

## **The Year in Bankruptcy: 2005**

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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 Airlines (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 USAir 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, over reliance 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 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 non-debtors 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*. 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 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.

### **Focus Abroad**

The volume of corporate bankruptcy and insolvency proceedings outside of the U.S. generally remained flat in 2005. The number of corporate insolvencies in Germany fell by 200 to 39,000

for January to November 2005, compared to the same period in 2004, according to estimates by the association of German insurers published on December 13, 2005. A total of 7,906 companies went bankrupt in Belgium in 2005, compared to 7,986 bankruptcies in 2004, according to a report of the research office Graydon published on December 30, 2005.

Norway registered some 3,000 corporate bankruptcies in 2005, down by 24 percent according to preliminary data of local market research and credit rating organization CreditInform. Corporate bankruptcies in Sweden fell by ten percent in 2005 to 5,389. Statistics Finland, the Finnish state statistics agency, reported on December 12, 2005 that Finnish bankruptcies decreased by six percent to 1,934 in the period from January to October 2005, as compared to the previous year.

South Korea's corporate bankruptcies declined to an all-time low last year amid growing signs of an economic recovery, the nation's central bank reported on January 18, 2006. According to the Bank of Korea, the number of corporate failures fell 23.1 percent to 4,445 in 2005, the lowest level since 1990, when the bank started compiling the data

The number of corporate bankruptcies in Japan fell below 13,000 in 2005 for the first time in 14 years. The 12,998 corporate bankruptcy cases for the year is a drop of 4.9 percent from 2004, the fourth-straight yearly decline, according to Tokyo Shoko Research, whose data cover the failures of firms with debts of 10 million yen or more.

By contrast, business bankruptcy filings in the UK, Denmark and the Netherlands went up in 2005. There were 18,122 corporate bankruptcies in the UK in 2005, an 11 percent increase over

2004 and the greatest number since 2002. Business bankruptcies in Denmark rose in 2005 by 1.7 percent to 238. The Netherlands experienced an eight percent increase in corporate bankruptcies in 2005 to 10,228.

The U.S. was not the only nation busy with bankruptcy reform in 2005. A major reform of Brazil's bankruptcy laws was approved by President Luiz Inacio Lula da Silva 12 years after the legislation was first introduced in 1993. Brazil's old law dated from 1945 and gave significantly greater preference to employee and tax claims.

Though not yet finalized, China's new PRC Enterprise Bankruptcy and Reorganization Law is likely to be enacted sometime in 2006. With limited exceptions, the law will apply to all types of business entities, including state owned enterprises and foreign invested enterprises. Also, it will create a mechanism for corporate reorganizations similar to chapter 11 of the U.S. Bankruptcy Code — a clear departure from current rules, which focus on liquidation as the sole mechanism for dealing with a bankrupt enterprise.

Canada's House of Commons also considered, but has not yet approved, sweeping changes to the country's insolvency laws in 2005. Among other things, the proposed amendments would create a "super priority" classification for unpaid wages accruing within six months of a bankruptcy filing and certain unpaid pension contributions. It would also confirm that collective bargaining agreements cannot be unilaterally terminated or modified in restructuring proceedings and provide for debtor-in-possession financing. In addition, the proposed law would authorize the rejection, assumption and assignment of executory contracts under court supervision, the

subordination of equity claims and it would exempt regulatory bodies from any stay of proceedings in an insolvency case.

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

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

*Deutsch 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 (1<sup>st</sup> 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).