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IN THIS ISSUE

1 **Successful Reorganization of Kaiser Aluminum Corporation**
Kaiser Aluminum and 20 of its subsidiaries, with Jones Day as counsel, emerged from chapter 11 protection on July 6, 2006, relieved of $4 billion in debt.

4 **The Cautionary Tale Continues: Debt Acquired From Recipient of Voidable Transfer Subject to Disallowance Under Section 502(d)**
A New York bankruptcy court ruled that an assigned claim can be disallowed under section 502(d) of the Bankruptcy Code if the assignor was allegedly the recipient of a voidable transfer.

5 **Newsworthy**

10 **Airline Focus: Using Section 1113 to Navigate Stormy Skies**
The bankruptcy court overseeing Delta Air Lines subsidiary Comair denied the carrier's motion to reject a collective bargaining agreement with its flight attendants, ruling that the debtor did not negotiate in good faith and that its proposal was not fair and equitable.

12 **From the Top**
Brief discussion of the U.S. Supreme Court's three bankruptcy rulings during the first six months of 2006.

17 **Creditor Disenfranchised After Failing to Seek Temporary Allowance of Its Claim**
The Fourth Circuit Court of Appeals held that neither the Rooker-Feldman doctrine nor local bankruptcy court rules excuse a creditor's failure to obtain an order temporarily allowing its claim so that it can vote on a plan.

SUCCESSFUL REORGANIZATION OF KAISER ALUMINUM CORPORATION

On July 6, 2006, with Jones Day's assistance as reorganization counsel, Kaiser Aluminum and 20 of its subsidiaries successfully emerged from chapter 11 protection, having resolved more than $4 billion in liabilities, many of which were unusually complex. Kaiser emerged virtually debt-free, with substantial liquidity and streamlined business operations that are considered first in class in the aluminum industry. The reorganization plan, which was confirmed by the U.S. Bankruptcy Court for the District of Delaware on February 6, 2006, and affirmed by the U.S. District Court for the District of Delaware on May 11, 2006, received over 90 percent acceptance by every class of creditors entitled to vote.

Kaiser, which was founded by well-known industrialist Henry J. Kaiser in 1946, commenced its reorganization case on February 12, 2002. At that time, it faced, among other issues, massive numbers of asbestos and other tort claims, significantly underfunded pension plans, crushing retiree medical obligations, and scores of environmental liabilities associated with numerous sites. In addition, Kaiser faced significant near-term debt maturities, including two issuances of senior notes with an aggregate outstanding principal balance of approximately $398 million (collectively, the "Senior Notes") and an issuance of senior subordinated notes with an outstanding principal balance of $400 million (the "Senior Subordinated Notes" and, together with the Senior Notes, the "Notes"). At the time of the filing, Kaiser had worldwide operations in all principal aspects of the aluminum industry—the mining of bauxite, the refining of bauxite into alumina, the production of primary aluminum from alumina, and the manufacture of both fabricated and semi-fabricated aluminum products. Much of the bauxite mining, alumina refining, and aluminum production was conducted

at overseas facilities owned through five nondebtor, joint venture affiliates in which Kaiser had less than a 100 percent ownership interest (collectively, the "Joint Ventures").

As part of the agreements in connection with the Joint Ventures, Kaiser was obligated to fund a percentage of the cash costs for each facility's operations and purchase a percentage of each facility's output. Failure to either fund the costs of, or purchase output from, the Joint Ventures could have resulted in forfeiture of Kaiser's ownership interests in the Joint Ventures. To ensure the preservation of these significant Joint Venture interests and the related flow of product from the Joint Ventures, which was critical to Kaiser's integrated operations, at the outset of the chapter 11 filing Kaiser obtained, with Jones Day's assistance, authority from the bankruptcy court to continue funding the Joint Ventures. In addition to that relief and other critical "first day" relief that was successfully obtained from the bankruptcy court, Jones Day assisted Kaiser in securing access to a $200 million postpetition revolving credit facility.

Once Kaiser's postbankruptcy operations were stabilized, the company began formulating a strategic plan. After extensive deliberations and consultations with its financial advisors, Kaiser proposed a strategic plan to its principal creditor constituents that involved the divestiture of most of its bauxite, alumina, and aluminum assets and a reorganization around its fabricated-products business. The creditors, with the assistance of their financial advisors, thoroughly reviewed and ultimately approved the strategic plan.

After formulating its strategic plan, the company focused its efforts on the multifold task of restructuring its substantial bond, retiree medical, pension, tort, intercompany, and environmental liabilities. Kaiser and Jones Day first sought to resolve the company's legacy liabilities—more than $600 million in underfunded pension liabilities and $790 million in retiree medical liabilities. Kaiser had eight separate defined benefit pension plans as well as retiree medical programs, most of which were provided pursuant to collective bargaining agreements with various unions. Annual benefit payments in respect of Kaiser's retiree medical liabilities were running $60 million, with cash requirements projected to increase substantially in future years due to a variety of factors, including double-digit percentage increases in medical and prescription drug costs and increased life expectancies of covered individuals. Required contributions to Kaiser's pension plans for hourly employees were projected to aggregate more than $274 million for calendar years 2004 through 2009.

A team of Jones Day attorneys including Gregory M. Gordon (Dallas), Henry L. Gompf (Dallas), Troy B. Lewis (Dallas), Daniel P. Winikka (Dallas), John R. Cornell (New York), Carl M. Jenks (New York), Candace A. Ridgway (Washington), Richard F. Shaw (Pittsburgh), Richard A. Chesley (Chicago), and Robert J. Graves (Chicago) represented Kaiser Aluminum Corporation and 20 of its affiliates in connection with their emergence from chapter 11 protection on July 6, 2006, in accordance with the terms of a joint plan of reorganization under which the companies eliminated approximately $4 billion in debt.

To achieve a resolution of these liabilities, the company, with the assistance of Jones Day, entered into negotiations with the United Steelworkers and four other labor unions, the Pension Benefit Guaranty Corporation (the "PBGC"), and a committee of salaried retirees. Although progress was being made in the negotiations, to bring closure to the issues, Kaiser, with Jones Day's assistance, filed motions requesting that the bankruptcy court (i) authorize the termination or substantial modification of the retiree medical obligations, (ii) determine that the financial requirements for a distress termination of certain of the pension plans were satisfied and authorize implementation of replacement defined contribution plans for active employees, and (iii) authorize the rejection of certain collective bargaining agreements as necessary to terminate certain of the pension plans. Shortly after filing these motions, Kaiser reached negotiated agreements with the unions and the retirees' committee that were eventually approved by the bankruptcy court. With respect to retiree medical liabilities, the agreements provided for the termination of all retiree medical plans and the establishment of voluntary employees' beneficiary associations to provide medical benefits to retirees and to be funded by a certain percentage of the equity of the reorganized Kaiser

and certain cash payments, including payments based on percentages of the reorganized Kaiser's after-tax profit. The agreements also provided for the termination of certain pension plans for hourly employees and the implementation of replacement pension plans.

The company, however, had to engage in litigation against the PBGC regarding the distress termination of Kaiser's pension plans. The litigation with the PBGC was ultimately resolved pursuant to a comprehensive settlement, resulting in the termination of Kaiser's three largest pension plans (representing over 90 percent of the liability) and the resolution of all the PBGC's administrative and unsecured claims against Kaiser. The settlement permitted the PBGC to continue its appeal to the Third Circuit Court of Appeals regarding the distress termination of certain smaller pension plans. Kaiser prevailed on the distress-termination issues in the bankruptcy court and the district court, and the Third Circuit recently affirmed the lower court decisions. The decisions of the bankruptcy court and district court have set a significant precedent regarding the standards for distress termination of multiple pension plans.

The official committee of unsecured creditors opposed these agreed resolutions of the retiree medical and pension issues absent resolution of Kaiser's intercompany claims. Kaiser's operations, which included transactions with the Joint Ventures and the use of a centralized cash management system, gave rise to a significant number of intercompany claims, in some cases aggregating more than $1 billion. In addition to the complex nature of the transactions and the significant amounts involved, there were numerous legal theories and arguments that could have been advanced to support varying treatments of all or a portion of the intercompany claims or to apply principles of setoff or recoupment to eliminate all or substantially reduce certain of the claims. Because some of the Kaiser entities did not commence their chapter 11 cases until January 2003—almost a year after the other Kaiser entities—novel issues were also presented regarding, among other things, the treatment of certain intercompany claims among the debtors that constituted a prepetition obligation of one Kaiser debtor but a postpetition obligation of the other Kaiser debtor. Threatened litigation over these issues jeopardized the retiree medical and pension settlements, as well as the reorganization as a whole.

With Jones Day's assistance, after protracted negotiations with the creditors' committee, the company successfully reached a complex global settlement of the intercompany claims that involved cash payments, offsets of claims, releases, and permission to substantively consolidate certain Kaiser entities. The intercompany claims settlement, once approved by the bankruptcy court, would enable the Kaiser subsidiaries that held most of the Joint Venture interests, which were at that time in the process of being sold as the strategic plan contemplated, to proceed with separate plans of liquidation without awaiting the formulation and confirmation of a plan of reorganization for the remaining Kaiser entities. Because of this proposed separation of the Kaiser entities, the asbestos claimants' committee and the bankruptcy court–appointed legal representatives for future asbestos and other tort claimants each filed an objection to the intercompany claims settlement. Those objections were ultimately resolved by an agreement among all principal constituencies on a plan of reorganization term sheet setting forth, among other things, the parameters for the treatment of the various tort claims and future demands under any plan of reorganization for the reorganizing Kaiser entities.

The tort claims that had to be addressed included not only asbestos claims and future demands—there were more than 100,000 pending asbestos-related lawsuits against Kaiser when the chapter 11 cases were filed—but also a significant number of non-asbestos tort claims and future demands, including claims relating to alleged injuries caused by exposure to silica, coal-tar-pitch volatiles, and excess occupational noise. The plan resolves each of these categories of tort claims through (a) the creation of trusts funded by a cash payment of $13 million, 6.4 percent of the equity in the reorganized company (plus 100 percent of the stock of a subsidiary with limited assets), and rights to insurance proceeds and (b) the implementation of channeling injunctions permanently directing these tort claims and future demands from Kaiser to the trusts. The primary source of funding for the trusts will consist of the proceeds of insurance coverage settlements that Kaiser entered into with its insurers prior to the plan's effective date, which proceeds total more than $1.2 billion.

Because of the nature of its operations, which had been conducted at many sites, Kaiser also faced significant environmental liabilities. Jones Day assisted Kaiser in resolving

these liabilities through the chapter 11 process. During the course of the bankruptcy cases, Kaiser entered into numerous consent decrees that collectively resolved the environmental liabilities related to numerous sites, including a multisite consent decree with certain federal agencies and states that resolved more than $727 million of environmental claims relating to 66 sites.

While dealing with all these issues, Jones Day also assisted Kaiser in implementing its strategic business plan, which resulted in the sales of most of Kaiser's commodities businesses worldwide, comprising all but one of Kaiser's Joint Venture interests. Those sales included sales of Kaiser's mining and refinery interests in Jamaica, an interest in an alumina refinery in Australia, and interests in a smelter in Ghana and a refinery in Louisiana. The Joint Venture structures, including rights of first refusal and rights of first opportunity held by certain of the Joint Venture partners, raised difficult issues in many of the transactions, requiring the establishment of creative structures to preserve those rights and also comply with appropriate bankruptcy auction procedures.

The proceeds of these sales, which aggregated approximately $700 million, are being distributed to creditors pursuant to separate liquidating plans that were confirmed by the bankruptcy court in December 2005. The liquidating plans were subject to extensive litigation among the Kaiser debtors; the respective indenture trustees for the Notes, which were guaranteed by the Kaiser entities that held the Joint Venture interests as well as certain other Kaiser entities; and certain material holders of Notes regarding the subordination provisions in the indenture for the Senior Subordinated Notes. Kaiser and the indenture trustees for the Senior Notes prevailed in the litigation in the bankruptcy court, and the subordination issues are currently on appeal to the district court.

As a result of the commodities business sales discussed above and the sales of other nonstrategic assets, Kaiser has now divested itself of most of its bauxite mining, alumina refining, and aluminum-production operations, retaining only a 49 percent interest in an aluminum smelter in Wales. Kaiser currently owns 11 aluminum-fabricating plants in North America. Before filing for protection, Kaiser was burdened by approximately $4 billion in debt, on a consolidated basis, but has emerged from bankruptcy with virtually no debt.

THE CAUTIONARY TALE CONTINUES: DEBT ACQUIRED FROM RECIPIENT OF VOIDABLE TRANSFER SUBJECT TO DISALLOWANCE UNDER SECTION 502(D)

Mark G. Douglas

In the January/February 2006 edition of *Business Restructuring Review* (Vol. 5, No. 1), we reported on a highly controversial ruling handed down by the New York bankruptcy court overseeing the chapter 11 cases of embattled energy broker Enron Corporation and its affiliates. The court held that a claim is subject to equitable subordination under section 510(c) of the Bankruptcy Code even if it is assigned to a third-party transferee who was not involved in any misconduct committed by the original holder of the debt.

The ruling had players in the distressed securities market scrambling to devise better ways to limit their exposure by building stronger indemnification clauses into claims transfer agreements. The "buyer beware" approach articulated by bankruptcy judge Arthur J. Gonzalez has been greeted by a storm of criticism from lenders and traders alike, including the Loan Syndications and Trading Association ("LSTA"); the Securities Industry Association; the International Swaps and Derivatives Association, Inc.; and the Bond Market Association. According to these groups, if *caveat emptor* is the prevailing rule of law, claims held by a bona fide purchaser can be equitably subordinated even though it may be impossible for the acquirer to know, even after conducting rigorous due diligence, that it was buying loans from a "bad actor."

Judge Gonzalez recently expanded the scope of his cautionary tale to encompass not only subordination of a transferred claim, but disallowance of the claim altogether. In *In re Enron Corp.,* he ruled that a transferred claim should be disallowed under section 502(d) of the Bankruptcy Code unless and until the transferor returns payments to the estate that are allegedly preferential. Judge Gonzalez also held that the safe harbor for good-faith recipients of avoidable transfers does not apply to the assignee of a claim and that even if it did, an assignee cannot qualify for the defense because it is presumed to have knowledge at the time it acquires a claim of both the debtor's precarious financial circumstances

NEWSWORTHY

Corinne Ball (New York), **Jeffrey B. Ellman (Atlanta)**, **Paul E. Harner (Chicago)**, **David G. Heiman (Cleveland)**, **Paul D. Leake (New York)**, **Heather Lennox (Cleveland)**, and **Charles M. Oellermann (Columbus)** were recognized by Chambers USA as being among the finest attorneys in the bankruptcy/restructuring practice area for 2006.

Corinne Ball (New York) was recognized by the K&A Restructuring Register as one of the outstanding attorneys practicing in the restructuring, reorganization, insolvency, and bankruptcy arenas in the United States in 2006. Qualification for listing in the Register is by invitation only and requires selection by an 18-member advisory panel.

On June 9, 2006, **Paul E. Harner (Chicago)** participated in a panel discussion of recent Supreme Court and Third Circuit decisions of interest to business bankruptcy practitioners, at the "Views from the Delaware Bench and Bar" seminar in Wilmington, Delaware, jointly sponsored by the American Bankruptcy Institute and the Delaware State Bar Association.

Gregory M. Gordon (Dallas) recorded podcasts on June 2 and July 10, 2006, for *Texas Lawyer* concerning, respectively, "Creative Solutions to Addressing the Recent Bankruptcy Amendment Limits on Key Employee Retention Plans" and "The Availability of Sovereign Immunity in Bankruptcy."

An article written by **Mark G. Douglas (New York)** entitled "In Search of a 'Good Faith' Filing Requirement for Non-Consumer Debt Chapter 7 Cases" appeared in the June 2006 edition of *Pratt's Journal of Bankruptcy Law*. His article entitled "Bankruptcy Battleground: Even 'Core' Disputes May Be Subject to Arbitration" was published in the June 2006 edition of *The Bankruptcy Strategist*.

or bankruptcy filing and the likelihood that an investigation will be conducted into possible grounds for disallowance of the claim.

ALLOWANCE AND DISALLOWANCE OF CLAIMS IN BANKRUPTCY

Whether a creditor's claim is allowed or disallowed in a bankruptcy case is governed by the procedures contained in section 502 of the Bankruptcy Code. Section 502(a) provides that a filed proof of claim is deemed allowed unless a party-in-interest files a written objection with the court. If an objection is filed, section 502(b) directs the bankruptcy court to determine the allowed amount of the claim after notice and a hearing in accordance with certain restrictions and limitations specified in the statute (*e.g.,* disallowing claims for unmatured interest and capping landlord claims for future rent).

Section 502(c) of the Bankruptcy Code mandates the estimation of almost any contingent or unliquidated claim if the failure to do so "would unduly delay the administration of the case." Thus, for example, if litigation is pending against the debtor when it files for bankruptcy, but has not yet gone to trial, the bankruptcy court can estimate the debtor's liability to the plaintiffs in lieu of modifying the automatic stay to allow the action to proceed until judgment.

The Bankruptcy Code also provides for the temporary estimation of a claim. Under Rule 3018(a) of the Federal Rules of Bankruptcy Procedure, a bankruptcy court "may temporarily allow [a] claim or interest in an amount which the court deems proper for the purpose of accepting or rejecting a plan." Temporary allowance of a claim for the limited purpose of voting on a plan is appropriate because creditors whose claims are disputed would otherwise be completely

disenfranchised in chapter 11 cases where the claims resolution process cannot be completed prior to voting.

The statute also creates a mechanism to penalize certain creditors who have possession of estate property on the bankruptcy petition date or are the recipients of pre- or postbankruptcy asset transfers that can be recovered because they are fraudulent, preferential, unauthorized, or otherwise subject to forfeiture by operation of a bankruptcy trustee's avoidance powers. Section 502(d) of the Bankruptcy Code provides that the court shall disallow any claim asserted by a creditor who falls into one of these categories, "unless such entity or transferee has paid the amount, or turned over any such property, for which such entity or transferee is liable." The purpose of the provision is to facilitate pro rata distribution of the bankruptcy estate among all creditors and to coerce payment of judgments obtained by the trustee. Most courts take the approach that the underlying avoidance claims must be adjudicated fully before a claim can be disallowed under section 502(d). Some courts, noting that the statute refers to property that is "recoverable" or a transfer that is "avoidable," find that colorable allegations to that effect are sufficient to trigger temporary disallowance for certain purposes (*e.g.,* voting on a plan of reorganization or to receive distributions of estate property) subject to later reconsideration.

CLAIMS TRADING

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 be often 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. In most cases, however, an assigned claim is also 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 pretransfer conduct of the transferor.

Only a handful of courts have considered the application of section 502(d) to a claim that has been assigned by a creditor who allegedly falls within the scope of the statute. The New York bankruptcy court was the latest to address the question in *Enron.*

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 co-administrative 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 acquirers. 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.

Enron sued the banks in 2003, claiming, among other things, that Fleet and certain of its affiliates were the recipients of prebankruptcy 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 or transfers made or obligations incurred in connection with the agreements. Instead, Enron's allegations concerned an unrelated prepaid forward transaction involving the same lenders that took place in 2000. In a separate proceeding filed in 2005, Enron sought to subordinate and disallow Fleet's claims under the credit

agreements. Enron sought to equitably subordinate the claims under section 510(c) and to disallow them under section 502(d) even though Fleet had transferred the claims to the defendants. The defendants moved to dismiss the proceeding.

THE BANKRUPTCY COURT'S RULING

As previously reported, the bankruptcy court denied the motion to dismiss Enron's equitable subordination claims, ruling that a debt can be subordinated even if assigned to a blameless transferee. In a separate opinion, the court addressed dismissal of Enron's causes of action against the defendants under section 502(d). Consistent with its previous determination, the bankruptcy court reaffirmed the principle that a transferred claim is subject to the same shortcomings, including any defenses, to which it was subject in the hands of the original holder of the obligation.

At the outset, the court examined whether entry of a judgment in the underlying avoidance action is a prerequisite to disallowance of a claim under section 502(d). It ruled that prior adjudication on the merits is unnecessary under the circumstances because, in connection with a motion to dismiss, it need only decide whether Enron's causes of action under section 502(d) are viable pending adjudication of the avoidance litigation. Even so, based upon its conclusion (discussed below) that Enron's section 502(d) claim is viable, the court held that "no distribution can be made to the Defendants with respect to the Claims pending a resolution of their disputed claims."

Next, the bankruptcy court addressed the application of section 502(d) to assigned claims. It rejected the defendants' argument that the plain language of the statute supports the position that a claim can be disallowed only if the holder of the claim can be a defendant in an avoidance or recovery proceeding. According to the court, section 502(d) clearly applies to "any claim" of an entity from whom property or its value can be recovered—it does not require that the claim be related to an avoidable transfer or that such a transfer or other basis for liability occur after a creditor acquires a claim. Observing that "[t]he Court has not found any case law mandating that the creditor who received an avoidable transfer be the same entity that actually asserts such claim against the debtor in the bankruptcy proceeding in order for a debtor to assert a section 502(d) disallowance against the claim," the bankruptcy court ruled that the defendants' claims were subject to the same defenses that applied to them when the claims were held by Fleet.

Responding to policy concerns implicated by a ruling that might encourage "claim washing," on the one hand, or undermine confidence in the claims-trading market, on the other, the bankruptcy court emphasized that the proper inquiry should focus on ensuring that the purpose of section 502(d) is not contradicted or undermined. It rejected the defendants' argument that their claims should not be subject to disallowance because Enron has a remedy against Fleet, a solvent entity that would be bound by any judgment issued by the court. According to the bankruptcy court, "[t]he solvency of an entity or creditor is not a factor or element required to be considered under section 502(d) of the Bankruptcy Code."

The allowance of a claim assigned by the recipient of a voidable transfer, the court observed, "would eviscerate the purpose of section 502(d)" because it would force a bankruptcy trustee or chapter 11 debtor-in-possession to act affirmatively to seek recovery from the original creditor rather than relying on section 502(d) as a defense that, when invoked, bars any distribution of estate funds to the holder of the claim. The bankruptcy court was unmoved by the defendants' contentions regarding an adverse impact on the claims-trading market, remarking that "participants in the claims-transfer market are aware of, or should be aware of, the risks and uncertainties inherent in the purchase of claims against the debtors, including the possibility of claims being temporarily disallowed under section 502(d) unless and until their predecessors turn over the avoidance transfers." Participants in the market, the court emphasized, assume the liabilities arising from acquired claims. According to the court, the risks associated with buying claims in a bankruptcy proceeding have been identified in the distressed debt industry for at least a decade and participants have dealt with such risks by including broad indemnification language in claims transfer agreements, such as the Standard Terms and Conditions on the Purchase and Sale Agreement for Distressed Trades published by the LSTA.

Finally, the bankruptcy court turned to the defendants' claim that, as "innocent" transferees, they are entitled to assert a "good faith" defense. The court explained that section 550

of the Bankruptcy Code, which is incorporated into section 502(d), provides that, even if a transfer is avoidable as a preference, fraudulent conveyance, or otherwise, the bankruptcy trustee may not recover the property or its value from any transferee "who takes for value, . . . in good faith, and without knowledge of the voidability of the transfer avoided." According to the defendants, the "good faith" defense should be extended to purchasers of claims, and because they had no knowledge of any of the allegations asserted in Enron's suit against Fleet when they purchased their claims, the claims should not be disallowed under section 502(d).

The bankruptcy court ruled that section 550(b) does not apply to claims transferees, and that, even if it did apply, the defendants could not establish that they were entitled to rely on the good-faith defense. Section 550(b), the court explained, on its face and by intention, protects only good-faith purchasers of estate property—there is no authority to support the proposition that its scope extends to purchasers of claims against the estate. Moreover, the court emphasized, even if the scope of the statute were broad enough to protect transferees of claims, the defendants could not successfully invoke the good-faith defense because "a purchaser of a claim, by definition, knows that it is purchasing a claim against a debtor and is on notice that any defense or right of the debtor may be asserted against that claim."

According to the court, the criteria for determining whether a transferee acted in good faith in purchasing a claim "does not solely rely upon such transferee's actual knowledge of whether the claims would be challenged." Instead, the bankruptcy court explained, a claims transferee cannot rely on section 550(b) if it has either (i) knowledge of the debtor's possible insolvency or unfavorable financial condition at the time of the transfer or (ii) notice that the transfer may be recovered by the trustee. Applying these criteria, the court concluded that the defendants clearly were not "without knowledge of the voidability of the transfer" as required by section 550(b). It accordingly denied the defendants' motion to dismiss Enron's causes of action under section 502(d).

OUTLOOK

Enron is not the first decision to address the disallowance of assigned claims under section 502(d) or its predecessor. The Eighth Circuit Court of Appeals confronted the issue over a century ago in *Swarts v. Siegel,* disallowing an assigned claim under section 57g of the Bankruptcy Act of 1898 because the original holder had received a preference and remarking that "[t]he disqualification of a claim for allowance created by a preference inheres in and follows every part of the claim, whether retained by the original creditor or transferred to another, until the preference is surrendered." More recently, Judge Robert D. Drain of the United States Bankruptcy Court for the Southern District of New York reached the same conclusion under the current statute in *In re Metiom, Inc.,* characterizing the attempted destruction of a section 502(d) claim defense by means of assignment of the claim as "a pernicious result" and observing that "[t]he assignment should not, and does not, affect the debtor's rights vis-à-vis the claim; it is incumbent, instead, on prospective assignees to take into account possible claim defenses when they negotiate the terms of their assignments."

The defendants in *Enron* relied on an unpublished opinion issued by a Texas district court in *Section 1102(A)(1) Comm. of Unsecured Creditors v. Williams Patterson, Inc. (In re Wood & Locker, Inc.)*, as support for the proposition that a claim in the hands of a transferee can be disallowed only if the transferee is subject to avoidance liability. In that case, the creditors' committee commenced preference litigation against a creditor that had assigned its claim to a bank. The bank was permitted to intervene in the avoidance action and later commenced a separate adversary proceeding seeking a declaratory judgment that it was not subject to preference liability under sections 547 and 550, and that its assigned claim could not be disallowed under section 502(d), so that it was entitled to receive distributions under the debtor's chapter 11 plan. The bankruptcy court granted summary judgment in the bank's favor on these issues.

On appeal, the district court explained that, under the former Bankruptcy Act, a creditor had the option of retaining a preference and forgoing any distribution from the estate or seeking recovery from the estate by filing a proof of claim. The trustee could invoke section 57g as a defense only in the latter case. "Such is not the case under the modern Code," the district court observed, emphasizing that "[t]he analytical tool to unlock the mysteries of Sec. 502(d) is to examine the

enumerated sections to determine whether the transferee has liability. Where there is no liability under those sections, Sec. 502(d) is not triggered."

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.

In *Enron*, Judge Gonzalez found *Wood* to be unpersuasive. He explained that the district court cited no authority for its interpretation of section 502(d) from either relevant case law or the provision's legislative history, which indicates that the focus of sections 57g and 502(d) is the same and that both provisions concern not the holder of a claim, but the claim itself. Judge Gonzalez also faulted the court in *Wood* for dismissing *Swarts* and other decisions interpreting section 57g as inapposite because they "involved sureties who had received provable and traceable direct benefits by the payment of the preferences," whereas no funds were traceable to the bank/transferee in *Wood*. According to Judge Gonzalez, "although there were factual differences between *Swarts* and *Wood*, those factual differences do not undermine the legal principle that 'the disqualification of a claim for allowance created by a preference inheres in and follows every part of the claim, whether retained by the original creditor or transferred by another, until the preference is surrendered.' "

The defendants in *Enron* also relied on *Maxwell Communication Corp. PLC v. Société Générale PLC (In re Maxwell Communication Corp.)* as authority for the principle that section 502(d) disallows only claims asserted by entities that have received voidable transfers. In *Maxwell*, the debtor, a U.K. corporation, sold certain U.S. assets and used the proceeds to pay obligations owed to three different U.K. banks shortly before filing for chapter 11 protection in the U.S. and filing a petition in the High Court of Justice in London for an administration order under the U.K. Insolvency Act of 1986.

After the banks filed their claims with the English court, the debtor commenced litigation in the U.S. bankruptcy court to avoid the payments to the banks as preferential and to disallow their claims under section 502(d). The U.K. banks moved to dismiss, arguing that an English court should adjudicate the preference claims applying English law because the debtor was a U.K. corporation, the recipients were U.K. banks, and the transfers were made overseas. The bankruptcy court agreed.

On appeal to the district court, the debtor contended, among other things, that even if the transfers could not be avoided under section 547, the claims filed by the banks in the U.K. should be disallowed under section 502(d). The district court rejected this argument:

> In order for a transferee's claim to be disallowed under § 502(d), however, it must have received a "transfer avoidable" under § 547. Obviously, the Banks have not received a "transfer avoidable" under § 547 because that section does not apply to the payments to the Banks. In addition, § 502 only applies to the allowance and disallowance of claims filed under 11 U.S.C. § 501. *See Durham v. SMI Indus Corp.*, 882 F.2d 881, 883 (4th Cir. 1989) ("Since a court can only disallow a claim after one has been filed under [section 501(a)], 'claim' in § 502(d) includes only one for which a proof has been filed."). As discussed above, the Banks have lodged a Notice of Claim in the English court but have not filed a Proof of Claim under § 501 and thereby submitted to the equitable jurisdiction of the U.S. court. Accordingly, there are no "claims" to disallow under § 502(d), and the appellants are therefore not entitled to the relief they seek.

The *Enron* court distinguished *Maxwell* because the entities asserting the claims in the case were the recipients of voidable transfers rather than purchasers of claims against the debtor. It also faulted the court's reasoning concerning the submission of a proof of claim as a condition to disallowance under section 502(d), observing that "[i]t is well established that 'section 502(d) does not deal with proofs of claim.' " The bankruptcy estate, the court emphasized, "can demand a creditor to surrender any avoidable transfers even in a circumstance where such creditor does not file a proof of claim against the debtor and thereby waives any distribution from the estate."

Even if *Enron* is not the first ruling on this issue, it may have a greater influence in terms of its impact on the claims-trading market. 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* could potentially increase the due diligence obligations for these trades. A transferor's creditworthiness, for example, may figure more prominently in an acquirer's calculus of the risks. Also, significant expense could be involved in litigation seeking indemnification.

The viability of *Enron* in cases involving securities or claims other than bank debt is not clear. In *dicta*, Judge Gonzalez suggested that the same rule should apply to traded claims based upon bonds or notes because the "post-petition purchaser of such debt instruments either knows or should know that the issuer of these securities is a debtor, so the prices of these transfers would reflect the attendant risks that the claims would be subordinated [sic]." He presumably intended to say "disallowed" rather than "subordinated," given the circumstances. Even so, the judge did not hazard an opinion on whether a different rule would apply if a note or bond is traded before the debtor files for bankruptcy, when the purchaser has no reason to be aware of anything other than the possibility that the obligor may file a bankruptcy case. Finally, in other contexts, nonbankruptcy law may insulate from attack certain kinds of claims held by a holder in due course or a good-faith purchaser.

In re Enron Corp., 340 B.R. 180 (Bankr. S.D.N.Y. 2006).

Swarts v. Siegel, 117 F. 13 (8th Cir. 1902).

In re Metiom, Inc., 301 B.R. 634 (Bankr. S.D.N.Y. 2003).

Section 1102(A)(1) Comm. of Unsecured Creditors v. Williams Patterson, Inc. (In re Wood & Locker, Inc.), 1988 U.S. Dist. LEXIS 19501 (D. Tex. 1988).

Maxwell Communication Corp. PLC v. Société Générale PLC (In re Maxwell Communication Corp.), 186 B.R. 807 (S.D.N.Y. 1995).

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AIRLINE FOCUS: USING SECTION 1113 TO NAVIGATE STORMY SKIES

Mark G. Douglas

The continuing financial malaise of U.S. air carriers has featured prominently in recent headlines, as airlines such as Northwest, Delta, Mesaba Aviation, Independence Air, and Era Aviation all sought chapter 11 protection in 2005 in an effort to manage a staggering confluence of nearly five years of lagging demand, high fuel prices, and escalating labor costs. A fair amount of scrutiny in connection with these developments has been devoted to the carriers' reliance on a chapter 11 filing (or the threat of one) as a way to reduce unionized labor costs by taking advantage of a provision in the Bankruptcy Code that allows a chapter 11 debtor-in-possession ("DIP") or bankruptcy trustee to reject a collective bargaining agreement. The bankruptcy court overseeing the chapter 11 case of Delta subsidiary Comair recently had an opportunity to examine the circumstances under which a labor agreement can be rejected in a chapter 11 case. The court denied the rejection motion, ruling that Comair failed to negotiate with the representative of its unionized flight attendants in good faith concerning proposed wage reductions.

COLLECTIVE BARGAINING AGREEMENTS IN BANKRUPTCY

Section 365 of the Bankruptcy Code allows a bankruptcy trustee or DIP to assume (reinstate) or reject (breach and terminate) most kinds of contracts or agreements that, as of the bankruptcy filing date, are "executory" in the sense that both parties to the contract have a continuing obligation to perform. For most kinds of contracts, the bankruptcy court will authorize assumption or rejection provided 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 DIP's decision to reject a collective bargaining agreement. The U.S. Supreme Court answered that question in 1984, ruling in *NLRB v. Bildisco & Bildisco* that a labor agreement can be rejected under section 365 if it burdens the estate, the equities favor rejection, and the debtor made reasonable efforts

to negotiate a voluntary modification without any likelihood of producing a prompt satisfactory solution.

Congress changed that 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 if:

> the debtor makes a proposal to the authorized representative of the employees covered by the agreement;
>
> the authorized representative has refused to accept the debtor's proposal without good cause; and
>
> 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 modification proposal treats all creditors, the debtor, and other stakeholders parties fairly. 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."

SPLIT IN AUTHORITY

Courts are split on which modifications to a bargaining agreement qualify as "necessary" within the meaning of section 1113. In *Wheeling-Pittsburgh Steel Corp. v. United Steelworkers of America*, the Third Circuit ruled that the term "necessary" includes only those minimum modifications that the debtor "is constrained to accept because they are directly related to the company's financial condition and its reorganization," in effect holding that the terms "necessary" and "essential" are synonymous. Moreover, the Third Circuit ruled, in keeping with section 1113's purpose, the objective of the modifications should be the short-term "goal of preventing the debtor's liquidation."

The Second Circuit rejected this approach in *Truck Drivers Local 807 v. Carey Transportation, Inc.* There, the Court of Appeals held that, in determining the degree and purpose of "necessary" modifications, "the necessity requirement places on the debtor the burden of proving that its proposal is made in good faith, and that it contains necessary, but not absolutely minimum, changes that will enable the debtor to complete the reorganization process successfully." In adopting this approach, the court focused on the long-term goal of reorganization, rather than the short-term goal of preventing liquidation. A majority of courts have adopted the more flexible approach articulated in *Carey Transportation*.

Section 1113's requirements regarding the provision of adequate information and the obligation to negotiate in good faith were recently examined by the New York bankruptcy court overseeing Comair's chapter 11 case.

COMAIR

Comair, its parent company Delta Air Lines, and various affiliates filed for chapter 11 protection in September of 2005. Comair is a regional air carrier operating on average 800 flights each day between Cincinnati, New York, Boston, and Washington as part of the "Delta Connection" program, which also includes five other regional carriers. Comair has approximately 6,400 employees, of whom roughly half are unionized pilots, maintenance workers, and flight attendants. The work rules, wages, and benefits of these employee groups are governed by three separate collective bargaining agreements. The authorized bargaining representative of the flight attendants is the International Brotherhood of Teamsters ("IBT").

Flight attendants are at or near the low end of the compensation level for all Comair employees, with wages ranging from an average of $16.50 per hour and $21.70 per hour for "B scale" and "A scale" first-year flight attendants to just over $42 per hour for attendants with 18 years or more of seniority. Flight attendants are also paid an hourly expense allowance of $1.75 (referred to as a "per diem") for every hour that an attendant is away from base on assigned trips.

FROM THE TOP

The U.S. Supreme Court issued three rulings on the subject of bankruptcy during the first half of 2006. Those rulings dealt with the states' sovereign immunity under the 11th Amendment (*Central Virginia Community College v. Katz*), the effect of the probate exception on a bankruptcy court's jurisdiction (*Marshall v. Marshall*) and, most recently, the priority of unsecured claims based upon unpaid workers' compensation premiums a debtor employer owes its insurance carrier. We reported on *Katz* and *Marshall* in past editions of *Business Restructuring Review*.

The Court's most recent pronouncement in the realm of bankruptcy in 2006 is contained in *Howard Delivery Service, Inc. v. Zurich American Insurance Co.* The debtor is a freight company employing more than 480 workers in 12 states. Each state requires it to maintain workers' compensation insurance, which the debtor obtained from the same insurer in 10 states.

When the debtor filed for chapter 11 protection in 2002, it owed the insurer $400,000 for workers' compensation premiums. The insurer asserted that its claim should be afforded priority status under section 507(a)(5) of the Bankruptcy Code, which grants priority (currently up to $10,000 per employee) to "unsecured claims for contributions to an employee benefit plan . . . arising from services rendered within 180 days before the date of the filing of the petition date or the date of cessation of the debtor's business, whichever occurs first." The bankruptcy and district courts denied priority to the insurer's claim, but the Fourth Circuit Court of Appeals reversed, holding that the phrase "employee benefit plan" in section 507(a)(5) is ambiguous and that lawmakers likely intended to give past-due workers' compensation premiums priority status. The Supreme Court granted *certiorari* to settle a circuit split on the issue.

The Supreme Court reversed. Writing for the 6-3 majority, Justice Ginsburg explained that another provision in the statute—section 507(a)(4)—which grants priority status to "wages, salaries, or commissions," is linked to section 507(a)(5) by a combined cap on the two priorities per employee. Observing that "[n]o other subsections of § 507 are joined together by a common cap in this way," she noted that subsection (a)(5) allows the provider of an employee benefit plan to recover unpaid premiums "only after the employees' claims for 'wages, salaries, or commissions' have been paid" under subsection (a)(4). According to Justice Ginsburg, the function of subsection (a)(5) is to capture employee compensation that is not covered by subsection (a)(4). The "juxtaposition of the wages and employee benefit plan priorities," she reasoned, "manifests Congress' comprehension that fringe benefits generally complement, or 'substitute' for, hourly pay."

The insurer contended that because the terms encompassed by the phrase "contributions to an employee benefit plan . . . arising from services rendered" are not defined in the Bankruptcy Code, courts searching for a definition should be guided by the Employee Retirement Income Security Act ("ERISA"). Acknowledging that ERISA's definition of these terms is "susceptible" to encompassing workers' compensation plans, Justice Ginsburg rejected this approach and instead examined "the essential character of workers' compensation regimes."

Justice Ginsburg emphasized that, unlike pensions or group life, health, and disability plans, which are negotiated or granted as pay supplements or substitutes, workers' compensation has a "dominant employer-oriented thrust"—it modifies, or substitutes for, the common law tort liability to which employers are exposed for work-related accidents. Moreover, she explained, workers' compensation benefits provide a quid pro quo—employees receive limited benefits regardless of fault and employers avoid exposure to substantial judgments and heavy tort costs. "No such tradeoff," Justice Ginsburg observed, "is involved in fringe benefit plans that augment each covered worker's hourly pay." She also drew a distinction between pension plans and group health or life insurance plans, which ordinarily insure only employees, and workers' compensation insurance, which, like other liability insurance, shields the entire insured enterprise. Finally, Justice Ginsburg emphasized, states "overwhelmingly prescribe and regulate insurance coverage for on-the-job accidents, while commonly leaving pension, health, and life insurance plans to private ordering."

Justice Ginsburg rejected the insurer's argument that affording priority status to its claim under section 507(a)(5) would give workers' compensation carriers an incentive to continue insuring a distressed enterprise and promote its prospects for rehabilitation of the business. "Rather than speculating on how workers' compensation insurers might react were they to be granted an (a)(5) priority," she wrote, "we are guided in reaching our decision by the equal distribution objective underlying the Bankruptcy Code, and the corollary principle that provisions allowing preferences must be tightly construed."

Chief Justice Roberts and Justices Stevens, Scalia, Thomas, and Breyer joined the majority opinion. Justice Kennedy, joined by Justices Souter and Alito, dissented, arguing that " 'employee benefit plan,' whether viewed as a term of art or in accordance with its plain meaning, includes workers' compensation."

Central Virginia Community College v. Katz, 126 S. Ct. 990 (2006).

Marshall v. Marshall, 126 S. Ct. 1735 (2006).

Howard Delivery Service, Inc. v. Zurich American Insurance Co., 2006 WL 1639224 (June 15, 2006).

As part of Delta's restructuring plan, Delta reduced by approximately 3.8 percent the amount it pays to Comair under the Delta Connection program. Because Delta is Comair's only source of revenue, this meant that Comair had to make a corresponding reduction as part of its own restructuring plan. Comair's plan called for reductions totaling $27.2 million in annual collective bargaining agreement costs, of which $17.3 million was allocated to pilots, $8.9 million was allocated to flight attendants, and $1 million was allocated to mechanics. The flight attendants' portion of the cuts included reductions of $6.8 million in wages and $2.1 million in per diem payments as well as the elimination of funding for a retirement program.

The pilots and mechanics agreed to the cuts, subject to contingency clauses invalidating their approval unless all unionized groups agreed to the package of reductions. The flight attendants, however, did not ratify the reductions despite a series of bargaining sessions and proposals between Comair and IBT. During the course of these negotiations, Comair refused to negotiate its original demand for $8.9 million in aggregate cost reductions from the flight attendants, although it was willing to vary the mix of cost savings among pay rates, per diems, work rules, and other costs. By contrast, IBT's counterproposal would achieve approximately $1.89 million in cost savings, or approximately 25 percent of the amount originally allocated by Comair to the flight attendants.

Comair moved to reject the flight attendants' bargaining agreement under section 1113. The bankruptcy court segmented its examination of the standards governing rejection into five parts: (i) whether the modifications proposed by Comair are necessary to permit reorganization; (ii) whether Comair conferred with IBT in good faith; (iii) whether Comair's proposal ensures that all parties are treated fairly and equitably; (iv) whether IBT refused to accept the proposal without good cause; and (v) whether the balance of the equities clearly favors rejection of the bargaining agreement. In four out of five of these categories, the court concluded, Comair's request to reject the flight attendants' agreement was deficient.

The court rejected IBT's contention that the proposed cuts were not "necessary" for Comair to reorganize because Comair "is a healthy, viable, regional operation" and cost cuts already agreed to by other unions made it unnecessary for the flight attendants to make additional concessions to the extent requested by Comair. Applying the Second Circuit's definition in *Carey Transportation* of "necessary," the bankruptcy court characterized IBT's assertions regarding Comair's financial health as "contrary to the unrebutted evidence." It then proceeded to discredit IBT's "last man standing" argument, explaining that the proposal called for by section 1113 must not only be necessary, but also ensure that all affected parties "are treated fairly and equitably." According to the bankruptcy court, section 1113 "does not contemplate that any single group of employees such as the flight attendants will be subsidized by the sacrifices of others."

The bankruptcy court also concluded that Comair had not fulfilled its obligation to confer with IBT in good faith by steadfastly maintaining that its initial proposal was nonnegotiable. True negotiation, the court observed, "necessarily requires compromise in each side's bargaining positions." It rejected Comair's argument that the contingency clauses in agreements reached with the other unions render Comair's proposal nonnegotiable because at stake is not merely the $8.9 million demanded from the flight attendants, but the entire $27.2 million required from all three unions. Explaining that section 1113 demands that each proposal be judged according to the statutory criteria on its own merits, the bankruptcy court emphasized that "the tacit consequences" of Comair's arguments predicated on the contingency clauses would be to usurp the court's function in judging the sufficiency of Comair's proposal to IBT.

Next, the bankruptcy court ruled that Comair's proposal to IBT failed to pass muster under section 1113's "fair and equitable" requirement because Comair's nonnegotiable demand called for flight attendants, who were already near the bottom level of compensation among Comair employees, to contribute twice their pro rata share of the cost cuts, while pilots and mechanics were asked for less than their proportionate shares. Given all of the foregoing, the bankruptcy court explained, IBT's refusal to accept Comair's proposal was not without good cause.

Finally, the court inquired whether "the balance of the equities clearly favors rejection" of the flight attendants' collective bargaining agreement. The court acknowledged that Comair's flight attendants' salary and per diem rates are substantially higher than the rates of flight attendants employed by other U.S. regional carriers and that Comair had made a "persuasive showing" that narrowing the gap between its own labor costs and the labor costs of its competitors would play an important role in Comair's ultimate success or failure as a reorganized entity. Even so, the bankruptcy court emphasized, based upon the other deficiencies in Comair's proposal, the balance of the equities does not clearly favor rejection. The court accordingly denied Comair's motion to reject its collective bargaining agreement with the flight attendants, without prejudice to its renewal after further negotiations.

OUTLOOK

The quandary faced by Comair and its employees is emblematic of the grim reality that all carriers have been forced to confront in their ongoing efforts to regain profitability. There have been 162 airline bankruptcy filings since the government deregulated commercial aviation in 1978. Collectively, the industry has lost nearly $28 billion since 2001 and is projected to lose another $3 billion in 2006. The bleeding continues despite $7.4 billion in financial assistance from the federal government and $1.6 billion in loan guarantees to help commercial airlines recover from the effects of the terrorist attacks of September 11, 2001. Only low-cost carrier Southwest Airlines has been consistently profitable over the past few years, thanks in part to its ability to hedge fuel contracts successfully.

Airlines intent upon cost cutting cannot help taking a hard look at labor costs—wages and related benefits are one of the few line items over which they have any direct control. In most cases, this means that the carriers will need to renegotiate the terms of their collective bargaining agreements with unionized employees, either outside of bankruptcy or in chapter 11. As indicated by *Comair*, carriers faced with an impasse in effectuating "necessary" reductions will seek relief under chapter 11 and section 1113.

Delta Air Lines sought to reject the collective bargaining agreement with its pilots in 2005. UAL Corporation also tried to reject labor agreements with its unionized pilots and flight attendants but withdrew both motions after reaching a settlement with pilots concerning modification of the agreement to allow UAL to terminate the pilots' pension plan, and after reaching a settlement with the Pension Benefit Guaranty Corporation ("PBGC") regarding the latter's consideration of a possible distressed termination of the flight attendants' defined benefit pension plan (which ultimately occurred). The bankruptcy court overseeing Northwest Airlines' chapter 11 case granted the carrier's request to reject a collective bargaining agreement with its flight attendants on June 29, 2006, but stayed implementation of the order for two weeks to allow the parties to continue negotiating a voluntary compromise, failing which cuts proposed by Northwest to the Professional Flight Attendants Association at the beginning of March 2006 will take effect.

Comair is not the only airline debtor whose efforts to reject a labor agreement have failed to pass muster under section 1113, at least on the first attempt. A Minnesota bankruptcy court recently denied regional carrier Mesaba Aviation's motion to reject collective bargaining agreements with its unionized pilots, mechanics, and flight attendants, based upon the court's findings that the debtor refused to provide adequate information to the unions' bargaining representatives, even though the court concluded that the cost reductions proposed by the debtor were necessary to its reorganization.

The bad news for employees in these developments is that some degree of wage and cost cuts is unavoidable if the airlines are to keep flying. In fact, stonewalled once again by the unions after revising their cost-reduction proposals, both Comair and Mesaba Aviation went back to the bankruptcy court seeking authority to reject their bargaining agreements under section 1113. Both were successful on the second attempt.

Much more is at stake for the carriers, their employees, and U.S. taxpayers than the airline wage scale. The driving motivation in many cases for rejecting a collective bargaining

agreement concerns not only wages, but pension benefits that are incorporated into the contracts. By rejecting a bargaining agreement under section 1113, an airline can proceed to disavow its underfunded pension liability by effectuating a distressed termination of its pension plans.

Airlines intent upon cost cutting cannot help taking a hard look at labor costs—wages and related benefits are one of the few line items over which they have any direct control. In most cases, this means that the carriers will need to renegotiate the terms of their collective bargaining agreements with unionized employees, either outside of bankruptcy or in chapter 11.

When an airline or any other company terminates its pension plans, the PBGC gets stuck with the pension obligations. Since 1991, the government insurer has assumed nearly $12 billion in airline pension obligations. With an aggregate deficit of nearly $23 billion as of the end of 2005, the PBGC needs help, and Congress is scrambling to put together yet another aid package that will leave corporations that are forced to pay even higher premiums fuming and taxpayers wondering when they will be compelled to burden the shortfall and to what extent. Led by lobbyists for Delta and Northwest, airlines have been pressuring lawmakers to pass legislation that would allow carriers 17 years to fund their pension obligations fully, rather than the seven-year funding period that would apply to other employers with underfunded pension liabilities under existing proposals. Given the course of negotiations, it is uncertain whether Congress will reach a compromise before its August recess on any pension relief, let alone special protections for U.S. air carriers.

Comair also illustrates the challenges faced by bankruptcy courts called upon to apply the standards set forth in section 1113. Section 1113 provides the court with a high level of discretion in making several subjective determinations. These include deciding what changes are "necessary" to a reorganization, assessing whether the debtor has conferred with union representatives in "good faith," deciding whether a proposal has been rejected "without good cause," and ensuring that the "balance of the equities clearly favors rejection" of a labor agreement. Making these determinations demands an exhaustive factual inquiry into not only the course of dealings between the debtor and union representatives, but also the debtor's financial condition and proposed restructuring plan—an inquiry that bankruptcy courts are ordinarily called upon to perform in connection with plan confirmation proceedings at the final stages of a chapter 11 case.

Bankruptcy reforms enacted in 2005 did nothing to ease the substantial burden borne by bankruptcy courts in applying section 1113. Moreover, a bill introduced in April of 2006—the Fairness and Accountability in Reorganization Act of 2006—would add an additional layer of inquiry to section 1113 by requiring that, in considering a proposal made to an authorized representative of employees covered by a collective bargaining agreement, the court must take into account the ongoing impact on the debtor of its relationships with debtor and nondebtor affiliates, domestic or otherwise.

In re Delta Air Lines, 342 B.R. 685 (Bankr. S.D.N.Y. 2006).

In re Mesaba Aviation, Inc., 341 B.R. 693 (Bankr. D. Minn. 2006).

NLRB v. Bildisco & Bildisco, 465 U.S. 513 (1984).

Wheeling-Pittsburgh Steel Corp. v. United Steelworkers of America, 791 F.2d 1074 (3d Cir. 1986).

Truck Drivers Local 807 v. Carey Transportation, Inc., 816 F.2d 82 (2d Cir. 1987).

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CREDITOR DISENFRANCHISED AFTER FAILING TO SEEK TEMPORARY ALLOWANCE OF ITS CLAIM

Kelly M. Neff and Mark G. Douglas

The ability of a creditor whose claim is "impaired" under a chapter 11 plan to vote in favor of or against the plan is one of the most important rights conferred on creditors under the Bankruptcy Code. The voting process is an indispensable aspect of safeguards built into the statute, designed to ensure that any plan ultimately confirmed by the bankruptcy court over the objection of a class of creditors meets certain minimum standards of fairness and does not discriminate unfairly between or among similarly situated creditors. Even so, a creditor's right to vote its claim is not absolute and it can be forfeited. As demonstrated by a ruling recently handed down by the Fourth Circuit Court of Appeals, if an objection is filed to a creditor's claim, the creditor will not be permitted to vote unless it takes the affirmative step of obtaining an order of the bankruptcy court either resolving the objection or temporarily allowing its claim for voting purposes. In *Jacksonville Airport, Inc. v. Michkeldel, Inc.*, the Fourth Circuit held that neither the Rooker-Feldman doctrine nor local bankruptcy court rules excuse a creditor's failure to obtain an order at least temporarily allowing its claim so that it can vote on a plan.

CLAIMS OBJECTION, ESTIMATION, AND TEMPORARY ALLOWANCE PROCEDURES

The allowance of claims in a bankruptcy case is governed by section 502 of the Bankruptcy Code. Section 502(a) provides that a filed proof of claim is deemed allowed unless a party-in-interest objects. If an objection to a claim is filed, section 502(b) directs the bankruptcy court to determine the allowed amount of the claim after notice and a hearing in accordance with certain restrictions and limitations specified in the statute (*e.g.*, disallowing claims for unmatured interest and capping landlord claims for future rent).

Section 502(c) of the Bankruptcy Code mandates the estimation of almost any contingent or unliquidated claim where failure to do so "would unduly delay the administration of the case." Thus, for example, if litigation is pending against the debtor when it files for bankruptcy, but has not yet gone to trial, the bankruptcy court can estimate the debtor's liability to the plaintiffs in lieu of modifying the automatic stay to allow the action to proceed until judgment, if doing so would unduly delay the bankruptcy case.

The Bankruptcy Code does not specify the method or procedure for estimating a claim. Rather, bankruptcy courts employ whatever method is best suited to the circumstances, so long as it comports with the legal rules that govern a claim's ultimate value (*e.g.*, contract law). Estimation of a claim can be accomplished by means of arbitration, mediation, a full-blown trial, or any other procedure that the court deems appropriate under the circumstances. Once a claim has been estimated, the claim becomes an allowed claim in the amount estimated on a par with all other claims of equal priority. Much is at stake in an estimation hearing. Upon confirmation of a chapter 11 plan, the estimated amount will, as a practical matter, act as a cap on the maximum amount of the debtor's obligation.

Procedural rules accompanying the Bankruptcy Code provide for the temporary estimation of a claim. Under Rule 3018(a) of the Federal Rules of Bankruptcy Procedure, a bankruptcy court "may temporarily allow [a] claim or interest in an amount which the court deems proper for the purpose of accepting or rejecting a plan." Temporary allowance of a claim for the limited purpose of voting on a plan is appropriate because creditors whose claims are disputed would otherwise be completely disenfranchised in chapter 11 cases where the claims resolution process cannot be completed prior to voting. Only holders of allowed claims are permitted to vote on a chapter 11 plan. A creditor's claim must also be part of an "impaired" class *(i.e.*, the claim is not being paid in full or the plan otherwise alters the creditor's legal rights). Creditors whose claims are unimpaired are deemed to vote in favor of a plan. Temporary allowance ensures that creditors asserting disputed claims will have an impact on the plan confirmation process that is commensurate with the court's estimate of the value of their claims, if any. As with estimation under section 502(c), there is no established procedure governing the temporary allowance of a claim under Rule 3018(a). A creditor's failure to comply with the Bankruptcy Code's temporary allowance requirements was the subject of the Fourth Circuit's ruling in *Jacksonville Airport*.

JACKSONVILLE AIRPORT

Before filing for chapter 11 protection in 2002 in Maryland, Michkeldel, Inc., was involved in litigation against Jacksonville Airport, Inc. ("JAI"), in Florida state court. The bankruptcy court granted JAI's motion for relief from the automatic stay to allow the Florida litigation to proceed to a final judgment and to permit appeal of that judgment. JAI prevailed in the trial court and filed an unsecured claim in Michkeldel's bankruptcy case based upon the judgment. Michkeldel objected to the claim, contending that it should not be allowed because Michkeldel intended to appeal the underlying judgment. JAI did not file a response to the claim objection.

Jacksonville Airport is emblematic of what can happen when a creditor fails to exercise due vigilance in protecting its rights by complying with the Bankruptcy Code's procedural requirements governing the claims resolution process.

As the holder of the largest unsecured claim against Michkeldel, JAI voted to reject Michkeldel's plan of reorganization. At the confirmation hearing (two days after expiration of the voting deadline), JAI learned that its vote had not been counted. According to Michkeldel, JAI was not entitled to vote because Michkeldel objected to JAI's claim.

JAI petitioned the bankruptcy court to allow its vote, but the court ruled that JAI's request was untimely because the voting deadline had passed. The court confirmed Michkeldel's chapter 11 plan, ruling in the confirmation order that it could not consider JAI's claim as an allowed claim because JAI failed to respond to Michkeldel's claim objection. JAI appealed the decision to the district court, which affirmed.

JAI fared no better before the Fourth Circuit. The Court of Appeals began its analysis by observing that section 1126(a) of the Bankruptcy Code permits only the holder of a "claim or interest allowed under section 502" to vote to accept or reject a plan. Explaining that section 502(a) of the Bankruptcy Code provides that a claim or interest is deemed allowed, unless a party-in-interest objects, the Fourth Circuit emphasized that "[t]hese provisions allow only holders of claims to which no party has objected to vote on Chapter 11 plans."

The court stated that JAI's claim was not allowed under section 502 of the Bankruptcy Code because it was undisputed that Michkeldel filed an objection to the claim. Therefore, it was proper for the bankruptcy court and district court to conclude that JAI was precluded from voting on the plan.

JAI offered several reasons as to why its vote should have been counted. First, JAI contended that Michkeldel's objection to its claim was without merit because it was premised upon a potential appeal of the Florida state court judgment. According to JAI, the bankruptcy court would have to examine the merits of the state court judgment to rule upon the objection—an examination barred by the Rooker-Feldman doctrine. The Rooker-Feldman doctrine provides that a federal court (other than the Supreme Court) lacks jurisdiction to adjudicate a dispute that would require it to review a state court judgment. Application of the doctrine, JAI insisted, should invalidate Michkeldel's objection, such that JAI should be deemed to have an allowed claim for voting purposes.

The Fourth Circuit rejected this argument. Acknowledging that JAI might ultimately prevail on the merits of the claim dispute by operation of a Rooker-Feldman defense, the Court of Appeals ruled that JAI could not circumvent the plain meaning of section 502(a). Section 502(a), the Fourth Circuit observed, is not limited to valid claims objections. Rather, so long as a party-in-interest objects to a claim, "regardless of the objection's validity or merit," the claim cannot be deemed an allowed claim. JAI, the Court emphasized, could and should have filed a motion to temporarily allow its claim for voting purposes under Bankruptcy Rule 3018. Moreover, it explained, the facts indicated that the bankruptcy court could have fully adjudicated any opposition filed by JAI on the merits prior to the voting deadline, thereby making temporary allowance unnecessary. Because JAI failed to do

anything before expiration of the plan's voting deadline, the Fourth Circuit ruled that JAI's vote could not be counted.

JAI also argued that its reliance on a local procedural rule excused it from opposing Michkeldel's objection. The rule in question dispensed with any requirement to file a written response to a claim objection if the claimant wished to rely solely upon the proof of claim. The Court of Appeals rejected this argument, stating that although the local rule may have excused JAI from offering papers in opposition, the rule could not grant a claimant the right to vote on a plan where the Bankruptcy Code expressly provides to the contrary. The Fourth Circuit affirmed the decisions below.

ANALYSIS

Jacksonville Airport is emblematic of what can happen when a creditor fails to exercise due vigilance in protecting its rights by complying with the Bankruptcy Code's procedural requirements governing the claims resolution process. The penalty in this case was severe—the creditor having not only the largest unsecured claim against the debtor but also potentially the means to block confirmation of its chapter 11 plan was stripped of its vote and, because the bankruptcy court found that the plan otherwise met the requirements for confirmation, the creditor was forced to accept whatever treatment of its claims (and the claims of other similarly situated unsecured creditors) was provided under the debtor's confirmed plan of reorganization.

Largest Public Company Bankruptcy Filings in 2006

Company	Filing Date	Assets
Dana Corporation	3/3/2006	$9,047,000,000
Pliant Corporation	1/3/2006	$777,092,000
OCA Inc.	3/14/2006	$660,303,000
Silicon Graphics, Inc.	5/8/2006	$452,145,000
Integrated Electrical Services, Inc.	2/14/2006	$416,372,000
J.L. French Automotive Castings, Inc.	2/10/2006	$366,681,000
Oneida Ltd.	3/19/2006	$328,812,000
Curative Health Services, Inc.	3/27/2006	$283,784,000
G+G Retail, Inc.	1/25/2006	$202,868,000
Werner Holding Co. (DE), Inc.	6/12/2006	$201,042,000
Easy Gardener Products, Ltd.	4/19/2006	$119,485,000
World Health Alternatives, Inc.	2/20/2006	$100,595,422
Riverstone Networks, Inc.	2/7/2006	$98,341,134
SeraCare Life Sciences, Inc.	3/22/2006	$89,128,046
OneTravel Holdings, Inc.	7/7/2006	$84,294,008
America Capital Corporation	6/19/2006	$52,005,000
Verilink Corporation	4/9/2006	$42,328,000
AirNet Communications Corporation	5/22/2006	$23,733,053
Trans-Industries, Inc.	4/3/2006	$15,729,000
Large Scale Biology Corporation	1/9/2006	$12,795,000
Weida Communications, Inc.	3/29/2006	$10,299,708

We can only speculate concerning the ramifications of JAI's disenfranchisement as it pertains to the ultimate recovery on its claims—the Fourth Circuit's ruling does not describe the terms of the debtor's plan of reorganization. If nothing more, its inability to vote very likely deprived JAI of crucial bargaining power, and the debtor effectively denied JAI any meaningful say concerning the outcome of the chapter 11 case simply by interposing a possibly meritless objection to JAI's claim. This is precisely what temporary allowance under Rule 3018(a) was designed to prevent. Having failed to protect its rights by seeking temporary allowance for voting purposes, the strong likelihood that JAI would have prevailed on the underlying merits was of no consequence whatsoever.

JAI never obtained a stay of the confirmation order pending its appeal of the bankruptcy court's rulings in the confirmation order itself and in JAI's subsequent motion to reconsider that order. Given the time that elapsed between confirmation and issuance of the Fourth Circuit's ruling, substantial consummation of Michkeldel's chapter 11 plan almost certainly should have mooted any appeal.

Jacksonville Airport, Inc. v. Michkeldel, Inc., 434 F.3d 729 (4th Cir. 2006).

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