"Gift" Arrangements in Chapter 11

[A Viable Tool?]

By Ann Marie Uetz and John A. Simon

Fast Facts:

Creative practitioners may attempt to solve obstacles presented by the absolute priority rule by having a senior class of creditors "gift" value to a junior class.

In the Chapter 11 plan context, the validity of a "gift" arrangement will likely depend on whether the senior creditor is conclusively entitled to the property it purports to give to the junior class, such as by a first-priority perfected lien.

Under recent case law, courts may also scrutinize "gift" arrangements under settlements outside of the plan context under the absolute priority rule.

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In a lean Chapter 11 case, when creditor recoveries are in doubt, the debtor-in-possession leading the charge to confirmation needs every tool it can muster to successfully exit from bankruptcy. Consensus of the debtor and creditors, who vote on the debtor's plan, is critical to enable the exit strategy. Absent creditor consensus, the debtor may be forced to seek confirmation through a "cram-down" plan, which permits confirmation even if certain classes of creditors have voted to reject the plan. To cram down a plan, the Bankruptcy Code requires, among other things, adherence to the absolute priority rule, which generally requires that senior classes of creditors be paid in full before junior creditors receive any value, as further explained below. Creative practitioners have attempted to overcome the absolute priority rule obstacle by having a senior class of creditors "gift" to a junior class (while skipping intermediate classes) value received by the senior class on its own claims. This article examines the courts' treatment of the "gifting" approach in Chapter 11.

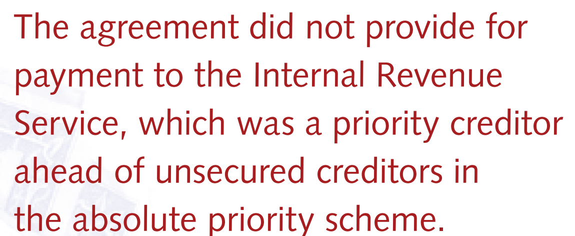
Cram-Down Plans

If at least one class of impaired[1] creditors approves the plan, and the other general requirements for confirmation set forth in Section 1129(a) of the Bankruptcy Code are met, Section 1129(b) of the Code permits a debtor to cram down a plan over objecting classes of creditors. This approach, however, imposes two additional requirements for confirmation. Section 1129(b) requires that a cram-down plan (a) not "discriminate unfairly" and (b) be "fair and equitable" with respect to each class of claims that is impaired and has not accepted the plan.[2] A cram-down plan is generally "fair and equitable" with respect to unsecured creditor and equity classes if those classes *either* (a) receive or retain on account of their claim or interest property of a value, as of the effective date of the plan, equal to (i) for unsecured creditors, the allowed amount of the claim, or (ii) for equity holders, the greater of the allowed amount of any fixed liquidation preference or redemption price or the value of the equity interest, or (b) the claims held by each senior class of creditors are paid in full before any junior class of claims receives anything under the plan.[3]

The latter requirement is known as the "absolute priority rule." The absolute priority rule enforces the bankruptcy priority scheme in the plan context. Generally, the Bankruptcy Code establishes a waterfall for distribution of estate proceeds: secured creditors are paid first, then administrative creditors and priority claimants, then general unsecured creditors, and, finally, equity holders. Under the absolute priority rule, a plan is "fair and equitable" even if classes of unsecured creditors or equity holders do not receive the full value of their claims and interests, *if* no class junior to each of them receives or retains anything of value under the plan on account of their claims or interests.

In many cases, permitting junior classes to receive or retain property without paying senior classes in full may provide a practical benefit to the estate, in the form of consensus and cooperation of the junior classes. For example, the pre-petition equity holders of a debtor may be needed to manage the debtor after reorganization, and they may demand an economic stake as a prerequisite to their participation. Or, on the flip side, the debtor may determine that certain classes of unsecured creditors should not receive scarce reorganization value because they are not practically supporting the reorganized debtor after confirmation. Allowing junior classes to receive value under these circumstances would generally not be permitted under the absolute priority rule absent payment of senior creditors in full.

In cases where there is a lack of consensus, creative practitioners have attempted to remove the absolute priority rule obstacle by having a senior class of creditors gift value received on its own claims to a junior class, while skipping the intermediate classes of creditors. A classic example of a gift scenario is one in which an undersecured creditor with a first priority all-assets lien negotiates with unsecured creditors to permit them to receive a distribution, despite the fact that administrative and priority creditors will not receive full payment. The case law on the permissibility of gift arrangements is largely unsettled and continues to develop.



The Evolution of the Gift Approach

The gift strategy stems from the case *In re SPM Mfg Corp.*[4] In that case, the pre-petition lender, Citizens Savings Bank, held a perfected first-priority security interest in all the debtor's (SPM's) assets, and was undersecured. The creditors' committee determined that reorganization under the existing management was not feasible, but that a liquidation would not achieve any value for any creditor other than Citizens. The committee entered into an agreement with Citizens, promising to support the replacement of management and pursuit of a plan, provided that Citizens agreed to share with the committee proceeds of SPM's disposition, pursuant to a designated waterfall. The agreement did not provide for payment to the Internal Revenue Service, which was a priority creditor ahead of unsecured creditors in the absolute priority scheme. The agreement was filed with the bankruptcy court as an exhibit to an ancillary motion, but was not formally approved. After it became clear that SPM could not be successfully reorganized, the bankruptcy court granted Citizens' motion to appoint a trustee to sell SPM's assets pursuant to Section 363 of the Bankruptcy Code. After the sale, the case was converted to Chapter 7.

Subsequently, the committee and Citizens filed a joint motion for an order requiring the distribution of proceeds under the agreement. The IRS objected to the motion, claiming that it violated the priority rules of the Bankruptcy Code. The bankruptcy court denied the motion to the extent that it requested approval of the agreement's distribution sharing provision, stating that it would not approve a distribution that was not in accordance with the Bankruptcy Code. The district court affirmed on appeal.

The First Circuit Court of Appeals reversed the lower courts. The First Circuit found that the agreement authorized sharing between Citizens and the committee only *after* distribution of the estate property under the Bankruptcy Code, and that the IRS was not harmed because it was not entitled to a distribution in any event as Citizens was undersecured.[5] The First Circuit analogized Citizens' right to share its collateral recoveries under the agreement to a creditor's general right to freely sell its claim against the estate to third parties. Therefore, the First Circuit approved the sharing provision of the agreement, holding that it was not improper.

Gifts as Part of a Chapter 11 Plan

The sharing arrangement in *SPM* was not part of a Chapter 11 plan. Therefore, the cram-down requirements, including unfair discrimination and the absolute priority rule, were not directly at issue. However, in several cases, debtors subsequently used the logic of the *SPM* ruling to achieve plan confirmation using gift-sharing concepts.

For example, in *In re Genesis Health Ventures, Inc,*[6] the debtors' plan classified certain punitive-damage claimants as separate from other general unsecured creditors. The debtors' senior secured creditors agreed to gift a certain portion of the value they would have otherwise received on their secured claims to the holders of general unsecured claims, but not to the punitive-damage claimants. The bankruptcy court confirmed the plan over the objection of the punitive-damage claimants. The bankruptcy court cited and quoted *SPM* for the proposition that "'[c]reditors are generally free to do whatever they wish with the bankruptcy dividends they receive, including to share them with other creditors,' even if such sharing conflicts with the Code's distribution and priority scheme."[7] In confirming the plan, the bankruptcy court also relied on its finding that even if the senior secured creditors received and retained *all* the value under the debtors' plan, they still would not be satisfied in full.[8] Therefore, there was no doubt as to whether the secured creditors were allocating the value to which they were otherwise entitled. Other courts have followed *SPM* to achieve similar results.[9]

> The Second Circuit also held that when other factors weigh heavily in support of a settlement, the settlement may be approved even if it deviates from the absolute priority rule, provided such deviation is expressly justified.

More recently, the Third Circuit dealt a blow to the use of gift-sharing arrangements in *In re Armstrong World Industries, Inc.*[10] In that case, the gift-sharing issues focused on the plan's treatment of three classes: a class of general unsecured creditors (Class 6), a class of holders of asbestos-related personal-injury claims (Class 7), and a class of equity interests (Class 12). The plan provided for the distribution of warrants to Class 12 equity holders if all classes of creditors voted for the plan. To address issues in achieving consensus, the plan also expressly contemplated that unsecured creditors might vote against the plan, and provided for an alternative mechanism for distributing the warrants in that event. Specifically, if Class 6 voted to reject the plan, the new warrants would be issued to the Class 7 asbestos claimants and, in turn, the Class 7 claimants would *automatically* waive receipt of the warrants, which would then be issued to the Class 12 shareholders.

The Class 6 unsecured creditors voted to reject the plan. The committee objected to the plan, arguing, among other things, that it violated the absolute priority rule. The bankruptcy court recommended confirmation of the plan to the district court, finding that the absolute priority rule was satisfied because Class 7 waived its rights to receive the warrants. The district court was required to affirm the bankruptcy court's findings and conclusions before the plan could go into effect, because the plan contained a channeling

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injunction. The district court denied confirmation. The district court ruled that the plan's provision for the warrants to be distributed to Class 12, when they otherwise would have been distributed to Class 7, violated the absolute priority rule. On appeal, the Third Circuit affirmed. The Third Circuit held that "[u]nder the plan at issue here, an unsecured creditor class would receive and automatically transfer warrants to the holder of equity interests in the event that its co-equal class rejects the reorganization plan. We conclude that the absolute priority rule applies and is violated by this distribution scheme."[11] The Third Circuit determined that "[a]llowing this particular type of transfer would encourage parties to impermissibly sidestep the carefully crafted strictures of the Bankruptcy Code and would undermine Congress's intention to give unsecured creditors bargaining power in this context."[12]

Similarly, in *In re OCA, Inc,*[13] the Louisiana Bankruptcy Court followed *Armstrong* in denying confirmation of a plan involving a gift because it violated the absolute priority rule. The plan provided that the secured creditor would be paid in full and would extend participation rights (i.e., a right to purchase stock) to equity holders, even though general unsecured creditors' claims were not fully satisfied. Importantly, the bankruptcy court distinguished *SPM* on the bases that (a) *SPM* did not involve a Chapter 11 plan and (b) the *SPM* arrangement involved the secured creditor and the unsecured creditors sharing only *after* the distribution of estate property, and thus had no effect on the distributions to other creditors.[14]

Recent Non-Plan Case Law

The Delaware Bankruptcy Court revisited the gift concept in a Chapter 11 scenario, albeit in the settlement context, in *In re World Health Alternatives*.[15] In that case, the bankruptcy court approved a settlement agreement among the debtors, the committee, and the secured lenders, whereby the committee withdrew its objections to a motion to sell the debtors' businesses, and the secured lender agreed to carve out from its collateral $1.625 million for the benefit of unsecured creditors. Priority creditors were not paid in full. The U.S. trustee objected to this settlement, arguing that it violated the absolute priority rule and the *Armstrong* precedent. In rejecting the U.S. trustee's argument and approving the settlement, the bankruptcy court noted that the absolute priority rule was not violated because the gifting took place in the context of a settlement and not a reorganization plan.[16] Further, the bankruptcy court reasoned that the case involved the distribution to a junior class from a "carve-out" of property that fully secured the creditor's perfected security interest, and thus was not subject to distribution, even under a plan, according to the Bankruptcy Code's priority scheme.[17] Accordingly, the bankruptcy court held that the secured lender had the right to distribute the property subject to its liens as set forth in the settlement agreement.

Most recently, the Second Circuit's decision in *In re Iridium Operating LLC*[18] has raised additional questions regarding the viability of gift arrangements. In *Iridium,* the committee reached an agreement with the debtors' secured lenders, and they jointly sought bankruptcy court approval of a proposed pre-plan settlement. The agreement acknowledged that, upon bankruptcy court approval of the agreement, the lenders' liens would be senior, perfected, and unavoidable and not subject to offsets, defenses, claims, or counterclaims. In addition, the settlement divided the debtors' remaining assets into three separate tranches, with certain funds being distributed into a new limited liability company created specifically to fund litigation against the debtors' former parent company and creditor, Motorola. A majority of any recovery on the litigation against Motorola would be used to fund a reorganization plan, with administrative creditors having priority. A minority of the recoveries would be paid directly to the lenders. After the litigation concluded, any remaining funds in the LLC would be paid directly to the unsecured creditors. The plan's provision for the post-litigation disbursement of the remaining LLC funds to unsecured creditors did not conform to the absolute priority rule because it did not allocate the remaining funds in the LLC to senior creditors, such as administrative claimants.

Motorola claimed Iridium owed it approximately $1.3 billion under various agreements, including approximately $700 million in administrative expenses. Motorola objected to the settlement with the lenders because it proposed the transfer of estate assets to the LLC, and then from the LLC to unsecured creditors after the conclusion of the litigation against Motorola. Motorola argued that the settlement could never be fair and equitable if the claims of junior creditors were satisfied before those of senior creditors (including Motorola's administrative expense claim).

The bankruptcy court approved the settlement over Motorola's objection, and the district court affirmed the bankruptcy court on appeal. On further appeal, the Second Circuit vacated the bankruptcy court's order and remanded for the bankruptcy court to review the justification for providing the distribution of remaining LLC assets to the general unsecured creditors in derogation

from the absolute priority rule. The Second Circuit held that the settlement carve-out for unsecured creditors could not be approved under *SPM* and its progeny because the determination that the lenders held a first-priority security interest in the Iridium debtors' assets was contingent on approval of the settlement, rather than absolute.[19] Therefore, the Second Circuit reasoned that the appropriate review of the settlement would be pursuant to Rule 9019 of the Federal Rules of Bankruptcy Procedure.[20]

Critically, the Second Circuit held that whether a settlement adheres to the absolute priority rule is the most important factor for a court to consider when determining whether to approve the settlement under Rule 9019.[21] However, the Second Circuit also held that when other factors weigh heavily in support of a settlement, the settlement may be approved even if it deviates from the absolute priority rule, provided such deviation is expressly justified.[22] In the end, the Second Circuit concluded that the portion of the settlement directing payment of remaining LLC assets to unsecured creditors after conclusion of the Motorola litigation was not justified in any manner on the record.[23] Therefore, the Second Circuit remanded the matter to the bankruptcy court for a clarification of why the settlement required the deviation from the absolute priority rule.[24]

If the gifting is done pursuant to a pre-plan settlement, the absolute priority rule may still be the chief determinant of whether the gift is appropriate.

Lessons from the Case Law

Although courts have more stringently reviewed the approach in recent years, gifting remains a viable strategy that may be successful in appropriate cases. If the gifting is done pursuant to a pre-plan settlement, the absolute priority rule may still be the chief determinant of whether the gift is appropriate, given the *Iridium* decision. In light of the courts' interpretation of gifting under the absolute priority rule, a gift from a senior creditor to a junior creditor that skips an intervening creditor is far more likely to be approved to the extent that (a) the senior creditor has been conclusively determined to hold a perfected first-priority lien and security interest in the debtor's assets, for instance by court order; (b) the senior creditor's lien encompasses all the value of the debtor's assets (including the value to be gifted); and (c) the gift is made using value the senior creditor actually receives under a plan *after* it has already been received by the senior creditor, or otherwise using value the senior creditor is entitled to independent of the estate's return to the senior creditor. ■

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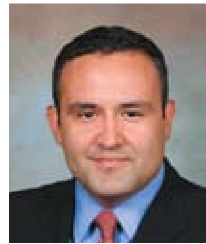

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FOOTNOTES

1. A class of claims or interests is generally "impaired" if the plan alters the rights of the claim or interest holders in the class from the treatment they would receive out of bankruptcy (such as by stretching out their payments over time or applying a discount). 11 USC 1124. A class may also be impaired if the plan does not cure defaults, reinstate maturity, and compensate the holder for certain losses in respect of the claim or interest as specified in the Bankruptcy Code. See *id*.
2. 11 USC 1129(b)(1).
3. 11 USC 1129(b)(2)(B), (C).
4. *In re SPM Mfg Corp*, 984 F2d 1305 (CA 1, 1993).
5. *Id.* at 1312–1314.
6. *In re Genesis Health Ventures, Inc*, 266 BR 591 (D Del, 2001).
7. *Id.* at 602 (quoting *In re SPM*, 984 F2d at 1313).
8. *Id.* at 601.
9. E.g., *In re Parke Imperial Canton*, 1994 Bankr LEXIS 2274 (ND Ohio, 1994) (confirming a cram-down plan that provided for a guarantee by two of the debtor's major secured creditors, using their assets, of a dividend to one junior class of unsecured creditors but not to another class of similar unsecured creditors, notwithstanding the objection of an intervening class on grounds of unfair discrimination); *In re MCorp Financial, Inc*, 160 BR 941 (SD Tex, 1993) (holding that senior creditors may share their proceeds with creditors lower in priority to junior creditors under a reorganization plan, as long as the junior creditors continue to receive at least as much as what they would without the sharing).
10. *In re Armstrong World Industries, Inc*, 432 F3d 507 (CA 3, 2005).
11. *Id.* at 514.
12. *Id.* at 514–515 (citing HR Rep No 95-595, at 416, reprinted in 1978 USCCAN 5963, 6372).
13. *In re OCA, Inc*, 357 BR 72 (ED La, 2006).
14. *Id.* at 84–85.
15. *In re World Health Alternatives*, 344 BR 291 (D Del, 2006).
16. *Id.* at 298.
17. *Id.* at 297 ("Although the general unsecured creditors will receive money before the priority creditors, that money does not belong to the estate—it belongs to [the secured lender].").
18. *In re Iridium Operating LLC*, 478 F3d 452 (CA 2, 2007).
19. *Id.* at 461.
20. *Id.*
21. *Id.* at 464.
22. *Id.* at 464–465.
23. *Id.* at 466.
24. *Id.*