New York Law Journal
Corporate Update
Thursday, April 24, 2008
ALM

Distressed Mergers & Acquisitions

Unaddressed Issues Scuttle Delphi Bankruptcy Plan

BY CORINNE BALL

After two and one-half years operating as a chapter 11 debtor, Delphi has failed to consummate its plan of reorganization. Its equity investor, Appaloosa, walked away on April 4, 2008. That failure should cause its constituents and other potential investors to retreat to the core distressed M&A inquiries: does Delphi have a reason to continue as a global enterprise and who among its constituents has any interest in its survival? When Delphi entered chapter 11 in early October 2005, General Motors, the UAW, and numerous vendors, among others, were vitally interested in Delphi's continued vitality as a global auto parts supplier. One may question whether that interest remains as strong today.

Throughout its 30-month case, Delphi endured continuing courtroom controversy. Some 15 months ago Delphi entered into the first equity commitment and plan support agreement, which was premised upon the investor participation of several funds, notably Cerberus, Appaloosa and Harbinger.[1] Shortly thereafter, the initial deal was terminated and Delphi substituted another deal in August 2007. The replacement deal was premised upon substantial equity investment funded by participants in the initial deal, notably Appaloosa and Harbinger. A few months later, the August deal was terminated and replaced by a December deal with the same investors, the terms of which again contained material conditions as well as an April 4, 2008 deadline. Thereafter, Delphi successfully convinced the bankruptcy court to confirm a plan premised upon the December deal and a "best efforts" exit financing.

Corinne Ball *is a partner at Jones Day.*

For nearly two years, Delphi pursued a transaction ceding control to an investor group, including Appaloosa and Harbinger. That avenue is ending in litigation: the investor group is claiming its "alternate transaction" or break-up fee,[2] and Delphi seems to be contemplating seeking specific performance.[3] Meanwhile, the transaction contained a limitation on the putative equity investors liability of $250 million for acts or omissions after Dec. 10, 2007. These limitations apply to willful breaches—essentially giving the investors the right to walk away from the deal with capped liability. It is not clear whether this limitation on liability will preclude specific performance as it did in the United Rentals case.[4] What should happen now? What lessons does Delphi's prolonged struggle to emerge from chapter 11 hold for distressed investors?

Background

Delphi filed for chapter 11 relief prior to the occurrence of two significant events: (i) the expiration of Delphi's ability to seek legacy support from its former parent, General Motors[5]; and (ii) the effective date of the amendments to the Bankruptcy Code which, among other things, would have limited Delphi's exclusive period to propose a plan to 18 months.[6] As primary causes of its bankruptcy filing, Delphi cited its unsustainable U.S. legacy liabilities and the operational restrictions arising from collective bargaining agreements with its unionized workforce that prevented Delphi from exiting unprofitable domestic facilities. Delphi also attributed its distress to the general downturn in the automotive industry marked by a sizable decrease in domestic production by its customers, primarily the OEMs, and, predominantly among those, General Motors. Delphi also reported that its revenue generating capacity was further exacerbated by increasing commodity prices at a time when its key-customers were demanding price decreases. Delphi's revenues suffered as a direct result of its inability to be cost competitive. Delphi left no doubt that its competitive problems were closely intertwined with its agreements with both General Motors and Delphi's unions, largely the UAW and the USW.

The early stages of Delphi's chapter 11 reorganization efforts witnessed litigation involving various stakeholders. It commenced a proceeding under section 1113 to

reject its collective bargaining agreements. It sought to reject its customer agreements with General Motors. Its Unsecured Creditors Committee sought authority to pursue Delphi's rights against General Motors regarding historical legacy obligations. Additionally, Delphi unsuccessfully opposed the effort of its shareholders, including Appaloosa, to secure the appointment of an official equity committee. Ironically, although Appaloosa was a major factor in that litigation, it was not appointed to the Delphi Equity Committee.

On the heels of these litigious months, Delphi came forward with the initial deal. The initial deal agreement had immensely detailed provisions regarding plan consideration payable to unsecured creditors totalling 100 percent plus interest, a rights offering to all equity holders, governance and other control rights to accrue to the putative equity investors, as well as break up fees and payment of the putative investors' legal costs. Nonetheless, the deal agreements left open resolution of the very issues that Delphi claimed brought it to bankruptcy, namely Delphi's relationship with General Motors as a customer and former parent, as well as its issues with its unionized workforce. Yet, Delphi and General Motors, with the support of the Unsecured Creditors Committee, agreed that they would continue to pursue resolution of these issues to the reasonable satisfaction of the proposed investors, on an exclusive basis.

Intervening Change

Early in 2007, the initial "commitment" was terminated by Cerberus. Concurrently starting in July and continuing through August, there was widespread turmoil in the credit markets, where investors witnessed large committed financings such as First Data and Chrysler encounter near insurmountable obstacles in syndication. Leverage transactions were becoming scarce. The Federal Reserve Bank began aggressively injecting additional liquidity into the market in levels not seen since the aftermath of Sept. 11, 2001. Nevertheless, certain of the initial investors, including Appaloosa and Harbinger, pursued a substitute transaction which was approved in August of 2007 and apparently took into account the heightening turmoil in the credit markets. The August substitute once again promised creditors a recovery of 100 percent plus interest.[7] Yet, the conditions precedent to the obligations of putative investors remained substantial, although still benefiting from an exclusive deal, or option, to buy control. The August deal was soon terminated by Appaloosa in November of 2007. Delphi now had to overcome two significant hurdles in order to emerge from chapter 11: coming to terms on the equity infusion that funded its plan while simultaneously obtaining a commitment for the exit financing required to successfully emerge from chapter 11. Not surprisingly, the exit financing was dependent on obtaining comfort with the adequacy and certainty of new equity. To further add to the conditionality, Delphi's negotiations with its equity investors largely revolved around its ability to obtain suitable exit financing.

While chapter 11 proceedings of this magnitude are often fraught with litigation, the long-term feasibility of a company may be diminished if its emergence from chapter 11 is premised solely upon victory in a contentious court battle.

The December Plan

On Dec. 10, 2007, Delphi agreed to revive the August deal on more favorable terms to the investors and an increased support level from General Motors. Yet, as observed by the court and other constituents, the conditions precedent to the equity investors' obligations were notable and included a limitation on the interest expense of any exit financing. The increasing distress in the leveraged capital markets meant Delphi could only obtain a "best efforts" exit financing. Delphi sought and obtained confirmation of its plan despite its inability to assure the bankruptcy court or its constituents of its ability to call upon its putative equity investors or otherwise demonstrate its ability to pay its DIP Loan and fund its plan.

December Deal Termination

In a letter dated April 4, 2008, Appaloosa notified Delphi that it was terminating the equity commitment, alleging that Delphi breached certain provisions contained in the equity purchase commitment agreement. Specifically, Appaloosa alleged that Delphi's proposed reemergence equity capitalization failed to adhere to the specifications of the equity commitment and, instead, diluted the equity that would be held by the putative plan investors. Appaloosa further alleged that Delphi's ultimate settlement agreement with GM did not comply with the GM-settlement terms contemplated by its commitment. The termination letter also alleged that the ultimate exit financing obtained by Delphi did not comply with the commitment because Delphi failed to show that its pro forma interest expense during 2008 would not exceed $585 million. On April 5, 2008, Appaloosa sent Delphi an additional letter noting that the lapse of the April 4, 2008 effective date without substantial consummation of the plan of reorganization constituted an additional reason for terminating its commitment. Moreover, Appaloosa and the investor group sought payment of the $82.5 million "alternative transaction" fee and reimbursement of their expenses.

In response, Delphi has stated that it and all other parties required to consummate the plan of reorganization, including General Motors and the lenders on the exit financing, were ready and able to take all steps necessary to consummate the plan of reorganization on April 4, 2008, in full compliance with the equity commitment agreement.

Review of the Situation

In order for a plan of reorganization to be confirmed, a bankruptcy court has an affirmative duty to make a determination that the plan is feasible. Although courts have previously sustained objections to plans that are conditioned on the occurrence of uncertain events, failure to have a committed exit financing may not be fatal to feasibility. Yet, when that failure is combined with highly conditional language in the equity funding commitment, the probability of failure for a plan premised on such tenuous occurrences should be sufficient to undermine its feasibility.

In Delphi's case, the nearly two dozen unsatisfied provisions in the equity funding commitment cited in Appaloosa's termination letters indicate that the highly conditional language of the equity investment agreement would allow its plan investors to escape its commitments for virtually any reason. With the benefit of hindsight, Delphi exemplifies an equity investors' ability to successfully obtain what is essentially an option contract, as opposed to providing committed equity.

Intervening changes in the economy and credit markets cannot be ignored when investment commitments critical to effecting a reorganization plan permit the investors to walk away. While no one condition can be identified as sufficient to block a finding of feasibility, the accumulation of conditions and the concomitant difficulty of satisfying them should have alerted Delphi that its chosen course was so rife with uncertainty as to question its judgment in seeking confirmation. This is particularly true when the capital structure framework is so conditional as to be ephemeral. In assessing the feasibility of a plan of reorganization, courts should ask: "to what extent may equity investors be granted exclusivity when the underlying equity commitments are conditioned upon, but fail to address, the fundamental business problems that prompted the bankruptcy in the first place?"

It may be that Delphi truly seeks success in litigating to compel a reluctant suitor to lead its emergence as a viable and successful tier-one automotive supplier in what is decidedly a challenging market. Circumstances suggest, however, that the controversy focuses on whether the putative investors should receive the "alternative investment" fee or if Delphi should collect the damages for what is alleged as the investors' unexcused failure to close. Delphi is a multi-billion dollar company which has more than 170,000 employees and a controversy of this size is far from determinative of its ability to survive as a competitive participant in the auto industry.

One might even suggest that Delphi's chapter 11 case has been plagued by diversions from achieving, as its primary objective, the turnaround of its business. Agreeing to pay creditors 100 percent plus interest without first resolving the critical customer and labor issues that prompted Delphi's entry into chapter 11 reverses the order of priority. The current controversy does little to advance Delphi's success as a viable tier-one auto supplier. While chapter 11 proceedings of this magnitude are often fraught with litigation, the long-term feasibility of a company may be diminished if its emergence from chapter 11 is premised solely upon victory in a contentious court battle. A debtor should emerge from chapter 11 as a viable enterprise based upon sustainable operations that enable it to compete and thrive. Can Delphi meet this target if it is funded by court compelled, but unwilling investors who have not reached an accord with Delphi's largest customer? Relying on litigation, rather than sound business prospects with investor support, does not bode well for success. While no one would advocate paying unnecessary fees, Delphi's focus seems to stray from where it should be: whether Delphi can be a viable competitor in its industry and what steps further its drive to that objective. It is time for Delphi, rather than relying on hope for better market or credit conditions, to regain its focus and emerge on the strength of Delphi's performance and prospects and turn to making a "real" deal that will close.

1. *In re Delphi Corp.*, No. 05-44481 (RDD) (Bankr. SDNY Jan. 12, 2007).
2. See Letter from A-D Acquisition Holdings Inc. to Delphi Corporation dated April 4, 2008, Ex. 51 to Appaloosa Schedule 13 D/A, filed April 4, 2008.
3. See Form 8-K filed by Delphi Corporation, April 9, 2008.
4. *United Rentals Inc. v. Ram Holdings Inc.*, 937 A.2d 810 (Del. Ch. 2007).
5. See *In re Delphi Corp.*, No. 05-44481 (RDD) Limited Objection of the Official Committee of Unsecured Creditors to Motion for Order Under 11 U.S.C. §363(b) and Fed. R. Bankr. P. 6004 Approving (I) Supplement to UAW Special Attrition Program, and (II) IUE-CWA Special Attrition Program (Bankr. SDNY June 27, 2006).
6. Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA) of 2005, Pub. L. No. 109-8, 119 Stat. 23 (codified as amended in scattered sections of 11 U.S.C.).
7. See *In re Delphi Corp.*, No. 05-44481 (RDD) (Bankr. SDNY Dec. 10, 2007) (Disclosure Statement at DS-xxiv).

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