Validity of Senior Class "Gifting" in the Aftermath of *Armstrong World Industries*

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The proposition that a creditor can do whatever it wants with its recovery from a chapter 11 debtor may seem to be a fundamental right. Even so, in the context of confirmation of a chapter 11 plan, that right may not be unqualified and may, in fact, violate well-established bankruptcy principles. One such principle that applies only in the context of non-consensual confirmation of a chapter 11 plan — or "cramdown" — is commonly referred to as the "absolute priority rule," a pre-Bankruptcy Code maxim that established a strict hierarchy of payment among claims of differing priorities. The rule's continued vitality and application under the current statutory scheme has been a magnet for controversy, particularly because "give ups" by senior classes of creditors to achieve confirmation have become increasingly common features of chapter 11 plans.

One of the most significant developments in the debate came at the end of 2005, when the Third Circuit Court of Appeals, in *In re Armstrong World Industries, Inc.*, affirmed a Delaware bankruptcy court's ruling that a chapter 11 plan could not be confirmed because a proposed distribution of warrants to the debtor's stockholders over the objection of the class of unsecured creditors violated the rule. The Delaware bankruptcy court recently had an opportunity to revisit the issue, with a twist, in *In re World Health Alternatives, Inc.*

Cram-Down and the Fair and Equitable Requirement

A chapter 11 plan can be confirmed by the bankruptcy court under either of two scenarios. The first is a consensual plan confirmation. This means that all classes of creditors and shareholders either have accepted the plan or are not "impaired" by it because the plan pays them in full or leaves their rights unchanged. By contrast, if a class of creditors or shareholders votes to reject a plan, it can be confirmed over the class's objection only if the plan satisfies the requirements of section 1129(b) of the Bankruptcy Code. Among these is the mandate that a plan "does not discriminate unfairly" and is "fair and equitable" with respect to dissenting classes of creditors and shareholders.

The Bankruptcy Code specifically details one of the prerequisites for a plan's treatment of a class of claims or equity interests to be "fair and equitable." This requirement varies depending on whether the dissenting impaired class contains secured claims, unsecured claims or interests. With respect to a dissenting impaired class of unsecured claims, section 1129(b)(2) of the Bankruptcy Code provides that a plan is fair and equitable if, among other things, the creditors in the class are paid in full, or failing full payment, no creditor of lesser priority, or shareholder, receives any distribution under the plan. This requirement is sometimes referred to as the "absolute priority rule."

Section 1129(b)(2) has been the focus of considerable debate in the courts even though it expressly delineates the circumstances under which a plan satisfies the standard. The dispute has generally concerned two areas. The first pertains to the ability of a company's existing shareholders, even though creditor claims are not paid in full, to retain an ownership interest in a

reorganized debtor by infusing new value into the debtor. Referred to as the "new value" exception to the absolute priority rule, this issue is outside the scope of this article. The second issue is whether section 1129(b)(2) allows a class of senior creditors voluntarily to cede a portion of its recovery under a plan to a junior class of creditors or shareholders.

Legitimacy of Senior Class "Give Ups" under the Absolute Priority Rule

Notwithstanding section 1129(b)(2)(B)(ii)'s preclusion of distributions to junior interests in cases where it applies, some courts have ruled that a plan does not violate the "fair and equitable" requirement if a class of senior creditors agrees that some of the property that would otherwise be distributed to it under the plan can be given to a junior class of creditors or shareholders. In doing so, many courts rely on a 1993 decision by the First Circuit Court of Appeals in *In re SPM Manufacturing Corp.*

In *SPM*, a secured lender holding a first priority security interest in substantially all of a chapter 11 debtor's assets entered into a "sharing agreement" with general unsecured creditors to divide the proceeds that would result from the reorganization, apparently as a way to obtain their cooperation in the case. After it became apparent that the company could not be reorganized, the court appointed a receiver to market SPM's assets, which were ultimately sold for $5 million. Soon afterward, the secured creditor obtained relief from the automatic stay and the case was converted to a chapter 7 liquidation.

Thereafter, the secured lender and the unsecured creditors tried to force the chapter 7 trustee to distribute the proceeds from the sale of the debtor's assets in accordance with the sharing

agreement. The agreement, however, contravened the Bankruptcy Code's distribution scheme because it provided for distributions to unsecured creditors before payment of priority tax claims.

Relying upon its equitable powers under section 105(a), the bankruptcy court ordered the trustee to ignore the sharing agreement, and to distribute the proceeds of the sale otherwise payable to the unsecured creditors in accordance with the statutory distribution scheme. The district court upheld that determination on appeal.

The First Circuit reversed. As a fully secured lienor, the Court of Appeals explained, the lender was entitled to the entire amount of any proceeds of the sale of the debtor's assets, whether or not there was a sharing agreement. Therefore, any money siphoned to unsecured creditors came from funds to which the secured creditor was otherwise entitled. Moreover, the First Circuit reasoned, because the secured lender would share its proceeds only after all unencumbered estate property had been distributed, the sharing agreement had no effect on distributions to other creditors. Without the sharing agreement, the secured lender would have received the entire allotted distribution under the reorganization plan, while tax creditors would have received nothing. Thus, the First Circuit concluded, "[w]hile the debtor and the trustee are not allowed to pay nonpriority creditors ahead of priority creditors . . . , creditors are generally free to do whatever they wish with the bankruptcy dividends they receive, including to share them with other creditors."

Other courts have cited *SPM* as authority for confirming a non-consensual chapter 11 plan (or settlement) in which a senior secured creditor assigns a portion of its recovery to creditors (or

shareholders) who would otherwise receive nothing by operation of section 1129(b)(2). Some have even extended this rationale to encompass voluntary concessions by unsecured creditors to other unsecured creditors with lesser priority. Still, as noted, the concept of allowing a senior creditor or class of creditors to assign part of its recovery under a chapter 11 plan to junior creditors or stockholders who would otherwise receive nothing by operation of section 1129(b)(2)(B)(ii) is controversial. So much so, in fact, that the Third Circuit declared the practice invalid under certain circumstances in *Armstrong World Industries*.

Armstrong World Industries

Facing significant asbestos liabilities, floor and ceiling products manufacturer Armstrong World Industries, Inc. ("Armstrong") and two of its wholly owned subsidiaries voluntarily sought chapter 11 protection in 2000. Armstrong's creditors included both general unsecured creditors and creditors whose claims were based upon injuries sustained due to asbestos exposure.

Armstrong filed its fourth amended chapter 11 plan in 2003. Under the plan, unsecured creditors (other than asbestos claimants) would recover approximately 59.5% of their claims and asbestos personal injury creditors would recover approximately 20% of an estimated $3.1 billion in claims. In addition, the plan provided that Armstrong's shareholders would receive warrants to purchase new common stock in the reorganized company valued at $35 million to $40 million. A key provision of the plan was the consent of the class of asbestos claimants to share a portion of its proposed distribution with equity. The plan provided that, if Armstrong's class of unsecured creditors (other than asbestos claimants) voted to reject the plan, asbestos claimants would receive new warrants, but would automatically waive their distribution, causing equity to obtain the warrants that otherwise would have been distributed to the asbestos claimants. The net result

of the waiver was that equity holders would receive property on account of their equity interests, although a senior class (*i.e.*, the unsecured creditors) was not paid in full.

Of the classes of creditors and shareholders impaired by the plan, only unsecured creditors voted to reject it. Thus, upon the submission of proposed findings by the bankruptcy court, the district court had to decide whether the plan could be confirmed over the objection of the unsecured class under section 1129(b). The court denied confirmation, ruling that distribution of new warrants to the class of equity holders over the objection of the unsecured creditors class violated the “fair and equitable” requirement of section 1129(b)(2)(B)(ii).

In doing so, the district court distinguished, or characterized as “wrongly decided,” cases in which the courts have not strictly applied section 1129(b)(2)(B)(ii). It found *SPM* to be inapposite for “several reasons.” Initially, the district court explained, the distribution in *SPM* occurred in a chapter 7 case, “where the sweep of 11 U.S.C. § 1129(b)(2)(B)(ii) does not reach.” Moreover, the court emphasized, SPM’s unsecured creditors, rather than being deprived of a distribution, were receiving a distribution ahead of priority, such that “the teachings of the absolute priority rule — which prevents a junior class from receiving a distribution ahead of the unsecured creditor class — are not applicable."

The district court reasoned that the secured lender in *SPM* held a first priority security interest in substantially all of the debtor’s assets. This meant that, although the sharing agreement implicated estate property, the property was not subject to distribution under the Bankruptcy Code’s priority scheme. Finally, the district court emphasized, the sharing agreement in *SPM*

might be more properly construed as an ordinary "carve out," whereby a secured party allows a portion of its lien proceeds to be paid to others as part of a cash collateral agreement.

The district court went on to distinguish other cases that have not strictly applied section 1129(b)(2)(B)(ii), flatly rejecting the contention that creditors, without adhering to the strictures of the statute, are free to do whatever they wish with their distributions under a plan, including sharing them with other creditors, so long as other creditor recoveries are not affected. "Bluntly put," the court concluded, "no amount of legal creativity or counsel's incantation to general notions of equity or to any supposed policy favoring reorganizations over liquidation supports judicial rewriting of the Bankruptcy Code."

The Third Circuit affirmed this determination on appeal, adopting substantially all of the district court's reasoning regarding the strictures of the absolute priority rule. Even so, the decision did not rule out the possibility that senior class give-ups might pass muster under different circumstances. What those circumstances can be was the subject of the Delaware bankruptcy court's ruling in *World Health Alternatives*.

World Health Alternatives

On the same day that World Health Alternatives, Inc. and its affiliates filed for chapter 11 protection in February of 2006, the debtors sought court authority to sell substantially all of their assets at auction, as well as approval of a post-petition financing to be provided by the debtors' pre-petition lender to allow for an orderly liquidation of their estates. The creditors' committee later appointed in the cases objected to the proposed auction procedures and the financing motion, but all parties concerned reached a global settlement of the disputed issues.

The settlement agreement provided that the lender would agree to a “carve-out” from its liens in the amount of $1,625,000 “to be distributed to the holders of allowed general unsecured claims after payment of any unpaid professional fees and expenses of the Committee and/or used to investigate and prosecute estate causes of action” against parties other than the lender. If approved, the settlement would allow for payments to unsecured creditors prior to full satisfaction of priority tax claims asserted by the Internal Revenue Service. The U.S. Trustee objected to the settlement, arguing, among other things, that the Third Circuit’s ruling in *Armstrong* prohibits any payment to general unsecured creditors before priority claims. No other party, including the IRS, objected to the settlement motion.

Citing *Armstrong*, the bankruptcy court noted that the absolute priority rule arises in the context of a plan of reorganization. Because the settlement agreement was not part of any plan, as was the case in *Armstrong*, the court explained, *Armstrong* does not control. The court reasoned that, rather than overruling prior cases that permitted a senior creditor to give up some of its collateral to a junior class, *Armstrong* expressly distinguished those cases, suggesting that the settlement in *World Health* did not necessarily violate the absolute priority rule. According to the court, the facts before it were much more comparable to the circumstances present in *SPM*, which involved, among other things, (i) a settlement agreement rather than a chapter 11 plan, (ii) property that was fully encumbered and, thus, not subject to distribution according to the Bankruptcy Code’s distribution scheme, and (iii) a carve-out of the secured creditor’s collateral. Even in the context of non-consensual confirmation of a plan, the court observed, a carve-out from a secured

creditor's collateral "does not offend the absolute priority rule or the Bankruptcy Code's distribution scheme because the property belongs to the secured creditor — not the estate."

The U.S. Trustee also contended that the settlement agreement violated the absolute priority rule by releasing causes of action against the lender that, if successfully prosecuted, would result in recoveries that would go first to priority creditors, who were receiving no compensation in return. The court rejected this argument, noting that the carve-out payment was not given solely in consideration for the release of estate causes of action but also in exchange for withdrawal of the committee's challenge to the sale motion. According to the court, withdrawal of the committee's objection was in and of itself sufficient consideration for the carve-out.

Analysis

World Health indicates that give-ups by senior classes as part of an overall negotiating strategy continue to be a vital and important part of the chapter 11 process. A "gift" of consideration to a junior class may enable the parties to reach agreement on a consensual plan of reorganization, thereby avoiding the need for a contested confirmation hearing. Without the gift, the junior class receiving nothing would have a strong incentive to litigate. The litigation, which often would require, among other things, expert testimony as to the value of the company, may be expensive and time consuming. Thus, it may be in the interests of the senior creditors to give up some value to get the deal done.

The decision also illustrates the limitations of *Armstrong*, and provides a possible road map to avoid running afoul of the Third Circuit's directives. First, the strictures of the absolute priority rule apply only in cases involving the non-consensual confirmation of a chapter 11 plan — if an

intervening class of creditors does not object to a senior class give-up as a means of achieving consensual confirmation, the rule does not come into play. *World Health* involved court approval of a settlement agreement in a case that would ultimately be converted to a chapter 7 liquidation. Moreover, the only intervening class of creditors involved (the IRS) chose not to object to the give-up or any other aspect of the settlement.

As such, the issue properly before the court was whether the settlement was reasonable and in the best interests of the bankruptcy estate, not whether one aspect of the agreement might be an impediment to confirming a chapter 11 plan. Even in reorganization cases, courts have been reluctant to invalidate pre-confirmation settlements involving senior class gifting that arguably violate the absolute priority rule because the issue is not ripe for consideration other than in the context of a contested confirmation hearing.

Finally, cases involving carve-outs from recoveries that would otherwise go exclusively to a senior class of secured creditors (as in *SPM*) are far more likely to pass muster under the standard articulated in *Armstrong*. In the vast majority of cases, all stakeholders involved recognize the practical utility of senior class gifting in achieving consensual confirmation and preserving value.

In re World Health Alternatives, Inc., 344 B.R. 291 (Bankr. D. Del. 2006).

Official Unsecured Creditors' Committee v. Stern (In re SPM Manufacturing Corp.), 984 F.2d 1305 (1st Cir. 1993).

In re Armstrong World Indus., Inc., 432 F.3d 507 (3d Cir. 2005).

Ad Hoc Adelphia Trade Claims Committee v. Adelphia Communications Corp., 337 B.R. 475 (S.D.N.Y. 2006).