The Year in Bankruptcy: 2007

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The author reviews the key bankruptcy developments for the past year, including the top 10 largest public company bankruptcy filings — and the year's notable bankruptcy exits — as well as some significant court decisions.

In a tumultuous year that is likely to be remembered for its extreme market volatility, skyrocketing commodity prices (*e.g.*, crude oil hovering at $100 per barrel), a slumping housing market, the weakest U.S. dollar in decades versus major currencies, a ballooning trade deficit with significant overseas trading partners such as China, Japan, and the European Union, and an unprecedented proliferation of giant private equity deals that quickly fizzled when the subprime mortgage meltdown made inexpensive corporate credit nearly impossible to come by, 2007 was anything but mundane. It was, however, far from a record-breaking year in terms of the volume of business bankruptcies and restructurings. A report released on November 19, 2007, by the Administrative Office of the U.S. Courts indicates that 5,888 Chapter 11 cases were filed in fiscal year 2007 (October 2006 to September 2007), representing a two percent drop from the previous year's total of 6,003. Business bankruptcy filings (Chapter 7 and Chapter 11) in fiscal year 2007 totaled 25,925, down 5 percent from

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27,333 in fiscal year 2006. Year-end statistics showed that business bankruptcy filings increased 24 percent last year from 2006. Chapter 11 filings reached 6,236 in 2007, up from 5,010 in 2006, according to a report compiled by Jupiter eSources LLC using its service AACER (Automated Access to Court Electronic Records). In all, 78 publicly traded companies filed for bankruptcy protection in 2007, compared to the 66 public cases filed in 2006. Six names were added to the billion-dollar bankruptcy club in 2007 (double the number for 2006), one of which edged into ninth position on the all-time Top 10 list.

TOP 10 BANKRUPTCIES OF 2007

A survey of the Top 10 list of business bankruptcy filings in 2007 indicates that nearly half of the biggest companies that filed for bankruptcy protection — four (and arguably all) of the top five — were direct casualties of the subprime mortgage meltdown, which, by some estimates, has already caused 50 subprime lenders to fold, file for bankruptcy, or "close their doors" by liquidating their mortgage inventory. Laurels for the largest public bankruptcy filing in 2007 (and the ninth-biggest public bankruptcy filing of all time) went to subprime lender New Century Financial Corp., once the second-largest provider of home loans to high-risk borrowers in the U.S., which filed for Chapter 11 protection in Delaware on April 2, 2007, listing more than $26 billion in assets. New Century wrote nearly $51.6 billion in mortgages in 2006 and once employed more than 7,200 people.

Coming in at No. 2 on the Top 10 list for 2007 was Melville, N.Y.-based American Home Mortgage Investment Corp., another major player in the subprime mortgage lending business. Unable to originate new loans after plummeting real estate values and snowballing mortgage defaults perpetuated a liquidity crisis, American Home filed for Chapter 11 protection on August 6, 2007, in Delaware with nearly $19 billion in assets and unknown liabilities that have been estimated to aggregate in excess of $20 billion. A mass default-driven liquidity crisis also led subprime mortgage lender HomeBanc Corp. to seek Chapter 11 protection on August 9, 2007, in Delaware, three days after the company announced that it was exiting the retail mortgage loan-origination business to concentrate on its mortgage-servicing operations. The third-largest public company to file for bankruptcy in 2007, HomeBanc indicated in its most recent public financial statements that it held more than $6.8 billion in assets when it filed for Chapter 11 protection.

The fourth-largest public bankruptcy case of 2007 was filed by Delta Financial Corp., the Woodbury, N.Y.-based subprime lender that filed for Chapter 11 protection in Delaware on December 17, 2007, after a financing deal with alternative asset management firm Angelo, Gordon & Co. collapsed because the derivatives market rejected Delta Financial's efforts to securitize $500 million in nonconforming loans. The company listed more than $6.5 billion in assets in its Chapter 11 filing.

Rounding out the top five public company bankruptcy filings in 2007 was Alpharetta, Georgia-based NetBank Inc., an Internet-only savings and loan that filed for Chapter 11 protection on September 28, 2007, in Florida, hours after federal regulators shut down its online financial subsidiary due to problems associated with its home mortgage loans. Plagued by a business model that was widely criticized as being inefficient due to its irrational growth strategy, the company listed approximately $4.8 billion in assets at the time of its bankruptcy filing. NetBank announced shortly after filing for Chapter 11 that it planned to liquidate its assets.

Coming in at No. 6 on the Top 10 list for 2007 was Dothan, Alabama-based Movie Gallery, Inc. The second-largest movie rental company in the U.S. after Blockbuster, the company filed for Chapter 11 protection on October 16, 2007, in Richmond, Virginia, after sustaining two years of losses and accumulating $1 billion in debt in connection with its 2005 acquisition of Hollywood Video. Listing nearly $1.4 billion in assets, Movie Gallery was the only nonlender in the billion-dollar bankruptcy club of 2007.

Cash-starved Anderson, Indiana-based auto supplier Remy International Inc. garnered the dubious honor of being the third major U.S. auto supplier to file for bankruptcy in 2007 when it sought Chapter 11 protection on October 8, 2007, in Delaware, listing approximately $871 million in assets. Unlike many others in the beleaguered industry, however, Remy's stay in Chapter 11 was brief. Its long-awaited Chapter

11 filing capped months of restructuring negotiations with bondholders collectively owed $460 million, a majority of whom voted to support a prepackaged plan of reorganization and agreed to "backstop" Remy's sale of $85 million worth of new preferred shares as part of its anticipated exit funding. The bankruptcy court confirmed Remy's prepackaged Chapter 11 plan on November 20, 2007, and the company announced its emergence from Chapter 11 on December 6, 59 days after filing its bankruptcy petition and prepackaged plan. Remy's bankruptcy was the seventh-largest public bankruptcy filing of 2007.

Logging in at No. 8 on the Top 10 list of 2007 was Oregon-based Pope & Talbot, Inc., the 158-year-old lumber company with 2,500 employees and extensive operations in Canada. Citing low lumber prices, high-priced pulp chips and sawdust, and the strong Canadian dollar, the company filed for Chapter 11 protection in Delaware on November 19, 2007, after filing for protection under Canada's Companies' Creditors Arrangement Act in the Ontario Superior Court of Justice on October 29, 2007, because a majority of its operations are based in British Columbia. Pope & Talbot listed assets of more than $660 million at the time of the filings.

Spot No. 9 on the Top 10 list of 2007 belonged to InSight Health Services Holdings Corp., which, together with its wholly owned subsidiary InSight Health Services Corp., filed for Chapter 11 protection on May 29, 2007, in Delaware, listing more than $408 million in assets. The Lake Forest, California-based provider of diagnostic imaging services at managed-care entities, hospitals, and other contractual customers in more than 30 states filed for bankruptcy after securing approval of the terms of a prepackaged Chapter 11 plan from holders of more than two-thirds of its outstanding senior subordinated notes and 100 percent of its common stockholders. The bankruptcy court confirmed InSight's joint prepackaged Chapter 11 plan on July 10, 2007.

Chicago-based gym operator Bally Total Fitness Holding Corporation filed the 10th-largest public bankruptcy case in 2007, listing just under $400 million in assets and more than $800 million in debt. The company, which operates more than 390 fitness clubs in 29 states, as well as in Canada, the Caribbean, China, Mexico, and South Korea, filed for Chapter 11 protection on July 31, 2007, in New York. Bally originally submitted a prepackaged plan of reorganization that would have wiped out the stakes of existing shareholders and taken the company private. It later modified the plan to give significant value to creditors and shareholders, which was made possible by $234 million provided by Bally's new owners. The bankruptcy court confirmed Bally's Chapter 11 plan on September 17, 2007, and Bally emerged from bankruptcy as a private company after a stay of less than two months.

Largest Public Company Bankruptcies in 2007*

Company	*Filing Date*	*Assets*	*Industry*
New Century Financial Corporation	4/2/07	$26.1 billion	Lending
Amer. Home Mortgage Investment Corp.	8/6/07	$18.8 billion	Lending
HomeBanc Corp.	8/9/07	$6.8 billion	Lending
Delta Financial Corp.	12/17/07	$6.6 billion	Lending
NetBank, Inc.	9/28/07	$4.8 billion	Lending
Movie Gallery, Inc.	10/16/07	$1.38 billion	Retail
Remy International, Inc.	10/08/07	$871.2 million	Automotive
Pope & Talbot, Inc.	11/19/07	$662 million	Lumber
InSight Health Services Holdings Corp.	5/29/07	$408.2 million	Health Care
Bally Total Fitness Holding Corporation	7/31/07	$396.8 million	Fitness
Pacific Lumber Company	1/18/07	$302.2 million	Lumber
Tweeter Home Entertainment Group	6/11/07	$258.6 million	Retail

*Assets taken from the most recent 10-K filed prior to bankruptcy.

The general malaise that has gripped the U.S. automotive and airline industries in recent years continued in 2007, with some notable exceptions (discussed below). High fuel prices, spiraling labor costs, increased competition, overleveraging, and general inefficiencies continue to plague major players in these industries, which are experiencing what appear to be endless cycles of restructuring and consolidation. The tightened credit market caused by the subprime mortgage fallout only added to the challenges faced by companies such as Dura Automotive Systems Inc., Delphi Corp., and Calpine Corp., all of which were forced to postpone their emergence from Chapter 11 due to the difficulty in lining up exit financing in the current hostile credit environment.

NOTABLE EXITS FROM BANKRUPTCY IN 2007

Bucking a dismal trend in recent memory and perhaps portending better days ahead as restructurings and consolidation in the industry continue, no fewer than six major automotive suppliers either confirmed a Chapter 11 plan or emerged from bankruptcy in 2007. Auto-parts manufacturer Dana Corporation was able to secure $2 billion in exit financing en route to confirmation of its Chapter 11 plan on December 26, 2007. Dana emerged from bankruptcy on February 1, 2008. As noted, Indiana-based auto supplier Remy International's prepackaged Chapter 11 plan was confirmed by the bankruptcy court on November 20, 2007, and the company announced its emergence from Chapter 11 on December 6, 59 days after filing its bankruptcy petition and prepackaged plan.

Foamex International Inc., a major supplier of cushioning supplies to the auto industry and other sectors, obtained confirmation of a Chapter 11 plan on February 1, 2007, that paid all creditors in full in cash and allowed existing shareholders to retain their stock, subject to dilution. Although the company had originally submitted a prenegotiated plan that would have swapped secured debt for stock and wiped out old equity, a drastic uptick in performance during the case led to the formulation of a new plan, which incorporated a $150 million stock offering and $790 million in exit financing.

Southfield, Michigan-based auto-parts supplier Federal Mogul Corp.

ended a six-year stint in bankruptcy on November 8, 2007, when it obtained confirmation of a Chapter 11 plan. The plan became effective on December 27, 2007. Tower Automotive Inc., a global designer and producer of components and assemblies used by every major original equipment manufacturer, obtained confirmation of a Chapter 11 plan on July 11, 2007, involving the sale of substantially all of its assets to an affiliate of private equity giant Cerberus Capital Management, L.P. Tower filed for bankruptcy on February 2, 2005, citing lower production volumes, rising steel prices, and a complex and unsustainable debt load. Finally, Smithfield, Michigan-based automotive supplier Collins & Aikman Corp., which filed for Chapter 11 protection on May 17, 2005, obtained confirmation of a liquidating Chapter 11 plan on July 12, 2007, completing a 22-month divestiture program that involved the sale of 26 plants and the closure of another 31 manufacturing facilities.

Two major air carriers managed to exit from bankruptcy in 2007. Seventy-nine-year-old Delta Air Lines, Inc., the third-largest airline in the U.S., ended its 19-month restructuring when it obtained confirmation of a Chapter 11 plan on April 25, 2007, that incorporated $2.5 billion in exit financing. Delta filed for Chapter 11 protection in September of 2005, following a spike in jet fuel prices caused by the Gulf hurricanes. Delta emerged from bankruptcy on April 30, 2007. Northwest Airlines Corp. also ended its 20-month stay in bankruptcy when it obtained confirmation of a plan of reorganization on May 18, 2007. The 81-year-old airline is among the largest in the world, with hubs at Detroit, Minnesota/St. Paul, Memphis, Tokyo, and Amsterdam. Northwest emerged from bankruptcy on May 31, 2007.

Other notable exits from bankruptcy or Chapter 11 plan confirmations in 2007 included Adelphia Communications Corp., once the fifth-largest cable company in the U.S., which emerged from bankruptcy on February 13, 2007, after obtaining confirmation of a Chapter 11 plan on January 5, 2007, that distributed $17 billion in cash and stock to creditors. Adelphia's operations were purchased in 2006 by Time Warner, Inc.'s cable unit and Comcast Corp. Energy company Calpine Corp., which supplies electricity to 27 million U.S. households, obtained confirmation of a Chapter 11 plan on December 20, 2007, providing for a debt-for-stock swap. Chemical manufacturer Solutia Inc. came close to ending its four-year stay in bankruptcy when it obtained confirmation of a Chapter 11 plan on November 29, 2007. The company has been repositioned as a producer of high-performance specialty materials that command premium prices and can pass through the rising costs of energy and petroleum-based raw materials.

Decatur, Georgia-based Allied Holdings Inc., the nation's largest vehicle transporter, emerged from bankruptcy protection on June 1, 2007, after it obtained confirmation of a Chapter 11 plan implementing a debt-for-equity swap with unsecured creditors funded by $315 million in exit financing. Allied filed for Chapter 11 protection on July 31, 2005. Finally, bringing an end to the initial chapter in the continuing saga of bankruptcies among Catholic churches spurred by widespread incidence of clergy sexual abuse, the Catholic Diocese of Spokane, Washington, ended its 28-month stay in bankruptcy when it obtained confirmation of a Chapter 11 plan on April 13, 2007, that incorporates a $48 million settlement with 160 alleged victims of abuse. The 93,000-member diocese with 82 parishes is among five nationwide that have sought bankruptcy protection against claims of abuse.

WHERE DO WE GO FROM HERE?

The ramifications of the subprime disaster are likely to manifest themselves well into 2008 and perhaps beyond. 2007 marked only the beginning of the problem, as default rates on subprime loans began to soar and financial institutions started to call in their loans. Subprime lenders began collapsing like dominos, and it was not long before even the mightiest institutions were forced to take a hard look at how much they stood to lose in portfolios that contained significant subprime investments that flooded the derivatives markets in 2006. Citicorp, for example, announced on January 15, 2008, that it would write down $18 billion due to the subprime meltdown. On January 17, 2008, Merrill Lynch, the nation's largest brokerage firm, posted a $9.8 billion fourth-quarter loss, reflecting $16.7 billion of write-downs on mortgage-related investments and leveraged loans. State Street Corp., which manages $2 trillion for pension funds and other institutions, announced on January 3, 2008, that it would set aside $618 million to cover legal claims stemming from investments tied to mortgage-related derivatives. Finally, in a move calculated to salvage a $2 billion investment jeopardized by the slumping housing market and subprime woes, Bank of America agreed on January 11, 2008, to acquire mortgage lender Countrywide Financial for $4 billion in stock. At the end of 2007, payments on more than seven percent of Countrywide's $1.5 trillion servicing portfolio were more than 60 days overdue and the company was considering a bankruptcy filing due to its liquidity crisis.

According to some estimates, companies involved in the subprime disaster have already wiped more than $170 billion from their books—an already staggering number that may be more than doubled by the middle of 2008, when defaults peak and home foreclosures mount as interest rates on subprime mortgages reset. With the specter of recession looming on the horizon, the homebuilding and building-products industries are obvious candidates "most likely to be hardest hit" by these developments, but other industries will almost surely suffer from the fallout, including the retail and consumer-product sectors as well as the music and entertainment and restaurant industries.

LEGISLATIVE DEVELOPMENTS

October 17, 2007, marked the second anniversary of the effectiveness of the most sweeping reforms in U.S. bankruptcy law in more than a quarter century, which were implemented as part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA"). In addition to the hotly contested and widely reported controversies regarding changes made by BAPCPA to various consumer bankruptcy provisions (such as the "means test" that acts as a gatekeeper to Chapter 7 filings), some of BAPCPA's business bankruptcy provisions have also proved to be controversial, inadequate, or ill-advised. Among these are the new 18-month limitation on a Chapter 11 debtor's exclusive right to propose a Chapter 11 plan, restrictions on a Chapter 11 debtor's ability to implement key employee retention programs, the new administrative priority given to claims asserted by suppliers of goods to debtors in the 20-day period prior to a bankruptcy filing, and the strict limitations on extensions of time to assume or reject leases of nonresidential real property. All of these are likely to remain "hot button" issues in 2008.

Amendments to the Federal Rules of Bankruptcy Procedure (the "Rules") became effective on December 1, 2007. These amendments, which apply to cases already pending on or after December 1, 2007, made some significant changes that will directly impact debtors, creditors, and other stakeholders. Among the most important changes is an amendment to Rule 3007, which imposes formatting standards governing claims objections and restricts the use of omnibus objections to certain limited circumstances generally involving technical rather than substantive challenges to the claims in question.

Changes were also made to Rule 4001, which governs motions and stipulations for the use of cash collateral and to authorize DIP financing. Among other things, the amended rule requires more detail to be disclosed concerning the terms and conditions of cash collateral and DIP financing agreements in any motion seeking court approval.

New Rule 6003 provides that "[e]xcept 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" involving requests for authority to (i) employ professionals; (ii) pay the prebankruptcy claims of "critical vendors" or other creditors, or 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; or (iii) assume or assign any executory contract or unexpired lease (including commercial real estate 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 under narrowly defined circumstances. Under new Rule 6006(f), each omnibus motion permitted under Rule 6006(e) can list no more than 100 executory contracts or leases.

All-Time Largest Public Bankruptcy Filings

Company	*Filing Date*	*Assets*
WorldCom Inc.	July 21, 2002	$103.9 billion
Enron Corp.	Dec. 2, 2001	$63.4 billion
Conseco Inc.	Dec. 18, 2002	$61.4 billion
Texaco Inc.	April 12, 1987	$35.9 billion
Financial Corporation of America	Sept. 9, 1988	$33.9 billion
Refco Inc.	Oct. 17, 2005	$33.3 billion
Global Crossing Ltd.	Jan. 28, 2002	$30.2 billion
Calpine Corp.	Dec. 20, 2005	$27.2 billion
New Century Financial Corp.	Apr. 2, 2007	$26.1 billion
UAL Corp.	Dec. 9, 2002	$25.2 billion
Delta Air Lines, Inc.	Sept. 14, 2005	$21.8 billion
Pacific Gas & Electric	Apr. 6, 2001	$21.5 billion
Adelphia Communications	June 25, 2002	$21.5 billion
MCorp.	Mar. 31, 1989	$20.2 billion
Mirant Corp.	July 14, 2003	$19.4 billion

NOTABLE BUSINESS BANKRUPTCY DECISIONS OF 2007

Equitable Subordination or Disallowance of Traded Claims

Featured prominently in business and financial headlines in late 2005 and early 2006 were a pair of highly controversial rulings handed down by the New York bankruptcy court overseeing the Chapter 11 cases of embattled energy broker Enron Corporation and its affiliates. In the first, *In re Enron Corp.*, 2005 WL 3873893 (Bankr. S.D.N.Y. Nov. 28, 2005), Bankruptcy Judge Arthur J. Gonzalez held that a claim is subject to equitable subordination under Section 510(c) of the Bankruptcy Code even if it is assigned to a third-party transferee who was not involved in any misconduct committed by the original holder of the debt. In the second, *In re Enron Corp.*, 340 B.R. 180 (Bankr. S.D.N.Y. Mar. 31, 2006), Judge Gonzalez broadened the scope of his cautionary tale, ruling that a transferred claim should be disallowed under Section 502(d) of the Bankruptcy Code unless and until the transferor returns payments to the estate that are allegedly preferential.

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

An enormous amount of attention was focused on the appeals, with industry groups, legal commentators, Enron creditors, distressed investors, academics, and other interested parties seeking the appellate court's leave to register their views on the issues involved and the impact of the rulings on the multibillion-dollar market for distressed claims and securities. The vigil ended on August 27, 2007. In *In re Enron Corp.*, 379 B.R. 425 (S.D.N.Y. 2007), District Judge Shira A. Scheindlin vacated both of Judge Gonzalez's rulings, holding that "equitable subordination under Section 510(c) and disallowance under Section 502(d) are personal disabilities that are not fixed as of the petition date and do not inhere in the claim." The key determination, she explained, is whether the claim transfer is in the form of an outright sale or merely an assignment. Judge Scheindlin remanded the case to the bankruptcy court for consideration of this issue, denying on September 24, 2007, a request for leave to appeal her ruling to the Second Circuit.

Fraudulent Transfer Litigation

In a decision with potential far-reaching effects on Wall Street firms servicing hedge funds as prime brokers, a New York bankruptcy court ordered Bear Stearns in *Gredd v. Bear, Stearns Securities Corp.* (*In re Manhattan Investment Fund Ltd.*), 2007 WL 534547 (Bankr. S.D.N.Y. Feb. 15, 2007), to disgorge nearly $160 million that it received in the form of margin payments, position closeouts, and fees from a hedge fund that had engaged in a Ponzi scheme because, among other things, the broker failed to adequately monitor the activities of the fund before it collapsed in 2000. The decision sent shock waves through the brokerage industry, raising the possibility that broker-dealers might be obligated to oversee the activities of their lucrative clients more diligently.

Bear Stearns obtained a reprieve from its repayment obligation on December 17, 2007, when the district court, in *In re Manhattan Investment Fund Ltd.*, 2007 WL 4440360 (S.D.N.Y. Dec. 17, 2007), reversed the bankruptcy court's ruling to the extent that it granted summary judgment against Bear Stearns on the issue of whether the broker could rely on the "good faith" defense contained in Section 548(c) of the Bankruptcy Code. Although the district court affirmed the bankruptcy court's entry of summary judgment against Bear Stearns on the issue of whether the broker was a transferee for purposes of Section 548(a)(1) liability as the recipient of a fraudulent transfer, it ruled that a trial must be held to determine whether the steps taken by the broker to inquire into the acts of the debtor transferor were sufficient to support a good faith defense.

In *In re Iridium Operating LLC*, 373 B.R. 283 (Bankr. S.D.N.Y. 2007), the bankruptcy court addressed the issue of proving insolvency in fraudulent-conveyance litigation. In litigation commenced by an unsecured creditors' committee on behalf of the estate seeking to avoid $3.7 billion in payments made during the four years prior to the debtor's Chapter 11 filings for development of a satellite system, the court ruled that the committee had not borne its burden of proving that the debtor was insolvent or had unreasonably small capital at the time of the transfers. According to the court, a company's subsequent failure alone is not sufficient evidence to prove the insolvency of the business in the months and years prior to its demise. The court also emphasized that the public trading markets constitute an impartial gauge of investor confidence and remain the best and most unbiased measure of fair market value and, when available to a bankruptcy court, are the preferred standards of valuation.

Unofficial Committee Disclosure Requirements

Bankruptcy headlines in February and March of 2007 were awash with tidings of controversial developments in the Chapter 11 cases of Northwest Airlines and its affiliates that set off alarms in the "distressed" investment community. A New York bankruptcy court ruled in *In re Northwest Airlines Corp.*, 363 B.R. 701 (Bankr. S.D.N.Y. 2007), that an unofficial, or "ad hoc," committee consisting of hedge funds and other distressed investment entities holding Northwest stock and claims was obligated under Rule 2019(a) of the Federal Rules of Bankruptcy Procedure to disclose the details of its members' trading positions, including the acquisition prices.

The ruling was particularly rankling to distressed investors, whose role in major Chapter 11 cases is growing in prominence, principally by virtue of collective participation in the form of ad hoc creditor groups. These entities have traditionally closely guarded information concerning their trading positions to maximize both profit potential and negotiating leverage. Compelling disclosure of this information could discourage hedge funds and other distressed investors from sitting on informal committees, resulting in a significant shift in what has increasingly become the standard negotiating infrastructure in Chapter 11 mega-cases.

Close on the heels of the rulings in *Northwest Airlines*, however, the Texas bankruptcy court presiding over the Chapter 11 cases of Scotia Pacific Company LLC and its affiliates directed in *In re Scotia Development LLC*, Case No. 07-20027-C-11 (Bankr. S.D. Tex. Apr. 18, 2007), that a group of noteholders need not disclose the details of its members' trading positions, ruling that an informal creditor group jointly represented by a single law firm is not the kind of "committee" covered by Rule 2019. The holding in *Northwest Airlines* was appealed, while the ruling in *Scotia Development* was not. Developments concerning this issue are being monitored closely by the distressed-investment community, including trading-industry watchdogs, such as the Loan Syndications and Trading Association and the Securities Industry and Financial Markets Association.

Tax-Free Asset Transfers in Chapter 11

The ability to sell assets during the course of a Chapter 11 case without incurring the transfer taxes customarily levied on such transactions outside of bankruptcy often figures prominently in a potential debtor's strategic bankruptcy planning. However, the circumstances under which a sale and related transactions (*e.g.*, recording of mortgages) qualify for the tax exemption have been a focal point of dispute for many courts, including no fewer than four circuit courts of appeal. Unfortunately, these appellate rulings have done little to clarify exactly what types of asset dispositions made during the course of a Chapter 11 case are exempt from tax. Adding to the confusion is a widening rift in the circuit courts of appeal concerning the tax exemption's application to asset sales occurring prior to confirmation of a Chapter 11 plan.

In 2007, the Eleventh Circuit had a second opportunity to examine the scope of Section 1146. In *State of Florida Dept. of Rev. v. Piccadilly Cafeterias, Inc.* (*In re Piccadilly Cafeterias, Inc.*), 484 F.3d 1299 (11th Cir. 2007), the court of appeals considered whether the tax exemption applies to a sale transaction under Section 363(b) of the Bankruptcy Code. Rejecting the restrictive approach taken by certain other circuit courts, the Eleventh Circuit held that the Section 1146 tax exemption "may apply to those pre-confirmation transfers that are necessary to the consummation of a confirmed plan of reorganization, which, at the very least, requires that there be some nexus between the pre-confirmation sale and the confirmed plan." On December 7, 2007, the U.S. Supreme Court granted *certiorari* in this case.

Cross-Border Bankruptcy Cases

October 17, 2007, marked the second anniversary of the effective date of Chapter 15 of the Bankruptcy Code, enacted as part of the comprehensive bankruptcy reforms implemented under BAPCPA. Governing cross-border bankruptcy and insolvency cases, Chapter 15 is patterned after the

Model Law on Cross-Border Insolvency, a framework of legal principles formulated by the United Nations Commission on International Trade Law in 1997 to deal with the rapidly expanding volume of international insolvency cases. It replaced Section 304 of the Bankruptcy Code, which allowed an accredited representative of a debtor in a foreign insolvency proceeding to commence a limited "ancillary" bankruptcy case in the U.S. for the purpose of enjoining actions against the foreign debtor or its assets located in the U.S. The policy behind Section 304 was to provide any assistance necessary to ensure the economic and expeditious administration of foreign insolvency proceedings. Chapter 15 continues that practice but establishes new rules and procedures applicable to transnational bankruptcy cases that will have a markedly broader impact than Section 304.

A number of significant rulings during 2007 were emblematic of both the breadth of discretion given to a bankruptcy court in granting (or refusing to grant) relief under Chapter 15 and the new chapter's shortcomings in providing clear guidance as to how it is to be applied in all cases. In a decision issued on August 30, 2007, Bankruptcy Judge Burton R. Lifland of the U.S. Bankruptcy Court for the Southern District of New York denied Chapter 15 petitions seeking recognition as a "foreign main proceeding" of winding-up proceedings commenced in the Cayman Islands for two failed hedge funds that were casualties of the subprime mortgage meltdown. In *In re Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd.* (*In Provisional Liquidation*), 2007 WL 2479483 (Bankr. S.D.N.Y. Aug. 30, 2007), *amended and superseded by*, 374 B.R. 122 (Bankr. S.D.N.Y. 2007), the court ruled that the representatives of the hedge funds, which had little or no contact with the Caymans other than a certificate of incorporation, failed to demonstrate either that their "center of main interests" ("COMI") was located, or that they even had an "establishment," in the Caymans.

Bear Stearns was not the first ruling denying recognition under Chapter 15 of a foreign main proceeding involving a Cayman Islands hedge fund. In 2006, Bankruptcy Judge Robert D. Drain, in *In re SPhinX, Ltd.*, 351 B.R. 103 (Bankr. S.D.N.Y. 2006), denied a petition seeking recognition of liquidation proceedings in the Cayman Islands as foreign main proceedings because the evidence did not support a finding that the debtor-hedge funds' COMI was in the Cayman Islands, and it appeared that the liquidators' motive for seeking recognition was to gain a tactical advantage in pending litigation involving the debtors. However, the judge ruled that recognition as a foreign nonmain proceeding was warranted, even though the Cayman liquidation did not qualify as a main proceeding and even though no such proceeding was pending elsewhere. Judge Drain's ruling was affirmed in all respects in 2007 by a New York district court in *In re SPhinX, Ltd.*, 371 B.R. 10 (S.D.N.Y. 2007).

Key Employee Retention Plans

One of the most controversial changes made to the Bankruptcy Code by BAPCPA was the addition of Section 503(c), which significantly restricts the circumstances under which a DIP may implement programs designed to encourage key employees to continue working for the company during its stay in bankruptcy. In substance, new Section 503(c) provides that a debtor may not agree to pay any form of compensation to a corporate insider for the purpose of inducing the insider to continue working for the debtor, unless the court finds that the compensation is essential to retention because the insider has a bona fide job offer elsewhere at the same or a greater rate of compensation, the services provided by the insider are essential to the survival of the debtor's business, and the compensation does not exceed certain amounts specified in the statute. The statute also severely limits severance payments to insiders of a debtor. Given the historical prevalence of "key employee retention plans" in large Chapter 11 cases, the new rules were bound to invite challenges in the courts concerning the scope of their limitations.

Several noteworthy rulings were handed down in 2007 concerning Section 503(c), including *In re Nellson Nutraceutical, Inc.*, 369 B.R. 787 (Bankr. D. Del. 2007), in which the bankruptcy court held that a modification made by DIPs to their employee incentive plan for a prior year, which provided for payment of bonuses despite the debtors' failure to achieve the lowest threshold for bonuses under the original plan, had the primary purpose of motivating employees' performance, even though it had some retentive effect, and therefore the plan payments were not restricted or precluded by Section 503(c). In *In re Global Home Products, LLC*, 369 B.R. 778 (Bankr. D. Del. 2007), the court ruled that management and sales bonus plans proposed by the DIPs were performance incentive, not retention, plans and therefore were not subject to review under Section 503(c).

Venue of a Bankruptcy Case

One of the most significant considerations in a prospective Chapter 11 debtor's strategic prebankruptcy planning is the most favorable venue for the bankruptcy filing. Given varying interpretations of certain important legal issues in the bankruptcy courts (*e.g.*, the ability to pay the claims of "critical" vendors at the inception of a Chapter 11 case, to include non-debtor releases in a Chapter 11 plan, or to reject collective bargaining agreements) and the reputation, deserved or otherwise, that certain courts or judges may be more "debtor-friendly" than others, choice of venue (if a choice exists) can have a marked impact on the progress and outcome of a Chapter 11 case.

Developments during 2007 suggest that bankruptcy courts may be casting a more critical eye on a Chapter 11 debtor's chosen venue, particularly if the nexus between the venue and the debtor's business, assets, and creditors is no more than tenuous. For example, in *In re Malden Mills Industries, Inc.*, 361 B.R. 1 (Bankr. D. Mass. 2007), the debtor, a Massachusetts-based manufacturer of Polartec® fleece blankets, filed for Chapter 11 protection in Delaware for the purpose of effectuating a sale of substantially all of its assets one day after a Massachusetts bankruptcy court entered an order closing a previous Chapter 11 case filed in 2001, based upon representations that the company was merely trying to tie up loose ends. A creditor trust appointed in the previous Chapter 11 bankruptcy case, claiming it had been misled into agreeing to the closure, moved to vacate the final decree and to transfer venue of the new case to Massachusetts, where substantially all of the debtor's operations, assets, employees, managers, and creditors were located. The Massachusetts bankruptcy court granted both requests, making clear that it felt deceived by conduct it obviously considered duplicitous and bordering on sanctionable.

The Sixth Circuit also addressed the Chapter 11 venue rules in 2007, ruling in *Thompson v. Greenwood*, 507 F.3d 416 (6th Cir. 2007), that a bankruptcy court does not have the discretion to retain an improperly venued bankruptcy case if a timely objection is interposed by a party-in-interest.

Settlements

"Give-ups" by senior classes of creditors to achieve confirmation of a plan have become an increasingly common feature of the Chapter 11 process, as stakeholders strive to avoid disputes that can prolong the bankruptcy case and drain estate assets by driving up administrative costs. Under certain circumstances, however, senior-class "gifting" or "carve-outs" from senior-class recoveries may violate a well-established bankruptcy principle commonly referred to as the "absolute priority rule," a maxim predating the enactment of the Bankruptcy Code that established a strict hierarchy of payment among claims of differing priorities. The rule's continued application under the current statutory scheme has been a magnet for controversy.

Most of the court rulings handed down recently concerning this issue have examined the rule's application to the terms of a proposed Chapter 11 plan that provides for the distribution of value to junior creditors without paying senior creditors in full. A decision issued in 2007 by the Second Circuit Court of Appeals, however, indicates that the dictates of the absolute priority rule must be considered in contexts other than confirmation of a plan. In *Motorola, Inc. v. Official Comm. of Unsecured Creditors* (*In re Iridium Operating LLC*), 478 F.3d 452 (2d Cir. 2007), the Second Circuit ruled that the most important consideration in determining whether a preplan settlement of disputed claims should be approved as being "fair and equitable" is whether the terms of the settlement comply with the Bankruptcy Code's distribution scheme.

Limitations on Estate Causes of Action

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 had an opportunity during 2007 to weigh in on the issue. In *Official Comm. of Unsecured Creditors v. Halifax Fund, L.P.* (*In re Applied Theory Corp.*), 493 F.3d 882 (2d Cir. 2007), 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.

The ability to borrow money during the course of a bankruptcy is one of the most important tools available to a DIP. Oftentimes, the most logical choice for a lender is one with an existing prebankruptcy relationship with the debtor. As a quid pro quo for making new loans, however, lenders commonly require the debtor to waive its right to pursue avoidance or lender-liability actions against the lender based upon prebankruptcy events. Normally, the waiver does not prohibit the creditors' committee from bringing these causes of actions, derivatively, on behalf of the estate — but the waiver provision may limit the amount of time the committee has to bring these claims.

An interesting issue arises when the case does not go as well as planned and converts from a Chapter 11 reorganization to a Chapter 7 liquidation. Suppose the Chapter 7 trustee wants to prosecute an avoidance action against the lender: does the waiver bind the trustee, as the successor to the DIP, or does the trustee succeed to the rights of the creditors' committee? The Tenth Circuit Court of Appeals considered this issue in *Hill v. Akamai Tech., Inc.* (*In re MS55, Inc.*), 477 F.3d 1131 (10th Cir. 2007). In a matter of first impression for the circuit, the court ruled that the only rights a Chapter 7 trustee inherits from a creditors' committee are derivative of the debtor's rights and therefore are barred if waived by the debtor.

Classification of Claims

The strategic importance of classifying claims and interests under a Chapter 11 plan is sometimes an invitation for creative machinations designed to muster adequate support for confirmation of the plan. Although the Bankruptcy Code unequivocally states that only "substantially similar" claims or interests can be classified together, it neither defines "substantial similarity" nor requires all claims or interests fitting the description to be classified together. It has been left to the courts to develop hard-and-fast rules on classification, and the results have occasionally been inconsistent or controversial.

An enduringly prominent bone of contention in the ongoing plan-classification dispute concerns the legitimacy of classifying in two or more separate classes similar, but arguably distinct, kinds of claims in an effort to create an impaired accepting class. Sometimes referred to as class "gerrymandering," this practice was the subject of a ruling handed down in 2007 by the Third Circuit Court of Appeals. In *In re Machne Menachem, Inc.*, 2007 WL 1157015 (3d Cir. Apr. 19, 2007), the court upheld an order vacating confirmation of a Chapter 11 plan because insiders of the debtor purchased unsecured claims during the case to ensure that an impaired unsecured class would vote in favor of the plan.

Fiduciary Duties

In a significant Delaware law decision in 2007 regarding creditors' ability to sue corporate fiduciaries, the Delaware Supreme Court addressed the issue of whether a corporate director owes fiduciary duties to the creditors of a company that is insolvent or in the "zone of insolvency." In *North American Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92 (Del. 2007), the court concluded that directors of a solvent Delaware corporation that is operating in the zone of insolvency owe their fiduciary duties to the corporation and its shareholders, and not creditors. The court also ruled that the fiduciary duties of directors of an insolvent corporation continue to be owed to the corporation. In the case of an insolvent corporation, however, creditors, as the true economic stakeholders in the enterprise, have standing to pursue derivative claims for directors' breaches of fiduciary duty to the corporation.

Unsecured Creditors' Right to Attorneys' Fees in Bankruptcy

In *Travelers Casualty & Surety Co. of America v. Pacific Gas & Electric Co.*, 127 S. Ct. 1199 (2007), the U.S. Supreme Court resolved a conflict among the circuit courts of appeal by overruling the Ninth Circuit's *Fobian* rule, which dictated that attorneys' fees are not recoverable in bankruptcy for litigating issues "peculiar to federal bankruptcy law." In reaching its decision, the Supreme Court reasoned that the *Fobian* rule's limitations on attorneys' fees find no support in Section 502 of the Bankruptcy Code or elsewhere. Perhaps more important, however, because the debtor did not raise such arguments below, the Supreme Court declined to express an opinion regarding whether other principles of bankruptcy law might provide an independent basis for disallowing the claims of an unsecured creditor for postpetition attorneys' fees. As a result, *Travelers* has forced an ongoing debate regarding the allowability of such claims.

A number of bankruptcy courts issued contrary opinions on this issue during 2007, thus signaling that there is no end in sight to the debate over this important issue. Among these decisions was *In re Astle*, 364 B.R. 743 (Bankr. D. Idaho 2007), in which the court denied the claim of an oversecured power company for postpetition attorneys' fees incurred in pursuing its claim because the claim for fees arose under federal bankruptcy law (not the general Idaho statute regarding attorneys' fees).

Less than two months later, a California bankruptcy court held in *In re Qmect, Inc.*, 368 B.R. 882 (Bankr. N.D. Cal. 2007), that an unsecured creditor's allowed claim included postpetition attorneys' fees payable in accordance with the provisions of its prepetition contract with the debtor because: (i) the Bankruptcy Code broadly defines a "claim" to include contingent claims; (ii) as of the petition date, postpetition attorneys' fees are contingent claims; and (iii) nothing in Section 502(b) of the Bankruptcy Code dictates that such claims should be disallowed. A Florida bankruptcy court later rejected this approach in *In re Electric*

Machinery Enterprises, 371 B.R. 549 (Bankr. M.D. Fla. 2007), adopting the reasoning of the pre-*Travelers* majority in ruling that an unsecured creditor is not entitled to attorneys' fees incurred in prosecuting its claims in bankruptcy. Mindful of the implications that a contrary decision would have on the administration of a bankruptcy estate, the court observed that "[t]here would be no finality to the claims process as bankruptcy courts would constantly have to revisit the issue of the amount of claims to include ever-accruing attorneys' fees." The administrative inconvenience this would cause in a Chapter 11 case would, in the court's estimation, be intolerable.

In *In re Busch*, 369 B.R. 614 (Bankr. 10th Cir. 2007), a Tenth Circuit bankruptcy appellate panel ruled that a bankruptcy court properly awarded a Chapter 7 debtor's former wife attorneys' fees incurred in connection with her participation in the debtor's prior Chapter 13 cases seeking payment of her priority claim and in a nondischargeability proceeding, because an applicable Utah statute permitted such fees to be awarded to a prevailing party for enforcement of obligations under a divorce decree. Finally, in *In re SNTL Corp.*, 380 B.R. 204 (Bankr. 9th Cir. 2007), a Ninth Circuit bankruptcy appellate panel concluded that the allowance functions of Section 506(b) and 502(b) have been incorrectly conflated by some courts, ruling that an unsecured creditor who has an entitlement to attorneys' fees under a prepetition contract may include postpetition attorneys' fees incurred litigating with the debtor as part of its allowed unsecured claim.

Section 502(b)(6) Cap on Rejection-Damages Claims

Section 502(b)(6) of the Bankruptcy Code caps claims "resulting from the termination" of a lease of real property generally at the greater of one year or 15 percent (not to exceed three years) of the "rent reserved" for the remaining term of the lease. If a lease has a long remaining term upon rejection, the cap can significantly reduce a landlord's rejection-damages claim. For many years, landlords and debtors have fought over whether claims for damages to leased premises are covered by the Section 502(b)(6) cap. Historically, the majority of lower courts have concluded that claims for damages to premises are covered by the cap, but until

2007, no circuit court of appeals had occasion to pass on the issue. In 2007, a Delaware bankruptcy court followed this majority trend in *In re Foamex Int'l, Inc.*, 368 B.R. 383 (Bankr. D. Del. 2007). *Foamex*, like many other rulings applying the cap to claims for damages to leased premises, adopted the analysis articulated by a Ninth Circuit bankruptcy appellate panel in *Kuske v. McSheridan* (*In re McSheridan*), 184 B.R. 91 (Bankr. 9th Cir. 1995). The McSheridan panel reasoned that, because the rejection of the lease is a deemed breach of all of the provisions of the lease, the claim for damages to the premises arises from the breach of any repair covenants in the lease and hence is covered by the Section 502(b)(6) cap.

The Ninth Circuit, however, reached the opposite result in *Saddleback Valley Community Church v. El Toro Materials Company, Inc.* (*In re El Toro Materials Company, Inc.*), 504 F.3d 978 (9th Cir. 2007). In *El Toro*, which represents the first ruling by a circuit court of appeals on the premises-damage issue, the debtor mining company allegedly left 1 million tons of wet clay "goo" on the premises after rejecting the related lease. The landlord asserted $23 million in claims against the debtor on account of the costs of removing the clay substance. Rejecting the majority position of the lower courts, and overturning the bankruptcy appellate panel's decision in *McSheridan*, the Ninth Circuit concluded that the landlord's claims on account of remediating the property were based on the tenant's conduct while on the premises, and not a result of the termination of the lease itself, and hence were not covered by the Section 502(b)(6) cap.

Attorney-Client Privilege

The effect of a bankruptcy filing on the ability of a DIP or bankruptcy trustee to rely on the debtor's attorney-client privilege to shield information from disclosure has long been a controversial issue. In a notable ruling on this issue handed down in 2007, the Third Circuit held in *In re Teleglobe Communications Corp.*, 493 F.3d 345 (3rd Cir. 2007), that a controlling corporation could be compelled to produce documents under the adverse-litigation exception to the co-client attorney-client privilege, in a lawsuit brought by Chapter 11 debtor subsidiaries of the parent corporation against the controlling corporation alleging breach of fiduciary duties and other claims, only if the controlling corporation and the debtors were jointly represented by the same attorneys on a matter of common interest that was the subject matter of those documents. This decision is discussed in more detail elsewhere in this edition of the *Business Restructuring Review*.

Chapter 11 Trustees

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 as a "debtor in possession" while devising a viable business plan or other workable exit strategy. The DIP is a concept rooted strongly in modern U.S. bankruptcy jurisprudence. Still, the presumption can be overcome.

The 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 of 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 considered in 2007 what impact the new provision has on the standard applied to a trustee-appointment motion. In *In re The 1031 Tax Group, LLC*, 374 B.R. 78 (Bankr. S.D.N.Y. 2007), Bankruptcy Judge Martin Glenn ruled 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, on such a request by the UST, a trustee should in fact be appointed. Judge Glenn had initially concluded that no trustee was warranted in the case because new management had been appointed without any ties to a previous manager accused of wrongdoing. However, in a subsequent unpublished ruling, *In re The 1031 Tax Group, LLC*, No. 07-11448(MG) (Bankr. S.D.N.Y. Oct. 23, 2007), he granted a renewed motion to appoint a trustee, finding that changed circumstances, including the absence of any money to fund a plan, justified the appointment of a trustee.

Assumption/Assignment of Executory Contracts

Lawmakers' efforts to overhaul the nation's bankruptcy laws two years ago as part of the sweeping reforms implemented by 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 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 handed down in 2007 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*, 373 B.R. 135 (Bankr. D.N.M. 2007), 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. The ruling was appealed to a Tenth Circuit bankruptcy appellate panel.

Collective Bargaining Agreements

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 two years. In 2006, the Third Circuit held in *In re Kaiser Aluminum Corp.*, 456 F.3d 328 (3d Cir. 2006), 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.*), 497 F.3d 838 (8th Cir. 2007), 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.

Pursuant to Section 502(g) of the Bankruptcy Code, the rejection of an executory contract under Section 365 generally gives rise to a claim for damages for breach of the contract. Since Section 1113 was added to the statute in 1984, however, there has been confusion in the courts as to whether rejection of a collective bargaining agreement also gives rise to a claim for breach. The legal effect of rejection of a bargaining agreement was the subject of a significant ruling in 2007 by the Second Circuit Court of Appeals. In *In re Northwest Airlines Corp.*, 483 F.3d 160 (2d Cir. 2007), the court ruled that an air carrier-debtor governed by the Railway Labor Act ("RLA") and authorized by the bankruptcy court acting pursuant to Section 1113 to reject its collective bargaining agreement and impose new terms abrogates, rather than breaches, the bargaining agreement, "effectively shielding it from a charge of breach." Based upon the Second Circuit's holding, the New York bankruptcy court subsequently ruled in *In re Northwest Airlines, Inc.*, 366 B.R. 270 (Bankr. S.D.N.Y. 2007), that the applicable union of flight attendants: (i) was subject to a new bargaining agreement as a result of the Section 1113 process; (ii) was precluded from striking by the terms of the RLA; and (iii) had no claim for rejection damages because the existing bargaining agreement had been abrogated rather than rejected.

Reclamation

"Reclamation" is the right under applicable nonbankruptcy law of a seller of goods to recover those goods when it learns that the buyer is insolvent. Section 546(c) of the Bankruptcy Code preserves that right if the buyer files for bankruptcy protection but establishes certain time periods within which the goods must have been provided and by which the seller must make a written reclamation demand. BAPCPA made certain important changes to Section 546(c) designed, among other things, to extend the reclamation demand period and dispel any confusion concerning the relative priorities between a reclaiming seller and a creditor holding a blanket security interest in the goods. The provision was also modified to give ordinary-course sellers the option to receive a priority administrative claim under Section 503(b)(9) for the value of the goods rather than reclaiming them.

A handful of decisions were issued by courts in 2007 construing the new reclamation rules. Among them was *In re Advanced Marketing Services, Inc.*, 360 B.R. 421 (Bankr. D. Del. 2007), in which the bankruptcy court ruled that books supplied by a publisher to a Chapter 11 debtor–book wholesaler were subject to first-priority prepetition and postpetition liens, which, under the express language of amended Section 546(c), were superior to the publisher's reclamation claim. In *In re Dana Corp.*, 367 B.R. 409 (Bankr. S.D.N.Y. 2007), the bankruptcy court held that, pursuant to the prior lien defense stated in Section 546(c), reclamation claims against Chapter 11 debtors were valueless, given that the reclaimed goods or their proceeds were either liquidated in satisfaction of prepetition debt secured by the goods in question or pledged to postpetition lenders as part of a DIP credit facility used to repay prepetition debt. In a related ruling, *In re Dana Corp.*, 2007 WL 1577763 (Bankr. S.D.N.Y. May 30, 2007), the bankruptcy court denied the administrative claim of an ordinary-course seller under Section 503(b)(9) because its claim was filed six months after the administrative bar date.

Good Faith Filing Requirement for Chapter 11 Cases

Two circuit courts of appeal considered in 2007 whether a company seeking Chapter 11 protection for the sole purpose of retaining vital leases did so in good faith. In *In re Capitol Food Corp. of Fields Corner*, 490 F. 3d 21 (1st Cir. 2007), the First Circuit, in a matter of first impression on the issue of Chapter 11's implied good faith filing requirement, declined to decide whether such a requirement exists but concluded that even if it does, a prima facie showing of bad faith could not be met because the debtor articulated several legitimate reasons for the necessity of reorganizing under Chapter 11. In *In re Premier Automotive Services, Inc.*, 492 F.3d 274 (4th Cir. 2007), the Fourth Circuit concluded that the debtor's Chapter 11 filing was objectively futile and therefore undertaken in bad faith. The rulings, which are discussed in more detail elsewhere in this edition of the *Business Restructuring Review*, are emblematic of the broad discretion given to bankruptcy courts in examining whether a debtor's motivation in seeking Chapter 11 protection comports with the purposes and policy of Chapter 11.

From the Top

The U.S. Supreme Court issued two bankruptcy rulings in 2007 and one related to bankruptcy because it involved a Chapter 11 debtor. On February 21, 2007, the Court ruled in *Marrama v. Citizens Bank of Massachusetts*, 127 S. Ct. 1105 (2007), that a debtor who acts in bad faith in connection with filing a Chapter 7 petition may forfeit the right to convert his case to one under Chapter 13. As noted, on March 20, 2007, the Court ruled in *Travelers Casualty & Surety Co. of America v. Pacific Gas & Electric Co.*, 127 S. Ct. 1199 (2007), that the Bankruptcy Code does not prohibit a creditor's contractual claim for attorneys' fees incurred in connection with litigating the validity in bankruptcy of claims based upon the underlying contract. On June 11, 2007, the Court ruled in *Beck v. Pace Intern. Union*, 127 S. Ct. 2310 (2007), that a merger with a multiemployer benefit plan was not a permissible method of terminating a single-employer defined-benefit pension plan under the Employee Retirement Income Security Act of 1974 but was instead an alternative to plan termination, and thus Chapter 11 debtor employers, as the plan administrators, had no fiduciary obligation to consider merging the plans as a termination method rather than by purchasing an annuity.

Looking forward to 2008, the Court granted *certiorari* on December 7, 2007, to review the Eleventh Circuit's ruling in *State of Florida Dept. of Rev. v. Piccadilly Cafeterias, Inc.* (*In re Piccadilly Cafeterias, Inc.*), 484 F.3d 1299 (11th Cir. 2007), *cert. granted*, 2007 WL 2605724 (Dec. 7, 2007), where the Court will consider whether the tax exemption in Section 1146 of the Bankruptcy Code applies to a sale transaction under Section 363(b) of the Bankruptcy Code rather than as part of a confirmed Chapter 11 plan. Argument in the case took place on March 26, 2008.