JONES DAY®

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# THE YEAR IN BANKRUPTCY: 2005

*Mark G. Douglas*

2005 was a notable year in bankruptcy, and not only because it saw some of the largest public company filings ever. The all-time hit parade of chapter 11 "mega" cases added three new stars in 2005. Delta Air Lines (tenth on the all-time list) was the first to file in September. Saddled with over $28 billion in debt, Delta became yet another victim of the lingering malaise that has beleaguered U.S. and foreign air carriers alike since the 2001 terrorist attacks. Scandal-ridden futures trader Refco Inc. sought chapter 11 protection in October, listing over $33 billion in assets and $16.8 billion in debt, which entitles the company to slot number five on the all-time list. Finally, power generator Calpine Corporation filed the eighth-largest U.S. bankruptcy on December 20, listing more than $22.5 billion in liabilities, after prices for natural gas, used to fuel its plants, soared to record highs.

Several billion-dollar bankruptcy filings in 2005 did not make the all-time list. American Business Financial Services, Inc., the holding company for American Business Credit, which originates, sells, and services home equity and small business loans, filed for chapter 11 in January of 2005, listing just over $1 billion in assets. Facilities-based competitive local-exchange telecommunications carrier McLeodUSA filed for bankruptcy for the second time in three years at the end of October, listing $1.025 billion in assets.

February saw filings by Winn-Dixie Stores, Inc. ($2.6 billion in assets), a regional grocery chain with 920 stores in eight Southeastern states and the Bahamas, and Tower Automotive, Inc., the world's largest supplier of vehicle frames, which sought chapter

11 protection to restructure $1.3 billion in debt. Collins & Aikman Corporation, a supplier of car interiors, filed for bankruptcy in May, listing approximately $3.2 billion in assets and nearly $2 billion in debt and citing a cash shortage after U.S. carmaker customers cut production and material costs rose.

ASARCO LLC, a subsidiary of Grupo México, the world's sixth-largest copper producer, sought chapter 11 protection in August, citing a combination of environmental liabilities, lawsuits from former workers with asbestos-related health problems, high labor and production costs, and continuing industrial action. The company listed $1.1 billion in assets and $1.9 billion in debt. Blaming nearly $22 billion in debt, crushing pension obligations, and skyrocketing fuel costs, Northwest Airlines filed for chapter 11 in September. America's biggest auto parts maker, Delphi Corporation, rounded out the billion-dollar club in 2005. It filed for bankruptcy in October, listing $17 billion in assets and $22 billion in debt, including an $11 billion underfunded pension liability.

Overall, 80 public companies filed for chapter 11 protection in 2005, with an aggregate pre-petition asset value of nearly $134 billion. By contrast, 2004 saw 92 public company chapter 11 cases, with an aggregate pre-petition asset value of only $47.7 billion.

## INDUSTRIES UNDER SIEGE

The airline and automotive industries were featured most prominently in the bankruptcy headlines of 2005. ATA, Delta, Independence, and Northwest all filed for bankruptcy protection in 2005, joining United, which had been in chapter 11 since 2002. High fuel costs were a key factor behind all four failures. Mounting pension and employee benefit liabilities also figured prominently in the meltdowns. Even though US Air successfully exited bankruptcy in 2005, the airline industry has not been in this much trouble since 1991, when Eastern Airlines, Braniff, Continental, and PanAm were all in bankruptcy at the same time.

Delphi's chapter 11 filing in October rounded out a dismal year for America's auto parts suppliers. No less than nine major suppliers (and dozens of smaller companies) sought bankruptcy protection in 2005. The downward spiral of the parts industry can in large part be blamed on the waning fortunes of original equipment manufacturers ("OEMs"). They 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. Increased capital intensiveness of automotive supply and pressure from OEMs to reduce costs have infected suppliers with the OEMs' distress, in many cases forcing the suppliers to seek bankruptcy protection.

## LONG-AWAITED BANKRUPTCY REFORM

2005 was (finally) the year for bankruptcy reform. After more than five years of partisan infighting, President George W. Bush gave his imprimatur on April 20 to the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. The most sweeping changes to U.S. bankruptcy law since 1994 became effective on October 17, 2005, precipitating a blizzard of last-minute consumer bankruptcy filings to avoid the more stringent eligibility requirements created by the new law. Part of the legislation was an entirely new section of the Bankruptcy Code — chapter 15 — to govern cross-border bankruptcy cases. The May/June 2005 edition of the *Business Restructuring Review* contains a comprehensive analysis of chapter 15 and significant provisions in the new law applying to business debtors.

## NOTABLE DECISIONS OF 2005

Several significant rulings were issued by the nation's bankruptcy and appellate courts in 2005. A pair of them originated from the Seventh Circuit Court of Appeals in connection with the chapter 11 case of United Airlines. In the first decision, the Seventh Circuit held that section 1110 of the Bankruptcy Code, which governs a chapter 11 debtor's continued use of leased or financed aircraft, must be strictly enforced to require surrender of the aircraft if the debtor fails to comply with the dictates of the statute. In a separate decision, the Seventh Circuit invalidated a stock trading injunction designed to prevent forfeiture of the debtor's favorable tax attributes, casting doubt on the legitimacy of a prophylactic device that has become routine in large chapter 11 cases.

The Second Circuit also laid claim to two of the most notable rulings of 2005. In *In re Metromedia Fiber Network, Inc.*, the Court of Appeals held that releases of nondebtors in a chapter 11 plan were invalid in the absence of any evidence that the releases were essential or even necessary to confirm the plan. The Second Circuit addressed the concept of "derivative standing" in *In re Smart World Technologies, LLC*, ruling that certain creditors lacked the ability to settle claims belonging to the bankruptcy estate over the debtor's objection.

A chapter 11 debtor's verge-of-retirement firing of employees was the subject of a 2005 ruling handed down by the Third Circuit Court of Appeals. In *In re General DataComm Industries, Inc.*, the Third Circuit ruled that the employees were still entitled to the benefit of provisions in the Bankruptcy Code protecting retiree benefits, even though the employees were not technically "retirees" because they were terminated before retiring. The Third Circuit also examined the Bankruptcy Code's "absolute priority rule" in 2005, ruling in *In re Armstrong World Industries, Inc.*, that a chapter 11 plan could not be confirmed because a proposed distribution of warrants to the debtor's stockholders over the objection of the class of unsecured creditors violated the rule.

The First Circuit addressed the power of a bankruptcy court to subordinate claims in *In re Merrimac Paper Company Inc*. The Court of Appeals ruled that claims based upon stock redemption notes issued under an employee stock option plan cannot be equitably subordinated in the absence of any finding of misconduct on the part of the individual claimants.

Equitable subordination was also the subject of a controversial ruling issued in 2005 by the New York bankruptcy court overseeing the Enron chapter 11 cases. The court held that equitable subordination is not limited to claims related to inequitable conduct that injures other creditors, and that a transferred claim can be equitably subordinated even though the transferee is blameless. This decision is discussed elsewhere in this edition of the *Business Restructuring Review*.

The Texas bankruptcy court overseeing the chapter 11 cases of energy supplier and marketing giant Mirant Corporation ruled in 2005 that the good faith of "corporate family" chapter 11 filings should not be judged by the same standard applied to stand-alone cases. The practice of paying the pre-bankruptcy claims of "critical" vendors at the inception of a chapter 11 case was the subject of a ruling handed down in 2005 by a Florida bankruptcy court. In *In re Tropical Sportswear International Corporation*, the court ruled that such payments can be authorized as a legitimate use of estate funds outside the ordinary course of business, rather than by means of the controversial "doctrine of necessity."

Bankruptcy courts in New York and California became the first courts to recognize the bankruptcy or insolvency proceedings of foreign business debtors under new chapter 15 of the Bankruptcy Code near the end of 2005. On December 7, 2005, Judge Burton R. Lifland of the U.S. Bankruptcy Court for the Southern District of New York issued an order recognizing the U.K insolvency proceedings of the U.K. branch of French insurer La Mutuelle du Mans Assurances IARD as a "foreign

**10 LARGEST BANKRUPTCIES, 1980 – PRESENT**

| Company | Filing Date | Assets |
|---|---|---|
| WorldCom, Inc. | 07/21/2002 | $103,900,000,000 |
| Enron Corp. | 12/02/2001 | $63,392,000,000 |
| Conseco, Inc. | 12/18/2002 | $61,392,300,000 |
| Texaco, Inc. | 04/12/1987 | $35,892,000,000 |
| Refco Inc. | 10/17/2005 | $33,333,172,000 |
| Global Crossing, Ltd. | 01/28/2002 | $30,185,000,000 |
| Pacific Gas & Electric | 04/06/2001 | $29,715,000,000 |
| Calpine Corporation | 12/20/2005 | $27,216,088,000 |
| UAL Corporation | 12/09/2002 | $25,197,000,000 |
| Delta Air Lines, Inc. | 09/14/2005 | $21,801,000,000 |

main proceeding" under chapter 15. The U.S. Bankruptcy Court for the Central District of California also recognized a foreign main proceeding under chapter 15 on December 7, 2005. The debtor is TriGem Computer Inc. of South Korea. These decisions are discussed in an article appearing elsewhere in this edition of the *Business Restructuring Review*.

Last, but never least, the U.S. Supreme Court issued only a single decision in bankruptcy in 2005. In *Rousey v. Jacoway*, the High Court ruled that an individual retirement account under which a debtor has the right to receive payments without penalty beginning at the age of 59 and a half may be exempted from a debtor's bankruptcy estate under section 522(d)(10)(E) of the Bankruptcy Code.

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*United Airlines, Inc. v. U.S. Bank, N.A.*, 406 F.3d 918 (7th Cir. 2005).

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

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

*Smart World Technologies, LLC v. Juno Online Services, Inc. (In re Smart World Technologies, LLC)*, 423 F.3d 166 (2d Cir. 2005).

*General DataComm Industries, Inc. v. Arcara (In re General DataComm Industries, Inc.)*, 407 F.3d 616 (3d Cir. 2005).

*In re Armstrong World Industries, Inc.*, 2005 WL 3544810 (3d Cir. Dec. 29, 2005).

*Merrimac Paper Company, Inc. v. Harrison (In re Merrimac Paper Co., Inc.)*, 420 F.3d 53 (1st Cir. 2005).

*In re Mirant Corporation*, No. 03-46590 (Bankr. N.D. Tex. Jan. 26, 2005) (unpublished memorandum opinion and order).

*In re Tropical Sportswear International Corporation*, 320 B.R. 15 (Bankr. M.D. Fla. 2005).

*In re Petition of Lloyd*, Case No. 05-60100 (BRL) (Bankr. S.D.N.Y. Dec. 7, 2005) (unpublished order).

*In re TriGem Computer, Inc.*, Case No. 2:05-bk-50052-TD (Bankr. C.D. Cal. Dec. 7, 2005) (unpublished order).

*Enron Corp. v. Avenue Special Situations Fund II, LP (In re Enron Corp.)*, 333 B.R. 205 (Bankr. S.D.N.Y. 2005).

*Rousey v. Jacoway*, 125 S.Ct. 1561 (2005).


# *CAVEAT EMPTOR:* CLAIM IN INNOCENT TRANSFEREE'S HANDS CAN BE EQUITABLY SUBORDINATED BASED UPON TRANSFEROR'S MISCONDUCT


*Paul D. Leake and Mark G. Douglas*


The power of a bankruptcy court to adjust the relative priority of claims against a debtor based upon the claimant's misconduct is widely recognized. By means of "equitable subordination," a bankruptcy court can remedy conduct that harms other creditors by relegating the offending creditor's claim to the lowest priority of payment or disallowance. Still, whether or not equitable subordination of a claim is warranted in the absence of creditor misconduct continues to be a subject of debate. Moreover, even where misconduct is present, it is unclear whether there must be a nexus between the misconduct and the claim to justify subordination. The New York bankruptcy court overseeing the chapter 11 cases of Enron Corporation and its affiliates addressed both of these issues in a recent ruling. In *Enron Corp. v. Avenue Special Situations Fund II, LP (In re Enron Corp.)*, the court held that a transferred claim can be eqitably subordinated even though the transferee is blameless and a creditor's misconduct need not be related to a claim to justify its subordination.

## SUBORDINATION IN BANKRUPTCY

A bankruptcy court's ability to reorder the relative priority of claims or debts under appropriate circumstances is derived from its broad powers as a court of equity. The statutory vehicle for applying these powers in a bankruptcy case is section 510 of the Bankruptcy Code.

Section 510 authorizes involuntary subordination — *i.e.*, subordination under circumstances not involving the voluntary undertakings of two or more parties to a contract — in two cases. First, section 510(b) automatically subordinates any claim for damages arising from the rescission of a purchase or sale of a debtor-company's securities to the claims of ordinary creditors. Its purpose is to prevent the bootstrapping of equity interests into claims that are on a par with other creditor claims, consistent with the Bankruptcy Code's "absolute priority" rule.

# WHAT'S NEW AT JONES DAY?

**Corinne Ball (New York)** spoke on January 23, 2005, at the Practising Law Institute's seminar "A Guide to Mergers & Acquisitions 2006" in New York. The topic of her presentation was "Advising the Board of Directors in the Context of Mergers & Acquisitions."

**Richard A. Chesley (Chicago)** and **Helena C. Huang (New York)** co-authored an article entitled "U.S. Bankruptcy Code for Asian Companies" that appeared in the December (2005)/January (2006) edition of *Asialaw*.

An article written by **Adam Plainer (London)** entitled "Global Focus: European Distressed Debt Market" appeared in the January 2006 edition of *Pratt's Journal of Bankruptcy Law*.

**Eric Messenzehl (Frankfurt)** lectured on December 14 and 15, 2005, at the University of Applied Sciences in Trier (Germany) concerning issues related to the acquisition of companies in crisis or insolvency.

An article written by **Mark G. Douglas (New York)** entitled "Second Circuit Rules that Creditors Lacked Standing to Settle Estate Claims" was published in the January 2006 edition of *Pratt's Journal of Bankruptcy Law*.

An article written by **Mark G. Douglas (New York)** entitled "Exceptions to Public Document Access in Bankruptcy Narrowly Construed" was published in the January 2006 edition of *Pratt's Journal of Bankruptcy Law*.

Second, misconduct that results in injury to other creditors can warrant the "equitable" subordination of a claim under section 510(c). The statute does not specify what kind or degree of misconduct justifies application of the remedy, providing merely that the bankruptcy court may "under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim." Nor does section 510(c) specify whether the misconduct must be somehow related to the claim. It has been left to the courts to develop criteria for applying the remedy.

In 1977, the Fifth Circuit Court of Appeals in *In re Mobile Steel Co.* articulated what has become the most commonly accepted standard for equitably subordinating a claim. Under the *Mobile Steel* test, a claim can be subordinated if the claimant engaged in some type of inequitable conduct that resulted in injury to creditors (or conferred an unfair advantage on the claimant), and if equitable subordination of the claim is consistent with the provisions of the Bankruptcy Code. Courts have since refined the test to account for special circumstances. For example, many make a distinction between insiders (*e.g.*, corporate fiduciaries) and noninsiders in assessing the level of misconduct necessary to warrant subordination. In addition, although subordination is most often invoked in cases where misconduct is related to a claim, the remedy has been applied when no such nexus exists. Regardless of the standard applied, two principles are clear under the *Mobile Steel* test: equitable subordination requires some kind of misconduct, and a claim or interest will be subordinated only to the extent necessary to redress it.

The majority of courts follow the *Mobile Steel* approach. Still, some courts have taken issue with the principle that subordination of nonshareholder claims requires a showing of misconduct that injures other creditors. In many cases, their reasoning derives from decisions and policies that pre-date enactment of the Bankruptcy Code in 1978. They also rely on statements in the legislative history of section 510(c) indicating that pre-Code decisions can assist in determining the priority of claims under the Bankruptcy Code. For example, a long line of cases in the First Circuit once stood for the proposition that stock redemption claims should be categorically subordinated even though such claims may not fall within the scope of present-day section 510(b).

In 1996, the U.S. Supreme Court attempted to dispel any lingering uncertainty concerning the scope of section 510(c) in a pair of rulings. In *United States v. Noland*, the Court found that section 510(c) does not permit a court to subordinate a noncompensatory tax penalty claim of the IRS that would otherwise have been entitled to administrative expense priority. In part, the ruling was predicated on the idea that section 510(c) codifies the equitable power of the bankruptcy court to consider claims on a case-by-case basis. The subordination of tax penalty claims based on a general policy, rather than the individual claim's merits, the Court reasoned, represents an inappropriate exercise of section 510(c) in a legislative, rather than equitable, manner. The Supreme Court employed similar reasoning to invalidate subordination of an unsecured tax penalty claim in *United States v. Reorganized CF & I Fabricators of Utah, Inc*. Even so, the Supreme Court stopped short of deciding whether creditor misconduct is a prerequisite to equitable subordination in all cases.

## CLAIMS TRADING

The answer to that question can be of crucial significance if a creditor sells or otherwise transfers its claim prior to or during the course of a bankruptcy case. The market for "distressed" debt is thriving and largely unregulated. Sophisticated players in the market are aware of most of the risks associated with acquiring discounted debt, but generally focus on the enforceability of the obligation in question and its probable payout or value in terms of bargaining leverage. These risks can often be assessed with reasonable accuracy by examining the underlying documentation, applicable nonbankruptcy law, the obligor's financial condition, and its prospects for satisfying its obligations in whole or in part. Other types of risk may be harder to quantify. For this reason, most claim transfer agreements include a blanket indemnification clause designed to compensate the transferee if a traded claim proves to be unenforceable in whole or in part.

An assigned claim is generally enforceable by the assignee in a bankruptcy case to the same extent that it would be enforceable in the hands of the assignor. With the exception of certain priority claims for employee wages and benefits, amounts owed to farmers and fishermen, consumer deposits, alimony and support, taxes, and capital maintenance obligations to federally insured banks, a transferred claim also retains its priority in the hands of the transferee. The flip side of the analysis, however, is whether a transferred claim is subject to the same defenses that the obligor could have asserted against the original holder of the claim, including limitations on the enforceability or priority of the claim based upon the pre-transfer conduct of the transferor. This was the question posed to the bankruptcy court in *Enron*.

## THE COURT'S RULING IN *ENRON*

Enron Corporation and approximately 90 affiliated companies began filing for chapter 11 protection in December of 2001. Shortly before filing for bankruptcy, Enron borrowed $3 billion under short- and long-term credit agreements from a consortium of banks, including Fleet National Bank and Citibank N.A. and Chase Manhattan Bank, as coadministrative agents. Citibank later filed a proof for claim for amounts due under the agreements on behalf of all participating banks, including Fleet.

During the course of Enron's bankruptcy, Fleet sold its claims against Enron to various entities, some of which later transferred the claims to other acquirors. The claims ultimately came to be held by five separate distressed investment funds (collectively referred to as the "defendants"), none of which had loaned money to Enron or had any existing relationship with the company.

In 2003, Enron sued the banks, claiming, among other things, that Fleet and certain of its affiliates were the recipients of pre-bankruptcy preferential or fraudulent transfers and that Fleet aided and abetted Enron's accounting fraud, resulting in injury to Enron's creditors and conferring an unfair advantage on Fleet. None of the allegations dealt with purported misconduct related to the credit agreements. In a separate proceeding, Enron sought to subordinate and disallow Fleet's claims under the credit agreements. Enron sought equitable subordination under section 510(c) even though Fleet had transferred its claims to the defendants. The defendants moved to dismiss the subordination proceeding.

The bankruptcy court denied the motion. Framing the ultimate question before it as "whether the Claims transferred by

the original holder . . . are immunized from equitable subordination," the court embarked upon a three-part analysis. First, it considered whether section 510(c) grants a court authority to subordinate claims that do not arise from misconduct, but were held initially by a creditor that engaged in misconduct unrelated to the claims. The court concluded that it does.

For support, it relied upon the Fifth Circuit's pronouncement in *Mobile Steel* that "[i]mproper acts unconnected with the acquisition or assertion of a particular claim have frequently formed at least a part of the basis for the subordination of that claim." No federal court, the court observed, has since ruled to the contrary, and the Fifth Circuit reaffirmed the vitality of the principle in 1987 in *In re Missionary Baptist Foundation*, where it noted that a claim could conceivably be subordinated even though the claimant "himself committed no overt acts of misconduct" because the claimant's partner did act inequitably.

The practical ramifications of *caveat emptor* as the prevailing rule of law on this issue will likely cause traders to build greater protections into loan/claim transfer agreements and focus far more attention on the indemnities commonly given in distressed trades.

The bankruptcy court also looked to a ruling handed down by the Ninth Circuit Court of Appeals in *Trone v. Smith (In re Westgate-California Corp.)*. There, a bankruptcy court initially subordinated claims that related to a creditor's misconduct as well as claims that did not, based upon evidence of pervasive misconduct on the part of the creditor throughout the course of her relationship with the debtor. It later modified this ruling to limit subordination only to those claims related to misconduct. On appeal, the district court reinstated subordination of all of the creditor's claims. The Ninth Circuit reversed that determination, concluding that because the harm caused by the creditor could be remedied by subordinating claims related to inequitable conduct, subordination of all of the creditor's claims was punitive.

Despite reversal of the underlying order subordinating claims unrelated to misconduct, the Ninth Circuit's ruling did not go so far as to condemn such a remedy in an appropriate case — *i.e.*, where the measure of harm or unfair advantage exceeds the value of claims directly tainted by misconduct. The bankruptcy court in *Enron* relied upon the Ninth Circuit's underlying rationale, consistent with subordination's purpose in ensuring a just and fair distribution of the bankruptcy estate, to conclude that section 510(c)'s scope is not limited to claims directly related to misconduct.

Next, the bankruptcy court considered whether claims that could have been subordinated in the hands of the original creditor remain subject to equitable subordination in the hands of a transferee. Remarking that "[t]here is no basis to find or infer that transferees should enjoy greater rights than the transferor," the court concluded that transferred claims are still subject to equitable subordination in the hands of a blameless transferee.

The court refused to speculate on the extent to which a contrary ruling would encourage creditors that have engaged in misconduct to "wash" their claims by selling them to innocent transferees. Instead, it focused on the added burden borne by debtors forced to expend estate assets in an effort to collect damages from a tainted claim's original holder rather than simply equitably subordinating the claim. According to the court, "[b]urdening of the estate with the necessity of collecting damages to effectuate the remedy of equitable subordination would undermine the remedy itself."

The bankruptcy court gave short shrift to the defendant's contention that subordination of an assigned claim in the hands of a blameless transferee would adversely impact the claims trading market. The risk of equitable subordination, the court emphasized, is a danger which potential acquirors are well aware of and, in fact, specifically account for by incorporating indemnifying language in any transfer agreement. Eliminating such risks by providing special protection to purchasers of claims subject to subordination, the bankruptcy court explained, "would create a 'special' class of claimholders," a concept that is supported neither by the Bankruptcy Code nor case law interpreting it.

Finally, the bankruptcy court considered whether the defendants could rely upon a "good faith" defense to insulate their assigned claims from subordination. It concluded that they could not. The court rejected the defendants' contention that provisions in the Bankruptcy Code protecting good-faith transferees from liability for otherwise avoidable transfers suggest that Congress intended to provide the same kind of safe harbor in the context of section 510(c). According to the court, the statute's protection of good-faith transferees is limited to avoidance actions, and had Congress intended to include subordination actions within the scope of the safe harbor, it would have done so specifically. Moreover, the court emphasized, even if such a safe harbor existed, the defendants could not qualify for it because they "knew or should have known the risks associated with the purchase of a debtor's distressed debt," including the risk of equitable subordination.

Based upon its findings, the bankruptcy court denied the defendants' motion to dismiss Enron's equitable subordination proceeding.

### OUTLOOK

The defendants in *Enron* immediately appealed the bankruptcy court's decision. The decision has been greeted by a storm of criticism from players in the distressed debt market, including the Loan Syndications and Trading Association ("LSTA"). According to the LSTA, if the decision stands, the claims held by a bona fide purchaser would be equitably subordinated even though it might be impossible for the acquiror to know, even after conducting rigorous due diligence, that it was purchasing loans from a "bad actor."

Beyond its possible impact on the claims trading market, the decision represents a departure from the typical equitable subordination paradigm. To be sure, all of the precedents relied upon by the bankruptcy court clearly articulate the proposition that misconduct need not be directly related to the claim that is being subordinated. Still, none of these cases involved claims asserted by an "innocent" transferee. In *Missionary Baptist,* the Fifth Circuit reversed the bankruptcy court's decision to subordinate claims asserted by the partner of a creditor that engaged in misconduct because the Court of Appeals could not determine from the lower court's decision the basis for its ruling. The Court's observation that the absence of any misconduct on the part of the claimant-partner would not preclude subordination was based upon the "peculiar" circumstance that the claimant, as the partner of an individual who did engage in misconduct, was "intimately familiar with the transactions that gave rise to the notes subordinated by the bankruptcy court." Moreover, the Fifth Circuit cautioned that its ruling should not be relied upon as a blanket mandate for subordinating claims in the hands of "innocent" transferees:

> [W]e do not express an opinion on a hypothetical case in which a note is in some way passed by an inequitable actor to an innocent, uninvolved bystander. In that hypothetical situation, one which is not presented in this case, there might be reasons to find that subordination of a note would be contrary to the principles of equitable subordination as they have developed in the courts.

*Westgate-California* similarly does not provide unequivocal support for the proposition that the claims of blameless transferees can be equitably subordinated based upon misconduct committed by the transferor unrelated to the assigned claim. Beyond the fact that the Ninth Circuit in that case reversed the determination below to subordinate both claims that were related to misconduct and those that were not, the case involved a single creditor holding both kinds of claims rather than an innocent transferee.

In the absence of solid precedent for equitably subordinating assigned claims on the basis of a transferee's unrelated misconduct, we are left to consider whether such a rule comports with the purpose of the remedy and its role in the pantheon of a bankruptcy court's equitable powers. On one hand, a rule that, once tainted, a claim remains tainted, no matter who asserts it, is consistent with section 510(c)'s purpose in compensating injured creditors. Absent subordination of a tainted claim, the estate's only recourse would be to sue the original transferor for damages. Section 510(c), like provisions in the statute disallowing claims asserted by the recipients of avoidable transfers, was designed in part to relieve the estate of this burden.

On the other hand, subordinating the claim of a blameless transferee based upon the original holder's misconduct, particularly where it is totally unrelated to the claim itself, may impose an unreasonable burden of inquiry on potential transferees. The practical ramifications of *caveat emptor* as the prevailing rule of law on this issue will likely cause traders to build greater protections into loan/claim transfer agreements and focus far more attention on the indemnities commonly given in distressed trades. Adoption of the rule announced in *Enron* might also increase the due diligence obligations for these trades. A transferor's creditworthiness, for example, may figure more prominently in an acquiror's calculus of the risks. Also, significant expense could be involved in litigation seeking indemnification.

Finally, the viability of *Enron* in cases involving securities or claims other than bank debt is not clear. In this context, non-bankruptcy law may insulate from attack securities held by a holder in due course or good-faith purchaser.

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*Enron Corp. v. Avenue Special Situations Fund II, LP (In re Enron Corp.)*, 333 B.R. 205 (Bankr. S.D.N.Y. 2005).

*Benjamin v. Diamond (In re Mobile Steel Co.)*, 563 F.2d 692 (5th Cir. 1977).

*United States v. Noland*, 517 U.S. 535 (1996).

*United States v. Reorganized CF & I Fabricators of Utah, Inc.*, 518 U.S. 213 (1996).

*Wilson v. Huffman (In re Missionary Baptist Foundation)*, 818 F.2d 1135 (5th Cir. 1987).

*Trone v. Smith (In re Westgate-California Corp.)*, 642 F.2d 1174 (9th Cir. 1981).


## SETTLEMENT AGREEMENT WITH PBGC DID NOT VIOLATE DEBTOR'S COLLECTIVE BARGAINING OBLIGATIONS

*Mark G. Douglas*

Retiree pension and benefit plans have featured prominently in recent headlines as cash-strapped airlines such as United Airlines, US Air, Midwest Air, and Delta struggle to manage skyrocketing retiree liabilities in an effort to emerge from or stave off bankruptcy. United Airlines and US Air recently used chapter 11 as a means of jettisoning over $9.6 billion in employee pension liabilities by obtaining bankruptcy court approval to terminate their pension plans. Delta and Northwest, both of which filed for chapter 11 protection on September 14, 2005, may seek to do the same. Their pension plans are underfunded by an estimated $16.3 billion.

Moreover, the crisis is not limited to the airlines — traditional employer-paid pension plans that give retirees a fixed monthly amount based on salary and years of employment were recently estimated to be underfunded by as much as $450 billion, nearly a quarter of which may have to be assumed by the Pension Benefit Guaranty Corporation ("PBGC"), whose current deficit was reported as of November 15, 2005, to be approximately $23 billion. Congress is actively working on a legislative fix designed to stanch the outflow of PBGC assets, but it remains to be seen whether these measures can remedy a problem that runs so deep throughout the fabric of U.S. industry and would have such a marked impact on companies' profits.

These developments provoke questions concerning the effect of a bankruptcy filing upon a debtor-employer's obligation to pay pension and benefits to retired employees under any pre-bankruptcy pension or benefit program. It is widely recognized that the Bankruptcy Code can provide relief to a debtor struggling to regain profitability despite onerous labor contracts and escalating liabilities for retiree benefits by allowing the debtor to modify, or in some cases even terminate, the underlying agreements. Less understood, however, are a debtor-company's options with respect to a pension

plan that may be critically underfunded, particularly if the pension benefits are incorporated into a collective bargaining agreement. Here, a debtor-employer's options and responsibilities implicate other federal laws governing the rights of retirees, such as the Employee Retirement Income Security Act ("ERISA").

## COLLECTIVE BARGAINING AGREEMENTS AND RETIREE BENEFITS IN BANKRUPTCY

Section 365 of the Bankruptcy Code allows a bankruptcy trustee or chapter 11 debtor-in-possession ("DIP") to assume or reject almost any contract or agreement that has not expired as of the bankruptcy filing date. The court will authorize assumption or rejection if it is demonstrated that either course of action represents an exercise of sound business judgment. Until 1984, courts struggled to determine whether the same standard or a more stringent one should govern a debtor's resolve to reject a collective bargaining agreement. The U.S. Supreme Court answered that question in 1984, ruling in *NLRB v. Bildisco and Bildisco* that a bargaining agreement can be rejected under section 365 if it burdens the estate, the equities favor rejection, and the DIP made reasonable efforts to negotiate a voluntary modification without any likelihood of producing a prompt satisfactory solution.

Congress changed that standard later the same year, when it enacted section 1113 of the Bankruptcy Code in response to a groundswell of protest from labor interests. Section 1113 provides that the court "shall" approve an application to reject a bargaining agreement only if: (i) the DIP makes a proposal to the authorized representative of the employees covered by the agreement; (ii) the authorized representative refuses to accept the debtor's proposal without good cause; and (iii) the balance of the equities clearly favors rejection of the agreement.

The provision "ensures that a chapter 11 debtor-employer cannot unilaterally rid itself of its labor obligations, and instead, mandates good faith negotiations with the union before rejection may be approved." To that end, section 1113 carefully spells out guidelines for any proposal presented by the debtor to the authorized labor representative. Underlying these guidelines is the premise that all parties must exercise their best efforts to negotiate in good faith to reach mutually satisfactory modifications to the bargaining agreement and that any proposal to modify fairly treats all creditors, the debtor, and other affected parties. Among other things, each proposal must be based on the most complete and reliable information available and must "provide for those necessary modifications in the employees' benefits and protections that are necessary to permit the reorganization of the debtor."

Special protections for retiree benefits were added to the Bankruptcy Code in 1988. As with the safeguards added four years earlier to protect current employees under collective bargaining agreements, the changes were deemed necessary because of widespread perception among labor advocates that a higher standard than the business judgment test governing the ability of a trustee or DIP to disavow the terms of most contracts should be applied to collective bargaining agreements and retiree benefit plans. Section 1114 of the Bankruptcy Code prohibits a DIP or trustee from unilaterally terminating or modifying retiree benefits unless the bankruptcy court orders the modification, or the trustee and an authorized representative of retirees agree to the modification. Section 1114's "clear purpose" is to give the bankruptcy court the ability "to resolve the competing interests of retirees, debtors and creditors, if agreement as to continuation and level of benefits cannot be reached."

Before seeking court authority to modify retiree benefit payments, the DIP is obligated to negotiate with the retiree's representative, accompanied by disclosure of the most complete and reliable information available, toward modifications "that are necessary to permit the reorganization of the debtor and assure that all creditors, the debtor and all of the affected parties are treated fairly and equitably." If the authorized representative rejects a modification proposal that meets these requirements "without good cause," the bankruptcy court is empowered to authorize the modification, so long as it finds that it is "necessary to permit the reorganization of the debtor and assures that all creditors, the debtor, and all affected parties are treated fairly and equitably, and is clearly favored by the balance of the equities." The court also has the power to order temporary modifications where such relief

is "essential to the continuation of the debtor's business, or in order to avoid irreparable damage to the estate."

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 added section 1114(l) to the Bankruptcy Code. It provides that, if the debtor modified retiree benefits in the 180 days before the bankruptcy filing and while it was insolvent, the bankruptcy court shall reinstate such benefits as they existed before modification and retroactive to such date unless the court finds that the "balance of equities" clearly favors such prior modification.

## ERISA AND PBGC

The Bankruptcy Code does not contain special provisions governing the respective rights and obligations of employers and retirees vis-à-vis pension benefits. Instead, ERISA provides the primary regulatory framework and protection for pension benefits. Enacted in 1974, ERISA is a comprehensive regulatory scheme intended to protect the interests of pension plan and welfare benefit participants and beneficiaries and to preserve the integrity of trust assets. On a basic level, it establishes minimum participation, vesting, and funding standards and contains detailed reporting and disclosure requirements. ERISA also created PBGC as the regulatory watchdog for the pension and related rights of the U.S. workforce.

Companies pay insurance premiums to the agency, and if an employer can no longer support its pension plan, PBGC takes over the assets and liabilities and pays promised benefits to retirees up to certain limits. The maximum annual benefit for plans assumed by the agency in 2005 was $45,614 for workers who wait until 65 to retire. PBGC self-finances payments to employees under terminated plans through four sources of income: (i) insurance premiums paid by current sponsors of active plans (currently $19 per year per participant, although companies posing high risks of underfunding must pay an additional $9 per participant); (ii) assets from terminated plans taken over by PBGC; (iii) recoveries from former sponsors of terminated plans; and (iv) PBGC's own investments.

The PBGC insures "defined benefit" plans. These are plans under which an employer determines the benefits it will pay its employees and contributes the necessary amount to a pension fund. The amount of retirement income an employee will receive generally depends on the employee's length of service. ERISA and the Internal Revenue Code determine the amount of the required minimum premiums. Not all plans are defined-benefit plans. Many employers have "defined contribution" plans instead. In these plans, the employer contributes a certain amount for each participant, but makes no promise regarding the ultimate benefit or amount that each participant will receive. Defined-contribution plans, such as 401(k) plans, are not guaranteed by PBGC.

There are several ways in which pensions may terminate under ERISA. In a "standard termination," an employer can voluntarily terminate its plan so long as the plan has sufficient assets to pay all future benefits. The employer remains liable to PBGC for all plan benefit liabilities. An employer can also voluntarily act to terminate its plan in a "distress termination." This is possible under the following circumstances: (i) liquidation in bankruptcy; (ii) a reorganization in bankruptcy in which the court determines that termination is necessary to facilitate the reorganization; and (iii) a nonbankruptcy situation where termination is necessary. Regardless of the particular circumstances, the employer must prove it will face financial difficulty if forced to continue the plan. PBGC will assume responsibility for guaranteed benefits while attempting to collect funds from the employer. An employer cannot effectuate either a standard or distressed termination if terminating the plan would violate the terms and conditions of an existing collective bargaining agreement. Finally, PBGC itself can move to terminate a company's pension plan if the company defaults on its minimum funding requirements and PBGC determines that it will be exposed to unreasonable risk in the long run if the plan continues. PBGC may terminate a plan regardless of any provision in a collective bargaining agreement prohibiting termination and without consulting with any union of affected employees.

The role of ERISA and PBGC in a bankruptcy case was the subject of a ruling recently handed down by the Seventh Circuit Court of Appeals in *In re UAL Corp.*

## THE SEVENTH CIRCUIT'S RULING IN *UNITED AIRLINES*

United Airlines and numerous affiliated entities filed for chapter 11 protection in 2002. A major impediment to United's ability to reorganize successfully in chapter 11 was its pension liability, which amounted to approximately $4.5 billion for the period from 2005 to 2009. Of United's aggregate pension liability, $625 million pertained to the pension plan for its flight attendants, which was established under a collective bargaining agreement with the Association of Flight Attendants ("AFA"). AFA and United negotiated for many months to effect a reduction in United's pension liability without terminating the bargaining agreement. These efforts unavailing, United sought bankruptcy court authority to reject the bargaining agreement under section 1113 of the Bankruptcy Code and to terminate the pension plan under the relevant provisions of ERISA.

While United's rejection/termination motion was pending before the bankruptcy court, United and PBGC reached a settlement resolving several complex liability and collection disputes concerning United's future obligations to PBGC for the company's failed and failing pension plans. The agreement gave PBGC a single unsecured claim for United's unfunded pension liabilities, as opposed to a myriad of joint and several claims against numerous United affiliates. PBGC would also receive $1.5 billion of United's post-confirmation securities. Finally, the settlement called for PBGC to begin evaluating whether it should terminate the flight attendant pension plan, although it did not obligate PBGC to do so.

United sought bankruptcy court approval of the settlement agreement. AFA objected, claiming that United violated its collective bargaining responsibilities by entering into the settlement. Overruling the objection, the court approved the settlement agreement. Thereafter, United withdrew its rejection/termination motion.

AFA appealed the order approving the settlement. It also sued PBGC in an effort to enjoin the plan termination evaluation process. After the district court denied AFA's motion for injunctive relief, PBGC conducted an exhaustive review of the administrative record and concluded that termination of the pension plan was in the best interests of the pension system as a whole. It accordingly took over the plan from United. Shortly afterward, the district court affirmed the bankruptcy court order approving the settlement. AFA appealed to the Seventh Circuit.

AFA fared no better with the Court of Appeals. The Seventh Circuit rejected AFA's contention that the settlement was improper because AFA was not party to the agreement. The settlement agreement, the Court explained, did not pertain to United's rejection/termination motion, to which AFA had objected, but dealt with United's obligations to PBGC for unfunded pension liabilities.

The Seventh Circuit's ruling in *United Airlines* illustrates the dynamic between ERISA and chapter 11 as a vehicle for a financially overburdened debtor-employer to manage its labor costs and deal with related liabilities in an effective way.

The Seventh Circuit was likewise unreceptive to AFA's argument that United abrogated its collective bargaining obligations by settling with PBGC. It emphasized that ERISA provisions authorizing PBGC to terminate a pension plan provide an alternative to the collective bargaining framework in Bankruptcy Code section 1113 and ERISA's employer-initiated distress termination provisions. In fact, the Court noted, nothing precludes an employer from pursuing a distress termination at the same time that the employer petitions PBGC to consider terminating a plan on its own initiative.

Given the clear permissibility of the settlement agreement under ERISA, the Seventh Circuit ruled, AFA's claim that United abrogated its collective bargaining obligations was baseless — United neither bargained with PBGC as if PBGC were a labor representative of the flight attendants, nor did it establish an agreement to rival the existing collective bargaining agreement. Moreover, the settlement merely obligated PBGC to consider terminating the pension plan, a course of action that PBGC could readily have rejected after it conducted an analysis of the circumstances.

Finally, the Seventh Circuit observed, AFA was not left without recourse to remedy what it perceived to be an improper termination. ERISA allows retirees covered by a terminated plan to challenge the termination in court, where PBGC's decision to take over a plan may be reversed. Based upon these deliberations, the Court affirmed the decisions below.

## OUTLOOK

Lawmakers have been grappling for months with an overhaul of the rules governing company pension plans to tighten controls over employers with underfunded plans and shore up the PBGC's finances. Democrats generally oppose legislation that passed the Senate in mid-November of 2005. They say it could lead some employers to drop their pension plans or switch from traditional defined-benefit plans to less costly defined-contribution programs, such as 401(k) plans, in which employers contribute to a retirement fund and workers receive only what the investments have earned. In fact, many companies are replacing defined-benefit pension plans with defined-contribution plans. As noted, PBGC insures only defined-benefit plans, which are most prevalent in older industries, such as the automotive, steel, and airline industries.

Whether or not a legislative fix can adequately address PBGC's immediate woes, the problems that spawned pension underfunding in the first place are not likely to go away any time soon. Pension underfunding is only part of the cost-infrastructure malaise plaguing U.S. industries. Escalating health-care and retiree benefit costs, environmental compliance costs and fuel prices, and a chronic U.S. trade deficit with many emerging markets (such as China and India) are also significant problems. Given the enormous funding costs associated with traditional defined-benefit pension plans already, adding to the burden by requiring employers to up the ante can only lead to wholesale departure from the traditional pension paradigm.

It is happening already. On December 5, 2005, Verizon Communications, Inc., announced that it was terminating contributions to the pension plan of 50,000 managerial personnel and shifting its retirement strategy to 401(k) plans. IBM Corp. reported on January 5, 2006, that it will freeze the pension plans of about 120,000 employees in the United States at the end of 2007 and will offer instead a more generous 401(k) plan. Members of the Air Line Pilots Association ratified an agreement on January 12, 2006, with Northwest Airlines to freeze the traditional pension plan of some 4,500 pilots and launch a new defined-contribution retirement plan. Motorola, Sears, and Hewlett-Packard also recently froze their pension plans. Other companies are likely to follow suit in anticipation of passage of stricter pension-funding requirements.

The Seventh Circuit's ruling in *United Airlines* illustrates the dynamic between ERISA and chapter 11 as a vehicle for a financially overburdened debtor-employer to manage its labor costs and deal with related liabilities in an effective way. As those liabilities pertain to pensions, ERISA describes the universe of a debtor-employer's options. Still, because the Bankruptcy Code allows employers to deal not only with related collective bargaining and retiree benefit claims but also with liabilities (individual or joint) created in connection with a terminated pension plan, bankruptcy may be the preferred forum for dealing with these issues collectively.

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*In re UAL Corp.*, 428 F.3d 677 (7th Cir. 2005).

*N.L.R.B. v. Bildisco and Bildisco*, 465 U.S. 513 (1984).

# WHEN IS A LEASE NOT A LEASE? SEVENTH CIRCUIT ADOPTS "SUBSTANCE OVER FORM" TEST FOR TRUE LEASE DETERMINATION

*David A. Hatch and Mark G. Douglas*

As secured financing and leasing transactions involving capital assets become more complicated to account for evolving tax, liquidity, equipment obsolescence, and similar considerations, the difference between "true" leases and financing arrangements has become increasingly difficult to ascertain. The similar economic function of these transactions allows for the drafting of "leases" that work like security agreements and secured loans that work like "leases."

The distinction between these property interests is an important one, particularly if the owner/lessee of an asset files for bankruptcy. This is so because different rights and obligations apply under the Bankruptcy Code, depending on the nature of the debtor's interest in the property. Bankruptcy courts are frequently called upon to determine the exact nature of the debtor's legal interest. The Seventh Circuit Court of Appeals recently examined this issue. In *United Airlines, Inc. v. HSBC Bank USA, N.A.*, the Court of Appeals ruled that a court must consider the substance of a transaction, rather than its form, in determining whether a transaction is a "true lease" or a disguised secured financing.

## TREATMENT OF LEASES IN BANKRUPTCY

The Bankruptcy Code itself does not define the term "lease." It broadly defines "security agreement" as an "agreement that creates a security interest" and "security interest" as a "lien created by an agreement." These definitions, however, offer little guidance in distinguishing between financing transactions that involve the retention of a security interest in sold assets, on the one hand, and leasing transactions where the lessor is granted a security interest in leased assets as an added layer of protection, on the other.

Why is the distinction important? The Bankruptcy Code confers certain rights, and imposes various obligations, upon a debtor who is party to leases and other contracts that are "executory" as of the bankruptcy filing date. A chapter 11 debtor-in-possession ("DIP") or bankruptcy trustee generally has the right to "assume" (reaffirm) or "reject" (disavow, resulting in breach) such contracts and leases under section 365 of the Bankruptcy Code. Moreover, most assumed contracts can be assigned as a means of creating value for the bankruptcy estate. Pending the decision to assume or reject, however, the DIP or trustee is obligated to remain current on post-petition lease obligations, failing which the leased property must be surrendered to the lessor, or the lessor will be allowed to exercise its contractual and legal remedies notwithstanding the strictures of the automatic stay.

Different rules apply if a transaction involves secured financing rather than a lease. In this case, the DIP's or trustee's obligation to make payments to the secured lender during the course of the bankruptcy hinge on the value of the collateral relative to the amount of the lender's claim. If the collateral value exceeds the amount of the debt, the DIP or trustee may be required to make periodic interest payments to the secured creditor as a means of "adequate protection." By contrast, if a secured creditor is undersecured because its collateral value is deficient, adequate protection payments are generally not required, and the creditor will hold a secured claim only to the extent of the collateral value and an unsecured claim for the deficiency.

The ultimate fate of the collateral depends on the kind of bankruptcy case (*i.e.*, chapter 7 or chapter 11) and the DIP's or trustee's ability to deal with the secured creditor's claims in accordance with the requirements of the Bankruptcy Code. In a chapter 7, the property would either be abandoned to the secured creditor or sold to the highest bidder, with the secured creditor's liens attaching to the proceeds. By contrast, in chapter 11, the DIP could confirm a plan of reorganization under which, among other things, the secured obligation is reinstated with the same collateral, the original collateral secures a new obligation whose terms vary from the original secured debt, collateral of equivalent value is substituted for the original collateral, or the collateral is sold, with the secured creditor's liens attaching to the proceeds.

Therefore, in addition to the ultimate issue of ownership of the asset in question, much depends on a transaction's characterization as a lease or a secured financing. How to make that determination given the absence of any concrete guidance under the Bankruptcy Code was the subject of the Seventh Circuit's ruling in *United Airlines*.

## *UNITED AIRLINES*

Prior to filing for chapter 11 protection in 2002, United Airlines entered into a series of transactions to fund the improvement of its facilities at four airports. One such lease arrangement involved public financing underwritten by the California Statewide Community Development Authority (the "Authority"). United has been the lessee since 1973 of a 128-acre maintenance base at San Francisco International Airport ("SFO"). The lease expires in 2013 unless the parties negotiate an extension. Rent depends on an independent party's estimate of the property's market value.

In 1997, the Authority issued $155 million in bonds to finance improvements to United's SFO facilities (other than the maintenance base). The bonds are without recourse to the Authority and are guaranteed by United. United subleases 20 acres of the 128-acre maintenance base to the Authority for 36 years — the term matches the bond repayment schedule rather than United's lease with SFO. The Authority paid $1 to sublet the premises.

The Authority leases the 20 acres back to United for rent equal to interest on the bonds plus an administrative fee. This lease has a $155 million balloon payment in 2033 to retire the principal. United may postpone final payment until 2038; if it does, the sublease also is extended. United is entitled to prepay, in which case the sublease and leaseback terminate. If United does not pay as agreed, the Authority can evict it from the 20 acres. The leaseback includes a "hell or high water" clause requiring United to pay the rent even if its lease from the SFO ends before 2033, the property is flooded, or some other physical or legal event deprives United of the use or economic benefit of the maintenance base.

After filing for chapter 11, United took the position that none of the arrangements at the four airports in question is a "lease" for purposes of section 365 of the Bankruptcy Code. Instead, United sought a declaratory judgment that each transaction involves secured financing and that United should have the right to continue using the airport facilities while paying only a portion of the promised "rent." The bankruptcy court ruled that the arrangement at one of the airports is a true lease, but that the other three transactions (including the SFO arrangement) are not. The district court reversed those rulings in part on appeal, holding that all four transactions involved true leases rather than secured financings. United appealed to the Seventh Circuit.

## THE SEVENTH CIRCUIT'S RULING

The Seventh Circuit joined all the other circuit courts of appeal that have considered this issue, ruling that substance rules over form and that only a "true lease" qualifies as a "lease" under section 365 of the Bankruptcy Code. In reaching this conclusion, the Court of Appeals considered the practical meaning of the Bankruptcy Code, the Uniform Commercial Code (the "UCC"), and the historical context of the Bankruptcy Code's enactment, including the statute's legislative history.

According to the Seventh Circuit, it "is unlikely that the [Bankruptcy] Code makes big economic effects turn on the parties' choice of language rather than the substance of their transaction," because to do so would allow the drafters of contracts to obliterate the distinction between the two types of transactions through creative drafting. This is consistent with the UCC, which, unlike the Bankruptcy Code, contains a detailed description of the distinction between a lease and a security interest, emphasizing that "[w]hether a transaction creates a lease or a security interest is determined by the facts of each case."

The Court of Appeals went on to explain that a lease in which "current consumption" (*i.e.*, lease payments at market rates for continued use of an asset) dominates is often called a

"true lease," while one in which the asset serves as security for an extension of credit is treated as a security agreement governed by the UCC. Finally, the Court of Appeals observed, the legal community of the 1970s understood that the distinction between leases and security agreements was based on substance rather than form, and looked to the relevant legislative history from the adoption of the Bankruptcy Code, which explains, in relevant part:

> Whether a "lease" is [a] true or bona fide lease or, in the alternative, a financing "lease" or a lease intended as security, depends upon the circumstances of each case. The distinction between a true lease and a financing transaction is based upon the economic substance of the transaction and not, for example, upon the locus of title, the form of the transaction or the fact that the transaction is denominated as a "lease."

Thus, the Seventh Circuit concluded that substance, rather than form, should be considered in determining whether a transaction is a "true lease" or a disguised secured financing for purposes of section 365 of the Bankruptcy Code.

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The Seventh Circuit's ruling illustrates the difficulties associated with sorting out the true nature of complicated lease and financing transactions by examining the substance of a transaction rather than the labels that have been attached to it by the parties.

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The Court of Appeals then examined which law should apply to divine the true nature of any given transaction. Explaining that "nothing in the Bankruptcy Code says which economic features of a transaction have what consequences," the Seventh Circuit concluded that state law is determinative on this issue — in this case California law. California, the Court of Appeals observed, has adopted a functional approach to the question in both the UCC and the common law governing real property transactions. It went on to discuss California court rulings examining various features of lease and financing transactions.

The Seventh Circuit ultimately determined that the transaction between United and the Authority was not a "true lease" under California law for the following reasons: (i) the "rent" was not measured by the market value of the property; (ii) at the conclusion of the lease, the Authority had no residual interest; (iii) the balloon payment had no counterpart in a true lease, but was a common feature of a secured financing; and (iv) upon prepayment, the lease and sublease terminated immediately, whereas in a true lease, prepayment secures the tenant's right to use the property for the term of the tenancy. Based upon this conclusion, the Court of Appeals reversed the district court's decision and remanded the case for further proceedings.

## ANALYSIS

The Seventh Circuit's ruling in *United Airlines* does not represent a departure from the approach employed by most courts, including every circuit court of appeals to consider the issue, in determining what kind of transactions qualify as "leases" under the Bankruptcy Code. Even so, it illustrates the difficulties associated with sorting out the true nature of complicated lease and financing transactions by examining the substance of a transaction rather than the labels that have been attached to it by the parties. In almost all cases, such an inquiry demands painstaking analysis of a laundry list of factors under applicable nonbankruptcy law that have been deemed emblematic of leases, on the one hand, and financing arrangements, on the other. This analysis will only become more difficult as commercial transactions become more complex and exhibit hybrid characteristics that are not readily pigeonholed in one category or the other.

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*United Airlines, Inc. v. HSBC Bank USA, N.A.*, 416 F.3d 609 (7th Cir. 2005).

# GLOBAL FOCUS: FOREIGN PROCEEDINGS RECOGNIZED UNDER NEW CHAPTER 15

*Mark G. Douglas*

Part of the sweeping bankruptcy reforms that became effective on October 17, 2005, is an entirely new chapter of the Bankruptcy Code — chapter 15 — governing cross-border bankruptcy and insolvency cases. Chapter 15 is patterned after the Model Law on Cross-Border Insolvency, a framework of legal principles formulated by the United Nations Commission on International Trade Law in 1997 to deal with the rapidly expanding volume of international insolvency cases.

Long-heralded chapter 15 replaces section 304 of the Bankruptcy Code. Section 304 allowed an accredited representative of a debtor in a foreign insolvency proceeding to commence a limited "ancillary" bankruptcy case in the U.S. for the purpose of protecting the foreign debtor's U.S. assets from creditor collection efforts and, in some cases, facilitating the repatriation of those assets abroad to be administered in the debtor's insolvency or bankruptcy case. Chapter 15 continues that practice, but establishes new rules and procedures applicable to transnational bankruptcy cases.

The new legislative regime governing cross-border bankruptcies having become effective on October 17, 2005, it has been left to the courts to iron out the details. Judging by rulings recently handed down by bankruptcy courts in New York and California, the transition from section 304 to chapter 15 appears to be proceeding smoothly. These courts are the first to recognize the "main proceedings" of foreign business debtors under chapter 15.

## THE PURPOSE OF CHAPTER 15

Chapter 15's purpose is "to provide effective mechanisms for dealing with cases of cross-border insolvency" consistent with the following objectives:

- Cooperation between U.S. and non-U.S. courts and related functionaries.
- Greater legal certainty for trade and investment.
- Fair and efficient administration of cross-border cases in a way that protects the interests of all interested parties.
- Protection and maximization of the value of the debtor's assets.
- Facilitation of the rescue of financially troubled businesses, thereby protecting investment and preserving employment.

## PROCEDURE

An accredited representative of a foreign debtor may file a petition in a U.S. bankruptcy court seeking "recognition" of a "foreign proceeding." "Foreign proceeding" is defined as a "collective judicial or administrative proceeding in a foreign country, including an interim proceeding, under a law relating to insolvency or adjustment of debt in which proceeding the assets and affairs of the debtor are subject to control or supervision by a foreign court, for the purpose of reorganization or liquidation."

Because more than one bankruptcy or insolvency proceeding may be pending against the same foreign debtor in different countries, chapter 15 contemplates "recognition" in the U.S. of both a "main" proceeding — a case pending in whatever country contains the debtor's "center of main interest" — and "nonmain" proceedings, which may have been commenced in countries where the debtor merely has an "establishment" (conducts business or owns assets). The debtor's registered office is presumed to be the center of the debtor's main interest.

If the U.S. bankruptcy court is provided with sufficient evidence (delineated in the statute) testifying to the legitimacy of a pending foreign bankruptcy proceeding (main, nonmain, or both), it may enter an "order of recognition."

## INTERIM RELIEF

Pending its decision on recognition, the court is empowered to grant certain kinds of provisional relief. Section 1521 authorizes the court, "where relief is urgently needed to protect the assets of the debtor or the interests of the creditors," to stay any execution against the debtor's assets, entrust the administration of the debtor's assets to a foreign representative, or

**10 LARGEST PUBLIC COMPANY BANKRUPTCIES OF 2005**

| Company | Filing Date | Assets |
|---|---|---|
| Refco Inc. | 10/17/2005 | $33,333,172,000 |
| Calpine Corporation | 12/20/2005 | $27,216,088,000 |
| Delta Air Lines, Inc. | 9/14/2005 | $21,801,000,000 |
| Delphi Corporation | 10/8/2005 | $16,593,000,000 |
| Northwest Airlines Corporation | 9/14/2005 | $14,042,000,000 |
| Collins & Aikman Corporation | 5/17/2005 | $3,196,700,000 |
| Tower Automotive, Inc. | 2/2/2005 | $2,846,406,000 |
| Winn-Dixie Stores, Inc. | 2/21/2005 | $2,618,891,000 |
| ASARCO LLC | 8/9/2005 | $1,108,447,000 |
| Am. Business Fin. Services, Inc. | 1/21/2005 | $1,042,870,000 |

suspend the right to transfer, encumber, or otherwise dispose of any of the debtor's assets.

### BROAD POWERS UPON RECOGNITION

Upon recognition of a foreign proceeding, certain provisions of the Bankruptcy Code automatically come into force, and others may be deployed in the bankruptcy court's discretion by way of "additional assistance" to the foreign bankruptcy case. Among these are the automatic stay (or an equivalent injunction) preventing creditor collection efforts with respect to the debtor or its assets located in the U.S. (section 362, subject to certain enumerated exceptions), the right of any entity asserting an interest in the debtor's U.S. assets to "adequate protection" of that interest (section 361), and restrictions on the debtor's ability to use, sell, or lease its U.S. property outside the ordinary course of its business (section 363).

Once a foreign main proceeding is recognized by the bankruptcy court, the foreign representative may also commence a full-fledged bankruptcy case under any other chapter of the Bankruptcy Code, so long as the foreign debtor is eligible to file for bankruptcy in the U.S. and the debtor has assets located in the U.S.

Chapter 15 expressly gives foreign creditors a significant degree of access and protection. For example, foreign creditors are entitled to notification of the commencement of a case under chapter 15. Among other things, the notice must specify the deadline for submitting documentation of unsecured and secured claims against the debtor. Foreign creditors have the same rights as domestic creditors regarding the commencement of, and participation in, a case under the Bankruptcy Code.

The law, however, is noncommittal as to whether foreign unsecured creditor claims are entitled to the same priority of distribution specified in sections 507 and 726 of the Bankruptcy Code. Instead, it provides that "the claim of a foreign creditor under those sections shall not be given a lower priority than that of general unsecured claims without priority solely because the holder of such claim is a foreign creditor."

### COOPERATION AND COORDINATION

Chapter 15 was designed to promote cooperation and coordination between courts in two or more countries presiding over bankruptcy or insolvency proceedings involving the same debtor. To that end, the U.S. bankruptcy court and, with court supervision, any bankruptcy trustee or examiner are authorized to communicate directly with a foreign court or a foreign representative.

If more than one bankruptcy case is commenced with respect to a foreign debtor in the U.S., chapter 15 creates a mechanism to coordinate the proceedings. Thus, for example, if a foreign debtor is already concurrently the subject of a foreign proceeding and a chapter 7 or 11 case in the U.S. when its foreign representative commences a chapter 15 case, the U.S. bankruptcy court, if it recognizes the foreign proceeding, is obligated to harmonize any relief it decides to grant in the chapter 15 case so that it is consistent with the relief granted in the chapter 11 case. Similarly, if the representative files a chapter 7 or 11 case in the U.S. after the bankruptcy court recognizes a pending foreign proceeding under chapter 15, the bankruptcy court must review the relief it has already granted under chapter 15 to ensure that it is consistent with the relief granted in the chapter 7 or 11 case. The bankruptcy court is also entrusted with coordinating nonmain foreign proceedings.

The importance of meaningful progress in this area cannot be overstated — the EU's enactment in 2002 of the European Union Regulation on Insolvency Proceedings gave Europe an advantage in the global commerce arena by creating a unified system of rules applying to insolvency proceedings in member countries. With chapter 15 finally in place, the U.S. has taken a big step toward leveling the playing field.

In addition, chapter 15 establishes rules to account for the possibility that creditors of a foreign debtor may have received full or partial satisfaction of their claims from sources outside the U.S. Chapter 15 provides that "[w]ithout prejudice to secured claims or rights in rem, a creditor who has received payment with respect to its claim in a foreign proceeding pursuant to a law relating to insolvency may not receive a payment for the same claim in a case under any other chapter of [the U.S. Bankruptcy Code] regarding the debtor, so long as the payment to other creditors of the same class is proportionately less than the payment the creditor has already received."

## PROTECTION OF FOREIGN CREDITORS

Chapter 15 expressly gives foreign creditors a significant degree of access and protection. For example, foreign creditors are entitled to notification of the commencement of a case under chapter 15. Among other things, the notice must specify the deadline for submitting documentation of unsecured and secured claims against the debtor. Foreign creditors have the same rights as domestic creditors regarding the commencement of, and participation in, a case under the Bankruptcy Code. However, the law is noncommittal as to whether foreign unsecured creditor claims are entitled to the same priority of distribution specified in sections 507 and 726 of the Bankruptcy Code. Instead, it provides that "the claim of a foreign creditor under those sections shall not be given a lower priority than that of general unsecured claims without priority solely because the holder of such claim is a foreign creditor."

## CHAPTER 15 IN PRACTICE: RECENT RECOGNITION RULINGS

Bankruptcy courts in New York and California were the first to apply the new legislative framework to foreign commercial debtors. On December 7, 2005, Judge Burton R. Lifland of the U.S. Bankruptcy Court for the Southern District of New York issued an order recognizing the U.K insolvency proceedings of Les Mutuelle du Mans Assurances IARD ("MMA"), the U.K. branch of French insurer La Mutuelle du Mans Assurances IARD, as a "foreign main proceeding" under chapter 15. Judge Lifland also permanently enjoined creditors from moving against MMA's assets.

MMA was the subject of an insolvency proceeding under the U.K. Companies Act of 1985. The High Court of Justice of England and Wales approved a "scheme of arrangement" for the insurer on October 28, 2005. MMA filed its chapter 15 petition on November 11, 2005, to gain time to make payouts under the scheme and to prevent creditors from suing it or attaching its assets in the U.S. Judge Lifland found that the "center of main interest" in the foreign proceeding is in the U.K., and not France, despite the fact that MMA is the U.K. branch of a French company. Among other things, the order recognizing MMA's proceeding provides that "[t]he scheme of arrangement sanctioned by the U.K. High Court in the foreign

proceeding shall be given full force and be binding on all persons and entities in the United States." MMA's chapter 15 petition was the first filed in New York.

The U.S. Bankruptcy Court for the Central District of California also recognized a foreign main proceeding under chapter 15 on December 7, 2005. The debtor is TriGem Computer Inc. of South Korea, which filed its chapter 15 petition on November 3, 2005, seeking recognition of a corporate reorganization proceeding filed by its corporate parent in the Bankruptcy Division of the Suwon District Court. Bankruptcy Judge Thomas Donovan enjoined creditors from proceeding against TriGem's U.S. assets and forced creditors to file their claims overseas.

Individual Ian Thou officially filed the first chapter 15 petition in the U.S. He filed his petition on November 2, 2005, with the U.S. Bankruptcy Court for the Western District of Washington, seeking recognition of a foreign main proceeding pending in Vancouver, British Columbia.

### OUTLOOK

To date, the U.S., Japan, Eritrea, Mexico, Poland, South Africa and, within Yugoslavia, Montenegro have adopted bankruptcy laws patterned after the Model Law. Canada, Australia, New Zealand, and the U.K. are actively considering whether to do so. Before chapter 15 was enacted, progress on implementing the principles contained in the Model Law was all but stalled as many countries waited to see whether the U.S. would sign on to the project. It remains to be seen whether the enactment of chapter 15 will jump-start the process.

The importance of meaningful progress in this area cannot be overstated — the EU's enactment in 2002 of the European Union Regulation on Insolvency Proceedings gave Europe an advantage in the global commerce arena by creating a unified system of rules applying to insolvency proceedings in member countries. To a considerable degree, transnational trade players outside the EU are still forced to cope with the vagaries of a hodgepodge of different laws governing such proceedings in the rest of the world. With chapter 15 finally in place, the U.S. has taken a big step toward leveling the playing field.

Recent decisions granting recognition to foreign insolvency proceedings indicate that the framework established by chapter 15 is functioning as it was intended. Still, not all recent developments are unequivocally positive. For example, a New York district court recently held that chapter 15 is the only recourse for an accredited representative of a foreign debtor seeking to enjoin U.S. litigation against the debtor. Although injunctive relief is clearly authorized by chapter 15, there is no indication that the statute was intended to preclude such a remedy outside of chapter 15 in accordance with traditional principles of comity that have been applied by federal courts for hundreds of years.

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*In re Petition of Lloyd,* Case No. 05-60100 (BRL) (Bankr. S.D.N.Y. Dec. 7, 2005) (unpublished order).

*In re TriGem Computer, Inc.*, Case No. 2:05-bk-50052-TD (Bankr. C.D. Cal. Dec. 7, 2005) (unpublished order).

*U.S. v. J.A. Jones Construction Group, LLC*, 2005 WL 3177053 (E.D.N.Y. Nov. 29, 2005).


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