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LANDMARK THIRD CIRCUIT RULING ON MULTIPLE PENSION PLAN TERMINATION

Gregory M. Gordon (Dallas) argued successfully on behalf of Kaiser before the Third Circuit.

Jones Day Obtains Unanimous Ruling From the Third Circuit Rejecting Plan-by-Plan Analysis in Favor of Aggregate Approach in Applying ERISA "Reorganization Test"

Termination of one or more defined-benefit pension plans has increasingly become a significant aspect of a debtor-employer's reorganization strategy under chapter 11 of the Bankruptcy Code, providing a way to contain spiraling labor costs and facilitate the transition from defined-benefit based programs to defined-contribution programs such as 401(k) plans. Recently, Jones Day obtained a victory for its client Kaiser Aluminum Corporation that will significantly impact the ability of a chapter 11 debtor to effect a "distress termination" of multiple pension plans. In the first circuit-level decision on the issue, the United States Court of Appeals for the Third Circuit unanimously held in *In re Kaiser Aluminum Corp.* that, when an employer in chapter 11 seeks to terminate more than one pension plan, the plans must be analyzed on an aggregate rather than a plan-by-plan basis.

ERISA AND PBGC

The respective rights and obligations of employers and retirees vis-à-vis pension benefits are governed not by the Bankruptcy Code, but by the Employee Retirement Income Security Act ("ERISA"), which provides the primary regulatory framework and protection for pension benefits. Enacted in 1974, ERISA is a comprehensive regulatory scheme intended to protect the interests of pension plan and welfare benefit participants and beneficiaries and to preserve the integrity of trust assets. On a basic level, it establishes minimum participation, vesting, and funding standards and contains detailed reporting and disclosure requirements. ERISA also created the Pension Benefit Guaranty Corporation ("PBGC") to act as both the regulatory watchdog and the guarantor, at least to a certain extent, for the pension and related rights of the U.S. workforce.

Companies pay insurance premiums to PBGC, and if an employer can no longer support its pension plan, PBGC takes over the assets and liabilities and pays promised benefits to retirees up to certain limits. The maximum annual benefit for plans assumed by the agency in 2005 was $45,614 for workers who wait until 65 to retire. For plans assumed in 2006, the maximum yearly benefit amount is $47,659. PBGC self-finances payments to employees under terminated plans through four sources of income: (i) insurance premiums paid by current sponsors of active plans (in 2006, $30 per year per participant, although companies posing high risks of underfunding must pay an additional $9 per participant); (ii) assets from terminated plans taken over by PBGC; (iii) recoveries from former sponsors of terminated plans; and (iv) PBGC's own investments.

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

There are several ways for a pension to terminate under ERISA. In a "standard termination," an employer can voluntarily terminate its plan so long as the plan has sufficient assets to pay all future benefits. The employer remains liable to PBGC for all plan benefit liabilities. An employer can also voluntarily act to terminate its plan in a "distress termination" under the following circumstances: (i) liquidation in bankruptcy; (ii) a reorganization in bankruptcy in which the court "determines that, unless the plan is terminated, [the employer] will be unable to pay all its debts pursuant to a plan of reorganization and will be unable to continue in business outside the chapter 11 reorganization process" and approves the termination; and (iii) a nonbankruptcy situation where termination is necessary because, unless a distress termination occurs, the employer will be unable to pay its debts when they mature and will be unable to continue in business, or the costs of providing pension coverage have become unreasonably burdensome solely as a result of a decline in the employer's workforce. The standard set forth in option (ii) is commonly referred to as the "reorganization test."

Upon termination of a plan, PBGC assumes responsibility for guaranteed benefits while attempting to collect funds from the employer. An employer cannot effectuate either a standard or distress termination if terminating the plan would violate the terms and conditions of an existing collective bargaining agreement. However, a plan sponsor seeking a distress termination while in bankruptcy may nullify a contractual bar to plan termination by obtaining court authority to reject or modify the bargaining agreement under section 1113 of the Bankruptcy Code. Finally, PBGC itself can move to terminate a company's pension plan if the company defaults on its minimum funding requirements and PBGC determines that it will be exposed to unreasonable risk in the long run if the plan continues.

Representing Kaiser Aluminum Corporation and its affiliates in their chapter 11 cases, Jones Day successfully litigated against PBGC in the bankruptcy court, the district court and, ultimately, the Third Circuit Court of Appeals regarding the application of the "reorganization test" to a chapter 11 debtor's distress termination of multiple pension plans.

KAISER ALUMINUM

Aluminum mining, refining, and manufacturing giant Kaiser Aluminum Corp. and 25 of its affiliates (collectively, "Kaiser"), with Jones Day's assistance as reorganization counsel, filed for chapter 11 protection between February 2002 and January 2003. As part of Kaiser's attempt to reorganize, the company moved to voluntarily terminate six of its seven

pension plans, all of which had been established pursuant to collective bargaining agreements with various unions. The plans covered nearly 13,500 active employees and retirees. The plans were underfunded by nearly $48 million for the 2003 plan year, and Kaiser projected that it would be required to make $230 million in minimum contributions to the plans between 2004 and 2009.

PBGC opposed Kaiser's motion to terminate the plans, arguing that the bankruptcy court should evaluate each proposed plan termination separately under the ERISA "reorganization test." PBGC acknowledged that Kaiser's two largest pension plans would satisfy the reorganization test, but claimed that, when considered on a plan-by-plan basis, Kaiser's four smaller plans did not satisfy the test. The combined minimum funding contributions for these four plans were projected to be roughly $12.8 million between 2004 and 2009 — less than 6 percent of the estimated $230 million required to fund all of Kaiser's pension plans during that time frame. When these smaller plans were considered on a plan-by-plan basis, PBGC contended, Kaiser could continue funding some or all of them and still successfully reorganize under chapter 11.

The bankruptcy court rejected PBGC's position, agreeing with Kaiser that the plan-by-plan approach endorsed by PBGC would violate the requirement under section 1113(b) of the Bankruptcy Code that debtors bargain fairly and equitably with unions. The court reasoned that considering the plans piecemeal would give creditors the kind of leverage that would force a debtor to initiate bargaining with one union and not with another. Likewise, the court observed, "debtors could use a plan-by-plan approach to gain leverage against creditors that Congress did not intend."

PBGC appealed the decision to the U.S. District Court for the District of Delaware, which affirmed, concluding that ERISA does not mandate a plan-by-plan approach in applying the reorganization test. PBGC then appealed to the Third Circuit Court of Appeals.

THE THIRD CIRCUIT'S RULING

Explaining that ERISA does not explicitly state how the reorganization test is to be applied when an employer seeks to terminate several plans at once, the Court of Appeals remarked that "[i]n every case that we have identified in which a debtor sought to terminate multiple pension plans under the reorganization test, bankruptcy courts have applied an aggregate analysis, apparently without protest from the PBGC." The Court rejected PBGC's contention that a plan-by-plan analysis is mandated by ERISA because lawmakers used the singular terms "single-employer plan" and "plan" in the relevant portion of the statute. The use of the singular form of "plan" in ERISA, the Third Circuit emphasized, "does not constitute a congressional mandate to the bankruptcy courts to apply a plan-by-plan approach to the reorganization test."

The Court of Appeals agreed with Kaiser that a plan-by-plan approach would be "unworkable" because it would compel bankruptcy courts to make basic assumptions about the order in which plans should be considered and the status of other plans that a debtor-employer proposes to terminate. As currently drafted, the Third Circuit observed, ERISA "leaves open too many questions about how to engage in a plan-by-plan analysis for us to conclude that Congress envisioned such an approach in the multiplan context."

Moreover, the Court of Appeals explained, the adoption of a plan-by-plan approach to the reorganization test would disrupt the bankruptcy courts in their traditional role as courts of equity:

> The PBGC would have the Bankruptcy Court terminate some of Kaiser's plans while leaving the others in place, seemingly without a principled basis on which it could make the determination of which workers to prefer over others. We will not impose this result, which we believe would treat Kaiser's workers unfairly and inequitably, without a clear congressional mandate.

The Third Circuit rejected PBGC's assertion that a legislative trend tightening restrictions on pension plan terminations indicates that Congress would endorse a plan-by-plan approach. According to the Court of Appeals, "[a]t most, the legislative history demonstrates that Congress had a general intent to make it more difficult for employers to terminate pensions; however, that is hardly determinative of whether, or how, the reorganization test should be applied in the multiplan context."

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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) and ***David G. Heiman (Cleveland)*** were recognized by the *K&A Restructuring Register* as being among the outstanding attorneys practicing in restructuring, reorganization, insolvency, and bankruptcy in the United States in 2006.

Corinne Ball (New York), ***Paul E. Harner (Chicago)***, ***David G. Heiman (Cleveland)***, and ***Paul D. Leake (New York)*** were recognized by *Who's Who Legal USA* for 2006 in the field of Insolvency & Restructuring.

An article co-written by ***David G. Heiman (Cleveland)*** and ***Gregory M. Gordon (Dallas)*** entitled "Innovative Approaches to Complex Restructurings: Creating a New Chapter for Kaiser Aluminum and USG" appeared in the September 2006 issue of *The Metropolitan Corporate Counsel*. Their article entitled "When the Dust Settles" was published in the October 16, 2006, edition of *The Deal*.

David G. Heiman (Cleveland) was among the *Lawdragon* 500 Leading Lawyers in America for 2006.

Brad B. Erens (Chicago) was rated as a "Highly Recommended" restructuring and insolvency lawyer in the 2006-2007 *PLC Cross-Border Restructuring and Insolvency Handbook*.

Corinne Ball (New York) was rated as a "Leading" restructuring and insolvency lawyer in the 2006-2007 *PLC Cross-Border Restructuring and Insolvency Handbook*.

An article co-written by ***Gregory M. Gordon (Dallas)*** and ***Debra K. Simpson (Dallas)*** entitled "Retaining Key Employees in Bankruptcy" appeared in the October 16, 2006, issue of *Texas Lawyer*.

Corinne Ball (New York) moderated a panel discussion on November 3, 2006, in San Francisco entitled "Debtor-in-Possession Financing in the Auto Industry: Global Sourcing, 'Just in Time' Inventory and OEM Customers" at a program sponsored by the American Bar Association in conjunction with the 80th Annual Meeting of the National Conference of Bankruptcy Judges.

Tobias S. Keller (San Francisco) moderated a panel discussion on November 2, 2006, in San Francisco entitled "Caveat Emptor: The Perils of Trading in Distressed Securities" at a program sponsored by the American Bar Association in conjunction with the 80th Annual Meeting of the National Conference of Bankruptcy Judges. On September 25, 2006, he lectured at Stanford Law School concerning "The Commercial Law of Intellectual Property."

Richard Engman (New York) gave a presentation on November 2, 2006, in San Francisco concerning "Committees After BAPCA – Emerging Issues" at a program sponsored by the American Bar Association in conjunction with the 80th Annual Meeting of the National Conference of Bankruptcy Judges.

NEWSWORTHY *(continued)*

Heather Lennox (Cleveland) was recognized as an "Outstanding Young Professional" for 2006 by *Turnarounds & Workouts*. She appears in the 2006 edition of *The Best Lawyers in America*.

Christopher L. Carson (Atlanta) was recognized by *Chambers USA* as being one of America's Leading Business Lawyers for 2006. He was listed among the "Top 100 Georgia Super Lawyers" in *Atlanta* magazine in 2006.

Corinne Ball (New York) was featured in *New York Super Lawyers* for 2006. She was listed in *The International Who's Who of Insolvency & Restructuring Lawyers 2006* and *The International Who's Who of Business Lawyers 2006*.

Tobias S. Keller (San Francisco) is the author of a November 2006 white paper entitled "An Overview of Legal Risks for Distressed Claims Traders." He gave a presentation on September 22, 2006, at the Asia America MultiTechnology Association concerning "Dealing with Distressed US Businesses: A Roundtable on Risks and Opportunities."

Paul E. Harner (Chicago), ***Brad B. Erens (Chicago)***, and ***Richard A. Chesley (Chicago)*** were featured in *Illinois Super Lawyers* for 2006.

David G. Heiman (Cleveland), ***Jeffrey B. Ellman (Atlanta)***, ***Heather Lennox (Cleveland)***, ***Charles M. Oellermann (Columbus)***, and ***Robert W. Hamilton (Columbus)*** were selected as "Ohio Super Lawyers" in 2006 by *Law & Politics* and *Cincinnati* magazine.

Adam Plainer (London) and ***Sion Richards (London)*** were recognized in *Chambers UK* and *Chambers Global* for 2006 in the field of Restructuring/Insolvency.

Pierre-Nicolas C. Ferrand (Paris) was ranked in *Chambers Global* for 2006 in the areas of Restructuring/Insolvency and Banking & Finance.

Kelley M. Griesmer (Columbus), ***Carl E. Black (Cleveland)***, and ***Ryan T. Routh (Cleveland)*** were named as "Ohio 2006 Rising Stars" (age 40 or under or practicing 10 years or less) by *Law & Politics* and *Cincinnati* magazine.

An article co-written by Michelle M. Harner and ***David A. Beck (Columbus)*** entitled "Sublicensing from a Distressed Company: Is Your Future in the Debtor's Hands?" appeared in the November 2006 edition of *American Bankruptcy Institute Journal*.

An article written by ***Ryan T. Routh (Cleveland)*** entitled " 'Twenty Day Claims' : The Anticipated and Unanticipated Consequences of Code § 503(b)(9)" was published in the November 2006 edition of *American Bankruptcy Institute Journal*.

An article written by ***Mark G. Douglas (New York)*** entitled "Unscrambling the Egg or Redividing the Pie? Revoking a Chapter 11 Plan Confirmation Order" was published in the October/November 2006 edition of *Pratt's Journal of Bankruptcy Law*. His article entitled "Airline Focus: Using Section 1113 to Navigate Stormy Skies" appeared in the September 15, 2006, issue of *Bankruptcy Law 360*.

CHAPTER 15 TURNS ONE: IRONING OUT THE DETAILS

Mark G. Douglas

October 17, 2006, marked the first anniversary of the effectiveness of chapter 15 of the Bankruptcy Code as part of the comprehensive bankruptcy reforms implemented under the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. Governing cross-border bankruptcy and insolvency cases, chapter 15 is patterned after the Model Law on Cross-Border Insolvency (the "Model Law"), a framework of legal principles formulated by the United Nations Commission on International Trade Law ("UNCITRAL") in 1997 to deal with the rapidly expanding volume of international insolvency cases.

Long-heralded chapter 15 replaces section 304 of the Bankruptcy Code. Section 304 allowed an accredited representative of a debtor in a foreign insolvency proceeding to commence a limited "ancillary" bankruptcy case in the U.S. for the purpose of enjoining actions against the foreign debtor or its assets located in the U.S. The policy behind section 304 was to provide any assistance necessary to ensure the economic and expeditious administration of foreign insolvency proceedings. Chapter 15 continues that practice, but establishes new rules and procedures applicable to transnational bankruptcy cases that will have a markedly broader impact than section 304.

Because many of the principles and concepts in chapter 15 are consistent with those that applied to ancillary bankruptcy proceedings under section 304, bankruptcy courts called upon to interpret the provisions of chapter 15 have some degree of guidance based upon past practice. In addition, during the seven years between chapter 15's introduction as part of comprehensive bankruptcy reform in 1998 and its enactment in 2005, a considerable body of literature was created to explain how the new rules are supposed to work. Even so, it has been left to the courts to iron out many of the details.

One issue that is unclear based upon the provisions of chapter 15 — whether a bankruptcy court can recognize and provide assistance to a foreign bankruptcy case as a secondary ("nonmain") proceeding when no primary ("main") proceeding is pending — was the subject of a ruling recently handed down by a New York bankruptcy court. In *In re SPhinX, Ltd.*, the court denied a petition seeking recognition of liquidation proceedings in the Cayman Islands as foreign "main" proceedings under chapter 15, because the evidence did not support a finding that the "center of main interest" ("COMI") of the companies involved was in the Cayman Islands. However, the court stopped short of announcing that the absence of COMI in the foreign country is, in and of itself, sufficient to deny "main" proceeding status to a foreign insolvency proceeding based on the court's concerns that the liquidators' motive for seeking recognition was to gain a tactical advantage in pending litigation involving the debtors.

THE PURPOSE OF CHAPTER 15

Chapter 15 is unique among the chapters of the Bankruptcy Code in declaring its purpose, which is "to provide effective mechanisms for dealing with cases of cross-border insolvency" consistent with the following objectives:

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

PROCEDURE

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

Because more than one bankruptcy or insolvency proceeding may be pending against the same foreign debtor in different countries, chapter 15 contemplates recognition in the U.S. of both a "main" proceeding — a case pending in whatever country contains the debtor's COMI — and "nonmain" proceedings, which may have been commenced in countries where the debtor merely has an "establishment" (conducts business or owns assets). The debtor's registered office or habitual residence, in the case of an individual, is presumed to be the center of the debtor's main interest. As discussed in greater detail below, the recognition of a foreign insolvency proceeding as a "main proceeding" has marked advantages over recognition as a "nonmain proceeding" — perhaps most significantly, the triggering of the automatic stay under section 362 of the Bankruptcy Code.

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

INTERIM RELIEF

Pending its decision on recognition, the court is empowered to grant certain kinds of provisional relief. Section 1519 authorizes the court, "where relief is urgently needed to protect the assets of the debtor or the interests of the creditors," to stay any execution against the debtor's assets; entrust the administration of the debtor's assets to a foreign representative; or suspend the right to transfer, encumber, or otherwise dispose of any of the debtor's assets. Any provisional relief granted pending approval of a request for recognition terminates at such time that the bankruptcy court rules on the request, unless the court expressly orders otherwise.

BROAD POWERS UPON RECOGNITION

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

The bankruptcy court's decision to provide "additional assistance" (*i.e.*, relief not expressly contemplated by chapter 15 or relief authorized under other U.S. laws) must be designed to reasonably ensure, among other things, that (i) all stakeholders are treated fairly; (ii) U.S. creditors are not prejudiced by asserting their claims in the foreign proceeding; (iii) the debtor's assets are not preferentially or fraudulently transferred; (iv) proceeds of the debtor's assets are distributed substantially in accordance with the order prescribed by the Bankruptcy Code; and (v) if appropriate, an individual foreign debtor is given the opportunity for a fresh start.

Finally, the bankruptcy court may exercise its discretion to order any of the relief authorized by chapter 15 upon the commencement of a case or recognition of a foreign proceeding "only if the interests of the creditors and other interested entities, including the debtor, are sufficiently protected."

Once a foreign main proceeding is recognized by the bankruptcy court, the foreign representative is authorized to operate the debtor's business in much the same way as a chapter 11 debtor-in-possession. He can also commence a full-fledged bankruptcy case under any other chapter of the Bankruptcy Code, so long as the foreign debtor is eligible to file for bankruptcy in the U.S. and the debtor has U.S. assets.

The foreign representative in a recognized chapter 15 case is conferred with some of the powers given to a bankruptcy trustee under the Bankruptcy Code, although they do not include the ability to invalidate preferential or fraudulent asset transfers or obligations, unless a case is pending with respect to the foreign debtor under another chapter of the Bankruptcy Code. The foreign representative may also intervene in any court proceedings in the U.S. in which the foreign debtor is a party, and can sue and be sued in the U.S. on the foreign debtor's behalf.

THE SPHINX FUNDS' CHAPTER 15 PROCEEDINGS

SPhinX Ltd. and a series of related companies incorporated in the Cayman Islands (collectively, the "Funds") operated as offshore hedge funds until July of 2006. Although regulated in the Cayman Islands, the Funds did not conduct any business there and had neither employees nor offices located on the islands. None of their directors resided in the

Cayman Islands. Substantially all of their assets are located in accounts in the U.S. The Funds' business was conducted under a management contract with a Delaware corporation that is a chapter 11 debtor in New York. Most, if not all, of the account managers retained under the contract to provide services to the Funds did so from the U.S.

The Funds' clients were located throughout the world. One of the largest of them was Refco Capital Markets, Ltd., which, together with its affiliates (collectively, "Refco"), is also undergoing liquidation as a chapter 11 debtor in New York. On April 13, 2006, the creditors' committee of Refco sued certain of the Funds to recover an alleged preferential payment in the amount of approximately $312 million. The committee also sought to attach the Funds' U.S. assets.

The Funds and the chapter 11 trustee that succeeded Refco's committee in the litigation reached a settlement before the preference trial began. As part of the agreement, the Funds deposited a settlement payment into escrow pending approval of the settlement by the bankruptcy court overseeing Refco's chapter 11 case. In conjunction with the committee's motion seeking that approval, certain investors in the Funds objected to the settlement on the basis that it was too favorable to Refco. They also caused involuntary winding-up proceedings to be commenced against two of the Funds in the Cayman Islands.

At the hearing to consider approval of the Refco settlement, the provisional liquidators appointed in the Cayman proceedings informed the bankruptcy court that they had filed chapter 15 petitions on behalf of the Funds, and requested that the settlement motion be adjourned to give them an opportunity to evaluate the terms of the settlement. The court denied the request, finding that its analysis in determining the propriety of the proposed settlement was directed toward its impact on Refco's estate and creditors, and noting that it was not the appropriate forum to resolve a dispute involving allegations that the nondebtor proponents' execution of the agreement was actionable in some way.

The bankruptcy court approved the Refco settlement on June 9, 2006. Certain Fund investors appealed that order to the district court. Under the terms of the settlement agreement, it will not become effective until the favorable resolution of any appeal of the bankruptcy court's order. Meanwhile, the Cayman Islands court overseeing the liquidation proceedings commenced on behalf of two of the Funds dismissed the cases, and the liquidators withdrew their chapter 15 petitions.

All of the Funds were put into voluntary liquidation on June 30, 2006, after certain investors assumed control of the group, and substantially all of them filed voluntary winding-up petitions in the Cayman Islands court on July 4, 2006. Although the Funds' liquidators agreed shortly thereafter to prosecute the pending appeal of the Refco settlement in accordance with the district court's scheduling order, they filed chapter 15 petitions on behalf of the Funds in New York on July 31, 2006, and immediately sought to enjoin continuation of the litigation, asserting that they needed time to investigate whether the settlement was improper from the Funds' perspective. The liquidators also requested an order recognizing the Cayman Islands' insolvency proceedings as foreign "main" proceedings.

THE BANKRUPTCY COURT'S RULING

Chapter 15, the bankruptcy court explained, maintains and in some respects enhances the "maximum flexibility" that section 304 gave to courts in dealing with ancillary cases. This flexibility is evident not only in chapter 15's statement of purpose, but in provisions of the statute that permit the court to grant or modify interim relief, or to grant additional relief "only if the interests of creditors and other interested entities, including the debtor, are sufficiently protected." According to the court, flexibility is also manifested in the broad range of relief that a bankruptcy court can grant to an accredited representative of a foreign debtor, and in the recognition in chapter 15 that a case under another chapter of the Bankruptcy Code may be pending concurrently with an ancillary chapter 15 proceeding, necessitating the implementation of mechanisms to coordinate all proceedings (domestic and foreign) involving the debtor. Finally, the bankruptcy court noted, the flexibility of chapter 15 is demonstrated by provisions that permit the court to condition relief or to modify relief previously granted based upon changed circumstances. The key to harmonizing this "pervasive flexibility" with chapter 15's objective of "greater legal certainty for trade and investment," the court observed, must lie in the directive to protect the interests of all stakeholders in accordance with procedures that maximize value.

With this as a preamble, the court turned to the threshold inquiry under chapter 15 — whether the Cayman Islands' liquidation proceedings involving the Funds should be recognized as "foreign proceedings." The parties did not dispute this issue. However, Refco's chapter 11 trustee opposed recognition of the Cayman Islands' insolvency proceedings as foreign "main" proceedings because the automatic stay triggered by such recognition would arguably prevent adjudication of the appeal involving the Refco settlement.

The practical significance of affording recognition as either category of foreign proceeding may be minimal, the court explained, given its power to grant substantially the same range of relief in a "nonmain" proceeding that is available automatically or otherwise in a "main" proceeding. Even so, the court reasoned, because the Cayman liquidators acknowledged that they were seeking recognition of the liquidation proceedings as "main" proceedings so that the resulting automatic stay would give them more time to consider the propriety of the settlement, it was appropriate to examine carefully whether the Cayman proceedings qualified for "main" proceeding status.

The court determined that they did not. Under chapter 15, the court emphasized, a foreign main proceeding is defined as a proceeding pending in the country where the debtor has its COMI. Chapter 15 creates a presumption that a debtor's COMI is located in the country in which its registered office is located. Still, that presumption can be rebutted, although the Bankruptcy Code, its legislative history, and the paucity of established precedent construing chapter 15 offer little guidance concerning the kind of evidence necessary to overcome the presumption.

The court looked to recent foreign court decisions applying comparable criteria under relevant insolvency legislation (*e.g.*, the Model Law and the European Union Regulation on Insolvency Proceedings, both of which incorporate the concept of COMI), which indicate that "the center of main interests must be identified by reference to criteria that are both objective and ascertainable by third parties." According to the court, "important objective factors point to the SPhinX Funds' COMI being located outside of the Cayman Islands." Among these, the court explained, are administration of the Funds' hedge-fund business and back-office operations outside the Caymans, the absence of any managers or employees in the Caymans, and the convening of all board meetings outside the Cayman Islands.

"Pragmatic considerations affecting the Debtors' cases" also indicate a COMI outside the Caymans, the court emphasized. With the exception of corporate minute books and other similar records, no assets belonging to the Funds are located in the Caymans, and most, if not all, of the Funds' creditors and investors are located outside the Caymans, all of which means that the Cayman court would have to rely to a substantial degree on foreign courts to wind up the Funds' affairs.

> The pragmatic and flexible approach employed by the bankruptcy court in *SPhinX* is consistent with chapter 15's intended purpose as a vehicle for coordinating the efficient and expeditious administration of a foreign debtor's assets while safeguarding the commercial expectations of stakeholders.

These factors alone, the court observed, did not preclude recognition of the Cayman liquidation as a "main" proceeding, because the Funds' investors, who comprised the vast majority of the stakeholders in the Cayman proceedings, did not object to the chapter 15 petition seeking recognition, and the liquidators, under the supervision of the Cayman court, were the only parties ready to perform the winding-up function. However, the bankruptcy court refused to recognize the Cayman proceedings as foreign "main" proceedings because the primary purpose of the chapter 15 petition was not to assist in the efficient administration of the Cayman proceedings, but to frustrate the Refco settlement by obtaining a stay of the appeal, which the court deemed "improper." According to the court, "staying the appeal would have the same effect as overturning the [Refco settlement] *without addressing or prevailing on the merits*." The liquidators' underlying strategy, the court remarked, "taints" their request for recognition as well as the investors' consent to the chapter 15 petition, "giving the clear appearance of improper forum shopping."

Having determined, however, that some kind of recognition of the Cayman proceedings is clearly warranted, the bankruptcy court proceeded to consider whether recognition of the proceedings as nonmain proceedings would somehow violate the dictates of chapter 15. The court concluded it would not. Even though no other insolvency proceedings are pending with respect to the Funds other than in the Caymans, the court explained, "it would run contrary to logic as well as [chapter 15's] plain language and purpose to force the court to recognize a foreign proceeding as a 'main' proceeding simply because it was the only proceeding currently pending." It accordingly entered an order recognizing the Cayman liquidation cases as foreign nonmain proceedings.

OUTLOOK

Chapter 15 is still very much in its infancy, but it is maturing rapidly. Nearly 70 chapter 15 petitions were filed in U.S. bankruptcy courts by the end of the third quarter of 2006, with the Southern District of New York by far the preferred forum (51 cases). During that same period, the courts entered 61 recognition orders. Those orders involved recognition of foreign main proceedings in all cases but those involving the 23 SPhinX-related entities.

The "main versus nonmain" distinction was a matter of first impression in *SPhinX*. Even so, the issue was revisited shortly afterward by a California bankruptcy court in *In re Tri-Continental Exchange Ltd.* There, the court recognized winding-up proceedings commenced on behalf of three related insurance companies in St. Vincent and the Grenadines as "foreign main proceedings" under chapter 15. In doing so, it overruled a judgment creditor's contention that the winding-up proceedings should be recognized only as nonmain proceedings because the debtors perpetrated insurance fraud primarily in the U.S. and Canada, and restrictions should be placed on their ability to transfer U.S. assets. The court determined that the debtors' COMI was in St. Vincent and the Grenadines because they were organized under the laws of the islands and conducted regular business operations at their registered offices in Kingstown, St. Vincent, in a manner that equated with a "principal place of business" under concepts of U.S. law.

SPhinX and *Tri-Continental Exchange* are emblematic of the kinds of challenges facing bankruptcy courts called upon to interpret and apply the statute's as yet largely untested framework. Determining COMI is only one of many issues in chapter 15 that may prove to be more difficult than anticipated — there are no clear guidelines governing this area in chapter 15 itself, and the body of jurisprudence construing the new law is not extensive. Although bankruptcy courts can look for guidance to rulings interpreting the Model Law and the EU Regulation on Insolvency Proceedings, both of which, as noted, incorporate COMI as a basis for a plenary bankruptcy or insolvency filing, the utility of reference is limited by the paucity of relevant decisions.

Additional guidance can be found in the Legislative Guide to the Model Law adopted by UNCITRAL on June 25, 2004, and an extensive body of legal commentary developed during the nine years since the Model Law was finalized in 1997. To date, Eritrea, Japan, Mexico, Poland, Romania, Montenegro, Serbia, South Africa, Great Britain, the British Virgin Islands, and the U.S. have enacted some version of the Model Law — Great Britain and the U.S. in the last two years. Thus, we can expect a significant proliferation in the body of case law interpreting COMI and many other significant concepts in chapter 15.

The pragmatic and flexible approach employed by the bankruptcy court in *SPhinX* is consistent with chapter 15's intended purpose as a vehicle for coordinating the efficient and expeditious administration of a foreign debtor's assets while safeguarding the commercial expectations of stakeholders. The decision is also a testament to the versatility of the new procedures and to the broad discretion that chapter 15 gives bankruptcy judges to fashion relief that is appropriate under the circumstances. Where, as in *SPhinX*, a bankruptcy court perceives forum shopping to be a primary motive for seeking recognition, chapter 15 gives the court sufficient discretion to tailor relief in a way that protects the interests of stakeholders in general, but stops short of conferring an unfair advantage on any particular stakeholder.

In re SPhinX, Ltd., 2006 WL 2578727 (Bankr. S.D.N.Y. Sept. 6, 2006).

In re Tri-Continental Exchange Ltd., 349 B.R. 627 (Bankr. E.D. Cal. 2006).

VALIDITY OF SENIOR-CLASS "GIFTING" IN THE AFTERMATH OF *ARMSTRONG WORLD INDUSTRIES*

Anne M. Sherry and Mark G. Douglas

The proposition that a creditor can do whatever it wants with its recovery from a chapter 11 debtor may seem to be a fundamental right. Even so, in the context of confirmation of a chapter 11 plan, that right may not be unqualified and may, in fact, violate well-established bankruptcy principles. One such principle that applies only in the context of nonconsensual confirmation of a chapter 11 plan — or "cram-down" — is commonly referred to as the "absolute priority rule," a pre-Bankruptcy Code maxim that established a strict hierarchy of payment among claims of differing priorities. The rule's continued vitality and application under the current statutory scheme have been a magnet for controversy, particularly because "give-ups" by senior classes of creditors to achieve confirmation have become increasingly common features of chapter 11 plans.

One of the most significant developments in the debate came at the end of 2005, when the Third Circuit Court of Appeals, in *In re Armstrong World Industries, Inc.*, affirmed a Delaware bankruptcy court's ruling that a chapter 11 plan could not be confirmed because a proposed distribution of warrants to the debtor's stockholders over the objection of the class of unsecured creditors violated the rule. The Delaware bankruptcy court recently had an opportunity to revisit the issue, with a twist, in *In re World Health Alternatives, Inc*.

CRAM-DOWN AND THE FAIR AND EQUITABLE REQUIREMENT

A chapter 11 plan can be confirmed by the bankruptcy court under either of two scenarios. The first is a consensual plan confirmation. This means that all classes of creditors and shareholders either have accepted the plan or are not "impaired" by it because the plan pays them in full or leaves their rights unchanged. By contrast, if a class of creditors or shareholders votes to reject a plan, it can be confirmed over the class's objection only if the plan satisfies the requirements of section 1129(b) of the Bankruptcy Code. Among these is the mandate that a plan "does not discriminate unfairly" and is "fair and equitable" with respect to dissenting classes of creditors and shareholders.

The Bankruptcy Code specifically details one of the prerequisites for a plan's treatment of a class of claims or equity interests to be "fair and equitable." This requirement varies, depending on whether the dissenting impaired class contains secured claims, unsecured claims, or interests. With respect to a dissenting impaired class of unsecured claims, section 1129(b)(2) of the Bankruptcy Code provides that a plan is fair and equitable if, among other things, the creditors in the class are paid in full, or failing full payment, no creditor of lesser priority, or shareholder, receives any distribution under the plan. This requirement is sometimes referred to as the "absolute priority rule."

Section 1129(b)(2) has been the focus of considerable debate in the courts even though it expressly delineates the circumstances under which a plan satisfies the standard. The dispute has generally concerned two areas. The first pertains to the ability of a company's existing shareholders, even though creditor claims are not paid in full, to retain an ownership interest in a reorganized debtor by infusing new value into the debtor. Referred to as the "new value" exception to the absolute priority rule, this issue is outside the scope of this article. The second issue is whether section 1129(b)(2) allows a class of senior creditors voluntarily to cede a portion of its recovery under a plan to a junior class of creditors or shareholders.

LEGITIMACY OF SENIOR-CLASS "GIVE-UPS" UNDER THE ABSOLUTE PRIORITY RULE

Notwithstanding section 1129(b)(2)(B)(ii)'s preclusion of distributions to junior interests in cases where it applies, some courts have ruled that a plan does not violate the "fair and equitable" requirement if a class of senior creditors agrees that some of the property that would otherwise be distributed to it under the plan can be given to a junior class of creditors or shareholders. In doing so, many courts rely on a 1993 decision by the First Circuit Court of Appeals in *In re SPM Manufacturing Corp.*

In *SPM*, a secured lender holding a first-priority security interest in substantially all of a chapter 11 debtor's assets entered into a "sharing agreement" with general unsecured creditors to divide the proceeds that would result from the reorganization, apparently as a way to obtain their cooperation in the case. After it became apparent that the company could not be reorganized, the court appointed a receiver to market SPM's assets, which were ultimately sold for $5 million. Soon afterward, the secured creditor obtained relief from the automatic stay and the case was converted to a chapter 7 liquidation.

Cases involving carve-outs from recoveries that would otherwise go exclusively to a senior class of secured creditors (as in *SPM*) are far more likely to pass muster under the standard articulated by the Third Circuit Court of Appeals in *Armstrong*.

Thereafter, the secured lender and the unsecured creditors tried to force the chapter 7 trustee to distribute the proceeds from the sale of the debtor's assets in accordance with the sharing agreement. The agreement, however, contravened the Bankruptcy Code's distribution scheme because it provided for distributions to unsecured creditors before payment of priority tax claims.

Relying upon its equitable powers under section 105(a), the bankruptcy court ordered the trustee to ignore the sharing agreement and to distribute the proceeds of the sale otherwise payable to the unsecured creditors in accordance with the statutory distribution scheme. The district court upheld that determination on appeal.

The First Circuit reversed. As a fully secured lienor, the Court of Appeals explained, the lender was entitled to the entire amount of any proceeds of the sale of the debtor's assets, whether or not there was a sharing agreement. Therefore, any money siphoned to unsecured creditors came from funds to which the secured creditor was otherwise entitled. Moreover, the First Circuit reasoned, because the secured lender would share its proceeds only after all unencumbered estate property had been distributed, the sharing agreement had no effect on distributions to other creditors. Without the sharing agreement, the secured lender would have received the entire allotted distribution under the reorganization plan, while tax creditors would have received nothing. Thus, the First Circuit concluded, "[w]hile the debtor and the trustee are not allowed to pay nonpriority creditors ahead of priority creditors . . . , creditors are generally free to do whatever they wish with the bankruptcy dividends they receive, including to share them with other creditors."

Other courts have cited *SPM* as authority for confirming a nonconsensual chapter 11 plan (or settlement) in which a senior secured creditor assigns a portion of its recovery to creditors (or shareholders) who would otherwise receive nothing by operation of section 1129(b)(2). Some have even extended this rationale to encompass voluntary concessions by unsecured creditors to other unsecured creditors with lesser priority. Still, as noted, the concept of allowing a senior creditor or class of creditors to assign part of its recovery under a chapter 11 plan to junior creditors or stockholders who would otherwise receive nothing by operation of section 1129(b)(2)(B)(ii) is controversial. So much so, in fact, that the Third Circuit declared the practice invalid under certain circumstances in *Armstrong World Industries*.

ARMSTRONG WORLD INDUSTRIES

Facing significant asbestos liabilities, floor and ceiling products manufacturer Armstrong World Industries, Inc. ("Armstrong"), and two of its wholly owned subsidiaries voluntarily sought chapter 11 protection in 2000. Armstrong's creditors included both general unsecured creditors and creditors whose claims were based upon injuries sustained due to asbestos exposure.

Armstrong filed its fourth amended chapter 11 plan in 2003. Under the plan, unsecured creditors (other than asbestos claimants) would recover approximately 59.5 percent of their claims and asbestos personal-injury creditors would recover approximately 20 percent of an estimated $3.1 billion in claims. In addition, the plan provided that Armstrong's shareholders would receive warrants to purchase new common stock in the reorganized company valued at $35 million to $40 million. A key provision of the plan was the consent of the class of asbestos claimants to share a portion of its proposed distribution with equity. The plan provided that, if

Armstrong's class of unsecured creditors (other than asbestos claimants) voted to reject the plan, asbestos claimants would receive new warrants, but would automatically waive their distribution, causing equity to obtain the warrants that otherwise would have been distributed to the asbestos claimants. The net result of the waiver was that equity holders would receive property on account of their equity interests, although a senior class (*i.e.,* the unsecured creditors) was not paid in full.

Of the classes of creditors and shareholders impaired by the plan, only unsecured creditors voted to reject it. Thus, upon the submission of proposed findings by the bankruptcy court, the district court had to decide whether the plan could be confirmed over the objection of the unsecured class under section 1129(b). The court denied confirmation, ruling that distribution of new warrants to the class of equity holders over the objection of the unsecured-creditors class violated the "fair and equitable" requirement of section 1129(b)(2)(B)(ii).

In doing so, the district court distinguished, or characterized as "wrongly decided," cases in which the courts have not strictly applied section 1129(b)(2)(B)(ii). It found *SPM* to be inapposite for "several reasons." Initially, the district court explained, the distribution in *SPM* occurred in a chapter 7 case, "where the sweep of 11 U.S.C. § 1129(b)(2)(B)(ii) does not reach." Moreover, the court emphasized, SPM's unsecured creditors, rather than being deprived of a distribution, were receiving a distribution ahead of priority, such that "the teachings of the absolute priority rule — which prevents a junior class from receiving a distribution ahead of the unsecured creditor class — are not applicable."

The district court reasoned that the secured lender in *SPM* held a first-priority security interest in substantially all of the debtor's assets. This meant that, although the sharing agreement implicated estate property, the property was not subject to distribution under the Bankruptcy Code's priority scheme. Finally, the district court emphasized, the sharing agreement in *SPM* might be more properly construed as an ordinary "carve-out," whereby a secured party allows a portion of its lien proceeds to be paid to others as part of a cash collateral agreement.

The district court went on to distinguish other cases that have not strictly applied section 1129(b)(2)(B)(ii), flatly rejecting the contention that creditors, without adhering to the strictures of the statute, are free to do whatever they wish with their distributions under a plan, including sharing them with other creditors, so long as other creditor recoveries are not affected. "Bluntly put," the court concluded, "no amount of legal creativity or counsel's incantation to general notions of equity or to any supposed policy favoring reorganizations over liquidation supports judicial rewriting of the Bankruptcy Code."

The Third Circuit affirmed this determination on appeal, adopting substantially all of the district court's reasoning regarding the strictures of the absolute priority rule. Even so, the decision did not rule out the possibility that senior class give-ups might pass muster under different circumstances. What those circumstances can be was the subject of the Delaware bankruptcy court's ruling in *World Health Alternatives*.

WORLD HEALTH ALTERNATIVES

On the same day in February 2006 that World Health Alternatives, Inc., and its affiliates filed for chapter 11 protection, the debtors sought court authority to sell substantially all of their assets at auction, as well as approval of a post-petition financing to be provided by the debtors' pre-petition lender to allow for an orderly liquidation of their estates. The creditors' committee later appointed in the cases objected to the proposed auction procedures and the financing motion, but all parties concerned reached a global settlement of the disputed issues.

The settlement agreement provided that the lender would agree to a "carve-out" from its liens in the amount of $1,625,000, "to be distributed to the holders of allowed general unsecured claims after payment of any unpaid professional fees and expenses of the Committee and/or used to investigate and prosecute estate causes of action" against parties other than the lender. If approved, the settlement would allow for payments to unsecured creditors prior to full satisfaction of priority tax claims asserted by the Internal Revenue Service. The U.S. Trustee objected to the settlement, arguing, among other things, that the Third Circuit's ruling in *Armstrong* prohibits any payment to general unsecured creditors before priority claims. No other party, including the IRS, objected to the settlement motion.

Citing *Armstrong*, the bankruptcy court noted that the absolute priority rule arises in the context of a plan of reorganization. Because the settlement agreement was not part of any plan, as was the case in *Armstrong*, the court explained, *Armstrong* does not control. The court reasoned that, rather than overruling prior cases that permitted a senior creditor to give up some of its collateral to a junior class, *Armstrong* expressly distinguished those cases, suggesting that the settlement in *World Health* did not necessarily violate the absolute priority rule. According to the court, the facts before it were much more comparable to the circumstances present in *SPM*, which involved, among other things, (i) a settlement agreement rather than a chapter 11 plan; (ii) property that was fully encumbered and, thus, not subject to distribution according to the Bankruptcy Code's distribution scheme; and (iii) a carve-out of the secured creditor's collateral. Even in the context of nonconsensual confirmation of a plan, the court observed, a carve-out from a secured creditor's collateral "does not offend the absolute priority rule or the Bankruptcy Code's distribution scheme because the property belongs to the secured creditor — not the estate."

The U.S. Trustee also contended that the settlement agreement violated the absolute priority rule by releasing causes of action against the lender that, if successfully prosecuted, would result in recoveries that would go first to priority creditors, who were receiving no compensation in return. The court rejected this argument, noting that the carve-out payment was not given solely in consideration for the release of estate causes of action but also in exchange for withdrawal of the committee's challenge to the sale motion. According to the court, withdrawal of the committee's objection was in and of itself sufficient consideration for the carve-out.

ANALYSIS

World Health indicates that give-ups by senior classes as part of an overall negotiating strategy continue to be a vital and important part of the chapter 11 process. A "gift" of consideration to a junior class may enable the parties to reach agreement on a consensual plan of reorganization, thereby avoiding the need for a contested confirmation hearing. Without the gift, the junior class receiving nothing would have a strong incentive to litigate. The litigation, which often would require, among other things, expert testimony as to the value of the company, may be expensive and time-consuming. Thus, it may be in the interests of the senior creditors to give up some value to get the deal done.

The decision also illustrates the limitations of *Armstrong* and provides a possible road map to avoid running afoul of the Third Circuit's directives. First, the strictures of the absolute priority rule apply only in cases involving the nonconsensual confirmation of a chapter 11 plan — if an intervening class of creditors does not object to a senior class give-up as a means of achieving consensual confirmation, the rule does not come into play. *World Health* involved court approval of a settlement agreement in a case that would ultimately be converted to a chapter 7 liquidation. Moreover, the only intervening class of creditors involved (the IRS) chose not to object to the give-up or any other aspect of the settlement.

As such, the issue properly before the court was whether the settlement was reasonable and in the best interests of the bankruptcy estate, not whether one aspect of the agreement might be an impediment to confirming a chapter 11 plan. Even in reorganization cases, courts have been reluctant to invalidate pre-confirmation settlements involving senior-class gifting that arguably violate the absolute priority rule because the issue is not ripe for consideration other than in the context of a contested confirmation hearing.

Finally, cases involving carve-outs from recoveries that would otherwise go exclusively to a senior class of secured creditors (as in *SPM*) are far more likely to pass muster under the standard articulated in *Armstrong*. In the vast majority of cases, all stakeholders involved recognize the practical utility of senior-class gifting in achieving consensual confirmation and preserving value.

In re World Health Alternatives, Inc., 344 B.R. 291 (Bankr. D. Del. 2006).

In re Armstrong World Industries, Inc., 432 F.3d 507 (3d Cir. 2005).

Official Unsecured Creditors' Committee v. Stern (In re SPM Manufacturing Corp.), 984 F.2d 1305 (1st Cir. 1993).

Ad Hoc Adelphia Trade Claims Committee v. Adelphia Communications Corp., 337 B.R. 475 (S.D.N.Y. 2006).

PUTTING TEETH INTO SECTION 1113(F)? STAKING OUT A MIDDLE GROUND FOR AWARDING ADMINISTRATIVE PRIORITY TO CLAIMS UNDER COLLECTIVE BARGAINING AGREEMENTS

Ryan T. Routh

Courts have wrestled for 20 years over the priority of claims asserted by workers if a chapter 11 debtor-in-possession fails to comply with its obligations under a collective bargaining agreement ("CBA"). Some courts, reasoning that such claims do not meet the traditional standards for administrative priority, relegate them to the pool of general unsecured claims. Other courts focus on the special protections afforded workers covered by a CBA under section 1113 of the Bankruptcy Code as grounds for granting such claims priority. The Tenth Circuit Court of Appeals recently injected its voice into this debate and staked out an interesting middle-ground position. In *Peters v. Pikes Peak Musicians Association*, the Court of Appeals ruled that the debtor's obligation under a CBA for payments to employees that became due between the chapter 11 petition date and the date that the debtor rejected the agreement were payable as priority administrative expenses.

A BRIEF HISTORY OF SECTION 1113

Section 1113 of the Bankruptcy Code contains procedures and standards governing any proposed rejection of a CBA in a chapter 11 case. The provision was not a part of the original Bankruptcy Code enacted in 1978, but was later added in response to the Supreme Court's 1984 decision in *NLRB v. Bildisco & Bildisco*. In that case, the Supreme Court ruled that a chapter 11 debtor's decision to reject a CBA should be subject to the same standard applicable to any other executory contract under section 365 of the Bankruptcy Code. The Court also determined that, like any counterparty to an executory contract with a debtor, covered employees could not enforce the provisions of an executory CBA pending the debtor's decision to assume or reject the agreement.

Congressional response to this decision was swift and decisive, through the enactment of section 1113. Much of the provision addresses the portion of the Supreme Court's ruling pertaining to the standard governing rejection and makes it comparatively more difficult for a debtor to reject a CBA. The final subsection, however (section 1113(f)), speaks directly to the other prong of *Bildisco* — namely, a chapter 11 debtor's post-petition, pre-rejection obligations under a CBA:

> No provision of this title shall be construed to permit a trustee to unilaterally terminate or alter any provision of a collective bargaining agreement prior to compliance with the provisions of this section.

This means that a chapter 11 debtor may not "terminate" or "alter" a CBA by not paying benefits or paying less than what the CBA requires. What Congress failed to specify, however, is what the penalty would be for a debtor who chooses to ignore the clear dictates of the new law.

VARYING INTERPRETATIONS OF SECTION 1113(F)

The first appellate court at the circuit level to address the issue was the Sixth Circuit in its 1988 decision in *United Steel Workers of America v. Unimet Corp*. In that case, the applicable CBA required the debtor to pay workers' health and life insurance premiums. The debtor failed to pay these both before and after the bankruptcy court denied its request to reject the CBA. The employees' bargaining representative sought an order directing the debtor to pay these amounts as administrative expenses, but the bankruptcy court denied the request, ruling that the obligations did not pass muster as administrative claims under the standards traditionally applied in gauging the propriety of conferring administrative status on a claim under section 503 of the Bankruptcy Code.

The Sixth Circuit reversed on appeal, explaining that whether or not the amounts in question would qualify as administrative expenses is irrelevant. Instead, the Court of Appeals ruled, the fact that section 1113 "unequivocally prohibits the employer from unilaterally modifying any provision of the [CBA]" means that the debtor has to abide by the dictates of the provision and make appropriate payments, even if the claims in question did not qualify for administrative status under other applicable provisions of the statute. In other words, the remedial purpose of section 1113 trumps the literal language of section 503, and a chapter 11 debtor is required to specifically perform the terms of a CBA prior to rejecting it.

Although a handful of bankruptcy and district courts followed the Sixth Circuit's lead, many did not. The first circuit court of appeals to stake out an alternative approach was the Third Circuit in its 1992 decision in *In re Roth American, Inc.*

In that case, a chapter 11 debtor failed to pay vacation and severance pay earned by its workers in accordance with the terms of a CBA on the grounds that certain of the amounts related to services rendered pre-petition. The employees sought administrative-expense priority for the entire amount of their claims, but the bankruptcy court ruled that only vacation and severance pay earned after the debtor filed for chapter 11 qualified for administrative status. The Third Circuit upheld that determination on appeal, reasoning that because the remainder of the claims did not qualify for priority treatment under sections 503 and 507 of the Bankruptcy Code, and because nothing in section 1113 provided such a remedy, claims based upon pre-petition services were not entitled to priority as administrative expenses.

Other courts quickly followed the Third Circuit's lead, holding that claims for unpaid wages and benefits under a CBA can be conferred with administrative priority only if they fulfill the requirements of sections 503 and 507 of the Bankruptcy Code (*i.e.*, such claims are based upon post-petition services that are deemed to benefit the estate). Over the years, this approach has become the majority position on this issue.

PIKES PEAK AND THE TENTH CIRCUIT'S SOLUTION

In *Pikes Peak*, the debtor was the Colorado Springs Symphony Orchestra, which was party to a CBA with the orchestra's musicians. The CBA required the musicians to make themselves available for performances and required the orchestra to pay the musicians whether or not actual performances were scheduled or held. After filing for chapter 11 relief in 2003, the debtor sought to reorganize for a period of several weeks. During this period, the debtor failed to pay the musicians. Ultimately, after its efforts to reorganize proved futile, the debtor obtained court approval to reject its CBA under section 1113. The musicians later sought administrative priority for wages payable under the CBA during the five-week post-petition, pre-rejection period.

At the outset, the Tenth Circuit examined the standard two-pronged test applied to determine whether a claim is entitled to administrative priority: (i) whether the claim arises from a post-petition transaction with the debtor-in-possession; or (ii) whether the claimant provided a benefit to the chapter 11 estate. The Tenth Circuit noted that the post-petition-transaction element of the test commonly requires a post-petition contract or some "inducement" from the debtor-in-possession.

> Applying a more liberal standard to awarding administrative status to post-petition, pre-rejection claims under a collective bargaining agreement gives teeth to section 1113(f), but it does not solve the underlying problem lurking in the seemingly irreconcilable conflict between the purpose of section 1113(f) and the express language of sections 503 and 507.

In this context, however, the Tenth Circuit reasoned that to enter into a post-petition transaction with the musicians, the debtor would have to enter into a new CBA with the musicians or alter the current one. Yet taking action to enter into a new CBA or to alter the current agreement, the Court explained, would violate the proscription of such action under section 1113(f). Accordingly, the Tenth Circuit held that in the CBA context, there need be neither a post-petition transaction nor a post-petition inducement, so long as the workers perform their obligations under the CBA. In this way, the Tenth Circuit ruled, the first prong of the normal administrative-expense-priority test should be relaxed in the CBA context and is deemed to be satisfied whenever post-petition services are performed under the agreement. Because the musicians made themselves available to perform during the five weeks prior to rejection of the CBA, the Tenth Circuit concluded that their conduct benefited the estate and that their claims were entitled to administrative priority.

ANALYSIS

Pikes Peak skirts the majority approach, but in many respects it represents a fresh, result-oriented solution to the problem

of reconciling section 1113(f) with the provisions of the statute specifically governing administrative priority. The approaches staked out by both the Sixth and Third Circuits fall short of solving this conflict in a way that does justice to the express terms of the Bankruptcy Code. Courts following the Sixth Circuit's approach essentially ignore the rules in the statute governing administrative priority, finding that the specific protections for pre-rejection CBA claims built into section 1113(f) trump the more general principles governing administrative priority in sections 503 and 507. On the other hand, courts following the majority approach essentially remove all teeth from section 1113(f), imposing no real downside on a debtor that simply ignores the provision.

The Tenth Circuit's middle-ground approach effectively limits the harsh effects of the competing views. While siding with the majority position, the Tenth Circuit has also clearly lowered the bar for establishing an entitlement to priority status under sections 503 and 507 of the Bankruptcy Code. Applying a more liberal standard to awarding administrative status to post-petition, pre-rejection claims under a CBA gives teeth to section 1113(f), but it does not solve the underlying problem lurking in the seemingly irreconcilable conflict between the purpose of section 1113(f) and the express language of sections 503 and 507. There now appear to be three competing interpretations of section 1113(f). The fact that this circuit split has persisted for well over 15 years makes this issue one ripe for determination by the Supreme Court or for resolution through legislation.

Peters v. Pikes Peak Musicians Ass'n., 462 F.3d 1265 (10th Cir. 2006).

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

United Steel Workers of America v. Unimet Corp. (In re Unimet Corp.), 842 F.2d 879 (6th Cir. 1988).

In re Roth American, Inc., 975 F.2d 949 (3d Cir. 1992).

SECOND-GUESSING A CHAPTER 11 DEBTOR'S "ABSOLUTE" RIGHT TO CONVERT

Mark G. Douglas

Although federal bankruptcy law and policy strongly encourage both business and individual debtors to pay at least a portion of their debts by means of either a plan of reorganization or a wage-earner repayment plan, the general rule is that a debtor cannot be forced to do so — a debtor always has the option to liquidate its assets in chapter 7 so long as it is eligible to be a debtor under that chapter of the Bankruptcy Code. Even so, a trend appears to be developing in the bankruptcy courts whereby what is generally understood to be a debtor's unfettered prerogative to convert its case from one of the "reorganization chapters" (chapters 11, 12, and 13) to a chapter 7 liquidation may be restricted under certain circumstances. A ruling recently handed down by a Michigan district court is emblematic of this restrictive approach. In *Monroe Bank & Trust v. Pinnock*, the court held that lawmakers' use of the word "may" in section 1112(a) of the Bankruptcy Code means that a bankruptcy court is not obligated to honor a chapter 11 debtor's request to convert its case to chapter 7 without considering what course of action is in the best interests of all stakeholders involved.

CONVERSION AND DISMISSAL OF A CHAPTER 11 CASE

Not every chapter 11 case culminates in the confirmation of a plan of reorganization or liquidation — some cases are dismissed outright, while others are converted to cases under other chapters of the Bankruptcy Code. Section 1112 of the Bankruptcy Code establishes the mechanism and standards for conversion and dismissal. Section 1112(a) provides that "[t]he debtor may convert a case under this chapter to a case under chapter 7 of this title unless" (i) the debtor is not a debtor-in-possession; (ii) the case originally was commenced as an involuntary chapter 11 case; or (iii) the case was converted to a case under chapter 11 other than on the debtor's request.

Section 1112(b) governs requests for conversion or dismissal by anyone other than the debtor. It provides that upon the request of a party-in-interest, "absent unusual circumstances specifically identified by the court that establish that the requested conversion or dismissal is not in the best interests of creditors and the estate, the court shall convert a case under this chapter to a case under chapter 7 or dismiss a case under this chapter, whichever is in the best interests of creditors and the estate, if the movant establishes cause." "Cause" is defined in section 1112(b)(4) to include the following:

- Substantial or continuing loss to or diminution of the estate and the absence of a reasonable likelihood of rehabilitation;
- Gross mismanagement of the estate;
- Failure to maintain appropriate insurance that poses a risk to the estate or to the public;
- Unauthorized use of cash collateral substantially harmful to one or more creditors;
- Failure to comply with an order of the court;
- Unexcused failure to satisfy timely any applicable filing or reporting requirements;
- Failure to attend the initial meeting of creditors or any examination ordered by the court without good cause shown by the debtor;
- Failure timely to provide information or attend meetings reasonably requested by the U.S. Trustee or any bankruptcy administrator;
- Failure timely to pay post-petition taxes or to file post-petition tax returns;
- Failure to file a disclosure statement, or to file or confirm a plan, within the time fixed by the Bankruptcy Code or the court;
- Failure to pay certain statutory fees or charges;
- Revocation of an order confirming a chapter 11 plan;
- Inability to effectuate substantial consummation of a confirmed plan;
- Material default by the debtor with respect to a confirmed plan;
- Termination of a confirmed plan by reason of the occurrence of a condition specified in the plan; and
- Failure of the debtor to pay any post-petition domestic support obligation.

Even upon a showing of "cause" to convert or dismiss, the debtor or any other party opposing the request can defeat it by demonstrating that (i) there is a reasonable likelihood that a chapter 11 plan will be timely confirmed, and (ii) "cause" consists of something other than diminution of the estate and the absence of any reasonable likelihood of rehabilitation, a reasonable justification exists for the act or omission in question, and such act or omission will be rectified within a reasonable period of time. The ability to ward off conversion or dismissal by remedying conduct amounting to "cause" was added to section 1112 as part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.

Based upon the express language of the statute and its accompanying legislative history, section 1112(a) has been almost universally interpreted to confer a chapter 11 debtor with the "absolute" right to convert to chapter 7 absent the existence of one of the disqualifying circumstances specified in the statute. That is not to say, however, that the debtor has the right to keep the case in chapter 7 — it can be converted back to chapter 11 if the court determines that reconversion best serves the interests of all stakeholders, or it can be dismissed altogether under the circumstances set forth in section 707 of the Bankruptcy Code (*e.g.*, unreasonable delay, failure to pay required fees or make required filings, or conduct amounting to "substantial abuse" if the debtor is an individual with primarily consumer debts).

Still, some courts quarrel with the notion that a chapter 11 debtor's right to convert to chapter 7 is unfettered, particularly if the debtor's motivation for doing so is perceived as being suspect. For example, in *In re Adler*, a chapter 11 debtor proposed a plan of reorganization that was unconfirmable and then moved to convert his case to a chapter 7 liquidation in response to the U.S. Trustee's motion seeking dismissal of his case and an order barring any subsequent bankruptcy filings. The bankruptcy court denied the conversion motion, ruling, among other things, that even though section 1112(a) clearly states that a debtor "may" convert his case, it does not state that the court "shall" honor the request. In addition, the court explained, because procedural rules require advance notice to creditors of a motion to convert, rather than the mere filing of a notice of conversion by the debtor, the bankruptcy court must retain some discretion to rule on the propriety of a conversion motion under section 1112(a).

In considering a debtor's proposed conversion under section 1112(a), the court observed, many courts have either: (i) recognized that conversion may be improper in situations involving "extreme circumstances" (*e.g.*, bad faith, abuse of process, or other gross inequity); or (ii) engaged in some kind of equitable analysis of the facts, including whether a debtor can propose a confirmable chapter 11 plan. Concluding that "the sole motive for the Debtor's conversion motion is to avoid the possibility of dismissal with prejudice," the bankruptcy court in *Adler* denied the debtor's request under section 1112(a). Instead, the court granted the U.S. Trustee's motion to dismiss, finding that "cause" existed to dismiss the case under section 1112(b). Similar reasoning was recently employed by a Michigan district court in *Monroe Bank & Trust v. Pinnock*.

THE DISTRICT COURT'S RULING IN *PINNOCK*

Lascelles Pinnock and Helen A. Byrd filed for chapter 11 protection in February 2005. After they were unable to confirm a chapter 11 plan, the debtors moved pursuant to section 1112(a) to convert their chapter 11 case to a chapter 7 liquidation. A creditor-bank opposed the motion, arguing that conversion would not be in the best interests of creditors because it would deprive them of access to significant assets acquired by the debtors during the course of their chapter 11 case. The bank moved to dismiss the case under section 1112(b).

The bankruptcy court granted the debtors' conversion motion, ruling that section 1112(a) gives a chapter 11 debtor the absolute right to convert to chapter 7 and, as a consequence, the factors set forth in section 1112(b) governing "cause" for dismissal do not figure into the calculus. The bank appealed the ruling to the district court.

Noting that the issue of whether a debtor has an absolute right to convert from chapter 11 to chapter 7 is a matter of first impression in the Sixth Circuit, the district court reversed. The court cited to *Adler* and authority construing a nearly identical provision in chapter 13 in concluding that Congress's omission of any language in section 1112(a) directing a court to convert a case upon the debtor's request means that there is no absolute right to convert. It ruled that the bankruptcy court erroneously held to the contrary and should have considered the bank's motion to dismiss the debtors' chapter 11 case according to the criteria set forth in section 1112(b). The district court accordingly reversed the ruling below and remanded the case to the bankruptcy court to determine whether dismissal or conversion was in the best interests of the estate and creditors.

ANALYSIS

The approach advocated by the courts in *Adler* and *Pinnock* undeniably has visceral appeal as a means of ensuring that a chapter 11 debtor cannot abuse the bankruptcy process in at least temporarily warding off outright dismissal of its bankruptcy case by converting to chapter 7. Even so, these rulings may be based on questionable logic. By focusing solely on the absence of any express language in section 1112(a) to the effect that a bankruptcy court "shall" grant a conversion motion filed by a chapter 11 debtor, these courts have overlooked the provision's unambiguous pronouncement that "[t]he debtor may convert a case" to chapter 7 and, without a statutory mandate for doing so, have superimposed the standards set forth in subsection (b) on the debtor's conversion "request." In effect, *Adler* and *Pinnock* have rewritten the statute to provide that a chapter 11 debtor may convert to chapter 7, unless someone (including the court *sua sponte)* objects, in which case the court will grant the request only if it determines that conversion would not amount to abuse of the bankruptcy process in some way.

The approach advocated by the courts in *Adler* and *Pinnock* undeniably has visceral appeal as a means of ensuring that a chapter 11 debtor cannot abuse the bankruptcy process in at least temporarily warding off outright dismissal of its bankruptcy case by converting to chapter 7. Even so, these rulings may be based on questionable logic.

The Bankruptcy Code, however, already contains a mechanism to address this eventuality — the objecting party-in-interest can simply move to reconvert the case to chapter

11 or to dismiss the chapter 7 case under section 707. The courts in *Adler* and *Pinnock* had the benefit of pending motions to dismiss under section 1112(b) when confronted with the debtors' conversion requests. Their rulings appear to indicate that a dismissal motion under section 1112(b) trumps a debtor's conversion motion under section 1112(a). Perhaps this should be the rule, but the reasoning articulated in the decisions falls short of explaining why. Moreover, consider what would have happened if the creditors involved had merely objected to conversion, but had not moved to dismiss. Without any standard of "cause" justifying dismissal to fall back upon, it would then be left to the bankruptcy court to fashion criteria by which a conversion request should be judged, an approach that is difficult at best to support based upon the Bankruptcy Code or its legislative history.

Interestingly, the predecessor to section 1112(a) under chapter X of the Bankruptcy Act of 1898 (Rule 11-42(a) of the former Rules of Bankruptcy Procedure) provided that, upon the debtor's motion to convert to a liquidating bankruptcy case, the court "shall . . . enter an order adjudicating the debtor a bankrupt." This language was construed to remove any discretion from the court to do otherwise when faced with a conversion request. The absence of a similar directive in section 1112(a) may indicate, consistent with *Adler* and *Pinnock*, that the drafters of the current statute wished to give the bankruptcy court the discretion to deny a conversion request under appropriate circumstances.

The imposition of a kind of moral calculus by bankruptcy judges in situations where the express terms of the Bankruptcy Code do not appear to require examination of a debtor's underlying motivation (or the impact on other affected parties) has been a magnet for controversy during recent times. A growing number of courts feel justified in exercising their broad discretion as instruments of equity to prevent what they perceive as conduct amounting to abuse of the bankruptcy process. In addition to restricting a chapter 11 debtor's ability to convert to chapter 7, courts have recently exercised their discretion in assessing "cause" to dismiss nonconsumer-debt chapter 7 cases and in denying a debtor's request to convert its chapter 7 case to one under another chapter of the Bankruptcy Code. The latter issue is currently being considered by the U.S. Supreme Court in *Marrama v. Citizens Bank of Massachusetts*. The Court heard argument on the case on November 6, 2006.

Monroe Bank & Trust v. Pinnock, 2006 WL 2367350 (E.D. Mich. Aug. 15, 2006).

In re Adler, 329 B.R. 406 (Bankr. S.D.N.Y. 2005).

In re Texas Extrusion Corp., 844 F.2d 1142 (5th Cir. 1988).

In re Schuler, 119 B.R. 191 (Bankr. D. Mo. 1990).

In re Marill Alarm Systems, Inc., 100 B.R. 606 (Bankr. D. Fla. 1989).

In re Dieckhaus Stationers of King of Prussia, Inc., 73 B.R. 969 (Bankr. E.D. Pa. 1987).

In re Grinstead, 75 B.R. 2 (Bankr. D. Minn. 1985).

In re Midheaven Restaurant, Inc., 1980 U.S. Dist. LEXIS 13848 (D. Mass. Oct. 1, 1980).

Marrama v. Citizens Bank of Massachusetts (In re Marrama), 313 B.R. 525 (Bankr. 1st Cir. 2004), *aff'd*, 430 F.3d 474 (1st Cir. 2005), *cert. granted,* 126 S.Ct. 2859 (2006).

TRANSFORMING DEBT TO EQUITY: FOURTH CIRCUIT RULES THAT BANKRUPTCY COURTS HAVE THE POWER TO RECHARACTERIZE

David A. Beck and Mark G. Douglas

The ability of a bankruptcy court to reorder the priority of claims or interests by means of "equitable subordination" or "recharacterization" of debt as equity is generally recognized. Still, the Bankruptcy Code itself expressly authorizes only the former of these two remedies — even though common law uniformly acknowledges the power of a court to recast a claim asserted by a creditor as a shareholder interest in an appropriate case, the Bankruptcy Code is silent upon the availability of the remedy in a bankruptcy case. This has led to confusion among bankruptcy courts concerning their power to recharacterize claims and the interaction between these two equitable remedies. The Fourth Circuit Court of Appeals recently had an opportunity to weigh in on the issue in *Fairchild Dornier GMBH v. Official Committee of Unsecured Creditors (In re Official Committee of Unsecured Creditors for Dornier Aviation (North America), Inc.)*. In a matter of first impression, the Fourth Circuit affirmed a bankruptcy court's recharacterization of a parent corporation's claim arising from the sale of spare parts to its chapter 11 debtor-subsidiary as an equity contribution.

EQUITABLE SUBORDINATION AND RECHARACTERIZATION

The bankruptcy court is a court of "equity." Although the distinction between courts of equity and law has largely become irrelevant in modern times, courts of equity have traditionally been empowered to grant a broader spectrum of relief in keeping with fundamental notions of fairness as opposed to principles of black-letter law. This means that a bankruptcy court can exercise its discretion to produce fair and just results to prevent fraud, to preclude the elevation of form over substance, and to ensure that technical considerations do not thwart the commission of substantial justice. One of the tools available to a bankruptcy court in exercising this broad equitable mandate is "equitable subordination."

Equitable subordination is a remedy developed under common law to penalize misconduct that results in injury to creditors or shareholders. It is expressly recognized in Bankruptcy Code section 510(c), which provides that the bankruptcy court may, "under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest." However, the statute neither explains the concept nor the standard that should be used to apply it.

This has been left to the courts. In 1977, the Fifth Circuit Court of Appeals articulated what has become the most commonly accepted standard for equitably subordinating a claim in *In re Mobile Steel Co.* Under the *Mobile Steel* standard, a claim can be subordinated if the claimant engaged in some type of inequitable conduct that resulted in injury to creditors (or conferred an unfair advantage on the claimant) and if equitable subordination of the claim is consistent with the provisions of the Bankruptcy Code. Courts have refined the test to account for special circumstances. For example, many make a distinction between insiders (*e.g.*, corporate fiduciaries) and noninsiders in assessing the level of misconduct necessary to warrant subordination.

A related but distinct remedy is "recharacterization." The power to treat a debt as if it were actually an equity interest is derived from principles of equity under common law. It emanates from the bankruptcy court's power to ignore the form of a transaction and give effect to its substance. The remedy is most commonly invoked when an insider purports to loan money to a company when it is undercapitalized and the cash infusion should have taken the form of a capital contribution. Recharacterization in such a circumstance ensures that noninsider creditor claims will be paid first from the available assets of the corporation.

Courts consider various factors when determining whether a debt should be recharacterized. As articulated by the Sixth Circuit Court of Appeals in *Bayer Corp. v. Masco Tech, Inc. (In re AutoStyle Plastics, Inc.),* these can include the labels given to the debt, the presence or absence of a fixed maturity date, interest rate and schedule of payments, whether the borrower is adequately capitalized, any identity of interest between the creditor and the stockholder, whether the loan is secured, and the corporation's ability to obtain financing from outside lending institutions. No single factor is controlling. Instead, they are considered within the particular circumstances of each case.

The effect of recharacterization may be similar to subordination — in both cases, the priority of the claim is made subordinate to that of other creditors. However, there are important differences. Recharacterization and equitable subordination serve different functions. Also, the extent to which a claim is subordinated under each remedy may be different. Recharacterization turns on whether a debt actually exists, not on whether the claim should be reprioritized. If the court determines that an advance of money is equity and not debt, the claim is transformed to a proprietary interest in respect of which no portion of the company's assets can be distributed unless and until its debts are paid in full. By contrast, in an equitable subordination analysis, the court reviews whether an otherwise legitimate creditor engaged in misconduct, in which case the remedy is subordination of the creditor's claim to the claims of other creditors, but only to the extent necessary to offset injury or damage suffered by the latter.

The Fourth Circuit's ruling in *Dornier* reaffirms the vitality of recharacterization as an important tool available to bankruptcy courts entrusted with ensuring that the basic priority scheme underpinning federal bankruptcy law is not thwarted by reason of misconduct or artful machinations designed to disguise the true nature of a stakeholder's relationship to a debtor or its assets.

Because the Bankruptcy Code does not expressly empower a bankruptcy court to recharacterize debt as equity, courts are split as to whether they have the authority to do so. According to some, because the statute authorizes subordination but is silent concerning recharacterization, Congress intended to deprive bankruptcy courts of the power to recharacterize a claim. Others disagree (including every circuit court of appeals that has considered the question), finding that a bankruptcy court's power to recharacterize debt stems from the authority vested in the bankruptcy courts to use their equitable powers to test the validity of debts. According to this view, the source of the court's power is section 105 of the Bankruptcy Code, which gives bankruptcy courts the authority to "issue any order, process or judgment that is necessary or appropriate to carry out the provisions" of the statute. In a matter of first impression, the Fourth Circuit allied itself with courts expansively construing the scope of a bankruptcy court's equitable powers in this context in *Dornier Aviation*.

DORNIER AVIATION

Dornier Aviation (North America) ("DANA") was a wholly owned subsidiary of German aircraft manufacturer Fairchild Dornier GMBH ("GMBH"), which sold spare parts to DANA that DANA then either used to provide warranty services for GMBH-manufactured aircraft or sold to end users providing repair services for out-of-warranty aircraft. Parts shipped by GMBH to DANA were accompanied by invoices that provided for 30-day payment terms "unless otherwise agreed."

Certain former DANA employees filed an involuntary bankruptcy case against the company in 2002 in Virginia, which DANA later converted to chapter 11. Unable to reorganize, DANA ultimately confirmed a liquidating chapter 11 plan in 2003. During the course of the case, evidence came to light indicating that DANA did not actually pay invoices generated by GMBH within 30 days, but instead had an agreement with GMBH whereby DANA was not expected to pay for any shipped spare parts until its operation became profitable.

GMBH asserted claims aggregating $146 million based upon, among other things, parts shipments that had not been paid for by DANA. The creditors' committee objected to the claims, contending that $86 million in claims for unpaid shipments of parts should be equitably subordinated or recharacterized as equity. The bankruptcy court rejected the committee's equitable subordination argument, but recharacterized GMBH's $86 million spare-parts claim as equity, effectively putting GMBH out of the money due to DANA's inability to pay its unsecured creditors in full. The district court upheld that determination on appeal, rejecting GMBH's contention that a bankruptcy court lacks the power to recharacterize debt as equity.

THE FOURTH CIRCUIT'S RULING

GMBH appealed to the Fourth Circuit. The Court of Appeals ruled that the power to recharacterize debt is drawn from sections 726 and 105 of the Bankruptcy Code. Section 726, the Court explained, establishes the priority scheme for the payment of claims and interests in a chapter 7 liquidation, incorporating the rule that equity is relegated to the lowest priority, and section 105 gives bankruptcy courts broad equitable powers to effectuate other provisions of the statute. Given the fundamental division of obligations into claims and equity interests, the Fourth Circuit reasoned, bankruptcy courts must have the power to distinguish between the two by looking beyond the form of any given transaction to examine its underlying substance. The power to recharacterize debt as equity in an appropriate case, the Court concluded, assists in implementing the priority scheme of section 726.

According to the Fourth Circuit, the different policy purposes served by disallowance, equitable subordination, and recharacterization also suggest that the latter must exist as an independent remedy. Disallowance of a claim, the Court of Appeals explained, is appropriate only when it is determined that the claimant has no rights vis-à-vis the debtor or its assets. In addition, the Fourth Circuit observed, "[w]hile a bankruptcy court's recharacterization decision rests on the substance of the transaction giving rise to the claimant's demand, its equitable subordination decision rests on its assessment of the creditor's behavior." In fact, the Court noted, the power to recharacterize debt as equity has been recognized by every other circuit court of appeals that has considered the question.

The Fourth Circuit applied the *AutoStyle* test to determine whether it would be appropriate to recharacterize GMBH's spare-parts claims as equity. Noting that application of the test produced mixed results, it agreed with the courts below that the factors weighing in favor of recharacterization predominated: (i) GMBH was an "insider" of DANA; (ii) the purported loan from GMBH lacked a fixed maturity date; (iii) DANA was not obligated to pay for shipped parts until it became profitable; (iv) DANA had a long history of unprofitability, and its liabilities far exceeded its assets; and (v) GMBH had historically assumed DANA's losses. The Fourth Circuit accordingly upheld the determinations rendered below.

ANALYSIS

Recharacterization is a remedy deeply rooted in the fabric of equity jurisprudence. The Fourth Circuit's ruling in *Dornier* reaffirms the vitality of recharacterization as an important tool available to bankruptcy courts entrusted with ensuring that the basic priority scheme underpinning federal bankruptcy law is not thwarted by reason of misconduct or artful machinations designed to disguise the true nature of a stakeholder's relationship to a debtor or its assets. By ruling that bankruptcy courts have the power to recharacterize debt as equity, the Fourth Circuit joins the Third, Sixth, and Tenth Circuits, whose approach to the issue can fairly be characterized as the majority rule.

Dornier also provides some useful lessons for insiders when dealing with corporations in financial distress. If a transaction is made according to terms that would not be acceptable to an arm's-length creditor, any resulting obligation may be susceptible to recharacterization as equity in any later bankruptcy proceeding.

Fairchild Dornier GMBH v. Official Committee of Unsecured Creditors (In re Official Committee of Unsecured Creditors for Dornier Aviation (North America), Inc.), 453 F.3d 225 (4th Cir. 2006).

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

Bayer Corp. v. Masco Tech, Inc. (In re AutoStyle Plastics, Inc.), 269 F.3d 726 (6th Cir. 2001).

Cohen v. KB Mezzanine Fund II, LP (In re SubMicron Systems Corp.), 432 F.3d 448 (3d Cir. 2006).

Sender v. Bronze Group, Ltd. (In re Hedged-Invs. Assocs., Inc.), 380 F.3d 1292 (10th Cir. 2004).

LANDMARK THIRD CIRCUIT RULING ON MULTIPLE PENSION PLAN TERMINATION

continued from page 3

Finally, the Third Circuit rejected PBGC's argument that the federal courts should defer to PBGC's interpretation of the reorganization test, stating that "deference to the PBGC here is improper because PBGC has neither the expertise nor the authority to determine when a plan should be terminated under the reorganization test." Issues relating to an employer's bankruptcy and reorganization, the Court of Appeals emphasized, "are within the expertise of the bankruptcy courts, not the PBGC."

OUTLOOK

While *Kaiser Aluminum* is not the first case in which a court has applied the aggregate-analysis approach in determining whether multiple plan terminations satisfy the reorganization test, it is the first case in which PBGC has challenged the application of an aggregate analysis and advocated a competing alternative. Moreover, the Third Circuit is the first court at the circuit level to consider the issue, and its decision in *Kaiser Aluminum* fortifies the "bigger picture" policy underlying the chapter 11 reorganization process. Employers in many financially troubled industries, including airlines, automobile manufacturers, and auto parts suppliers, have multiple pension plans that are underfunded. *Kaiser Aluminum* is a significant precedent for any employer with multiple plans considering chapter 11 as part of its overall reorganization strategy.

President George W. Bush gave his imprimatur on August 17, 2006, to the most sweeping pension reform in 30 years. Among other things, the Pension Protection Act of 2006 includes provisions that:

- Require employers to make sufficient contributions to their single-employer defined-benefit pension plans over the next seven years to achieve 100 percent funding;
- Prohibit employers and unions from increasing pension benefits from single-employer plans that are less than 80 percent funded, unless the additional benefits are paid for immediately;
- Require employers that terminate a pension plan in bankruptcy to pay $2,500 per participant upon exiting from bankruptcy; and
- Allow airlines that freeze all benefit accruals in their pension plans an additional 10 years to meet their funding obligations, while allowing airlines that freeze new plan participants but allow current participants to accrue new benefits three additional years to meet their funding obligations.

According to some commentators, the reforms are unlikely to restore PBGC to solvency, but they may improve the embattled insurer's financial outlook, at least in the short term. As more and more employers make the transition away from defined-benefit plans because of stricter funding requirements, PBGC's premium base may actually diminish in the long run. Moreover, the rules governing pension plan funding are not the only factors influencing PBGC's troubled financial condition — legislation can do little to stave off major business failures that are inevitable in a volatile economy.

In re Kaiser Aluminum Corp., 456 F.3d 328 (3d Cir. 2006).

In re Aloha Airgroup, Inc., 2005 WL 3487724 (Bankr. D. Haw. Dec. 13, 2005), *vacated as moot*, 2006 WL 695054 (D. Haw. Mar. 14, 2006).

In re Philip Servs. Corp., 310 B.R. 802 (Bankr. S.D. Tex. 2004).

In re Wire Rope Corp. of Am., 287 B.R. 771 (Bankr. W.D. Mo. 2002).

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