WAKE-UP CALL ON CHAPTER 11 FILINGS IN THE U.S.

Date: January 13, 2000

Recently, a U.S. appeals court issued a wake-up call to financially healthy companies that attempt to use Chapter 11 of the U.S. Bankruptcy Code to settle substantial litigation exposure. Creditors have a new ground of attack against companies that attempt to use Chapter 11 as a means of settling litigation if the company cannot demonstrate genuine financial distress or significant operational difficulties, or the threat of a potentially ruinous judgment is not imminent at the time of the Chapter 11 filing.

Over the years, Chapter 11 has been a powerful tool for companies facing potentially ruinous litigation. Among the most noteworthy of these cases are Texaco (large adverse judgment), Johns-Manville (asbestos), A. H. Robbins (Dalkon Shield) and Dow Corning (silicon breast implants).

In the case at hand, the court essentially determined that the company, SGL Carbon Corporation, filed its Chapter 11 petition too early. SGL was the target of a Justice Department investigation of alleged price fixing in its industry. Soon after the investigation began, various steel producers filed class action antitrust lawsuits against SGL and other manufacturers, and these were consolidated into a single class action and certified as a class consisting of all U.S. producers of graphite electrodes between 1992 and 1997. Many class members opted out of the class and later filed or threatened separate lawsuits.

Late in 1998, SGL filed a Chapter 11 petition as well as a proposed plan of reorganization and disclosure statement which characterized the antitrust litigation as the sole factor leading to the filing. The plan contemplated full cash payment for all creditors other than the antitrust plaintiffs, who were to receive credits against future purchases of SGL's products valid for 30 months following confirmation. In a press release issued the day after the filing, SGL explained that it had filed for bankruptcy "to protect itself against excessive demands made by plaintiffs in civil antitrust litigation and in order achieve an expeditious resolution of the claims against it." The company's president was quoted as saying: "SGL . . . is financially healthy. If we did not face [antitrust] claims for such excessive amounts, we would not have had to file for Chapter 11. We expect to continue our normal business operations."

SGL's creditors committee, almost all of whom were antitrust plaintiffs, sought to have the case dismissed on the ground that it was a "litigation tactic designed to frustrate the prosecution of the civil antitrust claims pending against [SGL] and preserve [SGL's] equity from these claims." The lower court refused to dismiss the case, even though there was testimony from an SGL officer that the company was financially healthy and that the "sole reason" for the filing was to "change the negotiating platform" with the plaintiffs and "increase the pressure on . . . the plaintiffs to settle." The creditors committee appealed.

Consistent with many previous court decisions, the appeals court ruled that there is a general requirement of good faith for all bankruptcy petitions. The court held that the lower court was wrong in finding that the managerial distractions caused by the antitrust litigation and the potential for an adverse judgment were a serious threat to the SGL's operations and finances.

At the time SGL filed its petition, it had a net worth of $124 million. Moreover, before the filing, SGL's German parent had set up a $240 million reserve in connection with civil and criminal

antitrust matters — but papers accompanying the filing had estimated the liquidation value of the antitrust claims at $54 million. The appeals court concluded that whether or not SGL faced a potentially crippling antitrust judgment, SGL did not need to file for bankruptcy when it did, reasoning that the same protections would be available to the company when the threat of such a judgment became imminent. Likewise, the court found that the distractions for the company's management caused by the litigation were overstated, since only one business unit of the company was actively involved in litigation management. The mere possibility of a future need to file, without more, could not establish that a petition was valid.

The court contrasted SGL's actions with that of other companies that had sought Chapter 11 protection in the face of large judgments. Texaco filed only after suffering an $11 billion judgment. In the Johns-Manville case, a growing wave of asbestos-related claims forced the debtor either to book a $1.9 billion reserve (which would have triggered a default under its loan agreements) or file for Chapter 11. A. H. Robbins filed only after settling over 9,000 claims for over $500 million, while still facing over 5,000 pending cases. Dow Corning faced over 400,000 potential claimants who had commenced over 19,000 individual lawsuits and at least 45 putative class actions.

So the timing of a Chapter 11 petition is critical. The courts recognize that the drafters of the Bankruptcy Code understood the need for early access to bankruptcy relief to allow a debtor to rehabilitate its business before it is faced with a hopeless situation. Nevertheless, debtors that cannot demonstrate genuine financial distress or significant operational difficulties, or who file for bankruptcy before the threat of a potentially ruinous judgment is imminent, are open to attack on "bad faith" grounds.

If you would like to discuss this or any other aspect of bankruptcy law, please call us at 416.865.0040. If you are calling long distance, you may call us toll-free at 1.800.505.8679 from anywhere in Canada and the continental United States.

This memorandum is a general discussion of certain legal and related developments and should not be relied upon as legal advice. If you require legal advice, we would be pleased to discuss the issues raised by this memorandum with you in the context of your particular circumstances.