Connecticut Law Tribune

MARCH 14, 2011
VOL. 37, NO. 11 • $10.00

An ALM Publication

CTLAWTRIBUNE.COM

A Rejection Of The 'Gifting' Theory

Decision affects debtors, creditors in commercial reorganization cases

By **IRVE J. GOLDMAN**

A core principle affecting the negotiations and outcome in most Chapter 11 reorganization cases is known in bankruptcy parlance as the "absolute priority rule." First developed in the railroad reorganization cases of the 1800s and codified by the Bankruptcy Code in 11 USC §1129(b)(2)(B), it provides that a plan of reorganization may only be confirmed over the opposition of a dissenting class of unsecured creditors – a so-called "cram-down" – if the unsecured creditors are paid in full *or* the equity holders of the Chapter 11 debtor will not receive or retain any property under the plan "*on account of*" their junior interests (i.e., junior to the unsecured creditors). 11 USC §1129(b)(2)(B)(i), (ii) (emphasis added).

The easiest example of compliance with the absolute priority rule is where the plan provides for the equity interests of shareholders to be "wiped out," with unsecured creditors to become the new owners of the reorganized debtor.

The U.S. Supreme Court has spoken twice about the absolute priority rule under the Bankruptcy Code and on both occasions, it was strictly construed. In *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197 (1989), the Supreme Court rejected a plan providing for shareholders of the debtor to retain their equity interests on account of "future labor, experience and expertise" they promised to provide to the reorganized debtor. And in *Bank of America v. 203 N. LaSalle Street Partnership*, 526 U.S. 434 (1999), the Supreme Court rejected a plan where the debtor's partners were, in effect, purchasing new equity in the debtor by agreeing to contribute $6.1 million of capital to the reorganized debtor. This plan was rejected because it provided the old equity holders with the exclusive opportunity to purchase the equity, without the benefit of a marketing process or the opportunity for competing plans from creditors, which itself was considered to be property received "on account of" the partners' existing equity interests.

Irve J. Goldman

Now adding to the jurisprudence on the absolute priority rule is *In re DBSD North America*, 2011 WL 350480 (2d Cir. Feb. 7, 2011). In *DBSD*, the 2nd Circuit Court of Appeals considered whether the rule can be satisfied when a reorganization plan that is rejected by unsecured creditors distributes equity to the debtor's existing shareholders (colloquially referred to as "old equity") with the acceptance of a higher priority "undersecured" creditor with a lien on all assets. The term "undersecured" in this context simply means that the value of all of the debtor's assets, as measured on a going-concern or fair market value basis, is less than the amount of the creditor's claim. The theory advanced for approval of such a plan was that the undersecured creditor is "giving up" equity interests in the debtor to which it would otherwise be entitled and, therefore, general unsecured creditors have no right to complain.

From a statutory perspective, the question addressed in *DBSD* was whether old equity would be receiving these new shares "on account of" its junior equity interest in the debtor or, as was argued by the proponents of the plan, as a "gift" from the holders of the secured debt, who were senior in priority to the dissenting class of unsecured creditors and who could therefore "voluntarily offer a portion of their recovered property to junior stakeholders without violating the absolute priority rule."

The answer to this question has far-reaching consequences for debtors and creditors in commercial reorganization cases. If non-consenting unsecured creditors could be crammed down any time an undersecured creditor of the debtor went along with a plan which issued new shares to old equity, confirmation of Chapter 11 plans might be made much easier, but at the substantial expense of unsecured creditors. That potential consequence was apparently acceptable to the bankruptcy court in *DBSD* because it confirmed the company's Chapter 11 plan by adopting the "gifting" theory that had been advanced by the plan proponents.

The 2nd Circuit saw it a different way, however. With surgical-like precision, the appeals court traced the roots of the absolute priority rule and analyzed modern Supreme Court precedent when it held that existing shareholders receive property "on account of" their prior junior interests, and not simply "on account of" the generosity of an undersecured creditor, when a plan distributes new equity to existing

Irve J. Goldman is a partner in the Bankruptcy and Creditors' Rights practice at Pullman & Comley LLC and has been certified by the American Board of Certification as a business bankruptcy specialist since 1993.

THIS ARTICLE IS REPRINTED WITH PERMISSION FROM THE MARCH 14, 2011 ISSUE OF THE CONNECTICUT LAW TRIBUNE. © COPYRIGHT 2011. ALM MEDIA PROPERTIES, LLC ALL RIGHTS RESERVED. DUPLICATION WITHOUT PERMISSION IS PROHIBITED. ALL RIGHTS RESERVED.

BUSINESS LITIGATION

shareholders with the acceptance of the undersecured creditor. Consistent with Supreme Court precedent, the 2nd Circuit interpreted the words, "on account of," to mean some form of "because of," i.e., if an existing shareholder receives any property under a plan "because of" his equity interest, the absolute priority rule would prevent confirmation of the plan.

The Court reasoned that the distribution of new shares to old equity, although argued to have been proposed to win their continued cooperation and assistance post-reorganization, and not on "account of" their equity interest, "was useful only *because of* the shareholder's position as equity holder and the rights emanating from the position." (emphasis added)

The 2nd Circuit also rejected the argument that a transfer of the new shares partly on account of factors other than the shareholder's prior interest could satisfy the absolute priority rule, reasoning that if this was a result intended by Congress, the statutory language "on account of," would have been modified by the words, "only," "solely," or even "primarily."

Prior to *DBSD*, many bankruptcy practitioners, as well as the bankruptcy court itself in *DBSD*, were of the view that the 1st Circuit Court of Appeals decision in *In re SPM Manufacturing Corp.*, 984 F. 2d 1305 (1st Cir. 1993) supported the gifting theory that had been used to confirm *DBSD*'s reorganization plan.

In that case, the 1st Circuit upheld an agreement between the debtor's secured creditor and a committee of unsecured creditors to share in the proceeds from a liquidation that had taken place prior to the conversion of the case to a Chapter 7, even though enforcing the agreement meant cutting out a distribution to a tax creditor that was in between those two classes in terms of priority.

While expressing no opinion on the result reached in *SPM*, the 2nd Circuit distinguished the case, principally on the ground that it involved a Chapter 7 and not a Chapter 11 case. This was considered an important distinction since unlike Chapter 11, Chapter 7 does not contain "the rigid absolute priority rule of §1129(b)(2)(B)."

A significant question expressly left open by the 2nd Circuit in *DBSD* is whether the Bankruptcy Code would sanction an agreement for the transfer of shares from an undersecured creditor to the existing shareholder "outside the plan," apparently after the creditor receives the entire equity interest of the debtor under the plan. Although such a scheme would appear to promote form over substance, it is perhaps a nuanced distinction that may receive acceptance by the courts.

There is little question that the ruling in *DBSD* takes away significant negotiating leverage for Chapter 11 debtors whose equity holders want to hold onto to their equity positions while paying unsecured creditors less than in full. It eliminates the option that the shareholders of the debtor and a dominating undersecured creditor can agree to share in the equity of the reorganized debtor while unsecured creditors are paid cents on the dollar, and points the way back to old-fashioned, hard bargaining. ■