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**United States: The Year In Bankruptcy: 2008 - Part 1**
27 February 2009
**Article by Mark Douglas**

In last year's edition of "The Year in Bankruptcy," we referred to a "looming specter of recession" in the U.S. near the end of 2007 triggered by the subprime-mortgage meltdown and resulting credit crunch. The recession arrived in 2008. What's more, it proved to be global rather than American. Anyone brave enough to follow the positively depressing financial and economic news stories of 2008 received a crash course on subprime loans, mortgage-backed securities, naked short selling, Ponzi schemes, and the $62 trillion (yes, trillion) global credit default swaps market, as well as frightening insight into the intricacies of executive compensation and the financial condition of U.S. automobile and parts manufacturers, banks, brokerage houses, homebuilders, airlines, and retailers, to name just a few. More than 1 million U.S. homes have been lost to foreclosure since the housing crisis began in August 2007, according to RealtyTrac, an online marketer of foreclosure properties. At year-end, the (nonfarm) unemployment rate in the U.S. spiked to 7.2 percent, the highest since 1992, with 3.6 million U.S. jobs lost in 2008.

A record $7.3 trillion of stock market value was obliterated in 2008, under the Dow Jones Wilshire 5000 index, the broadest measure of U.S. equity performance. Commodity prices both soared and crashed during 2008, spurring outrage directed at unscrupulous speculators accused of driving up prices. The price of light, sweet crude oil peaked at $147 a barrel on July 11 and plummeted to $34 a barrel on December 21. The average price of a gallon of regular unleaded gasoline in the U.S. reached $4.11 on July 17 (the highest ever), only to finish the year at approximately $1.67. The price of copper struck its highest-ever peak March 6 at $4.02 per pound, surpassing the previous record set on May 12, 2006. Globally, food prices continued to soar during 2008. From the beginning of 2006 through the end of 2008, the average world prices for rice, wheat, corn, and soybeans all rose well over 100 percent.

2008 was also the year in the U.S. of the "economic stimulus" package and government bailouts of financial services companies, banks, at least one major insurance company, and the beleaguered U.S. auto industry. On a worldwide basis, relief packages consumed more than $2 trillion in taxpayer assets as of the end of 2008, with little prospect of abating any time soon.

By any account, 2008 was a banner year for commercial bankruptcies and bank and brokerage-house failures; 136 public companies filed for bankruptcy protection, a 74 percent increase from 2007, when there were 78 public-company filings. Private companies, particularly private equity companies, fared equally poorly, with no fewer than 49 leveraged buyout-backed bankruptcies in 2008, according to a January 5, 2009, report posted by peHUB, a web-based public forum for private equity. Hardest hit among private equity-backed companies in 2008 were the automotive and retail sectors (each with eleven chapter 11 filings), airlines (six chapter 11 filings), media properties and consumer products vendors (three chapter 11 filings), and restaurants (two filings). All told, there were 64,318 business bankruptcy filings in calendar year 2008, compared to 28,322 in calendar year 2007, according to figures provided by Jupiter eSources, LLC's Automated Access to Court Electronic Records. In 2008, 10,084 chapter 11 cases were filed, compared to only 6,200 in 2007, representing a 62.6 percent increase. Fiscal-year statistics released by the Administrative Office of the U.S. Courts on December 15 reflect that for the 12-month period from October 1, 2007, through September 30, 2008, there were 38,651 business bankruptcy filings in the U.S., up 49 percent from the business filings reported for the 12-month period ending September 30, 2007. Chapter 11 filings during fiscal year 2008 numbered 8,799, also a 49 percent increase from the previous year.

No fewer than 25 federally insured U.S. banks failed in 2008, pushing the Federal Deposit Insurance Corporation to the wall to cover $373.6 billion in insured deposits by inducing healthier institutions to step in when other banks foundered due to extensive holdings in subprime assets. The Federal National Mortgage Association ("Fannie Mae") and the Federal Home Loan Mortgage Corporation ("Freddie Mac"), which own or guarantee nearly half of the U.S.'s $12 trillion mortgage market and which back nearly $5.2 trillion of debt securities held by investors worldwide, were essentially nationalized by the U.S. government due to liquidity concerns related to the subprime crisis when they were placed into conservatorship by the Federal Housing Finance Agency in 2008. Failures of other U.S. financial giants were averted in 2008 only because the government stepped in with taxpayer dollars to provide emergency assistance. The Federal Reserve was forced to provide $85 billion initially, then up to as much as $153 billion, in "bridge" financing to American International Group ("AIG"), the

largest insurer in the world with $1 trillion in assets, to avoid a cataclysmic bankruptcy brought on by mark-to-market losses from mortgage-related investments and swap exposures that precipitated a liquidity crisis. Investment banks Goldman Sachs Group Inc. and Morgan Stanley agreed to be converted into more tightly regulated depositary institutions in 2008 to avoid the fate of rivals that either collapsed or were taken over and to gain access to part of the $250 billion in capital provided by the U.S. government in 2008 to shore up the U.S. banking system.

No fewer than 25 names were added to the public-company billion-dollar bankruptcy club in 2008 (the most since 2002 and a sixfold increase over 2007), including the two largest bankruptcy filings ever in U.S. history—Lehman Brothers Holdings Inc. and Washington Mutual, Inc.—as well as the 10th-largest bankruptcy filing of all time—IndyMac Bancorp, Inc.

The 10 largest of those bankruptcy filings are discussed in more detail below. Seven of the companies on the Top 10 List for 2008 were involved in the banking or financial services business—all direct casualties of the subprime-mortgage and credit crises.

**Highlights of 2008**

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| January 24 | The National Association of Realtors announces that 2007 experienced the largest drop in existing home sales in 25 years and the first price decline in many years. |
| February 13 | President Bush signs into law an economic stimulus package costing $168 billion, mainly taking the form of income tax rebate checks mailed directly to taxpayers. |
| March 16 | Bear Stearns is acquired by JPMorgan Chase for $1.2 billion in a fire sale transaction backstopped by up to $30 billion in federal financing to cover subprime-mortgage losses. |
| July 11 | IndyMac Bank, the seventh-largest mortgage originator in the U.S., is placed into FDIC receivership by the Office of Thrift Supervision, representing the fourth-largest bank failure in U.S. history. Crude oil prices rise to an all-time high of $147.27 following concern over recent Iranian missile tests. |
| July 17 | The average price of a gallon of regular unleaded gasoline in the U.S. reaches $4.11 (the highest ever). |
| July 30 | President Bush signs into law the Housing and Economic Recovery Act of 2008, which authorizes the Federal Housing Administration to guarantee up to $300 billion in new 30-year fixed-rate mortgages for subprime borrowers if lenders write down principal loan balances to 90 percent of current appraisal value. |
| September 7 | The federal government takes over Fannie Mae and Freddie Mac, which own or guarantee nearly half of the U.S.'s $12 trillion mortgage market and which back nearly $5.2 trillion of debt securities held by investors worldwide. |
| September 14 | Merrill Lynch agrees to be acquired by Bank of America for $50 billion in stock amid fears of a liquidity crisis and Lehman Brothers' collapse. |
| September 15 | Lehman Brothers is forced to file for chapter 11 protection after buyout talks fall through and the federal government refuses to provide a bailout. |
| September 17 | The Federal Reserve loans $85 billion to AIG to avoid bankruptcy in exchange for an 80 percent equity interest and the right to veto dividend payments. |
| September 21 | Investment banks Goldman Sachs and Morgan Stanley agree to be converted into more tightly regulated depositary institutions to avoid the fate of rivals that either collapsed or were taken over in the worst financial crisis to sweep Wall Street since the Great Depression. |
| September 25 | Washington Mutual is seized by the FDIC and its banking assets are sold to JPMorgan Chase for $1.9 billion. |

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| September 29 | The Emergency Economic Stabilization Act of 2008 ("EESA") is defeated 228–205 in the House of Representatives. The FDIC announces that Citigroup Inc. will acquire the banking operations of Wachovia with federal assistance for $2.16 billion in stock and assumption of $53 billion in debt. The Dow Jones average has its worst single-day loss ever, plummeting 770.59 points to finish at 10,372.54. |
| October 1 | The Senate passes its version of the $700 billion bailout bill. |
| October 3 | President Bush signs EESA into law, creating the $700 billion Troubled Assets Relief Program ("TARP") to purchase failing bank assets. The new law eases accounting rules that forced companies to collapse due to toxic mortgage-related investments and is accompanied by the SEC's decision to ease mark-to-market accounting rules that require financial institutions to show the deflated value of assets on their balance sheets. Based on the tax-law changes, Wells Fargo makes a higher offer for Wachovia, ultimately acquiring the bank for $12.7 billion on December 31, 2008. The FDIC temporarily raises the limit on insured deposits from $100,000 to $250,000. |
| October 5 | Bailout packages announced by various governments across the globe reach the $2 trillion mark. |
| October 6 | The Federal Reserve announces that it will provide $900 billion in short-term cash loans to banks. |
| October 7 | The Federal Reserve announces that it will make emergency loans of approximately $1.3 trillion directly to companies outside the financial sector. |
| October 8 | The Federal Reserve reduces the federal funds rate, its emergency lending rate to banks, by half a percentage point to 1.75 percent. |
| October 6 to 10 | Worst week for the U.S. stock market in 75 years. The Dow Jones loses 22.1 percent, its worst week on record, and is down 40.3 percent since reaching a record high of 14,164.53 on October 9, 2007. The Standard & Poor's 500 index loses 18.2 percent, its worst week since 1933, and is down 42.5 percent since its record high on October 9, 2007, of 1,565.15. |
| October 10 | The Dow Jones caps its worst week ever with the highest-volatility day ever recorded in its 112-year history. The G7, a group of central bankers and finance ministers from the Group of Seven leading economies, meets in Washington and agrees to urgent coordinated action to prevent the credit crisis from throwing the world into depression but does not agree on a concrete plan for doing so. |
| October 13 | The Dow Jones industrial average gains 936.42 points, or 11 percent, the largest single-day point gain in the American stock market since the 1930s. |
| October 14 | The U.S. government announces that it will tap into the $700 billion TARP to inject $250 billion of public money into the U.S. banking system. The government will take an equity position in banks that choose to participate in the program. |
| October 21 | The Federal Reserve announces that it will spend $540 billion to purchase short-term debt from money market mutual funds in an effort to unfreeze the credit markets and make it easier for businesses and banks to obtain loans. |
| November 12 | Treasury Secretary Paulson abandons the plan to buy toxic assets under the TARP and announces that the fund's remaining $410 billion would be better utilized to recapitalize financial companies. |
| November 17 | The U.S. Treasury distributes $33.6 billion to 21 banks in the second round of disbursements from the $700 billion bailout fund. |
| November 19 | A Senate hearing on the automotive crisis is convened with the heads of Chrysler, Ford, and General Motors, who explain that they need $25 billion in financial aid to avoid bankruptcy. |
| November 24 | The U.S. government agrees to rescue Citigroup after its stock price plummets 60 percent in |

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| | one week, under a plan that includes injecting another $20 billion of capital into Citigroup, bringing the total infusion to $45 billion. |
| November 25 | The Federal Reserve pledges an additional $800 billion to help revive the financial system, $600 billion of which will be used to buy mortgage bonds issued or guaranteed by Fannie Mae, Freddie Mac, the Government National Mortgage Association ("Ginnie Mae"), and the Federal Home Loan Banks. |
| December 2 | The Big Three automakers submit revised plans to Congress that include more drastic cost-cutting measures and increase their bailout request to $34 billion. Chrysler says it needs $7 billion by the end of the month just to keep running, while GM asks for $4 billion immediately. |
| December 5 | The U.S. Bureau of Labor Statistics releases a report indicating that U.S. employment declined by 1.9 million jobs as of the end of November, with the unemployment rate rising to 6.7 percent. |
| December 10 | The House Financial Services Committee releases a proposed $15 billion bailout package for GM, Ford, and Chrysler that provides for the appointment of a "car czar" to oversee automakers' restructuring efforts and includes restrictions on executive compensation and benefits. |
| December 11 | The proposed auto-bailout package is rejected by the Senate. Bernard Madoff, former chairman of the NASDAQ Stock Market and founder in 1960 of Bernard L. Madoff Investment Securities LLC, is arrested and charged with running a $50 billion Ponzi scheme in what may rank among the biggest fraud cases ever. |
| December 16 | Goldman Sachs Group Inc. reports its first quarterly loss since it went public in 1999, losing $2.29 billion during its fiscal fourth quarter. The Federal Reserve lowers the federal funds rate to between 0 and 0.25 percent, the lowest since July 1954. |
| December 18 | Freddie Mac announces that the average 30-year fixed-mortgage interest rate is officially 5.19 percent, the lowest since it started the Primary Mortgage Market Survey in 1971. |
| December 19 | President Bush announces approval of an auto-bailout plan giving an aggregate $17.4 billion in loans to GM and Chrysler from the TARP, although the U.S. Treasury does not have the authority to direct TARP funds to companies other than financial institutions. The President uses his executive authority to declare that TARP funds may be spent on any program he personally deems necessary to avert the financial crisis. |
| December 21 | Light crude oil trades at $33.87 a barrel, less than one-fourth of the peak price reached in July. |
| December 22 | Automaker Toyota Motor Corp., the world's second-largest automaker, forecasts that it expects to register its first operating loss since World War II, due to the drastic decline in the demand for cars in the U.S. and the rest of the world. |
| December 29 | The U.S. Treasury Department injects $5 billion into GMAC, the automobile financing company, as part of a deal that will permit GMAC to convert itself into a bank holding company to reduce its borrowing costs and borrow money at low rates from the Federal Reserve. |

*The content of this article is intended to provide a general guide to the subject matter. Specialist advice should be sought about your specific circumstances.*

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**Top 10 Bankruptcies of 2008**

Nothing lasts forever, even in bankruptcy. The seemingly assured tenure of former telecommunications giant WorldCom Inc. atop the list of the largest bankruptcy cases ever filed in the U.S. lasted just over six years. The new titan among bankruptcy mega-filings was crowned on September 15, 2008, when 158-year-old international financial services conglomerate Lehman Brothers Holdings Inc. filed for chapter 11 protection in New York. The bankruptcy of Lehman Brothers is (by far) the largest bankruptcy filing in U.S. history, with Lehman holding nearly $700 billion in assets—nearly seven times the assets held by WorldCom when it filed for bankruptcy protection in 2002. Lehman's bankruptcy also represented the largest failure of an investment bank since the collapse of Drexel Burnham Lambert in 1990. Lehman was founded in 1850 and was headquartered in New York, New York, with regional headquarters in London and Tokyo. At the time of the bankruptcy filings, Lehman had more than 25,000 employees worldwide and was the fourth-largest investment bank in the U.S.

Lehman confronted unprecedented losses in 2008 due to the subprime-mortgage crisis that began in mid-2007, principally because it held approximately $4.3 billion in subprime and other lower-rated mortgage-backed securities. After discussions with several potential purchasers (including Bank of America and Barclays PLC) proved to be unsuccessful during the late summer of 2008, Timothy F. Geithner, the president of the Federal Reserve Bank of New York, called a meeting on September 12, 2008, to discuss Lehman's future, including the possibility of an emergency liquidation of the company's assets. By the end of that day, any interest by potential suitors for all or part of Lehman's assets appeared to evaporate, and the federal government refused to offer any assistance in the form of a bailout or loan guaranties, which it had provided in the spring of 2008 to facilitate the acquisition by JPMorgan Chase & Co. of 85-year-old Wall Street icon Bear Stearns Cos., Inc., once the fifth-largest securities firm in the U.S., using up to $30 billion in Federal Reserve emergency financing.

On the day that Lehman filed for bankruptcy, sometimes referred to as "Ugly Monday," the Dow Jones Industrial Average closed down just over 500 points, resulting in the SEC's prohibition of naked short selling and a three-week temporary ban on all short selling of financial stocks. At the time, the decline represented the largest drop by points in a single day since the days following the September 11, 2001, terrorist attacks (it was subsequently eclipsed just two weeks later on "Dark Monday," September 29, when the Dow experienced its largest daily point drop ever (more than 770 points), after Congress failed (albeit temporarily) to approve a $700 billion bailout). Contemporaneous with Lehman's decision to seek bankruptcy protection, another pillar of Wall Street—94-year-old brokerage giant Merrill Lynch & Company Inc. (the largest brokerage firm in the U.S.)—announced that it had agreed to be purchased by Bank of America for just over $50 billion in stock, rather than hazard the risk of being pulled under by the maelstrom of failure that had already swallowed Bear Stearns and Lehman Brothers.

Bankruptcy judge James M. Peck approved an emergency sale of Lehman's investment banking and brokerage operations, including Lehman's 32-story, Midtown Manhattan office tower, to Barclays Capital, Inc., for $1.35 billion in the early hours of September 20, 2008. In connection with the sale, Lehman's brokerage subsidiary, Lehman Brothers Inc., which was not a chapter 11 debtor because it is a registered broker-dealer, agreed to the commencement of a liquidation proceeding against it under the Securities Investor Protection Act of 1970. Judge Peck later approved the sale of Lehman's Asia-Pacific, European, and Middle Eastern operations, which were collectively responsible for more than 50 percent of Lehman's global revenue in 2007, to Nomura Holdings, Inc., Japan's largest brokerage firm, for approximately $2 billion. The full impact of the Lehman bankruptcy on the U.S. and world financial markets, as well as the thousands of companies and individuals who traded with Lehman, remains to be seen. According to some estimates, Lehman's emergency bankruptcy filing wiped out as much as $75 billion of potential value for creditors.

Lehman Brothers is a hard act to follow under any circumstances, but the company that took the second spot on the Top 10 List for public bankruptcy filings in 2008 is nearly as remarkable, even in a year of catastrophic failures. Logging in at No. 2 for 2008 was Washington Mutual, Inc., a savings bank holding company and the former owner of Washington Mutual Bank, which was once the largest savings and loan association in the U.S. (adding yet another ignominious superlative to the

annals of U.S. bankruptcy history). On September 25, 2008, the U.S. Office of Thrift Supervision ("OTS") seized Washington Mutual Bank and placed it into receivership under the auspices of the Federal Deposit Insurance Corporation ("FDIC"), after $16.4 billion in deposits were withdrawn from the bank during a 10-day period. The FDIC immediately sold the banking subsidiaries for $1.9 billion to JPMorgan Chase, which reopened the bank the next day. The holding company, which was left with $33 billion in assets and $8 billion in debt, filed for chapter 11 protection the next day in Delaware.

Washington Mutual's closure (and receivership) is the largest bank failure in U.S. history. It was once the sixth-largest bank in the U.S. According to Washington Mutual, Inc.'s annual report for 2007, as of December 31, 2007, the company held assets valued at $327.9 billion. In its chapter 11 filings, however, Washington Mutual, Inc., listed assets of $33 billion and debt of $8 billion. Washington Mutual Bank operated 2,257 retail banking stores and 233 lending stores and centers in 36 states. It was one of the 25 federally insured banks that were shut down in 2008.

The third-largest public bankruptcy filing of 2008 involved another banking giant, Pasadena, California-based IndyMac Bancorp, Inc., which, until July 11, 2008, was the holding company for hybrid thrift/mortgage bank IndyMac Bank, F.S.B. IndyMac Bank originated mortgages in all 50 states of the U.S. and was the seventh-largest savings and loan company nationwide. On July 11, 2008, citing liquidity concerns, the OTS placed IndyMac Bank into conservatorship with the FDIC. A bridge bank was established to assume control of IndyMac Bank's assets and secured liabilities (such as insured deposit accounts), and the bridge bank was also placed into conservatorship under the FDIC's control. The failure of IndyMac Bank is the seventh-largest bank failure in U.S. history and the second-largest failure of a regulated thrift. Its holding company, IndyMac Bancorp, Inc., filed for chapter 7 on August 1, 2008, in California to liquidate its remaining assets. IndyMac Bancorp reported more than $32 billion in assets in its annual report for 2007, but the holding company listed only between $50 million and $100 million in assets when it filed for chapter 7.

Logging in at No. 4 on the Top 10 List for 2008 was yet another bank holding company, Newport Beach, California-based Downey Financial Corp., which operated as the holding company for Downey Savings and Loan Association, F.A., until November 21, 2008, when federal regulators seized the bank due to its failure to satisfy minimum capital requirements. As of September 30, 2008, Downey Savings and Loan had 170 branches in California and five branches in Arizona. The bank lost $547.7 million in the first nine months of 2008, largely due to extensive holdings in subprime adjustable-rate mortgage loans.

The banking operations of Downey Savings and Loan were immediately sold to U.S. Bank, N.A., in a transaction facilitated by the OTS and the FDIC. The sale transaction also involved the banking subsidiary of PFF Bancorp, Inc. (No. 10 on the Top 10 List for 2008), PFF Bank & Trust, which was also seized by federal regulators on November 21, 2008, after posting losses from subprime-mortgage loans aggregating nearly $290 million through the first three quarters of 2008. Downey Savings and Loan had total assets of $12.8 billion and total deposits of $9.7 billion as of September 30, 2008. On November 25, 2008, Downey Financial Corp. filed a voluntary chapter 7 petition in Delaware to liquidate its remaining assets. Although Downey Financial reported $13.4 billion in assets as of September 30, 2008, the holding company's chapter 7 petition listed only between $10 million and $50 million in assets.

Capturing the No. 5 spot was the first nonbanking or non-financial services company to appear in the Top 10 List for 2008. The Chicago-based Tribune Company, which through its subsidiaries operates as a U.S. media and entertainment company engaged in newspaper publishing, television and radio broadcasting, and entertainment operations, filed for chapter 11 protection in Delaware on December 8, 2008, listing more than $13 billion in assets. The debtor owns the *Chicago Tribune*, *Los Angeles Times*, and *Baltimore Sun* newspapers. Its broadcasting holdings include WPIX in New York, KTLA in Los Angeles, and WGN in Chicago. Other assets include the Chicago Cubs baseball team, Wrigley Field, a share in the Food Network cable channel, and stakes in various online entities. The Cubs and Wrigley Field, both of which are for sale, were not included in the bankruptcy filing. The Tribune Company was a victim of declining revenue, the general economic malaise, and the credit crunch. Its enormous debt load—nearly $13 billion—coupled with an industrywide downturn in advertising and circulation revenue, made it impossible to stave off bankruptcy. Other newspaper publishers are struggling with the same confluence of bad news. The Tribune Company's bankruptcy filing is the largest (ranked by total pre-petition assets) publishing-industry bankruptcy of all time.

The No. 6 spot on the Top 10 List for 2008 belongs to Brea, California-based Fremont General Corporation, a financial services holding company that, through its subsidiary Fremont General Credit Corporation, owned the California bank Fremont Investment & Loan. Fremont Investment & Loan operated 22 branches in California. Founded in 1963 as Lemac Corporation, Fremont General Corporation wrote nonprime and subprime home mortgages nationwide until 2007 and sold the loans into the secondary market, retaining the servicing. It was hit hard by the housing bust and sold its subprime-lending unit to various investors. The company also sold its commercial real estate lending operations to iStar Financial in 2007 and sold the retail deposits and branches of Fremont Investment & Loan to CapitalSource Inc. for approximately $170 million in 2008. Fremont General Corporation filed for chapter 11 protection on June 18, 2008, in California. Although the company reported nearly $12.9 billion in assets in its most recent financial statements, it listed only $643 million in assets and debts exceeding $320 million in its bankruptcy filings.

Seventh place on the list of the largest public bankruptcy filings in 2008 went to Tulsa, Oklahoma-based SemGroup, L.P., a privately held midstream service company with public operating subsidiaries that provide the energy industry with the means to move products from the wellhead to wholesale marketplaces located principally in the U.S., Canada, Mexico, and the

United Kingdom. SemGroup, L.P., filed a chapter 11 petition in Delaware on July 22, 2008, after revealing that its traders, including cofounder Thomas L. Kivisto, were responsible for $2.4 billion in losses on oil futures transactions and the company faced insurmountable liquidity problems. The company listed more than $6.1 billion in assets at the time of its bankruptcy filing. As of 2007, SemGroup, L.P., was the 18th-largest private company in the U.S.

Houston, Texas-based Franklin Bank Corp., a savings and loan holding company that until November 7, 2008, provided community and commercial banking services, including single-family mortgage origination, through its wholly owned subsidiary, Franklin Bank, S.S.B., had the dubious distinction of being No. 8 on the Top 10 List for 2008. Ironically, the company, which was headed by Lewis Ranieri, who helped create the mortgage securities market in the 1980s while at Salomon Brothers Inc., was a victim of the current mortgage crisis, but on the commercial rather than residential side. In addition to its corporate offices in Houston, the company had 38 community banking offices in Texas; seven regional commercial lending offices in Florida, Arizona, Michigan, Pennsylvania, Colorado, California, and Washington, D.C.; and mortgage origination offices in 19 states throughout the U.S. On November 7, 2008, Franklin Bank, S.S.B., was closed by the Texas Department of Savings and Mortgage Lending, and the FDIC was named receiver. The bank's deposits were immediately sold by the FDIC to Prosperity Bank of El Campo, Texas. Franklin Bank, S.S.B., reported total assets of more than $5.5 billion as of September 30, 2008, and total deposits of $3.7 billion. Franklin Bank Corp. filed a chapter 7 petition in Delaware on November 12, 2008, to liquidate its remaining assets.

The penultimate spot on the Top 10 List for 2008 went to Philadelphia-based Luminent Mortgage Capital, Inc., a real estate investment trust investing primarily in both prime- and subprime-mortgage loans and mortgage-backed securities. Luminent, which once invested in billions of dollars of mortgages, including many rated "triple-A," collapsed as investor demand for many fixed-income securities vanished and the company was crippled by liquidity problems as it was forced to sell many assets at a loss to meet margin calls and heavy write-downs. Luminent filed for chapter 11 protection on September 5, 2008, in Maryland, listing just $13.4 million in assets and $486.1 million in debt as of July 31, 2008. The company previously reported more than $4.7 billion in assets.

Securing the final spot on the Top 10 List for public bankruptcy filings in 2008 was Rancho Cucamonga, California-based PFF Bancorp, Inc., the parent company of PFF Bank & Trust, which was seized by federal regulators on November 21, 2008, together with Downey Savings and Loan Association, F.A. (No. 4 on the Top 10 List), after posting losses from subprime-mortgage loans aggregating nearly $290 million through the first three quarters of 2008. The banking operations of PFF Bank & Trust and Downey Savings and Loan were immediately sold to U.S. Bank, N.A., in a transaction facilitated by the OTS and the FDIC. PFF Bank, which had 30 branches in California, had assets of $3.7 billion and deposits of $2.4 billion at the time it was seized by regulators. PFF Bancorp filed for chapter 11 protection on December 5, 2008, in Delaware. At the time of the filing, the holding company listed only between $10 million and $50 million in assets, although it had previously reported more than $4.1 billion in assets in its most recent financial statements.

**Largest Public Bankruptcies of 2008**

| Company | Filing Date | Court | Assets | Industry |
|---|---|---|---|---|
| Lehman Brothers Holdings Inc. | 9/15/08 | S.D.N.Y. | $691 billion | Investment Banking |
| Washington Mutual, Inc. | 9/26/08 | D. Del. | $328 billion | Banking |
| IndyMac Bancorp, Inc. | 7/31/08 | C.D. Cal. | $32.7 billion | Banking |
| Downey Financial Corp. | 11/25/08 | D. Del. | $13.4 billion | Banking |
| The Tribune Company | 12/08/08 | D. Del. | $13 billion | Media/Entertainment |
| Fremont General Corporation | 6/18/08 | C.D. Cal. | $12.9 billion | Financial Services |
| SemGroup, L.P. | 7/22/08 | D. Del. | $6.1 billion | Energy/Transportation |
| Franklin Bank Corp. | 11/12/08 | D. Del. | $5.5 billion | Banking |
| Luminent Mortgage Capital, Inc. | 9/05/08 | D. Md. | $4.7 billion | Real Estate Investment |

| **PFF Bancorp, Inc.** | **12/05/08** | **D. Del.** | **$4.1 billion** | **Banking** |
|---|---|---|---|---|
| Pilgrim's Pride Corporation | 12/01/08 | N.D. Tex. | $3.8 billion | Poultry Production |
| LandAmerica Fin. Group, Inc. | 11/26/08 | E.D. Va. | $3.8 billion | Insurance |
| Circuit City Stores, Inc. | 11/10/08 | E.D. Va. | $3.7 billion | Retail |
| WCI Communities, Inc. | 8/04/08 | D. Del. | $2.9 billion | Home Construction |
| TOUSA, Inc. | 1/29/08 | S.D. Fla. | $2.8 billion | Home Construction |
| VeraSun Energy Corporation | 10/31/08 | D. Del. | $1.8 billion | Energy |
| Linens 'n Things, Inc. | 5/02/08 | D. Del. | $1.7 billion | Retail |
| Tropicana Entertainment, LLC | 5/05/08 | D. Del. | $1.7 billion | Entertainment |
| Quebecor World (USA) Inc. | 1/21/08 | S.D.N.Y. | $1.7 billion | Print Media |
| Hawaiian Telcom Comms., Inc. | 12/01/08 | D. Del. | $1.6 billion | Telecommunications |
| SIRVA, Inc. | 2/05/08 | S.D.N.Y. | $1.4 billion | Transportation |
| Bally Total Fitness Holding Corp. | 12/03/08 | S.D.N.Y. | $1.4 billion | Entertainment |
| Integrity Bancshares, Inc. | 10/10/08 | N.D. Ga. | $1.3 billion | Banking |
| Chesapeake Corporation | 12/29/08 | E.D. Va. | $1.2 billion | Packaging Prods. Mfg. |
| Frontier Airlines Holdings, Inc. | 4/10/08 | S.D.N.Y. | $1 billion | Aviation |

**2008 U.S. Bank Failures**

| **Bank** | **Headquarters** | **Failure Date** |
|---|---|---|
| Sanderson State Bank | Sanderson, Texas | 12/12/08 |
| Haven Trust Bank | Duluth, Georgia | 12/12/08 |
| First Georgia Community Bank | Jackson, Georgia | 12/05/08 |
| PFF Bank & Trust | Pomona, California | 11/21/08 |
| Downey Savings and Loan | Newport Beach, California | 11/21/08 |
| The Community Bank | Loganville, Georgia | 11/21/08 |
| Security Pacific Bank | Los Angeles | 11/07/08 |
| Franklin Bank, S.S.B. | Houston | 11/07/08 |

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|---|---|---|
| Freedom Bank | Bradenton, Florida | 10/31/08 |
| Alpha Bank & Trust | Alpharetta, Georgia | 10/24/08 |
| Meridian Bank | Eldred, Illinois | 10/10/08 |
| Main Street Bank | Northville, Michigan | 10/10/08 |
| Washington Mutual Bank | Henderson, Nevada, and Park City, Utah | 9/25/08 |
| Ameribank | Northfork, West Virginia | 9/19/08 |
| Silver State Bank | Henderson, Nevada | 9/05/08 |
| Integrity Bank | Alpharetta, Georgia | 8/29/08 |
| The Columbian Bank and Trust | Topeka, Kansas | 8/22/08 |
| First Priority Bank | Bradenton, Florida | 8/01/08 |
| First Heritage Bank, N.A. | Newport Beach, California | 7/25/08 |
| First National Bank of Nevada | Reno, Nevada | 7/25/08 |
| IndyMac Bank | Pasadena, California | 7/11/08 |
| First Integrity Bank, NA | Staples, Minnesota | 5/30/08 |
| ANB Financial, NA | Bentonville, Arkansas | 5/09/08 |
| Hume Bank | Hume, Missouri | 3/07/08 |
| Douglass National Bank | Kansas City, Missouri | 1/25/08 |

**Municipal Bankruptcies**

Even though chapter 9 of the Bankruptcy Code has been in effect for more than 30 years, fewer than 200 chapter 9 cases have been filed during that time. Municipal bankruptcy cases—or, more accurately, cases involving the adjustment of a municipality's debts—are a rarity, compared to reorganization cases under chapter 11. The infrequency of chapter 9 filings can be attributed to a number of factors, including the reluctance of municipalities to resort to bankruptcy protection due to its associated stigma and negative impact, perceived or otherwise, on a municipality's future ability to raise capital in the debt markets. Also, chapter 9's insolvency requirement, which exists nowhere else in the Bankruptcy Code, appears to discourage municipal bankruptcy filings.

As the enduring fallout from the subprime-mortgage disaster and the commercial credit crunch that it precipitated continue to paint a grim picture for the U.S. economy, municipalities are suffering from a host of troubles. Among them are skyrocketing mortgage-foreclosure rates and a resulting loss of tax base, bad investments in derivatives, and the higher cost of borrowing due to the meltdown of the bond mortgage industry and the demise (temporary or not) of the $330 billion market for auction-rate securities, which municipalities have relied upon for nearly two decades to float inexpensive debt in the $2.7 trillion U.S. market for state, county, and city debt. According to the National Conference of State Legislatures, states project a $97 billion shortfall over the next two years. This confluence of financial woes is likely to propel an increasing number of municipalities to the brink of insolvency and beyond. This may mean a significant uptick in the volume of chapter 9 filings.

The present-day legislative scheme for municipal debt reorganizations was implemented in the aftermath of New York City's financial crisis and federal government bailout in 1975, but chapter 9 has proved to be of limited utility thus far. Only a handful of cities or counties have filed for chapter 9 protection. The vast majority of chapter 9 filings involve municipal instrumentalities, such as irrigation districts, public utility districts, waste-removal districts, and health-care or hospital districts. In fact, according to the Administrative Office of the U.S. Courts, fewer than 500 municipal bankruptcy petitions have been filed in the more than 60 years since Congress established a federal mechanism for the resolution of municipal debts. Until 2008, Bridgeport, Connecticut (pop. 138,000), was the only large city even to have attempted a chapter 9 filing, but its effort to use chapter 9 in 1991 to reorganize its debts failed because it did not meet the insolvency requirement. In 1999, mid-sized Camden, New Jersey (pop. 87,000), and Prichard, Alabama (pop. 28,000), also filed for chapter 9. Camden's stay in chapter 9 ended abruptly when the State of New Jersey took over the failing city in 2000. Prichard confirmed its chapter 9 plan in October 2000. More recently, the City of Vallejo, California (pop. 117,000), filed a chapter 9 petition on May 23, 2008,

claiming that it lacked sufficient cash to pay its bills after negotiations with labor unions failed to win salary concessions from firefighters and police. The San Francisco suburb became the largest city in California to file for bankruptcy and the first local government in the state to seek protection from creditors because it ran out of money amid the worst housing slump in the U.S. in more than a quarter century. Orange County, California (pop. 2.8 million), is the other prominent municipality to have taken the plunge. Having filed the largest chapter 9 case in U.S. history and confirmed a plan in 1995, Orange County stands alone as the only large municipal debtor to have navigated chapter 9.

Even so, the only alternative to chapter 9 is restructuring by the municipality under applicable state law, which may be difficult and require voter approval. The ability under chapter 9 to bind dissenting creditors without obtaining voter approval may make that option preferable. Thus, as the financial problems of municipalities continue to mount, there may be a significant surge in chapter 9 filings. To be sure, chapter 9's utility in dealing with some of these problems may be limited. For example, to the extent that a municipality's questionable investments include securities, forward or commodities contracts, or swap, repurchase, or master netting agreements, bankruptcy (and the automatic stay) will not prevent the contract parties from exercising their rights. Also, although a chapter 9 debtor can restructure its existing debt, new long-term borrowing is unlikely to be obtained at any favorable rate of interest. Still, the suspension of creditor collection efforts and the prospect of restructuring existing debt may mean that chapter 9 is the most viable strategy for many beleaguered municipalities.

**Stockbroker Bankruptcies**

By almost every estimate, the fallout from the subprime-mortgage/investment disaster and resulting credit calamity has proved to be worse than anticipated, numbering among its casualties more than 100 mortgage lenders, 25 federally insured banks and, in the span of only six months, no fewer than three of the top five brokerage firms in the U.S.: Bear Stearns Cos., Inc.; Lehman Brothers Holdings Inc.; and Merrill Lynch & Co. Bear Stearns was acquired by JPMorgan Chase in March 2008 for $1.2 billion in a fire sale transaction backstopped by up to $30 billion in federal financing to cover possible subprime-mortgage losses. Lehman Brothers was forced into bankruptcy on September 15, 2008, after talks with potential acquirers fell through and the federal government refused to provide any assistance in the form of a bailout. Fearing the same fate, Merrill Lynch agreed on September 14, 2008, to be acquired by Bank of America for $50 billion.

As the affairs of Bear Stearns, Lehman Brothers, and Merrill Lynch unraveled at lightning speed, there was a good deal of speculation that all of them might seek bankruptcy protection. Only Lehman Brothers ultimately did so, but its brokerage subsidiary did not file for bankruptcy. Moreover, although Bear Stearns and Merrill Lynch were global investment banking firms, a significant percentage of their businesses involved brokerage services. To the extent that any of their respective business entities are considered "stockbrokers" (defined generally to include any securities broker), those entities would be ineligible for relief under chapter 11 of the Bankruptcy Code. As a result, the alternative would be liquidation under either chapter 7 or the Securities Investor Protection Act of 1970 ("SIPA").

The Bankruptcy Code precludes relief to a securities broker under any chapter other than chapter 7. Recourse to chapter 11 is precluded because the complexities of chapter 11 are incompatible with the narrow purpose for which the special stockbroker liquidation provisions in chapter 7 were designed—the protection of customers. Notable attempts have been mounted to circumvent that proscription, but with limited success. For example, Drexel Burnham Lambert Group Inc. filed for chapter 11 protection in 1990, but only after selling its brokerage operations, which were ultimately liquidated. Commodities broker Refco Inc. filed for chapter 11 in 2005, notwithstanding a similar ban on commodity-broker chapter 11 filings, contending that it should be permitted access to chapter 11 because its substantial brokerage activities were carried out by an offshore vehicle. The bankruptcy court ruled otherwise, and the Refco affiliate that was a registered commodities broker was liquidated in chapter 7 while Refco's remaining operations and assets were ultimately liquidated in chapter 11. Lehman Brothers' brokerage subsidiary, Lehman Brothers Inc., did not file for chapter 11 protection along with its parent. Instead, in connection with Lehman's sale of its investment banking and brokerage operations to Barclays Capital, Inc., Lehman Brothers Inc. assented to the commencement of a liquidation proceeding against it under SIPA.

Thus, few options are available to stock or commodity brokers intent upon obtaining a breathing spell while they attempt to sort out financial problems brought on by the subprime disaster. More likely than not, escalating liabilities will propel many brokers toward either SIPA or chapter 7, both of which are geared toward protecting customers rather than creditors.

**Notable Exits From Bankruptcy in 2008**

Irvine, California-based New Century Financial Corp., once the second-biggest subprime-mortgage lender in the U.S., ended its 16-month stint in bankruptcy on August 1, 2008, after a Delaware bankruptcy court confirmed New Century's liquidating chapter 11 plan on July 15. During its heyday as a mortgage-originating behemoth, New Century had 35 regional operating centers located in 18 states and originated and purchased loans through its network of 47,000 mortgage brokers, in addition to operating a central retail telemarketing unit, two regional processing centers, and 222 sales offices. New Century wrote nearly $51.6 billion in mortgages in 2006 and once employed more than 7,200 people. Its chapter 11 filing on April 2, 2007, was the largest public bankruptcy filing in 2007, involving more than $26 billion in assets.

Troy, Michigan-based Delphi Corporation, once America's biggest auto-parts maker, obtained confirmation of a chapter 11

plan on January 25, 2008, but struggled throughout 2008 to secure exit financing or capital (including Delphi's inability to close on a $2.55 billion investment from private equity fund Appaloosa Management) and has yet to emerge from bankruptcy more than a year after confirmation. Delphi filed for bankruptcy on October 8, 2005, in New York, listing $17 billion in assets and $22 billion in debt, including an $11 billion underfunded pension liability. While in bankruptcy, Delphi radically contracted its manufacturing presence in the U.S., with thousands of Delphi workers taking buyouts financed by General Motors Corp., which spun off Delphi a decade ago, and the closure or sale of plants that made low-tech products like door latches and brake systems. Delphi also negotiated lower wages with its remaining American workers. As a consequence, Delphi's U.S. operations have become a small adjunct to its international businesses. At the end of 2007, only 28,000 of Delphi's 169,000 employees worked in the U.S.

Auto-parts manufacturer Dana Corporation was able to secure $2 billion in exit financing en route to emerging from bankruptcy as Dana Holding Corporation on February 1, 2008, after obtaining confirmation of its chapter 11 plan on December 26, 2007. The Toledo, Ohio-based company filed for chapter 11 protection in New York on March 3, 2006, listing $7.9 billion in assets and $6.8 billion in debt.

Delta Financial Corp., the Woodbury, New York-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, obtained confirmation of a liquidating chapter 11 plan on December 12, 2008. When it filed for bankruptcy, the company listed more than $6.5 billion in assets.

Georgia-based NetBank Inc., a pioneer of internet banking 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, announced shortly after filing for chapter 11 that it planned to liquidate its assets. It obtained confirmation of a liquidating chapter 11 plan on September 12, 2008. NetBank listed approximately $4.8 billion in assets at the time of its bankruptcy filing and was the fifth-largest public bankruptcy filing of 2007.

A Delaware bankruptcy court confirmed a chapter 11 plan on November 24, 2008, for Sea Containers Ltd., the London- and Bermuda-based shipping and railroad company, after the company was able to reach a crucial settlement regarding funding of its two U.K.-based pension funds. Blaming higher fuel prices and fallout from the July 2005 London terrorist bombings, the company filed for chapter 11 protection on October 15, 2006, after failing to make a scheduled $115 million debt payment. Sea Containers had nearly $2.75 billion in assets at the time of its bankruptcy filing and was the second-largest public bankruptcy filing of 2006.

Rochester Hills, Michigan-based components supplier Dura Automotive Systems Inc. finally emerged from bankruptcy on June 27, 2008, after obtaining confirmation of a chapter 11 plan on May 13, 2008. Dura had hoped to exit chapter 11 before the end of 2007, but credit market instability undermined its efforts to obtain acceptable exit financing. Dura filed for chapter 11 protection in Delaware on October 30, 2006, blaming an accelerating deterioration of the North American automotive industry, including escalating raw-materials costs. Dura's filing was the third-largest in 2006, with the company listing more than $2 billion in assets.

Interstate Bakeries Corp. ("IBC"), the Kansas City, Missouri-based maker of Hostess Twinkies and Wonder Bread, obtained confirmation of a chapter 11 plan on December 5, 2008, after more than four years in bankruptcy, leaving completion of an exit financing deal and investment as the only impediments to the company's emergence from bankruptcy. IBC filed for chapter 11 protection in September 2004 in Missouri in an effort to restructure $1.3 billion in debt. Under the plan, Ripplewood Holdings LLC will provide a $130 million equity investment, and IBC will fund its exit from bankruptcy with a $125 million senior secured revolving credit facility led by GE Capital Corp. and a $339 million first-lien term loan from Silver Point Finance LLC and Monarch Alternative Capital LP.

Global relocation services provider SIRVA, Inc., better known as Allied Van Lines Inc. and North American Van Lines Inc., obtained confirmation of its pre-packaged chapter 11 plan and emerged from bankruptcy on May 12, 2008, as a privately owned company just over three months after it filed for chapter 11 protection on February 5, 2008, in New York. The company reported more than $1.4 billion in assets prior to filing for bankruptcy.

Dothan, Alabama-based Movie Gallery, Inc., the nation's No. 2 video rental chain, emerged from bankruptcy on May 20, 2008, after a Virginia bankruptcy court confirmed a chapter 11 plan involving a debt-for-equity swap and cancellation of the company's existing common stock. Movie Gallery filed for chapter 11 protection on October 16, 2007, with approximately $1.4 billion in assets, after months of struggling with debt from its purchase of rival Hollywood Entertainment Corp. for $1 billion in 2005. Its filing was the sixth-largest public bankruptcy case of 2007.

*The content of this article is intended to provide a general guide to the subject matter. Specialist advice should be sought about your specific circumstances.*

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**United States: The Year In Bankruptcy: 2008 - Part 3**
27 February 2009
**Article by Mark Douglas**

**Where Do We Go From Here?**

The prognosis for 2009 is unclear, but given trends firmly established in 2008, yet another surge in corporate bankruptcies is likely, as companies across all sectors react to the global economic crisis. Companies in the automotive and retail industries top the list of markets impaired by the credit crunch and constriction of consumer spending, supplanting the homebuilding sector, which was generally regarded among industry professionals and watchdogs as the most troubled industry for 2008 but falls to third for 2009. U.S. retailers are especially vulnerable, given a lackluster 2008 holiday shopping season that prompted retailers to slash 66,000 jobs in December, the worst year for U.S. retail employees since 1939, and what would appear to be an enduring retrenchment in consumer spending. Other industries that are not likely to fare well due to the unavailability of credit and a decrease in discretionary spending include the media, entertainment, and restaurant sectors. Commercial real estate is also likely to be hard hit, due to escalating vacancy rates and the resulting difficulties in meeting debt service demands.

The fundamental strategy of commercial bankruptcies may also change in 2009, given the enduring difficulties in lining up debtor-in-possession ("DIP") and exit financing (DIP loans dropped from $7.9 billion in the second quarter of 2008 to $2.9 billion in the fourth quarter, according to statistics published by the Deal Pipeline) and the more abbreviated "drop dead" dates built into the Bankruptcy Code for the debtor's exclusive right to propose and solicit acceptances for a chapter 11 plan and to assume or reject unexpired leases of nonresidential real property. This means that more companies may resort to bankruptcy protection in 2009 to effect an orderly liquidation, rather than to reorganize, or to effect expeditious cash-generating asset sales under section 363 of the Bankruptcy Code. This year may also see a greater volume of "pre-packaged" chapter 11 cases, a trend that began in late 2005 after the new deadlines were implemented.

**Legislative Developments**

**Supreme Court Approves Changes to Bankruptcy Rules**

On April 23, 2008, the U.S. Supreme Court approved and forwarded to Congress amendments to the Federal Rules of Bankruptcy Procedure. The amendments generally reflect interim rules already adopted to implement the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. The amended rules took effect on December 1, 2008.

Among the rule changes affecting large business bankruptcy cases are the following:

> Rule 1007 continues to require debtors to file a variety of lists, schedules, statements, and other documents. The amendments require any chapter 15 petition filed on behalf of a foreign debtor to be accompanied by a list of entities with which the debtor has been engaged in litigation in the U.S.
>
> Amended Rule 1010 requires service of a summons and a chapter 15 petition (voluntary or involuntary) on a debtor with respect to which recognition of a foreign nonmain chapter 15 proceeding is sought, as well as any entity against which the foreign debtor's representative is seeking provisional or additional relief. The rule also requires each corporate petitioner in an involuntary chapter 15 case to file a corporate-ownership disclosure statement.
>
> Rule 1011 as amended provides that the debtor named in an involuntary chapter 11 petition, or a party in interest to a petition for recognition of a foreign proceeding, may contest the petition. It further provides that in the case of an involuntary chapter 15 petition against a partnership, a nonpetitioning general partner, or a person who is alleged to be a general partner but denies the allegation, may contest the petition. The rule also now includes a requirement that any corporation responding to an involuntary or voluntary chapter 11 petition must file a corporate-ownership

disclosure statement.

New Rule 1021 establishes procedures for designating a debtor as a health-care business.

Amendments to Rule 2002 require the bankruptcy court to provide notice to a foreign debtor and to entities against which relief is sought of a hearing on a petition for recognition of a foreign proceeding under chapter 15.

New Rule 2007.2 implements the requirement in section 333 of the Bankruptcy Code that a patient-care ombudsman be appointed in the first 30 days of any health-care business bankruptcy case unless the court finds it is not necessary for the protection of patients. The rule also establishes procedures for a party in interest to seek or object to the appointment of an ombudsman.

Amended Rule 2015 requires a foreign representative in a chapter 15 case to file notice of a change in status in the foreign proceeding or in the representative's appointment.

New Rule 2015.1 governs reports issued by a patient-care ombudsman and the protection of patient privacy when the ombudsman requests access to patient records.

New Rule 2015.2 authorizes and prescribes procedures for the relocation of patients when a health-care business is being closed.

New Rule 2015.3 requires a chapter 11 debtor-in-possession or trustee to file periodic reports of the value and profitability of any entity in which the debtor has a substantial or controlling interest.

Amended Rule 3002 provides that the bankruptcy court may extend the time for a creditor with a foreign address to file a proof of claim in a chapter 9 or chapter 11 case.

**New Bankruptcy Rules to Implement Chapter 15**

The Judicial Conference of the United States Committee on Rules of Practice and Procedure released for public comment a preliminary draft of the latest proposed amendments to the Federal Rules of Bankruptcy Procedure. Many of the proposed amendments would implement chapter 15, which was added to the Bankruptcy Code in 2005 as part of the Bankruptcy Abuse Prevention and Consumer Protection Act. Chapter 15 establishes a framework of rules governing cross-border bankruptcy and insolvency cases patterned on the Model Law on Cross-Border Insolvency formulated by the United Nations Commission on International Trade Law in 1997.

The rule changes have been proposed by the various advisory committees to the Judicial Conference's Rules Committee. The Rules Committee has not yet approved the proposed amendments, other than authorizing their publication for comment. After considering the public comments, the Advisory Committee on Bankruptcy Rules will determine whether to submit the proposed amendments to the Rules Committee for approval. Any proposals approved by the Rules Committee will then go to the Judicial Conference, and afterward to the U.S. Supreme Court, for approval. Comments on the draft proposed amendments were due February 17, 2009. Approved amendments would become effective at the earliest on December 1, 2010.

**Changes to Italian Bankruptcy Law**

After a number of unsuccessful attempts, Italy managed to enact comprehensive reforms of its bankruptcy laws in 2005 and 2006. Among other things, the new legislation: (a) redefined the basic focus of bankruptcy proceedings toward satisfaction of creditor claims and away from penalizing debtors for their inability to pay their debts; (b) expanded the role and scope of creditors' committees; (c) allowed for the continuation of a debtor's business operations during a bankruptcy proceeding; (d) introduced the concept of a discharge from indebtedness for individual debtors; and (e) simplified the procedures for liquidating a debtor's assets and distributing the proceeds among creditors.

These enactments were complemented on September 12, 2007, by the Italian government's approval of Legislative Decree No. 169 (the "Corrective Decree"). Effective January 1, 2008, the Corrective Decree further amended Italy's bankruptcy laws to provide for more effective and efficient procedures governing the liquidation and/or reorganization of distressed companies. Notably, the Corrective Decree introduced more flexible pre-insolvency procedures, including the possibility for arrangements between debtors and creditors similar in substance to "pre-packaged" reorganizations under U.S. bankruptcy law.

**Australia Adopts Model Law on Cross-Border Insolvency**

Australia's Federal Parliament enacted the Cross-Border Insolvency Act of 2008, which elevates to domestic law the United Nations Commission on International Trade Law's Model Law on Cross-Border Insolvency (the "Model Law"), a framework of principles designed to coordinate cross-border bankruptcy and insolvency cases that has now been adopted in one form or another by 15 nations or territories. The U.S. adopted the Model Law in 2005 when it enacted chapter 15 of the Bankruptcy Code as part of the Bankruptcy Abuse Prevention and Consumer Protection Act.

**Notable Business Bankruptcy Decisions of 2008**

**Allowance/Disallowance/Priority of Claims**

Section 502(d) of the Bankruptcy Code provides that "any claim" asserted by the recipient of an avoidable transfer shall be disallowed unless and until the transferee returns the property to the estate. In *In re Plastech Engineered Products, Inc.*, 394 B.R. 147 (Bankr. E.D. Mich. 2008), a Michigan bankruptcy court ruled that section 502(d) applies only to pre-petition claims, and not administrative claims asserted under section 503(b)(9), which confers administrative priority upon claims asserted by vendors for the value of goods received by the debtor within 20 days of filing for bankruptcy.

Such "20-day claims" were the subject of another ruling handed down in 2008 in the same bankruptcy case. In *In re Plastech Engineered Products, Inc.*, 397 B.R. 828 (Bankr. E.D. Mich. 2008), the bankruptcy court examined the meaning of "goods" in section 503(b)(9). It ruled that vendors may provide both goods and services to a debtor, but only the value of goods is entitled to section 503(b)(9) priority, and natural gas sold to a debtor pre-bankruptcy, which qualifies as goods, is not deprived of section 503(b)(9) priority merely because the utility that provided it has rights and remedies under section 366 (giving utilities the right to discontinue service to a debtor absent adequate assurance of payment).

Equitable subordination, a common-law remedy codified in section 510(c) of the Bankruptcy Code that permits a court to reorder the relative priority of claims to redress creditor misconduct, was the subject of a ruling handed down by the Seventh Circuit Court of Appeals in 2008. In *In re Kreisler*, 546 F.3d 863 (7th Cir. 2008), the court reversed a lower court ruling equitably subordinating secured claims held by a corporation formed by the debtors for the purpose of acquiring the claims, ruling that even if the debtors' actions amounted to misconduct, the other creditors of the estate were not harmed in any way.

The Employee Retirement Income Security Act of 1974, as amended by the Multiemployer Pension Plan Amendments Act, imposes withdrawal liability on participating employers that withdraw from a multi-employer defined-benefit pension plan insured by the Pension Benefit Guaranty Corporation. In *United Mine Workers of Amer. v. Lexington Coal Co., LLC (In re HNRC Dissolution Co.)*, 396 B.R. 461 (Bankr. 6th Cir. 2008), a bankruptcy appellate panel for the Sixth Circuit was asked to determine the priority of withdrawal liability claims against debtor-employers that withdrew from a multi-employer pension plan two years after filing for chapter 11 protection. The court ruled that such claims lacked the causal relationship to the work performed by the debtors' employees necessary for the claims to be treated as an administrative expense. According to the court, unlike other cases that have applied the narrow exception stated in *Reading Co. v. Brown*, 391 U.S. 471 (1968), the withdrawal liability claim did not stem from tortious or deliberate misconduct by the debtors.

The priority in bankruptcy of claims for damages under the Worker Adjustment and Retraining Notification ("WARN") Act was the subject of a ruling handed down in 2008 by a Delaware bankruptcy court. In *In re Powermate Holding Corp.*, 394 B.R. 765 (Bankr. D. Del. 2008), the court held that WARN Act damage claims asserted by the employees of chapter 11 debtors accrued in their entirety at the moment the employees were terminated without notice (which occurred shortly before their employers filed for chapter 11 relief) so that the WARN Act claims were pre-petition claims entitled not to second-level priority as administrative expenses, but only to fourth- and fifth-level priority as wage claims, to the extent that they did not exceed the statutory cap on such claims, and to general unsecured status to the extent that they did exceed the cap. According to the court, it did not matter that the 60-day period over which WARN Act damages were calculated extended after the petition date.

**Automatic Stay**

The enforceability of pre-petition agreements to modify the automatic stay by a debtor that later files for bankruptcy has been the subject of long-standing debate, with many courts finding that such agreements are invalid due to the countervailing interests of the estate and other stakeholders involved, unless made during the course of a previous chapter 11 case. A Florida bankruptcy court had an opportunity to address this issue in 2008. In *In re Bryan Road, LLC*, 382 B.R. 844 (Bankr. S.D. Fla. 2008), the court ruled enforceable a stay relief provision in a pre-petition forbearance agreement pursuant to which the debtor, in exchange for the mortgagee's agreement to reschedule the foreclosure sale to give the debtor time to refinance the debt, agreed, on the advice of experienced counsel, to waive the protections of the automatic stay if it later filed for bankruptcy relief. According to the court, factors that should be considered in deciding whether to grant stay relief based on a pre-petition waiver of the stay's protections include: (i) the sophistication of the debtor waiving the stay; (ii) the consideration that the debtor received for the waiver, including the creditor's risk and the length of time covered by the waiver; (iii) whether other parties are affected, including unsecured creditors and junior lienholders; and (iv) the feasibility of the debtor's reorganization plan.

**Avoidance Actions**

The appropriate test for determining a company's solvency in connection with litigation later commenced in a bankruptcy case to avoid a pre-bankruptcy transfer that is allegedly preferential or fraudulent is the subject of considerable debate in the bankruptcy courts. Several courts had an opportunity to address this issue in 2008. For example, in *In re American Classic Voyages Co.*, 384 B.R. 62 (D. Del. 2008), a Delaware district court held that a bankruptcy court properly relied on a discounted cash flow analysis to evaluate the solvency of chapter 11 debtors on the date of a transfer challenged as preferential, given that the data and analysis were consistent with available marketplace data.

Valuation is a critical and indispensable part of the bankruptcy process. How collateral and other estate assets (and even creditor claims) are valued will determine a wide range of issues, from a secured creditor's right to adequate protection, post-petition interest, or relief from the automatic stay to a proposed chapter 11 plan's satisfaction of the "best interests" test or whether a "cram-down" plan can be confirmed despite the objections of dissenting creditors.

When assets are valued may be just as important as the method employed to assign value. In the context of preference litigation, for example, whether collateral is valued as of the bankruptcy petition date or at the time pre-bankruptcy that a debtor made allegedly preferential payments to a secured creditor can be the determinative factor in establishing or warding off avoidance liability. This controversial valuation issue was the subject of a ruling handed down in 2008 by an Eighth Circuit bankruptcy appellate panel in *Falcon Creditor Trust v. First Insurance Funding (In re Falcon Products, Inc.)*, 381 B.R. 543 (Bankr. 8th Cir. 2008). Taking sides on an issue that has produced a rift among bankruptcy and appellate courts, the bankruptcy appellate panel ruled that in assessing whether a defendant in preference litigation received more as a consequence of pre-bankruptcy payments than it would have been paid in a chapter 7 liquidation, the creditor's collateral must be valued as of the bankruptcy petition date rather than the date of the payments.

In a matter of apparent first impression in the federal circuit courts of appeal, the Ninth Circuit ruled in *Aalfs v. Wirum (In re Straightline Investments, Inc.)*, 525 F.3d 870 (9th Cir. 2008), that although "diminution of the estate" is required to support an avoidance recovery under sections 547 or 548 of the Bankruptcy Code, which involve preferential and fraudulent pre-petition transfers, no such requirement exists with respect to liability under section 549, which provides for the avoidance of unauthorized post-petition transfers. Thus, the Ninth Circuit held, a transferee who purchased receivables from an estate outside the ordinary course of business was not entitled to defend against a section 549 suit, based upon the fact that he paid the estate more than the receivables were worth.

A number of rulings handed down in 2008 addressed the "earmarking" doctrine, a judicially created, equitable exception to a bankruptcy trustee's power to avoid preferential and unauthorized transfers, under which a payment that a debtor makes to an existing creditor using funds loaned to the debtor by a new creditor for the express purpose of paying the pre-existing debt is not avoidable as preference because it does not involve the "transfer of an interest of the debtor in property." For example, in *Caillouet v. First Bank and Trust (In re Entringer Bakeries, Inc.)*, 548 F.3d 344 (5th Cir. 2008), the Fifth Circuit Court of Appeals ruled that the doctrine did not apply to prevent a chapter 7 trustee from avoiding as a preference a pre-petition payment that the debtor made from the proceeds of a long-term loan to a lender that had previously provided the debtor with a short-term "bridge" loan, where the long-term loan was not conditioned upon payoff of the "bridge" loan and where, prior to challenged payment, the proceeds of the long-term loan were deposited into a general operating account over which the debtor had complete control and which could be used for any purpose. In *Chase Manhattan Mortgage Corp v. Shapiro (In re Lee)*, 530 F.3d 458 (6th Cir. 2008), the Sixth Circuit Court of Appeals ruled that a creditor that refinanced a debtor's mortgage was not a new creditor and thus could not invoke the earmarking doctrine to avoid preference liability with respect to a late-perfected refinanced mortgage. A Sixth Circuit bankruptcy appellate panel subsequently followed *Lee* in *Baker v. Mortgage Electronic Registration Systems, Inc. (In re King)*, 397 B.R. 544 (Bankr. 6th Cir. 2008), ruling that a mortgage-refinancing transaction involving two separate lenders was not protected from avoidance under the earmarking doctrine because the new mortgagee failed to perfect its mortgage within the grace period specified in section 547(e).

In *Betty's Homes, Inc. v. Cooper Homes, Inc. (In re Betty's Homes, Inc.)*, 393 B.R. 671 (Bankr. W.D. Ark. 2008), the bankruptcy court held that the earmarking doctrine did not apply to prevent a chapter 11 debtor-contractor from avoiding as a preference a $200,000 payment that the debtor made to one of its suppliers by drawing down on its secured construction loan from a bank in order to obtain a cashier's check in the supplier's name because, although an agreement existed between the debtor and the bank for payment of the debtor's antecedent obligation to the supplier, the transaction, viewed as a whole, resulted in diminution of the estate by substituting a secured debt to the bank for the debtor's unsecured debt to the supplier. In *In re Velazquez*, 397 B.R. 231 (Bankr. D. Puerto Rico 2008), the bankruptcy court ruled that a bank mortgagee of property that was sold by a chapter 7 debtor pre-petition could not rely on the earmarking doctrine to prevent the chapter 7 trustee from avoiding as a preference the mortgagee's subsequent attachment of a bank account into which the debtor had deposited the sales proceeds, where, among other things, the debtor did not receive the proceeds as a mere conduit but exercised dominion and control over the funds. Finally, in *Parks v. FIA Card Services, N.A. (In re Marshall)*, 2008 WL 5401418 (10th Cir. Dec. 30, 2008), the Tenth Circuit became the first federal circuit court of appeals to rule that using one credit card to pay off another within 90 days of a bankruptcy filing is an avoidable preferential transfer to the bank that was paid off.

**Bankruptcy Court Powers/Jurisdiction**

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. As illustrated by a ruling handed down in 2008 by the Fifth Circuit Court of Appeals, however, purported creditor misconduct in and of itself does not warrant subordination of a claim. In *Wooley v. Faulkner (In re SI Restructuring, Inc.)*, 532 F.3d 355 (5th Cir. 2008), the Fifth Circuit reversed an order equitably subordinating secured claims for the repayment of "eleventh hour" insider financing provided to the debtors to stave off bankruptcy, holding that subordination was inappropriate, given the lack of evidence that other creditors were injured in any way as a consequence of the insider creditors' alleged misconduct.

Section 303 of the Bankruptcy Code spells out the requirements for filing an involuntary bankruptcy case. Whether those requirements are jurisdictional in nature, such that they cannot be waived and may be raised at any time during a bankruptcy case, was an issue addressed by the Eleventh Circuit Court of Appeals three times in 2008, albeit all in the same bankruptcy case. In *In re Trusted Net Media Holdings, LLC*, 525 F.3d 1095 (11th Cir. 2008), a panel of the court of appeals, concluding it was bound by a previous ruling handed down by the Court of Appeals for the Fifth Circuit, from which the Eleventh Circuit was formed in 1980, ruled, contrary to the weight of authority and what it considered sound judgment, that section 303's requirements are jurisdictional and cannot be waived. The Eleventh Circuit reconsidered its stance on the issue less than two months later in *In re Trusted Net Media Holdings, LLC*, 530 F.3d 1363 (11th Cir. 2008), vacating its ruling and agreeing to rehear the matter *en banc* in the fall of 2008. On rehearing *en banc*, the court of appeals did an about-face on the issue. In *In re Trusted Net Media Holdings, LLC*, 550 F.3d 1035 (11th Cir. 2008), the Eleventh Circuit, observing that a court of appeals "sitting en banc is not bound by prior decisions of a panel of this Court or its predecessor," ruled that the Bankruptcy Code's involuntary filing requirements are not jurisdictional and that a debtor that failed to object to an involuntary bankruptcy petition on the grounds of lack of subject matter jurisdiction due to noncompliance with section 303(b) until two years after the involuntary petition date waived the right to raise the defense. The *Trusted Net* rulings are discussed in more detail elsewhere in this edition of the *Business Restructuring Review*.

The constructive trust, an equitable remedy designed to prevent unjust enrichment, is the vestige of a U.S. legal system that originally comprised separate courts of law and equity. Its vitality in the bankruptcy context is unclear, fueling an enduring debate that has evolved during the 30 years since the Bankruptcy Code was enacted in 1978 to polarize and confuse courts and practitioners alike on the question. A ruling handed down in 2008 by the Second Circuit Court of Appeals indicates that the controversy is far from over. In *Ades and Berg Group Investors v. Breeden (In re Ades and Berg Group Investors)*, 550 F.3d 240 (2d Cir. 2008), the court of appeals affirmed a decision below refusing to impose a constructive trust on proceeds from a settlement of reinsurance claims that were paid to a chapter 11 debtor. According to the Second Circuit, "retention by the bankruptcy estate of assets that, absent bankruptcy, would go to a particular creditor is not inherently unjust."

**Chapter 11 Plans**

The solicitation of creditor votes on a plan is a crucial part of the chapter 11 process, yet the Bankruptcy Code does not provide a mechanism to force creditors to vote, nor does it clearly spell out the consequences of not voting where none of the creditors or interest holders in a given class has voted to accept or reject a chapter 11 plan. The lack of any clear guidance on this important issue has spawned a rift in the courts. In *In re Vita Corp.*, 380 B.R. 525 (C.D. Ill. 2008), an Illinois district court addressed the ramifications of a creditor class's failure to vote in its entirety, ruling that classes in which all impaired creditors fail to cast ballots either accepting or rejecting a plan are not deemed to have accepted the plan for purposes of confirmation.

For decades now, debtors in chapter 11 have proposed in their chapter 11 plans "third-party releases," whereby creditors are deemed to have released certain nondebtor parties (such as officers, directors, or affiliates of the debtor) upon the confirmation and effectiveness of the plan. For an equally long period, such third-party releases have engendered controversy in the courts and elsewhere as to when, if ever, such releases are appropriate. Over the years, the issue has been considered by several courts of appeals, with somewhat differing results. Until recently, the Second Circuit Court of Appeals was widely thought to be one of the most favorable jurisdictions to debtors on the issue of the propriety of third-party releases in a chapter 11 plan.

In February 2008, however, the Second Circuit struck down a third-party release in the long-running Johns-Manville Corporation chapter 11 case, *In re Johns-Manville Corp.*, 517 F.3d 52 (2d Cir. 2008), and in so doing potentially signaled a shift in that Circuit's position on the issue. Not long after, in March 2008, the Seventh Circuit Court of Appeals issued its own opinion on third-party releases in the case of *In re Airadigm Communications, Inc.*, 519 F.3d 640 (7th Cir. 2008). In approving the third-party release in that case, the Seventh Circuit now may be viewed as a relatively favorable jurisdiction for debtors on the issue. As such, the Circuit split on third-party releases continues, but perhaps not for long. The U.S. Supreme Court granted certiorari in the *Manville* case on December 12, 2008.

In addressing asbestos liabilities, whether in bankruptcy or otherwise, disputes between the company and its insurers are common, if not inevitable. In *In re Federal-Mogul Global Inc.*, 385 B.R. 560 (Bankr. D. Del. 2008), a Delaware bankruptcy court was tasked with resolving a dispute between the debtor and its insurers. The issue was whether assignment of asbestos insurance policies to an asbestos trust established under section 524(g) of the Bankruptcy Code is valid and enforceable against the insurers, notwithstanding anti-assignment provisions in (or incorporated in) the policies and applicable state law. Despite a Ninth Circuit ruling that could be interpreted to support the insurers' position, *Pac. Gas & Elec. Co. v. California ex rel. California Dept. of Toxic Substances Control*, 350 F.3d 932 (9th Cir. 2003), the bankruptcy court held

that assignment of the insurance policies was proper because the Bankruptcy Code preempts any contrary contractual or state-law anti-assignment provisions.

**Claims/Debt Trading**

Participants in the multibillion-dollar market for distressed claims and securities had ample reason to keep a watchful eye on developments in the bankruptcy courts during each of the last three years. Controversial rulings handed down in 2005 and 2006 by the bankruptcy court overseeing the chapter 11 cases of failed energy broker Enron Corporation and its affiliates had traders scrambling for cover due to the potential that acquired claims/debt could be equitably subordinated or even disallowed, based upon the seller's misconduct. Although the severity of the cautionary tale writ large in the bankruptcy court's Enron decisions was ultimately ameliorated on appeal in the late summer of 2007, the 20-month ordeal (and the uncertainty it spawned) left a bad taste in the mouths of market participants.

2008 proved to be little better in providing traders with any degree of comfort with respect to claim or debt assignments involving bankrupt obligors. In *In re M. Fabrikant & Sons, Inc.*, 385 B.R. 87 (Bankr. S.D.N.Y. 2008), a New York bankruptcy court took a hard look for the first time at the standard transfer forms and definitions contained in nearly every bank loan transfer agreement, ruling that a seller's reimbursement rights were transferred along with the debt. The ruling indicates that the rights assigned to a buyer using the standard transfer forms are broad and include both contingent (and even post-petition) claims. The decision also fortifies the conventional wisdom that transfer documents should be drafted carefully to spell out explicitly which rights, claims, and interests are not included in the sale.

**Corporate Fiduciaries**

The strictures of the fiduciary duties of loyalty and care in a distressed scenario were the subject of a ruling handed down by a Delaware bankruptcy court in *In re Bridgeport Holdings, Inc.*, 388 B.R. 548 (Bankr. D. Del. 2008), where the court considered a motion to dismiss litigation commenced by a liquidating trust against a chapter 11 debtor's former directors, officers, and restructuring professional asserting claims for breach of fiduciary duty and lack of good faith. The bankruptcy court ruled that the complaint alleged facts sufficient to support a claim of breach of duty of loyalty by detailing the directors' conscious disregard of their duties to the corporation by abdicating all responsibility to the hired restructuring professional and then failing to adequately monitor the restructuring professional's execution of his own sell strategy, which, according to the court, resulted in an abbreviated and uninformed sale process and the ultimate sale of assets for grossly inadequate consideration.

**Corporate Governance**

Principles of corporate governance that determine how a company functions outside of bankruptcy are transformed and in some cases abrogated once the company files for chapter 11 protection, when the debtor's board and management act as a DIP that bears fiduciary obligations to the chapter 11 estate and all stakeholders involved in the bankruptcy case. As illustrated by a ruling handed down in 2008 by the Delaware Chancery Court, however, certain aspects of corporate governance are unaffected by a bankruptcy filing. In *Fogel v. U.S. Energy Systems, Inc.*, 2008 WL 151857 (Del. Ch. Jan. 15, 2008), the court held that the automatic stay did not preclude it from directing a chapter 11 debtor to hold a meeting of the corporation's shareholders in the absence of any showing that the call for a meeting amounted to "clear abuse."

**Creditor Rights**

An oversecured creditor's right to interest, fees, and related charges as part of its allowed secured claim in a bankruptcy case is well established in U.S. bankruptcy law. Less clear, however, is whether that entitlement encompasses interest at the default rate specified in the underlying contract between the creditor and the debtor. The answer to that question can be a thorny issue in chapter 11 cases because the Bankruptcy Code provides that a chapter 11 plan may cure and reinstate most defaulted obligations, and courts disagree as to whether the power to cure defaults nullifies all consequences of default, including the obligation to pay default interest. The Ninth Circuit Court of Appeals had an opportunity in 2008 to examine the interplay between these seemingly incongruous provisions of the Bankruptcy Code. In *General Elec. Capital Corp. v. Future Media Productions, Inc.*, 536 F.3d 969 (9th Cir. 2008), the court reversed a bankruptcy court order disallowing default interest and costs as part of the claim of a secured creditor whose collateral was sold by the debtor outside of a chapter 11 plan, ruling that the court erred by applying the Bankruptcy Code's plan-confirmation provisions in a situation where cure and reinstatement of the secured creditor's debt were neither contemplated nor possible.

The ability of stakeholders to participate in the plan-confirmation process, either by voting to accept or reject a chapter 11 plan or by articulating their concerns regarding the terms of a proposed plan as part of a confirmation hearing, is arguably the most important right given to creditors and interest holders. As demonstrated by a ruling handed down in 2008 by a New York bankruptcy court, however, a stakeholder can forfeit its right to seek certain kinds of relief following confirmation of a chapter 11 plan if it refuses to participate fully in the confirmation process. In *In re Calpine Corp.*, 2008 WL 207841 (Bankr. S.D.N.Y. Jan. 24, 2008), the bankruptcy court denied a request made by certain shareholders for a stay pending their appeal of an

order confirming a chapter 11 plan because even though the shareholders had voted against the plan, they chose not to participate in any other way in the confirmation process.

As a general rule, absent an express agreement to the contrary, expenses associated with administering the bankruptcy estate, including pledged assets, are not chargeable to a secured creditor's collateral or claim but must be paid out of the estate's unencumbered assets. Section 506(c) of the Bankruptcy Code creates an exception to this rule, providing that a DIP or trustee "may recover from property securing an allowed secured claim the reasonable, necessary costs and expenses of preserving, or disposing of, such property to the extent of any benefit to the holder of such claim, including the payment of all *ad valorem* property taxes with respect to the property."

As noted, secured creditors may expressly consent to payment of certain costs and expenses of administering a bankruptcy estate from their collateral. Such administrative "carve-outs" are common in chapter 11 cases involving a debtor with assets that are fully or substantially encumbered by the liens of pre-bankruptcy lenders. As part of a post-petition financing or cash collateral agreement, a pre-bankruptcy lender may agree that a specified portion of its collateral can be used to pay administrative claims.

The quid pro quo for an administrative carve-out in a post-petition financing or cash collateral agreement, however, is commonly waiver of the ability to surcharge under section 506(c). Because the total amount of administrative costs incurred in connection with a chapter 11 case is difficult to predict at the outset of the bankruptcy, a carve-out accompanied by a surcharge waiver must be negotiated carefully to ensure as nearly as possible that there will be adequate funds available to meet anticipated administrative expenses. A ruling handed down in 2008 by the Ninth Circuit Court of Appeals illustrates what can happen when a carve-out later proves to be inadequate to satisfy costs in a chapter 11 case bordering on administrative insolvency. The court of appeals held in *Weinstein, Eisen & Weiss v. Gill (In re Cooper Commons LLC)*, 512 F.3d 533 (9th Cir. 2008), that professional fees and expenses incurred by a DIP could not be paid from the DIP lender's collateral because the DIP waived its right to seek a section 506(c) surcharge and, unlike the subsequently appointed bankruptcy trustee, failed to negotiate an adequate carve-out in connection with the financing.

A creditor's ability in a bankruptcy case to exercise rights that it has under applicable law to set off an obligation it owes to the debtor against amounts owed by the debtor to it, thereby converting its unsecured claim to a secured claim to the extent of the setoff, is an important entitlement. Setoff rights are generally preserved in a bankruptcy case under section 553 of the Bankruptcy Code. The provision, however, does not create a setoff right, but provides merely that the Bankruptcy Code shall not "affect" setoff rights that exist under applicable nonbankruptcy law as of the bankruptcy petition date. A Delaware bankruptcy court had an opportunity in 2008 to consider whether a claim arising from the rejection in bankruptcy of a pre-petition contract, which the Bankruptcy Code designates a pre-petition claim, can be set off against the nondebtor contract party's pre-petition obligation to the debtor. In *CDI Trust v. U.S. Elec., Inc. (In re Commun. Dynamics, Inc.)*, 382 B.R. 219 (Bankr. D. Del. 2008), the court ruled that the setoff was appropriate, adopting the majority view on the issue and repudiating a competing (and widely criticized) approach taken by a New York bankruptcy court in its 2006 ruling in *In re Delta Airlines, Inc.*, 341 B.R. 439 (Bankr. S.D.N.Y. 2006).

Since the Sarbanes-Oxley reforms were implemented in 2002, the heightened accountability of corporate fiduciaries has made restatements of public-company SEC filings and indictments of corporate fiduciaries routine fodder for business and financial headlines. The financially devastating and sometimes criminal consequences of such revisionism for the companies and their fiduciaries have been highly visible. Less attention, however, has been devoted to the impact that forensic accounting may have on the company's obligations to its creditors. A New York district court had an opportunity in 2008 to examine this issue. In *Bank of Nova Scotia v. Adelphia Communications Corp. (In re Adelphia Communications Corp.)*, 2008 WL 3919198 (S.D.N.Y. Aug. 22, 2008), the district court reversed a bankruptcy court order excluding from the allowed amount of a secured claim "grid" interest to which the lenders would have been entitled under their loan agreement had the debtors provided them with accurate financial information.

The Bankruptcy Code generally preserves the rights of vendors under applicable nonbankruptcy law to reclaim goods sold to an insolvent buyer, providing in most cases that a reclaiming seller that makes a timely demand is entitled to either the goods or equivalent compensation such as an administrative claim. Even though the statute was amended in 2005 to clarify that reclamation rights are subordinate to the rights of any creditor asserting a security interest in the goods, a number of unsettled issues endure concerning the impact of a bankruptcy filing on reclamation rights. One such issue—whether sale of the goods during a chapter 11 case to satisfy a DIP lender's claims effectively extinguishes the seller's reclamation right—was the subject of a ruling handed down by the Sixth Circuit Court of Appeals in 2008. In *Phar-Mor, Inc. v. McKesson Corp.*, 534 F.3d 502 (6th Cir. 2008), the court ruled that disposition of goods to satisfy a DIP lender's claims did not extinguish a pre-petition vendor's valid reclamation right.

A secured creditor's right to "credit-bid" its claim in a proposed sale of the underlying collateral free and clear of interests under section 363(f) of the Bankruptcy Code was the subject of a significant ruling in 2008 by a bankruptcy appellate panel from the Ninth Circuit. In *Clear Channel Outdoor, Inc. v. Knupfer (In re PW, LLC)*, 391 B.R. 25 (Bankr. 9th Cir. 2008), the court ruled that section 363(f)(5) of the Bankruptcy Code does not allow a senior secured creditor to credit-bid its claim and, by doing so, wipe out the junior secured creditor's interest. Adopting an extremely narrow view of when section 363(f) applies, the panel concluded that the debtor must establish that there is some form of legal or equitable proceeding in which the junior

lienholder could be compelled to take less than the value of the claim secured by the lien. The court also held that section 363(m), which makes approved sale transactions irreversible unless the party objecting obtains a stay pending appeal, does not apply to lien stripping under 363(f).

A creditor's right to due process in the bankruptcy context was addressed by the First Circuit Court of Appeals in *Arch Wireless, Inc. v. Nationwide Paging, Inc. (In re Arch Wireless, Inc.)*, 534 F.3d 76 (1st Cir. 2008), where the court affirmed the bankruptcy court's denial of a chapter 11 debtor's motion for an order holding in contempt a creditor that sued the debtor post-confirmation to collect on a pre-petition claim, because the creditor did not receive proper notice of the chapter 11 proceedings. According to the First Circuit, the creditor was a "known creditor," and a known creditor's general awareness of a pending chapter 11 reorganization proceeding is insufficient to satisfy the requirements of due process and render a discharge injunction applicable to the creditor's claims.

**Cross-Border Bankruptcy Cases**

The failed bid of liquidators for two hedge funds affiliated with defunct investment firm Bear Stearns Cos., Inc., to obtain recognition of the funds' Cayman Islands winding-up proceedings under chapter 15 of the Bankruptcy Code was featured prominently in business headlines during the late summer and fall of 2007. News of the July 2007 filings fueled speculation that offshore investment funds, of which it is estimated that approximately 75 percent are registered in the western Caribbean, would potentially utilize chapter 15 of the Bankruptcy Code to thwart creditor action or litigation in the U.S. while attempting to wind up their affairs in non-U.S. jurisdictions perceived to be more management-friendly.

In a pair of decisions issued on August 30, 2007 (and later amended on September 5), bankruptcy judge Burton R. Lifland denied recognition of the Cayman proceedings as either "main" or "nonmain" foreign proceedings under chapter 15. In *In re Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd. (In Provisional Liquidation)*, 374 B.R. 122 (Bankr. S.D.N.Y. 2007), Judge Lifland ruled that the funds, whose operations, assets, managers, clients, and creditors were not located in the Caymans, failed to prove either that their "center of main interests" was located in the Caymans or that they even maintained an "establishment" there. The judge did so despite the absence of any objection to the liquidators' petitions for recognition under chapter 15. His rulings sent a clear message that U.S. bankruptcy courts interpreting the newly minted chapter 15 will not rubber-stamp requests designed to take advantage of the broad range of relief available under the statute to assist qualifying bankruptcy and insolvency proceedings commenced abroad.

The decision was decidedly unwelcome news for a great number of offshore hedge funds and other investment vehicles scrambling to sort out financial woes precipitated by the subprime-mortgage crisis. Even so, trepidation in the hedge fund community over the hard-line approach adopted in Bear Stearns was ameliorated somewhat by the prospect that the ruling might be overturned during the appellate process, which the liquidators began in earnest in September 2007. The appellate process at the district court level ended on May 22, 2008. In *In re Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd.*, 389 B.R. 325 (S.D.N.Y. 2008), U.S. district court judge Robert W. Sweet affirmed Judge Lifland's rulings in all respects.

A further significant development in the evolution of chapter 15 jurisprudence was contributed in 2008 by Judge Robert E. Gerber of the U.S. Bankruptcy Court for the Southern District of New York. In *In re Basis Yield Alpha Fund (Master)*, 381 B.R. 37 (Bankr. S.D.N.Y. 2008), Judge Gerber denied a request by the court-appointed liquidators of a Cayman Islands-registered hedge fund for summary judgment on their petition seeking recognition of the fund's Cayman Islands liquidation proceeding as a "foreign main proceeding" because the liquidators declined to submit any evidence to support their allegations that the company's "center of main interests" was located in the Cayman Islands. The ruling demonstrates that U.S. bankruptcy courts will not rubber-stamp recognition requests that pay lip service to the strictures of chapter 15 without fulfilling the substantive requirements of the statute.

Another ruling handed down in 2008 illustrates that U.S. bankruptcy courts can and will look to the purpose behind chapter 15 to ensure a result that is consistent with the goals chapter 15 is trying to advance for foreign debtors here in the U.S. as well as U.S. debtors that may be the subject of cross-border proceedings outside the U.S. In *In re Oversight and Control Commission of Avanzit, S.A.*, 385 B.R. 525 (Bankr. S.D.N.Y. 2008), the court ruled that a "suspension proceeding" commenced by a telecommunications company in a Spanish court, pursuant to which creditor collection activity against the company was stayed while the company attempted to work out a repayment agreement with its creditors, qualified as a "foreign proceeding" under chapter 15, even after the repayment agreement was approved by the Spanish court, as the debtor was still subject to court supervision and could be forced into a liquidation proceeding if it failed to comply with the terms of the repayment agreement.

**Executory Contracts and Unexpired Leases**

The ability of a DIP or bankruptcy trustee to assume or reject unexpired leases or contracts that are "executory" as of the bankruptcy filing date is one of the most important entitlements created by the Bankruptcy Code. It allows a DIP to rid itself of onerous contracts and to preserve contracts that can either benefit its reorganized business or be assigned to generate value for the bankruptcy estate and/or fund distributions to creditors under a chapter 11 plan. The fundamental importance of

affording the DIP or trustee adequate time to decide whether a given contract should be assumed or rejected, even when the attendant delay and uncertainty may subject nondebtor contracting parties to considerable prejudice, is deeply rooted in the fabric of U.S. bankruptcy jurisprudence.

As demonstrated by a ruling issued in 2008 by the Second Circuit Court of Appeals, courts only rarely find that the right to assume or reject can be compromised or abridged under circumstances not expressly spelled out in the Bankruptcy Code. In *COR Route 5 Co. v. The Penn Traffic Co. (In re The Penn Traffic Co.)*, 524 F.3d 373 (2d Cir. 2008), the court of appeals held that post-petition completion of performance by a nondebtor party to a contract that was executory as of the chapter 11 petition date cannot strip the DIP of the right to assume or reject the contract.

Courts rarely prevent a debtor from assuming or rejecting an unexpired lease if the debtor has demonstrated a sound business reason for the decision. A ruling issued in 2008 by a Delaware bankruptcy court, however, indicates that a debtor's discretion to assume or reject its unexpired leases may not exist in situations where an individual lease is part of a master agreement. In *In re Buffets Holdings, Inc.*, 387 B.R. 115 (Bankr. D. Del. 2008), the court prevented the debtors from assuming or rejecting the individual leases contained under master agreements, forcing the debtor to determine whether to assume or reject the master agreement as a whole, rather than each agreement on an individual basis.

The Bankruptcy Code requires current payment of a debtor's post-petition obligations under a lease of nonresidential real property pending the decision to assume or reject the lease. However, if a debtor fails to pay rent due at the beginning of a month and files for bankruptcy protection sometime after the rent payment date—thereby creating "stub rent" during the period from the petition date to the next scheduled rent payment date—it is unclear how the landlord's claim for stub rent should be treated. Two notable decisions issued in 2008 addressed this controversial issue. In *In re Goody's Family Clothing, Inc.*, 392 B.R. 604 (Bankr. D. Del. 2008), a Delaware bankruptcy court ruled that even if section 365(d)(3) of the Bankruptcy Code does not require immediate payment of stub rent claims, such claims may nevertheless be entitled to administrative priority whether or not the lease is later assumed. In *In re Stone Barn Manhattan LLC*, 398 B.R. 359 (Bankr. S.D.N.Y. 2008), a New York bankruptcy court ruled that section 365(d)(3) requires payment of stub rent, but recognizing that the "proration" approach has been rejected by three circuit courts and a number of intermediary appellate courts, the court stayed its decision so that the parties would have an opportunity to appeal the ruling immediately to the Second Circuit Court of Appeals, which has not yet considered the issue. These rulings are discussed in more detail elsewhere in this edition of the *Business Restructuring Review*.

**Financial Contracts**

The 2005 amendments to the Bankruptcy Code included provisions designed to clarify, expand, and augment the Bankruptcy Code's treatment of financial transactions, including securities, commodities, and forward contracts; repurchase agreements; swap agreements; and master netting agreements. In a case of first impression regarding application of the Bankruptcy Code's amended financial and securities contract "safe harbor" provisions to a mortgage loan repurchase agreement, a Delaware bankruptcy court ruled in *Calyon, New York Branch v. Amer. Home Mortgage Corp. (In re Amer. Home Mortgage, Inc.)*, 379 B.R. 503 (Bankr. D. Del. 2008), that under the plain meaning of section 101(47) of the Bankruptcy Code, a contract for the sale and repurchase of mortgage loans is a "repurchase agreement" under the statute. The court also held that the "safe harbor" provisions of sections 555 and 559 of the Bankruptcy Code applied to exclude from the reach of the automatic stay the counterparty bank's exercise of its rights under the contract, except for that portion of the contract providing for the servicing of the mortgage loans, which was neither a "repurchase agreement" nor a "securities contract" under the Bankruptcy Code. The bankruptcy court revisited the issue in *In re American Home Mortgage Holdings, Inc.*, 388 B.R. 69 (Bankr. D. Del. 2008), ruling that: (i) subordinated notes qualified as "interests in mortgage related securities" under section 559 of the Bankruptcy Code, even though the notes did not receive one of the two highest credit ratings from either of the two nationally recognized credit-rating companies, because the notes were secured by mortgage loans; and (ii) the counterparty to the subordinated note transaction with the debtor was a "stockbroker" and did not violate the automatic stay when it foreclosed on or liquidated the subordinated notes pursuant to the repurchase agreement's *ipso facto* clause. The major role played by credit default swaps and other financial derivatives in the prevailing economic crisis portends increased litigation in U.S. bankruptcy courts in 2009 and beyond regarding the impact of a bankruptcy filing on the rights of contract counterparties under the Bankruptcy Code's financial contract provisions.

**Good-Faith Filing Requirement**

For the third time in as many years, the Delaware Chancery Court handed down an important ruling in 2008 interpreting the interaction between federal bankruptcy law and Delaware corporate law. The thorny question this time was whether a bankruptcy court's determination that the directors of a corporation acted in good faith when they authorized a chapter 11 filing precluded a subsequent claim that the directors breached their fiduciary duties by doing so. The Delaware Chancery Court concluded that it did, ruling in *Nelson v. Emerson*, 2008 WL 1961150 (Del. Ch. May 6, 2008), that a minority shareholder's claims for breach of fiduciary duty must be dismissed because a bankruptcy court's finding that a chapter 11 filing was not made in bad faith "precludes a finding that the Company's directors violated their fiduciary duties by filing for bankruptcy."

**Pension Plans**

Under the Employee Retirement Income Security Act of 1974, as amended by the Deficit Reduction Act of 2005 and the Pension Protection Act of 2006, and regulations implemented by the Pension Benefit Guaranty Corporation ("PBGC"), a premium must be paid to PBGC annually for three years after termination of an insured pension plan for certain distress and involuntary plan terminations, including terminations that take place during a chapter 11 case. The premiums, which amount to $1,250 per employee (except for certain airline-related plans), could aggregate hundreds of millions of dollars in post-petition liabilities for debtors, limiting significantly the benefits of terminating an underfunded pension plan in chapter 11.

In a matter of first impression, a New York bankruptcy court held in *Oneida Ltd. v. Pension Benefit Guaranty Corp. (In re Oneida Ltd.)*, 383 B.R. 29 (Bankr. S.D.N.Y. 2008), that the termination premiums assessed against a chapter 11 debtor as a result of the distress termination of its pension plan during its chapter 11 case were pre-petition claims that were discharged when the bankruptcy court confirmed the debtor's chapter 11 plan. According to the court, Congress did not intend to amend the Bankruptcy Code to create a new class of nondischargeable debt, as such a provision would give states and private parties an avenue to circumvent the Bankruptcy Code's priority scheme. The ruling has broad-ranging implications for all chapter 11 debtors, including troubled industries, such as the automotive, airline, home construction, and retail sectors, that are burdened with unsustainable "legacy" costs associated with pension obligations.

**Standing**

A bankruptcy trustee or DIP is entrusted in the first instance with prosecuting avoidance claims and other causes of action that are part of a debtor's estate when it files for bankruptcy protection. However, in some cases, a trustee or DIP is either unwilling or unable (due, for example, to a lack of funds) to pursue such actions. Although the Bankruptcy Code does not unambiguously create a mechanism for conferring "standing" to prosecute estate claims on someone other than a trustee or DIP, the majority of courts recognize the concept of "derivative standing." The Eighth Circuit Court of Appeals had an opportunity in 2008 to reconsider the legitimacy of derivative standing, but under circumstances that it had never previously encountered. In *PW Enterprises, Inc. v. North Dakota Racing Commission (In re Racing Services, Inc.)*, 540 F.3d 892 (8th Cir. 2008), the court of appeals ruled that derivative standing may be appropriate if a trustee or DIP consents to, or does not oppose, the prosecution of estate claims by a creditor or committee, and the doctrine is not limited to situations involving a trustee's inability or unwillingness to prosecute such claims.

The Second Circuit added yet another chapter to the evolution of the doctrine of derivative standing in 2008. In *Official Committee of Equity Security Holders of Adelphia Comm. Corp. v. Official Committee of Unsecured Creditors of Adelphia Comm. Corp. (In re Adelphia Comm. Corp.)*, 544 F.3d 420 (2d Cir. 2008), the court of appeals affirmed a district court ruling dismissing an official equity committee's challenge of an order confirming Adelphia's chapter 11 plan. The equity committee challenged the plan-confirmation order on the grounds that the bankruptcy court lacked the power to transfer derivative claims that the committee had been authorized to prosecute to a litigation trust established under the plan, the proceeds of which would benefit unsecured creditors. According to the Second Circuit, a court "may withdraw a committee's derivative standing and transfer the management of its claims, even in the absence of that committee's consent, if the court concludes that such a transfer is in the best interests of the bankruptcy estate."

Standing to challenge a chapter 11 plan was the subject of a New York bankruptcy court's ruling in *In re Quigley Co., Inc.*, 391 B.R. 695 (Bankr. S.D.N.Y. 2008), where the court held that although section 1109(b) of the Bankruptcy Code appears to give stakeholders a broad right to participate in a chapter 11 case, including the right to object to confirmation of a plan, a party in interest cannot challenge portions of a chapter 11 plan that do not affect its direct interests. Thus, the court ruled, the insurers in a case involving asbestos liabilities could object to a provision in the plan that would assign the debtor's policy rights, and to trust distribution procedures as they affected the debtor's duty to cooperate with the insurers, but could not object to the plan based upon how it affected the rights of third parties, even if those objections might provide a basis for denying confirmation.

**From the Top**

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.*, mortgage recordation) qualify for the tax exemption have been a focal point of vigorous dispute in bankruptcy and appellate courts for more than a quarter century, resulting in a split on the issue among the federal circuit courts of appeal and, finally, the U.S. Supreme Court's decision late in 2007 to consider the question.

The Supreme Court resolved that conflict decisively when it handed down its long-awaited ruling on June 16, 2008. The missive, however, is decidedly unwelcome news for any chapter 11 debtor whose reorganization strategy includes a significant volume of pre-confirmation asset divestitures under section 363(b) of the Bankruptcy Code. The 7–2 majority of the Court ruled in *State of Florida Dept. of Rev. v. Piccadilly Cafeterias, Inc. (In re Piccadilly Cafeterias, Inc.)*, 128 S. Ct. 2326 (2008), that section 1146(a) of the Bankruptcy Code establishes "a simple, bright-line rule" limiting the scope of the transfer

tax exemption to "transfers made pursuant to a Chapter 11 plan that has been confirmed."

*Piccadilly Cafeterias* was the Supreme Court's sole contribution to bankruptcy jurisprudence in 2008. Coming up for 2009, the Court agreed to hear an appeal to reinstate a $500 million settlement blocking asbestos-related lawsuits against Travelers Cos. Inc., insurer of one of the world's largest asbestos producers, former chapter 11 debtor Johns-Manville Corp. The justices agreed to hear the case, on appeal from the U.S. Second Circuit Court of Appeals, on December 12, 2008, consolidating two cases—*Travelers Indemnity Co. v. Bailey* and *Common Law Settlement Counsel v. Bailey*—both of which were addressed by the Second Circuit Court of Appeals in *In re Johns-Manville Corp.*, 517 F.3d 52 (2d Cir.), *cert. granted*, 2008 WL 4106796 (Dec. 12, 2008). The court is expected to offer some much-needed clarification on the propriety of third-party releases that are sometimes incorporated into chapter 11 plans, a controversial issue that concerns the scope of a bankruptcy court's jurisdiction. Oral argument on the case is scheduled for March 2009.

*The content of this article is intended to provide a general guide to the subject matter. Specialist advice should be sought about your specific circumstances.*

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Doing Business With A Customer In Bankruptcy: What You Need To Know (Cooley Godward Kronish LLP)
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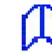
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