abfjournal
Reprinted from the October 2003 Issue

Kmart, WorldCom & Adelphia: *Mega-Issues from Mega-Cases*

This article examines some of the recent issues that have arisen in the mega-cases of Kmart, WorldCom and Adelphia and analyzes fundamental bankruptcy principles that have interfered with the agendas of some of the constituents in these cases.

By Randall L. Klein & Dimitri G. Karcazes

Editor's Note:
After this article went to press, MCI announced that, as predicted by the authors, a settlement had been reached with the objecting parties concerning substantive consolidation.

There is only one U.S. Bankruptcy Code, and regardless of the complexity of the case or the number of co-debtors in jointly-administered cases, the same provisions of Chapter 11 apply. This article examines some of the recent issues that have arisen in the mega-cases of Kmart, WorldCom and Adelphia and analyzes fundamental bankruptcy principles that have interfered with the agendas of some of the constituents in these cases.

The Basics

Certain fundamental bankruptcy principles are frequent issues in bankruptcy cases. For example, multiple borrowers and upstream, downstream and side-stream guarantees. What these terms bring to mind for most lawyers and lenders is fraudulent conveyance law. At its most basic level, this structural issue arises when an insolvent company guarantees the debts of another. The theory is that an insolvent company's assets should first go to repay the debts of creditors who provided it with value. A second basic principle, known to all in the lending industry, is that transfers of property by a debtor to or for the benefit of an (unsecured) creditor within 90 days of bankruptcy may be attacked as a preference. A third principle is that in order to confirm a non-consensual plan, each impaired class must either accept the plan or no holder of a claim or interest junior to the rejecting class may receive or retain any property on account of its claim or interest. This last principle is also known as the absolute priority rule.

Multiple Debtor Mega-Cases

Massive securities fraud claims, accounting "irregularities" and the need to "rationalize" the balance sheet. What comes to mind are the Chapter 11 mega-cases such as Kmart, WorldCom and Adelphia. The Kmart case was actually the Chapter 11 case of Kmart Corp. and 37 other cases for its domestic affiliates. WorldCom involved 179 separate cases and there were 231 separate cases in Adelphia. One of the first orders entered in those cases was to approve "joint administration" of each of the affiliated Chapter 11 cases. Joint administration causes each case to be administratively tethered to one main case. Also known as "procedural consolidation," this device is purely for administrative convenience and does not result in the aggregation of assets and liabilities into one master case (known as "substantive consolidation"). Separate cases means separate assets and liabilities. Separate bankruptcy code causes of action for fraudulent conveyances and preferences. Separate requirements for class voting for purposes of confirming of a plan.

Things can get considerably more complicated, however, when what starts off as an intercompany transaction ends up under the bankruptcy microscope as a debtor-plaintiff versus a debtor-defendant, or when bondholder recoveries at the parent level are at the mercy of bank debt claims at the subsidiary level. Kmart, WorldCom and Adelphia provide some fascinating examples of how the basics described at the beginning of this article can lead to challenging issues and complex resolutions.

Even if fraudulent conveyance and preference law may not help the creditors of the parent, they have the tool of threatening substantive consolidation.

The Kmart Guarantees

Take a not uncommon fact pattern. Bank debt and bond debt are at the parent level. Perhaps the bond indenture prohibits or restricts asset transfers to wholly owned subsidiaries, or perhaps not. Maybe the subsidiaries are prohibited from granting liens, or are permitted to guaranty parent company debt. Step one: transfer a major asset, perhaps a trademark licensed to affiliates for aggressive, perpetual royalties, to a newly formed subsidiary that has no other creditors. (In Kmart's case, the royalty fees were $75 million per quarter). Adding fuel to the fire, the royalty payments continue to accrue postpetition, creating an unpaid administrative claim of $225 million against the parent, the proceeds of which would go directly to the creditors of the trademark licensor (i.e., the banks). Pushing the assets into a wholly-owned solvent subsidiary is not a constructively fraudulent conveyance against the parent company creditors, even if the parent is insolvent, since it continues to own 100% of the value of the asset through the stock — right? Step two: some time later (doing it at the same

time might invite a judge to collapse the separate steps and take a different view), cause the cash rich subsidiary to guarantee the parent company's bank debt. Not a fraudulent conveyance as against the subsidiary-guarantor's creditors (there are none). Not a preferential transfer, even if the guarantee is taken within 90 days of bankruptcy, because there is no transfer of property by the debtor (the subsidiary), only the incurrence of an obligation (the guarantee). One more problem for the creditors of the parent — even if the transfer of the assets to the subsidiary was constructively fraudulent — how do you get the assets back? A fraudulent conveyance lawsuit cannot be commenced to recover property from the defendant who is a debtor protected by the automatic stay.

Even if fraudulent conveyance and preference law may not help the creditors of the parent, they have the tool of threatening substantive consolidation. Collapse the subsidiary back into the parent and the guarantee disappears. But substantive consolidation litigation is very difficult, very expensive, and very uncertain — the double-edged swords of debt traders who want to lock in quick returns.

The foregoing is a rough outline of the intercompany issues central to Kmart's reorganization. Bank creditors of Kmart Corp. had the benefit of the Kmart subsidiary guarantee. Bondholders had the threat of litigation. The holders of Kmart bank debt and bond debt eventually settled, aided by one hedge fund that bought a large enough position in both bank debt and bond debt to fashion an acceptable recovery. The banks got a premium by reason of the subsidiary guarantees and enough benefit went to the bonds, when coupled with a fast track exit, to justify dropping the threat of substantive consolidation or fraudulent conveyance attack.

Kmart — The Other Side of Substantive Consolidation

One of the reasons articulated by Kmart for the bank debt/bond debt settlement was the complexity and uncertainty of the claim for substantive consolidation. In Kmart's words, "substantive consolidation would harm the banks in violation of one of the key requirements that substantive consolidation be in the best interest of all creditors… because if the Kmart entities were substantively consolidated, the Subsidiary Guarantees would be eliminated… and [the bank's] anticipated recovery on that single claim would be diluted by the claims of all other unsecured creditors." Accordingly, there would be no formal substantive consolidation. The 38 cases would remain unconsolidated for plan confirmation purposes; however, the bank claimants would agree to reallocate some of the value of the subsidiary back to certain of the parent company creditors.

This meant 38 separate debtors, with 38 plans (each adopted the same plan) and 38 separate requirements to comply with class voting and the absolute priority rule. Kmart had wide acceptance of its plan — it reported that, on a consolidated basis, all classes had accepted (other than the classes deemed to have rejected by reason of not getting an unconditional dividend). Interesting but legally irrelevant. The trouble was that Kmart was not in fact substantively consolidated. The "consolidated" class vote (i.e., adding all the classes of unsecured claims against each debtor into a pot and getting the affirmative vote of that pot of creditors) meant nothing as a matter of law. What mattered is that some classes of some debtors rejected the Kmart plan. That is no small problem when the absolute priority rule prohibits the equity holders (i.e., the parent company) from retaining its ownership (and tax attributes) without payment in full of the claims of the subsidiary creditors — or at least acceptance of each class of creditors. If you are sensing that this issue was settled, you would be right — the risk of litigation was too costly for the creditors and the risk of an adverse legal ruling too costly for the debtors. In the end, the fundamental principles of debtor-creditor law outlined at the beginning of this article were pushed to their limits, but ultimately did not give way except to foster settlements among differing constituencies.

WorldCom — Intermedia Note

The real facts in WorldCom are far more complex, so with some literary license, assume the following. Parent company (WorldCom) acquires subsidiary (Intermedia). Unlike the Kmart guarantee, this time there is substantial pre-existing indebtedness at the subsidiary level. In order to comply with the subsidiary's tangible net worth requirements under the subsidiary's debentures, the parent company obligates itself to purchase $7 billion of preferred stock of the subsidiary, payable over time and evidenced by a true note issued in favor of the subsidiary. Assume some significant payments ($1 billion or so) are made on account of that note to or for the benefit of its subsidiary, an insider. The preference rule for insiders is 1 year. Assume further that there are no defenses to the preference action. Like the situation in Kmart, however, the preference defendant (Intermedia) is also a debtor in bankruptcy.

The claim's snapshot is straightforward: $6 billion unsecured note claim of the subsidiary against the parent and $1 billion preference claim of the parent against the subsidiary. What is not straightforward is the application of certain provisions of the Bankruptcy Code when one debtor is liable on a preference claim to another debtor. Section 502(d) of the Bankruptcy Code disallows claims generally until the preference defendant has "paid the amount… for which such entity or transferee is liable." As applied to WorldCom, if Intermedia were not a co-debtor, Intermedia would have to return $1 billion to WorldCom in order to receive its pro rata share dividend as a creditor with a $7 billion claim (the original $6 billion, plus the new $1 billion claim that springs back to life when the preferential note repayment is returned). Intermedia, as a debtor, could argue that WorldCom is not entitled to prosecute the preference action against it by reason of the automatic stay. Accordingly, WorldCom's estate simply has a general

One of the reasons articulated by Kmart for the bank debt/bond debt settlement was the complexity and uncertainty of the claim for substantive consolidation.

unsecured claim against Intermedia, and the only amount for which the bankruptcy estate of Intermedia "is liable" for purposes of 502(d) would be the dividend payable to other general unsecured creditors of Intermedia. In other words, if the Intermedia dividend was $.10 on the dollar, then Intermedia's liability to WorldCom would be a mere $100 million. Once paid, Intermedia would have the right to its dividend as a creditor of WorldCom for the $6 billion note balance (plus the $100 million payment).

If that is not confusing enough, consider Section 542(b) of the Bankruptcy Code. This section gives the debtor's estate a cause of action to compel "turnover" of any debt that is "matured, payable on demand, or payable on order." The WorldCom note defined "maturity" to include the due date upon acceleration by reason of an event of default, including bankruptcy. Return now to Section 502(d), which also governs in the Intermedia case — WorldCom's claim against Intermedia (the preference) shall be disallowed until WorldCom pays the amount for which it, as a debtor, is liable by reason of Section 542(d).

How these conflicts would be resolved is unclear, as there is very little case law authority on point. One answer is to net the preference amount from the unpaid balance of the note, such that each estate is paying its full Section 502(d) liability to the other. However, this result would harm WorldCom much more than if it simply did not make the preference claim

against Intermedia. Another interpretation would be to strictly enforce 502(d) against each estate, thereby disallowing both claims and putting 502(d) (exercised by WorldCom) in direct conflict with Section 542(b) (exercised by Intermedia). A middle ground would be to interpret 502(d) as only obligating the estate (as distinguished from the pre-bankruptcy entity) to pay its pro rata dividend to the other. Intermedia pays WorldCom the dividend on account of its preference claim and WorldCom pays Intermedia its dividend on account of the unpaid balance of the Note (or simply offsets the preference dividend against the Note claim). Of course, it may be a challenge to calculate the dividend that each owes the other, when each dividend is predicated in part on receiving money from the other. Interestingly, one week after WorldCom commenced its Chapter 11 case, the first opinion was published dealing with the 502(d) issue that arises with dueling bankruptcy estates. In re Shared Technologies, 281 B.R. 804 (Bankr. D. Ct. 2002), aff'd, 293 B.R. 89 (D. Ct. 2003) (interpreting 502(d) to require the debtor-defendant to pay only the general unsecured claim dividend, not the face amount of the preference liability).

WorldCom — Partial Substantive Consolidation

Like the Kmart guaranty, the Intermedia note would present a major problem for the creditors of Intermedia if the estates of Intermedia and WorldCom were substantively consolidated. Instead of obtaining the dividend from WorldCom on account of the $6 billion note claim, the recoveries to creditors of Intermedia would be diluted by all of the WorldCom claims. One can imagine the resistance to substantive consolidation from Intermedia creditors, with multi-billion recoveries hanging in the balance.

WorldCom filed an initial plan of reorganization that keeps Intermedia (and the $6 billion note) separate from the proposed substantive consolidation of all other WorldCom affiliated debtors. The other WorldCom entities have not yet been substantively consolidated. Just as was the case in Kmart, until the Court rules on the appropriateness of substantive consolidation, each of the WorldCom debtors must comply with the plan voting requirements and the absolute priority rule. There is at least one class of creditors of one of WorldCom's subsidiary debtors, a small company called MCI, that does not want substantive consolidation. Those creditors and preferred security holders, whose claims and interests have priority over WorldCom's common stock ownership interest in MCI, oppose the plan of reorganization.

These dissenting claimants have filed a fifty-plus page brief opposing the treatment of their claims and interests and objecting to substantive consolidation. What is important for purposes of this article is not whether WorldCom can sustain its burden of proof to substantively consolidate MCI into WorldCom. Rather, the point is that the subordinated creditors have a very powerful legal argument in the MCI case, precisely because of the inviolable, fundamental premise articulated above — each class must accept the plan of each debtor or else the junior class (WorldCom's common stock ownership) cannot retain its interest. Kmart resolved this problem, not by forcing a judge to rule on the issue, but by settlement with each of the disgruntled creditors. We suspect that WorldCom, too, will settle, as there is simply too much at stake and the only way to overcome the plan objection is to substantively consolidate the entities. No easy task, especially if the dissenting claimants have enough stamina.

Adelphia — Separate Estates as a Shield

The last story, and one that is only beginning to take shape, is the fifty-two count complaint filed by "Adelphia Communications Corp. and its Affiliated Debtors and Debtors in Possession and Official Committee of Unsecured Creditors of Adelphia Communications Corp." against hundreds of the world's largest banks, financial institutions and hedge funds. No defendants have filed motions to dismiss this 243 page complaint, but they are sure to follow.

The gist of the complaint is that agents of the credit facilities for certain of Adelphia's subsidiaries (guaranteed by the Adelphia parent) allegedly knowingly participated in fraudulent transactions in favor of the Rigas family. Each original member of the various credit facility syndicates is named, as the plaintiffs seek to impute the alleged conduct of the agent to each of the members of the credit facilities. Further, each secondary market transferee is also named, seeking disallowance of the bank debt claims in the hands of the current holders and recoveries of allegedly fraudulent transfers made to former holders. Again, the doctrine of separate bankruptcy estates and the complementary doctrine of substantive consolidation should prove fatal to the central arguments of the plaintiffs.

The problem is that the complaint essentially disregards (or attempts to sidestep) the import of having 231 separate debtor estates. Each debtor has its own claims and each debtor has its own creditors. Absent substantive consolidation of the estates, the parent company's creditors will have significant difficulty using the theories alleged in the complaint in order to upstream value to the parent. A significant portion of the value of Adelphia, on a consolidated basis, rests within certain of its subsidiaries. Before any value can be allocated to the creditors of the parent company, the claims of the subsidiaries' creditors must be paid in full or each class of such creditors must otherwise consent to the transfer of value to the parent (i.e., the absolute priority rule). Attack as they might the grant of guarantees by the Adelphia parent as fraudulent conveyances, or seek to recover under various theories repayments by the Adelphia parent of the subsidiaries' indebtedness, ultimately the parent company creditors must confront the fact that the subsidiaries incurred the bank debt directly.

In other words, the plaintiffs complain that the parent company guarantees should be invalidated as fraudulent conveyances. We are familiar with that type of argument in the context of cross-stream guarantees for multi-borrower facilities. Accordingly, we know that the sister company guaranty may be limited or avoided entirely by operation of fraudulent conveyance law if the borrowers, on a consolidated basis, are insolvent at the time of incurring each guaranteed debt. But what of the debt to the primary obligor? The loans are made and the debt is incurred. Perhaps creditors of the Adelphia subsidiaries could argue that the loans did not benefit the subsidiaries as the proceeds were siphoned off by the Rigas family. Those fraudulent conveyance claims, which sound a lot like the LBO theories of loan proceeds going to shareholders and not the borrowers, can be asserted only by creditors of the transferor — not the creditors of the parent company of the transferor.

Similarly, the law of equitable subordination should not help the plaintiffs. Part of the Adelphia complaint seeks to equitably subordinate the bank debt claims. However, absent avoidance of the claim in its entirety (which is a fraudulent conveyance remedy that, as discussed, is for the benefit of the subsidiary creditors), equitable subordination of a claim in a separate, subsidiary case would only serve to subordinate the bank debt claims to the claims of the other creditors of that subsidiary. Section 510(c) is clear on its face that claims may only be subordinated to other claims. To subordinate bank debt claims in the subsidiaries' cases to the equity interests of the Adelphia parent would contravene the plain language of the statute. Accordingly, even if the Adelphia bank debt claims could be equitably subordinated in the subsidiaries' cases, that remedy would only go so far as to reallocate value first to the repayment of other creditors of the subsidiaries. Thereafter, the subsidiaries' value would be distributed to the subordinated bank debt claims. In effect, the doctrine of equitable subordination has no value in contests between debtor estates, such as that posed in Adelphia. The claims of each separate estate, and the rights of creditors as against other creditors of that estate, must be resolved separately.

The Adelphia plaintiffs, mindful of this proposition, seek not only to equitably subordinate the bank debt claims, but also to "equitably disallow" the claims. There is little authority after the enactment of the 1978 Code and Section 510(c) for equitable disallowance. We suggest that the notion of "equitable disallowance" has no place in today's bankruptcy jurisprudence. If there is cause to substantively consolidate the Adelphia estate, then the bank debt claims against the subsidiaries would rank pari passu with the bond debt of the parent company. At that point, the doctrine of equitable subordination could be invoked to subordinate the bank debt claims to the bond debt. However, absent sufficient cause to substantively consolidate the estates, the parent company creditors should not be permitted to use the creditors' rights of the subsidiaries' estates. If, in fact, certain of the defendants committed wrongful acts that damaged the parent company, a basic claim for damages would be the more direct route. The damage claim would be paid into the parent company estate and shared by the parent company creditors. The bank debt claim (whether held by the defendant or one of its transferees) would remain as a valid claim in the subsidiaries' estates.

We suspect the Adelphia plaintiffs will not be content with a direct damage claim against a small number of defendants who allegedly engaged in wrongful conduct. Rather, they will attempt to use the uncertainty of the legal rights and remedies, against the backdrop of the threat of substantive consolidation, to drive a settlement in the context of a confirmed plan of reorganization. abfj

Randall L. Klein *is a principal in the Goldberg Kohn's Bankruptcy & Creditors' Rights Group. His practice is devoted exclusively to the protection and enforcement of creditors' rights, representing institutional lenders and purchasers of distressed claims.*

Klein is co-executive editor of Ginsberg & Martin on Bankruptcy (1996-present) and was a contributing editor of Norton's Annual Survey of Bankruptcy Law (1994-2000) and has written extensively on creditors' rights. Klein is also a frequent speaker on bankruptcy and workout topics for the Commercial Finance Association and the American Bankruptcy Institute among others.

Dimitri G. Karcazes *is an associate at Goldberg Kohn's Bankruptcy & Creditors' Rights Group and represents institutional lenders in the protection and enforcement of creditors' rights. He is involved in all aspects of commercial workouts, from documentation to forbearance, restructuring, and reorganization, sale or liquidation. His experience includes out-of-court workouts, assignments for the benefit of creditors, and commercial reorganizations and liquidations. His most recent presentations dealt with debtor-in-possession financing and with asbestos bankruptcies.*