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To be restricted or not to be restricted: affiliate securities trading after bankruptcy

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"To be [restricted], or not to be [restricted]: that is the [securities] question:
Whether 'tis nobler in the mind to suffer
The slings and arrows of outrageous [holding periods],
Or to [sell securities after] a sea of troubles,
And by [disposing] end them?"
— William Shakespeare, Hamlet, Act III, Scene I (as revised)

Something is rotten in the state of trading by affiliates after the issuer's emergence from bankruptcy. Despite the broad exemption for post-emergence resales provided by section 1145 ("Section 1145") of title 11 of the United States Code (the "Bankruptcy Code"), practitioners remain wary of public trading by former creditors that become large equity holders. Yet we need not let caution "make cowards of us all" — as the staff of the Securities and Exchange Commission ("SEC") has repeatedly confirmed in interpretive letters and no-action letters, restrictions on affiliate resales are not as tragic as they seem.

Public resales after Section 1145 distributions

Section 1145 serves a critical role in facilitating reorganizations under chapter 11 of the Bankruptcy Code ("Chapter 11") by exempting certain securities issuances and resales from registration requirements under section 5 of the Securities Act of 1933, as amended (the "Securities Act"). Among other things, Section 1145(a) exempts from registration offers or sales under a plan of reorganization of securities principally in exchange for a claim against, or an interest in, a debtor or its affiliate.

Debtors have more flexibility in negotiating plans of reorganization because creditors know that they can freely trade securities received in exchange for their claims.

Under Section 1145, debtors are able to issue new securities without the need to undertake an expensive registration process or to qualify for another exemption from registration. A Section 1145 distribution of securities is "deemed to be a public offering" pursuant to Section 1145(c), which means that the distributed securities generally are freely tradable.

Recipients of securities issued in Section 1145 distributions usually may resell the securities without registration under the Securities Act and without waiting for any holding period to pass. Accordingly, securities distributed under Section 1145 are often held through The Depository Trust Company ("DTC") without any legends indicating limitations on resale under the Securities Act.

In contrast, securities received in a private placement under section 4(a)(2) of the Securities Act or Regulation D thereunder generally are "restricted securities" for purposes of resales pursuant to Rule 144 under the Securities Act ("Rule 144"). Restricted securities are subject to a six-to-twelve-month holding period before public resales are permitted under Rule 144. Restricted equity securities typically must be held on the books of the transfer agent with a legend stating that they may only be resold in registered transactions or pursuant to exemption from registration under the Securities Act.

Consistent with the purpose of Chapter 11, Section 1145 promotes reorganizations of distressed companies. Debtors have more flexibility in negotiating plans of reorganization because creditors know that they can freely trade securities received in exchange for their claims. Section 1145 also avoids burdening former creditors with securities law compliance responsibilities and may even provide an incentive for distressed debt investors to provide liquidity in secondary debt markets.

Treatment of 'underwriters'

Although Section 1145(a) has a broad scope, its exemption from Securities Act registration requirements is unavailable for issuances of securities to "underwriters," as defined in Section 1145(b)(1), and for resales by such "underwriters." The definition of "underwriter" is not the standard definition from section 2(a)(11) of the Securities Act ("Section 2(a)(11)"). Instead, Section 1145(b)(1) provides, in relevant part:

(1) [E]xcept with respect to ordinary trading transactions of an entity that is not an issuer, an entity is an underwriter under section 2(a)(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(a)(11), with respect to such securities.

Subparagraphs (A), (B) and (C) closely approximate the concept of an "underwriter" under Section 2(a)(11), by covering entities who purchase claims against a debtor or securities issued under a bankruptcy plan "with a view to distribution" or who offer to sell securities under a plan on behalf of the securityholders.

However, unlike the definition of "underwriter" in Section 2(a)(11), Section 1145(b)(1)(D) adds "an issuer, as used in such section 2(a)(11)." In Section 2(a)(11), the term "issuer" includes "any person directly or indirectly controlling ... the issuer."

When affiliates receive securities in a registered offering or in the open market, the securities they hold are considered "control securities" that are not "restricted securities."

Although there is some debate about the scope of this control person concept in the post-bankruptcy context, there may be a risk that holders of more than 10% of a reorganized debtor's outstanding common stock after a bankruptcy distribution could be considered control persons (and hence issuers under Section 2(a)(11) and underwriters for purposes of Section 1145).

Under Section 1145(b), a holder that would otherwise be an underwriter (and therefore unable to receive and resell securities under Section 1145), may receive such securities under Section 1145(a) so long as they are subsequently resold in "ordinary trading transactions." Congress added this exception to Section 1145 in 1984 to "captur[e] 'classical' underwriters engaged in an organized distribution while permitting resales by creditors that are not 'real' underwriters."[1] This "ordinary trading transactions" exception, however, is not available to an entity that is an "issuer."

The issuer exclusion from the "ordinary trading transactions" exception, together with the inclusion of "an issuer, as used in such section 2(a)(11)" as a category of deemed underwriters for which Section 1145(a) is unavailable, has generated a great deal of confusion for many securities and bankruptcy lawyers. Can a creditor who is "an issuer, as used in such section 2(a)(11)" solely because it will be a control person of the issuer upon emergence from bankruptcy nevertheless take advantage of the "ordinary trading transactions" exception, which by its terms excludes "issuers"?

If control persons were per se "underwriters" in bankruptcy distributions, they would in many circumstances only be able to receive restricted securities that would be subject to a holding period under Rule 144. More technically, if Section 1145(a) were unavailable to affiliates, the issuance of securities to those affiliates under the plan of reorganization would require registration or another exemption from registration.

The use of a private placement exemption for the initial issuance would result in the securities being treated as restricted securities, meaning that public resales would only be possible in registered transactions or following a Rule 144 holding period.

'Ordinary trading transactions' by control persons

A number of securities law practitioners have fallen in a trap here, which could be called the Polonius "to thine ownself be true" mistake. Arguably, the exclusion of control persons from the "ordinary trading transactions" exception would be "true" to the phrase "issuer, as used in such section 2(a)(11)," in Section 1145(b)(1)(D), but it would also mean that affiliates could not resell those securities to the public in unregistered transactions until a holding period had passed.

Practitioners that make this mistake typically state that control persons are considered per se underwriters, implying that the "ordinary trading transactions" exception is unavailable to control persons. Other lawyers have made the ambiguous statement that unregistered resales by affiliates must comply with Rule 144, which is accurate, but dodges the question of whether the affiliates hold "restricted securities" subject to a holding period or must only comply with the Rule 144 restrictions for "control securities" discussed further below.

Similar reasoning and ambiguous disclosures often appear in discussions of Section 1145 in disclosure statements. Fortunately, the text and purpose of Section 1145(b) support the availability of the "ordinary trading transactions" exception for control persons (and as discussed further in the next section, the SEC staff has repeatedly confirmed this conclusion).

The drafting of Section 1145(b)(1) may "be madness, yet there is method in't." Unlike the text of Section 1145(b)(1)(D), the introductory language in Section 1145(b)(1) excluding "an issuer" from the "ordinary trading transactions" exception does *not* refer to Section 2(a)(11). In fact, the reference to "an issuer," without the reference to Section 2(a)(11), appears *earlier* in Section 1145(b)(1) than the reference to "an issuer, as used in such section 2(a)(11)," in Section 1145(b)(1)(D).

From a statutory interpretation perspective, this placement implies the initial term was intended to have the common meaning of "issuer" rather than the broader definition that includes control persons. The later reference to Section 2(a)(11) in subparagraph (D) suggests the statutory reference is necessary to capture control persons. Since that reference is missing in the "issuer" exclusion from the "ordinary trading transactions" exception, only issuers themselves, and not control persons, are excluded from reselling securities distributed under Section 1145 in "ordinary trading transactions."

Permitting control persons to take advantage of the "ordinary trading transactions" exception is also consistent with the relationship between the "ordinary trading transactions" exception and Rule 144. The notion of an "ordinary trading transaction" under Section 1145 closely tracks the Rule 144 requirements for resales by affiliates of securities that were acquired in registered or open-market transactions.

When interpreting the "ordinary trading transaction" exception in no-action letters, the SEC staff has considered criteria similar to Rule 144's treatment of control securities.

When affiliates receive securities in a registered offering or in the open market, the securities they hold are considered "control securities" that are not "restricted securities." Affiliates may resell such control securities to the public in unregistered transactions without a holding period as long as those sales meet the requirements for "control securities" under Rule 144:

- *Current Public Information*: For a company that files reports under section 13 or 15(d) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), the company's Exchange Act reports must be up to date at the time of the sale (i.e., all Form 10-Qs and Form 10-Ks that were due in the preceding 12 months have been properly filed). For a non-reporting company, certain specified information must be publicly available.
- *Volume Limitations*: The amount sold during any three-month period by an affiliate cannot exceed the greatest of (A) 1% of the total outstanding securities of that class, (B) if the class of securities is listed on a national securities exchange, the average reported weekly trading volume during the four calendar weeks preceding the sale, or (C) in the case of debt securities, 10% of the principal amount of the tranche.
- *Manner of Sale*: Sales of equity securities must be in the form of ordinary unsolicited brokerage transactions, transactions directly with "market makers" or certain riskless principal transactions.
- *Form 144*: For sales exceeding either 5,000 shares or $50,000 in a three-month period, the seller must file a Form 144 with the SEC.

Given that these rules apply to any of the issuer's securities in the hands of the affiliate, control securities frequently do not bear a Securities Act legend and are often held through DTC. Since a Section 1145 distribution is "deemed to be a public offering," then as long as sales in accordance with Rule 144 control securities requirements constitute "ordinary trading transactions," securities issued to affiliates should be treated similarly to control securities purchased in registered transactions or the open market.

Indeed, when interpreting the "ordinary trading transaction" exception in no-action letters, the SEC staff has considered criteria similar to Rule 144's treatment of control securities. These criteria include the Exchange Act reporting status of the issuer, as well as manner of sale requirements relating to sales on existing markets without concerted marketing actions, separate offering materials or special commissions.[2]

As *Collier on Bankruptcy* explains, "the obvious relationship to concepts contained in Rule 144 and the absence of any reference to section 2(a)(11) with respect to the term 'issuer' as applied to the ordinary trading transaction exception, may suggest that the exception should be available to control persons."[3]

Section 1145's purpose and history also support applying the "ordinary trading transactions" exception to control persons. First, as noted above, Section 1145(b)'s purpose was to deny the exemption to "real" underwriters while permitting it for "technical" underwriters.[4] Control persons undoubtedly are not "real" underwriters because they are not even captured by the broad definition of "underwriter" in Section 2(a)(11).

Second, the report of the U.S. House of Representatives relating to Section 1145 expressed a concern applicable to post-bankruptcy affiliates that "unless creditors are permitted to dispose of securities issued under the plan in a public market without filing a registration statement, the flexibility of the plan is impaired."[5]

Finally, Congress recognized that creditors may be involuntary participants in a bankruptcy. As *Collier* points out, "[i]t would indeed be an anomaly if a person 'in control' of the issuer due to the involuntary conversion of its claim were to suffer greater restrictions" — i.e., unavailability of the "ordinary trading transactions" exception — "than the more 'classical' underwriters described in other subsections of section 1145(b)(1)."[6]

With this context, it becomes clear that the exclusion of "issuers" from the "ordinary trading transactions" exception has a much more mundane meaning: Although issuers can issue securities under Section 1145(a),[7] they cannot resell their own securities under Section 1145(c).

This reading of Section 1145(c) mirrors the resale safe harbor in Rule 144, for which the SEC staff has confirmed, "Rule 144 is not available to the issuer of the securities."[8] And of course, no one reads the broad definition of "issuer" in Section 2(a)(11) into that

guidance — after all, the entire purpose of the "control securities" concept in Rule 144 is to permit unregistered public resales by control persons.

Control securities interpretive letters and no-action letters

"Madness in [statutes] must not unwatched go." Consistent with the textual and purpose-based reasons that control persons should be able to rely on the "ordinary trading transactions" exception, the SEC has clarified its interpretation of Section 1145(b)(1) in two seminal interpretive letters and multiple no-action letters.

These letters explain that under normal circumstances, control persons who might otherwise be deemed "issuers" under Section 2(a)(11) may receive securities under Section 1145 and resell those securities to the public without registration and without a holding period. Under these letters, the resales are subject only to the Rule 144 restrictions for control securities — as is true of all securities sold by control persons in unregistered public transactions — and not the holding period requirements for restricted securities.

The interpretive letters involved fact patterns common to Chapter 11 bankruptcies. In *Calstar, Inc.,* the debtor sought to distribute to its creditors shares of common stock, along with warrants, rights and options to purchase common stock.[9] The creditors included the company's principal lending bank (which would receive 30% of the initial shares issued in the distribution and warrants to purchase additional shares), as well as other affiliates.

In asking for an interpretation that unregistered resales by the affiliates would be permitted without a holding period, the company's counsel initially fell into the "to thine ownself be true" trap described above, stating that the "'ordinary trading transactions' language appears to incorporate the Rule 144 concept into Section 1145, but it inexplicably precludes the use of such transactions by an 'issuer,' that is, an affiliate."

Despite this oversight in the textual analysis, the company's letter continued with policy arguments covering many of the points discussed above. Ultimately, the SEC staff issued an interpretive letter stating that the affiliates could resell securities issued under the plan of reorganization by complying with Rule 144 other than the holding period requirement.

In *Jacques Sardas,* the SEC staff affirmed the interpretation in the *Calstar* letter.[10] In this case, the debtor's President and Chief Executive Officer received options to purchase common stock under Section 1145(a).

The SEC staff confirmed that since the affiliate "would not be deemed to be an 'underwriter' under Section 1145(b)" if not for the definition of the term "issuer" including control persons, he may "resell the common stock to be issued to him pursuant to the Company's plan of reorganization without registration under the Securities Act of 1933 by complying with Rule 144, except for the holding period requirement."

Similarly, in both *General Development Corporation*[11] and *UNR Industries, Inc.*,[12] the SEC staff took the view that creditors "who become affiliates of" the debtor "after the reorganization would be subject to the provisions of Rule 144 (except for the holding period requirement) in effecting" public resales without registration.

The SEC staff again confirmed this position in *AWS Reorg, Inc.*[13] The incoming letter primarily addressed the application of the other underwriter definitions in Section 1145(b)(1) after a bankruptcy distribution, but also requested that the staff reaffirm its position in *Calstar* regarding affiliate resales after emergence.

In response, the SEC staff stated that "[a]ffiliates of the issuer may effect resales ... in reliance on rule 144 under the Securities Act of 1933. Because such securities are not restricted securities, rule 144(d), the holding period condition, will not apply to such resales." In other words, consistent with the treatment of securities issued to affiliates in a public offering, the securities received by affiliates in a Section 1145 distribution are "control securities," but not "restricted securities."

Conclusion

Large creditors of distressed companies need not wonder if securities received in exchange for claims upon emergence from bankruptcy are subject to holding periods. Following the language and purpose of Section 1145, securities held by control persons may be resold in "ordinary trading transactions."

Furthermore, interpretive letters and no-action letters from the SEC staff have confirmed securities received by control persons under Section 1145 are subject only to the Rule 144 limitations for control securities, not the rule's holding periods for restricted securities. As Shakespeare might say, "Good night sweet [holding periods]; And flights of [SEC staff letters] sing thee to thy rest."

Notes

[1] 8 Collier on Bankruptcy § 1145.03[1] (16th ed. 2022).

[2] See, e.g., Manville Corp., SEC No-Action Letter, 1986 WL 68341 (Aug. 28, 1986). UNR Industries, Inc., SEC No-Action Letter, 1989 WL 246122 (July 11, 1989). https://bit.ly/3MZVRb1

[3] 8 Collier on Bankruptcy § 1145.03[3][e].

[4] In re Kenilworth Sys. Corp., 55 B.R. 60, 62-63 (Bankr. E.D.N.Y. 1985); 8 Collier on Bankruptcy § 1145.03[3][e]. https://bit.ly/3MZld8H

[5] Kenilworth, 55 B.R. at 62 (quoting H.R. Rep. No. 595, 95th Cong., 1st Sess. 237-38 (1977)). https://bit.ly/3QqRLvu

[6] 8 Collier on Bankruptcy § 1145.03[3][e] n.49.

[7] See 8 Collier on Bankruptcy § 1145.03[3][d][i].

[8] Question 128.01, Compliance and Disclosure Interpretations: Securities Act Rules, Jan. 26, 2009 (citing Securities Act Release No. 5306, 1972 WL 121529 (Sept. 26, 1972)). https://bit.ly/3N0wK7V

[9] Calstar, Inc., SEC Interpretive Letter, 1985 WL 54372 (Aug. 26, 1985). https://bit.ly/3b9n25X

[10] Jacques Sardas, SEC Interpretive Letter, 1993 WL 273674 (July 16, 1993). https://bit.ly/3QuM4fN

[11] General Development Corporation, SEC No-Action Letter, 1992 WL 19993 (Feb. 3, 1992). https://bit.ly/3MXC3Fc

[12] UNR Industries, supra. https://bit.ly/3xZwe5U

[13] AWS Reorg, Inc., SEC No-Action Letter, 1997 WL 665063 (Oct. 27, 1997). https://bit.ly/3xA5E1J

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