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To Gift or Not to Gift: Chapter 11 Plans in the 2nd and 3rd Circuits

COLE SCHOTZ
Cole, Schotz, Meisel, Forman & Leonard, P.A.
Attorneys at Law A Professional Corporation

By Norman L. Pernick, David R. Hurst & Therese Scheuer

In a chapter 11 case, a senior claimholder may seek to share recovered property with junior stakeholders, to promote a speedy and cooperative reorganisation. This "gifting" may be allowed under certain circumstances. Official Unsecured Creditors Comm. v. Stern (In re SPM Mfg. Corp.), 984 F.2d 1305 (1st Cir. 1993) (holding that, in chapter 7 case, secured creditor could gift property to unsecured creditors over objection of priority creditor). However, the Second and Third Circuits have held that absent consent, "gifting" pursuant to a chapter 11 plan violates the so-called "absolute priority rule." Dish Network Corp. v. DBSD N. Am., Inc. (In re DBSD N. Am., Inc.), 634 F.3d 79 (2d Cir. 2011); In re Armstrong World Indus., Inc., 432 F.3d 507 (3rd Cir. 2005).

Title 11 of the United States Code (the "Bankruptcy Code") sets forth a waterfall for paying claims and interests. 11 U.S.C. section 507. Pursuant to the "absolute priority rule" codified in section 1129(b)(2)(B) of the Bankruptcy Code, a chapter 11 plan cannot be confirmed over the vote of a dissenting class of claims unless (i) the dissenting class receives the full value of its claims or (ii) no classes junior to that class receive property under the plan on account of their junior claims or interests. 11 U.S.C. § 1129(b)(2)(B); DBSD, 634 F.3d at 95. Put simply, unless senior creditors agree otherwise, they must be paid in full before junior stakeholders receive any distribution under a chapter 11 plan.

The Third Circuit addressed the conflict between the gifting doctrine and the absolute priority rule in Armstrong. In Armstrong, the chapter 11 plan provided that the debtor's unsecured creditors would not be paid in full, but also provided that the debtor's direct and indirect equity interest holders would be issued warrants to purchase common stock in the reorganised debtor valued at approximately $35-$40 million dollars. If a class of unsecured creditors rejected the plan, a co-equal class of unsecured creditors would receive and automatically transfer the warrants to the debtor's equity interest holders. The court held that because the chapter 11 plan would make a distribution to equity without fully paying off unsecured claims, it could not be confirmed over the objection of the unsecured creditors. 432 F.3d at 513-14. The court reasoned that "[a]llowing this particular type of transfer would encourage parties to impermissibly sidestep the carefully crafted strictures of the Bankruptcy Code, and would undermine Congress' intention to give unsecured creditors bargaining power in this context." Id. at 514-15.

Similarly, in Dish Network Corp. v. DBSD North America, Inc., the Second Circuit held that the distribution of shares and warrants to the debtor's equity holder violated the absolute priority rule where a senior class voted against the plan. 634 F.3d at 101. In DBSD, the chapter 11 plan proposed that the holders of unsecured claims would receive shares estimated to be worth between 4% and 46% of their original claims, and the current equity holder would receive shares and warrants. The bankruptcy court characterised the equity holder's receipt of shares and warrants as a "gift" from second lien debt holders, who were senior to the objecting creditor, but would not be receiving the full value of their claims. The bankruptcy court reasoned that the second lien holders could "voluntarily offer a portion of their recovered property to junior stakeholders" without violating the absolute priority rule. The Second Circuit disagreed, citing the long history of case law prohibiting equity holders from receiving a distribution before creditors have been paid in full. The court noted that "a weakened absolute priority rule could allow for serious mischief between senior creditors and existing shareholders." Id. at 100. The court adopted the Third Circuit's view in Armstrong and held that the bankruptcy court erred in confirming the chapter 11 plan. Id. at 100-01.

In DBSD, a class senior to the class receiving the "gift" voted against the plan. Note that if all voting classes accept the plan, the gifting can likely be accomplished, because the Court can confirm the plan under section 1129(a) and does not have to make a finding under section 1129(b)(2)(B) that the plan complies with the "absolute priority rule."

Although gifting pursuant to a chapter 11 plan is not permitted in the Second or Third Circuit, debtors and senior creditors who seek the cooperation of junior stakeholders may be able to accomplish gifting property pursuant to pre-plan settlements. In the Second Circuit, parties must clearly articulate the reasons for approving a settlement that does not appear to comply with the absolute priority rule. See, e.g., In re Iridium Operating LLC, 478 F.3d 452, 464-65 (2d Cir. 2007); In re Dewey & LeBoeuf, LLP, 478 B.R. 627 (Bankr. S.D.N.Y. 2012).

In the Third Circuit, parties should consider whether a settlement can be structured so that junior stakeholders receive non-estate property. See, e.g., Deangelis v. Official Comm. of Unsecured Creditors (In re Kainos Partners Holding Co.), 1:10-cv-00560-LPS, 2012 WL 6028927 (D. Del. Nov. 30, 2012) (settlement amount was from a carve-out of the secured creditor's collateral); In re TSIC, Inc., 393 B.R. 71 (Bankr. D. Del. 2008) (unsecured fund came from settlement of claims with stalking horse bidder); In re World Health Alts, Inc., 344 B.R. 291 (Bankr. D. Del. 2006) (money paid to unsecured creditors came from carve-out of the secured creditor's collateral).

Norman Pernick is Co-Chair of the Bankruptcy & Corporate Restructuring Department of Cole, Schotz, Meisel, Forman & Leonard, P.A.and heads the firm's Wilmington, DE office. Mr. Pernick practices many aspects of bankruptcy and workouts, primarily representing debtors, but also represents creditors' committees, major creditors, and trustees. He has served as lead debtor's counsel in numerous major Chapter 11 cases, including Owens Corning, Leslie Controls, Ritz Camera Centers, Cadence Innovation, J.G. Wentworth, Fedders Corporation, Barzel Industries, BNA Subsidiaries, and Open Range Communications. He serves as co-counsel for Tribune Company. He is also lead counsel for the Official Committee of Unsecured Creditors in the Monitor Group case. Mr. Pernick is a Fellow of the American College of Bankruptcy. He is the author of the Bankruptcy Deadline Checklist, which is published by the Business Law Section of the American Bar Association. Mr. Pernick is very active in community activities, and is currently the Chair of the Boards of Directors of Downtown Visions and Wilmington Main Street (the largest certified Main Street program in the United States), which are the umbrella organizations for a community-wide effort to revitalize downtown Wilmington, Delaware.

Mr. Pernick can be contacted by phone on +1 302 651 2000 or alternatively via email at npernick@coleschotz.com

David Hurst is a partner in the Bankruptcy and Corporate Restructuring Department, and is resident in both Cole Schotz's New York and Wilmington, Delaware offices. Mr. Hurst has represented numerous public and private companies in out-of-court restructurings, "prepackaged" bankruptcies and traditional chapter 11 cases. He also has represented creditor committees, lenders, secured and unsecured creditors and asset purchasers in a wide variety of bankruptcy and restructuring matters.

Mr. Hurst's previous representations include Autobacs Strauss Inc., Chart Industries, Inc., Eagle Food Centers, Inc., EBG Holdings LLC, Exodus Communications, Inc., Fletcher International, Ltd., GenTek Inc., Genuity Inc., Lang Holdings, Inc., Mrs. Fields' Original Cookies, Inc., New Century TRS Holdings, Inc., Owens Corning, Refco Inc., ResMAE Mortgage Corporation, Sterling Chemicals Holdings, Inc., and The Delaco Company.

Mr. Hurst can be contacted by phone on +1 646 563 8952 or alternatively via email at dhurst@coleschotz.com

Therese Scheuer is an associate in the firm's Bankruptcy & Corporate Restructuring Department in the Wilmington office. Ms. Scheuer has experience representing debtors, bondholders, creditors' committees, and other interested parties in chapter 11 reorganisations and out of courtrestructurings. Ms. Scheuer has also represented creditors and other interested parties in chapter 15 ancillary proceedings. During law school, Ms. Scheuer served as a summer judicial intern to the Honorable Douglas P. Woodlock, District Court Judge for the District of Massachusetts. Prior to joining Cole Schotz, Ms. Scheuer was an associate in the bankruptcy department of a prominent Boston-based law firm.

Ms. Scheuer has volunteered for the M. Ellen Carpenter Financial Literacy program for the Boston Bar Association and has also served on the board of directors of the Boston Dance Alliance.

Ms. Scheur can be contacted by phone on +1 302 651 2003 or alternatively via email at tscheuer@coleschotz.com

COLE SCHOTZ
COLE, SCHOTZ, MEISEL, FORMAN & LEONARD, P.A.
Attorneys at Law A Professional Corporation