Taking the Gift Back: Second Circuit Alters Future Plan Negotiations by Striking Down the Use of Gifting Through a Chapter 11 Plan

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Rehabilitating a debtor's business and maximizing the value of its estate for the benefit of its various stakeholders through the confirmation of a chapter 11 plan is the ultimate goal in most chapter 11 cases. Achievement of that goal, however, typically requires resolution of disagreements among various parties in interest regarding the composition of the chapter 11 plan and the form and manner of the distributions to be provided thereunder. While formulating and negotiating a chapter 11 plan, the debtor and other parties need to be cognizant of the requirements for plan confirmation, including, among others, those found in section 1129 of the Bankruptcy Code. In particular, where a chapter 11 plan purports to provide a class of unsecured creditors with a distribution worth less than the allowed amount of the creditors' claims, and that class of creditors votes against the plan, the "absolute priority rule," as codified in section 1129(b)(2)(B) of the Bankruptcy Code, dictates that no holder of any claim or interest which is junior to such class—typically, equity holders—shall "receive or retain under the plan on account of such junior claim or interest any property."

Notwithstanding the absolute priority rule, however, in order to foster plan confirmation or pursue other goals, a senior creditor, as part of a deal, may try to bypass an intermediate class of creditors by providing, from value that absent the deal would have gone to the senior creditor, a "gift" distribution to a junior class that would not otherwise be entitled to anything under the plan. Although the United States Court of Appeals for the Third Circuit limited the use of gifting in that circuit in its 2005 ruling in *In re Armstrong World Indus., Inc.*, gifting retained viability as a tool to achieve certain goals within the Second Circuit. However, in *Dish Network Corp. v. DBSD N. Am., Inc. (In re DBSD N. Am., Inc.),* the Second Circuit, among other rulings discussed below, recently rejected gifting as inconsistent with the absolute priority rule requirements for "cramdown" under section 1129(b)(2)(B) of the Bankruptcy Code.

Cramdown and the Absolute Priority Rule

Section 1129 of the Bankruptcy Code requires, among other things, that for a plan to be confirmable, each class of claims or interests must either accept the plan or not be "impaired." There is, however, an exception contained in section 1129 that a plan may be confirmed over the negative vote of an impaired class (*i.e.*, crammed down on that class) if all of the other plan requirements are satisfied and the plan is, among other things, "fair and equitable," with respect to each class of claims or interests that is impaired under, and has not accepted, the plan. For a plan to be "fair and equitable," it must, with respect to a class of unsecured creditors, provide that either: (i) holders of claims in the rejecting class will receive value, as of the effective date, equal to the allowed amount of their claims; or (ii) holders of claims or interests in a junior class will not receive or retain any property under the plan on account of their claims or interests. The "fair and equitable" requirement as to unsecured creditors thus includes a form of the absolute priority rule.

Gifting Around the Absolute Priority Rule

In the context of negotiating a chapter 11 plan, certain parties may determine that providing value to a junior class on account of its junior claims or interests, without paying the claims of an intermediate class in full, is advantageous. If such intermediate class accepts the plan, the absolute priority rule is inapplicable to that class. If, however, the intermediate class rejects the plan, the plan is not fair and equitable vis-à-vis that class and thus is unconfirmable.

In cases where such a distribution to junior classes is advantageous, but where an intermediate class rejects the plan, parties sometimes have sought to comply with the absolute priority rule by arguing that the value to be provided to the junior class is a "gift" from property that otherwise would be distributed to senior creditors, rather than a distribution on account of the claims or interests in the junior class. Under this theory, the rights of any intermediate creditors who received less than payment in full arguably are not affected because any distribution to the junior holders is merely a "gift" out of the senior creditor's distribution. Gifting, in this sense, provided parties with a powerful tool to accomplish a restructuring. The First Circuit's 1993 decision in *In re SPM Mfg. Corp.*, which allowed a secured creditor in a chapter 7 case to share a portion of its collateral with other creditors, provided some support for the gifting argument.

In *DBSD*, the Second Circuit ruled that a gift from a secured creditor to equity over the objection of a dissenting unsecured creditor class violated the absolute priority rule, thus significantly curtailing the gifting approach in the Second Circuit.

The Bankruptcy and District Court Rulings

In *DBSD*, Sprint Nextel Corp. ("Sprint"), a litigation claimant that filed a claim against the debtor in the amount of $211 million (which was temporarily allowed for voting purposes in the amount of $2 million), objected to the plan of reorganization proposed by DBSD North America, Inc., and its various subsidiaries (collectively, "DBSD"), arguing, among other things, that the plan violated the absolute priority rule. Under the plan, holders of unsecured claims, such as

Sprint, would receive shares of reorganized DBSD estimated to be worth between 4 and 46 percent of their allowed claims, while DBSD's existing equity owner would also receive shares and warrants in the reorganized company. Sprint argued that because old equity received a distribution under the plan—in fact, the value to be distributed to old equity exceeded the value to be distributed to creditors by more than a factor of 20—the plan violated the absolute priority rule and could not be confirmed.

DBSD argued that this aspect of the plan was an acceptable gifting arrangement. Specifically, for equity to receive a distribution, the second lien holders, holding a lien on substantially all of the debtors' assets, made a gift to equity under the plan from their distribution of the majority of the equity of the reorganized company, which was estimated to be valued at 51 to 73 percent of their allowed claims. In confirming the plan, the bankruptcy court agreed with the characterization of the recovery to equity as a gift from the second lien holders. The bankruptcy court held that the second lien holders were free to "voluntarily offer a portion of their recovered property to junior stakeholders." In addition, the court noted that gifting should be permissible "where, as here, the gift comes from secured creditors, there is no doubt as to their secured creditor status . . . and where the complaining creditor would get no more if the gift had not been made."

The district court affirmed.

The Second Circuit Decision

The Second Circuit's full opinion addressed three issues: (i) Sprint's standing to appeal; (ii) whether the plan violated the absolute priority rule; and (iii) whether the bankruptcy court correctly “designated” (disallowed) the vote of Dish Network Corp. (“Dish”), an indirect competitor of DBSD.

As a preliminary matter, the Second Circuit determined that Sprint had standing to appeal even though, absent the gift, there would be no recovery for unsecured creditors and therefore the gift did not affect Sprint’s recovery. The Second Circuit rejected the notion that a creditor lacks standing merely because its claim is out of the money. As the court noted, Sprint might do better by using its unsecured claim as leverage to increase its recovery if the reasons for the gift to equity were worth the cost to the second lien holders of obtaining the unsecured creditors’ approval of the plan. For Sprint to have standing, the Second Circuit determined, the court need only determine that Sprint at the very least stood a reasonable chance of improving its position.

The Second Circuit then turned to gifting and the absolute priority rule. Citing the plain language of section 1129(b)(2)(B) and case law construing the absolute priority rule from its initial use in railroad reorganization cases in the 19th century to the present, the court held that because old equity received property—stock and warrants—under the plan on account of its interest, the bankruptcy court should not have confirmed the plan. Further, the court noted that additional reasons cited for the gift, including the shareholder’s continued cooperation and assistance, did not justify what was, in its view, a clear violation of the absolute priority rule. In fact, the court believed that strict application of the absolute priority rule was mandated on the basis of two prior Supreme Court decisions indicating a preference for a strict reading of the rule—*Bank of Am. Nat’l Trust & Sav. Ass’n v. 203 N. LaSalle St. P’ship* and *Norwest Bank Worthington v. Ahlers*.

The Second Circuit distinguished its ruling from *SPM*. In *SPM*, the First Circuit held that nothing in the Bankruptcy Code barred secured creditors in a case converted from chapter 11 to chapter 7 from sharing with certain unsecured creditors, ahead of higher-priority unsecured creditors, proceeds they received from liquidating the debtor's assets where the amount of the secured lender's liens exceeded the debtor's value. The Second Circuit noted an important distinction between the two cases: *SPM* involved a chapter 7 liquidation, not chapter 11, and the absolute priority rule of section 1129(b)(2)(B) does not apply in chapter 7. The court also noted that in *SPM*, the secured creditor had obtained relief from the automatic stay to foreclose on the proceeds of the liquidation, such that those proceeds no longer constituted property of the estate but were property of the secured creditor, which could do with them what it pleased.

The Second Circuit also addressed certain policy arguments against strictly construing the absolute priority rule as a prohibition against gifting, including that: (i) gifting can be a powerful tool in encouraging an efficient and nonadversarial chapter 11 process; and (ii) enforcing the absolute priority rule, by contrast, may lead to holdout behavior. The court responded that strong policy arguments exist in support of strict construction as well. For example, it explained, because shareholders may retain substantial control over the chapter 11 process (as existing management or otherwise as a debtor in possession), a weakened absolute priority rule could allow for self-enrichment and other serious mischief between senior creditors and existing shareholders. Along those lines, the court found it telling that while the commission charged with reviewing the bankruptcy laws in the lead-up to the enactment of the Bankruptcy Code suggested loosening the absolute priority rule to allow greater participation by equity owners, and whereas

Congress did in fact weaken the absolute priority rule in some ways, it did not create an exception for gifts of the type at issue in *DBSD*.

Importantly, because the distributions to old equity in *DBSD* were provided under the plan, the Second Circuit expressly declined to determine whether the Bankruptcy Code would allow the existing equity holder to receive the gift *outside the plan*.

Notably, the Second Circuit also affirmed an order of the bankruptcy court designating Dish's votes against the plan as having been cast in bad faith and thus disregarding Dish's vote for plan confirmation purposes. Dish, an indirect competitor of DBSD, purchased all of DBSD's first lien debt after the plan disclosure statement was released in an effort to control the plan process and eventually acquire some of DBSD's strategic assets. The Second Circuit held that, in rejecting the plan as proposed, Dish was not acting as a creditor seeking to maximize the return on its claims, but rather voting with an improper ulterior motive—the classic rationale for vote designation under section 1126(e) of the Bankruptcy Code.

Conclusion

DBSD undoubtedly will shift the dynamic in some chapter 11 plan negotiation processes in the Second Circuit and, in some cases, may render confirmation more difficult or expensive. In the single-debtor context, the ruling in particular may make it more difficult for equity holders to recover any property under a plan. But in the multiple-debtor context, its consequences may reach other types of constituencies as well. For example, if a dissenting unsecured class is not paid in full at the subsidiary level, what are the ramifications for the debtor's corporate structure? Will the court find that the absolute priority rule is not implicated where the debtor parent retains its equity in its debtor subsidiary even though the subsidiary's creditors do not receive payment in full under the plan because keeping the corporate structure intact is for convenience only? Or will the debtors be required to structure their plans around such a possibility or to rely on such other doctrines as the "new value" exception to the absolute priority rule?

Importantly, the Second Circuit limited its ruling to distributions under a plan. The court expressly declined to determine whether the second lien holders, after receiving a distribution under the plan, could in turn distribute a portion of that recovery to old equity outside the plan. A potential "gift" outside the plan raises many questions. For example, would the gift be permissible under *SPM*, or would it contravene the spirit of the absolute priority rule and therefore taint the plan? Even if permissible, how would the gift be implemented? Would it be based on a preconfirmation agreement between the parties? If not, what recourse would the prospective recipient have in the event the gift were not made? What are the disclosure obligations and considerations regarding such a gift? How would the gift be distributed, particularly if the junior class has disputed claims or interests, or numerous holders? What are the consequences for both the distributor and the recipient of the gift, particularly if the gift is in the form of noncash consideration?

By eliminating the ability to make class-skipping gifts pursuant to a plan, the *DBSD* ruling may change the plan negotiation process in some chapter 11 cases in the Second Circuit. As the Second Circuit noted, strict enforcement of the absolute priority rule would provide Sprint with additional leverage in negotiating for the value of the distribution to equity. As a result, intermediate classes may be able to obtain a greater recovery than they otherwise would receive if gifting under a plan were permissible in the Second Circuit.

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

In re DBSD N. Am., Inc., 419 B.R. 179 (Bankr. S.D.N.Y. 2009), *aff'd*, 2010 WL 1223109 (S.D.N.Y. Mar. 24, 2010), *aff'd in part, rev'd in part sub nom. Dish Network Corp. v. DBSD N. Am., Inc. (In re DBSD N. Am., Inc.)*, 2010 WL 4925878 (2d Cir. Dec. 6, 2010), *opinion issued by* 2011 WL 350480 (2d Cir. Feb. 7, 2011).

In re SPM Mfg. Corp., 984 F.2d 1305 (1st Cir. 1993).

Bank of Am. Nat'l Trust & Sav. Ass'n v. 203 N. LaSalle St. P'ship, 526 U.S. 434 (1999).

Norwest Bank Worthington v. Ahlers, 485 U.S. 197 (1988).