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,[1] the United States Court of Appeals for the Second Circuit added to a growing body of jurisprudence questioning the use of "senior class gifting" 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 "gifting" 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 requirements for a "cramdown" under section 1129(b) of the Bankruptcy Code. In these situations, bankruptcy courts must consider whether the plan complies with the "absolute priority rule" 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 class voluntarily "carves out" a part of its collateral for the junior class, if it has no impact on intervening creditors' distributions.

Before *DBSD,* Second Circuit bankruptcy courts had been viewed as among the more receptive venues for using senior class gifting in various forms. *DBSD* is the first time the Second Circuit has squarely applied the absolute priority rule to invalidate a gift under a chapter 11 plan. Though DBSD clearly prohibits a specific type of gifting structure in a plan that has been rejected by an impaired class, the Second Circuit left open the possibility that senior class gifting arrangements can be approved in forms other than that presented in the *DBSD* plan. Companies contemplating or operating in chapter 11, secured lenders and other parties in interest (and their respective advisors) should consider the implications of *DBSD* as they endeavor to achieve consensus among major parties in interest and implement that consensus in a manner that will withstand legal challenge.

Background

DBSD North America, Inc. and its various debtor subsidiaries (the "Debtors") were founded by ICO Global Communications (the "Stockholder") to develop a mobile communications network. Ultimately, the network was never fully developed and the Debtors' debt mounted without sufficient revenues to support such obligations. Substantially all of the Debtors' assets were encumbered by liens and security interests securing (i) $40 million 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 voting purposes in the amount of $2 million (the "Sprint Unsecured Claim")[2] and classified with other general unsecured claims against one of the Debtors.[3]

The Debtors' plan of reorganization (the "Plan") provided for the following treatment of creditor and equity classes:

(i) The First Lien Debt would be reinstated.[4]

(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).[5]

(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).[6]

(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, settlement, release, and discharge of each Existing Stockholder Interest, and on account of all valuable consideration provided by the Existing Stockholder, including without limitation, certain consideration provided in the Support Agreement … the Holder of such Class 9 Existing Stockholder Interest shall receive the Existing Stockholder Shares and the Warrants.[7]

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 of the plan under section 1129(b) of the Bankruptcy Code.[8] Sprint argued that the Plan was not confirmable over the objection of a dissenting class since it violated the absolute priority rule and contravened the Bankruptcy Code requirement that a plan be "fair and equitable, with respect to each class of claims … that is impaired under, and has not accepted, the plan."[9] 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 Bankruptcy Code's requirement that "[a]bsent the consent of all impaired classes of unsecured claimants, … a confirmable plan must ensure either (i) that the dissenting class receive[] the full value of its claim, or (ii) that no classes junior to that class receive any property under the plan on account of their junior claim or interests."[10]

In considering whether the Plan violated 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 Bankruptcy Court's conclusion that the Stockholder's distribution was not a distribution of estate property. The Bankruptcy Court had adopted the underlying premise of gifting: the "[Bankruptcy] Code does not govern the rights of creditors to transfer or receive nonestate property."[11] Focusing on the fact that the "gift" at issue was coming from an undersecured 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 distribution to unsecured creditors."[12] Accordingly, 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.'"[13] Significantly, the Second Circuit opined that "the secured creditors could have demanded a plan in which they received all of the reorganized corporation, but, having chosen not to, they may not 'surrender' part of the value of the estate for distribution 'to the stockholder[],' as 'a gift.' … Whatever the secured creditors here did not take remains in the estate for benefit of other claimholders."[14]

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 treatment under the Plan. Citing corresponding language in the Debtors' disclosure statement for the Plan, the Second Circuit found it clear that the Stockholder would receive New Equity and Warrants under the Plan.[15]

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 clearly 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 contended that the distribution to the Stockholder was actually in exchange for the Stockholder's "continued cooperation and assistance in the reorganization," the Second 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 previously held insufficient to justify a distribution to an old equity holder in contravention of the absolute priority rule.[16]

Because the Plan failed all three elements of the test – the Stockholder was receiving property under the Plan on account of its equity interests – the Second Circuit found that the Plan violated the absolute priority rule and should not have been confirmed.

DBSD's Implications

The Second Circuit limited its application of the absolute priority rule to transfers under a plan, leaving open the possibility that transfers of property that are structured to occur "outside of the plan" that would achieve similar results are still viable.[17] Parties in interest seeking to effect consensual 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 gifting arrangement that entailed a distribution outside of a plan that was implemented in tandem with the plan and fully disclosed to the bankruptcy court and parties in interest.[18] That plan provided for a distribution to the entire class of unsecured creditors, while a subset of trade creditors in that class received an additional payment outside of the plan, funded from the distribution allocated to the secured lender class. The "carve out" used to pay that additional distribution to trade creditors was deposited into an account that was not property of the debtors. Trade creditors were obligated to provide releases and not object to confirmation of the plan in order to receive payment from the account. Any amounts in the account not distributed from the trade account reverted to the secured lenders. In confirming the Plan, the Bankruptcy Court found that the distributions to trade creditors from the "carve out" were outside the plan and that the plan's mechanism for implementing those distributions did not invoke the absolute priority rule.

In *DBSD,* the Second Circuit recognized that that there are sound policy arguments in favor of gifting, including that it can be a "powerful tool in accelerating an efficient and non-adversarial …chapter 11 proceeding."[19] Faced with this reality, it is unlikely that parties in restructurings will be willing to declare "gifting" dead; however, they will need to explore creative alternatives (such as the *Journal Register* model) to facilitate restructurings with broad (if not universal) support among stakeholders.

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[1] *DISH Network Corp. v. DBSD North America, Inc.,* Case No. 10-1175 (2d Cir. Feb. 7, 2011) (Pooler, J., *dissenting) ("Decision").*

[2] *Decision* at 5-6.

[3] *In re DBSD North America, Inc. (the "Bankruptcy Court Decision"),* 419 B.R. 179, 203-04 (Bankr. S.D.N.Y. 2009).

[4] *Decision* at 6-7.

[5] *Decision* at 7.

[6] *Id.*

[7] Debtors' Second Amended Joint Plan of Reorganization Pursuant to Chapter 11 of the United States Bankruptcy Code, *In re DBSD North America, Inc., et al.,* Case No. 09-13061 (Bankr. S.D.N.Y.) (Oct. 29, 2009) [Docket No. 500], at § III.B.9.

[8] *Bankruptcy Court Decision* at 203.

[9] 11 U.S.C. § 1129(b)(1).

[10] *Decision* at 25.

[11] *Bankruptcy Court Decision* at 211.

[12] *Id.*

[13] *Decision* at 25.

[14] *Decision* at 34.

[15] *Decision* at 25-26.

[16] *Decision* at 29 (citing *Norwest Bank Worthington v. Ahlers,* 485 U.S. 197, 199 (1989)).

[17] *Decision* at 26.

[18] *In re Journal Register Company,* 407 B.R. 520 (Bankr. S.D.N.Y. July 7, 2009).

[19] *Decision* at 35 (citation omitted).

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