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LANDMARK REORGANIZATION OF USG CORPORATION

David G. Heiman (Cleveland) led Jones Day's representation of USG in its successful chapter 11 cases.

The emergence of USG Corporation from chapter 11 in June of this year produced unique and unprecedented positive results: all creditors were paid about $6 billion in cash — the full amount of their prepetition allowed claims and five years of postpetition interest — and the shareholders retained 100 percent of their stock interests. At the same time, the company emerged with an investment-grade credit rating, a strong balance sheet, and freedom from the asbestos cloud under which it operated for decades. Jones Day served a critical role, with the help of other outside advisors, in helping USG prepare and execute its successful chapter 11 strategy.

USG, which through its affiliated companies is a leading manufacturer and distributor of a wide range of building products, commenced its chapter 11 reorganization case on June 25, 2001. At that time, United States Gypsum Company, a wholly owned subsidiary of USG, was faced with more than 100,000 pending personal injury lawsuits stemming from alleged exposure to asbestos-containing products and faced the prospect of potentially many times that number of claims in the future. This enormous and growing asbestos liability threatened to engulf the debtors' businesses. Indeed, the mounting asbestos personal injury claims had exhausted virtually all of the debtors' insurance coverage for such claims and were requiring the debtors to spend approximately $1 million per day for asbestos-related defense costs.

During USG's bankruptcy case, the aggregate amount of the debtors' present and future asbestos liabilities was the subject of significant dispute. The official committee of asbestos personal injury claimants and the asbestos personal injury futures representative asserted that the aggregate amount of current and future asbestos personal injury claims was enormous. These parties ultimately quantified their position as to the amount of the claims at no less than $5.5 billion and potentially significantly more. USG disagreed, arguing that the aggregate amount of the asbestos claims was significantly less. USG, with Jones Day and a team of other professionals, developed a strategy to judicially establish the legitimate value of the asbestos personal injury claims. The strategy employed in USG's chapter 11 cases was based on the parallel tracks of staying all nonbankruptcy litigation, seeking an estimation of that liability via litigation in the U.S. District Court for the District of Delaware, pursuing federal legislation that would limit the liability to a fair and reasonable amount and, under all of those circumstances, seeking a fair and just settlement that would protect the interests of all creditor and shareholder constituents. The debtors, Jones Day, and a team of professionals persistently maintained and implemented this multitrack strategy over the five-year duration of the case, leading to unprecedented results for all stakeholders.

As the litigation portion of the strategy was developed and implemented over the course of several years, Jones Day worked to ensure that the chapter 11 process did not negatively affect USG's businesses or prevent the growth and prosperity of such businesses. To that end, during USG's chapter 11 cases, Jones Day helped USG through several acquisitions of existing businesses as part of USG's efforts to strengthen its operations. In addition, Jones Day obtained court approval of several procedures to ensure that USG's operations could proceed seamlessly and efficiently notwithstanding the bankruptcy. By late 2005, as a result of the financial and operational success of USG's businesses during the chapter 11 cases, USG had a stock price of approximately $70 per share and an equity market capitalization of approximately $3 billion.

USG's multitrack strategy developed with Jones Day and other professionals proved successful. In December 2005, Jones Day, USG, and USG's financial advisors met with the asbestos personal injury committee and the asbestos personal injury futures representative to determine whether a consensual resolution of the reorganization cases could be reached. These negotiations took place in the context of the asbestos constituencies facing significant uncertainty on two fronts. First, they faced the estimation of the asbestos liability in the courts and the prospect that, after several more years of litigation, that estimation could produce a liability substantially less than that which they were asserting. In addition, in part as a result of USG's own efforts, legislation titled the Fairness in Asbestos Injury Resolution Act of 2005 (Senate Bill 852) (the "FAIR Act") had been introduced in Congress that would have significantly limited the amount of U.S. Gypsum's asbestos liability, again compared to what the plaintiffs had asserted the liability to be.

A team of Jones Day attorneys including David G. Heiman (Cleveland), Brad B. Erens (Chicago), Mark A. Cody (Chicago), Robert J. Graves (Chicago), Kathleen B. Burke (Cleveland), Timothy J. Melton (Chicago), Scott J. Moore (Chicago), Edward A. Purnell (Chicago), and Robert A. Profusek (New York) represented USG Corporation and its 10 domestic subsidiaries, including United States Gypsum Company, in connection with their successful emergence from chapter 11 protection on June 20, 2006, having resolved more than $6 billion in liabilities, including more than 100,000 pending asbestos personal injury cases.

As a result, in late January 2006, after extensive negotiations, USG was able to reach an agreement with the asbestos personal injury committee and the asbestos personal injury futures representative to resolve all asbestos personal

injury claims in an amount significantly less than the amount the asbestos claimants previously had asserted. The agreement, which enabled USG to preserve the interests of its stockholders, entailed the payment of either $900 million or $3.95 billion, depending upon the passage of the FAIR Act, to a personal injury trust under section 524(g) of the Bankruptcy Code, and channeling of all of the present and future asbestos personal injury claims against USG and the other USG companies into the trust, which would be responsible for administering and paying those claims. In particular, under the plan, the debtors funded the section 524(g) trust by paying $890 million to the trust and issuing to the trust an interest-bearing note in the amount of $10 million, payable no later than December 31, 2006. The debtors also issued to the trust a contingent payment note in the aggregate amount of $3.05 billion, which will be payable to the trust depending upon whether the FAIR Act or substantially similar legislation creating a national trust or similar fund is enacted in the current term of Congress. Unlike in most asbestos cases, the asbestos claimants received no stock under the plan, but instead were cashed out in full.

The agreement permitted the debtors to provide an extraordinary result for all of their stakeholders — (i) the payment in full in cash, with interest, on all creditor claims, and (ii) the retention by USG shareholders of their equity interests. The successful resolution of USG's chapter 11 cases is historic in the context of asbestos bankruptcy cases, as no previous asbestos-driven case has preserved such meaningful value for equity. In fact, shortly after the announcement of the settlement, the stock price rose to $90 per share and continued to rise thereafter to a high of approximately $120 per share.

To achieve this result, the debtors required a significant amount of cash to fund the payments under the plan. USG, with the assistance of Jones Day and USG's financial advisors, funded the settlement in part by implementing a $1.8 billion rights offering to existing shareholders backstopped by Warren Buffett's Berkshire Hathaway Inc. For each share of common stock outstanding on the record date of the rights offering, the stockholder received a right to purchase one new USG common share at a price of $40. The rights offering was supported by a backstop equity agreement from Berkshire Hathaway that contained a "hell or high water" firm commitment to purchase any shares of stock not otherwise purchased by existing shareholders in the rights offering, up to a total of $1.8 billion. As such, the equity backstop agreement assured all parties that the debtors would raise gross proceeds of $1.8 billion needed to fund the plan. The rights offering was the largest in chapter 11 history and the first to permit participation by existing shareholders.

With the equity backstop agreement in place, USG, with Jones Day's assistance, moved swiftly to obtain confirmation of its plan of reorganization. The plan of reorganization was approved by more than 99 percent of the asbestos personal injury claimants voting and was subject to no objections at confirmation. USG and its subsidiaries, with their existing stock intact, emerged from chapter 11 on June 20, 2006, becoming the first of the major companies with asbestos-related chapter 11 cases pending in Delaware to emerge from bankruptcy.

In connection with the debtors' emergence, Jones Day also assisted USG in obtaining a $2.8 billion exit financing facility, which is available to fund working capital needs and to finance the payment of the contingent payment note to the asbestos trust in accordance with the plan. The exit financing facility was rated investment grade by Moody's Investors Service Inc., an extremely rare occurrence in a chapter 11 case that underscores the fact that the debtors' strong businesses have been preserved.

UNSCRAMBLING THE EGG OR REDIVIDING THE PIE? REVOKING A CHAPTER 11 PLAN CONFIRMATION ORDER

Mark G. Douglas

Confirmation of a chapter 11 plan providing for the reorganization or liquidation of a debtor and dealing with the claims and interests of various stakeholders is the culmination of the chapter 11 process. In keeping with a fundamental policy promoting the finality of the chapter 11 process, the general rule is that a final confirmation order is inviolable. The absence of certainty that the transactions effectuated under a plan are valid and permanent would undermine chapter 11's fundamental purpose as a vehicle for rehabilitating ailing enterprises and providing debtors with a fresh start.

Even so, a final order confirming a chapter 11 plan can be revoked under very limited circumstances. Precisely what those circumstances are was the subject of a pair of rulings recently handed down by the courts. In *In re Genesis Health Ventures, Inc.*, the Delaware district court held that investors' allegations of pre-confirmation fraud against a chapter 11 debtor represented a disguised attack on the confirmation order and were therefore barred as having been brought more than 180 days after the order was entered. A New York bankruptcy court also denied a challenge to its order confirming a chapter 11 plan in *In re Trico Marine Services, Inc.*, ruling that it would not revoke the order as allegedly procured by fraud because, pursuant to the debtor's plan, new common stock distributed to noteholders and sold to the public had already been widely traded and it was not possible either to restore the *status quo ante* or to protect the investing public.

REVOCATION OF AN ORDER CONFIRMING A PLAN

Section 1144 of the Bankruptcy Code provides that, upon the request of a party-in-interest made within 180 days after the entry of an order confirming a chapter 11 plan, the bankruptcy court "may revoke such order if and only if such order was procured by fraud." In the event that the court exercises its discretion to revoke a confirmation order, the statute further provides that the revocation order "shall" (i) contain such provisions as are necessary to protect any entity acquiring rights in good-faith reliance on the confirmation order, and (ii) revoke the debtor's discharge. Section 1144 is designed to restore the parties to their pre-confirmation positions, as long as the rights of third parties who relied on the plan in good faith are protected. The extreme difficulty of doing so in many cases means that revocation is regarded as a "drastic remedy."

The 180-day period specified in section 1144 is absolute. Unlike certain other deadlines contained in the Bankruptcy Code, it may not be extended by the court, even if fraud in procuring a confirmation order is not discovered until after the 180-day period expires. This rule represents a compromise between the strong bankruptcy policy against recognizing the validity of a chapter 11 plan procured by fraud and the equally strong policy promoting the finality of a confirmation order.

The court must specifically find that the order was procured by fraud before revoking a confirmation order. The fraud need not have been committed by the debtor or any other proponent of the plan. Fraud committed during a chapter 11 case that is unrelated to plan confirmation is not a basis for revocation — the bankruptcy court can implement other remedies designed to punish the malefactor or remedy any resulting harm, such as the entry of a judgment against the perpetrator. Section 1144, unlike its predecessor provision under the former Bankruptcy Act, does not require on its face that the party seeking revocation have been unaware of the fraud at the time the plan was confirmed. A defense frequently invoked in connection with a revocation request is that the party seeking revocation knew or should have known of the fraud prior to confirmation. Unless the party in question is the plan proponent, who has affirmative duties of disclosure and good faith, such knowledge is not a bar to revocation under section 1144, although the party seeking revocation may be required to justify its failure to call the fraud to the court's attention when it occurred.

Section 1144 does not explain the meaning of "fraud." As a consequence, it has been left to the courts to fashion a definition. They have done so by looking to the traditional elements of fraud under common law and precedent construing section 1144, the revocation provisions under other chapters of the

NEWSWORTHY

Corinne Ball (New York) spoke at the 22nd Annual *Corporate Mergers and Acquisitions* seminar jointly sponsored by the American Law Institute and the American Bar Association in Boston on September 15, 2006. The topic of her presentation was "Buying a Distressed or Bankrupt Company." On November 3, 2006, she will moderate a panel discussion concerning "Debtor-in-Possession Financing in the Auto Industry: Global Sourcing, 'Just in Time' Inventory and OEM Customers" at the 80th Annual Meeting of the National Conference of Bankruptcy Judges in San Francisco.

Heather Lennox (Cleveland) will be a panelist in a round-table discussion on November 1, 2006, concerning "The Automotive Industry — Where It Was, Where It Is and Where It's Going" at the Fall 2006 conference sponsored by the International Women's Insolvency & Restructuring Confederation in San Francisco. She was part of a panel discussion entitled "Developing Opportunities for a Multicultural Workplace — How to Create Opportunities for All Women" on October 6, 2006, at a "Reach for the Stars" networking event sponsored by Capgemini in Cleveland.

An article written by ***Charles M. Oellermann (Columbus)*** entitled "Businesses Often Use Chapter 11 Bankruptcy as a Restructuring Tool" appeared in the August 25, 2006, issue of *Columbus Business First*.

On September 22, 2006, ***Tobias S. Keller (San Francisco)*** moderated a panel discussion on "Opportunities and Risks in Dealing with Distressed US Businesses" at the AAMA Connect 2006: Navigating China Conference sponsored by the Asia America MultiTechnology Association in Santa Clara, California. On September 25, 2006, he lectured on "Financing Intellectual Property: Protecting Intellectual Property in the Face of Failure" at Stanford Law School.

An article written by ***H. Joseph Acosta (Dallas)*** entitled "'Cram Down' of Secured Creditor Under Chapter 11 Plan Requires Market Rate of Interest" appeared in the July/August edition of *ABF Journal*. His article entitled "Third Circuit Says 'No' to Double-Discounting" was published in the July/August edition of *ABI Journal*. The July 1, 2006, issue of *Dallas Bar Association Headnotes* contains his article entitled "Bankruptcy Jurisdiction Upheld in a State Probate Matter."

Nicholas M. Miller (Cleveland) spoke on June 23, 2006, at a Joint Bankruptcy and Labor & Employment Sections Meeting sponsored by the Cleveland Bar Association. The topic of his presentation was "Enforcement and Rejection of Employment Agreements and Collective Bargaining Agreements in Bankruptcy."

An article written by ***Mark G. Douglas (New York)*** entitled "Global Focus: Foreign Insolvency Proceedings Recognized Under New Chapter 15 of the Bankruptcy Code" was published in the Spring 2006 edition of *Uniform Commercial Code Law Journal*. His articles entitled "The Cautionary Tale Continues: Debt Acquired from Recipient of Voidable Transfer Subject to Disallowance Under Section 502(d)" and "Airline Focus: Using Section 1113 to Navigate Stormy Skies" appeared in the August/September 2006 issue of *Pratt's Journal of Bankruptcy Law*.

Bankruptcy Code, and their predecessors under the former Bankruptcy Act, all of which are similar enough to be informative in assessing the kind of conduct that can justify revocation of an order confirming a chapter 11 plan. Many courts construe "fraud" in section 1144 to mean "fraud on the court." In addition, most courts require a showing of actual fraudulent intent. The fraud can consist of either material misstatements or omissions in the face of a duty to disclose information.

Even if it finds that actionable fraud was committed, the bankruptcy court is not obligated to revoke a confirmation order. Section 1144 gives the court considerable discretion to fashion whatever remedy is appropriate under the circumstances to achieve an equitable outcome. If, for example, it is too late to remedy fraud or too impractical to revoke a confirmation order and restore the *status quo ante*, the court may exercise its discretion to deny revocation in lieu of other more effective and less disruptive remedies.

Any order revoking a plan under section 1144 must "protect any entity acquiring rights in good faith reliance on the confirmation order." The myriad transactions provided for under a chapter 11 plan, including distributions to creditors, asset sales, lease assignments, the incurrence of new indebtedness in the form of exit financing, and the cancellation and/or issuance of stock and other securities to existing creditors,

private investors, and the public, would in many cases be extremely difficult or impossible to undo once they have occurred. For this reason, any relief ordered under section 1144 must be fashioned to protect the legitimate expectations of any stakeholder not involved in the fraudulent conduct.

APPLICATION OF THE DOCTRINE OF EQUITABLE MOOTNESS

Protecting the legitimate expectations of innocent stakeholders and the difficulty of "unscrambling the egg" are issues that a court is obligated to consider when confronted with any kind of challenge to a confirmation order, whether or not it involves a request to revoke the order under section 1144. Courts faced with various kinds of challenges to a confirmation order will sometimes reject the assault under the "doctrine of equitable mootness" because it is simply too late or too difficult to undo what has already been done.

A court will dismiss a proceeding challenging an order confirming a chapter 11 plan as moot if such relief, although possible, would be inequitable under the circumstances, given the difficulty of restoring the *status quo ante* and the impact on all parties involved. The threshold inquiry in applying the doctrine is ordinarily whether a chapter 11 plan has been "substantially consummated" (*i.e.*, substantially all property transfers contemplated by the plan have been completed, the reorganized debtor or its successor has assumed control of the debtor's business and property, and plan distributions have commenced). If so, a court is more likely than not to reject a challenge to a confirmation order, even if it is mounted within the statutory period prescribed by section 1144.

The difficulty of protecting blameless stakeholders and/or undoing a series of complicated transactions effectuated under a plan has led many courts to deny revocation. These concerns figured prominently in the courts' rulings in *Genesis Health Ventures* and *Trico Marine*.

GENESIS HEALTH VENTURES

Genesis Health Ventures, Inc. ("Genesis"), a provider of health-care services to the elderly from approximately 200 assisted living and skilled nursing facilities in 12 states, filed for chapter 11 protection in 2000 in Delaware. In the following year, Genesis filed a joint plan of reorganization together with its affiliate Multicare AMC, Inc. ("Multicare"). The bankruptcy court confirmed the plan on September 21, 2001.

Prior to confirmation, Genesis' capital structure included approximately $400 million in senior subordinated notes and nearly $1.3 billion in senior debt. About half of the latter had been purchased by Goldman, Sachs & Co. ("Goldman") shortly before the debtors filed for bankruptcy. Goldman was the largest senior creditor of both Genesis and Multicare and underwrote both debtor-in-possession and exit financing extended to the companies during and upon emergence from the chapter 11 cases. The plan effectuated a merger of Genesis and Multicare, extinguished both companies' existing common stock, and distributed 94 percent of the newly issued stock of the reorganized, combined entities to Goldman, Highland Capital Partners ("Highland"), another senior debt participant, and Mellon Bank N.A. ("Mellon"), the debtors' lead senior lender bank (collectively, the "Senior Lenders"). Junior creditors (including subordinated noteholders) received a dividend of approximately 7.3 percent, plus warrants to purchase new common stock.

During the months following confirmation, information came to light that cast into doubt the veracity of the historical and projected earnings figures presented by the debtors in support of their joint chapter 11 plans. Two and a half years after confirmation, 275 investors who collectively held 55 percent of the senior subordinated notes (more than $205 million in face value) sued Genesis, its chief financial officer, and the Senior Lenders. In their complaint, the plaintiffs alleged that the Senior Lenders "conspired with Genesis management to put the Company into bankruptcy and 'cram down' a reorganization plan that would eliminate junior creditors (including plaintiffs) and existing stockholders, while conveying virtually total ownership of Genesis to the senior creditors."

According to the plaintiffs, the enterprise value of Genesis was misrepresented at confirmation as being about $1.3 billion, based upon depressed earnings figures, when it was actually much higher. The complaint stated causes of action for fraud, conspiracy to commit fraud, and gross negligence, alleging, among other things, that (i) the Senior Lenders, collaborating with Genesis' chief financial officer, controlled and manipulated the process by which earnings and other

financial information were provided to creditors in connection with confirmation of the plan of reorganization; (ii) by virtue of their position as senior creditors of the debtor, and as proponents of a bankruptcy reorganization plan that would drastically affect the junior creditors, the defendants owed the junior creditors a duty of care, including the duty to provide fair, accurate, and complete information; and (iii) the defendants violated that duty of care by disseminating false and misleading financial information that misled the bankruptcy court and the plaintiffs concerning the true financial condition and prospects of Genesis.

If Genesis had been properly valued, the plaintiffs claimed, there would have been sufficient value for the subordinated noteholders to recover the full par value of their notes. The plaintiffs contended that they did not have an opportunity to discover the alleged fraud before the bankruptcy court confirmed the debtors' chapter 11 plan because they did not receive certain of the voluminous earnings reports until six days prior to the confirmation hearing.

The defendants moved to dismiss the complaint, contending that it was untimely under section 1144 and that the claims asserted should be rejected under the doctrines of *res judicata* and collateral estoppel. The bankruptcy court granted the dismissal request, ruling that the plaintiffs' claims against Genesis were time-barred because they were asserted more than 180 days after confirmation of Genesis' chapter 11 plan. The court also held that the claims asserted against the remaining defendants were precluded under the doctrines of *res judicata* and collateral estoppel because such claims were "so close to the claim actually liquidated at confirmation" that they should have been asserted at that time. According to the court, the complaint simply attempted to "add additional factual bases to the allegation that the debtor was misvalued."

The plaintiffs fared no better on appeal to the district court, at least with respect to their claim against Genesis under section 1144. Explaining that the 180-day period specified in the statute is "strictly construed," the district court emphasized that courts have adopted a "wider approach" to section 1144 by construing the scope of its proscription to encompass requests for relief that are not expressly denominated as "revocation," but nevertheless represent indirect attacks on the finality of a confirmation order after the period has expired. Independent causes of action based upon a debtor's wrongful conduct, the court noted, are not barred by section 1144. Even so, the district court cautioned, courts must carefully scrutinize such claims to ensure that they are not "an attempt to redivide the pie by a disgruntled participant in a Plan." A truly independent cause of action, the court observed, can be maintained "at least where the alleged fraud could not have been asserted in the bankruptcy proceedings, the underlying factual claims were not actually adjudicated, and the relief sought would not upset the confirmed plan of arrangement."

The bankruptcy court found that awarding money damages to the plaintiffs would be to "redivide the pie, to upset the confirmed plan, and to negatively affect innocent parties and creditors." The district court did not fault its reasoning on appeal, affirming dismissal of the plaintiffs' claims under section 1144 against Genesis. Because, however, the bankruptcy court never addressed whether the time bar in the statute should also apply to the Senior Lenders and Genesis' CFO, it remanded the case below for consideration of that issue. The district court also vacated the order below dismissing the plaintiffs' claims on the basis of *res judicata* and collateral estoppel. In ruling to dismiss, the district court explained, the bankruptcy court did not properly consider the claim that information casting doubt on the veracity of reported earnings only first came to light after confirmation of the plan and other related allegations. It accordingly remanded that issue below as well for additional consideration.

TRICO MARINE

Another aspect of section 1144 — the court's discretion to refuse revocation if it would be impossible to restore the *status quo ante* and protect innocent third parties — was the subject of the bankruptcy court's ruling in *Trico Marine*. Trico Marine Services, Inc., and two affiliates ("Trico") filed "prepackaged" chapter 11 cases in New York on December 21, 2004. At the time, Trico had approximately $400 million in debt, including approximately $275 million in senior notes.

Under its joint plan of reorganization, Trico proposed to exchange the notes for 100 percent of the reorganized entity's new common stock, subject to dilution based upon the grant of certain options and warrants. The noteholder class—the only impaired class entitled to vote on the plan—voted to accept it. Trico's existing shareholders received nothing under the plan. Under a separate "plan support agreement" between Trico and the noteholders, however, the noteholders agreed that Trico's existing shareholders would receive warrants that could be exercised for up to 10 percent of the new common stock.

The requirements of section 1144 are strictly construed and a bankruptcy court has considerable discretion to rebuff a challenge to a confirmation order — even in demonstrated cases of fraud — if it concludes that more harm than good would result from revocation or that less drastic remedies are available to remedy misconduct.

The bankruptcy court confirmed Trico's plan of reorganization on January 21, 2005. On March 15, 2005 (the plan's effective date), Trico distributed 10 million shares of new common stock to its noteholders and nearly one million warrants to its old stockholders.

Steven and Gloria Salsberg (the "Salsbergs"), holders of old common stock that was converted to warrants on the effective date of Trico's chapter 11 plan, commenced litigation in the bankruptcy court on May 19, 2005, seeking revocation of the confirmation order under section 1144. Although the Salsbergs had objected to confirmation of Trico's plan, they chose to seek revocation of the confirmation order rather than appealing it. According to the Salsbergs, Trico's chief financial officer intentionally and significantly underestimated the company's projected revenue when he testified at the confirmation hearing. Based upon this alleged fraud on the court, the Salsbergs sought revocation of the confirmation order, cancellation of all the new common stock and warrants, and reinstatement of the notes. Any damages incurred as a consequence of unraveling these transactions, the Salsbergs suggested, could be paid from the increased tax benefits (preservation of net operating losses) that would be realized by Trico from not having experienced a change in control in connection with issuance of the new stock.

On October 24, 2005, Trico completed a public offering of an additional 4,273,500 shares of common stock at $24 per share. Reorganized Trico's stock is publicly traded through NASDAQ. Trico moved to dismiss the Salsbergs' complaint on November 28, 2005. Its basis for dismissal was the doctrine of equitable mootness. Treating its request as a motion for summary judgment, the bankruptcy court granted Trico's motion.

The doctrine of equitable mootness, the court explained, is "closely related" to the ability of a court to grant relief under section 1144 — both require the court to consider whether disturbing a confirmation order, although possible, would be inequitable under the circumstances, given the difficulty of "unscrambling the egg" and the impact on all parties involved. Because section 1144 spells out the standard to govern a request for revocation, the court acknowledged, it is unclear whether the doctrine of equitable mootness has any role in a revocation proceeding. Still, the court concluded that it need not answer that "thorny" question because the Salsbergs' complaint failed to pass muster under either standard.

According to the court, "[a]lthough the Plan is deceptively simple to describe, it would be exceedingly difficult to unwind and impossible to protect innocent third parties." The plan was substantially consummated in March of 2005, the court noted, and common stock issued under the plan and pursuant to Trico's subsequent public stock offering had been widely traded. Revocation, the court emphasized, would "possibly render the common stock valueless" and convert some unsuspecting shareholders into noteholders by canceling new Trico stock and reinstating the notes, causing "substantial uncertainty that the Court cannot even begin to predict." Finally, the court explained, because the Salsbergs are the only parties seeking to revoke the confirmation order, it would be more practical to leave the order intact and allow the Salsbergs to seek an award of damages if they are able to prove the existence of fraud.

EPILOGUE

The bankruptcy court in *Trico Marine* granted summary judgment dismissing the action seeking revocation of the order confirming the debtor's plan, but gave the plaintiffs leave to amend their complaint to seek other appropriate relief. Instead, the plaintiffs sought to supplement the evidentiary record with additional information concerning Trico's financial condition. Treating the request as a motion for reargument of its January 6, 2006, ruling, the court adhered to its original disposition.

During the three-month period ending on March 14, 2006, the average daily trading volume for Trico's common stock was 143,000 shares. This meant that approximately 13 million of the more than 14.6 million shares outstanding as a result of the plan, the public offering, and exercised warrants exchanged hands during this period. As a consequence, the bankruptcy court concluded that even if the plaintiffs could prove fraud, the court could not fashion a remedy that would satisfy the requirements of section 1144 because it was impossible to restore the *status quo ante* or protect investors who purchased Trico's new common stock.

OUTLOOK

Genesis Health Ventures and *Trico Marine* illustrate the importance of finality in the context of an order confirming a chapter 11 plan, and the exacting scrutiny that bankruptcy courts will bring to bear on any attempt to attack a confirmation order outside the normal appellate process. The requirements of section 1144 are strictly construed and a bankruptcy court has considerable discretion to rebuff a challenge to a confirmation order — even in demonstrated cases of fraud — if it concludes that more harm than good would result from revocation or that less drastic remedies are available to remedy misconduct.

Interestingly, neither the Delaware district court nor the New York bankruptcy court felt it necessary to delve too deeply into the allegations of procurement fraud in the cases before them. Such a "bigger picture" approach is precisely what section 1144 was intended to achieve. In a typical chapter 11 scenario, much more is at stake than the parochial concerns of a single disgruntled stakeholder. That is not to say that a court cannot or would not unravel the fabric of a chapter 11 plan by revoking a confirmation order under appropriate circumstances — it means that a court has considerable leeway to decide what is most fair in any given case, based upon the severity of the alleged infraction, its impact on all stakeholders, and the likely consequences of revocation.

Finally, courts disagree as to whether section 1144 is the exclusive vehicle for revoking a confirmation order. Some courts have held that it is, while others have ruled that Rule 60(b) of the Federal Rules of Civil Procedure, which specifies several grounds for "relief" from any judgment or order (*e.g.*, mistake, inadvertence, surprise, excusable neglect, newly discovered evidence, or fraud), also provides a basis for revocation.

Haskell v. Goldman, Sachs & Co. (In re Genesis Health Ventures, Inc.), 340 B.R. 729 (D. Del. 2006).

Salsberg v. Trico Marine Services, Inc. (In re Trico Marine Services, Inc.), 337 B.R. 811 (Bankr. S.D.N.Y.), *on reargument*, 343 B.R. 68 (Bankr. S.D.N.Y. 2006).

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WHEN IS IT TOO LATE FOR SUBSTANTIVE CONSOLIDATION?

Ross S. Barr and Mark G. Douglas

The substantive consolidation of two or more entities is an important tool available to a bankruptcy court overseeing the cases of related entities whose financial affairs are hopelessly entangled or whose separate corporate identities otherwise have been disregarded by those in control or the companies' creditors. In deciding whether to consolidate two or more estates, a court must conduct a factually intensive inquiry and carefully balance the competing concerns of all interested parties. Most courts acknowledge that the remedy should be invoked only under narrowly defined circumstances, given the significant potential for prejudice to creditors and other stakeholders in a bankruptcy case.

A bankruptcy court's discretion in directing the substantive consolidation of legally constituted entities or individuals is broad — it may extend to the consolidation of debtors with nondebtors, or retroactive consolidation of entities to a point in time preceding a consolidation request. Even so, as demonstrated by a ruling recently handed down by the Fifth Circuit Court of Appeals, such discretion is not unlimited. In *In re AMCO Insurance*, the Court of Appeals held that the bankruptcy court abused its discretion in *nunc pro tunc* substantively consolidating a debtor corporation with its nondebtor sole shareholder because the court had previously authorized a secured creditor of both entities to pursue its remedies against the shareholder in state court.

SUBSTANTIVE CONSOLIDATION

The bankruptcy court is a court of "equity." Although the distinction between courts of equity and courts of law largely has become irrelevant in modern times, courts of equity traditionally have been empowered to grant a broader spectrum of relief in keeping with fundamental notions of fairness as opposed to principles of black-letter law. As explained by the U.S. Supreme Court nearly 70 years ago, this means that a bankruptcy court can exercise its discretion to produce fair and just results, "to the end that fraud will not prevail, that substance will not give way to form, that technical considerations will not prevent substantial justice from being done." The remedies available to a bankruptcy court in exercising this broad equitable mandate include the power to invalidate pre-bankruptcy transfers that are fraudulent or preferential, the ability to "pierce the corporate veil" if a subsidiary is nothing more than its parent's "alter ego," and the power to reorder the priority of claims or interests in cases of misconduct.

A bankruptcy court also can treat the assets and liabilities of two or more separate but related entities as inhering to a single integrated bankruptcy estate. In this case, creditors of each of the entities involved look to the common pool of assets for satisfaction of their claims. This remedy is referred to as "substantive consolidation."

The Bankruptcy Code does not expressly authorize substantive consolidation (although it recognizes that a chapter 11 plan may provide for the consolidation of a "debtor with one or more persons" as a means of implementation). Rather, substantive consolidation is a product of judicial gloss. Courts generally find authority for the remedy in the broad equitable powers conferred in section 105(a) of the Bankruptcy Code, which authorizes the court to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions" of the Bankruptcy Code. However, because of the dangers of forcing creditors of one entity to share equally with creditors of a less solvent debtor, courts generally hold that it is to be used sparingly and have labeled substantive consolidation an "extraordinary remedy."

Courts disagree as to whether the remedy can be exercised to consolidate debtors with nondebtors. The majority rule favors the practice under appropriate circumstances, with the caveat that increased caution should be exercised in assessing the propriety of the remedy. Some courts hold otherwise, citing jurisdictional concerns and/or ruling that substantive consolidation should not be used to circumvent the involuntary bankruptcy petition procedures of the Bankruptcy Code. Finally, some bankruptcy courts have ordered substantive consolidation of two different entities retroactive to a date preceding the date of the request (*nunc pro tunc*).

THE STANDARD FOR SUBSTANTIVE CONSOLIDATION

Different standards have been employed by courts to determine the propriety of substantive consolidation. Common to all of these tests are a fact-intensive examination and an analysis of consolidation's impact on creditors. For example, in *Eastgroup Properties v. Southern Motel Assoc., Ltd.*, the Eleventh Circuit adopted a modified version of the standard articulated by the District of Columbia Circuit in *In re Auto-Train Corp., Inc.*, under which the proponent of consolidation must demonstrate that (i) there is substantial identity between the entities to be consolidated, and (ii) consolidation is necessary to avoid some harm or to realize some benefit.

Factors that may be relevant in satisfying the first requirement include:

(1) Fraud or other complete domination of the corporation that harms a third party;

(2) The absence of corporate formalities;

(3) Inadequate capitalization of the corporation;

(4) Whether funds are put in and taken out of the corporation for personal rather than corporate purposes;

(5) Overlap in ownership and management of affiliated corporations;

(6) Whether affiliated corporations have dealt with one another at arm's length;

(7) The payment or guarantee of debts of the dominated corporation by other affiliated corporations;

(8) The commingling of affiliated corporations' funds; and

(9) The inability to separate affiliated corporations' assets and liabilities.

The Second Circuit established a somewhat different standard for gauging the propriety of substantive consolidation in *In re Augie/Restivo Baking Co., Ltd.* There, the Court concluded that the factual elements considered by the courts are "merely variants on two critical factors: (i) whether creditors dealt with the entities as a single economic unit and did not rely on their separate identity in extending credit, . . . or (ii) whether the affairs of the debtors are so entangled that consolidation will benefit all creditors."

The *Augie/Restivo* test recently was adopted by the Ninth Circuit in *In re Bonham*. Many other circuit and lower courts have adopted tests similar to the *Augie/Restivo* and *Eastgroup* standards. The Third Circuit recently addressed the question for the first time in *In re Owens Corning*, reversing a bankruptcy court order authorizing the deemed consolidation of the estates of a parent company and its subsidiaries that effectively nullified intercompany guarantees. In doing so, the Third Circuit opted for an "open ended, equitable inquiry" rather than the factor-based analysis employed by many courts.

RETROACTIVE SUBSTANTIVE CONSOLIDATION IN *AMCO INSURANCE*

In September 2000, automobile insurance broker Rehmat A. Peerbhai approached a bank, seeking financing both for himself and on behalf of AIG Corp., an auto insurance company of which he was the sole shareholder. The bank agreed to extend financing to both but required Peerbhai to guarantee the loan to AIG. When AIG materially breached the loan agreement, the bank sued in state court to enforce its rights under both the loan agreement and the guarantee.

AIG filed a chapter 7 petition on February 4, 2002. Thereafter, the bankruptcy court approved an agreement between the bank and the chapter 7 trustee modifying the automatic stay to allow the state court litigation to proceed against Peerbhai. The bank and Peerbhai reached a settlement shortly thereafter under which Peerbhai confessed to a judgment secured by a lien on his residence.

Three months later, the chapter 7 trustee sought bankruptcy court authority to substantively consolidate AIG and Peerbhai, retroactively effective as of the date that AIG filed for bankruptcy. Although Peerbhai was not a debtor in bankruptcy at that time, he later filed a chapter 11 petition, and his bankruptcy case was converted to a chapter 7 liquidation.

The bankruptcy court ruled that substantive consolidation was appropriate because Peerbhai had, among other things, used AIG as his alter ego to commit fraud against his creditors. Additionally, the court reasoned that: (1) substantive consolidation would benefit all creditors and not unfairly prejudice any creditor because the financial affairs of AIG and Peerbhai were so entangled that the assets of each could not be segregated; (2) substantive consolidation would avoid the harm of AIG's creditors receiving virtually nothing in the bankruptcy case, due primarily to Peerbhai's looting of AIG; (3) the bank would not be unfairly harmed by substantive consolidation due to its knowledge of the circumstances surrounding the execution of the settlement agreement; (4) the fact that the parties were essentially a single financial entity could not have been ignored by the bank or any other reasonably diligent party extending credit to Peerbhai; and (5) substantive consolidation should be effective as of AIG's petition date because at all relevant times Peerbhai and AIG operated as one financial entity. The ruling effectively invalidated the authority conferred by the bankruptcy court upon the bank nearly 20 months earlier because *nunc pro tunc* consolidation would nullify any liens granted under the settlement agreement.

AMCO Insurance illustrates the importance of strategic planning during a bankruptcy case — every stakeholder should carefully consider the possible ramifications of taking a position that may later compromise its ability to seek certain kinds of relief from the court.

Following an unsuccessful appeal to the district court, the bank appealed the ruling to the Fifth Circuit. The Court of Appeals noted that the bankruptcy court's order modifying the automatic stay caused the bank to expend significant time and money prosecuting the state court litigation and reaching a settlement. Moreover, the Fifth Circuit emphasized, by requesting that the consolidation be effective as of AIG's petition date (so that the bank would be returned to its pre-settlement status), the chapter 7 trustee sought to undo what he had earlier authorized. According to the Court of Appeals, "[w]e think it was a little late for this reversal of course."

Although section 105(a) grants bankruptcy courts certain equitable powers, the Fifth Circuit cautioned that such power is not unlimited and does not "permit courts to act as roving commissions to do equity." It held that the bankruptcy court erred in applying substantive consolidation retroactively because the bank invested time and money pursuing a settlement based on the trustee's acquiescence in modifying the stay and because "nothing in the record suggest[ed] that the trustee knew anything more at the later date when he asked the court to grant substantive consolidation than he reasonably could have known at the time the agreed order was entered into."

ANALYSIS

Substantive consolidation of affiliated debtors' estates in a negotiated plan of reorganization as a means of simplifying a complicated corporate structure is not uncommon, particularly as corporate structures increasingly are driven by tax considerations that may cease to become viable once an affiliated network of companies files for bankruptcy. As illustrated by *AMCO Insurance*, substantive consolidation in contexts other than a negotiated consensual chapter 11 plan is much less common and demands careful examination of the impact that consolidation will have on all stakeholders in the bankruptcy case.

The Fifth Circuit's ruling also demonstrates that although a bankruptcy court has considerable discretion to order substantive consolidation, such discretion is not unfettered, particularly in cases involving the consolidation of nondebtors and/or retroactive consolidation. If the circumstances demonstrate that substantive consolidation would be fundamentally unfair or otherwise prejudicial due to events that have occurred during the course of the bankruptcy case, a consolidation order may be open to challenge. Finally, *AMCO Insurance* illustrates the importance of strategic planning during a bankruptcy case — every stakeholder should carefully consider the possible ramifications of taking a position

that may later compromise its ability to seek certain kinds of relief from the court.

Interestingly, the Fifth Circuit declined to address the bank's argument that a bankruptcy court's power to order consolidation was effectively eliminated by the U.S. Supreme Court's 1999 ruling in *Grupo Mexicano de Desarrollo, S.A. v. Alliance Bond Fund, Inc.*, where the Court ruled that a preliminary injunction issued to prevent a possible fraudulent transfer of assets is an improper use of a federal court's equity powers. The court below had found *Grupo Mexicano* to be inapposite because it did not involve the remedy of substantive consolidation and was otherwise factually distinguishable. The Fifth Circuit confined its ruling to the impropriety of *nunc pro tunc* consolidation under the circumstances, observing that "[g]iven that the order of substantive consolidation, in the absence of a *nunc pro tunc* order, appears likely to be fruitless, there is the probability that the issue will not arise on remand."

Wells Fargo Bank of Texas N.A. v. Sommers (In re AMCO Insurance), 444 F.3d 690 (5th Cir. 2006).

Pepper v. Litton, 308 U.S. 295 (1939).

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

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

Union Savings Bank v. Augie/Restivo Baking Co., Ltd. (In re Augie/Restivo Baking Co., Ltd.), 860 F.2d 515 (2d Cir. 1988).

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

In re Owens Corning, 419 F.3d 195 (3d Cir. 2005).

Grupo Mexicano de Desarrollo, S.A. v. Alliance Bond Fund, Inc., 527 U.S. 308 (1999).

SECOND-QUARTER BUSINESS BANKRUPTCY FILINGS WANE

The number of business chapter 11 filings decreased to its lowest point in more than a decade during the three months that ended June 30, 2006. According to the Administrative Office of the U.S. Courts, 1,079 businesses filed for chapter 11 protection during the second quarter of 2006 — a 16.4 percent decrease from the previous three months and the lowest quarterly figure since 1995.

Analysts say the recent falloff in business filings is a reflection of the easy availability of money. Although the Federal Reserve has raised its key interest rate 17 times over the past two years (from 1 percent to 5.25 percent), yields on Treasury bonds have not experienced a corresponding increase. As a consequence, institutional investors such as hedge funds and private-equity firms have sought higher returns by investing in financially troubled companies. According to analysts, such investments have permitted distressed companies to postpone a restructuring they otherwise would have been forced to undertake.

By contrast, chapter 7 business liquidations have begun to rebound after a steep drop earlier this year. Chapter 7 filings increased by about 800 to 2,940 during the second quarter of 2006. Even so, the volume of such filings remained significantly below last year's levels, when quarterly figures consistently exceeded 5,000.

FOCUS ABROAD: CHINA

Twenty years after it first implemented trial corporate bankruptcy legislation in 1986 and 12 years after setting out to reform laws that quickly became obsolete as market reforms swept the country, China finally enacted a permanent bankruptcy law designed to establish a legal framework for corporate bankruptcy and the discharge of debts and interests and governed by clear procedures. China's National People's Congress approved the PRC Enterprise Bankruptcy Law on August 26, 2006, although the legislation is not slated to become effective until June 1, 2007.

With limited exceptions, the law applies to all types of business entities, including state-owned enterprises and foreign-invested enterprises. For the first time, the law sets out clear procedures regarding the bankruptcy of China's financial institutions, an issue that had long been a gray area. It also creates a mechanism for corporate reorganizations similar to chapter 11 of the U.S. Bankruptcy Code — a clear departure from current rules, which focus on liquidation as the sole mechanism for dealing with a bankrupt enterprise.

The new law, consisting of 12 chapters and 136 articles, is far more comprehensive than the previous version, which had six chapters and 43 articles and was widely considered incomplete when it was enacted. In addition, the 1986 version also had no provision for personal bankruptcies and applied primarily to state-owned enterprises.

The new law establishes procedures governing the discharge of creditor claims, bringing it more in line with international conventions. It also gives enhanced protection to investors and lenders. Bankruptcy proceedings commenced after the effective date of the legislation will afford the highest priority to the claims of secured creditors, after which available unsecured assets will be used to pay the claims of employees for wages, medical costs, insurance, and other compensation. Previously, employee claims had first priority and could even be paid from lenders' collateral, a rule that was widely criticized as being contrary to market practices.

It is anticipated that the new bankruptcy law will bring an end to the government's rescue of nonfinancial enterprises experiencing financial woes as a result of poor management or negligence. Going forward, most corporate bankruptcies will have to follow market-oriented rules and procedures, which means that managers will be held accountable if an enterprise is not well run.

The Chinese government drew up plans before the new law was approved to close down another 2,000 state-owned enterprises by 2008. It set aside 33.8 billion yuan ($4.2 billion) this year to help those companies settle claims from laid-off workers. Although these companies will benefit from the bailouts, other state-owned enterprises will have to rely on the new legislative framework to work out their financial problems. It remains to be seen to what extent the new rules and procedures will make the bankruptcy process more efficient and encourage a greater degree of foreign commerce with, or investment in, Chinese companies. The U.S. has repeatedly urged China to adopt national bankruptcy standards, characterizing the existing climate as a trade barrier. Meanwhile, the European Union has pointed to China's lack of a national bankruptcy law as one of its primary reasons for refusing to grant China coveted market-economy status as a trade partner.

LARGEST PUBLIC COMPANY BANKRUPTCY FILINGS IN 2006

COMPANY	FILING DATE	ASSETS
Dana Corporation	3/3/2006	$9,047,000,000
Satélites Mexicanos, S.A. de C.V.	8/11/2006	$925,271,000
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
Radnor Holdings Corp.	8/21/2006	$361,454,000
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
Vesta Insurance Group, Inc.	8/8/2006	$195,325,000
Portrait Corporation of America, Inc.	8/31/2006	$161,310,000
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
Inland Fiber Group, LLC	8/18/2006	$84,775,000
OneTravel Holdings, Inc.	7/7/2006	$84,294,008
Copelands' Enterprises, Inc.	8/14/2006	$56,600,000
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

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