JONES DAY

RECENT DEVELOPMENTS IN BANKRUPTCY AND RESTRUCTURING

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BUSINESS RESTRUCTURING REVIEW

IN THIS ISSUE

THE YEAR IN BANKRUPTCY: 2006

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In light of the continued favorable business climate and ample liquidity in the U.S., the falloff in business bankruptcy filings in 2006 should come as no big surprise. Unlike 2005, which added three new stars to the all-time hit parade of chapter 11 "mega" cases, 2006 saw no new additions to the Top 10 list for public-company chapter 11 filings. Overall, the number of business bankruptcy filings dropped 20 percent in fiscal year 2006, the fifth straight year a decline was reported, according to statistics released by the Administrative Office of the U.S. Courts in October of 2006. Only 27,333 businesses sought bankruptcy protection for the fiscal year ending September 30, 2006, compared with 34,222 in fiscal year 2005. Of those, the number of chapter 11 cases fell from 6,637 to 6,003. Public business bankruptcy filings fell to a 25-year low in 2006. Sixty-six public companies filed for bankruptcy protection in 2006, the lowest number of filings since 1980, when 62 public companies filed for bankruptcy.

Even so, 2006 saw a handful of notable billion-dollar chapter 11 cases. Two of the Top 10 chapter 11 filings in 2006 involved automobile-parts suppliers, adding another grim chapter to the continuing saga of an industry that has been slammed by declining market share, overcapacity, and high labor costs. Toledo, Ohio-based Dana Corp., a key supplier of axles, brakes, and truck frames to Detroit automakers, filed for chapter 11 protection in March of 2006, citing its customers' shrinking market share (a quarter of Dana's revenue comes from Ford) and higher costs of raw materials and energy. Listing more than $9 billion in assets, Dana's chapter 11 case was the largest bankruptcy filing of 2006.

Components supplier DURA Automotive Systems Inc., together with its U.S. and Canadian subsidiaries, filed for chapter 11 protection at the end of October 2006, blaming the decision on an accelerating deterioration of the North American automotive industry, including escalating raw-materials costs. DURA's filing was the third-largest in 2006, the company listing more than $2 billion in assets. Bankruptcy filings by Dana and DURA follow those of, among others, Tower Automotive, Collins & Aikman Corp., and Delphi Corp., the last of which is the largest U.S. auto-parts supplier. Six of the 20 largest North America-based auto-parts suppliers are trying to reorganize their finances in bankruptcy. At least 36 U.S. auto-parts suppliers have filed for bankruptcy since 1999, including eight in 2006.

Coming in at No. 2 on the Top 10 public chapter 11 filing hit parade for 2006 was Sea Containers Ltd., the London- and Bermuda-based shipping and railroad company. Blaming higher fuel prices and fallout from the July 2005 London terrorist bombings, the company filed for chapter 11 protection on October 15, 2006, after failing to make a scheduled $115 million debt payment. Sea Containers listed nearly $2.75 billion in assets at the time of its bankruptcy filing.

The fourth-largest public chapter 11 case of 2006 was filed by Satelites Mexicanos S.A. de C.V. The Mexican satellite services company filed a chapter 11 petition on August 11, 2006, after finalizing the terms of a pre-negotiated chapter 11 plan with noteholders who had filed an involuntary bankruptcy case against the company in 2005 that was subsequently dismissed in favor of a Mexican insolvency proceeding and a companion U.S. ancillary proceeding under section 304 of the Bankruptcy Code. Plagued by financial woes dating back as far as 2001, when it was battered by an economic downturn in Mexico and the U.S. that severely cut into demand for its telecommunications services, Satelites Mexicanos listed approximately $925 million in assets at the time of its bankruptcy filing.

Spot No. 5 on the Top 10 list for 2006 went to Pliant Corporation. The Schaumburg, Illinois-based packaging company filed for chapter 11 on January 3, 2006, citing severe increases in resin prices and tightening of trade terms with key suppliers as the reason for the filing. Pliant listed total assets of $777 million and total debts of nearly $1.2 billion.

Orthodontic Centers of America Inc., a Metairie, Louisiana-based provider of business services to orthodontic and dental practices worldwide, filed a chapter 11 petition on March 14, 2006. OCA cited the need to protect its contractual relationship with its affiliated practices and to provide necessary "breathing room" to restructure its balance sheet and operations as the reason for seeking chapter 11 protection. At the time of the filing, the company listed more than $660 million in assets. The case was the sixth-largest public chapter 11 case filed in 2006.

The seventh-largest chapter 11 case in 2006 was filed by Silicon Graphics, Inc., which sought bankruptcy protection on May 8, 2006, after pre-negotiating a plan of reorganization with its bondholders under which they agreed to swap their debt for a stake in the reorganized company. Silicon Graphics does high-end computer design and engineering work and manufactures supercomputers for clients such as NASA. Employing more than 1,800 people worldwide, the company listed assets of more than $450 million at the time of its bankruptcy filing.

Houston, Texas-based electrical contractor Integrated Electrical Services, Inc., and its subsidiaries filed for chapter 11 protection on February 14, 2006. Listing more than $416 million in assets, the companies' filings were the eighth-largest of 2006. Rounding out the Top 10 public chapter 11 filings in 2006 were cases filed by Granite Broadcasting Corp., an operator of 23 television stations throughout the U.S., which filed for chapter 11 protection on December 12, 2006, listing more than $405 million in assets, and Tulsa, Oklahoma-based designer and manufacturer of natural-gas turbine equipment Global Power Equipment Group, Inc., which filed a chapter 11 petition on September 28, 2006, listing more than $381 million in assets.

2006 was notable for the absence of any new airline chapter 11 cases, suggesting that the industry may at last be headed for better times, as the nation's troubled air carriers struggle to reinvent themselves through rounds of consolidation and cost cutting. In fact, the resurgent airline industry in 2006 experienced its first profitable year since before the 2001 terrorist attacks, and analysts expect even healthier earnings in 2007. Higher fares, continued seat demand, and lower operating costs have helped to revive an industry that saw little reason for optimism in 2005, as major carriers Delta and Northwest scrambled for cover in chapter 11 in an effort to sort out their financial and operational problems. Provisions in sweeping pension reforms enacted in 2006 designed to give air carriers more time to fund shortfalls in their pension plans may also help the ailing industry get back on its feet. Still to be seen is the impact that the consolidation frenzy sparked in late 2006 by US Air's hostile buyout bid for Delta will have on the industry in 2007 and beyond.

LARGEST PUBLIC-COMPANY BANKRUPTCY FILINGS IN 2006

COMPANY	FILING DATE	ASSETS
Dana Corporation	3/03/2006	$9,047,000,000
Sea Containers Ltd.	10/15/2006	$2,736,100,000
DURA Automotive Systems, Inc.	10/30/2006	$2,075,209,000
Satelites Mexicanos S.A. de C.V.	8/11/2006	$925,271,000
Pliant Corporation	1/03/2006	$777,092,000
OCA Inc.	3/14/2006	$660,303,000
Silicon Graphics, Inc.	5/08/2006	$452,145,000
Integrated Electrical Services, Inc.	2/14/2006	$416,372,000
Granite Broadcasting Corp.	12/11/2006	$405,836,710
Global Power Equipment Group, Inc.	9/28/2006	$381,131,000
J.L. French Automotive Castings, Inc.	2/10/2006	$366,681,000
Radnor Holdings Corp.	8/21/2006	$361,454,000
Oneida Ltd.	3/19/2006	$328,812,000
Curative Health Services, Inc.	3/27/2006	$283,784,000
Premier Entertainment Biloxi LLC	9/19/2006	$240,896,996
AMTROL Inc.	12/18/2006	$222,451,000
G+G Retail, Inc.	1/25/2006	$202,868,000
Werner Holding Co. (DE), Inc.	6/12/2006	$201,042,000
Vesta Insurance Group, Inc.	8/08/2006	$195,325,000
Home Products International, Inc.	12/20/2006	$192,488,000

NOTABLE DECISIONS OF 2006

BANKRUPTCY COURT AUTHORITY/JURISDICTION

A New York district court fired the latest salvo in a battle concerning the prerogative of a bankruptcy court to authorize the modification or termination of contracts regulated by the Federal Energy Regulatory Commission ("FERC") under the Federal Power Act. In *In re Calpine Corp.*, 337 B.R. 27 (S.D.N.Y. 2006), the court ruled that a bankruptcy court did not have the power to authorize rejection of a FERC-regulated power contract because the debtor's justification for rejection involved the rate in the contract. In doing so, the court adopted an even more restrictive approach than that applied by the Fifth Circuit Court of Appeals in its controversial 2004 ruling in *In re Mirant Corp.*, 337 B.R. 511 (5th Cir. 2004), where the Court of Appeals held that a debtor could reject a FERC-regulated contract, but only because the rationale for rejection had nothing to do with the rates under the contract, but was based upon the fact that the debtor simply did not need the power covered by the agreement.

Conflicts between the Bankruptcy Code and another federal statute — the Federal Arbitration Act — were the subject of rulings handed down by the Second and Third Circuit Courts of Appeal in 2006, both of which suggest that the scope of a bankruptcy court's retained discretion to deny arbitration may be even less broad than is generally understood. In *MBNA America Bank, N.A. v. Hill*, 436 F.3d 104 (2d Cir. 2006), the Second Circuit reversed an order denying arbitration of a dispute between the debtor and a bank involving allegations of willful violation of the automatic stay because the governing credit agreement contained a valid arbitration clause, the litigation was styled as a class action, and even a "core" stay-violation proceeding may be subject to arbitration. Claims asserted by a chapter 13 debtor against a lender under the Truth in Lending Act as well as various federal and state consumer protection laws were also subject to arbitration according to the Third Circuit, which ruled in *Mintze v. American General Financial Services Inc. (In re Mintze)*, 434 F.3d 222 (3d Cir. 2006), that the party opposing arbitration of a dispute covered by an arbitration clause is obligated to prove that there is "an inherent conflict between arbitration and the Bankruptcy Code" that manifests Congress's intent to preclude a waiver of judicial remedies for the statutory rights at issue.

A bankruptcy court's authority to order the substantive consolidation of two or more related entities was the subject of a ruling handed down in 2006 by the Fifth Circuit Court of Appeals. In *Wells Fargo Bank of Texas N.A. v. Sommers (In re Amco Insurance)*, 444 F.3d 690 (5th Cir. 2006), the Court held that the bankruptcy court abused its discretion in *nunc pro tunc* substantively consolidating a debtor corporation with its nondebtor sole shareholder, because the court had previously authorized a secured creditor to pursue its remedies against the shareholder in state court.

GOOD-FAITH REQUIREMENTS

A ruling handed down by the Ninth Circuit Court of Appeals in 2006 examined whether the motive of nonconsumer chapter 7 debtors bears on their ability to file for bankruptcy protection. In *Sherman v. SEC (In re Sherman)*, 441 F.3d 794 (9th Cir. 2006), the Ninth Circuit ruled that misconduct by a debtor cannot constitute "cause" for dismissal under section 707(a) of the Bankruptcy Code if it can be remedied by applying other provisions of the Bankruptcy Code.

A debtor's motives in connection with a bankruptcy filing were also addressed in 2006 by a Michigan district court, albeit in a slightly different context. In *Monroe Bank & Trust v. Pinnock*, 349 B.R. 493 (E.D. Mich. 2006), the court ruled that a chapter 11 debtor does not have the absolute right to convert its chapter 11 case to a chapter 7 liquidation even though section 1112(a) expressly provides that the debtor "may" do so, because the statute does not state that the court "shall" honor the debtor's request. Concluding that dismissal would better serve the interests of the estate and creditors, the court denied the debtor's conversion request and instead granted a creditor's motion to dismiss the chapter 11 case.

ENFORCEMENT, ALLOWANCE, AND PRIORITY OF CLAIMS

A controversial decision rendered in 2005 by the New York bankruptcy court overseeing the chapter 11 cases of Enron Corp. and its affiliates sent traders in the multibillion-dollar distressed-claims market scrambling to devise better ways to minimize exposure and maximize profit in connection with acquired claims against bankrupt entities. In *Enron Corp. v. Avenue Special Situations Fund II, LP (In re Enron Corp.)*, 333

NEWSWORTHY

Corinne Ball (New York) was named by *Turnarounds & Workouts* as one of the 12 "Outstanding Restructuring Lawyers" in the United States in 2006.

David G. Heiman (Cleveland) and **Gregory M. Gordon (Dallas)** were featured in a first-page article in the January 10, 2007, issue of *The National Law Journal* regarding U.S. corporate bankruptcies in 2006.

Corinne Ball (New York), **David G. Heiman (Cleveland)**, and **Heather Lennox (Cleveland)** are listed in the 2007 edition of *The Best Lawyers in America*.

Corinne Ball (New York), **David G. Heiman (Cleveland)**, **Adam Plainer (London)**, and **Sion Richards (London)** were named "Leaders in their Field" for 2007 in the Chambers and Partners *Global Guide*.

Paul E. Harner (Chicago) and **Brad B. Erens (Chicago)** were named "Illinois Super Lawyers" for 2007 by *Law & Politics* magazine.

David G. Heiman (Cleveland), **Robert W. Hamilton (Columbus)**, **Fordham E. Huffman (Columbus)**, **Heather Lennox (Cleveland)**, and **Charles M. Oellermann (Columbus)** were selected as "Ohio Super Lawyers" for 2007 by *Law & Politics* and *Cincinnati* magazine.

Gregory M. Gordon (Dallas) gave a presentation on November 17, 2006, entitled "Avoiding Arbitration and Arbitration Awards," to the 25th Anniversary Jay L. Westbrook Bankruptcy Conference at The University of Texas School of Law in Austin, Texas.

Gregory M. Gordon (Dallas) gave a presentation on January 11, 2007, entitled "The Bankruptcy Solution to Asbestos and Other Mass Tort Liability," to the Houston Turnaround Management Association.

An article written by **Mark G. Douglas (New York)** entitled "Terminating Multiple Pension Plans in Bankruptcy: Third Circuit Rejects Plan-By-Plan Analysis in Favor of Aggregate Approach in Applying 'Reorganization Test' " was published in the January 2007 edition of *Pratt's Journal of Bankruptcy Law*.

B.R. 205 (Bankr. S.D.N.Y. 2005), the court ruled that a claim can be equitably subordinated even if it is transferred to an entity that did not engage in any misconduct.

This "caveat emptor" cautionary tale continued in 2006, with yet another controversial ruling by the same court in the same chapter 11 case. In *In re Enron Corp.*, 340 B.R. 180 (Bankr. S.D.N.Y. 2006), the court held that a transferred claim should be disallowed altogether under section 502(d) of the Bankruptcy Code unless and until the transferor returns payments to the estate that are allegedly preferential. The practical ramifications of caveat emptor as the prevailing rule of law have already spurred traders to build greater protections into loan/claim transfer agreements and to focus far more attention on the indemnities commonly given in distressed trades.

The Fourth Circuit Court of Appeals examined the consequences of a creditor neglecting to seek temporary allowance of its claim for the purpose of voting on a chapter 11 plan in *Jacksonville Airport, Inc. v. Michkeldel, Inc.*, 434 F.3d 729 (4th Cir. 2006). In that case, the Court held that if the debtor objects to a claim, it is incumbent upon the creditor to seek temporary allowance of the claim for voting purposes pending resolution of the objection on the merits, failing which the creditor does not have the right to vote.

A bankruptcy court's authority as a court of equity to recharacterize debt as equity in appropriate circumstances was the subject of a ruling in 2006 by the Fourth Circuit Court of Appeals. In *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), the Court held that a bankruptcy court has the power to order that obligations denominated as debts be treated as equity interests, and it affirmed a bankruptcy court's ruling recharacterizing a parent corporation's claim arising from the sale of spare parts to its chapter 11 debtor-subsidiary as an equity contribution.

Courts have wrestled for 20 years over the priority of claims asserted by workers if a chapter 11 debtor fails to comply with its obligations under a collective bargaining agreement. 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 bargaining agreement under section 1113 of the Bankruptcy Code as grounds for granting such claims priority. The Tenth Circuit Court of Appeals injected its voice into the debate in 2006, staking out a middle-ground position in a widening rift regarding this controversial issue among the circuit courts of appeal. In *Peters v. Pikes Peak Musicians Association*, 462 F.3d 1265 (10th Cir. 2006), the Court ruled that the debtor's obligation under a collective bargaining agreement for payments to employees that became due between the chapter 11 petition date and the date that the debtor rejected the agreement was payable as priority administrative expenses.

In an issue of first impression in the federal circuit courts of appeal, the Third Circuit ruled in *Cohen v. KB Mezzanine Fund II, LP (In re SubMicron Systems Corporation)*, 432 F.3d 448 (3d Cir. 2006), that creditors whose claims are only partially secured because of inadequate collateral value are entitled to credit-bid their claims at full face value rather than the economic value of the claims (*i.e.*, the value of the collateral) in any sale of the collateral proposed during the bankruptcy case.

COMPENSATION OF PROFESSIONALS

A pair of court rulings handed down in 2006 dealt with the allowance of professional fees incurred by an official committee as an expense of administration, even though the committee's constituency was "out of the money." In *In re Veltri Metal Products, Inc.*, 2006 WL 1716732 (6th Cir. June 22, 2006), the Sixth Circuit Court of Appeals reversed a bankruptcy court's order denying compensation to counsel for a creditors' committee because no distribution was likely to unsecured creditors. Benefit to the estate, the Court emphasized, need not be quantified monetarily to qualify a claim for administrative status.

In *In re Gadzooks, Inc.*, 352 B.R. 796 (Bankr. N.D. Tex. 2006), the bankruptcy court ruled that counsel for a committee of equity security holders could receive a professional fee award for services provided prior to the date on which it became clear that the committee's proposed plan would not be confirmed, regardless of whether the committee could show any "identifiable, tangible, and material benefit" to the estate. According to the court, the services were reasonable and necessary when rendered; the work was beneficial to the estate when performed; and, based upon its complexity, the work was performed in a timely manner at rates customarily charged by comparably skilled practitioners.

REJECTION OF COLLECTIVE BARGAINING AGREEMENTS

Employers' reliance on chapter 11 as a way to revise, restructure, or eliminate obligations under collective bargaining agreements figured prominently in both the headlines and court rulings of 2006, particularly in connection with the continuing efforts of troubled U.S. air carriers to regain profitability. In *In re Delta Air Lines*, 342 B.R. 685 (Bankr. S.D.N.Y. 2006), the bankruptcy court denied a request by Delta Air Lines subsidiary Comair to reject its bargaining agreement with flight attendants under section 1113 of the Bankruptcy Code, finding that the debtor did not comply with the requirement that it "confer in good faith in attempting to reach mutually satisfying modifications" to the agreement prior to seeking to reject it. In a subsequent decision, *In re Delta Air Lines*, 351 B.R. 67 (Bankr. S.D.N.Y. 2006), the court granted Comair's renewed motion to reject the collective bargaining agreement, ruling that the modifications proposed by Comair to the agreement were necessary to the airline's reorganization, given the fact that Comair's flight-attendant costs significantly exceeded those of all other regional carriers with which it was in direct competition, and that it had to bring these costs in line with those of its competitors to obtain contracts with other airlines to provide regional service. Finally, in *In re Delta Air Lines, Inc.*, 2006 WL 3771049 (Bankr. S.D.N.Y. Dec. 21, 2006), the bankruptcy court authorized Comair to reject the collective bargaining agreement with its unionized pilots.

Regional carrier and chapter 11 debtor Mesaba Aviation also encountered a rocky road in seeking to terminate its collective bargaining agreements with pilots, mechanics, and flight attendants. After denying the carrier's initial request to reject the agreements in *In re Mesaba Aviation, Inc.*, 341 B.R. 693 (Bankr. D. Minn. 2006), based on the debtor's refusal to provide adequate information to the unions' bargaining representative, the bankruptcy court subsequently authorized rejection of the agreements in *In re Mesaba Aviation, Inc.*, 2006 WL 2739047 (Bankr. D. Minn. July 14, 2006), finding that the debtor had remedied its earlier indiscretions and that the proposed cost reductions were necessary to Mesaba's reorganization. That ruling, however, was reversed in part on appeal. In *Association of Flight Attendants-CWA, AFL-CIO v. Mesaba Aviation, Inc.*, 350 B.R. 435 (D. Minn. 2006), the district court held that the debtor demonstrated bad faith by wholly refusing to negotiate regarding "snap-backs" restoring employee wages in the future. Upon remand of the case for additional consideration of the issue, the bankruptcy court ultimately authorized Mesaba to reject the agreements and to impose new work rules and conditions on its union employees.

The bankruptcy court overseeing the chapter 11 cases of Northwest Airlines and its affiliates authorized rejection of the air carrier's collective bargaining agreement with its flight attendants in *In re Northwest Airlines Corp.*, 346 B.R. 307 (Bankr. S.D.N.Y. 2006). The bankruptcy court concluded that rejection was necessary to the debtors' reorganization, given the fact that they had lost approximately $4 billion in the four years prior to seeking bankruptcy protection and were currently losing approximately $4 to $5 million per day, their borrowing capacity was limited by the absence of unencumbered assets, and $195 million in flight-attendant concessions was both a necessary and integral part of their business plan.

Northwest's subsequent unilateral imposition of new labor terms and conditions on employees covered by the rejected bargaining agreement led to calls for a strike by the flight attendants' union. Northwest responded by seeking to enjoin any strike. In *Northwest Airlines Corp. v. Assoc. of Flight Attendants-CWA (In re Northwest Airlines Corp.)*, 346 B.R. 333 (Bankr. S.D.N.Y. 2006), the bankruptcy court ruled that the Norris-LaGuardia Act deprived it of jurisdiction to enjoin the strike. The district court reversed that determination on appeal. In *Northwest Airlines Corp. v. Assoc. of Flight Attendants-CWA (In re Northwest Airlines Corp.)*, 349 B.R. 338 (S.D.N.Y. 2006), the court ruled that Northwest's rejection of the bargaining agreement did not constitute an act of bad faith that would relieve the union of its obligation under the Railway Labor Act to bargain in good faith and that a preliminary injunction was warranted to prevent the strike.

CHAPTER 11 PLAN ISSUES

The continued vitality of what has become a common practice in chapter 11 cases — senior-class "gifting" to junior classes of creditors as a way to achieve a consensus on the terms of a consensual chapter 11 plan — was called into doubt in 2005 by the Third Circuit Court of Appeals, which ruled in *In re Armstrong World Indus., Inc.*, 432 F.3d 507 (3d Cir. 2005), that senior-class give-ups violate the "absolute priority" rule if an intervening objecting class of creditors is not paid in full. In 2006, a Delaware bankruptcy court examined the legacy of *Armstrong,* ruling in *In re World Health Alternatives, Inc.*, 344 B.R. 291 (Bankr. D. Del. 2006), that a "carve-out" from a senior secured creditor's recovery to be distributed to unsecured creditors as part of a settlement agreement outside a chapter 11 plan violated neither the dictates of *Armstrong* nor the absolute-priority rule, where the funds in question were not estate property because the senior creditor was fully secured and the only intervening class of creditors did not object to the settlement.

A pair of rulings handed down in 2006 addressed the circumstances under which an order confirming a chapter 11 plan can be revoked in the face of allegations of fraud. In *Haskell v. Goldman, Sachs & Co. (In re Genesis Health Ventures, Inc.)*, 340 B.R. 729 (D. Del. 2006), the Delaware district court upheld an order dismissing a lawsuit seeking revocation in which it was alleged that the debtor and its senior lenders fraudulently misrepresented the debtor's enterprise value in connection with confirmation of a chapter 11 plan, because the complaint was filed after the 180-day period specified in section 1144 of the Bankruptcy Code. The inability to restore the status quo ante and protect innocent third parties prompted a New York bankruptcy judge to deny a request to revoke an order confirming a plan in *Salsberg v. Trico Marine Services, Inc. (In re Trico Marine Services, Inc.),* 337 B.R. 811 (Bankr. S.D.N.Y.), *disposition unaltered on reargument*, 343 B.R. 68

(Bankr. S.D.N.Y. 2006). According to the court, because the plan of reorganization, which contemplated the issuance of new stock that had already been widely traded, was substantially consummated at the time of the revocation request, a far less disruptive and potentially damaging remedy would be to allow the parties seeking revocation to sue for damages arising from the alleged misrepresentations concerning projected revenues made by the debtor during the plan confirmation hearing.

PENSION PLAN TERMINATION

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. Although the Employee Retirement Income Security Act ("ERISA"), rather than the Bankruptcy Code, establishes the rules and procedures governing an employer's obligations under a defined-benefit pension plan, a bankruptcy filing can provide a vehicle for an employer to effectuate a "distress termination" of its pension plan.

A landmark ruling handed down by the Third Circuit Court of Appeals in 2006 examined a matter of first impression in the federal circuit courts of appeal — how ERISA's "reorganization test" for distressed pension plan terminations should be applied in cases where a chapter 11 debtor-employer seeks to terminate multiple pension plans. In *In re Kaiser Aluminum Corp.*, 456 F.3d 328 (3d Cir. 2006), the Court held that a chapter 11 debtor's pension plans should be considered in the aggregate rather than separately when applying the "reorganization test."

CROSS-BORDER BANKRUPTCIES

October 17, 2006, marked the one-year anniversary of new chapter 15 of the Bankruptcy Code. As the volume of chapter 15 filings steadily increases, the bankruptcy courts are being called upon to iron out the details of an as yet largely untested legislative framework. 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 handed down in 2006 by a New York bankruptcy court. In *In re SPhinX, Ltd.*, 351 B.R. 103 (Bankr. S.D.N.Y. 2006), 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" of the companies involved was in the Cayman Islands and it appeared that the liquidators' motive for seeking recognition was to gain a tactical advantage in pending litigation involving the debtors. Even so, the court recognized the Cayman Islands liquidation proceedings as foreign "nonmain" proceedings.

DEEPENING INSOLVENCY

An emerging but controversial theory of tort liability based upon actions that allegedly cause or contribute to the "deepening insolvency" of a company was addressed in several significant bankruptcy and appellate court decisions issued during 2006. In *Seitz v. Detweiler, Hershey & Assoc. (In re CitX Corp.)*, 448 F.3d 672 (3d Cir. 2006), the Third Circuit Court of Appeals considered whether an accountant for an internet company could be held liable for the deepening insolvency of the company because the accountant was allegedly negligent in his review of the company's finances. The Court concluded that a claim of negligence cannot sustain a deepening insolvency cause of action, explaining that, notwithstanding its descriptions of deepening insolvency in a previous ruling as a "type" or "theory" of injury, it had never held that deepening insolvency was "a valid theory of damages for an independent cause of action." Shortly after the Third Circuit issued its ruling in *CitX*, the Delaware Chancery Court rejected deepening insolvency as a valid cause of action under Delaware law in *Trenwick Am. Litig. Trust v. Ernst & Young, LLP*, 906 A.2d 168 (Del. Ch. 2006).

Taking its cue from the Third Circuit and the Delaware Chancery Court, the bankruptcy court in *In re Greater Southeast Community Hosp. Corp. I*, 2006 WL 2793177 (Bankr. D.D.C. 2006 Sept. 21, 2006), ruled that deepening insolvency is properly treated as a theory of harm, not as a separate cause of action under Delaware law. Finally, in *In re Southwest Florida Heart Group, P.A.*, 346 B.R. 897 (Bankr. M.D. Fla. 2006), the bankruptcy court held that no viable claim exists under Florida law against members of a bankrupt physicians' association for prolonging the association's existence and thereby deepening its insolvency. According to the court, the alleged deepening of the association's insolvency was relevant only to the measure of damages on breach of fiduciary duty and other claims and was not a viable claim in its own right.

FROM THE TOP

The U.S. Supreme Court issued three rulings on the subject of bankruptcy during 2006. In *Central Virginia Community College v. Katz*, 126 S. Ct. 990 (2006), a 5-4 majority of the Court ruled that an adversary proceeding brought by a chapter 11 trustee to set aside alleged preferential transfers to state agencies was not barred by the agencies' sovereign immunity. In ratifying the Bankruptcy Clause of the U.S. Constitution, the Court emphasized, the individual states acquiesced in the subordination of whatever sovereign immunity they might otherwise have asserted in proceedings brought to enforce the *in rem* jurisdiction of the bankruptcy court, such as litigation to avoid preferences.

In *Marshall v. Marshall*, 126 S. Ct. 1735 (2006), the Court held that the probate exception to federal jurisdiction did not deprive a bankruptcy court of jurisdiction over a debtor's counterclaim asserting that her stepson tortiously interfered with her expectancy of inheritance from her deceased husband, because the counterclaim sought a judgment against the stepson personally and did not involve probate or annulment of the husband's will or administration of his estate or seek to reach property in the custody of the state probate court.

Finally, in *Howard Delivery Service, Inc. v. Zurich American Ins. Co.*, 126 S. Ct. 2105 (2006), a 6-3 majority of the Court ruled that an insurance company's unsecured claim against a chapter 11 debtor-employer for unpaid premiums for workers' compensation coverage was not entitled to priority status as a claim for "contributions to an employee benefit plan arising from services rendered."

Bankruptcy issues to be addressed by the Supreme Court in 2007 include whether a chapter 7 debtor's alleged bad faith has any bearing on the debtor's right to convert his chapter 7 case to a case under chapter 11 or 13 of the Bankruptcy Code. The Court heard oral argument in *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), on November 6, 2006, and is expected to issue its ruling in the spring of 2007. On January 16, 2007, the Court heard argument in *Travelers Casualty & Surety Co. of America v. Pacific Gas & Electric Co.*, 2006 WL 285977 (9th Cir. Feb. 7, 2006), *cert. granted*, 127 S. Ct. 377 (2006), to consider whether a creditor who engages an attorney to assert its claim in a bankruptcy proceeding is entitled to an award of attorneys' fees from the bankruptcy estate, where a pre-bankruptcy contract between the creditor and the debtor provides for an award of such fees.

LEGISLATIVE UPDATE

The end of 2006 heralded the completion of the first full year that the Bankruptcy Abuse Prevention and Consumer Protection Act ("BAPCPA") applied to U.S. bankruptcy filings. Developments during 2006 indicate that the new legislative regime may have created new problems in its attempt to curb perceived bankruptcy abuse and to streamline the process for business bankruptcies. For example, the new chapter 7 means test, the credit-counseling requirements applicable to all individual bankruptcy cases, and the new restrictions on "debt relief agencies" have ignited a flurry of protest and litigation over, among other things, the fairness of the means test as a gatekeeper for consumer chapter 7 cases, confusion concerning the credit-counseling rules, and application by some courts of the restrictions governing debt relief agencies to preclude bankruptcy attorneys from charging fees for services rendered in anticipation of individual bankruptcy filings. The latter dispute has already resulted in a handful of court rulings declaring the debt relief agency rules to be unconstitutional — the application to attorneys of the Bankruptcy Code's prohibition of advice from a paid provider of "bankruptcy assistance" to incur additional debt in contemplation of a bankruptcy filing has been deemed to violate the First Amendment right to free speech. This and other problems encountered in applying the new rules have already provoked calls on Capitol Hill to roll back the reforms.

BAPCPA also made significant and controversial changes to the rules and procedures governing business bankruptcy cases. Notable among these are limitations on the duration of a chapter 11 debtor's exclusive period to propose and solicit acceptances for a chapter 11 plan, creditors' committee disclosure requirements, significant limitations on a debtor's ability to defer the decision to assume or reject commercial real property leases, and strict limitations on a chapter 11 debtor's ability to institute key employee retention and severance programs. Other significant changes include new rules governing the modification of employee benefits by insolvent companies that later file for chapter 11 protection, and the newly created administrative priority for trade debts incurred in the ordinary course of business by a debtor within 20 days of filing for bankruptcy. Certain of these amendments have already sparked a significant volume of litigation. In addition, the new commercial real property lease and chapter 11 exclusivity limitations are likely to have a marked impact on the progress of some chapter 11 cases.

BAPCPA implemented sweeping changes to the Bankruptcy Code's provisions governing financial contracts to ensure that a bankruptcy filing by any party to a securities contract, forward contract, commodities contract, swap agreement, or other type of financial contract does not in any way hinder the free operation of the market. Even so, the new rules proved to be deficient in certain respects, prompting lawmakers to devise legislation in 2006 designed to fix the problems. President George W. Bush gave his imprimatur on December 12, 2006, to the Financial Netting Improvements Act of 2006 (the "FNIA"). The FNIA builds on BAPCPA and is intended to clarify the treatment of certain financial contracts in the event of the insolvency of a counterparty and to promote a reduction of systemic risk.

The creation of an entirely new framework of rules to govern cross-border bankruptcy cases was a prominent feature of BAPCPA. New chapter 15 of the Bankruptcy Code replaced section 304 of the statute, which allowed an accredited representative of a debtor in a foreign bankruptcy proceeding to file an ancillary bankruptcy case in the U.S. for the purpose of protecting the foreign debtor's U.S. assets. Chapter 15 is patterned on the Model Law on Cross-Border Insolvency (the "Model Law"), a system of legal principles formulated by the United Nations Commission on International Trade Law in 1997 to deal with the rapidly expanding volume of international insolvency cases. Chapter 15 significantly expands the power of U.S. bankruptcy courts to grant relief for the purpose of rendering assistance to foreign bankruptcy or insolvency proceedings.

Chapter 15 is still very much in its infancy, but it is maturing rapidly. More than 80 chapter 15 petitions were filed in U.S. bankruptcy courts by the end of 2006, with the Southern District of New York by far the preferred forum (54 cases). During that same period, the courts entered more than 60 orders officially recognizing qualified foreign bankruptcy proceedings.

The United Kingdom enacted its own version of the Model Law in April of 2006. On November 23, 2006, the first application seeking recognition of a foreign bankruptcy proceeding — a U.S. chapter 7 bankruptcy case pending in a Georgia bankruptcy court — was filed under the U.K.'s Cross-Border Insolvency Regulations on behalf of the U.S. bankruptcy trustee for the purpose of recovering the chapter 7 debtor's U.K. assets.

The perceived ease with which financially strapped chapter 11 debtors such as United Airlines, US Air and, most recently, Delta Air Lines were able to jettison nearly $12 billion in pension liabilities has figured prominently in recent headlines. Assumption of these obligations by the beleaguered Pension Benefit Guaranty Corporation ("PBGC") contributed to a deficit that aggregated nearly $23 billion at the end of fiscal year 2005 and was reported at $18.1 billion at the end of fiscal year 2006. Lawmakers responded to the crisis in 2006 by passing the most sweeping pension reform in 30 years. The Pension Protection Act of 2006 became law on August 17, 2006, and 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.

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. In fact, the $4.7 billion net improvement in PBGC's financial picture from 2005 to 2006 is attributable mainly to the airline relief provisions in the Pension Protection Act that led to a sharp reduction in the amount of "probable" liabilities reflected on the agency's balance sheet. Even so, 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.

2006 was also the year that China finally enacted a permanent bankruptcy law designed to establish a comprehensive legal framework for corporate bankruptcies and the discharge of debts and interests. China's National People's Congress approved the PRC Enterprise Bankruptcy Law on August 26, 2006, although the legislation is not slated to become effective until June 1, 2007. With limited exceptions, the law applies to all types of business entities, including state-owned enterprises and foreign-invested enterprises. For the first time, the law sets out clear procedures regarding the bankruptcy of China's financial institutions, an issue that had long been a gray area. It also creates a mechanism for corporate reorganizations similar to chapter 11 of the U.S. Bankruptcy Code — a clear departure from current rules, which focus on liquidation as the sole mechanism for dealing with a bankrupt enterprise.

PENSION PLANS ASSUMED BY PBGC IN 2005-2006
(B) = IN BANKRUPTCY

COMPANY	DATE	SHORTFALL ASSUMED
Republic Storage Systems Co., Inc. (b)	10/23/06	$29 million
Levitz Home Furnishings, Inc. (b)	10/03/06	$23.5 million
Plymouth Rubber Co. (b)	7/19/06	$11.9 million
Victory Memorial Hospital	7/05/06	$29 million
Pittsburgh Brewing Co. (b)	5/23/06	$11 million
Jernberg Industries Inc.	5/05/06	$10.2 million
Aloha Airlines Inc. (b)	4/28/06	$117 million
Falcon Products Inc. and sub. Shelby Williams Industries Inc. (b)	11/25/05	$31.6 million
Huffy Corp. (b)	10/05/05	$80 million
Westpoint Stevens Corp. (b)	8/19/05	$286 million
Amcast Industrial Corporation (b)	7/28/05	$83 million
Techneglas Inc. (b)	6/30/05	$70 million
United Airlines (b)	4/22/05	$6.6 billion
Liam Ventures Inc.	3/31/05	$133 million
Lobdell Emery Corp. and Howell Industries, subsidiaries of Oxford Automotive Inc. (b)	2/25/05	$35 million
Penn Traffic Co. (b)	2/24/05	$125 million
US Airways (b)	2/02/05	$2.3 billion
Murray Inc. (b)	1/19/05	$103 million

THE "POISON PILL" ALTERNATIVE TO STOCK-TRADING INJUNCTIONS IN CHAPTER 11

Brad B. Erens and Mark G. Douglas

The implementation of restrictions on stock and/or claims trading has become almost routine in large chapter 11 cases involving public companies on the basis that such restrictions are vital to prevent forfeiture of favorable tax attributes that can be triggered by a change in control. Continued reliance on stock-trading injunctions as a means of preserving net operating loss carry-forwards, however, may be problematic, after the controversial ruling handed down in 2005 by the Seventh Circuit Court of Appeals in *In re UAL Corp*. In that case, the Court sharply criticized stock-trading freezes and suggested that the quid pro quo for preventing trading should be a bond or some other form of security posted by the chapter 11 debtor to compensate stockholders for any losses sustained as a consequence of their inability to trade. Although courts continue to impose stock- and claims-trading restrictions as part of customary "first day" orders in chapter 11 cases filed by publicly traded companies, the possibility that trading injunctions will be harder to obtain begs the question whether other means of preventing significant shifts in equity ownership are available. Carefully tailored measures implemented by a debtor-corporation's board of directors, such as "poison pills," may be one option.

TAX ATTRIBUTES AND CHANGES IN CONTROL

An indispensable feature of almost every chapter 11 case involving a business that is attempting to reorganize by reworking its capital structure is the ability to preserve as much as possible existing net operating losses ("NOLs") to offset future tax liabilities of the reorganized or successor entity. NOLs are an excess of deductions over income in any given year. They can generally be carried back to use against taxable income in the two previous years and, to the extent not used, may be carried forward for 20 years. Losses remain with the debtor during a bankruptcy case because a bankruptcy filing for a corporation does not create a new taxable entity.

Certain provisions in the Internal Revenue Code ("IRC") significantly limit the ability of a company to preserve its NOLs upon a "change in ownership." The vast majority of all corporate reorganizations under chapter 11 result in a change of ownership under section 382 of the IRC. If the change occurs prior to confirmation of a chapter 11 plan, the standard NOL limitation of section 382 applies. This means that, on a going-forward basis, the company's allowed usage of NOLs against future income will be capped at an annual rate equal to the equity value of the corporation immediately before the change in ownership multiplied by the long-term tax-exempt bond rate. Capping the NOLs will delay (or may even prevent) the company from using the NOLs, in either case often significantly reducing the present value of the tax savings.

Under certain limited circumstances, a debtor can undergo a change of ownership under a chapter 11 plan and emerge without any section 382 limitation on its NOLs or built-in loss. To qualify for this provision (contained in section 382(l)(5) of the IRC): (i) shareholders and creditors of the company must end up owning at least 50 percent of the reorganized debtor's stock (by vote and value); (ii) shareholders and creditors must receive their minimum 50 percent stock ownership in discharge of their interest in and claims against the debtor; and (iii) stock received by creditors can be counted toward the 50 percent test only if it is received in satisfaction of debt that (a) had been held by the creditor for at least 18 months on the date of the bankruptcy filing (*i.e.*, was "old and cold") or (b) arose in the ordinary course of the debtor's business and is held by the person who at all times held the beneficial interest in that indebtedness.

A significant volume of stock transfers prior to confirmation of a plan of reorganization can jeopardize the debtor-company's ability to retain the full benefit of its NOLs under that plan. Some bankruptcy courts recognized this potential risk relatively early on, finding that NOLs are property of a chapter 11 debtor's bankruptcy estate and enjoining any action that had the potential to adversely affect them. The seminal case in this area is *Official Committee of Unsecured Creditors v. PSS Steamship Co.* (*In re Prudential Lines, Inc.)*. In that case, the Second Circuit Court of Appeals upheld a bankruptcy court's ruling, based upon sections 362(a)(3) and 105(a) of the Bankruptcy Code, that an NOL is property of the debtor's bankruptcy estate and that the efforts of the debtor's nonbankrupt corporate parent to claim a worthless stock deduction, which under then-existing law would have rendered the debtor's NOL useless, violated the automatic stay. Adopting the approach articulated in *Prudential*, many courts have ruled that stock trading may be prohibited under section 362(a)(3), as an exercise of control over NOLs, which are property of the debtor's bankruptcy estate.

Debtors have been swift to seek court intervention in cases that have the potential for a significant volume of stock trading. Companies such as First Merchants Acceptance Corporation, Service Merchandise Company, Phar-Mor, Southeast Banking Corp. and, more recently, Conseco, Williams Communications Group, United Airlines, Owens Corning, Foamex International Inc., FLYi, Dana Corporation, and DURA Corporation have sought court approval at the outset of a chapter 11 case to implement procedures designed to monitor trading and to prevent trading if it threatens important tax attributes. Typical stock-trading injunctions protect against ownership changes prior to the effective date of a chapter 11 plan and are generally designed to limit trading by any entity holding 5 percent or more of the debtor's stock.

A WRENCH IN THE WORKS? THE SEVENTH CIRCUIT'S RULING IN *UAL*

The prevalence of routine stock-trading injunctions in large chapter 11 cases was challenged in 2005 by the Seventh Circuit Court of Appeals in *In re UAL Corp.* When United Airlines sought chapter 11 protection in 2002, United's employees owned slightly more than one-half of the company's stock through an employee stock ownership plan ("ESOP"). Concerned that the ESOP might sell the stock and thereby cause a change in control that would jeopardize its ability to preserve NOLs, United obtained an injunction forbidding any stock sales by the ESOP. The ESOP did not ask the bankruptcy court to require United to post a bond or implement other measures to protect the ESOP against losses occurring as a result of its inability to sell the United stock.

The trustees of the ESOP appealed the injunction. Before the appellate court could render a decision, the Internal Revenue Service issued a regulation permitting ESOPs to pass through shares to employee beneficiaries without jeopardizing the issuer's ability to preserve NOL carry-forwards. United terminated the ESOP, which distributed the stock it held to the employees, who were free to trade the shares. The ESOP having been dissolved, the injunction lapsed, although it was never formally vacated by the bankruptcy court. Even though United then asked the district court to dismiss the appeal as moot, the court affirmed the bankruptcy court's decision to enjoin the stock sales. The ESOP's trustees appealed that determination to the Seventh Circuit.

At the time that the bankruptcy court issued the injunction, United's stock was trading at $1.06 per share. When employees were again able to trade (upon dissolution of the ESOP), the stock price had fallen to $.76. On appeal to the Seventh Circuit, the trustees sought an award of damages to compensate for the decrease in the price of the stock during the trading freeze.

The Seventh Circuit denied the trustees' request for damages because they never obtained a bond or other equivalent means of protection to safeguard against any diminution in value in the stock caused by the trading freeze. Even so, the Court of Appeals vacated the district court's order affirming the injunction and remanded the case with instructions to enter an order formally dissolving the injunction. In doing so, the Seventh Circuit was highly critical of the bankruptcy court's decision to enjoin trading in the case:

> Requiring investors to bear the costs of illiquidity and underdiversification was both imprudent and unnecessary. United wants to preserve the value of tax deductions that, it contends, are worth more than $1 billion should it return to profitability. There is no reason why investors who need liquidity should be sacrificed so that other investors (principally, today's debt holders) can reap a benefit; bankruptcy is not supposed to appropriate some investors' wealth for distribution to others. United should have been told to back up its assertions with cash, so that put-upon shareholders could be made whole. If United's views are right, it would not have had any trouble borrowing to underwrite a bond or other form of protection; and if lenders would not make such loans, that would have implied to the court that United's contentions are hot air.

The Court of Appeals went on to characterize reliance on sections 105(a) and 362(a)(3) of the Bankruptcy Code as a basis for issuing a trading injunction as "weak enough to make a bond or adequate-protection undertaking obligatory before a bankruptcy judge may forbid investors to sell their stock on the market." According to the Seventh Circuit, a carefully drafted adequate-protection agreement could have "protected stockholders against an erosion of their position while requiring them to indemnify United if the market price of the stock should rise, and the expense of a bond or other security turn out to have been unnecessary." Nevertheless, because no such protective measures were implemented at the time the trading freeze took place, the Court of Appeals ruled that the employee shareholders were not entitled to damages for any diminution in United's stock value.

At least one bankruptcy court has interpreted *UAL* as a mandate for refusing to impose stock-trading restrictions in a chapter 11 case. On March 3, 2006, Judge Jerry W. Venters of the Bankruptcy Court for the Western District of Missouri, relying upon *UAL*, denied a motion to implement equity-trading restrictions filed by chapter 11 debtors Interstate Bakeries Corp. and its affiliates. According to Judge Venters, the requested relief, which the debtors sought 18 months after filing for chapter 11, when it first appeared that they might have tax attributes to protect, was a procedurally improper request for injunctive relief and, moreover, was unjustified because equity securities are not property of a debtor's estate. Similar objections were raised to equity-trading orders requested in the chapter 11 cases of Dana Corporation and Foamex International Inc., although the bankruptcy courts involved ultimately approved the restrictions.

A WAY FORWARD: THE POISON PILL?

Devised in the early 1980s, shareholder rights plans, or "poison pills," are a commonplace takeover defense. According to recent estimates, approximately 46 percent of the S&P 500 companies had a rights plan in place at the end of 2005. A rights plan can be quickly implemented by action of a company's board of directors, and most important, shareholder approval is generally not required. In the most common form, the board of directors declares a dividend of share purchase rights and enters into a shareholder rights agreement with a rights agent (typically the transfer agent for the company's common stock). The purchase rights attach to the company's common stock and remain inactive and unexercisable until a shareholder acquires more than a certain percentage of the company's outstanding stock—typically 10 to 20 percent—triggering detachment and exercisability of the purchase rights. All other shareholders then have the right to purchase newly issued shares of the company's common stock at a 50 percent discount to the current market price, thereby significantly diluting the acquiring shareholder's equity holdings. The existence of a poison pill generally forces potential acquirors to negotiate with the target's management and board before consummating an offer. There are ways to defeat a pill, but they are difficult, costly, and time-consuming.

Under the right circumstances, the poison pill may be an attractive alternative to a traditional stock-trading order, given the uncertainty in obtaining such an order after the *UAL* decision. This may entail amending the pill to make it more restrictive—the typical 10 to 20 percent threshold likely would need to be dropped to 5 percent to protect forfeiture of a chapter 11 debtor's tax attributes. Court approval may not even be necessary to adopt a poison pill or to make an existing provision more restrictive. As a general rule, although chapter 11 shifts the fiduciary paradigm of a company's directors to account for creditor and estate interests, a chapter 11 filing does not intrude upon the corporate governance of the debtor-in-possession. Bankruptcy courts are reluctant to interfere with a debtor's management of its business. Further, under the Bankruptcy Code, a debtor's management decisions are entitled to a presumption of reasonableness.

The Bankruptcy Code provides that a debtor-in-possession or bankruptcy trustee may enter into transactions in the ordinary course of business without court approval. Although court approval is required for any use, sale, or lease of estate property that is outside the ordinary course of the debtor's business, a debtor's stock is not considered property of its bankruptcy estate. As a consequence, a chapter 11 debtor-in-possession arguably can rely upon its general mandate to continue operating the debtor's business as authority for implementing or amending a poison pill. For example, shortly after filing for chapter 11 protection in March of 2006, Dana Corporation extended the duration of a "poison pill" provision that would otherwise have expired on July 25, 2006, without the need for bankruptcy court approval. In addition, on January 30, 2006, chapter 11 debtor USG Corporation announced that it was adopting a revised shareholder rights plan. Under the revised plan, which expired on December 31, 2006, if any person acquired beneficial ownership of 5 percent or more of USG's voting stock, other shareholders had the right to purchase additional USG common stock at half the market price. After emerging from chapter 11 protection, USG implemented a new plan, effective January 1, 2007, which reinstitutes the 15 percent threshold.

The practical utility of implementing a poison pill or beefing up an existing provision as a way to prevent forfeiture of NOLs may be limited — merely giving other stockholders the right to acquire stock at a discount may not prevent a "change in control" if the rights are not timely exercised in sufficient quantity. Still, the threat of significant dilution could be adequate to ward off a substantial equity ownership shift and provide the debtor with enough time to seek court intervention under circumstances that may be more likely to pass muster under the restrictive approach suggested by the Seventh Circuit in *UAL*.

In re UAL Corp., 412 F.3d 775 (7th Cir. 2005).

Official Committee of Unsecured Creditors v. PSS Steamship Co. (*In re Prudential Lines, Inc.)*, 928 F.2d 565 (2d Cir. 1991).

In re Interstate Bakeries Corp., Case No. 04-45814 (JWV) (Bankr. W.D. Mo. Mar. 3, 2006) (unpublished ruling).

Jones Day acted as debtor's counsel in the chapter 11 cases of Williams Communications Group; FLYi, Inc.; Dana Corporation; and USG Corporation.

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PRE-PACKAGED AND PRE-NEGOTIATED CHAPTER 11 CASES FILED AND CONFIRMED POST-EFFECTIVE DATE OF BAPCPA

COMPANY	ASSETS	FILED	CONFIRMED
ABB Lummus Global, Inc.	$414,039,169	4/21/06	6/16/06
Blue Bird Body Co.	$346,777,000	1/26/06	1/27/06
Curative Health Services, Inc.	$283,784,000	3/27/06	5/22/06
Davis Offshore LP	$69,336,438	3/07/06	3/10/06
Inland Fiber Group, LLC	$84,775,000	8/18/06	11/09/06
Integrated Electrical Services, Inc.	$416,372,000	2/14/06	4/26/06
McLeodUSA Incorporated	$1,025,800,000	10/28/05	12/16/05
Oneida Ltd.	$328,812,000	3/19/06	8/30/06
Pliant Corporation	$777,092,000	1/03/06	6/23/06
Satelites Mexicanos S.A. de C.V.	$925,271,000	8/11/06	10/26/06
Silicon Graphics, Inc.	$452,145,000	5/08/06	9/19/06

ASSESSING THE IMPACT OF THE NEW CHAPTER 11 EXCLUSIVITY DEADLINE

Mark G. Douglas

A debtor's exclusive right to formulate and solicit acceptances for a plan of reorganization during the initial stages of a chapter 11 case is one of the most important benefits conferred under the Bankruptcy Code as a means of facilitating the successful restructuring of an ailing enterprise. By giving a chapter 11 debtor-in-possession time to devise a solution to balance-sheet and operational problems without being burdened by the competing agendas of other stakeholders in the bankruptcy case, exclusivity levels the playing field, at least temporarily.

Even so, exclusivity is flexible, reflecting the recognition that in some cases, a debtor's sole right to control the plan process should be extended, while in others, it should be abridged. In most large chapter 11 cases, extensions of exclusivity have become the norm — a practice that has been criticized because of the perception that giving a debtor exclusive control of the plan process for an extended period (in some cases years) is unproductive and unfair. Responding to concerns that debtors' reliance on exclusivity unduly prolongs chapter 11 cases, Congress amended the Bankruptcy Code in 2005 to place an outside limitation on exclusivity. At this juncture, what impact the new rule will have on the progress of chapter 11 cases remains to be seen. Recent developments, however, suggest that bankruptcy courts are casting a more critical eye on exclusivity-extension motions, even short of the new time limitation, particularly in cases where progress toward a negotiated exit plan is less than satisfactory.

CHAPTER 11 EXCLUSIVITY

Upon the commencement of a chapter 11 case, Bankruptcy Code section 1121 gives a debtor-in-possession ("DIP") the exclusive right to file a plan of reorganization for 120 days. The DIP also has the exclusive right to solicit acceptances (votes) for a plan filed within that 120-day period until 180 days after filing for chapter 11. No competing plans may be filed during this period of exclusivity.

The concept of limited exclusivity in the Bankruptcy Code was based upon a compromise. Under the corporate reorganization provisions of U.S. bankruptcy law pre-dating the enactment of the current statute in 1978, only the debtor had the right to propose a plan. Armed with exclusivity throughout the case, a debtor could hold creditors hostage to its own reorganization agenda and threaten to convert to a liquidating case if creditors were reluctant to do so. Lawmakers attempted to remove what was considered to be undue bargaining leverage when they enacted the Bankruptcy Code.

Congress recognized, however, that eliminating exclusivity altogether would be ill-advised. It might remove the incentive of existing management — which is often crucial to the debtor's reorganization prospects — to manage the debtor during the chapter 11 case because disaffected creditors or shareholders could file a plan at any time to bring in new owners and dislodge it. The absence of exclusivity, and the prospect of one or more competing plans filed at the inception of a case, could also lead to chaos. Recognizing the utility of permitting a DIP to act as an "honest broker" for a negotiated solution during the initial stages of a case, Congress opted for limited exclusivity in section 1121.

"Limited" exclusivity means that the time frame is flexible and may terminate upon the occurrence of certain specified conditions. Among these are the appointment of a trustee and the debtor's failure to file a plan or obtain acceptance of a plan by the requisite majorities of all impaired classes of claims and interests within the exclusive periods. If any of these occur, any party-in-interest in the bankruptcy case, "including the debtor, the trustee, a creditors' committee, an equity security holders' committee, a creditor, an equity security holder, or any indenture trustee," has the right to file its own plan of reorganization.

Exclusivity is also flexible because it may be modified. Bankruptcy Code section 1121 gives the bankruptcy court the discretion to either extend or reduce the exclusive periods upon a showing of "cause." The Bankruptcy Code does not define "cause." Courts have fashioned their own definitions, based upon the legislative purpose underlying section 1121 and the practical realities of chapter 11 cases, where it may be unrealistic to suppose that the debtor can turn its attention to formulating, negotiating, and winning acceptance of a plan within the 120- and 180-day periods specified in the statute. Over the years, courts have developed a variety of factors, each of which, standing alone, may provide sufficient justification for extending the exclusive periods. These factors include:

- The size and complexity of the case;
- The necessity of sufficient time to negotiate and prepare adequate information;
- The existence of good-faith progress toward reorganization;
- Whether the debtor is paying its debts as they come due;
- Whether the debtor has demonstrated reasonable prospects for filing a viable plan;
- Whether the debtor has made progress in negotiating with creditors;
- The length of time the case has been pending;
- Whether the debtor is seeking the extension to pressure creditors; and
- Whether unresolved contingencies exist.

Bankruptcy courts are given wide latitude to evaluate whichever factors apply in any given case and to give them appropriate weight in determining whether to extend exclusivity.

NEW "DROP DEAD" DATE FOR EXCLUSIVITY

Congress made important changes to section 1121 as part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. As amended, the statute provides that the 120-day period during which the DIP has the exclusive right to file a chapter 11 plan "may not be extended beyond a date that is 18 months" after the bankruptcy petition date. In addition, the 180-day period during which only the DIP may solicit votes for a plan may not be extended beyond 20 months after the filing date. The amendment was prompted by a widespread perception that some debtors were languishing in chapter 11 for inordinate periods of time and that a more abbreviated time frame for exclusivity will encourage debtors and other

LARGEST PUBLIC-AIRLINE CHAPTER 11 FILINGS

COMPANY	PETITION DATE	ASSETS
UAL Corp.	12/09/02	$25.2 billion
Delta Air Lines, Inc.	9/14/05	$21.8 billion
Northwest Airlines Corp.	9/14/05	$14.04 billion
US Airways Group, Inc. (2004)	9/12/04	$8.35 billion
US Airways Group, Inc. (2002)	8/11/02	$8.025 billion
Continental Airlines Holdings, Inc.	12/03/90	$7.66 billion
Eastern Air Lines, Inc.	3/09/89	$4.04 billion
Trans World Airlines, Inc. (1992)	1/31/92	$2.86 billion
Trans World Airlines, Inc. (1995)	6/30/95	$2.5 billion
Pan Am Corp. (1991)	1/08/91	$2.44 billion
Trans World Airlines, Inc. (2001)	1/10/01	$2.14 billion
Atlas Air Worldwide Holdings, Inc.	1/30/04	$2.08 billion
America West Airlines, Inc.	6/27/91	$1.17 billion
Kitty Hawk, Inc.	5/01/00	$983 million
ATA Holdings Corp.	10/26/04	$870 million
FLYi, Inc.	11/07/05	$678 million
Midway Airlines, Inc. (1991)	3/25/91	$468 million
Tower Air, Inc.	2/29/00	$351 million
Midway Airlines Corp. (2001)	8/13/01	$349 million
Hawaiian Airlines, Inc.	3/21/03	$305 million
Fine Air Services Corp.	9/27/00	$303 million
Braniff, Inc.	9/28/89	$238 million
Western Pacific Airlines, Inc.	10/05/97	$120 million
HAL, Inc.	9/21/93	$106 million

stakeholders to come to the table sooner for the purpose of negotiating a viable exit strategy, which will ultimately reduce administrative costs.

The immediate impact of the new "drop dead" date for chapter 11 exclusivity has been difficult to gauge thus far. Because the 18-month period applies only to cases filed on or after October 17, 2005, no chapter 11 debtor will confront the deadline until the middle of April 2007. Even so, anecdotal evidence and filing statistics indicate that the new rule already figures prominently in pre-chapter 11 strategic planning. A substantial number of companies filed for chapter 11 before October 17, 2005, to avoid being subject to the 18-month deadline (as well as other aspects of the amendments). In addition, the volume of "pre-packaged" or pre-negotiated chapter 11 cases has been on the upsurge, suggesting that potential chapter 11 debtors are increasingly striking deals with creditors and other stakeholders in advance of a bankruptcy filing as a way to avoid losing control of the negotiating process.

Moreover, the "feet to the fire" mentality underlying the changes may lead bankruptcy courts to examine exclusivity-extension requests with stricter scrutiny, even in cases where the new deadline does not apply. For example, Judge Jerry A. Brown of the United States Bankruptcy Court for the Eastern District of Louisiana, who is presiding over the chapter 11 case of the utility Entergy New Orleans, Inc., terminated the debtor's exclusivity on December 8, 2006. Entergy, which filed for chapter 11 protection on September 23, 2005, due to losses stemming from Hurricane Katrina, did not file a plan of reorganization until more than a year after seeking chapter 11 protection and had been granted two extensions of exclusivity. In granting the motion filed by Entergy's unsecured creditors' committee, Judge Brown expressed a desire to speed up negotiations on a plan, noting that professional fees in the case were averaging $1.8 million each quarter. He ruled that any party-in-interest (including Entergy) that wanted to submit a plan of reorganization in the case had to do so by December 19, 2006. Entergy and its unsecured creditors' committee submitted competing plans of reorganization before the deadline.

IN SEARCH OF THE MEANING OF "UTILITY" IN BANKRUPTCY CODE SECTION 366

Mark G. Douglas

Entities doing business with a customer that files for bankruptcy protection generally have the right to refuse to continue providing goods or services to the chapter 11 debtor, unless such goods or services are covered by a continuing contract, in which case any forfeiture of the debtor's rights under the agreement is generally prohibited to afford the debtor a reasonable opportunity to decide what to do with the contract. Special rules, however, apply to utilities — without essential utility services, the debtor can neither reorganize nor obtain the fresh start that is a fundamental premise underpinning federal bankruptcy law. For this reason, utilities are precluded from discontinuing service to any customer solely on the basis that the entity involved filed for bankruptcy or has not paid for utility services prior to filing a bankruptcy petition. Instead, the Bankruptcy Code requires debtors to provide "adequate assurance" of payment to utilities shortly after a bankruptcy filing.

Exactly what qualifies as a "utility" has become the focus of a broadening debate, as reliance on telecommunications and related services has rapidly expanded to the point of achieving "necessity" status that, up until the last 15 or 20 years, had been principally the exclusive province of more traditional (and largely monopoly) providers such as gas, electric, water, sewer, and telephone companies. The Fifth Circuit Court of Appeals recently had an opportunity to consider this issue in *Darby v. Time Warner Cable, Inc. (In re Darby)*. In a matter of first impression, the Fifth Circuit ruled that a provider of cable television service did not qualify as a "utility."

CONTINUATION OF UTILITY SERVICE IN BANKRUPTCY

A debtor's rights and obligations under agreements existing as of the bankruptcy filing date are governed for the most part by section 365 of the Bankruptcy Code. Among other things, section 365 prohibits termination of most kinds of contracts triggered by a bankruptcy filing and gives the debtor a reasonable opportunity (*i.e.*, 60 days, 120 days, or any time before confirmation of a plan, depending on the kind of contract and bankruptcy case involved) to assume, assume and assign, or reject a contract so long as the decision is supported by sound business judgment. Pending the decision to assume or reject, the counterparty to the contract must continue to render performance so long as the debtor honors its post-petition contractual obligations. Assumption of an agreement is possible only if the debtor cures any outstanding defaults and provides adequate assurance of future performance.

Special rules, however, apply to services provided by utilities, whether under contract or otherwise. Section 366 of the Bankruptcy Code provides that "a utility may not alter, refuse, or discontinue service to, or discriminate against, the trustee or the debtor solely on the basis of the commencement of a case under this title or that a debt owed by the debtor to such utility for service rendered before the order for relief was not paid when due." However, the section also provides that a utility may alter, refuse, or discontinue service if the trustee or the debtor fails to "furnish adequate assurance of payment" within 20 days of the bankruptcy petition date (30 days, if the case is filed under chapter 11). Section 366 was amended in 2005 to clarify that "adequate assurance" may take several forms (*e.g.*, a cash deposit, letter of credit, or prepayment) and that certain other forms (*e.g.*, the prospect of an administrative priority claim for amounts owed for post-petition utility services) do not constitute "adequate assurance."

"Utility" is not defined in the Bankruptcy Code. The legislative history of section 366 indicates that the provision was "intended to cover utilities that have some special position with respect to the debtor, such as an electric company, gas supplier, or telephone company that is a monopoly in the area so that the debtor cannot easily obtain comparable service from another utility." A utility provider's obligation under section 366 to continue uninterrupted utility services post-petition represented a conscious desire to overrule pre-Bankruptcy Code decisions to the contrary. Under the former Bankruptcy Act, a substantial split had developed in the federal circuit courts over whether a utility might be prevented from using the threat of service discontinuance as a collection device.

The absence of any express definition of "utility" in the statute and the legislative history's nonexclusive catalogue of qualifying providers suggest that lawmakers intended the concept to evolve as more or different services came to occupy a "special position" with respect to the debtor. The Fifth Circuit recently examined this idea in *Darby*.

THE FIFTH CIRCUIT'S RULING IN *DARBY*

Damon Fitzgerald Darby filed a chapter 13 case in July of 2004. Soon after receiving notice of the filing, Time Warner Cable, Inc., disconnected Darby's cable television service. Darby offered Time Warner a deposit to reconnect his cable service, but Time Warner refused to reinstate his service.

Darby sought a court order under section 366 directing Time Warner to do so upon provision of adequate assurance of payment. Time Warner argued that it was not a "utility" within the meaning of the statute and consequently was not obligated to reinstate Darby's cable service even if he offered adequate assurance. The bankruptcy court directed Time Warner to reconnect Darby's service and granted the cable company an administrative priority claim as adequate assurance. The court reversed that determination, however, on reconsideration, ruling that Time Warner was not a utility within the meaning of section 366 and did not have to reinstate Darby's cable television service. The district court upheld that ruling on appeal.

> Applying the "necessary" and "essential" standard may be more complicated than it would appear — certain kinds of services could readily be essential to some debtors but not others, and the increasing prevalence of service "bundling" (*e.g.,* television, phone, and internet service in one package) is likely to make the analysis more difficult.

Darby appealed to the Fifth Circuit, which affirmed the rulings below. Noting that the classification of cable service under section 366 is an issue of first impression in the circuit, the Court of Appeals looked for guidance to the provision's legislative history as well as other decisions construing the meaning of "utility." The Fifth Circuit focused on the "special position" status indicated by the legislative history, observing that "it seems logical that a strong justification, such as the need for continued access to essential services, underlies the

SIGNIFICANT AUTO-PARTS SUPPLIER BANKRUPTCIES 2004–2006

COMPANY	FILING DATE
Citation Corp.	9/21/04
Intermet Corp.	9/30/04
Amcast Industrial Corp.	11/30/04
Oxford Automotive Inc.	12/07/04
Tower Automotive Inc.	2/02/05
Meridian Automotive Systems Inc.	4/26/05
Collins & Aikman Corp.	5/17/05
Universal Automotive Industries Inc.	5/27/05
Metalforming Technologies Inc.	6/16/05
Uniboring	6/09/05
Jernberg Industries Inc.	6/29/05
Delphi Corp.	10/05/05
J.L. French Automotive Castings	2/10/06
Dana Corp.	3/03/06
Oris Automotive Parts AL, Ltd.	3/16/06
Q.C. Onics Ventures LP	5/02/06
Steel Parts Corp.	9/15/06
Creative Engineered Polymer Products	9/20/06
Union Stamping & Assembly Inc.	10/03/06
DURA Automotive Systems, Inc.	10/30/06

provision." According to the Court of Appeals, "the necessity of service is what creates a 'special' relationship between a debtor and a utility."

The Fifth Circuit did not fault the bankruptcy court's determination that cable service is not a necessity because it is "not necessary to a minimum standard of living." The Court of Appeals rejected Darby's contention that he could not easily obtain comparable service because he would be required to pay $250 to initiate satellite service. The availability in and of itself of other options, such as satellite or network service, the Fifth Circuit emphasized, dictates that cable service is not a necessity and that Time Warner is not governed by the strictures of section 366.

ANALYSIS

The Fifth Circuit's restrictive definition of "utility" to encompass only providers whose services are essential comports with the underlying purpose of section 366. Still, applying the "necessary" and "essential" standard may be more complicated than it would appear — certain kinds of services could readily be essential to some debtors but not others, and the increasing prevalence of service "bundling" (*e.g.*, television, phone, and internet service in one package) is likely to make the analysis more difficult. Recognizing that the term "utility" is a fluid concept, the Fifth Circuit stated in a footnote that "[w]e express no opinion on the effect of § 366 on telephone service that is bundled with cable service." As companies and individuals increasingly rely on alternative providers, such as cable companies, for services traditionally offered by phone or television companies, the universe of "utilities" under section 366 is likely to evolve.

Darby v. Time Warner Cable, Inc. (In re Darby), 470 F.3d 573 (5th Cir. 2006).

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