Second Circuit Court Of Appeals Holds “Gift” From Secured Creditor To Shareholder Under A Chapter 11 Plan Violates Absolute Priority Rule

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In a recent decision, the United States Court of Appeals for the Second Circuit added to a growing body of jurisprudence questioning the so-called “absoluteness of the senior class gift- ing” to resolve intercreditor disputes in chapter 11 cases. For decades, debtors and their senior creditors have often resolved disputes with junior creditors and equity holders by “carving out” value that would otherwise go to the senior class and “gift- ing” that value to junior stakeholders. The challenge arises when a class of creditors of intervening priority rejects the debtor’s plan of reorganization, and confirmation of the plan is made subject to the require- ments for “cramdown” under section 1129(b) of the Bankruptcy Code. In these situations, bankruptcy courts must con- sider whether the plan complies with the “absolute priority rule” set forth in section 1129(b)(2)(B) of the Bankruptcy Code. That rule prohibits a junior class of claims or interests from receiving or retaining property under a plan on account of those claims or interests unless all classes with higher priority will be paid in full. Many courts have found the absolute priority rule inapplicable where a senior lender has “gifted” property to a junior class of claims or interests in a recent example of a court-approved gift- ing arrangement that entailed a distribu- tion outside of a plan that was imple- mented in tandem with the plan and fully disclosed to the bankruptcy court and par- ties in interest. That plan provided for a distribution of property to the entire class of unsecured creditors, while a subset of trade creditors in that class received an additional pay- ment outside of the plan. While the plan’s mechanism for implementing those dis- tributions did not invoke the absolute priority rule. In DBSD, the Second Circuit recog- nized that there are sound policy argu- ments in favor of gifting, including that it can be a “powerful tool in accelerating an efficient and non-adversarial … chapter 11 proceeding.” Faced with this reality, it is unlikely that parties in restructurings will be willing to declare “gifting” dead; how- ever, they will need to explore creative alternatives (such as the journal register model) to facilitate restructurings with broad (if not universal) support among stakeholders.

Background

DBSD North America, Inc. and its vari- ous debtor subsidiaries (the “Debtors”) were found by CO Global Communica- tions (the “Stockholder”) to develop a mobile communications network. Ulti- mately, the network was never fully devel- oped and the Debtors’ debt mounted with- out sufficient revenues to support such obligations. Substantially all of the Debtors’ assets were encumbered by liens and security agreements in favor of $50 mil- lion in claims under a revolving credit facility (the “First Lien Debt”) and (ii) $650 million in claims under second lien notes (the “Second Lien Notes”). Sprint

Nextel Corporation (“Sprint”) held an unliquidated, disputed unsecured claim that was temporarily allowed for plan vot- ing purposes in the amount of $32 million (the “Sprint Unsecured Claim”) and clas- sified with other general unsecured claims against one of the Debtors. The Debtors’ plan of reorganization (the “Plan”) provided for the following treatment of creditor and equity classes:

(i) The First Lien Debt would be rein- ducted.
(ii) The Second Lien Noteholders would receive the majority of the equity in the reorganized enterprise (“New Equity”) (valued at 51-73 percent of the allowed amount of the Second Lien Notes).
(iii) Sprint and other holders of general unsecured claims would receive a smaller share of the New Equity and Warrants (“Warrants”) (valued at 4-46 percent of the allowed amount of general unsecured claims, including the Sprint Unsecured Claim if it were ultimately allowed).
(iv) The Stockholder would receive a significant distribution of New Equity and Warrants.

Importantly, though the old equity had no value per se, the Plan provided that the Stockholder’s distribution was, at least in part, to be made on account of its old equity which was classified in Class 9 of the Plan:

Class 9 – Existing Stockholder Interests
...In full and final satisfaction, settle- ment of all claims, and discharge of each Existing Stockholder Interest, and on account of all valuable consideration provided by the Existing Stockholder, including without limitation, the plan consideration provided in the Support Agreement ...the Holder of such Class 9 Existing Stockholder Interest shall receive the Existing Stockholder Shares and the Warrants.

Sprint had a controlling vote in an unsecured creditor class and caused that class to reject the Plan, which required the debtors to pursue confirmation under section 1129(b) of the Bankruptcy Code. Sprint argued that the Plan was not confirmable over the objection of a dis- senting creditor since it violated the absolute priority rule and contravened the Bank- ruptcy Code requirement that a plan be “fair and equitable, with respect to each class of claims, that is, is fair and has not accepted, the plan.” The United States Bankruptcy Court for the Southern District of New York confirmed the Plan over Sprint’s objection, and the district court affirmed. Sprint appealed to the Second Circuit.

Applying The Absolute Priority Rule

The Second Circuit cited the Bank- ruptcy Code’s requirement that “[a]bsent the consent of all impaired classes of un- secured claimants, ... a confirmable plan must ensure either (i) that the dissenting class receive[] the full value of its claim, or (ii) that there be no class other than the claim holder receive any property under the plan on account of their junior claims or interests.” In considering whether the Plan viol- ated the absolute priority rule, the Second Circuit examined whether (1) the Stockholder would receive “property,” (2) whether such property would be received “under the plan,” and (3) whether such property would be received “on account of” the Stockholder’s equity interests. Was the Proposed Distribution Estate Property?

The Second Circuit rejected the Bank- ruptcy Court’s conclusion that the Stock- holder’s distribution was not a distribution of estate property. The Bankruptcy Court had adopted the underlying premise of general bankruptcy code (“Bankruptcy”) Code provisions to govern the rights of creditors to transfer or receive nonestate property. Focusing on the fact that the “gift” at issue was coming from an undesignated senior lender group, the Bankruptcy Court noted that if that lender group “were to enforce its security interest, the property would never become part of the estate to be subject to distribu- tion to unsecured creditors.” Accord- ingly, the Bankruptcy Court reasoned that the transferred property was outside the auspices of the absolute priority rule. The Second Circuit disagreed, finding that “the Bankruptcy Code extends the absolute priority rule to ‘any property,’ ... not ‘any property not covered by a senior creditor’s lien.’” Significantly, the Second Circuit opined that “the secured creditors could have demanded a plan in which they received all of the reorganizing assets, but, having chosen not to, they may not ‘surrender’ part of the value of the estate for distribution to the stockholder[,] ... as a ‘gift’ from the secured creditors here did not take remain in the estate for benefit of other claim- holders.”

Would the Distribution Be Received “Under a Plan”?

The Second Circuit then focused on whether the property would be received by the Stockholder “under the plan.” As noted above, the Plan explicitly provided for the distribution to the Stockholder as its treat- ment under the Plan. Citing corresponding language in the Debtors’ disclosure state- ment for the Plan, the Second Circuit found that if the Stockholder would receive New Equity and Warrants under the Plan.

Would the Distribution Be Received “on account of” a Junior Priority Interest?

The Second Circuit examined whether the Stockholder would receive New Equity and Warrants “on account of” its junior interest. Noting that the phrase “on account of” could be interpreted in several ways, the Second Circuit found that under even the most generous of interpretations, the plain language of the Plan stated that the distribution would be made, at least in part, on account of the Stockholder’s prepetition equity interest. While the proponents of the Plan con- tended that the distribution to the Stock- holder was actually in exchange for the Stockholder’s “continued cooperation and assistance in the reorganization,” the Sec- ond Circuit was unpersuaded. The court equated “cooperation and assistance” of an existing shareholder to the type of vague, future benefit that the Supreme Court has held the bankruptcy code did not recognize as “property” to an old equity holder in contra- vention of the absolute priority rule. Because the Plan failed all three ele- ments of the absolute priority rule, the Second Circuit concluded that the Plan violated the absolute priority rule and should not have been confirmed.

DBSD’s Implications

The Second Circuit limited its applica- tion of the absolute priority rule to trans- fers under a plan, leaving open the possi- bility that transfers of property that are structured to occur “outside of the plan” that would achieve similar results are still viable. Parties interested seeking to effect carveouts or reallocations of recovery between parties will be more likely to focus on finding means to achieve those reallocations outside of the plan.

The confirmed plan in the chapter 11 case of In re Journal Register Co., et al is a recent example of a court-approved gift- ing arrangement that entailed a distribu- tion outside of a plan that was imple- mented in tandem with the plan and fully disclosed to the bankruptcy court and par- ties in interest. That plan provided for a distribution of property to the entire class of unsecured creditors, while a subset of trade creditors in that class received an additional pay- ment outside of the plan. While the plan’s mechanism for implementing those dis- tributions did not invoke the absolute priority rule.

Decision at 5-6.

Decision at 26.

Decision at 6-7.

Decision at 7.

Decision at 8.

Decision at 11.

Decision at 25.

Bankruptcy Court Decision at 311.

Id.

Decision at 25.

Decision at 25-26.

Decision at 29 (citing Norwest Bank Worthington v. Ahrens, 485 U.S. 197, 199 (1989)).