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FIRST RULING: NEW SECTION 1104(E) MAY NOT BE A TICKING TIME BOMB AFTER ALL

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A fundamental premise of chapter 11 is that a debtor's prebankruptcy management is presumed to provide the most capable and dedicated leadership for the company and should be allowed to continue operating the company's business and managing its assets in bankruptcy while devising a viable business plan or other workable exit strategy. The chapter 11 "debtor-in-possession" ("DIP") is a concept rooted strongly in modern U.S. bankruptcy jurisprudence. Still, the presumption can be overcome. In cases involving demonstrated fraud, incompetence, or gross mismanagement, or where the interests of the estate and the stakeholders in the chapter 11 case would be better served by designation of an impartial fiduciary to supplant the DIP, section 1104 of the Bankruptcy Code authorizes the court to direct the appointment of a bankruptcy trustee conferred with a broad array of powers and duties.

Ouster of a DIP is an extraordinary remedy. As a consequence, bankruptcy courts have traditionally been given considerable latitude in determining: (i) what degree of misconduct or incompetence qualifies as "cause" for the appointment of a trustee; and (ii) what factors should be considered in determining the "best interests" of the estate, creditors, and shareholders. Even so, a perception that corporate executives have sometimes used chapter 11 as a means of deflecting allegations of fiduciary improprieties or illegality led Congress to amend the Bankruptcy Code in 2005 to expedite court consideration of misdeeds allegedly committed by prebankruptcy management that could warrant replacing the DIP with a trustee. New section 1104(e) obligates the Office of the U.S. Trustee, an agency of the Justice Department entrusted with overseeing the administration of bankruptcy cases ("UST"), to move for the appointment of a trustee when it becomes aware of colorable allegations that a DIP's corporate executives or board engaged in actual fraud, dishonesty, or criminal misconduct either before or after the bankruptcy filing.

Although greeted upon its enactment in April 2005 with a significant amount of trepidation owing to its potential for derailing reorganizations or forcing companies to "clean house" in anticipation of filing for chapter 11 protection, section 1104(e) remained virtually untested in the courts for more than two years. That is no longer the case. In an apparent matter of first impression, a New York bankruptcy court recently considered what impact the new provision has on the standard applied to a trustee appointment motion. In *In re The 1031 Tax Group, LLC*, the court denied the UST's motion to appoint a trustee or, in the alternative, to convert the case to a chapter 7 liquidation, despite unrefuted allegations that the debtors' principal shareholder committed fraud, because control of the debtors had been subsequently transferred to new managers who had no material connection to either the bad actor or his misconduct. In doing so, the court concluded that the UST's duty to seek the appointment of a trustee under new section 1104(e) has no bearing on the standard customarily applied to determine whether a trustee should in fact be appointed.

THE STATUTORY BACKGROUND

Section 1104(a) of the Bankruptcy Code provides as follows:

(a) At any time after the commencement of the case but before confirmation of a plan, on request of a party in interest or the United States trustee, and after notice and a hearing, the court shall order the appointment of a trustee—

(1) for cause, including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management, either before or after the commencement of the case, or similar cause, but not including the number of holders of securities of the debtor or the amount of assets or liabilities of the debtor;

(2) if such appointment is in the interests of creditors, any equity security holders, and other interests of the estate, without regard to the number of holders of securities of the debtor or the amount of assets or liabilities of the debtor; or

(3) if grounds exist to convert or dismiss the case under section 1112, but the court determines that the appointment of a trustee or an examiner is in the best interests of creditors and the estate.

The examples of "cause" specified in section 1104(a)(1) are illustrative rather than exclusive. In keeping with its broad equitable mandate to protect all stakeholders involved in a chapter 11 case, the bankruptcy court has considerable latitude in determining what conduct or circumstances fit the definition. However, if the court finds that cause exists under section 1104(a)(1), "there is no discretion; an independent trustee must be appointed." A "cause" standard also governs dismissal or conversion of a chapter 11 case under section 1112, which provides that "cause" includes, among other things, substantial or continuing loss to or diminution of the estate; gross mismanagement; and failure to comply with court orders, reporting requirements, or statutory fee obligations.

The "best interests" standard in section 1104(a)(2) has been described as "amorphous and necessarily involv[ing] a great deal of judicial discretion." Courts have considered several factors in determining whether the appointment of a chapter 11 trustee would best serve the interests of creditors and the estate, including: (i) the debtor's trustworthiness; (ii) the debtor's past and present performance and prospects for rehabilitation; (iii) confidence or lack of confidence of the business community and creditors in present management; and (iv) the benefits that can be derived from the appointment of a trustee balanced against the cost of appointment.

Section 1104(a) provides that parties in interest or the UST may seek court intervention if they can either demonstrate by "clear and convincing" evidence that cause exists under subsection (a)(1) or show that the appointment of a trustee is in the best interests of stakeholders under subsection (a)(2), but it does not require them to take action. New section 1104(e), however, creates an affirmative duty for the UST to act in cases where there is a "reasonable" suspicion of wrongdoing by management:

> The United States trustee shall move for the appointment of a trustee under subsection (a) if there are reasonable grounds to suspect that current members of the governing body of the debtor, the debtor's chief executive or chief financial officer, or members of the governing body who selected the debtor's chief executive or chief financial officer, participated in actual fraud, dishonesty, or criminal conduct in the management of the debtor or the debtor's public financial reporting.

Section 1104(e) was added to the Bankruptcy Code as part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA"). Unlike other provisions in the Act, section 1104(e) became effective immediately—it applies to chapter 11 cases commenced on or after April 20, 2005, instead of October 17, 2005.

The bankruptcy court's concern regarding the potential for derailing a reorganization by displacing a DIP based solely upon creditor distrust or lack of confidence is notable. It demonstrates the difficulty in balancing the important public interests in ensuring that chapter 11 not act as a smokescreen to conceal the misconduct of corporate fiduciaries against the equally important policy favoring a presumption that existing management has the best chance to steward a company successfully through chapter 11.

Under prior law, the UST had the discretion to move for the appointment of a chapter 11 trustee. Now, the UST is obligated to do so under the circumstances specified in section 1104(e). The legislative history of the provision is scant. According to one commentator, a spokesperson for Senator Edward M. Kennedy, who introduced section 1104(e), indicated that the new provision is designed to spur the UST to act quickly to redress malfeasance, instead of refusing to assume an aggressive posture, as had been the case previously. Other commentators have pointed to the provision as an indication of lawmakers' strong desire to ensure that corporate executives cannot seek refuge from their responsibilities to the investing public in a chapter 11 case.

Many commentators have criticized the provision's lack of clarity, some speculating that its ambiguity may force financially distressed companies to "clean house" before seeking chapter 11 protection, resulting in blameless executives with expertise crucial to the success of a reorganization effort being forced out (or choosing to seek alternate employment) along with the bad actors. Conjecture among bankruptcy professionals that the provision could seriously disrupt, complicate, or even derail a chapter 11 reorganization by causing the unwanted departure of executives has not been borne out by the handful of section 1104(e) motions filed thus far by the UST. Moreover, judging by the only published ruling on the issue handed down so far, apprehension that section 1104(e) could be a ticking time bomb may be overblown.

1031 TAX GROUP

The 1031 Tax Group, LLC, and 16 affiliated entities (collectively, "1031") were "qualified intermediaries" engaged in the business of providing custodial services to individuals and entities relying on section 1031 of the Internal Revenue Code to defer capital-gains tax resulting from the sale of investment property through like-kind property exchanges. Until shortly before 1031 filed for chapter 11 protection in May 2007 in New York, Edward H. Okun, either directly or indirectly, was the sole principal of each of the entities involved. Beginning in 2005 and continuing through May 2007, Okun orchestrated a series of unsecured intercompany "loans" that funneled money deposited by 1031's customers away from 1031 to other entities that he owned or controlled.

When 1031's financial woes ripened into a crisis in early May, the companies retained restructuring professionals. Shortly thereafter and, as the bankruptcy court subsequently noted, "[p]resumably, at least in part, to avoid the appointment of a chapter 11 trustee," Okun took the initial steps necessary to cede control of 1031 to independent management. 1031 informed the bankruptcy court of the ongoing process to select new management when it filed for chapter 11 on May 14, 2007, including the fact that Okun had arranged to retain a turnaround firm and a chief restructuring officer prior to the bankruptcy filings. The court subsequently approved 1031's application to continue employing the turnaround firm.

1031 sought authority to hire a new manager on June 21, 2007. The court provisionally approved the appointment of a new manager on July 17, specifying in its order that its approval was conditioned on 1031 taking all actions required under applicable state laws within 10 days to amend its organizational documents to effect the change in management for each of the debtors and amending various agreements to make it clear that, without court approval, Okun could not fire the new manager or exercise management authority. Final approval of the management change came on July 27, after 1031 reported to the court that it had complied with the conditions.

Meanwhile, on May 29, 2007, the UST (later joined by various creditors and other interested parties), contending that Okun had engaged in fraud and other misconduct by diverting funds from 1031 to nondebtor entities he controlled, moved for an order directing the appointment of a chapter 11 trustee or, in the alternative, converting 1031's bankruptcy cases to chapter 7 liquidations.

THE BANKRUPTCY COURT'S RULING

The bankruptcy court denied both of the UST's alternative requests for relief. At the outset of its discussion, the court observed that section 1104(e) "gave the U.S. Trustee an important but ill-defined role requiring vigilance and action where fraud, dishonesty, or criminal misconduct by 'current members' of management is suspected." Even so, the court explained, the "reasonable grounds to suspect" standard established in the provision was unquestionably satisfied in the case before it, given the uncontested facts surrounding Okun's "borrowings" from 1031.

When considering whether to appoint a trustee for "cause," the bankruptcy court explained, "a court's focus is on the debtor's current management, not the misdeeds of past management." According to the court, fraud, dishonesty, incompetence, or gross mismanagement by prior management "does not necessarily provide grounds for the appointment of a trustee under § 1104(a)(1), as long as a court is satisfied that the current management is free from the taint of prior management."

By challenging "whether new management may be tainted by an association with, or selection or appointment by, the governing body," the court explained that the UST fulfilled its obligation under section 1104(e). The court then addressed the new provision's impact on the standard governing-trustee appointment motions. Acknowledging the absence of any rulings to date on the issue, the court concluded that the statutory requirements in section 1104(e) have no bearing on the standard applied. Sections 1104(a)(1) and (a)(2) and cases interpreting the provisions, the court emphasized, "continue to control whether a trustee should be appointed."

Even so, the court concluded that section 1104(e) does impact the burden of proof in connection with a trustee appointment motion made in cases where tainted old management appoints new management:

> While prior case law establishes that the U.S. Trustee as the moving party bears the burden of proving "cause" by clear and convincing evidence, the Court believes that where the U.S. Trustee establishes a *prima facie* case that a tainted current member of the governing body has selected or appointed new management shortly before or after a chapter 11 filing, a court should apply heightened scrutiny in reviewing whether new management is also tainted, thereby requiring appointment of a chapter 11 trustee for "cause." Once a *prima facie* showing is made by the U.S. Trustee, the burden then shifts to the debtors, or other parties opposing the appointment of a chapter 11 trustee, to demonstrate that the new management is unconflicted by any association with the tainted members of the governing body that made the selection or appointment. If the parties opposing appointment meet this burden, the ultimate burden of establishing cause shifts back to the moving parties.

The court ruled that 1031 had satisfied this shifting burden. The postpetition agreement appointing a new manager, who was not in any way associated with or beholden to Okun or complicit in his alleged misdeeds, implemented a complete, irrevocable, authorized, and legally binding change in control during the pendency of 1031's chapter 11 cases. Taken together, the court explained, these measures not only were adequate to overcome the UST's *prima facie* showing under section 1104(e) and to shift the ultimate burden of establishing "cause" back to the UST, but ruled out any finding that cause existed under section 1104(a)(1).

NEWSWORTHY

David G. Heiman (Cleveland) has been nominated as one of the world's leading practitioners in *The International Who's Who of Insolvency & Restructuring Lawyers 2007*.

Corinne Ball (New York), ***David G. Heiman (Cleveland)***, ***Sion Richards (London)***, and ***Steven D. Richards (London)*** have been recommended as "Leaders in their Field" in *Chambers Global 2008*.

Tobias S. Keller (San Francisco), ***Mark A. Cody (Chicago)***, ***Robert J. Graves (Chicago)***, ***Robert E. Krebs (Chicago)***, ***Steven A. Domanowski (Chicago)***, ***Kelly M. Mayerfeld (Chicago)***, ***Timothy Hoffmann (Chicago)***, and ***Joseph M. Tiller (Chicago)*** are representing Performance Transportation Services, Inc., a domestic vehicle carrier, in connection with its chapter 11 filing in the United States Bankruptcy Court for the Western District of New York.

Corinne Ball (New York), ***David G. Heiman (Cleveland)***, ***Paul D. Leake (New York)***, and ***Heather Lennox (Cleveland)*** were named "Leading Lawyers" in the 2008 edition of *IFLR1000*.

Paul D. Leake (New York), ***Brad B. Erens (Chicago)***, ***Richard Engman (New York)***, ***Jane Rue Wittstein (New York)***, ***Gus Kallergis (Cleveland)***, ***David A. Beck (Columbus)***, ***Daniel B. Prieto (Dallas)***, and ***Ross S. Barr (New York)*** are representing PLVTZ, LLC, a leading specialty retailer of furniture, bedding, and home furnishings that does business as Levitz Furniture, in connection with its November 8, 2007, chapter 11 filing in the United States Bankruptcy Court for the Southern District of New York.

An article written by ***Dan Winikka (Dallas)*** entitled "When Do Rights of First Refusal Constitute an Unenforceable Restriction on Assignment in Bankruptcy?" was published in the October/November 2007 issue of the *Journal of the Association of Insolvency & Restructuring Advisors*.

Gregory M. Gordon (Dallas) was mentioned in *IFLR1000* regarding his leading role in representing Kaiser Aluminum and its affiliates in connection with their chapter 11 cases.

An article written by ***Mark G. Douglas (New York)*** entitled "The Fight Continues on Ad Hoc Committee Disclosure Requirements" was published in the September 2007 edition of *Pratt's Journal of Bankruptcy Law*. His article entitled "Creditors' Committee Lacks Standing to Seek Equitable Subordination" also appeared in the September 2007 edition of *Pratt's Journal of Bankruptcy Law*.

The court concluded that the appointment of a trustee would not be in the best interests of creditors and other stakeholders. Standing alone, the court noted, "a well-founded distrust and a lack of confidence" expressed by some creditors, even with new management, would point to the appointment of a trustee. Still, the court emphasized, "there are additional factors to consider," including: (i) the existence of an active creditors' committee functioning effectively and working well with the debtors; (ii) significant progress achieved in the chapter 11 case, as demonstrated by the filing of a disclosure statement jointly proposed by the committee and 1031; and (iii) the shared interest of all constituents in confirming a viable chapter 11 plan as expeditiously as possible, given the 180-day deadline established by the tax laws for completing like-kind exchanges. According to the court, "ordering the appointment of a chapter 11 trustee now would threaten these positive developments." Finally, citing substantially the same reasons, the court denied the UST's motion in the alternative to convert 1031's chapter 11 cases to chapter 7 liquidations.

ANALYSIS

1031 Tax Group provides useful guidance in determining what impact section 1104(e) has on the criteria traditionally applied to trustee motions under sections 1104(a)(1) and (a)(2), but it leaves several important questions unanswered. For example, the bankruptcy court's burden-shifting paradigm apparently applies only to situations where tainted old management appoints new management that is allegedly unsullied and independent. Moreover, unlike *1031 Tax Group*, other cases are likely to involve contested allegations of wrongdoing. How is the burden of proof to be allocated in cases where the UST's "suspicions" of wrongdoing are refuted or where control has not been transferred to new management? Presumably, the burden would then rest squarely on the shoulders of the UST to demonstrate the existence of "cause" by clear and convincing evidence, as was the law prior to section 1104(e)'s enactment. Proving that management engaged in fraud, dishonesty, or criminal conduct, moreover, may be more difficult than establishing what would otherwise amount to "cause" under section 1104(a)(1), especially in light of management's heightened stake in the outcome and the possibility of facing criminal liability based upon the bankruptcy court's determination.

Uncertainty also remains regarding the meaning in section 1104(e) of "reasonable grounds to suspect," a phrase that appears nowhere else in the Bankruptcy Code. Other provisions of the Bankruptcy Code contain the phrase "reasonable cause to believe," but we are left to speculate whether the language in section 1104(e) establishes a lower standard triggering the UST's obligation to act than what is commonly understood to be reasonable belief.

The bankruptcy court's concern regarding the potential for derailing a reorganization by displacing a DIP based solely upon creditor distrust or lack of confidence is notable. It demonstrates the difficulty in balancing the important public interests in ensuring that chapter 11 not act as a smokescreen to conceal the misconduct of corporate fiduciaries against the equally important policy favoring a presumption that existing management has the best chance to steward a company successfully through chapter 11. Finally, *1031 Tax Group* indicates that, consistent with the purpose of the provision, the scope of section 1104(e) should extend beyond CEOs, CFOs, or "governing body" members of corporate debtors—a limitation that the provision's language could be interpreted to impose—to encompass any individual or entity in control of a chapter 11 debtor.

The 2005 BAPCPA amendments added numerous provisions to the Bankruptcy Code designed to augment management accountability and provide greater protection to creditors, shareholders, and the public. In addition to section 1104(e), the reforms placed new limitations on a chapter 11 debtor's exclusive right to file and solicit acceptances for a chapter 11 plan and severely curtailed the circumstances under which a debtor can win approval of key employee retention plans that had been perceived to provide overly generous stay-on benefits and incentives to existing management. In addition, section 1112(b) was amended to limit the court's discretion to refuse to order conversion of a chapter 11 case to a chapter 7 liquidation if the debtor fails to move expeditiously toward confirmation of a plan. These changes are one of the latest salvos in a wave of corporate accountability reforms that began in 2002 with passage of the Sarbanes-Oxley Act. Among other things, Sarbanes-Oxley amended the Bankruptcy Code to add section 523(a)(19), which makes nondischargeable in an individual's bankruptcy case debts based upon violations of securities laws if there has been a judgment, order, consent order, or decree in a federal or state judicial or administrative proceeding entered against the debtor.

EPILOGUE

Just over two months after bankruptcy judge Martin Glenn issued his ruling in *1031 Tax Group*, the UST, joined by various creditors and with the support of the official unsecured creditors' committee, renewed her motion to appoint a chapter 11 trustee for the 17 affiliated debtors. This time Judge Glenn granted the motion.

Developments in the chapter 11 cases had been anything but positive after Judge Glenn denied the UST's trustee motion on August 13, 2007. Among other things, the proposed cash infusion promised by Okun that was to be drawn from non-debtor affiliates controlled by him proved to be much less than anticipated, especially after three of the companies filed for chapter 11 protection in early October. With little or no prospect for a finalized plan funding agreement on the horizon and a continuing lack of creditor confidence in management, Judge Glenn reconsidered his previous determination that the appointment of a chapter 11 trustee would not, on balance, best serve the interests of the estate and its stakeholders.

Given the changed circumstances in the case, Judge Glenn concluded that a trustee should be appointed under section 1102(b)(2):

> The factors that weighed heavily in denying the earlier trustee motions either no longer apply at all or are now greatly attenuated. Any hope for a prompt exit from chapter 11 has seemingly vanished. Okun has proven that he is unreliable (or worse) in delivering in any timely way on the promises he made at the start of these cases and many times since. If there are benefits to the estate from the proposed new agreement with Okun, the chapter 11 trustee should be the one in the first instance to reach that conclusion. . . . The level of distrust between the Debtors, on the one hand, and the objecting creditors, on the other hand, already high earlier in the case, has only increased.

In re The 1031 Tax Group, LLC, 374 B.R. 78 (Bankr. S.D.N.Y. 2007).

In re The 1031 Tax Group, LLC, No. 07-11448 (MG) (Bankr. S.D.N.Y. Oct. 23, 2007) (unpublished amended memorandum opinion and order granting motions for appointment of chapter 11 trustee).

IP PERSPECTIVE: ACTUAL TEST AND *FOOTSTAR* APPROACH GOVERN DIP'S ABILITY TO ASSUME PATENT AND TECHNOLOGY LICENSE

Mark G. Douglas

Lawmakers' efforts to overhaul the nation's bankruptcy laws two years ago as part of the sweeping reforms implemented by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA") failed to resolve a number of important business bankruptcy issues that have been and continue to be the subject of protracted debate among the bankruptcy and appellate courts. One lingering controversy concerns restrictions in the Bankruptcy Code on the ability of a bankruptcy trustee or chapter 11 debtor-in-possession ("DIP") to assume "executory" contracts that cannot be assigned without consent under applicable nonbankruptcy law.

On one side of the divide stand the circuit courts of appeal for the Third, Fourth, Ninth, and Eleventh Circuits. These courts, applying the "hypothetical test," have held that section 365(c)(1) of the Bankruptcy Code should be strictly interpreted to prohibit the assumption of any unassignable contract, whether or not the DIP or trustee intends to assign it. Arrayed against them is the First Circuit as well as the great majority of lower courts, which have applied the "actual test" in ruling that unassignable contracts can be assumed if the DIP intends to continue performing under them. Yet another view—the *Footstar* approach—permits a DIP to assume such a contract, but not a bankruptcy trustee. A ruling recently handed down by a New Mexico bankruptcy court suggests that the Tenth Circuit Court of Appeals may soon have an opportunity to weigh in on the issue. In *In re Aerobox Composite Structures, LLC*, the court adopted the actual test and the *Footstar* approach, holding that a chapter 11 debtor licensee was not precluded from assuming a patent and technology license agreement.

ASSUMPTION, REJECTION, AND ASSIGNMENT OF EXECUTORY CONTRACTS

Section 365(a) of the Bankruptcy Code allows a DIP or bankruptcy trustee to "assume" (reaffirm) or "reject" (breach) most kinds of contracts or agreements that are in force—in bankruptcy parlance, "executory"—as of the bankruptcy filing date. In a chapter 11 case, the decision to assume or reject contracts (other than nonresidential real property leases) can be made at any time prior to confirmation of a chapter 11 plan, unless the court orders otherwise upon request of the nondebtor contracting party. This latitude affords the DIP an opportunity to determine which of its executory contracts should be retained because they are beneficial and which should be jettisoned.

The advantages of having the ability to assume or reject contracts extend beyond relief from onerous obligations that may be instrumental to the success of a reorganization. This is so because the Bankruptcy Code allows a DIP or trustee to extract value from favorable contracts and leases by first assuming a contract and then assigning it to a third party for consideration. Under section 365(f)(1), moreover, assignment is generally permitted, "notwithstanding a provision in an executory contract . . . or in applicable law, that prohibits, restricts, or conditions the assignment of such contract or lease."

Despite the broad powers granted to a DIP or trustee in this respect, certain parties that contract with a debtor are granted special protection by the Bankruptcy Code. Section 365(c) of the statute provides that a DIP or trustee may not "assume or assign" an executory contract or unexpired lease if "applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession" and such party does not consent to assumption or assignment.

Courts have applied this provision to a wide variety of contracts. Among these are personal service contracts, including employment agreements; contracts with the United States government, which cannot be freely assigned under federal law; certain kinds of franchise agreements; and licenses of intellectual property, which cannot be assigned without consent under federal intellectual property law. Thus, many debtors (especially those in the technology industry) find that their options with respect to certain executory contracts are significantly limited.

THE STATUTORY MUDDLE

Few (if any) courts quarrel with the proposition that section 365(c) prevents a debtor from *assigning* a contract without the nondebtor's consent if the contract cannot be assigned outside of bankruptcy without it. The language of section 365(c), however, would seem to mean that a debtor cannot even *assume* the contract and agree to perform under it, even if the debtor has no intention of assigning the contract to a third party.

The confusion stems from the statute's use of the phrase "may not assume *or* assign" instead of "assume *and* assign." Many courts construe this language to mean that the statutory proscription applies to a debtor who seeks either: (i) to assume and render performance under the agreement; or (ii) to assume the agreement and assign it to a third party. Under this literal interpretation, the court posits a hypothetical question: Could the debtor assign the contract to a third party under applicable nonbankruptcy law? If the answer is no, the debtor may neither assume nor assign the contract. This approach is commonly referred to as the "hypothetical test." The Third Circuit applied it in *In re West Electronics, Inc.*, ruling that the debtor could not assume a contract with the federal government calling for production of military equipment because federal law prohibited assignment of the contract without the government's consent. The Fourth, Ninth, and Eleventh Circuits have also adopted this approach.

Other courts have determined that the phrase "may not assume *or* assign" should be read to mean "may not assume *and* assign," and they apply the statutory proscription only when the debtor actually intends to assign the contract to a third party. This approach is commonly referred to as the "actual test." Prominent among its adherents is the First Circuit, which ruled in *Institut Pasteur v. Cambridge Biotech Corp.* that federal common-law and contractual restrictions against assignment of patents did not preclude assumption of a patent by a chapter 11 debtor. The vast majority of lower courts considering the issue have adopted this approach to section 365(c)(1). Also, the Fifth Circuit applied the actual test in construing the Bankruptcy Code's exception to the prohibition against enforcement of *ipso facto* clauses that act to terminate or modify a contract as a consequence of a bankruptcy filing.

KEY POINTS

- A widening rift exists among the circuit and lower courts concerning the ability of a DIP to assume an executory contract if applicable non-bankruptcy law excuses the nondebtor contracting party from accepting performance from or rendering performance to anyone other than the debtor. Courts have developed three different approaches to the issue.
- Under the "hypothetical test," a DIP cannot assume or assign such a contract.
- Under the "actual test," a DIP will be prohibited from assuming such a contract only if it intends to assign the contract to a third party.
- Under the *Footstar* approach, a DIP may assume such a contract, but a bankruptcy trustee may not.
- Congress had an opportunity to resolve this controversy when it enacted BAPCPA in 2005, but the reforms made no changes to section 365(c)(1). It may be left to the U.S. Supreme Court to address an issue that is of vital importance to licensees of intellectual property and patents.

Many courts have rejected the literalist hypothetical test because it arguably flies in the face of the general goals of chapter 11 in permitting licensees to benefit from the protections of bankruptcy law while encouraging maximization of the economic value of the estate. Moreover, these courts suggest, the odd result required by the hypothetical test, which effectively allows the nondebtor party to free itself from some kinds of contracts simply because of the debtor's bankruptcy filing, cannot be supported by any recognized bankruptcy policy. Finally, actual-test adherents emphasize that the relevant language of section 365(c)(1) appears to be a simple drafting error—lawmakers meant "and" but said "or."

The provision's scant legislative history does little to resolve the controversy. In its current form, the provision likely had its genesis in a 1980 House amendment to an earlier Senate technical corrections bill. That amendment was accompanied by an obscure committee report, which states in relevant part:

> This amendment makes it clear that the prohibition against a trustee's power to assume an executory contract does not apply where it is the debtor that is in possession and the performance to be given or received under a personal service contract will be the same as if no petition had been filed because of the personal nature of the contract.

The First Circuit relied on the 1980 report in adopting the actual test, but other courts find it unpersuasive in divining what Congress intended in section 365(c).

In *In re Footstar, Inc.*, the bankruptcy court adopted a slightly different test predicated upon the legal distinctions between the debtor and the DIP on the one hand and the bankruptcy trustee on the other. The court reasoned that the term "trustee" in section 365(c)(1) should not automatically be read (as it is in many other provisions "as a matter of simple logic and common sense") as synonymous with the term "debtor-in-possession," such that the proscription of assumption and assignment is limited to situations where a trustee, rather than a DIP, seeks to assume an executory contract. Under the *Footstar* approach, the DIP would be precluded from assigning a qualifying contract because assignment would force the nondebtor contracting party to accept performance from or render performance to an entity other than the debtor, but the DIP can assume the contract because, unlike a bankruptcy trustee, the DIP is "not an entity other than itself." According to the court, this approach is consistent with both the language and purpose of section 365(c):

> This conclusion comports with the "plain meaning" of all of the words employed in Section 365(c)(1) and gives full effect to that section and to the provisions and objectives of Chapter 11, which are designed to foster, not frustrate, the reorganization and the economic well-being of debtors in possession. And it avoids the perverse and anomalous consequence of the "hypothetical test" rule under which a debtor may lose the benefit of a non-assignable contract vital to its economic future solely because it filed for bankruptcy.

Footstar was a welcome development for debtors, particularly for licensees of intellectual property and patents, but the ruling did little to end the debate concerning section 365(c)(1). The latest salvo in the controversy came in *Aerobox*. The ruling may be a prelude to review by the Tenth Circuit Court of Appeals.

AEROBOX

Aerobox Composite Structures, LLC ("Aerobox"), a manufacturer of unit load devices for the airline industry using unique preformed thermoplastic body panels, filed for chapter 11 protection in January 2007 in New Mexico. Prior to filing its bankruptcy case, Aerobox entered into a 15-year license agreement with Tubus Bauer GmbH ("Tubus Bauer") in which Tubus Bauer granted Aerobox a license in North America to use patent rights and confidential information for the manufacture of certain Tubus Bauer products for resale. The license agreement permits assignment only with Tubus Bauer's prior written approval but provides that such approval may not be withheld unreasonably.

Aerobox is unquestionably a welcome development for intellectual property and patent licensees facing the prospect of a chapter 11 filing, but it neither ends the debate on this important issue nor gives prospective debtors any sense of certainty regarding their ability to avoid forfeiture of assets that may be vital to their chances for successful reorganization and ongoing business operations.

Shortly after Aerobox filed for chapter 11 protection, Tubus Bauer filed a motion to compel Aerobox to reject the license agreement, contending that, consistent with the rulings of courts applying the hypothetical test, section 365(c)(1) precludes assumption or assignment of the agreement. The bankruptcy court denied the motion.

After determining that the license agreement was in fact executory, the court examined section 365(c)(1) and the competing views on the ability of a DIP to assume a contract covered by it. Because the license agreement involved the use of a patent, the bankruptcy court determined that "applicable law" in the statute means federal patent law, which generally prohibits assignment of both exclusive and nonexclusive license agreements absent consent of the licensor.

The court rejected the hypothetical test as the appropriate standard to apply in assessing whether a DIP may assume an unassignable contract. Emphasizing that the DIP is not "materially distinct from the pre-bankruptcy entity that is a party to the executory contract," the court adopted the actual test and the reasoning articulated in *Footstar* as being most true to both the language and purpose of section 365(c)(1):

> [B]ecause the limitation contained in § 365(c)(1) is aimed at protecting non-debtor parties to personal services contracts from being forced to accept service from or render service to an entity other than the entity with whom it originally contracted, it is appropriate to determine whether the nondebtor party is actually being forced to accept performance under its executory contract from an entity other than the debtor. . . . [W]here the debtor-in-possession seeks to assume, or, as is the situation in the instant case, where the debtor-in-possession has neither sought to assume nor reject the executory contract but simply continues to operate post-petition under its terms, 11 U.S.C. § 365(c)(1) does not prohibit assumption of the contract by the debtor-in-possession and cannot operate to allow the non-debtor party to the executory contract to compel the Debtor to reject the contract. In reaching this conclusion, the Court finds that the "actual test" articulated in *Cambridge Biotech*, and the reasoning of the court in *Footstar*, is the better approach to § 365(c)(1) when determining whether a debtor-in-possession is precluded from assuming an executory contract.

CONCLUSION

Aerobox is unquestionably a welcome development for intellectual property and patent licensees facing the prospect of a chapter 11 filing, but it neither ends the debate on this important issue nor gives prospective debtors any sense of certainty regarding their ability to avoid forfeiture of assets that may be vital to their chances for successful reorganization and ongoing business operations. Because the decision was appealed, this issue may eventually make its way to yet another circuit court of appeals if the bankruptcy appellate panel's ruling is appealed to the Tenth Circuit.

The ruling highlights the need for clarification of the meaning of section 365(c)(1) by either Congress or the Supreme Court. Neither has acted so far to resolve a conflict that has been smoldering for nearly 20 years. The issue isn't likely to be settled any time soon. The Supreme Court has yet to agree to hear a case on whether the hypothetical, the actual, or some other test is the proper one. Lawmakers have not been moved to solve the problem either. With no resolution of this matter on the horizon, the practical challenges confronting parties to these kinds of contracts can be accurately assessed only on a case-by-case basis by reference to the particular court presiding over the debtor's bankruptcy case.

In re Aerobox Composite Structures, LLC, 373 B.R. 135 (Bankr. D.N.M. 2007).

RCI Technology Corp. v. Sunterra Corp., 361 F.3d 257 (4th Cir. 2004).

In re West Electronics, Inc., 852 F.2d 79 (3d Cir. 1988).

Institut Pasteur v. Cambridge Biotech Corp., 104 F.3d 489 (1st Cir. 1997).

Perlman v. Catapult Entm't, Inc. (In re Catapult Entm't, Inc.), 165 F.3d 747 (9th Cir. 1999).

City of Jamestown v. James Cable Partners, L.P. (In re James Cable Partners, L.P.), 27 F.3d 534 (11th Cir. 1994).

In re Mirant Corp., 440 F.3d 238 (5th Cir. 2006).

In re Footstar, Inc., 323 B.R. 566 (Bankr. S.D.N.Y. 2005).

CREDITORS' COMMITTEE LACKS STANDING TO SEEK EQUITABLE SUBORDINATION

Mark G. Douglas

The power to alter the relative priority of claims due to the misconduct of one creditor that causes injury to others is an important tool in the array of remedies available to a bankruptcy court in exercising its broad equitable powers. However, unlike provisions in the Bankruptcy Code that expressly authorize a bankruptcy trustee or chapter 11 debtor-in-possession ("DIP") to seek the imposition of equitable remedies, such as lien or transfer avoidance, the statutory authority for equitable subordination—section 510(c)—does not specify exactly who may seek subordination of a claim. This ambiguity has spawned confusion and inconsistency in court rulings on the issue, with some courts holding that "standing" to seek equitable subordination is limited to the trustee or DIP, at least in the first instance, while others have ruled that creditors' committees or individual creditors can invoke the remedy directly. The Second Circuit Court of Appeals recently had an opportunity to weigh in on the issue. In *Official Comm. of Unsecured Creditors v. Halifax Fund, L.P. (In re Applied Theory Corp.)*, the court ruled that, without bankruptcy-court approval under the doctrine of "derivative standing," a creditors' committee does not have standing to seek equitable subordination of a claim.

EQUITABLE SUBORDINATION

Equitable subordination is a common-law doctrine predating the enactment of the Bankruptcy Code designed to remedy misconduct that causes injury to creditors (or shareholders) or confers an unfair advantage on a single creditor at the expense of others. The remedy is now codified in section 510(c) of the Bankruptcy Code, which provides that "the 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." The statute, however, does not define the circumstances under which subordination is warranted, leaving the development of such criteria to the courts.

In 1977, the Fifth Circuit Court of Appeals in *In re Mobile Steel Co.* articulated what has become the most commonly accepted standard for equitably subordinating a claim. Under the *Mobile Steel* test, 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 since 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. For insiders, inequitable conduct is generally found if the claimant has: (i) committed fraud or illegality or breached its fiduciary duties; (ii) left the debtor undercapitalized; or (iii) used the debtor as a mere instrumentality or alter ego. By contrast, subordination of the claim of a noninsider creditor requires a showing of gross misconduct tantamount to fraud, misrepresentation, overreaching, or spoliation.

STANDING

Standing is the ability to commence litigation in a court of law. It is a threshold issue—a court must determine whether a litigant has the legal capacity to pursue claims before the court can adjudicate the dispute. In the bankruptcy context, various provisions of the Bankruptcy Code confer standing on various entities (*e.g.*, the debtor, a bankruptcy trustee, creditors, equity interest holders, committees, or indenture trustees) to, among other things, participate generally in a bankruptcy case or commence litigation involving causes of action or claims that either belonged to the debtor prior to filing for bankruptcy or are created by the Bankruptcy Code.

The right to participate in a chapter 11 case is explicit. Section 1109 of the Bankruptcy Code provides that any "party in interest," including the debtor, the trustee, a committee of creditors or equity interest holders, a creditor, or an indenture trustee, "may appear and may be heard on any issue" in a chapter 11 "case." This general right to participate, however, does not confer standing upon every party in interest to engage in litigation expressly contemplated by other provisions of the Bankruptcy Code, such as lien and transfer avoidance. Many of these provisions deal with claims or causes of action belonging to the debtor prior to filing for bankruptcy, which become part of its bankruptcy estate on the petition date. Standing to prosecute estate claims is expressly given by statute to a bankruptcy trustee (or DIP, by operation of section 1107(a) of the Bankruptcy Code).

The court of appeals refused to adopt a "bright line" rule under which subordination claims may be brought directly by a creditor or committee without court approval, opting instead for a more flexible and utilitarian approach involving scrutiny of the nature of the alleged misconduct, against whom it was directed, and who stands to benefit from the remedy.

Although the Bankruptcy Code does not expressly authorize anyone other than a trustee or DIP to prosecute claims belonging to the estate, many courts will allow committees or individual creditors to commence litigation on behalf of the estate under narrowly defined circumstances. In one of the seminal cases addressing this issue, the Second Circuit Court of Appeals held in *In re STN Enterprises* that, in considering a creditors' committee's request for leave to sue a director for misconduct, a court is required to consider whether the debtor unjustifiably failed to initiate suit against the director and whether the action is likely to benefit the debtor's estate.

The Second Circuit later refined the doctrine of "derivative standing" in *In re Commodore Int'l Ltd.*, which involved litigation brought by a creditors' committee against various officers and directors for fraud, waste, and mismanagement. Unlike in *STN Enterprises*, the debtor in *Commodore* had not unreasonably refused to bring suit but agreed to permit the committee to litigate the claims on behalf of the estate. The court of appeals ruled that a committee may bring suit even if the debtor does not unjustifiably refuse to do so as long as: (i) the trustee or debtor consents; and (ii) the court finds that the litigation is (a) in the best interests of the estate, and (b) necessary and beneficial to the fair and efficient resolution of the bankruptcy proceedings. The Second Circuit's approach represents the majority view.

STANDING TO SEEK EQUITABLE SUBORDINATION

Unlike other provisions in the Bankruptcy Code that specifically authorize a bankruptcy trustee (or DIP) to challenge liens or transfers, section 510(c) does not specify who may seek the equitable subordination of a claim or interest. Given the remedy's fundamental aim to undo or offset any inequality in relative priorities that will produce injustice, however, many courts have concluded that a trustee (or DIP), as the representative of the estate, is the proper party to raise claims of equitable subordination. Many of these courts liken equitable subordination to an avoidance action, reasoning that because both remedies are invoked against creditors, only the trustee or DIP should have the capacity to sue. Some courts have permitted an individual creditor, acting on its own without first obtaining court authority, to seek equitable subordination, particularly if it is attempting to redress a specific injury to itself, rather than damage to the estate or other creditors. Finally, some courts have adopted an approach whereby either a creditor or a committee can seek equitable subordination, provided it satisfies the requirements for "derivative standing." The ability of a creditors' committee to assert an equitable subordination claim was the subject of the Second Circuit's ruling in *Applied Theory Corp*.

APPLIED THEORY CORP.

Applied Theory Corporation, a provider of managed web-hosting, internet, and security services, filed for chapter 11 protection in 2002 in New York. Having consummated a sale of substantially all of its assets six weeks after the petition date, the debtor sought to convert its chapter 11 case to a chapter 7 liquidation. The court, however, denied the motion, instead ordering the appointment of a chapter 11 trustee.

The official creditors' committee appointed in the case sought court authority to commence litigation against various prepetition lenders. The proposed complaint stated causes of action for avoidance of preferential and fraudulent transfers, equitable subordination, and aiding and abetting breach of fiduciary duty. The chapter 11 trustee later issued a report in which he concluded that, of the claims asserted in the committee's complaint, only the fraudulent transfer claim was colorable. He accordingly sued the lenders on that basis but lost.

Shortly thereafter, the lenders sought a court order clarifying that the committee did not have standing to prosecute the equitable subordination claim. The bankruptcy court granted that request, emphasizing that the trustee "would ordinarily" be the proper party to prosecute the claim and that the committee required court approval before it could do so. Finding that the equitable subordination claim "would seek to redress injuries allegedly inflicted upon the [debtor and its] creditors generally, and that it would not be directed toward any particularized injury suffered by any specific creditor," the court ruled that the trustee "has the sole and exclusive right to assert" the claim. The court then applied the *STN* factors to the committee's request to prosecute the claim, concluding that the committee should not be granted derivative standing to seek equitable subordination of the lenders' claims. The district court upheld the ruling on appeal.

THE SECOND CIRCUIT'S RULING

The court of appeals also affirmed. It rejected the committee's contention that it was not obligated to seek court approval before prosecuting an equitable subordination claim. According to the Second Circuit, while section 1109 gives a committee the general right to participate in a chapter 11 case, it does not allow the committee "to usurp the trustee's role as a representative of the estate with respect to the initiation of certain types of litigation that belong exclusively to the estate." Moreover, the court emphasized, the Bankruptcy Code does not explicitly authorize a committee to initiate an adversary proceeding.

Only under the circumstances specified in *STN* and *Commodore*, the Second Circuit observed, does a committee have standing to commence litigation involving estate causes of action. In this case, both the trustee and the bankruptcy court concluded that litigation for the purpose of subordinating the lenders' claims was not likely to benefit the estate. Allowing litigation to proceed without court authority based upon benefit to the estate, the court of appeals explained, would frustrate important policy objectives:

> [S]ound reasons underlie the requirement of court authorization that STN and Commodore insist upon. Reorganizations would routinely spin out of control if decisions that would commit the time and limited

resources of the estate could be taken without the consent of the bankruptcy court, the entity charged by law with controlling and regulating such matters. Requiring bankruptcy court approval conditioned upon the litigation's effect on the estate helps prevent committees and individual creditors from pursuing adversary proceedings that may provide them with private benefits but result in a net loss to the entire estate.

Finally, the Second Circuit rejected the committee's argument that *STN* and *Commodore* did not apply because those cases involved "derivative" claims brought on behalf of a trustee or DIP, whereas the committee's claim for equitable subordination was "direct." Both lower courts, the court of appeals noted, found that the committee's equitable subordination claim was not directed toward any particularized injury suffered by any creditor but alleged harm to the debtor generally, belying any argument that the claim was "direct" rather than "derivative" of the estate or creditors. Moreover, the Second Circuit remarked, "[s]ince the Committee is not itself a creditor, it does not have any rights held by any creditor to assert such a claim against another creditor."

ANALYSIS

The Second Circuit's approach in *Applied Theory Corp.* to the issue of standing to bring an equitable subordination claim comports with its previous rulings in *STN* and *Commodore*—all three decisions are premised upon the importance of allowing the court to be the gatekeeper in regulating litigation that will drain estate assets. The court of appeals refused to adopt a "bright line" rule under which subordination claims may be brought directly by a creditor or committee without court approval, opting instead for a more flexible and utilitarian approach involving scrutiny of the nature of the alleged misconduct, against whom it was directed, and who stands to benefit from the remedy. If the entity seeking subordination does not complain of any direct injury to itself that can be remedied by subordination, but alleges harm to the estate or creditors generally, the claim is derivative and can be asserted only by the trustee or DIP, unless the court orders otherwise.

The Second Circuit rejected contentions that the Bankruptcy Code itself does not support such an approach. Even so, the argument for conferring standing under section 510(c) upon parties other than a trustee or DIP is not specious. Lawmakers' express limitation of standing to a particular entity in other provisions of the statute indicates, as a matter of basic statutory construction, that they meant to include no such limitations under section 510(c). Furthermore, equitable subordination is arguably a creditor or shareholder remedy—it is designed to compensate for misconduct by one creditor or shareholder that injures others or confers an unfair advantage upon the bad actor. The bankruptcy estate generally has nothing to gain by subordination because it merely reorders the priorities of creditors or stockholders, rather than relieving the estate of a debt (as does the remedy of recharacterization).

Many equitable subordination claims are premised upon the allegation that one creditor's misconduct resulted in injury to the debtor, which in turn harmed other creditors by preventing them from receiving full payment of their claims. For such claims, it would be rare for a single creditor to be able to demonstrate that it holds a "direct" equitable subordination claim. The rationale for denying standing to individual creditors is questionable not only because the statute provides for no such restriction, but for practical reasons—if an individual creditor is willing to bear the time and expense litigating such a difficult claim (with the possibility, perhaps, of later recouping its costs upon a showing to the court of "substantial contribution"), why should it be prevented from doing so? The case is much stronger for applying a more restrictive approach to standing to litigate such claims by a committee, whose expenses and professionals are paid by the estate.

Official Comm. of Unsecured Creditors v. Halifax Fund, L.P. (In re Applied Theory Corp.), 493 F.3d 882 (2d Cir. 2007).

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

Unsecured Creditors Committee of Debtor STN Enterprises, Inc. v. Noyes (In re STN Enterprises), 779 F.2d 901 (2d Cir. 1985).

Commodore Int'l Ltd. v. Gould (In re Commodore Int'l Ltd.), 262 F.3d 96 (2d Cir. 2001).

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ANOTHER CIRCUIT CONSIDERS THE "AGGREGATE APPROACH" IN APPLYING THE "REORGANIZATION TEST" TO DISTRESS TERMINATIONS OF MULTIPLE PENSION PLANS IN CHAPTER 11

Mark G. Douglas

The perceived ease with which financially strapped companies such as Delta Air Lines, Inc., and Collins & Aikman Corp. were able to jettison more than $1 billion in pension liabilities has figured prominently in recent headlines. Assumption of these obligations by the Pension Benefit Guaranty Corporation ("PBGC") contributed to a PBGC deficit that aggregated nearly $18.1 billion at the end of fiscal year 2006 (for the single-employer insurance program), although that was an improvement from the deficit of nearly $23 billion in fiscal year 2005. Airline relief provisions contained in recently enacted pension reform helped to stanch the flow of PBGC assets, but the agency's overall financial outlook is anything but rosy, given a nationwide underfunding of defined-benefit pension plans that, depending on whose accounting is more accurate, ranges anywhere from $300 billion to $450 billion.

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. The circumstances under which a chapter 11 debtor can effect a "distress termination" of its pension plans were the subject of a pair of rulings handed down by the federal circuit courts of appeal in the last 18 months. In 2006, the Third Circuit 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 considered in the aggregate rather than on a plan-by-plan basis. The Eighth Circuit had an opportunity to address the same issue in 2007. In *Pension Benefit Guaranty Corporation v. Falcon Products, Inc. (In re Falcon Products, Inc.)*, the court ruled that it need not decide whether the "reorganization test" requires a plan-by-plan or aggregate analysis in light of a bankruptcy court's findings that the debtor could not survive outside of chapter 11 without a $50 million investment conditioned on termination of all three of its pension plans.

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 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 2007 was $49,500 for workers who wait until 65 to retire. For plans assumed in 2008, the maximum yearly benefit amount will be $51,750. PBGC self-finances payments to employees under terminated plans through five sources of income: (i) insurance premiums paid by current sponsors of active plans (in 2008, $33 per year per participant, although companies posing high risks of underfunding must pay an additional variable-rate premium equal to $9 for every $1,000 of unfunded vested benefits); (ii) assets from terminated plans taken over by PBGC; (iii) recoveries from former sponsors of terminated plans; (iv) PBGC's own investments; and (v) in connection with certain distress and involuntary plan terminations occurring on or after January 1, 2006, termination premiums of $1,250 per participant payable for three years after the termination.

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 may contribute a certain amount for each participant (who typically contributes most of the funds to the plan), but the employer 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 defined-benefit plan 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 approves the termination after determining "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 (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 (ii) above 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. PBGC need not consult with union representatives before terminating a plan on its own initiative.

2006 PENSION REFORMS

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;
- Increase the flat-rate premiums payable per participant each year from $19 to $30 (adjusted upward to $33 for 2008);
- Make permanent the $1,250-per-participant penalty premium payable in the event of certain distress and involuntary plan terminations (first implemented as a temporary measure as part of the Federal Deficit Reduction Act of 2005); 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.

The reforms are unlikely to restore PBGC to solvency, but according to PBGC, the airline relief provisions have improved the embattled insurer's short-term financial outlook by reducing the agency's deficit by nearly $5 billion in fiscal year 2006. However, 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.

DISTRESS TERMINATION OF MULTIPLE PENSION PLANS: THE CIRCUITS WEIGH IN

Until recently, the circuit courts of appeal had not considered how the "reorganization test" should be applied when a chapter 11 debtor-employer seeks court authority to implement a distress termination of multiple pension plans. The Third Circuit Court of Appeals was the first to do so in 2006.

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 terminate voluntarily 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.

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 Third Circuit remarked, "In 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 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 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, "[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."

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 emphasized, "are within the expertise of the bankruptcy courts, not the PBGC."

THE LATEST WORD: *FALCON PRODUCTS*

Commercial furniture maker Falcon Products, Inc. ("Falcon"), filed for chapter 11 protection in St. Louis in 2005. In the fall of that year, Falcon sought court authority to effect a distressed termination of its three pension plans. Considering the three plans in the aggregate, Falcon claimed, it could not afford to pay the required contributions for the pension plans, estimated at nearly $19 million for the period from 2005 through 2012. Moreover, Falcon emphasized, third-party investors, who had agreed to fund Falcon's reorganization and ongoing operations with a $50 million cash infusion, insisted on termination of the plans as a condition to the investment. PBGC countered that ERISA required Falcon to demonstrate that the requirements of the reorganization test were satisfied on a plan-by-plan basis as opposed to the aggregate basis proposed by Falcon.

The bankruptcy court concluded that the pension plans could be considered in the aggregate and decided that Falcon had satisfied the reorganization test. The court rejected PBGC's contention that Falcon could afford the minimum payments on at least one of its pension plans based upon Falcon's funding projections, emphasizing that the projections depended upon a $50 million cash investment that would not be made unless all of the plans were terminated. PBGC appealed to the district court, which affirmed, and then to the Eighth Circuit.

The Eighth Circuit affirmed the rulings below. Although urged by PBGC to adopt an approach to the question contrary to the view expressed by the Third Circuit in *Kaiser Aluminum*, the court declined, explaining, however, that it need not choose between a plan-by-plan or aggregate analysis in applying the reorganization test. It rejected PBGC's argument that investors' conditions cannot replace the analysis a bankruptcy court is required to conduct under ERISA, observing that

> while it is improper to allow an investor to make the decision reserved to the bankruptcy court under ERISA, it is the duty of the bankruptcy judge to look to [the] existential financial reality and try to judge whether the plan provisions are necessary or whether they are merely desired by the entities that would benefit from the termination.

The Eighth Circuit looked to the bankruptcy court's factual findings that: (i) the cash infusion was conditioned upon termination of all three pension plans; and (ii) the investors' insistence upon the condition was "reasonable." It faulted neither:

> Here, the bankruptcy court reviewed the extensive steps Falcon had taken to secure additional funds, it noted that the only investments Falcon was successful in securing were conditioned on a termination of all three pension plans, and the court found that, absent the $50 million in additional funding, Falcon would be forced to liquidate which would result in a termination of all three pension plans. In light of these factual findings, which are not clearly erroneous, it is not necessary for this court to consider the question of whether the pension plans should have been considered in the aggregate or on a plan-by-plan approach.

OUTLOOK

Kaiser Aluminum was not the first case in which a court has applied the aggregate-analysis approach in determining whether multiple plan terminations satisfy the reorganization test—at least three bankruptcy courts have employed this approach in applying the test without any commentary concerning the possible application of a competing alternative. Even so, *Kaiser Aluminum* was the first case in which PBGC challenged the application of an aggregate analysis and advocated a competing approach. *Falcon Products* indicates that PBGC will continue to mount vigorous opposition to attempted distress terminations of multiple pension plans if the reorganization test is applied in any way other than on a plan-by-plan basis.

The Third Circuit was the first court at the circuit level to consider the issue. Although the Eighth Circuit declined to decide whether the approach articulated in *Kaiser Aluminum* is the right one, both rulings fortify 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* and *Falcon Products* are significant precedents for any employer with multiple plans considering chapter 11 as part of its overall reorganization strategy.

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

Pension Benefit Guaranty Corporation v. Falcon Products, Inc. (In re Falcon Products, Inc.), 497 F.3d 838 (8th Cir. 2007).

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).

Jones Day acted as counsel to Kaiser Aluminum Corp. and its subsidiaries in connection with their chapter 11 cases.

RELEASE OF CHAPTER 11 PLAN PROPONENT OVERBROAD AND IMPERMISSIBLE

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Chapter 11 plans in complex restructurings routinely contain provisions either releasing or enjoining litigation against various stakeholders involved in the case, particularly where the plan contemplates an infusion of cash from an existing creditor or insurance company to fund distributions or is predicated in part on the settlement of a major dispute between the debtor and a significant creditor or shareholder. The validity of such releases or injunctions, however, has often been disputed in the courts. Two areas that continue to be a magnet for controversy concern: (i) a provision in a chapter 11 plan purporting to enjoin actions against, or release entities other than, the debtor; and (ii) the scope of the release or injunction. Both of these were the subject of a ruling recently handed down by the First Circuit bankruptcy appellate panel. In *Whispering Pines Estates, Inc. v. Flash Island, Inc. (In re Whispering Pines Estates, Inc.)*, the court reversed an order confirming a creditor-proposed chapter 11 plan, ruling that a release provision in the plan that insulated the plan proponent from a breach of its obligations to implement the plan was overbroad.

EFFECT OF PLAN CONFIRMATION ON THIRD-PARTY OBLIGATIONS

With certain exceptions, the provisions of a confirmed chapter 11 plan of reorganization are binding upon all creditors, whether or not they vote to accept the plan. In addition, confirmation of a plan acts to discharge the debtor from any debt that arose prior to the confirmation date, even if a creditor failed to file a proof of claim evidencing its debt or voted to reject the plan. Although the Bankruptcy Code precludes actions against the reorganized debtor or its property to collect on prebankruptcy debts, the same cannot be said with respect to litigation against nondebtor third parties who share liability for the same debts. Thus, section 524(e) of the Bankruptcy Code provides that "the discharge of a debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt."

The Bankruptcy Code explicitly authorizes nondebtor releases only in cases involving companies with asbestos-related liabilities. Section 524(g) was added to the Bankruptcy Code in 1994. It establishes a procedure for dealing with future personal-injury asbestos claims against a chapter 11 debtor. The procedure entails the creation of a trust to pay future claims and the issuance of an injunction to prevent future claimants from suing the debtor. All claims based upon asbestos-related injuries are channeled to the trust. Section 524(g) was enacted in response to lawmakers' concerns that future claimants—*i.e.*, persons who have been exposed to asbestos but have not yet manifested any signs of illness—are protected and recognizes that these claimants would be ill-served if asbestos companies are forced into liquidation. The statute contains detailed requirements governing the nature and scope of any injunction issued under section 524(g) in connection with the confirmation of a chapter 11 plan under which a trust is established to deal with asbestos claims.

Nevertheless, under certain circumstances, courts have approved chapter 11 plans that release or enjoin litigation against nondebtors in nonasbestos cases. Examples include situations where the estate receives substantial consideration in exchange for the release or injunction, where the enjoined claims are "channeled" to a settlement fund rather than extinguished, or where the enjoined or released claims would indirectly impact the debtor's reorganization by way of indemnity or contribution and the plan otherwise provides for full payment of the claims. Nondebtor releases have also been approved if the affected creditors consent. In addition, releases have been approved as part of a settlement between the debtor and various stakeholders, without which the debtor could not achieve confirmation of a chapter 11 plan.

INCONSISTENCY AMONG THE CIRCUIT COURTS OF APPEAL

The courts of appeal for the Ninth and Tenth Circuits have held that nondebtor releases and injunctions are impermissible (outside the scope of section 524(g)). The Second and Fourth Circuits have approved releases and injunctions benefiting nondebtors in the context of global settlements of massive liabilities of debtors and co-liable nondebtors that provided for compensation to claimants in exchange for releases that made the reorganizations feasible. The D.C. Circuit ruled that a plan provision releasing nondebtors was unfair because the plan did not provide additional compensation to a creditor whose claim against a nondebtor was being released. The Fifth Circuit reversed approval of a settlement that permanently enjoined a variety of claims because the injunction impermissibly discharged nondebtor liabilities, distinguishing other cases where the injunction channeled those claims to allow recovery from separate assets.

After it concluded that enjoining claims against a nondebtor consulting firm for contribution and indemnification was integral to a debtor's settlement with the firm, the Eleventh Circuit affirmed a district court ruling that a bankruptcy court has the power to enjoin nonsettling defendants from asserting such claims. The Third Circuit, declining to decide whether or not nondebtor releases legitimately can be part of a chapter 11 plan, ruled that a plan releasing and permanently enjoining litigation against the nondebtor defendants (officers and directors) did not pass muster under even the most flexible tests for the validity of nondebtor releases.

The Sixth Circuit Court of Appeals picked up the gauntlet in 2002 when it ruled in *Class Five Nevada Claimants v. Dow Corning Corp. (In re Dow Corning Corp.)* that the issuance of an injunction preventing a nonconsenting creditor from suing a nondebtor is within the powers conferred to bankruptcy courts under the Bankruptcy Code but that this power can be wielded only under "unusual circumstances." The court adopted a seven-part, conjunctive test to be applied in determining whether such circumstances exist:

- There is an identity of interests between the debtor and the third party, usually an indemnity relationship, such that a suit against the nondebtor is, in essence, a suit against the debtor or will deplete assets of the debtor's estate;
- The nondebtor has contributed substantial assets to the reorganization;
- The injunction is essential to reorganization—namely, the reorganization hinges on the debtor being free from indirect suits against parties who would have indemnity or contribution claims against the debtor;
- The affected class or classes have voted overwhelmingly to accept the plan;
- The plan provides a mechanism to pay for all, or substantially all, of the claims in the class or classes affected by the injunction;
- The plan provides an opportunity for those claimants who choose not to settle to recover in full; and

- The bankruptcy court made a record of specific factual findings that support its conclusions.

Finally, in one of the latest pronouncements on the issue at the circuit level, the Second Circuit ruled in *Deutsche Bank AG v. Metromedia Fiber Network, Inc.* (*In re Metromedia Fiber Network, Inc.)*, that release provisions in a plan were invalid, in the absence of any showing that they were necessary or even important to the plan's confirmation, because the releases purported to exonerate the debtor's personnel as well as a trust settled by various insiders to infuse capital into the reorganized debtor from a wide range of liabilities. Remarking that "a nondebtor release is a device that lends itself to abuse," the court characterized the potential for abuse as "heightened" in cases, such as the one before it, where the release affords blanket immunity from a wide universe of claims. Other courts of appeal have either issued nonbinding rulings on the subject or avoided addressing the issue on its merits.

The chapter 11 plan in *Whispering Pines* also contained a provision releasing a nondebtor. The reason that the appellate panel found it objectionable, however, had more to do with the scope of conduct covered by the release than the identity of the parties released.

WHISPERING PINES

Whispering Pines Estates, Inc., operates an assisted-living facility in New Hampshire. Its most valuable asset—the real property housing the facility—is encumbered by first and second mortgages held by Flash Island, Inc., securing loans in the amounts of, respectively, $489,000 and $920,000. Facing imminent foreclosure on Flash Island's first mortgage, Whispering Pines filed for chapter 11 protection in 2005 in New Hampshire. Flash Island acquired the second-mortgage debt shortly afterward.

Whispering Pines' estate included potential causes of action against Flash Island, whose second mortgage was allegedly avoidable as a fraudulent transfer because the proceeds of the loan were paid to an affiliate of the debtor. In an order authorizing the debtor's consensual use of Flash Island's cash collateral, the bankruptcy court established a deadline to object to Flash Island's secured claims or liens. No objections were ever filed.

After exclusivity expired without any plan proffered by Whispering Pines, Flash Island filed a liquidating chapter 11 plan. Under the proposed plan, a plan trustee would be appointed to manage the debtor's business for 60 days, during which time the trustee would market and attempt to sell the property for no less than $1.7 million, relying on funds provided by Flash Island for a marketing budget. In the event that the trustee could not close on any sale during that period, the plan provided that Flash Island would be free to sell the property at foreclosure, without further order of the court. Other plan provisions included a carve-out from Flash Island's collateral to pay administrative claims, professional fees, and nonpriority unsecured claims (each capped at a specified amount). The plan also contained the following release of the plan proponent:

> In consideration of (1) the Carve-out, without which no Dividends could be paid to the Unsecured Creditors holding Allowed Claims, (2) the Marketing Budget and (3) the implementation of the Plan (the "Proponent Release Consideration"), the Trustee for himself and on behalf of the Debtor and the Estate (the "Releasing Trustee Parties") shall execute and deliver to the Proponent on the Effective Date a General Release discharging, releasing and relinquishing all Claims and Causes of Action which any Releasing Trustee Party has or might have against the Proponent or its participants and any of their equity holders, directors, managers, officers, employees, accountants, attorneys, consultants, and other agents (the "Released Proponent Parties").

Whispering Pines objected to the plan, contending, among other things, that the plan's release provisions violate section 1129(a)(1) of the Bankruptcy Code, which requires, as a condition to confirmation, that a plan comply with all applicable provisions of the statute, and the requirement in section 1129(a)(3) that a chapter 11 plan be proposed in good faith and not by any means forbidden by law. After conducting a confirmation hearing during which no evidence on this or any other contested issue was offered or received, the bankruptcy court confirmed Flash Island's plan.

THE APPELLATE PANEL'S RULING

The bankruptcy appellate reversed the confirmation order on appeal. In articulating the reasons for its ruling, the court explained that the release provision in Flash Island's plan was really "two distinct releases rolled into one": a settlement or adjustment of claims belonging to the estate and a release or limitation of liability of the party responsible for implementing the plan. Both releases were objectionable, the court concluded, but for different reasons.

Observing that "the standard governing approval of [a release of estate claims] in a plan of reorganization has not been established in this circuit," the court concluded that it need not decide what standard should apply, given the absence of any evidentiary findings below on any issue regarding the propriety of the release. It accordingly ruled that, if the order were not reversible on other grounds, the court would vacate the confirmation order and remand the case below to remedy this error.

Ultimately, however, the court reversed the confirmation order because the release purported to absolve the plan proponent of all liability. "As a grant of immunity to a party responsible for implementing the plan," the court explained, "the release is overbroad and impermissible." According to the court, the release would insulate Flash Island from suit by Whispering Pines or the plan trustee for breach of the terms of the plan and for negligence or malfeasance in its implementation. Moreover, the court emphasized, "the release being categorical, even gross negligence and willful misconduct would be inactionable." A provision of this kind, the court ruled, "renders a plan unenforceable."

ANALYSIS

Whispering Pines differs from many cases involving the propriety of releases in a chapter 11 plan in two respects: (i) most rulings on the issue involve releases or injunctions that operate to prevent creditors and other third parties from suing the nondebtor recipient of the release; and (ii) relatively few cases involve releases of a plan proponent. Even so, the decision is consistent with the approach taken by the handful of other courts that have considered whether a plan can permissibly release the party implementing it from liability.

For example, a bankruptcy court ruled in *In re Hoffinger Indus., Inc.*, that a plan provision purporting to insulate the reorganized debtor from liability for simple breach of the plan was unconscionable because "a confirmed plan should be enforceable and amenable to damages between contractually bound parties." Likewise, the bankruptcy court in *In re WCI Cable, Inc.*, held that a provision in a plan exculpating the debtor's officers, directors, employees, and agents (including professionals) from liability for postpetition acts, except for willful misconduct or gross negligence, precluded confirmation of the plan unless it were amended to include acts of negligence and fiduciary infractions.

Whispering Pines Estates, Inc. v. Flash Island, Inc. (In re Whispering Pines Estates, Inc.), 370 B.R. 452 (Bankr. 1st Cir. 2007).

Resorts Int'l, Inc. v. Lowenschuss (In re Lowenschuss), 67 F.3d 1394 (9th Cir. 1995).

Landsing Diversified Props.-II v. First Nat'l Bank & Trust Co. (In re Western Real Estate Fund, Inc.), 922 F.2d 592 (10th Cir. 1990), *modified sub nom. Abel v. West*, 932 F.2d 898 (10th Cir. 1991).

Menard-Sanford v. Mabey (In re A.H. Robins Co.), 880 F.2d 694 (4th Cir. 1989).

SEC v. Drexel Burnham Lambert Group, Inc. (In re Drexel Burnham Lambert Group, Inc.), 960 F.2d 285 (2d Cir. 1992).

In re AOV Indus., Inc., 792 F.2d 1140 (D.C. Cir. 1986).

Feld v. Zale Corp. (In re Zale Corp.), 62 F.3d 746 (5th Cir. 1995).

In re Munford, 97 F.3d 449 (11th Cir. 1996).

In re Continental Airlines, 203 F.3d 203 (3d Cir. 2000).

Monarch Life Ins. Co. v. Ropes & Gray, 65 F.3d 973 (1st Cir. 1995).

In re Specialty Equipment Cos., 3 F.3d 1043 (7th Cir. 1993).

Class Five Nevada Claimants v. Dow Corning Corp. (In re Dow Corning Corp.), 280 F.3d 648 (6th Cir. 2002).

Deutsche Bank AG v. Metromedia Fiber Network, Inc. (In re Metromedia Fiber Network, Inc.), 416 F.3d 136 (2d Cir. 2005).

In re Hoffinger Indus., Inc., 321 B.R. 498 (Bankr. E.D. Ark. 2005).

In re WCI Cable, Inc., 282 B.R. 457 (Bankr. D. Or. 2002).

BANKRUPTCY RULE CHANGES TAKE EFFECT

Amendments to the Federal Rules of Bankruptcy Procedure (the "Rules") became effective on December 1, 2007, after having been approved by the U.S. Supreme Court in April and transmitted to Congress in June. These amendments, which apply to cases already pending on December 1, 2007, as well as cases filed thereafter, make some significant changes that will directly impact debtors, creditors, and other stakeholders.

Omnibus Claim Objections. Among the most significant changes is an amendment to Rule 3007, which concerns the form and notice of hearing on an objection to a claim filed in a bankruptcy case. In large bankruptcy cases, because the debtor-in-possession ("DIP") or bankruptcy trustee is obligated to address such a large volume of claims, objections to dozens or even hundreds of different claims are commonly combined in a single "omnibus" objection or a series of them. This practice places a not insignificant burden on individual creditors whose claims are buried in a mass of documentation (typically in an attached list or chart) to ensure that they timely respond to the objection, failing which their claims will be disallowed.

Amended Rule 3007 is intended to help individual creditors deal with this problem. The new rule imposes formatting standards and restricts the use of omnibus objections to certain limited circumstances generally involving technical rather than substantive challenges to the claim in question. Otherwise, each claim must be the subject of a separate objection, unless the combined objection covers claims filed by the same person or entity. Under the amended rule, omnibus objections may be filed with respect to:

- Duplicate claims.
- Claims filed in the wrong case.
- Claims that have been amended.
- Claims that were not timely filed.
- Claims that have already been satisfied or released.
- Claims filed in a form that does not comply with applicable rules.
- Claims that should have been asserted as equity interests.
- Priority claims that exceed the maximum amounts specified in the Bankruptcy Code.

An omnibus objection based upon one or more of these grounds must list all covered claimants in alphabetical order, cross-reference claim numbers, state the basis for the objection (with a cross-reference to the text of the objection), and describe the objector and the reason for the objection in the title of the document. No more than 100 claims may be combined in a single omnibus objection.

Amended Rule 3007 is similar to the Delaware Bankruptcy Court's Local Rule 3007-1, which establishes limitations on "non-substantive" and "substantive" claim objections but is less restrictive than the new federal rule. Speculation by practitioners and commentators concerning how the conflict between the local and federal rules would be resolved was put to rest by Chief Bankruptcy Judge Mary F. Walrath on November 27, 2007. Relying on language in Amended Rule 3007(c) that permits a bankruptcy court to opt out of the new requirements, Judge Walrath directed in a general order that Amended Rule 3007(c) "shall not be applicable to omnibus objections that are filed in accordance with Local Rule 3007-1." As a consequence, unless another bankruptcy judge in Delaware directs otherwise in a particular case, omnibus objections in Delaware bankruptcy cases will continue to be governed by Delaware's local procedural rule.

Clearer Disclosure in Connection With DIP Financing and Use of Cash Collateral. Changes have also been made to Rule 4001, which governs motions and stipulations for the use of cash collateral and to authorize DIP financing. The amended rule requires that more detail be disclosed concerning the terms and conditions of cash collateral and DIP financing agreements in any motion seeking court approval, that a proposed form of order be submitted with the motion, and that cross-references be made in the motion to the location of key provisions in the operative agreements.

Limitations on "First Day" Orders. A significant change made by the amendments is the addition of Rule 6003. The new rule provides that "[e]xcept and to the extent that relief is necessary to avoid immediate and irreparable harm, the court shall not, within 20 days after the filing of the petition, grant relief" with respect to three key areas:

- Requests for authority to employ professionals.
- Requests for authority to pay the prebankruptcy claims of "critical vendors" or other creditors, or to use, sell (*i.e.*, section 363 sales), lease, or incur obligations regarding property of the bankruptcy estate, other than motions to use cash collateral or incur DIP financing.
- Requests for authority to assume or assign any executory contract or unexpired lease (including commercial real estate leases).

New Rule 6003 provides that the bankruptcy court should defer decisions on these matters until 20 days after the chapter 11 filing date, unless relief is necessary to avoid immediate and irreparable harm. Deferring rulings on these important matters was deemed necessary to afford adequate time for the appointment of a creditors' committee and its retention of counsel.

Assumption or Rejection of Executory Contracts and Unexpired Leases. Rule 6006 was amended to impose restrictions on the use of omnibus motions dealing with executory contracts and unexpired leases. Under new Rule 6006(e), without special court authority, omnibus motions may be used for multiple executory contracts or leases only when: (i) all of the executory contracts to be assumed or assigned either involve the same parties or are being assigned to the same assignee; (ii) a DIP or trustee seeks to assume real property leases, but not to assign the leases to more than one assignee; or (iii) the motion requests authority to reject multiple executory contracts or leases.

Under new Rule 6006(f), each omnibus motion permitted under Rule 6006(e) can list no more than 100 executory contracts or leases, and multiple motions must be numbered consecutively. The new rule also requires permitted omnibus motions to provide the following information:

- An alphabetical listing by party name.
- The terms of the assumption or assignment, including amounts necessary for curing defaults.
- If applicable, the identity of the assignee and the adequate assurance of future performance, to be provided in connection with the assignment.

Other Changes. Other rule amendments effective December 1, 2007, include:

- Amendment of Rule 1014 to state explicitly that the bankruptcy court may order a change of venue on its own initiative rather than solely upon the request of a party.
- Amendment of Rule 7007.1 to clarify that a corporate debtor must file a statement of corporate ownership together with its initial filing (regardless of the nature of that filing) in an adversary proceeding.
- Addition of Rule 9005.1 to adopt new Federal Rule of Civil Procedure 5.1, addressing the procedures for constitutional challenges to statutes.
- Addition of Rule 9037 to address procedures for protecting Social Security numbers and other private information in court filings.

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