estate has received an actual benefit, as opposed to the loss a creditor might experience by virtue of the debtor's possession of its property.") (emphasis in original) (citations omitted); accord *Broadcast*

first entails determining the dollar amount of NOLs the creditor's losses preserved. Then anticipate the claim objector requiring the creditor to show the dollar value to the debtor of those NOLs' preservation.

The creditor lacks the information to answer those questions. Discovery about the debtor will be required from a contentious estate administrator. Then, comes the quantitative analysis. This exercise is not cheap. However, both sides must do it and there is risk to both sides. So, settlement discussions can occur before there is a trial on the issues.

Public equity security holders have always had to claw their way to recover anything in bankruptcy cases. With the advent of "zombie corporations" and "ponzi financing," other parties in interest exclude equity security holders from a place at the bargaining table.³² The view is the debtors lack any equity for equity security holders to share in.

However, as the foregoing shows, equity security holders who have been wronged, independently of merely losing their investment through a debtor's failure, may have recourse in a bankruptcy case. Securing recourse will be a struggle. But, that's not new for equity security holders.

Corp. v. Broadfoot, 54 B.R. 606, 611 (N.D. Ga. 1985) ("administrative expense scheme does not focus in the first instance on whether a creditor sustained a loss during this period, but on whether the estate has received an actual benefit"), *aff'd*, *In re Subscription Television*, 789 F.2d 1530, 1532 (11th Cir. 1986).

³²See, *In re Eastman Kodak Company*, 2013 WL 4413300 (Bkrtcy.S.D.N.Y., 2013), *In re SunEdison, Inc.*, 556 B.R. 94, 102 (Bkrtcy.S.D.N.Y., 2016) ("...stockholders of a "hopelessly insolvent" estate have no economic interest in the case.")