AKIN GUMP
STRAUSS HAUER & FELD LLP
Attorneys at Law

December 2006

BANKRUPTCY UPDATE

New York Judge Sides With Bondholders 1

Further Limitations On Deepening Insolvency: "Zone Of Insolvency" Does Not Mean "Open Season" On Corporate Fiduciaries 3

The 3rd Circuit Is Not "Seeing Double" 4

Pre-Petition "KERP" Falls Prey To Avoidance As Fraudulent Transfer. 6

Sixth Circuit Finds Default In Dow Corning's Argument. 7

NEW YORK JUDGE SIDES WITH BONDHOLDERS

In a victory for bondholders, a New York trial court judge granted the bondholders' request for an expansive reading of bondholder rights under the issuer's indenture in the recent case of *The Bank of New York v. BearingPoint, Inc.*[1] In an area of the law that is sparse with judicial decisions, this trial court's opinion may have significant repercussions.

Because of accounting problems, BearingPoint did not file its annual and quarterly reports with the SEC, as required by law. A group of distressed debt hedge funds, believing that the failure to file constituted a default under the company's indenture, acquired a 25 percent position in the company's bonds, and caused their counsel to provide the company with a notice of default, and, later, a notice of acceleration. The company claimed that it was not in default under the indenture, and that the notice of default was deficient. To enforce their rights, the bondholders sued.

At issue was whether the failure to file the SEC reports constituted a breach of the company's indentures, and whether the beneficial owners of the bonds could declare the default and accelerate, or whether that authority was vested only in the registered holder acting through the indenture trustee.

The covenant under which holders alleged a default provides as follows:

> [T]he Company shall file with the Trustee, within 15 days after it files such annual and quarterly reports, information, documents and other reports with the SEC, copies of its annual report and of the information, documents and other reports (or copies of such portions of any of the foregoing as the SEC may by rules and regulations prescribe) which the Company is required to file with the SEC pursuant to section 13 or 15(d) of the Exchange Act. The Company shall comply with the other provisions of TIA section 314(a).

1 13 Misc.3d 1209(A), 2006 WL 2670143, 2006 N.Y. Slip Op. 51739(U), Unpublished Disposition, N.Y. Sup., September 18, 2006.

This document is distributed for informational use only; it does not constitute legal advice and should not be used as such.
© 2006 Akin Gump Strauss Hauer & Feld LLP

akingump.com

In addition, sections 314(a) and 318 of the Trust Indenture Act (TIA) provide that each qualified indenture is deemed to include a covenant that the issuer "shall file with the indenture trustee copies of the annual reports and of the information, documents and other reports … which [the issuer] is required to file with the [SEC] pursuant to section 13 or section 15(d) of the [Exchange Act]."

BearingPoint argued that its obligation to furnish reports to the trustee was contingent upon its first filing the reports with the SEC. Since it had not filed with the SEC, it had no obligation to provide copies of non-existent reports to the trustee.

The judge disagreed with the company's literal reading of the indenture and the statute, stating that the unambiguous intent of the indenture and of the TIA is to provide information to investors, and therefore BearingPoint was obligated under the indenture to file timely reports with the SEC.

The company next argued that the default notice was technically deficient because it was sent by counsel on behalf of *beneficial* owners of the bonds, and not by the *registered holder* of the bonds. The indenture provides that notice of default must be sent by the registered holders of at least 25 percent of the bonds. Since the note was a global note, the only registered holder was Cede & Co., as nominee for the DTC. The bondholders were not the registered holders, but rather held beneficial interests in the global note through DTC and their respective brokerage accounts. Under the company's literal reading of the indenture, the notice of default would have to come from Cede & Co. as DTC's nominee. Again the judge disagreed with the company, finding that the bondholders' notices were adequate under the notice provisions of the indenture.

The *BearingPoint* decision is particularly important in light of the current wave of stock option reporting investigations. As companies are forced to investigate their stock option issuances, they are often unable to file their SEC reports in a timely manner. Seeking to capitalize on the situation, investors have been carefully reviewing the indentures of these companies to determine whether the failure to file is a default under the relevant reporting covenants. A number of companies have received notices of default, and some have reached deals with bondholders for waivers; others have cured before acceleration, and others are in litigation over these issues. Many hedge funds have become active players in this field.

BearingPoint reduces the uncertainty regarding the interpretation of reporting covenants. Although reporting covenants are a standard feature in all indentures, there are a number of different types of reporting covenants. Some appear on their face to require only a filing with the trustee if a prior filing has been made with the SEC, as in the *BearingPoint* indenture, while others clearly mandate that the company must file its SEC reports with the SEC in a timely fashion. In addition, there are a number of formulations in the market that appear to intend to require timely filing, but contain technical flaws. The *BearingPoint* decision suggests that, regardless of the formulation in the indenture, the issuer must file with the SEC in a timely fashion.

The new-issuance market is keenly aware of the growing sophistication and activism of bond investors with respect to this issue, and is responding. In one recent transaction, an issuer with *no* anticipated SEC reporting problems obtained a 240-day cure period with respect to any SEC filings. However, it is too early to tell if extended cure periods will become common in new high-yield issuances.

Commentators are already lining up against the *BearingPoint* decision, arguing that it runs counter to the traditional literal reading of indentures under New York law. Regardless of the common understanding regarding these provisions, *BearingPoint* may provide leverage to bondholders in negotiations with issuers that have not filed SEC reports.

This document is distributed for informational use only; it does not constitute legal advice and should not be used as such.
© 2006 Akin Gump Strauss Hauer & Feld LLP

To view *The Bank of New York v. BearingPoint, Inc.* opinion, please visit www.akingump.com/docs/pdf/FRN_200611_1.pdf.

For further information, please contact:

Ira S. Dizengoff
212.872.1096
idizengoff@akingump.com
Financial Restructuring Group

Alan L. Laves
512.499.6292
alaves@akingump.com
Corporate Finance/M&A Group

FURTHER LIMITATIONS ON DEEPENING INSOLVENCY: "ZONE OF INSOLVENCY" DOES NOT MEAN "OPEN SEASON" ON CORPORATE FIDUCIARIES

While Deepening Insolvency – as a cause of action – continues to be a popular rallying cry for creditors in search of deep pockets, courts continue to be less than enthusiastic about legitimizing such claims. Two recent opinions, in the 3rd Circuit and in the Delaware Chancery Court, continue this trend.

The 3rd Circuit, in *Gary Seitz v. Detweiler, Hershey, and Assoc. (In re CitX Corp., Inc.)*[2], dispensed with the theory of deepening insolvency as a measure of damages and increased the hurdle for establishing such a cause of action. CitX was an Internet-based company that contracted with Professional Systems International, Inc. (PRSI) to create an Internet shopping mall for home-based merchants who would pay a fee to be featured. PRSI, however, turned out to be a fraudulent enterprise that eventually pilfered over $18 million from would-be online merchants before the Florida attorney general shut it down. At the time PRSI was shut down, CitX was due over $2.4M in receivables from PRSI. CitX eventually became insolvent and filed for relief under Chapter 7 of the Bankruptcy Code. However, before filing, CitX was able to acquire over $1 million in additional financing based on a financial statement which indicated that CitX was solvent, including the questionable PRSI receivable amongst CitX's assets. CitX's Chapter 7 trustee sued the accounting firm that had issued the financial statements on a variety of claims, including professional malpractice and deepening insolvency. All of the trustee's causes of action were dismissed or summary judgment was entered for the defendants in the bankruptcy and district courts. The trustee appealed only the portions of the ruling dismissing the malpractice and deepening insolvency claims to the 3rd Circuit.

Acknowledging that Pennsylvania law recognized professional malpractice as a cause of action, the court noted that the trustee would have to show that (i) the accountant owed a duty to the debtor, (ii) the accountant breached that duty, (iii) the debtor was actually harmed and (iv) the accountant's breach of duty caused that harm. The trustee alleged harm in the form of "deepening insolvency," asserting that the accountant's negligently prepared financial statements severely deepened the insolvency of the debtor by permitting and enabling the debtor wrongfully to incur additional debt.

The 3rd Circuit noted that its prior decision in *Official Committee of Unsecured Creditors v. R.F. Lafferty & Co.*,[3] while (i) concluding that deepening insolvency was a valid Pennsylvania *cause of action* and (ii) describing deepening insolvency as a "*theory of injury*," never held that it was a valid *theory of*

2 No. 05-2760 (3rd Cir. Apr. 27, 2006).
3 267 F.3d 340 (3d Cir. 2001).

This document is distributed for informational use only; it does not constitute legal advice and should not be used as such.
© 2006 Akin Gump Strauss Hauer & Feld LLP

damages for an independent cause of action and should not be interpreted to create a novel theory of damages for an independent cause of action like malpractice.

The court then addressed deepening insolvency as an independent cause of action, initially noting that the trustee's complaint failed to make any showing of fraudulent conduct on the accountant's part but rather asserted negligence as a sufficient basis for deepening insolvency. The court held that only fraudulent conduct will suffice to support a deepening-insolvency claim, noting that *Lafferty* had held the same in defining the injury as a "*fraudulent* expansion of corporate debt and prolongation of corporate life." Accordingly, the court held that a claim of negligence cannot sustain a deepening-insolvency cause of action.

The limitations on deepening insolvency constructed by the 3rd Circuit in *CitX* appear to have become even more constrictive as the Delaware Chancery Court issued a significant opinion in *Trenwick America Litigation Trust v. Ernst & Young, L.L.P.*,[4] essentially stating that Delaware does not recognize a claim for deepening insolvency. In that court's view, existing causes of action for breach of fiduciary duty, fraud or breach of contract are sufficient to cover potential claims against fiduciaries. Stressing the right of directors and other fiduciaries to protection of the business judgment rule, the court stated that "the words 'zone of insolvency' should not declare open season on corporate fiduciaries."

To view the *Trenwick* opinion, please visit www.akingump.com/docs/pdf/FRN_200611_3.pdf.

For further information, please contact:

Peter J. Gurfein	Scott L. Alberino
310.552.6696	202.887.4027
pgurfein@akingump.com	salberino@akingump.com
Financial Restructuring Group	Financial Restructuring Group

THE 3RD CIRCUIT IS NOT "SEEING DOUBLE"

The 3rd Circuit Court of Appeals has rendered a landmark decision with respect to what has become known as "double discounting." In *In re Oakwood Homes*,[5] the court held that a bankruptcy court may either disallow an unsecured creditor's claim for unmatured interest, or discount to present value that creditor's entire principal-plus-interest claim, but not both.

The *Oakwood Homes* decision provides much needed certainty to the treatment of unsecured lender claims on account of interest-bearing instruments. Prior to *Oakwood Homes*, there were a rash of decisions by numerous district and bankruptcy courts which concluded that in determining the allowed amount of a claim, Bankruptcy Code section 502(b) requires that any portion of a claim that is unmatured as of the petition date must be discounted to its present value. *See In re Loewen Group Int'l, Inc.*[6] The rationale for discounting the claims was always the same: it reflected the economic reality that a sum of money received today is worth more than the same amount received tomorrow. Absent bankruptcy, the claimants would have to wait many years before receiving the entire payout under the subject instruments.

---

4 906 A.2d 168 (Del. Ch. 2006), 2006 Del. Ch. LEXIS 139 (C.A. No. 1571-N Delaware Chancery Court, New Castle County 8/10/06).

5 449 F.3d 588 (3d Cir. 2006)

6 274 B.R. 427, 434 (Bankr. D. Del. 2002); *In re CSC Indus., Inc.*, 232 F.3d 505, 507 (6th Cir. 2000).

This document is distributed for informational use only; it does not constitute legal advice and should not be used as such.
© 2006 Akin Gump Strauss Hauer & Feld LLP

As such, paying the face amount on an accelerated basis would overcompensate the creditor by enabling him to receive and use the money sooner.

Critically, all of these decisions involved ***non-interest-bearing*** instruments. As the 3rd Circuit would later explain in *Oakwood Homes*, the distinction between interest-bearing and non-interest-bearing instruments is highly relevant.

In *Oakwood Homes*, JPMorgan Chase Bank (JPMorgan), as successor trustee on behalf of holders of debt securities known as "real estate mortgage investment conduits" (REMICs), filed proofs of claim seeking payment of past and future shortfalls of principal and interest on the REMICs. The indenture trustee for holders of certain senior notes issued by Oakwood filed objections to JPMorgan's claims, arguing that the unmatured principal balance under the REMICs must be discounted to its present value. The bankruptcy court agreed, holding that even after disallowing JPMorgan's claims for post-petition interest, Bankruptcy Code section 502(b) also required that JPMorgan's claims for principal shortfalls be discounted to present value, as of the petition date. JPMorgan alleged that its claim had been unfairly "double discounted," and appealed both discounts to the Delaware District Court. The district court upheld the bankruptcy court's decision, concluding that the principal payments were not due until the future and, therefore, discounting the claims was appropriate since "money received today is more valuable than money received tomorrow."

On appeal, the 3rd Circuit reversed the lower court rulings, concluding that section 502(b) is far from clear and unambiguous in directing discounting to present value in all situations. The appeals court examined the language of 502(b), which speaks of the "amount" of a claim "as of" the petition date. The court noted that given that the remainder of the Bankruptcy Code uses the term "value, as of" to signify discounting to present value, and "amount" and "value" are not synonymous, that section 502(b) could not be found to clearly and unambiguously require discounting to present value in all situations. According to the appeals court, once the bankruptcy court disallowed post-petition interest pursuant to section 502(b)(2), the economic reality of the transaction at issue, the legislative history of section 502(b) and fundamental tenets of bankruptcy law do not permit further discounting of the principal. Discounting an interest-bearing unmatured principal claim to present value on top of disallowing all post-petition interest would effectively be "double discounting" that claim, inequitably penalizing the creditor twice for the time value of money. The 3rd Circuit concluded that such "double discounting" was not permitted under the Bankruptcy Code.

While not completely closing the door on discounting to present value claims for unmatured principal (under interest-bearing notes), the 3rd Circuit made abundantly clear that any such discounting is not permitted where unmatured interest has already been disallowed pursuant to section 502(b)(2). Thus, to the extent that a claim for post-petition interest is disallowed, *Oakwood Homes* would preclude a further discounting of the unmatured principal due and owing under the debt instrument.

For further information, please contact:

Charles R. Gibbs
214.969.4710
cgibbs@akingump.com
Financial Restructuring Group

This document is distributed for informational use only; it does not constitute legal advice and should not be used as such.
© 2006 Akin Gump Strauss Hauer & Feld LLP

PRE-PETITION "KERP" FALLS PREY TO AVOIDANCE AS FRAUDULENT TRANSFER

In a recent opinion, the 3rd Circuit avoided an "eve of bankruptcy filing" amendment to a pension plan as a fraudulent transfer, notwithstanding that the trustee, as plaintiff, was not able to calculate with certainty the value received by the estate in exchange for the amendment. The "calculation requirement" generally requires a plaintiff to prove that the alleged fraudulent transfer resulted in no value for the debtor or that the value received was not "reasonably equivalent." In the decision, *Pension Transfer Corp. v. Beneficiaries Under the Third Amendment to Fruehauf Trailer Corp. Retirement Plan No. 003 (In re Fruehauf Trailer Corp.)*,[7] the 3rd Circuit clarified that there is no *per se* rule that requires a plaintiff to present precise calculations comparing the value given to the value received by the debtor. Rather, the court employed a "totality of circumstances" test and clarified that if, based on the totality of circumstances, it is clear that the benefits to the debtor are minimal and not equivalent in value, then a precise calculation will not be required.

Fruehauf Trailer Corporation (Fruehauf or the Company) operated several facilities throughout the United States that manufactured, sold, distributed and serviced truck trailers and related parts. Despite its early success, by the 1990s Fruehauf had overextended its capital. In 1996 Fruehauf held an emergency board meeting where it discussed the possibility of filing for bankruptcy. At the same meeting, the board considered an amendment to the Company's pension plan for non-salaried and nonunion workers (the Third Amendment).

The thrust of the Third Amendment provided for two changes: (1) benefits would be calculated based on 1996 salaries rather than on 1991 salaries and (2) all eligible employees would receive a cash contribution of five percent of their annual salary plus eight percent annual interest to their pension account. The cost of the Third Amendment, which was to be funded by a surplus on the union side of Fruehauf's pension plan, was estimated to be approximately $2.4 million. Had it not been for this amendment to the pension plan, this surplus would have reverted to the Company for the benefit of all creditors. The board approved the Third Amendment, and days later Fruehauf filed for bankruptcy protection in Delaware.

Fruehauf, as debtor-in-possession, commenced a fraudulent transfer action against the pension plan. Both the bankruptcy court and the District Court held that the Third Amendment was a fraudulent transfer. This decision was affirmed by the 3rd Circuit on appeal.

The main issue on appeal centered on whether the plaintiff successfully proved that the transfer resulted in no value for the debtor or the value received was not "reasonably equivalent" to the value of the relinquished property interest. The defendants argued that the Third Amendment conferred value on Fruehauf because it helped retain certain key employees necessary to maintain ongoing business operations while the Company was looking for a buyer. Further, the defendants argued that under the "calculation requirement" the plaintiff was required to provide a precise calculation comparing the benefits received to the benefits given; because the plaintiff failed to provide these calculations, it did not meet its burden of proof. The 3rd Circuit disagreed, finding that when direct monetary amounts must be weighed against indirect values, it is often impossible to provide precise calculations. Rather, "in those cases where a court has sufficient evidence to conclude, based on a totality of circumstance, that the benefits to the debtor are minimal and certainly not equivalent in value of a substantial outlay of assets, the plaintiff need not prove the precise value of the benefits because such a calculation is unnecessary to the court's analysis."

---

7 444 F.3d 203 (3d Cir. 2006).

This document is distributed for informational use only; it does not constitute legal advice and should not be used as such.
© 2006 Akin Gump Strauss Hauer & Feld LLP

In *Fruehauf*, the court found that the Company failed to prove that the Third Amendment kept certain key employees at the Company. This fact underscored that "whatever the value was [that the Company received], it was considerably less than the cost of the Third Amendment."

For further information, please contact:

Lisa G. Beckerman
212.872.8012
lbeckerman@akingump.com
Financial Restructuring Group

SIXTH CIRCUIT FINDS DEFAULT IN DOW CORNING'S ARGUMENT

A solvent Chapter 11 debtor must pay its unsecured lenders at the contractual default rate of interest if a default has occurred, even where the default was the bankruptcy filing itself.

In *Official Comm. of Unsecured Creditors v. Dow Corning Corp. (In re Dow Corning Corp.)*[8], the 6th Circuit faced the unusual circumstance of a debtor that had been solvent throughout its bankruptcy case. Dow Corning Corporation filed for bankruptcy in 1995 to facilitate a "uniform settlement of numerous breast-implant related lawsuits" then pending against Dow Corning. Dow Corning, which is jointly owned by Dow Chemical Co. and Corning Corp., was "fully solvent" when it filed for bankruptcy, "remained so throughout the proceedings and … never disputed its ability to pay all of its creditors."

As Dow Corning was solvent, Dow Corning's plan of reorganization proposed to pay its creditors in full and to return significant value to its two shareholders, Dow Chemical and Corning. Notably, the confirmed plan proposed to pay interest to Dow Corning's unsecured lenders (the Lenders) at the interest rate provided in the Lenders' contracts. The Lenders' contracts generally imposed a higher interest rate in the event of a default and specified that filing for bankruptcy constituted such a default. Based on the default provisions, the Lenders asserted that they should receive interest at the higher default interest rate.

The Lenders argued that failure to pay the default interest would violate the so-called "Absolute Priority Rule" – which requires Chapter 11 plans to pay senior interests in full prior to paying anything to junior interests – because the Lenders would not receive full payment of their claims while Dow Corning's equity holders would receive a significant distribution. *See* 11 U.S.C. § 1129(b)(1)(B)(ii). Dow Corning opposed, arguing that (a) Dow Corning had not defaulted as of the date of the filing of Dow Corning's Chapter 11 case and (b) applicable case law required the Lenders to show special equitable considerations entitling them to default interest, which the Lenders had not done. The bankruptcy court accepted Dow Corning's argument, the district court affirmed and the Lenders appealed to the 6th Circuit.

In reversing, the 6th Circuit acknowledged the many cases holding that a plan could, for equitable reasons, fail to award interest at the default rate without violating the Absolute Priority Rule, but noted that those cases involved insolvent debtors. Reviewing the few relevant solvent debtor cases the 6th Circuit stated that in such cases, "rather than considering equitable principles," courts generally enforce "whatever pre-petition rights a given creditor has against the debtor." The 6th Circuit then held that in solvent debtor cases, a presumption exists in favor of enforcing "the contractual rights of the parties," and the role of equity "is significantly reduced." Thus, the Absolute Priority Rule presumptively required enforcement of the Lenders' contractual rights, including the Lenders' right to interest at the

[8] 456 F.3d 668.

This document is distributed for informational use only; it does not constitute legal advice and should not be used as such.
© 2006 Akin Gump Strauss Hauer & Feld LLP

default rate. The 6th Circuit then remanded the case, holding that the record did not present sufficient information to determine if the necessary "compelling equitable considerations" existed to override the general rule permitting default interest.

Solvent debtor cases are unusual, but they do occur, particularly in mass tort situations where a company files for bankruptcy to facilitate a global settlement of the innumerable lawsuits it faces. The *Dow Corning* ruling may make solvent debtor cases highly profitable for unsecured lenders if its holding is adopted in other circuits. Applying the *Dow Corning* rule, unsecured lenders to solvent debtors will reap the benefits of high default interest rates during bankruptcy cases that can last for many years.

To view the *In re Dow Corning Corp.* opinion, please visit
www.akingump.com/docs/pdf/FRN_200611_2.pdf.

For further information, please contact:

David P. Simonds
310.552.6692
dsimonds@akingump.com
Financial Restructuring Group

CONTACT INFORMATION

If you have any questions, please contact any of the lawyers listed below:

Editor in Chief

Peter J. Gurfein............................310.552.6696 ....pgurfein@akingump.com...........................Los Angeles

Managing Editor

Scott L. Alberino ....202.887.4027 ....salberino@akingump.com ....Washington, D.C.

Contributing Editors

J. Meritt Crosby Jr. ....214.969.4255...........................mcrosby@akingump.com ....Dallas
Patrick J. Ivie ....310.728.3326...........................pivie@akingump.com ....Los Angeles
Ryan C. Jacobs.............................212.872.7434...........................rjacobs@akingump.com ....New York
Joanna F. Newdeck ....202.887.4549...........................jnewdeck@akingump.com ....Washington, D.C.
Sara J. L. Wahl.............................214.969.2845...........................swahl@akingump.com ....Dallas
James A. Wright III ....212.872.8182...........................jawright@akingump.com ....New York

Austin Dallas Dubai Houston London Los Angeles Moscow New York
Philadelphia San Antonio San Francisco Silicon Valley Taipei Washington, D.C.

If you wish to receive future issues of Bankruptcy Update by mail only or e-mail only, send an e-mail to bankruptcyupdate@akingump.com to set your preference.

This document is distributed for informational use only; it does not constitute legal advice and should not be used as such.
© 2006 Akin Gump Strauss Hauer & Feld LLP