JONES DAY

RECENT DEVELOPMENTS IN BANKRUPTCY AND RESTRUCTURING

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IN THIS ISSUE

TRADING RESTRICTIONS IN BANKRUPTCY: DID THE SEVENTH CIRCUIT UP THE ANTE FOR STOCK TRADING INJUNCTIONS?

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Although the outcome of a chapter 11 restructuring seldom can be predicted at the outset of a case with any degree of certainty, one thing is assured: the company will not have the same creditors and shareholders at the end of the case that it had at the beginning. The proliferation of vulture funds and other traders in distressed "securities" provides a ready market for creditors and shareholders who want to cut their losses without waiting until confirmation of a plan of reorganization that may not take place for several years.

Trading in public securities issued by a debtor is regulated by disclosure and other requirements contained in federal securities laws, although transfers of creditor claims are not subject to such regulation. Astute claims traders can profit considerably if claims acquired at a steep discount later reap significant recoveries. Whether such speculation turns a profit depends on the quality of an acquiror's investigation of the debtor company's affairs and an educated bet on the likely outcome of the case — information and expertise that few creditors have or are willing to develop.

The disparity in resources and expertise between creditors and sophisticated claims speculators has been perceived as creating a potential for abuse in an unregulated market. For this reason, bankruptcy courts have played a role in monitoring and sometimes preventing claims trading. Court scrutiny also has been brought to bear because buying claims against a company may be a means of acquiring a controlling stake in the company if the company converts its debt to equity as part of a chapter 11 plan of reorganization. Creditors selling their claims against a bankrupt company in the early stages of a case do not have the benefit of the same disclosure to which they would be entitled in connection with the chapter 11 plan confirmation process.

Neither the Bankruptcy Code nor its accompanying procedural rules expressly give the bankruptcy courts the power to regulate trading once a company files for bankruptcy protection. Rule 3001(e) of the Federal Rules of Bankruptcy Procedure ("Bankruptcy Rules") merely contains certain notification requirements that vary depending upon when a claim is transferred to ensure that the court has an accurate record of the identity of the holder of the claim and, in a chapter 11 case, to ensure that the actual holder of the claim has an opportunity to vote to accept or reject a plan. It does not provide for any court involvement in the trading process.

THE OLD RULE

This was not always the case. Prior to 1991, Bankruptcy Rule 3001(e) invited relatively open-ended bankruptcy court scrutiny of the fairness of a pending trade. At that time the rule provided that substitution of the transferee as the holder of a claim after the filing of a proof of claim required court approval after notice and a hearing. Potential transferees typically provided notice not only to the transferor and the court, but to all other creditors and interested parties in the bankruptcy case. Third parties then had an opportunity to object to the transfer, the terms of which were disclosed to the court. Whether or not anyone objected, the bankruptcy court was in a position to determine whether the seller was sufficiently informed of the value of its claim or was susceptible to being misled.

Bankruptcy Rule 3001(e) was amended in 1991 with the express intention of curtailing judicial oversight of claims trading by limiting the requirement of court approval, minimizing what had to be disclosed to the court and eliminating third-party involvement altogether. Under the present version of the rule, no notice of a transfer of a claim need be given to anyone other than the court (by filing a notice of such transfer) and the transferor. Moreover, the parties to the trade are not required to disclose the terms of transfer. If the transferor makes a timely objection to the transfer, the "court's role is to determine whether a transfer has been made that is enforceable under nonbankruptcy law."

TAX ATTRIBUTES AND CHANGES IN CONTROL

What rulemakers apparently overlooked when attempting to remove the bankruptcy courts from the process was the resulting potential for losing a sometimes significant asset in chapter 11 reorganizations involving companies with valuable tax attributes. An indispensable feature of almost every chapter 11 case involving a business that is attempting to reorganize by reworking its capital structure is the ability to preserve as much as possible existing net operating losses ("NOLs") to offset against future tax liabilities of the reorganized or successor entity. NOLs are an excess of deductions over income in any given year. They generally can be carried back to use against taxable income in the two previous years and, to the extent not used, may be carried forward for 20 years. Losses remain with the debtor during a bankruptcy case because a bankruptcy filing for a corporation does not create a new taxable entity.

The potential concern is that certain provisions in the Internal Revenue Code ("IRC") significantly limit the ability of a company to preserve its NOLs upon a "change in ownership." The vast majority of all corporate reorganizations under chapter 11 result in a change of ownership under section 382 of the IRC. If the change occurs prior to confirmation of a chapter 11 plan, the standard NOL limitation of section 382 applies. This means that, on a going-forward basis, the company's allowed usage of NOLs against future income will be capped at an annual rate equal to the equity value of the corporation immediately before the change in ownership times the long-term tax-exempt bond rate. Capping the NOLs will delay (or may even prevent) the company from using the NOLs, in either case often significantly reducing the present value of the tax savings. If, for example, an ownership change occurs because of a worthless stock deduction, the equity of the company is presumed to be worthless, thereby preventing the use of its NOLs to offset future income.

When a change of ownership takes place pursuant to a plan of reorganization, the tax attributes that remain after giving effect to other attribute reduction rules in the IRC generally — although not always — are subject to an annual limitation on future use. Under section 382(l)(6) of the IRC, that limitation is equal to the annual long-term tax-exempt bond rate times the value of the company's equity immediately after the change of ownership (and after giving effect to the reduction in liabilities occurring pursuant to the plan of reorganization).

Under certain limited circumstances, a debtor can undergo a change of ownership in bankruptcy and emerge without any section 382 limitation on its NOLs or built-in loss. To qualify for this provision (contained in section 382(l)(5) of the IRC): (i) shareholders and creditors of the company must end up owning at least 50 percent of the reorganized debtor's stock (by vote and value); (ii) shareholders and creditors must receive their minimum 50 percent stock ownership in discharge of their interest in and claims against the debtor; and (iii) stock received by creditors can only be counted toward the 50 percent test if it is received in satisfaction of debt that (a) had been held by the creditor for at least 18 months on the date of the bankruptcy filing (*i.e.*, was "old and cold") or (b) arose in the ordinary course of the debtor's business and is held by the person who at all times held the beneficial interest in that indebtedness.

Section 382(l)(5) of the IRC serves a valuable rehabilitative purpose by permitting bankrupt corporations that can qualify for that provision's treatment to restructure their finances and emerge from bankruptcy with a largely unfettered ability to use their NOLs to shelter income earned after an ownership change takes place as part of a chapter 11 plan of reorganization. Even that ability may be compromised in certain circumstances. Thus, if the company's business enterprise is not continued at all times during the two-year period beginning upon confirmation of a plan, or if a second change in ownership takes place within two years, the company will forfeit the right to benefit from the liberal rules of section 382(l)(5). Also, a debtor company making use of section 382(l)(5) must undergo a statutory NOL "haircut" whereby it loses certain interest deductions taken within the previous three tax years.

These rules place a heavy burden on the debtor to monitor the identity of its creditors and shareholders with fairly exacting precision. A significant volume of stock or claims transfers can jeopardize the debtor-company's ability to retain the full benefit of its NOLs. Bankruptcy courts recognized this potential risk relatively early on, finding that NOLs are property of a chapter 11 debtor's bankruptcy estate and enjoining any action that had the potential to adversely affect them. The seminal case in this area is *In re Prudential Lines, Inc.*, where the bankruptcy court found that an NOL was property of the debtor's bankruptcy estate and that the efforts of the debtor's corporate parent to claim a worthless stock deduction, which under then-existing law would have rendered the debtor's NOL useless, violated the automatic stay.

Recent developments in high-profile chapter 11 cases such as United Airlines, Conseco and Owens Corning have brought renewed attention to the role played by bankruptcy courts in regulating the trading of creditor claims and stock issued by debtor companies.

The court predicated its ruling, which subsequently was upheld on appeal by the Second Circuit, upon sections 362(a)(3) and 105(a) of the Bankruptcy Code. The former precludes "any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate." Section 105(a) gives a bankruptcy court broad equitable powers to issue any order "that is necessary or appropriate to carry out the provisions of" the Bankruptcy Code. Other courts have since followed suit, recognizing that preservation of a debtor's NOLs may be crucial to the success of the reorganization.

Debtors have been swift to seek court intervention in cases that have the potential for a significant volume of claim or stock trading. Companies such as First Merchants Acceptance Corporation, Service Merchandise Company, Phar-Mor, Inc. and South East Banking Corp. and, more recently, Conseco, Williams Communications Group, United Airlines and Owens Corning have sought at the outset of a bankruptcy case court approval of procedures designed to monitor trading and afford the debtor an opportunity to prevent trading if it threatens important tax attributes. Conseco obtained a bankruptcy court order blocking major shareholders from selling or transferring common stock as part of its first-day chapter 11 filings. United Airlines successfully enjoined the trustee of its employee stock ownership plan from selling its majority stock holdings to preserve NOLs estimated to exceed $20 billion. In February of 2005, the Delaware bankruptcy judge presiding over Owens Corning's chapter 11 case issued an order requiring investors who own 4.75 percent or more of the company's 55 million shares to notify the company and give it an opportunity to object before engaging in further purchases or sales of stock. In fact, NOL preservation motions are becoming almost routine in large chapter 11 cases.

TYPICAL TRADING INJUNCTIONS

Three basic types of trading injunctions commonly are relied upon to protect NOLs. The first is an injunction enjoining the transfer of equity interests. Stock trading injunctions protect against ownership changes prior to the effective date of a chapter 11 plan and generally are designed to limit trading by any entity holding five percent or more of the debtor's stock. If there are multiple classes of stock with varying economic values, the injunction should be tailored to account for this, as the five percent holder threshold is determined by reference to value.

Another type of injunction prevents a stockholder from taking a worthless stock deduction. Generally, such an injunction would be necessary only where there has been a 50 percent shareholder during the three-year period ending on the last day of the taxable year. Any one-time 50 percent shareholder that sold enough stock to fall below the threshold during the relevant period is still treated as a 50 percent shareholder in determining whether a worthless stock deduction by that shareholder could trigger a reduction or forfeiture of a debtor's NOL carry-forwards.

Finally, claims trading injunctions commonly are issued to protect the debtor-company's ability to rely on section 382(l)(5) of the IRC as a means of preserving NOL carry-forwards. Such injunctions typically set a threshold dollar amount of trading in claims that will trigger the provisions of the trading prohibition.

RECENT RULING IN UNITED AIRLINES

A decision recently handed down by the Seventh Circuit Court of Appeals is emblematic of the types of problems that can arise in connection with trading restrictions in a bankruptcy case. When United Airlines sought chapter 11 protection in 2002, United's employees owned slightly more than one-half of the company's stock through an employee stock ownership plan ("ESOP"). Concerned that the ESOP might sell the stock, and thereby cause a change in control that would jeopardize its ability to preserve NOLs, United sought and obtained an injunction forbidding any stock sales by the ESOP. The ESOP failed to ask the bankruptcy court to require United to post a bond or implement other measures to protect the ESOP against losses occurring as a result of its inability to sell the United stock.

The trustees of the ESOP appealed the injunction. Nevertheless, before the appellate court could render a decision, the Internal Revenue Service issued a regulation permitting ESOPs to pass through shares to employee beneficiaries without jeopardizing the issuer's ability to preserve NOL carry-forwards. United terminated the ESOP, which distributed the stock it held to the employees, who were free to trade the shares if they wished. The ESOP having been dissolved, the injunction lapsed, although it was never formally vacated by the bankruptcy court. Even though United then asked the district court to dismiss the appeal as moot, the court affirmed the bankruptcy court's decision to enjoin the stock sales. The ESOP's trustees appealed that determination to the Seventh Circuit.

At the time that the bankruptcy court issued the injunction, United's stock was trading at $1.06 per share. When employees were again able to trade (upon dissolution of the ESOP), the stock price had fallen to $.76. On appeal to the Seventh Circuit, the trustees sought an award of damages to compensate for the decrease in the price of the stock during the trading freeze.

The Seventh Circuit denied the trustees' request for damages because the trustees failed to obtain a bond or other equivalent means of protection to safeguard against any diminution in value in the stock caused by the trading freeze. Still, the Court of Appeals vacated the district court's order affirming

WHAT'S NEW AT JONES DAY?

David G. Heiman (Cleveland), **Corinne Ball** (New York), **Christopher L. Carson** (Atlanta) and **Heather Lennox** (Cleveland) were selected by a peer group of 18,500 leading attorneys throughout the U.S. for inclusion in *The 2006 Best Lawyers in America* in the specialty of "Bankruptcy and Creditor-Debtor Rights Law."

An article written by **Corinne Ball** (New York) entitled "Ruling Suggests 'Inattention' May Lead to Personal Liability" appeared in the "Corporate Update" column of the August 25, 2005 edition of *The New York Law Journal*.

An article co-authored by **Paul D. Leake** (New York) and **Mark G. Douglas** (New York) entitled "Trading Restrictions in Bankruptcy: Did the Seventh Circuit Up the Ante for Stock Trading Injunctions?" appeared in the August/September 2005 edition of *Pratt's Journal of Bankruptcy Law*.

Erica M. Ryland (New York) led Jones Day's representation of Ashmore Investment Management Limited and an ad hoc committee of noteholders in the restructuring of Compañía de Inversiones de Energía S.A., the parent of Transportadora de Gas del Sur S.A., one of Argentina's largest natural gas distributors. The transactional documents for a conversion of the noteholders' debt into 50 percent of the company's equity went effective on September 7, 2005 and now await approval by Argentine energy and other regulatory entities.

Heather Lennox (Cleveland) and **Carl E. Black** (Cleveland) presided over a seminar in Cleveland on September 20, 2005 concerning the significant business provisions of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.

An article co-authored by **Kelly M. Neff** (Chicago) and **Mark G. Douglas** (New York) entitled "Bankruptcy Court Has Broad Discretion to Estimate and Temporarily Allow Claims for Voting Purposes" appeared in the August/September 2005 edition of *Pratt's Journal of Bankruptcy Law*.

Sean P. Byrne (Columbus) moderated and participated in a panel discussion at a Columbus Bar Association seminar on September 1, 2005 entitled "The CBA on the BAPCPA: Practical Applications (Your Practice Under the New Bankruptcy Law)."

the injunction and remanded the case with instructions to enter an order formally dissolving the injunction. In doing so, the Seventh Circuit was highly critical of the bankruptcy court's decision to enjoin trading in the case:

> Requiring investors to bear the costs of illiquidity and underdiversification was both imprudent and unnecessary. United wants to preserve the value of tax deductions that, it contends, are worth more than $1 billion should it return to profitability. There is no reason why investors who need liquidity should be sacrificed so that other investors (principally, today's debt holders) can reap a benefit; bankruptcy is not supposed to appropriate some investors' wealth for distribution to others. United should have been told to back up its assertions with cash, so that put-upon shareholders could be made whole. If United's views are right, it would not have had any trouble borrowing to underwrite a bond or other form of protection; and if lenders would not make such loans, that would have implied to the court that United's contentions are hot air.

The Court of Appeals went on to characterize reliance on sections 105(a) and 362(a)(3) of the Bankruptcy Code as a basis for issuing a trading injunction as "weak enough to make a bond or adequate-protection undertaking obligatory before a bankruptcy judge may forbid investors to sell their stock on the market." According to the Seventh Circuit, a carefully drafted adequate protection agreement could have "protected stockholders against an erosion of their position while requiring them to indemnify United if the market price of the stock should rise, and the expense of a bond or other security turn out to have been unnecessary." Nevertheless, because no such protective measures were implemented at the time the trading freeze took place, the Court of Appeals ruled that the employee shareholders were not entitled to damages for any diminution in United's stock value.

OUTLOOK

Highly visible bankruptcy cases such as the chapter 11 cases filed by United Airlines, WorldCom, Enron, Global Crossing, Kmart and Owens Corning have focused attention on investing and trading in the securities of troubled companies and highlight the influential role played by distressed investment funds in large and medium-sized chapter 11 cases. These and many other cases also illustrate some of the challenges confronted by companies seeking to reorganize in bankruptcy. The practical challenge for debtors that possess sizeable NOLs is to safeguard these tax attributes by avoiding an ownership change (or excessive claims trading) until confirmation and consummation of a plan of reorganization. Notwithstanding rulemakers' efforts in 1991 to remove the bankruptcy court from regulating trading, recent developments indicate that the courts are still very much involved in regulating trading if the success of a debtor's reorganization is at stake.

These developments also suggest that as part of pre-bankruptcy strategic planning, potential debtors should determine whether they have any NOLs or other tax attributes (such as built-in losses) that require protection. The unwary debtor may find that it already has undergone an ownership change (or has lost its ability to qualify for section 382(l)(5) of the IRC) prior to filing or that it is dangerously close to the threshold. Swift action may be necessary given the robust market for trading in the claims and stock of financially troubled companies.

The impact of the Seventh Circuit's ruling in *United Airlines* is unclear. At a minimum, the decision suggests that shareholders and creditors alike should be vigilant to ensure that debtors seeking court approval of procedures restricting claim and equity trading show that the benefit to the estate through preserving tax attributes outweighs prejudice to creditors and shareholders who are being precluded from liquidating their holdings.

Because the specific issue before the Seventh Circuit in *United Airlines* was whether the ESOP trustees were entitled to money damages, the court's pronouncements concerning the legitimacy of trading injunctions may be regarded as *dicta*. Still, given widespread reliance among bankruptcy courts upon sections 362(a)(3) and 105(a) of the Bankruptcy Code as authority for regulating trading, the Seventh Circuit's criticism of this approach in cases distinguishable from the *Prudential* worthless stock deduction scenario should put bankruptcy advisors on notice. It remains to be seen whether the *quid pro quo* for implementing trading restrictions in the future will involve some type of bond or other equivalent means of economic protection for those parties prohibited from trading.

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

Official Comm. of Unsecured Creditors v. PSS S.S. Co. (In re Prudential Lines Inc.), 107 B.R. 832 (Bankr. S.D.N.Y. 1989), *aff'd*, 119 B.R. 430 (S.D.N.Y. 1990), *aff'd*, 928 F.2d 565 (2d Cir. 1991).

First Merchants Acceptance Corp., 1998 Bankr. LEXIS 1816 (Bankr. D. Del. Jan. 20, 1998).

In re Service Merchandise Co., Inc., 2000 Bankr. LEXIS 1523 (M.D. Tenn. Dec. 2000).

In re Phar-Mor, Inc., 152 B.R. 924 (Bankr. N.D. Ohio 1993).

In re Southeast Banking Corp., 1994 WL 1893513 (Bankr. S.D. Fla. July 21, 1994).

In re Conseco Inc., Case No. 02-49671 (Bankr. N.D. Ill. Dec. 18, 2002).

In re Williams Communications Group Inc., Case No. 02-11957 (BRL) (Bankr. S.D.N.Y. July 24, 2002).

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THIRD CIRCUIT RAISES THE BAR FOR SUBSTANTIVE CONSOLIDATION

Mark G. Douglas

The substantive consolidation of two or more entities is an important tool available to a bankruptcy court overseeing the cases of related companies whose financial affairs are hopelessly entangled or whose separate corporate identities otherwise have been disregarded by those in control or the companies' creditors. In deciding whether to consolidate two or more estates, a court must conduct a factually intensive inquiry and carefully balance the competing concerns of all interested parties. In the December 2004 edition of the *Business Restructuring Review* (vol. 3, no. 7), we examined a ruling handed down by the Delaware district court overseeing the chapter 11 cases filed by Owens Corning and its subsidiaries. The outcome had dire ramifications for the companies' lenders — the court authorized the deemed consolidation of the debtors' estates, thereby invalidating guarantees issued to the lenders by the debtor subsidiaries. That decision recently was reversed by the Third Circuit Court of Appeals. In *In re Owens Corning*, the Third Circuit emphasized that substantive consolidation is a remedy that should be invoked sparingly and only under very narrowly defined circumstances.

SUBSTANTIVE CONSOLIDATION

The bankruptcy court is a court of "equity." Although the distinction between courts of equity and courts of law largely has become irrelevant in modern times, courts of equity traditionally have been empowered to grant a broader spectrum of relief in keeping with fundamental notions of fairness as opposed to principles of black-letter law. This means that a bankruptcy court can exercise its discretion to produce fair and just results "to the end that fraud will not prevail, that substance will not give way to form, that technical considerations will not prevent substantial justice from being done." The remedies available to a bankruptcy court in exercising this broad equitable mandate include the power to invalidate pre-bankruptcy transfers that are fraudulent or preferential, the ability to "pierce the corporate veil" if a subsidiary is nothing more than its parent's "alter ego," and the power to reorder the priority of claims or interests (*i.e.*, equitable subordination) in cases of misconduct.

A bankruptcy court also can treat the assets and liabilities of two or more separate but related entities as inhering to a single integrated bankruptcy estate. Employing this tool, courts, in effect, "pierce the corporate veil" to satisfy claims of the creditors of the consolidated entities from their common pool of assets. This remedy is referred to as "substantive consolidation."

The Bankruptcy Code does not expressly countenance substantive consolidation (although it recognizes that a chapter 11 plan may provide for the consolidation of a "debtor with one or more persons" as a means of implementation). Rather, substantive consolidation is "a product of judicial gloss." Courts consistently have found the authority for substantive consolidation in the bankruptcy court's general equitable powers as set forth in section 105(a) of the Bankruptcy Code, which authorizes the court to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of [the Bankruptcy Code]." Some courts have expanded the reach of the remedy further to allow the consolidation of debtors with non-debtors. Nevertheless, because of the dangers of forcing creditors of one entity to share equally with creditors of a less solvent debtor, "substantive consolidation 'is no mere instrument of procedural convenience . . . but a measure vitally affecting substantive rights.'" Accordingly, courts generally hold that it is to be used sparingly.

Different standards have been employed by courts to determine the propriety of substantive consolidation. All of them involve a fact-intensive examination and an analysis of consolidation's impact on creditors. For example, in *Eastgroup Properties v. Southern Motel Assoc., Ltd.*, the Eleventh Circuit adopted, with some modifications, the standard enunciated by the District of Columbia Circuit in *In re Auto-Train Corp., Inc.* At the outset, the Eleventh Circuit emphasized that the overriding concern should be whether "consolidation yields benefits offsetting the harm it inflicts on objecting parties."

Under this standard, the proponent of substantive consolidation must demonstrate that (i) there is substantial identity between the entities to be consolidated and (ii) consolidation is necessary to avoid some harm or to realize some benefit. Factors that may be relevant in satisfying the first requirement include:

- the presence or absence of consolidated financial statements;
- any unity of interests and ownership between various corporate entities;
- the existence of parent and intercorporate guarantees on loans;
- the degree of difficulty in segregating and ascertaining individual assets and liabilities;
- the existence of transfers of assets without formal observance of corporate formalities;
- any commingling of assets and business functions;
- the profitability of consolidation at a single physical location;
- whether the parent owns the majority of the subsidiary's stock;
- whether the entities have common officers or directors;
- whether a subsidiary is grossly undercapitalized;
- whether a subsidiary transacts business solely with the parent; and
- whether both a subsidiary and the parent have disregarded the legal requirements of the subsidiary as a separate organization.

If the proponent is successful, a presumption arises "that creditors have not relied solely on the credit of one of the entities involved." The burden then shifts to any party opposing consolidation to show that it relied on the separate credit of one of the entities to be consolidated and that it will be prejudiced by consolidation. Finally, if an objecting creditor makes this showing, "the court may order consolidation only if it determines that the demonstrated benefits of consolidation 'heavily' outweigh the harm."

The Second Circuit, in *In re Augie/Restivo Baking Co., Ltd.*, established a somewhat different standard for gauging the propriety of substantive consolidation. The court concluded that the various elements listed above, and others considered by the courts, are "merely variants on two critical factors: (i) whether creditors dealt with the entities as a single economic unit and did not rely on their separate identity in extending credit, . . . or (ii) whether the affairs of the debtors are so entangled that consolidation will benefit all creditors." With respect to the initial factor, the Court of Appeals explained that creditors who make loans on the basis of a particular borrower's financial status expect to be able to look to the assets of that borrower for repayment and that such expectations create significant equities. Addressing the second factor, the Second Circuit observed as follows:

> [E]ntanglement of the debtors' affairs involves cases in which there has been a commingling of two firms' assets and business functions. Resort to consolidation in such circumstances, however, should not be Pavlovian. Rather, substantive consolidation should be used only after it has been determined that all creditors will benefit because untangling is either impossible or so costly as to consume the assets.

The *Augie/Restivo* test recently was adopted by the Ninth Circuit in *In re Bonham*. Other circuit and lower courts have adopted tests similar to the *Augie/Restivo* and *Eastgroup* standards. The Third Circuit took a hard look at the question for the first time in *Owens Corning*.

SUBSTANTIVE CONSOLIDATION IN OWENS CORNING

Owens Corning and 17 of its wholly owned subsidiaries, a major supplier of building and industrial materials based in Toledo, Ohio, sought chapter 11 protection in 2000 in an effort to manage skyrocketing asbestos litigation exposure. At the time that the companies filed for chapter 11, a consortium of more than 40 banks had loaned or committed to loan the parent company and five of its subsidiaries more than $2 billion in a series of revolving loans, competitive advance loans, swing line loans and letter of credit commitments under a master credit agreement that could be drawn on from time to time by the borrowers.

The parent guaranteed all loans made under the master credit agreement to either itself or its subsidiaries. Because the lenders refused to extend financing without subsidiary guarantees as a "credit enhancement," each major subsidiary (those with assets having a book value of $30 million or more) also guaranteed the loans. The credit agreement also contained provisions specifically designed to protect the separateness of the parent company and its subsidiaries, including an undertaking to maintain separate books and records in order to prepare separate financial statements and restrictions on mergers with affiliates.

Among the companies' other creditors at the time of the filing were bondholders, trade creditors and asbestos litigants. These and other creditor interests were represented during the case by an official unsecured creditors' committee, a committee or subcommittee representing bondholders and trade creditors, an official committee of asbestos claimants, and a legal representative for future claimants.

The Third Circuit's formulation of the standard would appear to raise the bar for achieving consolidation by placing more emphasis on the absence of prejudice to any single creditor than the "balance of harm versus benefit" that figures prominently in the *Augie/Restivo* and *Auto-Train* approaches.

In connection with their efforts to devise a plan of reorganization, the debtors sought a court order "deeming" their estates and the assets and liabilities of three non-debtor subsidiaries substantively consolidated. This meant that consolidation would be deemed to exist for purposes of valuing and satisfying creditor claims, plan voting and making distributions in respect of allowed claims. The chapter 11 plan, however, would "not result in the merger of or the transfer or commingling of any assets of the Debtors or Non-Debtor Subsidiaries, . . . [which would] continue to be owned by the respective Debtors or Non-Debtors." Moreover, "all guarantees of the Debtors of the obligations of any other Debtor [would] be deemed eliminated, so that any claim against any such Debtor and any guarantee thereof . . . will be deemed to be one obligation of the Debtors with respect to the consolidated estate."

Nearly all creditors, other than the banks, supported the request. According to the banks, the cross-guarantees elevated their claim for $1.6 billion outstanding under the credit agreement to a higher priority than other claims because it represented a direct claim against both the parent company and each of the subsidiary guarantors, whereas other creditors asserted direct claims only against the parent.

After conducting a four-day evidentiary hearing, the judge of the district court (sitting in bankruptcy) granted the motion to consolidate the Owens Corning estates, observing that "I have no difficulty in concluding that there is indeed substantial identity between the parent debtor . . . and its wholly-owned subsidiaries." Each of the subsidiaries, the court explained, was controlled by a single committee, from central headquarters, without regard to the subsidiary structure. Among other things, this meant that the officers and directors of the subsidiaries did not establish business plans or budgets and did not appoint senior management except at the direction of the central committee. Subsidiaries were established for the convenience of the parent, principally for tax reasons. Also, the subsidiaries were entirely dependent on the parent for funding and capital, and the financial management of the entire enterprise was conducted in an integrated manner.

Substantive consolidation, the court emphasized, would greatly simplify and expedite the successful completion of the bankruptcy proceedings. More importantly, the court remarked, "it would be exceedingly difficult to untangle the financial affairs of the various entities," despite the considerable sums expended by the debtors to sort out the financial affairs of each individual entity.

Having concluded that the proponents of consolidation established a *prima facie* case, the court then examined whether the banks proved that they relied on the separate credit of the subsidiaries. It ruled that they did not, remarking that "[t]here can be no doubt that the Banks relied on the overall credit of the entire Owens Corning enterprise." According to the court, the evidence showed that each bank's loan commitment was to the entire enterprise, and the decision as to whether funds would be borrowed by the parent or one or more subsidiaries was made by the borrowers, not the banks. In obtaining guarantees from the major subsidiaries, the court emphasized, the banks knew only that each guarantor had assets with a book value greater than $30 million — they had no information regarding the debts of the guarantor subsidiaries. The very existence of the cross-guarantees, the court explained, was a reason to substantively consolidate the estates because "[a]ny guarantor held liable on its guarantee would have a right of indemnification against whichever entity or entities borrowed the money . . . . [and] [i]t would be extremely difficult to sort out the inter-subsidiary claims." Moreover, the court observed that the claims based upon the guarantees were not as clear-cut as the banks maintained and had in fact been challenged by the debtor and various creditor groups as fraudulent conveyances.

Finally, in ruling that substantive consolidation of the debtors' estates was a "virtual necessity," the district court did not rule out the possibility that some portion of the banks' claim (based upon the cross-guarantees) ultimately might enjoy a higher priority than other unsecured creditors of the consolidated estates. The court, however, stated that this issue was more properly joined in connection with a "fair and equitable" analysis undertaken as part of confirmation of a chapter 11 plan of reorganization.

THE THIRD CIRCUIT REVERSES

The banks appealed the district court's decision to the Third Circuit Court of Appeals, which reversed. After examining the historical provenance of the remedy and noting that it had never before directly considered its character and scope, the Third Circuit embarked upon its analysis with the observation that "there appears to be nearly unanimous consent that it is a remedy to be used 'sparingly.'" With this admonition as a prelude, the court considered what standards should govern invocation of the remedy. It opted for an "open ended, equitable inquiry" rather than the factor-based analysis employed by many courts. According to the court, "[t]oo often the factors in a check list fail to separate the unimportant from the important, or even to set out a standard to make the attempt." The factor-based approach, the court explained, "often results in rote following of a form containing factors where courts tally up and spit out a score without an eye on the principles that give the rationale for substantive consolidation (and why, as a result, it should so seldom be in play)."

The Third Circuit articulated these principles as follows:

- limiting the cross-creep of liability by respecting entity separateness as a fundamental ground rule informing the general expectations of state law, the Bankruptcy Code and commercial markets;
- the harms substantive consolidation addresses are nearly always caused by debtors (and entities they control) who disregard separateness;
- mere benefit to case administration is not a harm justifying consolidation;
- because consolidation is extreme (in that it may profoundly affect creditor rights and recoveries) and imprecise, this "rough justice" remedy should be "rare and, in any event, one of last resort after considering and rejecting" other available remedies; and
- although consolidation may be used defensively to remedy the identifiable harms caused by entangled affairs, it may not be used offensively, such as, for example, to disadvantage tactically a group of creditors in the plan process.

Based upon these principles, the Third Circuit ruled that, absent consent, a proponent of substantive consolidation must prove either that: (i) pre-bankruptcy, the entities to be consolidated "disregarded separateness so significantly that their creditors relied on the breakdown of entity borders and treated them as one legal entity"; or (ii) after filing for bankruptcy, the entities' assets and liabilities "are so scrambled that separating them is prohibitive and hurts all creditors."

Addressing the first scenario, the Court of Appeals explained that a *prima facie* case for it typically exists when, based upon pre-bankruptcy dealings, a proponent can prove corporate disregard "creating contractual expectations of creditors that they were dealing with debtors as one indistinguishable entity." Proponents of consolidation who are creditors, the Third Circuit added, also must prove that "they actually and reasonably relied on debtors' supposed unity" in their pre-bankruptcy dealings. Even so, the court emphasized, creditor opponents of substantive consolidation can defeat a *prima facie* showing under the first scenario "if they can prove they are adversely affected and actually relied on debtors' separate existence."

Having laid the ground rules, the Court of Appeals applied them to Owens Corning. First, the court examined the record and found lacking any evidence that the corporate separateness of the entities to be deemed consolidated was disregarded. The facts indicated that Owens Corning and the banks negotiated the lending transaction premised on the separateness of each of the affiliated companies, leading the Third Circuit to fault the district court's conclusion that "substantial identity" existed between parent and subsidiaries. It also characterized as "overly simplistic" the argument that the banks intended to ignore the separateness of the entities because they failed to obtain independent financial statements for each of the entities at the time of the financing. According to the court, "[w]e cannot conceive of a justification for imposing the rule that a creditor must obtain financial statements from a debtor in order to rely reasonably on the separateness of that debtor." Creditors, the Third Circuit added, "are free to employ whatever metrics they believe appropriate in deciding whether to extend credit free of court oversight."

The Court of Appeals next examined whether there was any evidence of hopeless commingling of the debtors' assets and liabilities post-bankruptcy. It found none. The Third Circuit ruled that the lower court mistakenly concluded that commingled assets warrant consolidation when the affairs of the companies are so entangled that consolidation "will be beneficial":

> As we have explained, commingling justifies consolidation only when separately accounting for the assets and liabilities of the distinct entities will reduce the recovery of every creditor — that is, when every creditor will benefit from the consolidation. Moreover, the benefit to creditors should be from cost savings that make assets available rather than from the shifting of assets to benefit one group of creditors at the expense of another. Mere benefit to some creditors, or administrative benefit to the Court, falls far short. The District Court's test not only fails to adhere to the theoretical justification for "hopeless commingling" consolidation — that no creditor's rights will be impaired — but also suffers from the infirmity that it will almost always be met. That is, substantive consolidation will nearly always produce some benefit to some in the form of simplification and/or avoidance of costs. Among other things, following such a path misapprehends the degree of harm required to order substantive consolidation.

According to the Third Circuit, although the debtors' intercompany accounting was assuredly imperfect, "perfection is not the standard in the substantive consolidation context." The court expressed confidence that a court could properly order and oversee an accounting process designed to sort out any inaccuracies in the debtors' intercompany books.

The Third Circuit also ruled that other considerations "counsel strongly against consolidation." Among these were the debtors' misuse of the remedy "offensively to achieve advantage over one group in the plan negotiation process" and their reliance on consolidation as a "free pass" to avoid prosecuting threatened fraudulent transfer claims, "that are liberally brandished to scare yet are hard to show." Finally, the court was highly critical of the proposed "deemed consolidation" structure, characterizing it as "perhaps the flaw most fatal" to the bid for substantive consolidation. In effect, the Third Circuit remarked, the plan proponents "seek to remake substantive consolidation not as a remedy, but rather a stratagem to 'deem' separate resources reallocated to [Owens Corning] to strip the Banks of rights under the Bankruptcy Code, favor other creditors, and yet trump possible Plan objections by the Banks." Finding such a scheme untenable, the court concluded that the "nearly perfect storm" needed to invoke substantive consolidation was absent.

ANALYSIS

Substantive consolidation of affiliated debtors' estates in a negotiated plan of reorganization as a means of simplifying a complicated corporate structure is not uncommon, particularly as corporate structures increasingly are driven by tax considerations that may cease to become viable once an affiliated network of companies files for bankruptcy. *Owens Corning* is unusual because it involves a request for consolidation by the debtors outside of a plan of reorganization over the objection of a significant creditor group. More commonly, the creditors of an asset-poor debtor whose affiliates also have filed for bankruptcy seek substantive consolidation of the related debtors' estates as a means of enhancing their recoveries.

To the extent that a "liberal trend" has developed toward the increased use of substantive consolidation, the Third Circuit flatly rejected it. Even so, its conclusion that consolidation was unjustified in *Owens Corning* likely was driven by the perception that the facts of the case rose to the level of a clear abuse of the remedy. It is unclear whether the standard for consolidation articulated by the Third Circuit differs in any meaningful sense from the standards traditionally applied by other courts. In fact, the Third Circuit's standard appears to consider the same factors as the traditional standards, but it uses those factors as guidelines rather than a rote checklist of indiscretions to be tallied.

The ruling, however, can be interpreted to allow a single creditor, provided it demonstrates reasonable reliance on corporate separateness, to defeat consolidation (at least with respect to its claim) even where the remaining creditors do not object and consolidation clearly would benefit the estates and the vast majority of creditors. To this extent, the Third Circuit's formulation of the standard would appear to raise the bar for achieving consolidation by placing more emphasis on the absence of prejudice to any single objecting creditor than the "balance of harm versus benefit" analysis that figures prominently in the *Augie/Restivo* and *Auto-Train* approaches.

Owens Corning sends a clear message that non-consensual consolidation rarely is appropriate and should be authorized only after meticulous fact-finding demonstrates that the remedy is justified. It also indicates that chapter 11 plans proposing "deemed consolidation" have little chance of being confirmed in a cram-down scenario in the Third Circuit if the remedy is a strategy devised to disadvantage a creditor or group of creditors.

In re Owens Corning, 2005 WL 1939796 (3d Cir. Aug. 15, 2005), *reversing* 316 B.R. 168 (Bankr. D. Del. 2004).

Drabkin v. Midland-Ross Corp. (In re Auto-Train Corp., Inc.), 810 F.2d 270 (D.C. Cir. 1987).

Eastgroup Properties v. Southern Motel Assoc., Ltd., 935 F.2d 245 (11th Cir. 1991).

In re Augie/Restivo Baking Co., 860 F.2d 515 (2d Cir. 1988).

In re Bonham, 229 F.3d 750 (9th Cir. 2000).

SECOND CIRCUIT INVALIDATES CHAPTER 11 PLAN RELEASES OF NON-DEBTORS

Mark G. Douglas

A provision in a chapter 11 plan releasing or enjoining litigation against non-debtors who play a significant role in a reorganization case is an increasingly common feature of many large chapter 11 cases, especially if the case involves a company seeking to deal with mass tort liabilities. Nevertheless, whether and under what circumstances a bankruptcy court has the power to approve such releases or injunctions has been a magnet for controversy. So much so, that two courts of appeal have ruled that such provisions in a chapter 11 plan are categorically invalid, while other circuit and lower courts are divided on the issue. A ruling recently handed down by the Second Circuit Court of Appeals represents the latest word on the controversy at the appellate level. In *In re Metromedia Fiber Network, Inc.*, the court held that a chapter 11 plan impermissibly released certain non-debtors where there was no indication that the release was important or even necessary to implementation of the plan.

EFFECT OF PLAN CONFIRMATION ON THIRD-PARTY OBLIGATIONS

With certain exceptions, the provisions of a confirmed chapter 11 plan of reorganization are binding upon all creditors, whether or not they vote to accept the plan. In addition, confirmation of a plan acts to discharge the debtor from any debt that arose prior to the confirmation date, even if a creditor failed to file a proof of claim evidencing its debt or voted to reject the plan. Although the Bankruptcy Code precludes actions against the reorganized debtor or its property to collect on pre-bankruptcy debts, the same cannot be said with respect to litigation against non-debtor third parties who share liability for the same debts. Thus, section 524(e) of the Bankruptcy Code provides that "the discharge of a debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt."

The Bankruptcy Code explicitly authorizes non-debtor releases only in cases involving companies with asbestos-related liabilities. Section 524(g) was added to the Bankruptcy Code in 1994. It establishes a procedure for dealing with future personal injury asbestos claims against a chapter 11 debtor. The procedure entails the creation of a trust to pay future claims and the issuance of an injunction to prevent future claimants from suing the debtor. All claims based upon asbestos-related injuries are channeled to the trust. Section 524(g) was enacted in response to lawmakers' concerns that future claimants — *i.e.*, persons who have been exposed to asbestos but have not yet manifested any signs of illness — are protected and recognizes that these claimants would be ill-served if asbestos companies are forced into liquidation. The statute contains detailed requirements governing the nature and scope of any injunction issued under section 524(g) in connection with the confirmation of a chapter 11 plan under which a trust is established to deal with asbestos claims.

Nevertheless, under certain circumstances, bankruptcy courts have approved chapter 11 plans that release or enjoin litigation against non-debtors in non-asbestos cases. Examples include situations where the estate receives substantial consideration in exchange for the release or injunction, where the enjoined claims are "channeled" to a settlement fund rather than extinguished or where the enjoined or released claims would indirectly impact the debtor's reorganization by way of indemnity or contribution and the plan otherwise provides for full payment of the claims. Non-debtor releases also have been approved if the affected creditors consent.

The Courts of Appeals for the Ninth and Tenth Circuits have held that non-debtor releases and injunctions are impermissible (outside the scope of section 524(g)). The Fourth and Second Circuits (prior to the decision discussed below) have approved releases and injunctions benefiting non-debtors in the context of global settlements of massive liabilities of debtors and co-liable non-debtors that provided for compensation to claimants in exchange for releases that made the reorganizations feasible. The D.C. Circuit ruled that a plan provision releasing non-debtors was unfair because the plan did not provide additional compensation to a creditor whose claim against a non-debtor was being released. The Fifth Circuit reversed approval of a settlement that permanently enjoined a variety of claims because the injunction impermissibly discharged non-debtor liabilities, distinguishing other cases where the injunction channeled those claims to allow recovery from separate assets.

After it concluded that enjoining claims against a non-debtor consulting firm for contribution and indemnification was integral to a debtor's settlement with the firm, the Eleventh Circuit affirmed a district court ruling that a bankruptcy court has the power to enjoin non-settling defendants from asserting such claims. The Third Circuit, declining to decide whether or not non-debtor releases legitimately can be part of a chapter 11 plan, ruled that a plan releasing and permanently enjoining litigation against the non-debtor D&O defendants did not pass muster under even the most flexible tests for the validity of non-debtor releases. Other courts of appeal either have issued non-binding rulings on the subject or avoided addressing the issue on its merits.

In situations where section 524(g) does not apply (*i.e.*, non-asbestos cases), most courts — if they do not categorically consider the practice illegitimate — will carefully scrutinize the circumstances under which a non-debtor is receiving the benefit of a release or injunction to ascertain whether the circumstances are unusual enough to warrant extraordinary relief.

The Sixth Circuit Court of Appeals picked up the gauntlet in 2002 when it ruled in *Class Five Nevada Claimants v. Dow Corning Corp. (In re Dow Corning Corp.)* that the issuance of an injunction preventing a non-consenting creditor from suing a non-debtor was within the powers conferred to bankruptcy courts under the Bankruptcy Code, but that this power can be wielded only under "unusual circumstances." The Court of Appeals adopted the following seven-part test to be applied in determining whether "unusual circumstances" justify enjoining non-consenting creditors under a plan of reorganization:

- there is an identity of interests between the debtor and the third party, usually an indemnity relationship, such that a suit against the non-debtor is, in essence, a suit against the debtor or will deplete assets of the debtor's estate;
- the non-debtor has contributed substantial assets to the reorganization;

- the injunction is essential to reorganization — namely, the reorganization hinges on the debtor being free from indirect suits against parties who would have indemnity or contribution claims against the debtor;
- the affected class or classes have voted overwhelmingly to accept the plan;
- the plan provides a mechanism to pay for all, or substantially all, of the claims in the class or classes affected by the injunction;
- the plan provides an opportunity for those claimants who choose not to settle to recover in full; and
- the bankruptcy court made a record of specific factual findings that support its conclusions.

Applying this test to the facts before it, the Sixth Circuit found that the record produced by the bankruptcy court was inadequate to support a conclusion that "unusual circumstances" existed. It faulted both the bankruptcy court's ambiguous factual determination that the release and injunction provisions were essential to the reorganization and the absence of detailed factual findings that contributions to be made by Dow's insurers and affiliates were substantial. Finally, the court took exception to the absence of any finding by the bankruptcy court that each claimant who chose not to settle had an opportunity to recover in full by pursuing litigation against the non-debtor insurers and shareholders.

THE SECOND CIRCUIT REVISITS THE ISSUE IN METROMEDIA

The Second Circuit is the latest court of appeals to rule on the propriety of non-debtor releases. The chapter 11 plan proposed by Metromedia Fiber Network, Inc. and its subsidiaries contained three separate release provisions. The first released all claims against a trust settled by certain Metromedia insiders in exchange for, among other things, forgiveness of approximately $150 million in unsecured claims, conversion of $15.7 million in senior secured claims to equity, and investment in the reorganized company of up to $37 million. The release covered "any and all claims, obligations, rights, causes of action and liabilities arising out of or in connection with any matter related to [Metromedia] or one or more subsidiaries based in whole or in part upon any act or omission or transaction taking place on or before the [effective date of the plan]." The plan also barred claims against former or current Metromedia personnel related to the bankruptcy case and based upon acts or omissions that occurred on or before the plan's effective date, unless based upon "gross negligence or willful misconduct." Finally, the plan released former or current Metromedia personnel from any claim relating to Metromedia, the reorganized companies, or the plan.

Several creditors objected to the plan, claiming, among other things, that non-debtor releases are not authorized by the Bankruptcy Code. The bankruptcy court overruled these objections and confirmed Metromedia's chapter 11 plan on August 21, 2003. The district court affirmed that determination on March 18, 2004, but not before Metromedia's plan became effective on September 8, 2003. At no time did the creditors seek a stay of the order confirming the chapter 11 plan.

The creditors appealed the lower courts' decisions to the Second Circuit. Emphasizing that a non-debtor release "is proper only in rare cases," the court noted that "[a]t least two considerations justify the reluctance to approve" such a release. First, the Second Circuit explained that the only explicit authority in the Bankruptcy Code for such releases is section 524(g). Acknowledging that section 105(a) contains broad equitable authority for a bankruptcy court to issue orders necessary to carry out the provisions of the Bankruptcy Code, the court rejected the provision as a source of authority for non-debtor releases because section 105(a) does not allow the bankruptcy court "to create substantive rights that are otherwise unavailable under" other provisions of the statute. Second, the Court of Appeals observed that "a non debtor release is a device that lends itself to abuse." According to the Second Circuit, "[i]n form, it is a release; in effect, it may operate as a bankruptcy discharge arranged without a filing and without the safeguards of the Code." It characterized the potential for abuse as "heightened" in cases, such as the one before it, where the release affords blanket immunity from a wide universe of claims.

The Second Circuit distinguished Metromedia's case from other cases in which courts have approved non-debtor releases. "No case," the Court of Appeals remarked, "has tolerated nondebtor releases absent the finding of circumstances that may be characterized as unique." The record in *Metromedia*, the Second Circuit emphasized, was devoid of any evidence that the releases were necessary or even important to implementation of Metromedia's chapter 11 plan. According to the Second Circuit, "[a] nondebtor release in a plan of reorganization should not be approved absent the finding that truly unusual circumstances render the release terms important to success of the plan," focusing on the considerations that typically inform a court's reluctance to authorize such releases except in a narrow range of circumstances.

Moreover, the Court of Appeals rejected Metromedia's contention that because the creditors received a distribution under the plan, they were compensated for releasing the trust and Metromedia personnel from liability. "[A] nondebtor release is not adequately supported by consideration," the Second Circuit concluded, "simply because the nondebtor contributed something to the reorganization and the enjoined creditor took something out."

The creditors' victory on the release issue was short-lived. Because they failed to obtain a stay pending their appeal of the order confirming Metromedia's chapter 11 plan, the plan had been substantially consummated by the time the Second Circuit issued its ruling. As such, the Court of Appeals ruled that the appeal was moot and affirmed the decision below on this basis.

OUTLOOK

The rulings in *Dow Corning* and *Metromedia* can be regarded as a primer on the usage of releases or injunctions for the benefit of non-debtors in a bankruptcy case. In situations where section 524(g) does not apply (*i.e.,* non-asbestos cases), most courts — if they do not categorically consider the practice illegitimate — will carefully scrutinize the circumstances under which a non-debtor is receiving the benefit of a release or injunction to ascertain whether the circumstances are unusual enough to warrant extraordinary relief. To a considerable degree, the ruling in *Metromedia* appears to be driven by the debtors' failure to develop an adequate evidentiary record more than any substantive failure on the merits. The outcome might have been otherwise if the debtors had introduced evidence demonstrating that the non-debtor releases were a necessary or even indispensable prerequisite to implementation of their chapter 11 plan.

Both decisions reinforce the important principles underlying chapter 11 of the Bankruptcy Code, particularly in large cases involving mass tort liabilities. A great many chapter 11 plans are the product of extensive negotiations resulting in a carefully crafted settlement of complex debtor-creditor, intercreditor and shareholder issues. This is especially so in mass tort cases involving tens of thousands of existing creditors, as well as an untold number of future creditors whose injuries have not even manifested themselves at the time of the chapter 11 case.

Deutsche Bank AG v. Metromedia Fiber Network, Inc. (In re Metromedia Fiber Network, Inc.), 416 F.3d 136 (2d Cir. 2005).

Resorts Int'l, Inc. v. Lowenschuss (In re Lowenschuss), 67 F.3d 1394 (9th Cir. 1995), *cert. denied*, 517 U.S. 1243 (1996).

Landsing Diversified Props. II v. First Nat'l Bank & Trust Co. (In re Western Real Estate Fund, Inc.), 922 F.2d 592 (10th Cir. 1990), *modified sub nom. Abel v. West*, 932 F.2d 898 (10th Cir. 1991).

Securities & Exchange Commission v. Drexel Burnham Lambert Group, Inc. (In re Drexel Burnham Lambert Group, Inc.), 960 F.2d 285 (2d Cir. 1992).

Menard-Sanford v. Mabey (In re A.H. Robins Co.), 880 F.2d 694 (4th Cir.), *cert. denied*, 493 U.S. 959 (1989).

In re AOV Indus., Inc., 792 F.2d 1140 (D.C. Cir. 1986).

Feld v. Zale Corp. (In re Zale Corp.), 62 F.3d 746 (5th Cir. 1995).

In re Munford, 97 F.3d 449 (11th Cir. 1996).

In re Specialty Equipment Cos., 3 F.3d 1043 (7th Cir. 1993).

Monarch Life Ins. Co. v. Ropes & Gray, 65 F.3d 973 (1st Cir. 1995).

In re Continental Airlines, 203 F.3d 203 (3d Cir. 2000).

Class Five Nevada Claimants v. Dow Corning Corp. (In re Dow Corning Corp.), 280 F.3d 648 (6th Cir. 2002).

CHARTER EXCULPATORY PROVISIONS PRECLUDE BANKRUPTCY TRUSTEE FROM SUING ON BREACH OF DUTY OF CARE

Ross S. Barr

Among the powers conferred upon a bankruptcy trustee or chapter 11 debtor-in-possession ("DIP") is the ability to "stand in the shoes" of a debtor corporation and to prosecute any claims held by the debtor at the time it filed for bankruptcy protection. These claims are considered property of the debtor's estate.

Consistent with this authority, a trustee (or DIP) may pursue any of the corporate debtor's claims against its officers and directors for breach of fiduciary duty and other forms of misconduct. Certain questions, however, exist regarding the extent of the trustee's authority to bring claims on behalf of the corporate debtor. For example, is the trustee bound by the same constraints on the corporation's right to file suit against its directors and officers, such as the business judgment rule and certain director and officer exoneration provisions authorized under state corporate law? Similarly, are these claims property of the debtor's estate or do they belong exclusively to the debtor's creditors (in which case the trustee does not have the authority to assert them)?

These questions were the subject of a ruling recently handed down by the Second Circuit Court of Appeals in *Pereira v. Farace*. The court held that a bankruptcy trustee could not prosecute a corporate debtor's claims against its former directors for breach of the duty of care where the corporation's charter contained a provision shielding its directors from such liability.

FIDUCIARY DUTIES OF OFFICERS AND DIRECTORS

State law uniformly subjects corporate fiduciaries to duties of loyalty and care. The former is premised upon the fundamental principle that a director stands in a special relationship of trust to the corporation and must act in furtherance of the best interests of the corporation rather than his own self-interest. The duty of care obligates a fiduciary to discharge his duties in good faith and to make informed decisions predicated upon a level of care that a similarly situated person would reasonably believe appropriate under the circumstances. This rule generally protects directors from liability for detrimental corporation transactions so long as they are undertaken in good faith and with due care, and the relevant decisions are within the directors' authority.

In exercising the duty of care, fiduciaries generally enjoy the protection of the "business judgment rule" — a judicially created presumption that an officer or director has exercised due care in the furtherance of his duties. When directors are both disinterested and have been appropriately informed in the decision-making process, courts generally will refrain from substituting their own judgment for that of the directors, thereby deferring to the directors' "business judgment."

Additional protection for corporate fiduciaries also can be found in a corporation's by-laws or charter. A growing number of by-laws or charters take advantage of state law provisions that exonerate directors from monetary liability for any breach of the duty of care not involving bad faith, intentional misconduct, improper payment of dividends, improper stock purchase or redemption, as well as any breach of the duty of loyalty.

FIDUCIARY DUTIES IN THE ZONE OF INSOLVENCY

Although it has long been universally understood that corporate management's fiduciary duties run to the corporation and its shareholders, the Delaware Chancery Court reconstructed the paradigm regarding the obligations of directors when the corporation enters the "zone of insolvency." In *Credit Lyonnais Bank Nederland, N.V. v. Pathé Communications Corp.*, the court stated that "[a]t least where a corporation is operating in the 'vicinity of insolvency,' a board of directors is not merely the agent of the residue risk bearers, but owes its duty to the corporate enterprise." The court recognized that once a corporation enters the "zone of insolvency," its directors must "consider the community of interests that the corporation represents" and choose a course of action that will maximize the corporation's value, which "may diverge from the choice that the stockholders . . . would make if given the opportunity to act." Many courts have interpreted this decision as imposing on corporate management fiduciary duties to creditors once the corporation enters the "zone of insolvency."

BANKRUPTCY TRUSTEE'S STANDING TO ASSERT CLAIMS

The ability to commence litigation in a court of law is generally referred to as "standing." Standing is a threshold issue in which the court must determine whether the claimant has a right to be heard in that forum. In the bankruptcy context, standing is conferred upon the trustee by statute, which both empowers the trustee and limits his ability to commence litigation or otherwise assert claims of the corporate debtor to only those claims that the debtor could have prosecuted itself.

Along those lines, the trustee generally is not able to assert claims that belong exclusively to individual creditors, who generally have the right to assert a claim for breach of management's fiduciary duties once the corporation enters the zone of insolvency. Still, there are certain exceptions to the general rule that a trustee lacks standing to assert claims on behalf of individual creditors. For example, section 544(b) of the Bankruptcy Code authorizes the trustee to prosecute certain claims belonging to creditors under state law. This authority, however, is limited to actions to avoid fraudulent or preferential transfers.

State law determines whether a claim seeking recovery against corporate officers and directors is derivative (*i.e.*, the claim actually belongs to the corporation and, therefore, may be asserted by a bankruptcy trustee) or held directly by creditors (in which case the trustee lacks standing to assert it). In the context of claims against corporate fiduciaries, this important distinction was the subject of a decision rendered by the Delaware Chancery Court in *Production Resources Group, LLC v. NCT Group, Inc.*

In that case, a judgment creditor claimed that the company's directors breached their fiduciary duty of loyalty to the company, which was purportedly insolvent, by engaging in conscious wrongdoing. The court stated that although creditors have standing to bring this type of action, any recovery should go to the company itself, rather than creditors. The court reasoned that even where a company is insolvent, conduct by directors that deepens the company's insolvency and is actionable by creditors harms the company itself. Whether such claims are brought by a shareholder when the company is solvent or a creditor when it is not, the court concluded that any recovery "logically flows to the corporation and benefits the derivative plaintiffs indirectly to the extent of their claim on the firm's assets." Furthermore, the court explained that, under state law, provisions exonerating management from certain fiduciary infractions continue to protect directors once the corporation enters the zone of insolvency, regardless of whether those claims are asserted derivatively by stockholders or by creditors.

The decision can be viewed as a welcome development by corporate fiduciaries. If its rationale is adopted by other courts, directors acting in good faith need not fear that the safe harbor protections established in *Production Resources* will be abridged or forfeited if a bankruptcy case is filed by or against the corporation.

The ramifications of this approach on a bankruptcy trustee's standing to prosecute alleged fiduciary indiscretions were addressed by the Second Circuit Court of Appeals in *Pereira v. Farace*.

THE SECOND CIRCUIT'S RULING

The chapter 7 trustee of Trace International Holdings, Inc. ("Trace") filed a complaint against former Trace officers and directors claiming, among other things, breach of fiduciary duty arising from their roles in Trace's financial demise. The complaint alleged that because Trace had been insolvent since 1995, management owed fiduciary duties to Trace's creditors as well as its stockholders. The district court held that the defendants breached their fiduciary duties by allowing a number of improper transactions to occur that depleted Trace's assets and ultimately drove it into bankruptcy. Importantly, the court held that the exculpatory clause in Trace's articles of incorporation, which shielded the directors from liability to Trace for breach of the duty of care, was inapplicable because the trustee had brought the action on behalf of all of Trace's creditors, and not Trace itself. The court rejected the defendants' argument that the exculpatory clause applied only to claims asserted by individual creditors (as opposed to the aggregate body of Trace's creditors), which the trustee lacked standing to assert.

The defendants appealed the district court's decision to the Second Circuit. The Court of Appeals acknowledged that a bankruptcy trustee generally lacks standing to sue third parties on behalf of the estate's creditors and may assert only the claims held by the bankrupt corporation itself. It then stated that "[a]lthough corporate officers and directors owe fiduciary duties to creditors when a corporation is insolvent in fact, these duties do not expand the circumscribed rights of the trustee, who may only assert claims of the bankrupt corporation, not its creditors." Therefore, the Second Circuit ruled that because breach of fiduciary duty claims belong to the corporation, they are subject to the corporate charter's exculpatory provisions, even when asserted by a trustee in bankruptcy on behalf of the corporation.

ANALYSIS

Pereira v. Farace reinforces the important principle that the powers of a bankruptcy trustee or DIP are subject to certain restrictions. Unless causes of action arise under provisions of the Bankruptcy Code that specifically confer standing upon a trustee to prosecute them in a bankruptcy case (*e.g.*, avoidance of fraudulent or preferential transfers), applicable non-bankruptcy law generally will govern the extent to which a trustee can pursue such claims on behalf of the estate (if at all).

The decision can be viewed as a welcome development by corporate fiduciaries. If its rationale is adopted by other courts, directors acting in good faith need not fear that the safe harbor protections established in *Production Resources* will be abridged or forfeited if a bankruptcy case is filed by or against the corporation.

Pereira v. Farace, 413 F.3d 330 (2d Cir. 2005).

Credit Lyonnais Bank Nederland v. Pathé Communications Corp., 1991 WL 277613 (Del. Ch. Dec. 30, 1991).

Production Resources Group, LLC v. NCT Group, Inc., 863 A.2d 772 (Del. Ch. 2004).

10 LARGEST AIRLINE BANKRUPTCY FILINGS 1980 — PRESENT

AIRLINE	CHAPTER 11 FILING DATE	ASSETS
UAL Corp.	Dec. 9, 2002	$25,197,000,000
Delta Air Lines, Inc.	Sept. 14, 2005	$21,801,000,000
Northwest Airlines Corp.	Sept. 14, 2005	$14,042,000,000
US Airways (2004)	Sept. 12, 2004	$8,349,000,000
US Airways (2002)	Aug. 11, 2002	$7,941,000,000
Continental Airlines (1990)	Dec. 3, 1990	$7,656,140,000
Eastern Air Lines, Inc.	Mar. 9, 1989	$4,037,000,000
Trans World Airlines (1992)	Jan. 31, 1992	$2,864,530,000
Trans World Airlines (1995)	June 30, 1995	$2,495,210,000
Pan Am Corp. (1991)	Jan. 8, 1991	$2,440,830,000

PROPERTY CAN BE RECOVERED FROM SUBSEQUENT TRANSFEREE WITHOUT FIRST AVOIDING FRAUDULENT TRANSFER TO INITIAL RECIPIENT

Robert E. Krebs

The power of a bankruptcy trustee or a chapter 11 debtor-in-possession ("DIP") to avoid and recover fraudulent transfers can bring significant resources into a debtor's estate. In cases where there is little value remaining for unsecured creditors, recovered assets can be among the most important sources of recovery. Such recovery actions, however, can prove challenging in cases where the transferred property has subsequently been transferred to one or more additional parties. In such complex transactions, a transferee that received a debtor's property may be required to return the asset, or its value, to the debtor's estate, even if the transferee did not receive the property directly from the debtor. The Eleventh Circuit Court of Appeals recently had an opportunity to decide whether a trustee may look for recovery to the ultimate recipients of fraudulently conveyed property without first avoiding the initial transfer. In *In re International Administrative Services, Inc.*, the Eleventh Circuit confronted some of the issues and challenges that face trustees seeking to recover property that a debtor fraudulently transferred through a complicated series of transactions.

RECOVERY OF FRAUDULENTLY TRANSFERRED PROPERTY IN BANKRUPTCY

If a debtor transfers assets or incurs an obligation within one year of filing for bankruptcy (or sometimes earlier), either with the intent to defraud creditors or when it is insolvent and receives inadequate value in exchange, a bankruptcy trustee or DIP can avoid (invalidate) the transfer. In addition, section 550 of the Bankruptcy Code authorizes a trustee or DIP to recover the property in question or its value. Specifically, section 550(a) provides that "to the extent that a transfer is avoided . . . , the trustee may recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property, from — (1) the initial transferee of such transfer or the entity for whose benefit the transfer was made; or (2) any immediate or mediate transferee of such initial transferee."

There are exceptions to a trustee's ability to recover from initial or subsequent transferees of an avoided transfer. Section 550(b) prohibits recovery from any "transferee that takes for value, including satisfaction or securing of a present or antecedent debt, in good faith and without knowledge of the voidability of the transfer."

Thus, actual avoidance of the initial transfer enables a trustee to recover the transferred property from any transferee, initial or otherwise (assuming the absence of a good faith defense). Notwithstanding the statute's reference to an "avoided" transfer, however, a controversy has developed in the courts concerning the trustee's ability to recover from non-initial transferees where the trustee merely shows that the subject transfer is "avoidable" but does not seek to avoid the transfer. The Eleventh Circuit addressed this uncertainty in *International Administrative Services*.

INTERNATIONAL ADMINISTRATIVE SERVICES

Four years before International Administrative Services, Inc. ("International") filed for chapter 11 protection, the company's founder and sole shareholder, Charles Givens, hired David Tedder, a self-described expert in shielding assets from creditors, to develop and implement a plan that would move substantially all of International's assets beyond the reach of its creditors. Between January 1992 and June 1996, under Tedder's asset protection plan, International's assets were transferred to various Tedder-owned entities, some of which were created for the sole purpose of receiving transfers from International. After the initial transfers, the assets were transferred more than 100 times through a complex structure of international transactions that ultimately resulted in the extraction of $50 million from International. During a two-month period in 1993, IBT International, Inc. ("IBT") and California Sunbelt Developers, Inc. ("Sunbelt") received $1,050,000 in funds as a result of Tedder's asset protection plan. IBT and Sunbelt were real estate development companies owned by one of Tedder's business associates.

After International filed for bankruptcy in 1996, the creditors' committee appointed in the chapter 11 case obtained authority to prosecute the estate's avoidance claims. International's efforts to reorganize soon failed, and the company proposed a liquidating chapter 11 plan under which all avoidance causes of action were entrusted for prosecution to a stock trustee.

The Eleventh Circuit's adoption of an approach pursuant to which transferred property can be recovered from subsequent transferees once it has been proven that the initial transfer is "avoidable" — rather than actually avoided — highlights how many courts pragmatically apply the avoidance mechanisms of the Bankruptcy Code.

The trustee ultimately sued several defendants, including IBT and Sunbelt, seeking to avoid and recover assets transferred by International pre-bankruptcy. At trial, the bankruptcy court found that International, with the assistance of Givens and Tedder, engaged in a complex plan designed to defraud International's creditors. Because of the fraudulent asset protection scheme, IBT and Sunbelt received $1,050,000 from International. Neither IBT nor Sunbelt received the assets directly from International, but through a series of transactions involving many other mediate or intermediate transferees, the first of which were Tedder's law firm and a company controlled by him. Even so, the bankruptcy court entered judgment against IBT and Sunbelt for approximately $1,680,000, representing the amount originally conveyed plus interest. The district court upheld that determination on appeal.

THE ELEVENTH CIRCUIT'S DECISION

The defendants appealed the district court's decision to the Eleventh Circuit, arguing that section 544 of the Bankruptcy Code — the avoidance vehicle chosen by the trustee — requires avoidance of a conveyance to an initial transferee before property or its value can be recovered from any subsequent transferee under section 550(a)(2). Because the trustee did not bring an action against the initial transferees, the defendants argued that the transferred property could not be recovered from any subsequent transferee. According to the defendants, the plain language of the statute, which provides that a trustee may recover property from transferees "to the extent that a transfer is avoided," clearly means that avoidance must precede recovery. In addition, the defendants relied on *In re Trans-End Tech., Inc.*, where an Ohio bankruptcy court interpreted section 550(a) to require avoidance of an initial transfer as a prerequisite to recovery from subsequent transferees.

The Eleventh Circuit rejected these arguments. It held that a trustee can recover from successive transferees without first avoiding an initial transfer, so long as the trustee demonstrates that the initial transfer is avoidable. Initially, the Court of Appeals considered whether the defendants could be considered initial, rather than subsequent, transferees under the "mere conduit" rule. The mere conduit rule states that a party that receives property from the debtor in good faith with instructions to transfer it to a third party fails to have sufficient dominion and control over the transferred property to be considered the initial transferee. Courts, therefore, consider the party who receives the property from the conduit as the initial transferee. The Eleventh Circuit, however, found that the mere conduit rule did not apply in this case because the initial transferees did not act in good faith.

The Eleventh Circuit then addressed the defendants' interpretation of the language of section 550(a). Characterizing as "ambiguous" the clause "to the extent that a transfer is avoided," the court looked beyond the statute's plain meaning to determine lawmakers' intent in enacting it. According to the Eleventh Circuit, the strict interpretation of section 550(a) argued by the defendants would require a "bizarre exercise in futility" that was not intended by Congress:

> The strict interpretation of § 550(a) produces a harsh and inflexible result that runs counterintuitive to the nature of avoidance actions. If the initial transaction must be avoided in the first instance, then any streetwise transferee would simply re-transfer the money or asset in order to escape liability. The chain of transfers would be endless.

Next, the court found that the weight of authority was against the defendants' interpretation of section 550(a) — the defendants could point to only two cases requiring the actual avoidance of an initial transfer before subsequent transferees are subject to liability under section 550(a) of the Bankruptcy Code. Based upon these considerations, the Eleventh Circuit held that the trustee did not first have to pursue actions against the initial transferees of International's assets to recover transfers made to IBT and Sunbelt.

ANALYSIS

The Eleventh Circuit's adoption of an approach pursuant to which transferred property can be recovered from subsequent transferees once it has been proven that the initial transfer is "avoidable" — rather than actually avoided — highlights how many courts pragmatically apply the avoidance mechanisms of the Bankruptcy Code. Similar to the mere conduit rule, the "avoidable" approach allows the trustee to skip over the initial transferee, or any mediate transferee, to recover from transferees down the line, as long as the initial transfer is avoidable. The Court of Appeals, however, was careful to emphasize that its approach in no way derogates the conduit theory:

> We emphasize that this ruling does not erode the conduit theory. Rather, it accommodates a case involving a multitude of patently fraudulent transfers. Not all cases can conveniently be characterized as involving a "conduit" in order to reach property from later transfers. Thus, the decision today allows a more pragmatic and flexible approach to avoiding transfers; for if the Bankruptcy Code conceives of a plaintiff suing independently to avoid and recover, then bringing the two actions together only advances the efficiency of the process and furthers the "protections and forgiveness inherent in the bankruptcy laws." "The cornerstone of the bankruptcy courts has always been the doing of equity," and in situations such as this, where money is spread throughout the globe, fraudulent transferors should not be allowed to use § 550 as both a shield and a sword.

Other courts have held that a trustee first must actually avoid the initial transfer before seeking recovery against subsequent transferees. It is not certain whether other circuits will follow the Eleventh Circuit's "avoidable" approach. Considering the close relationship between the initial transferees and the subsequent transferees, however, it is possible that *International Administrative Services* will be read narrowly. That is, the result may be different in a similar case where the subsequent transferees are not so closely related to the initial transferees.

In re International Administrative Services, Inc., 408 F.3d 689 (11th Cir. 2005).

In re Trans-End Tech., Inc., 230 B.R. 1010 (Bankr. N.D. Ohio 1998).

B-DAY AT HAND

THE POTENTIAL RAMIFICATIONS FOR U.S. DEBTORS HAVING BEEN REPORTED EXTENSIVELY AFTER PRESIDENT GEORGE W. BUSH GAVE HIS IMPRIMATUR ON APRIL 20 TO THE BANKRUPTCY ABUSE PREVENTION AND CONSUMER PROTECTION ACT OF 2005, THE MOMENT OF REALIZATION HAS NOW ARRIVED — THE LEGISLATION BECOMES EFFECTIVE ON OCTOBER 17, 2005.

ROCKY ROAD FOR PARTS SUPPLIERS

What do Tower Automotive, Meridian Automotive, Collins & Aikman, Universal Automotive, Metalforming Technologies, Uniboring, Jernberg Industries Inc. and Hastings Manufacturing Co. have in common?

All of them are suppliers in the beleaguered North American automobile industry. What's more, they all filed for bankruptcy in 2005. In fact, no less than eight major suppliers sought bankruptcy protection in the first half of 2005 and a total of twelve have taken the plunge in the last two years.

The downward spiral of the parts industry can in large part be blamed on the waning fortunes of original equipment manufacturers ("OEMs"). These manufacturers have entered crisis mode because of a combination of the massive legacy costs of providing health care and pension benefits to active workers and retirees, fluctuating steel prices, overreliance on gas-guzzling SUVs at a time when gas prices have skyrocketed, and stiff competition overseas.

OEMs outsource the manufacture of parts to thousands of third-party suppliers. These are known as Tier I, Tier II and Tier III suppliers. The tier signifies whether supply is furnished directly to the OEMs or to other suppliers. The automotive industry has for many years been characterized by a multitude of suppliers. Recently, "sourcing" by OEMs to suppliers of whole component and module production on a "platform" basis has been part of an industrywide restructuring designed to reduce labor costs and to shift capital-intensive manufacturing to suppliers. The shift allows OEMs to focus on less capital-intensive final assembly, marketing and design.

OEMs manage thousands of suppliers with a view toward meeting three critical demands: cost control, quality and performance control, and supply continuity. Herein lies the root of the suppliers' malaise — increased capital intensiveness of automotive supply and pressure from OEMs to reduce costs have infected suppliers with the OEMs' distress, in some cases forcing the suppliers to seek bankruptcy protection.

Even brief disruptions in the delivery of components can halt OEM production, with costs escalating into the billions. As such, confidence in supply continuity is always a key factor in OEM and supplier relations. OEMs commonly avoid sourcing additional platforms to, and may re-source away from, suppliers known to be in distress or in bankruptcy. A prolonged reorganization or extended period of public financial distress can have dire consequences for an automotive supplier.

The upshot of these developments for suppliers is daily fodder for the financial pages. Given the existing state of the market, the prospect of even higher oil prices (currently hovering near $70 per barrel), and stricter fuel economy guidelines for light trucks and certain SUVs approved by the Bush administration at the end of August, it remains to be seen whether a bankruptcy filing can offer a workable solution to suppliers' problems in the long term.

The results so far have been mixed. Citation Corp. confirmed a chapter 11 plan at the end of May 2005 reducing its $550 million debt to $210 million and emerging from bankruptcy with new customer contracts and supply agreements and an $80 million line of credit, but with a creditor-controlled board of directors. Oxford Automotive Inc. emerged from bankruptcy on March 25, 2005 after shedding or shuttering its ten U.S. plants in favor of exclusively European operations. Amcast Industrial Corp. confirmed a plan of reorganization on July 28, 2005 that ceded ownership of the company to its secured lenders, who ended up taking a $55 million haircut in the process. Intermet Corp. confirmed a chapter 11 plan on September 26, 2005 under which existing shareholder interests were extinguished, secured creditors were paid in full, unsecured creditors received a 50 percent recovery and the company emerged from bankruptcy with a new name (Light Metals Group Inc.) and $265 million in exit financing.

SIGNIFICANT AUTOPART SUPPLIER BANKRUPTCIES 2004-05

Company	Filing Date
Citation Corp.	Sept. 21, 2004 (emerged May 2005)
Intermet Corp.	Sept. 30, 2004 (emerged October 2005)
Amcast Industrial Corp.	Nov. 30, 2004 (emerged July 2005)
Oxford Automotive Inc.	Dec. 7, 2004 (emerged March 2005)
Tower Automotive Inc.	Feb. 2, 2005
Meridian Automotive Systems Inc.	April 26, 2005
Collins & Aikman Corp.	May 17, 2005
Universal Automotive Industries Inc.	May 27, 2005
Uniboring	June 9, 2005
Metalforming Technologies Inc.	June 16, 2005
Jernberg Industries Inc.	June 29, 2005
Hastings Manufacturing Co.	September 14, 2005

BILLION-DOLLAR BANKRUPTCIES

The chart below illustrates the number of publicly traded companies that have filed for chapter 11 and the ratio of those reporting $1 billion or more in assets in their most recent annual report prior to filing for chapter 11.

	NUMBER OF PUBLIC BANKRUPTCIES		ASSETS		BILLION $ BANKRUPTCIES AS % OF TOTAL	
Year	**Billion $**	**All**	**Billion $**	**All**	**Number**	**Assets**
1987	1	112	32,892	41,503	0.9%	86.5%
1988	3	122	38,347	43,488	2.5%	88.2%
1989	12	135	65,435	71,371	8.9%	91.7%
1990	15	115	73,401	82,781	13.0%	88.7%
1991	18	123	64,310	93,624	14.6%	68.7%
1992	14	91	44,011	64,226	15.4%	68.5%
1993	3	86	5,026	18,745	3.5%	26.8%
1994	1	70	1,139	8,337	1.4%	13.7%
1995	7	85	14,592	23,107	8.3%	63.1%
1996	3	86	4,012	14,201	3.5%	28.3%
1997	4	83	9,003	17,247	4.8%	52.2%
1998	4	122	12,532	29,195	3.3%	42.9%
1999	20	145	40,018	58,760	13.8%	68.1%
2000	23	176	66,824	94,786	13.1%	70.5%
2001	44	257	225,086	258,490	16.7%	87.1%
2002	34	195	348,679	382,683	17.4%	91.1%
2003	21	143	74,391	97,404	14.7%	76.4%
2004	8	84	32,334	46,374	9.5%	69.7%
2005	7	58	46,656	53,212	12.0%	87.6%

THE 15 LARGEST BANKRUPTCIES 1980 — PRESENT

COMPANY	BANKRUPTCY DATE	TOTAL ASSETS	COURT DISTRICT
WorldCom, Inc.	7/21/2002	$103,914,000,000	SDNY
Enron Corp.	12/2/2001	$63,392,000,000	SDNY
Conseco, Inc.	12/18/2002	$61,392,000,000	NDIL
Texaco, Inc.	4/12/1987	$35,892,000,000	SDNY
Financial Corp. of America	9/9/1988	$33,864,000,000	CDCA
Global Crossing Ltd.	1/28/2002	$30,185,000,000	SDNY
Pacific Gas and Electric Co	4/6/2001	$29,770,000,000	NDCA
UAL Corp.	12/9/2002	$25,197,000,000	NDIL
Delta Air Lines, Inc.	9/14/2005	$21,801,000,000	SDNY
Adelphia Communications	6/25/2002	$21,499,000,000	SDNY
MCorp	3/31/1989	$20,228,000,000	SDTX
Mirant Corporation	7/14/2003	$19,415,000,000	NDTX
First Executive Corp.	5/13/1991	$15,193,000,000	CDCA
Gibraltar Financial Corp.	2/8/1990	$15,011,000,000	CDCA
Kmart Corp.	1/22/2002	$14,600,000,000	NDIL

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