New York Law Journal
Corporate Update
VOLUME 235—NO. 81 THURSDAY, APRIL 27, 2006 ALM

DISTRESSED MERGERS & ACQUISITIONS

'Delphi' May Encourage Formation of Equity Panels

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While the appointment of a creditors' committee is required in every chapter 11 case, equity committees are not.[1] In fact, they "should be the rare exception."[2] Yet, recently, in *In re Delphi Corp., et al.*,[3] the court directed the appointment of an equity committee—the expense of which will be borne by the Delphi estate—despite the rigorous objections of Delphi Corporation, the U.S. Trustee, the Creditors' Committee, and General Motors. Interestingly, the request was made by Appaloosa Management L.P., a 9 percent shareholder of Delphi that had acquired its interest after the commencement of the case. Delphi joins *Adelphia*, *Mirant* and *Kmart* as recent cases with equity committees.[4] In contrast, courts declined to direct the appointment of equity committees in *Conseco*, *UAL*, *WorldCom*, *Global Crossing*, *Enron*, and *Pacific Gas & Electric*.[5] Factors courts consider in determining whether to appoint an equity committee include: (i) whether the interest of shareholders are otherwise adequately represented, (ii) the debtor's solvency and the prospects for a meaningful distribution to equity, (iii) the complexity of the case, (iv) whether the stock was widely held and actively traded, (v) timeliness, and (vi) the balance between concerns for adequate representation and the cost to the estate.

Each of these major cases, including the six in which equity committees were denied, was complex and involved equity that was widely held and actively traded pre- and post-bankruptcy. Hence the distinguishing factors among cases in which equity committees were appointed and those in which they were not must be one or more of solvency, timeliness, or adequate representation. While the few decisions on this subject are not clear, it is also likely that these factors are assessed in the context of the limited protections accorded equity under the chapter 11 plan confirmation process. Because the absolute priority rule of chapter 11 permits a plan to be "crammed down" upon a dissenting class if no junior class is receiving or retaining value under the plan, equity is particularly vulnerable to a "cram down," provided that no class of creditors has received more than payment in full on account of their claims. Absent a negotiated result with creditor consent, recovery for equity depends upon whether the creditors' claims exhaust the reorganized debtor's value. Thus, one can appreciate why timing of the request for appointment of an equity committee, the solvency of the debtor, and adequate representation of equityholders in the chapter 11 process are key factors.

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Timeliness

Turning to *Delphi*, Appaloosa first made its request for an equity committee to the U.S. Trustee, as required by the Bankruptcy Code.[6] The request came within the first six months of Delphi's case during its labor and legacy negotiations and before any significant plan negotiations. Following the U.S. Trustee's denial of Appaloosa's request, Appaloosa requested that the bankruptcy court direct the U.S. Trustee to appoint an equity committee. Appaloosa, of course, argued that (i) the case was complex, (ii) Delphi's shares were widely and actively traded, (iii) its motion was timely, (iv) Delphi was solvent, and (iv) Delphi's shareholders were otherwise inadequately represented.

Appaloosa argued that it was necessary to appoint an equity committee relatively early in the case because Delphi was making critical decisions regarding its labor and legacy costs. Appaloosa distinguished its request from other cases in which unsuccessful requests for an equity committee were made later in the case and found untimely.[7] Moreover, it affirmatively relied on these cases to argue that meaningful participation by Delphi's equity required that an equity committee be appointed prior to formulation of a plan. The court found the request timely.

Solvency and Other Economic Factors

Appaloosa again relied upon an earlier decision declining to appoint an equity committee, *In re Williams Communications Group*.[8] In *Williams*, the court declined to appoint a committee, finding that the debtor was "hopelessly insolvent" and the movants could not establish that there was potential for a meaningful distribution to equity. It was undisputed that *Williams* was a complex case and that its shares were widely held and actively traded both pre- and post-bankruptcy. Relying on *Williams*, Appaloosa argued that it need not establish solvency, but only that Delphi was not hopelessly insolvent. Thus, Appaloosa relied upon the market trading value of the equity immediately before and after the commencement of the case, Delphi's declaration of a dividend to equity as recently as two months prior to the bankruptcy petition, and statements of Delphi's CEO that the chapter 11 cases were not predicated upon any immediate or looming liquidity crisis, but instead commenced because "Delphi identified a strategic advantage, in light of its inability to reach timely agreement with its organized labor unions, on commencing chapter 11 cases prior to the recent amendments to the Bankruptcy Code."[9] In contrast to Appaloosa's use of market indicia and prebankruptcy reports, Delphi relied upon the shareholders' deficit of approximately $6.4 billion reflected in the schedules and statements of liabilities that it had certified and filed as required by the Bankruptcy Code. The court found that the solvency factor was satisfied because (i) Appaloosa had presented sufficient evidence to prevent a finding that Delphi was "hopelessly insolvent;" and (ii) Appaloosa need not demonstrate potential for a "meaningful distribution to equity."

Adequacy of Representation

Appaloosa also argued that no other constituent would adequately represent its interests because (a) Delphi was dominated by GM, its former parent and largest creditor, who Appaloosa asserted urged Delphi into filing a chapter 11 petition in order to gain leverage over a certain labor union in GM's labor negotiations; and (b) the Creditors' Committee has neither the duty nor the incentive to choose strategic alternatives that maximize value for equity. The reference to the Creditors' Committee should not mitigate in favor of appointing an equity committee. It is the debtor in possession, not the Creditors Committee, that serves as a fiduciary for shareholders and creditors and is charged with the fiduciary duty to maximize value for all constituents. Appaloosa quarreled with this fundamental principle of chapter 11, arguing that Delphi's managers and directors, which, in a solvent company, are the bastions of shareholders' interests, were subject to other, conflicting fiduciary duties to Delphi's creditors upon Delphi's entry into the "zone of insolvency." Contrary to long established precedent,[10] Appaloosa contended that, as a matter of law, a debtor in possession is disabled from adequately representing equity. Noting its disagreement with Appaloosa, the court offered its view of a debtor's likely responsiveness to equity and turned to the undisputed facts that the cases were complex and Delphi's common stock was widely held and still actively traded, concluding simply that the additional expense of an equity committee was justified to assure that Delphi's approximately 300,000 record holders were adequately represented.

Troubling Aspects of 'Delphi'

First, the significance of solvency has been diminished to the extent that that criterion can be satisfied so long as the debtor is not "hopelessly insolvent" and established by reference to market share pricing. It is troubling that although the court was "skeptical that there will be a meaningful distribution" to shareholders, it was not prepared to rule it out because, among other reasons, the price of Delphi's actively-traded securities "indicate[d] at least a hope of solvency"[11] and it was not certain how much money the debtors would save through their negotiations with their unions. In suggesting that market share price, which is frequently driven by exogenous factors such as option value, covering prior positions and hedging debt positions, may provide the basis for satisfying the solvency factor, *Delphi* could impact many major cases. Ironically, although the court relied upon market activity as an indicator of Delphi's value, it also admonished that it would "look very closely…at any action in court or otherwise not to maximize recoveries for all committee constituents, but instead to artificially pump up the value of the current stock on a trading basis."[12] The deference given by the court to stock market trading activity as an indication of solvency is especially troubling when such deference is concurrent with an acknowledgement that movement in stock prices may be due to forces, including distressed investors, entirely independent of the debtor's performance or prospects.

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Second, the court offered unsubstantiated observations in rebutting Delphi's argument that its board adequately represented equity. Noting that Delphi's board of directors has continuing fiduciary duties to Delphi's shareholders, the court, without any evidentiary basis, nevertheless recognized the merit in the argument that the "debtors' natural desire to resolve the case may lead the debtor to give short shrift to shareholders' views."[13] Although the record is not clear, the court might have been concerned by factors unique to Delphi, such as a concern that there was undue influence exercised by GM as (i) one of Delphi's largest creditors and customers, (ii) the key to its viability, and (iii) a potential source of recovery for Delphi's labor and legacy costs. In any case, there is no limiting language or clarity on this point.

It is clear, however, that the court sought to limit the cost of the equity committee by prohibiting retention of any professionals other than a law firm and directing the equity committee to use the Creditors' Committee's actuaries, again suggesting that the resolution of the labor and legacy issue would be critical for equity. The effectiveness of this limitation remains to be seen.

Delphi will serve as a troubling precedent if it is seen as requiring little more than a showing of a complex case with widely and actively traded shares at more than a nominal price to support the appointment of an equity committee. If *Delphi* is seen as precedent for the early appointment of equity committees in more major cases, one would hope that parties take seriously the court's suggestion to disband such committees when there is little or no potential for a meaningful distribution to equity.

The full impact of *Delphi* is dependent on gaining greater clarity on who has the burden of proof on a subsequent motion to disband the committee and what level of proof will be required regarding the potential for a meaningful distribution to equity. There is little precedent on any of these points. Nevertheless, *Delphi* has the potential to substantially increase the likelihood of an equity committee in major cases, turning the rare exception into a more frequent occurrence.

1. See 11 U.S.C §1102(a)(1).
2. *In re Williams Communications Group, Inc.*, 281 B.R. 216, 223 (Bankr. S.D.N.Y. 2002).
3. Case No. 05-44481 (RDD) (S.D.N.Y. March 30, 2006).
4. *In re Mirant Corp.*, Case No. 03-46590 (DML) (Bankr. N.D. Tex. July 14, 2003); *In re Adelphia Communications Corp.*, Case No. 02-41729 (REG) (Bankr. S.D.N.Y. June 25, 2002); *In re Kmart Corp.*, Case No. 02-02474 (SPS) (Bankr. N.D. Ill. Jan. 22, 2002); see also *In re Texaco, Inc.*, Case No. 87-20142 (ASH) (Bankr. S.D.N.Y. April 12, 1987). Additionally, equity committees were appointed in several asbestos dominated cases when it became apparent that the debtors in those cases would be able to fully pay their commercial non-tort creditors.
5. *In re Conseco, Inc.*, Case No. 02-49672 (CAD) (Bankr. N.D. Ill. Dec. 18, 2002); *In re UAL Corp.*, Case No. 02-48191 (ERW) (Bankr. N.D. Ill. Dec. 9, 2002); *In re WorldCom, Inc.*, Case No. 02-13533 (AJG) (Bankr. S.D.N.Y. July 21, 2002); *In re Global Crossing, Ltd.*, Case No. 02-40188 (REG) (Bankr. S.D.N.Y. Jan. 28, 2002); *In re Enron Corp.*, Case No. 01-16034 (AJG) (Bankr. S.D.N.Y. Dec. 2, 2001); *In re Pacific Gas & Electric Co.*, Case No. 01-30923 (DM) (Bankr. N.D. Cal. April 6, 2001).
6. See 11 U.S.C. §1102(a)(1)-(2).
7. See e.g., *In re Johns-Manville Corp.*, 68 B.R. 155, 161 (S.D.N.Y. 1986) ("Since one of its most important functions is to negotiate a reorganization plan, a committee will most effectively exercise its responsibilities at the beginning of a reorganization, prior to the formulation of a plan."); *In re Kalvar Microfilm*, 195 B.R. 599 (Bankr. D. Del. 1996) (denying request to appoint committee filed two months into case that was product of extensive negotiations with prepetition unsecured debt holders and debtor filed pre-negotiated plan with petition).
8. 281 B.R. 216 (Bankr. S.D.N.Y. 2002).
9. Motion of Appaloosa Management L.P. Pursuant to 11 U.S.C. §1102(a)(2) for an Order Directing the United States Trustee to Appoint an Equity Committee in these Chapter 11 Cases, *In re Delphi Corp.*, Case No. 05-44481 (RDD) (S.D.N.Y. Dec. 22, 2005), ¶9 [hereinafter the Appaloosa Motion].
10. See, e.g., *Production Resources Group LLC v. NCT Group, Inc.*, 863 A.2d 772 (Del. Ch. 2004) and cases cited therein.
11. Transcript of Section 1102(a)(2) Evidentiary Hearing Before the Honorable Robert D. Drain, United States Bankruptcy Judge, *In re Delphi Corp.*, Case No. 05-44481 (RDD) (S.D.N.Y. March 22, 2006) at 180:21.
12. Id. at 185: 17-22.
13. Id. at 170: 21-23.