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Game Changer: Second Circuit Finds "Gifting" By Secured Creditor to Old Equity Pursuant to Chapter 11 Plan Violates Absolute Priority Rule

BY THE FINANCE AND RESTRUCTURING PRACTICE

The concept of "gifting" in the chapter 11 plan context has been discussed for years. It often arises when secured creditors who have a lien on all, or substantially all, of a borrower's assets seek to take control of the borrower. The enterprise value of the borrower is less than the amount of the secured debt, so unsecured creditors and old equity are out-of-the-money. Nonetheless, to ensure a peaceful and relatively smooth transition, the secured creditors offer a "tip" to old equity, essentially out of their own recoveries, by turning over a small portion of value to the former owners and bypassing unsecured creditors. This "gifting" practice became quite common and has been approved by a number of courts over the years, although some courts have called the practice into question.[1] A recent decision by the Second Circuit Court of Appeals appears to have brought the practice to a screeching halt, at least in chapter 11 cases filed in the Second Circuit.

In an appeal arising in the chapter 11 case of *In re DBSD North America, Inc.*, a panel of the Second Circuit overturned, on February 7, 2011, an order issued by Judge Gerber of the United States Bankruptcy Court for the Southern District of New York (the "Bankruptcy Court") confirming a plan of reorganization that contemplated just such a "gifting" transaction. On an appeal brought by an unsecured creditor, the panel held, in a 2-to-1 decision, that such a plan of reorganization violated the absolute priority rule and could not be confirmed.[2] The ruling is a game changer because it bars a common practice (at least in the Second Circuit) and has the potential to change the dynamics of chapter 11 plan negotiations among secured creditors, unsecured creditors and equity holders.[3]

"Absolute Priority" Provisions of Bankruptcy Code Section 1129(b)(2)(B)

The decision in *Sprint Nextel Corp. v. DBSD North America, Inc. (In re DBSD North America, Inc.)*, Nos. 10-1175, 10-1201, 10-1352 (2d Cir. Feb. 7, 2011) (Docket No. 261) (hereinafter, the "DBSD Opinion") arises under the "absolute priority" provision of Bankruptcy Code section 1129(b)(2)(B).[4] That section provides that a plan of reorganization is not confirmable over the rejection vote of a class of unsecured creditors that will not receive the full value of their claims if a junior class of creditors or interest holders will receive or retain property under the plan on account of such junior claim or interest.[5] The Third Circuit had already ruled in 2005, in the *Armstrong World Industries* case, that a plan contemplating a gift by unsecured creditors to equity holders over the objection of a dissenting class of creditors[6] was not confirmable because it violated the absolute priority rule.[7] Parties to chapter 11 cases in the Second Circuit nonetheless had assumed the continuing vitality of the gifting

doctrine, at least from a secured class to a junior class, and had proposed and successfully confirmed plans of reorganization providing for just such gifts to old equity. With its decision in *DBSD North America*, the Second Circuit now rejects gifting pursuant to a plan of reorganization, even by secured creditors, as a violation of the absolute priority rule.

DBSD North America Decision

In *DBSD North America*, secured creditors holding blanket liens on all of the debtor's assets sought to take control of a satellite and land-based telecommunications company. The Bankruptcy Court found that the debtor's enterprise value was less than the amount of secured debt, and the secured lenders were therefore entitled to 100% of the equity of the company on a reorganized basis.[8] In its appeal to the Second Circuit, the unsecured creditor-appellant did not challenge that finding. [9] To ensure the cooperation of the old shareholders in obtaining regulatory approvals needed for the secured creditors to take control of the DBSD business, however, the secured creditors agreed to "gift" a portion of their recovery of stock worth approximately $850,000 to unsecured creditors, and another portion of stock in the form of warrants worth $28.5 million, to the former shareholders.[10] DBSD and its affiliates filed chapter 11 petitions in order to effectuate this transaction gifting through a plan of reorganization.[11]

Sprint Nextel Corporation ("Sprint") asserted unsecured claims against the DBSD debtors in the aggregate amount of $211 million. The debtors disputed the Sprint claim, and the Bankruptcy Court temporarily allowed the Sprint claims in the amount of $2 million for voting purposes only.[12] Sprint cast its vote against confirmation, causing its class to reject the plan. Thereafter, Sprint objected to confirmation of the plan of reorganization as violative of the "absolute priority" rule because the plan did not provide for payment in full of all unsecured claims in its class before any value flowed to old equity.[13]

The Bankruptcy Court concluded that the value that was being transferred to the old equity was essentially a gift from the (under)secured creditors, who were entitled to claim 100% of the enterprise value but nonetheless had valid business reasons for transferring part of that recovery to old equity. The Bankruptcy Court carefully evaluated the state of the law on such "gifting" plans of reorganization. It concluded that secured creditors who are not themselves being paid in full may "voluntarily offer a portion of their recovered property to junior stakeholders" without violating the absolute priority rule, and confirmed the plan.[14] On appeal by Sprint from the confirmation order, the district court affirmed.[15] The Second Circuit, however, disagreed and reversed.

The majority began its analysis with case law from 1868, noting that it was well-established that stockholders are not entitled to any share of the capital stock or dividends from a corporation until all debts of the corporation are paid. Yet even then, secured creditors of a failing corporation would often provide a recovery to old equity to facilitate the turnover process, while junior creditors received little or nothing. According to the majority, the United States Supreme Court crafted the principle that was ultimately codified in the absolute priority rule precisely to prevent such an inequitable result.[16]

Returning to the facts of the *DBSD North America* case, the majority then held that the plan violated the absolute priority rule because a junior class of interests (old equity) was receiving "property" in the form of shares and warrants in the reorganized entity, "under" the plan, "on account of its junior interests."[17]

The majority had no trouble distinguishing the First Circuit decision in *In re SPM Manufacturing Corp.*, 984 F.2d 1305 (1st Cir. 1993). In *SPM*, the First Circuit had upheld a decision that permitted the conversion of a case from chapter 11 to a chapter 7 liquidation and approved an agreement between

the secured lender and unsecured creditors to share in the proceeds of the liquidation, skipping the claim of a priority creditor. The First Circuit held that, in a chapter 7 liquidation, nothing prevented a secured lender from voluntarily gifting some part of its recovery to whomever it chose.[18] In the chapter 11 reorganization context, by contrast, the absolute priority rule of section 1129(b)(2)(B) does expressly prohibit confirmation of a plan that ignores the statutory distribution scheme.[19] Perhaps more importantly, the majority found a distinction in the property interests at stake in *SPM* and *DBSD North America*. In *SPM*, the lower court had granted the secured creditor relief from the automatic stay in order to exercise its rights, and therefore the property at question was already the secured creditor's property before it chose to gift a portion to unsecured creditors. In the chapter 11 context, however, the property at all times remained property of the estate, albeit subject to the secured creditors' liens. The secured creditor could have taken all of the property, but they chose instead to leave behind a portion.[20] The majority reasoned that, "[w]hatever the secured creditors . . . did not take remains in the estate for the benefit of other claim-holders."[21]

The majority was mindful of the policy arguments in favor of the gifting doctrine and the value to secured creditors in achieving a peaceful transition through a tip to old equity. Nonetheless, it ruled that, in enacting section 1129(b)(2)(B), Congress already had established a policy that the risk of shareholders exerting improper holdup value in a reorganization to extract value for themselves (at the expense of unsecured creditors) outweighs the supposed marginal benefit of such a smooth transition.[22] In sum, the *DBSD North America* plan violated the absolute priority rule by providing a recovery to old equity while a senior class of creditors was not paid in full, and should not have been confirmed.[23]

Observations

The Second Circuit (albeit by two judges of a single panel) appears to have taken an even more draconian view than the Third Circuit in rejecting the gifting doctrine in a chapter 11 case. In light of the 2-1 ruling, we would expect that a petition for an *en banc* review by the Second Circuit or a direct appeal to the United States Supreme Court would be filed, but given other developments in the case it is unclear whether this will occur.[24] Accordingly, an *en banc* review by the Second Circuit or an appeal to the United States Supreme Court on the gifting decision does not appear likely, and practitioners and regular participants in New York bankruptcy cases may very well have to adapt to this new paradigm.

The majority did leave open the possibility that the Bankruptcy Code might allow secured creditors to transfer shares or other property to existing shareholders outside of a plan.[25] This option is less than satisfactory as there may well be material securities laws issues (if the gift is not cash but rather, as is the norm, securities of the debtor) or tax law issues making a gift outside of a plan impractical.

As a practical matter, the *DBSD North America* decision suggests that the shareholders of a company whose enterprise value is completely subject to secured debt no longer will have the ability to offer the secured creditors a smooth transition through a speedy chapter 11 plan in exchange for a tip of new equity in the reorganized company. On the other hand, unsecured creditors in such a situation may find their leverage to extract a gift from the secured creditors has increased. Whether this shift in bargaining power results in slower, more contentious reorganization cases remains to be seen.

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[1] *See Official Unsecured Creditors Comm. v. Stern (In re SPM Mfg. Corp.),* 984 F.2d 1305, 1312-14 (1st Cir. 1993) (senior secured creditors permitted to share bankruptcy proceeds with junior unsecured creditors while skipping over priority tax creditors in chapter 7 liquidation); *In re MCorp Fin., Inc.*, 160 B.R. 941, 960 (S.D. Tex. 1993) (senior unsecured bondholders permitted to allocate part of their claim to fund settlement with FDIC over objection of junior subordinated bondholders); *In re Journal Register Co.*, 407 B.R. 520, 533 (Bankr. S.D.N.Y. 2009) (authorizing gift from secured lenders to unsecured trade creditors); *In re World Health Alternatives, Inc.*, 344 B.R. 291, 298–99 (Bankr. D. Del. 2006) (permitting secured creditor to give up portion of its lien for benefit of junior creditors without violating Bankruptcy Code); *In re RCN Corp.*, Case No. 04-13638, at *17-18 (RDD) (Bankr. S.D.N.Y. Dec. 8, 2004) (approving plan that provided distributions to junior equity interests pursuant to gift from unsecured creditor class, even though subordinated claims would receive nothing under plan, and preferred stock interests were paid less than in full); *In re WorldCom, Inc.*, 2003 WL 23861928, at *61 (Bankr. S.D.N.Y. Oct. 31, 2003) (stating that contributions from secured creditor to unsecured creditors did not violate Bankruptcy Code because creditors "are generally free to do whatever they wish with the bankruptcy dividends they receive, including sharing them with other creditors, so long as recoveries received under the Plan by other creditors are not impacted"); *In re Union Fin. Servs. Group*, 303 B.R. 390, 423 (Bankr. E. D. Mo. 2003) (holding that payment to unsecured creditors by senior secured creditors did not constitute unfair discrimination); *In re Genesis Health Ventures, Inc.*, 266 B.R. 591, 598, 617-18 (Bankr. D. Del. 2001) (holding that issuance of stock and warrants to management who were former equity holders did not violate absolute priority because issuance was voluntary transfer of value from debtors' secured lenders). *But see In re Armstrong World Indus., Inc.*, 432 F.3d 507, 514 (3d Cir. 2005) (finding absolute priority rule was violated where "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"); *In re Sentry Operating Co.*, 264 B.R. 850, 862-64 (Bankr. S.D. Tex. 2001) (finding that plan unfairly discriminated against class of unsecured creditors where co-equal unsecured class was receiving higher distribution on account of gift from secured creditors).

[2] The third judge believed that the unsecured creditor lacked standing to appeal confirmation of the plan and would not have reached the merits of the absolute priority argument. *See Sprint Nextel Corp. v. DBSD North America, Inc. (In re DBSD North America, Inc.)*, Nos. 10-1175, 10-1201, 10-1352 (2d Cir. Feb. 7, 2011) (Docket No. 262).

[3] The Second Circuit panel also addressed the issues of vote designation and affirmed the Bankruptcy Court's decision with respect thereto. This client alert, however, is limited to the gifting issue discussed in the Second Circuit's decision.

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[4] Unless otherwise indicated, all section references are to the United States Bankruptcy Code, 11 U.S.C. § 101, *et seq.*

[5] 11 U.S.C. § 1129(b)(2)(B).

[6] The dissenting class in *Armstrong* was comprised of unsecured creditors who held claims of equal priority to the claims of the "gifting" class. *Armstrong World Indus.*, 432 F.3d at 509.

[7] *Id.* at 514. The *Armstrong* decision has been subsequently distinguished, including in the Third Circuit, on the grounds that the class providing the gift in *Armstrong* held unsecured claims. *See World Health Alternatives, Inc.*, 344 B.R. at 298-99. There, the court held that the absolute priority rule is not violated where secured creditors are providing the gift to junior classes because (a) secured creditors have perfected security interests, meaning that the secured lenders' property is not subject to distribution under the Bankruptcy Code's priority scheme, and (b) the distribution is a "carve out," a situation where a party whose claim is secured by assets in the bankruptcy estate allows a portion of its lien proceeds to be paid to others.

[8] *See In re DBSD North America, Inc.*, 419 B.R. 179, 186 (Bankr. S.D.N.Y. 2009).

[9] *See* DBSD Opinion, at 5-7.

[10] *Id.* at 36. It goes without saying that the gross disparity in the relative distributions to the unsecured creditor class and the equity holder class was detrimental to the debtor's arguments in support of the gifting doctrine. *See id.*

[11] *See id.* at 4-5.

[12] *Id.* at 6.

[13] DISH Networks also objected to confirmation on grounds not relevant here. The Bankruptcy Court overruled DISH Networks' objection, and the Second Circuit affirmed. *See id.* at 37-53.

[14] *Id.* at 7-9 (citing *In re DBSD North America, Inc.*, 419 B.R at 201).

[15] *Id.* at 10.

[16] *Id.* at 23-30.

[17] *Id.* at 26-28.

[18] *SPM Manufacturing*, 984 F.2d at 1312-14.

[19] *See* DBSD Opinion, at 31-32.

[20] *Id.* at 33-34.

[21] *See id.* at 34.

[22] *Id.* at 35-37.

[23] *Id.* at 37.

[24] From recent filings in the DBSD bankruptcy docket, it appears that Sprint has been party to settlement discussions with the DBSD debtors and the secured lenders. *See Debtors' Statement Regarding Ad Hoc Committee's (A) Response In Support Of Modified Plan And (B) Request To Proceed With Scheduled Hearing On Modified Plan* at 3, *In re DBSD North America, Inc.*, Case No. 09-13061 (REG) (Feb. 4, 2011) (Docket No. 915); *Ad Hoc Committee's (A) Response In Support Of Modified Plan And (B) Request To Proceed With Scheduled Hearing On Modified Plan* at 3, *In re DBSD North America, Inc.*, Case No. 09-13061 (REG) (Feb. 2, 2011) (Docket No. 904); *Debtors' Motion For Entry Of An Order (A) Authorizing The Debtors To Obtain Replacement Postpetition Financing On A Third Lien, Secured, And Superpriority Basis And (B) Granting Related Relief*, *In re DBSD North America, Inc.*, Case No. 09-13061 (REG) (Feb. 1, 2011) (Docket No. 900); *Debtors' Motion For Entry Of An Order Authorizing And Approving The Investment Agreement*; *In re DBSD North America, Inc.*, Case No. 09-13061 (REG) (Feb. 1, 2011) (Docket No. 899).

[25] *See* DSBD Opinion, at 26, 27 n. 6. The Second Circuit also left open the possibility that equity holders could receive a distribution under a plan that is not "on account" of their junior equity interests and thus not prohibited by the absolute priority rule. *Id.* For example, in a situation where equity holders are receiving distributions "on account" of a new infusion of capital, such distributions may be permissible under the Bankruptcy Code. The precise contours of this exception to the absolute priority rule are beyond the scope of this client alert.