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Beware of Creditors Bearing Gifts: A Primer on Sharing Property in Chapter 11

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

> While the debtor and the trustee are not allowed to pay nonpriority creditors ahead of priority creditors, creditors are generally free to do whatever they wish with the bankruptcy dividends they receive, including to share them with other creditors.[1]

In the often contentious world of Chapter 11 proceedings, dissent among a debtor's stakeholders may impede and/or delay a successful reorganization and delay and/or diminish the return to creditors. Senior claimholders seeking to promote cooperation may attempt to share or "gift" property to junior stakeholders in order to improve the confirmability of a proposed plan.[2] Although it seems common sense that creditors are "generally free to do whatever they wish" with their own property, the issue is more complex than appears at first blush.[3] Indeed, the First Circuit's decision in *Official Unsecured Creditors Comm. v. Stern (In re SPM Mfg. Corp.)*, quoted above, has sparked much discussion among courts and commentators as to whether gifting is a viable strategy in Chapter 11.[4]

Gifting may interfere with the strictures of the Bankruptcy Code's[5] distribution scheme codified by the so-called "absolute priority rule" of 11 U.S.C.A. § 1129(b)(2)(B),[6] and has been disallowed by a number of recent courts.[7] Nevertheless, gifting to junior stakeholders has been

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allowed under certain circumstances.[8] Whether gifting is permissible varies by, among other things (i) jurisdiction, (ii) whether parties seek to gift property pursuant to a settlement, sale, Chapter 11 plan or by some other mechanism, and (iii) whether the property being transferred is a direct carveout from a secured creditor's collateral.[9] Part I of this article provides an overview of the gifting doctrine. Part II discusses the contexts in which gifting may be used. This article recommends that a debtor should carefully consider the jurisdiction where it chooses to file for bankruptcy if it anticipates employing gifting as a strategy. With careful planning, parties may be able to structure a gift that survives creditor attack, even in the wake of recent Second and Third Circuit decisions that have denied confirmation of plans that incorporate gifting.

I. Overview of Gifting Doctrine

In Chapter 11 cases, a debtor generally does not have enough assets to pay all of its creditors in full. The Bankruptcy Code dictates a strict distribution system for the payment of claims and interests pursuant to which senior classes must be paid in full before a junior class receives any recovery.[10] This means that junior claimants are often fully or partially out of the money. Yet, a senior creditor may wish to encourage the support of junior creditors to obtain approval of, for example, debtor in possession financing, a section 363 sale, or a Chapter 11 plan.[11] A creative way to obtain the consensus of junior claimants is for senior creditors to share or "gift" property to the junior claimants. However, this "gifting" may run afoul of the Bankruptcy Code's distribution scheme. There is disagreement among the courts that have considered the issue as to whether and under what circumstances such gifting is allowed.[12]

i. Problems With the Absolute Priority Rule and Unfair Discrimination Prohibition

As part of the Chapter 11 process, claims and interests are placed in different classes for voting and treatment under a Chapter 11 plan.[13] The plan will be confirmed if (i) each class of impaired[14] creditors votes to accept it or, (ii) if there is a dissenting class, by "cramming down" such class under section 1129(b) of the Bankruptcy Code.[15] To cram down a dissenting class, (1) all provisions of section 1129(a) must be satisfied, other than (a)(8), which requires acceptances from all impaired classes, (2) the plan must not discriminate unfairly, and (3) the plan must be fair and equitable with respect to the dissenting class.[16]

Section 1129(b) provides that a plan is "fair and equitable" with respect to a class of unsecured claims if (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.[17] This second requirement has been termed the "absolute priority rule,"[18] and it is a major obstacle to gifting in Chapter 11 cases.[19] Put simply, unless senior creditors agree otherwise, they must be paid in full before junior stakeholders receive any distribution under a Chapter 11 plan.[20] This is problematic where a senior creditor seeks to "gift" to a junior class and an intervening class of creditors, which is not being paid in full, objects.

Another, though lesser, obstacle to gifting is the unfair discrimination prohibition. Although "unfair discrimination" is not defined by the Bankruptcy Code, courts have held that a plan discriminates unfairly if it treats similar claims differently under certain circumstances.[21] This issue may arise if a class objects to a gift to a co-ranking, as opposed to junior, class.[22]

ii. Origins of Gifting Doctrine[23]

Prior to enacting the Bankruptcy Code, there was some discussion by Congress as to whether gifting should be permitted.[24] Ultimately, however, the House Report did not address whether gifting was permissible.[25] Without firm guidance from Congress, the viability of gifting was left to the courts, which first tackled the issue (at an appellate level) in *Official Unsecured Creditors' Committee v. Stern (In re SPM Manufacturing Corp.)*.[26]

In *SPM*, the debtor's secured creditor, which was undersecured and held a first priority security interest on substantially all of the debtor's assets, agreed to seek liquidation of the debtor and share a percentage of its distribution with general unsecured creditors. The First Circuit held that the agreement was permissible, even though it provided a distribution to general unsecured creditors ahead of priority tax claims, because the property being gifted belonged to the secured creditor and was not property of the estate. Accordingly, the secured creditor could "gift" non-estate property to a junior class of creditors.

Following *SPM*, a number of courts began to approve of gifting in Chapter 11 cases. However, more recently, courts including the Second and Third Circuits have rejected or limited the holding of *SPM*.[27]

II. The Who, What, Where and When of Gifting

i. Who Can Gift?

a. Gifting By Secured Creditors

In *Armstrong*, the Third Circuit discussed why courts should be hesitant to allow gifting by an unsecured creditor, as opposed to a secured creditor.[28] The Third Circuit adopted the reasoning of the district court, which had distinguished *SPM*, noting in pertinent part that, in *SPM*:

> [T]he senior creditor had a perfected security interest, meaning that the property was not subject to distribution under the Bankruptcy Code's priority scheme; and … the distribution was 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.[29]

Following the *Armstrong* decision, a number of lower courts have reasoned that the Third Circuit left open the possibility of gifting from a secured creditor's collateral.[30] However, in *DBSD*, the Second Circuit explicitly held that it would not allow gifting by a secured creditor, despite the fact that the debtor's assets were not enough to satisfy the secured lenders' claims.[31]

Secured creditors may also attempt to "gift" to junior creditors through carveouts of their collateral as part of, for instance, debtor in possession financing or cash collateral agreements.[32] For example, a secured lender may agree to allow administrative expenses, such as attorneys' fees, to be paid out of their collateral.[33] Such carveouts provide assurance to professionals that they will be paid, and may "add value to the loan, add value to the debtor, and help ensure a smooth administration of the estate."[34]

b. Gifting By Unsecured Creditors

Prior to the Second Circuit's decision in *DBSD*, the bankruptcy court for the Southern District of New York pushed the gifting doctrine beyond *SPM*, by approving a plan which provided for gifting from unsecured bondholders to an ad hoc committee of trade creditors.[35] In *Worldcom*, the plan provided that unsecured bondholders accepting the plan would be automatically deemed to gift part of their recovery to the ad hoc committee. Although the plan was accepted by the vast majority of bondholders, such acceptance was not unanimous.[36] In addition, a co-equal class of trade creditors objected to the gift. In approving the plan as a cramdown under section 1129(b) of the Bankruptcy Code, the court cited the familiar notion from *SPM* that "[c]reditors 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."[37] In relying on this rationale, *Worldcom* expanded the application of the gifting doctrine (1) by approving a gift made to only one co-equal class of creditors, but not to another, (2) by deeming creditors to gift property, even if a minority of the class had voted to reject the plan, (3) by approving a gift that could not have occurred outside the plan context and (4) by approving a gift made by a class of unsecured creditors.[38] However, *Worldcom*'s vitality after *DBSD* is questionable at best.[39]

The district court for the Southern District of Texas also has approved gifts made by unsecured creditors in *In re MCorp Financial, Inc.*[40] In *MCorp*, the liquidating plan included a settlement pursuant to which one class of unsecured creditors gifted a part of its recovery to the Federal Deposit Insurance Corporation (the "FDIC") to settle years of acrimonious litigation.[41] Junior unsecured creditors (the "Juniors"), which were subordinated by an indenture to the gifting class, objected. The court reasoned that, even if the FDIC were junior to the Juniors, senior unsecured creditors "may share their proceeds" with the FDIC "as long as the juniors continue to receive at least as much as what they would without the sharing."[42] Thus, as long as the Juniors' recovery was not affected, gifting was permissible under the Bankruptcy Code's distribution scheme. The court opined that the creditor's secured status in *SPM* was not relevant, reasoning that it was the creditor's *senior* status that allowed it to share with junior creditors.[43]

ii. When To Gift

a. Sale

A number of courts following *SPM* have allowed gifting in the context of a sale of the debtor's assets, reasoning that (i) gifting pursuant to a sale, rather than a Chapter 11 plan, does not implicate the absolute priority rule, or (ii) gifting of non-estate property does not violate the absolute priority rule. For example, in *In re World Health Alternatives, Inc.*, the bankruptcy court for the District of Delaware approved a settlement in connection with a sale which provided, among other things, that a secured creditor would cap its secured claim against the estate, waive any deficiency claim, and provide a $1.625 million collateral carve-out from its lien for the benefit of unsecured creditors.[44] The funds distributed to unsecured creditors could be used to investigate and prosecute claims against parties other than the secured creditor. In exchange, the estate would release its claims against the secured creditor and the committee would withdraw its objections and support the proposed sale. The United States Trustee objected to the settlement, arguing that the Third Circuit's decision in *In re Armstrong World Industries, Inc.*[45] prohibited the court from approving the settlement, as the settlement would provide a recovery to unsecured creditors before priority tax claims were paid in full.[46] The bankruptcy court noted that *Armstrong* "distinguished, but did not disapprove of" *SPM* and its progeny.[47] Thus, as in *SPM*, because the payout to unsecured creditors was from a carve out of the secured creditors' lien and not from estate property, the court concluded that it was not prohibited by the Bankruptcy Code. The court further reasoned that section 1129(b)(2)(B) and the absolute priority rule were not implicated by the settlement because it arose in the context of a sale rather than a Chapter 11 plan.[48]

Similarly, in *In re TSIC, Inc. f/k/a Sharper Image Corp.,*[49] the bankruptcy court for the District of Delaware approved a settlement agreement in the context of a sale which provided, in part, that the buyer would fund a trust account for the benefit of general unsecured creditors. The U.S. Trustee objected, arguing that the settlement "is improper, unfairly favors the unsecured creditors, and contradicts the absolute priority rule."[50] The court reasoned that the settlement did not conflict with the absolute priority rule, and distinguished *Armstrong* on the grounds that the settlement (i) involved property from the buyer, not property of the estate, and (ii) was not connected to a plan of reorganization. Moreover, no intervening creditor objected to the settlement.[51]

However, other courts have held that gifting is not permitted in connection with a sale of the debtor's assets, either because (i) the Bankruptcy Code's distribution system must be complied with even in the context of a sale or (ii) the sale cannot be substituted for a Chapter 11 plan, as it does not provide the same disclosure and voting protections. For example, in *Dorroh v. Wurst (In re Warren)*,[52] the Bankruptcy Appellate Panel for the Ninth Circuit held that a settlement "contravened the fundamental concept of ratable distribution to creditors."[53] The settlement provided in pertinent part that the insurer would use its best efforts to acquire at face value, plus 5% interest, all unsecured claims other than the debtor's largest creditor's. Although the insurer would be paying consideration directly to creditors, the court held that such payment was at odds with section 726. The court distinguished *SPM*, noting that the insurer was not a senior secured creditor proposing to gift plan distributions to another creditor class, but was rather "proposing to funnel proceeds from the sale of an estate asset to some but not all of the debtor's unsecured creditors."[54]

Some courts have held that section 363 sales which included gifts to junior creditors could not be substituted for a Chapter 11 plan which provides fulsome disclosure, voting and the opportunity to object to proposed gifting. For example, in *In re On-Site Sourcing, Inc.*,[55] the bankruptcy court for the Eastern District of Virginia denied payment to a proposed general unsecured creditors trust as part of a section 363 sale. The sale proposed that the purchaser would fund a trust for the benefit of general unsecured creditors. The court reasoned that the trust provision was contrary to the Bankruptcy Code's distribution scheme set forth in Chapter 7 and Chapter 11, as it would assure payment to general unsecured creditors ahead of administrative and priority claims.[56] The court noted that in the context of a Chapter 11 plan, consent would enable the court to confirm a plan with the trust provision, since the disclosure statement is "the mechanism by which creditors make informed choices on a proposed chapter 11 plan."[57] In the context of a preplan sale, administrative and priority creditors are deprived of adequate information to make an informed decision and object to a Chapter 11 plan.[58] In addition, the court noted that it was troubling to increase an inadequate sales price to a fair sales price, but then keep that benefit for one's own constituency at the expense of other more senior classes of creditors.[59]

b. Preplan Settlements

Certain courts have allowed gifting in the context of preplan settlements, although other courts have declined to do so, holding that the absolute priority rule applies to preplan settlements. For example, in *Motorola Inc. v. Official Committee of Unsecured Creditors (In re Iridium Operating LLC)*,[60] the Second Circuit vacated and remanded a decision approving a proposed preplan settlement which provided, in pertinent part, that the lenders' liens were senior, perfected and unavoidable, and distributed the estate's cash to the lenders and to a litigation trust set up to sue the debtor's former parent company for the benefit of unsecured creditors.[61] The former parent, which was also a priority creditor, objected to the settlement on the grounds that the settlement would distribute estate property to junior creditors before the former parent, in its capacity as a priority creditor, received any payment. The Second Circuit distinguished *SPM* as standing for the proposition that "in a Chapter 7 liquidation proceeding, an under-secured lender with a conclusively determined and uncontested 'perfected, first security interest' in all of a debtor's assets may, through a settlement, 'share' or 'gift' some of those proceeds to a junior, unsecured creditor, even though a priority creditor will go unpaid."[62] By contrast, in *Iridium*, the lenders' liens were contested and would only be deemed perfected and validated upon entry of an order approving the settlement and only to the extent authorized by the settlement.[63] The parent/priority creditor argued that the settlement was not "fair and equitable" because junior creditors would be paid ahead of priority creditors. The court held that whether a settlement complies with the Bankruptcy Code's priority scheme is often a dispositive factor. However, "where the remaining factors weigh heavily in favor of approving a settlement, the bankruptcy court, in its discretion, could endorse a settlement that does not comply in some minor respects with the priority rule if the parties to the settlement justify, and the reviewing court clearly articulates the reasons for approving, a settlement that deviates from the priority rule."[64] The Second Circuit vacated the judgment and remanded the case to the lower court to clarify why the settlement required a possible deviation from the absolute priority rule.[65]

In *In re AWECO, Inc.*,[66] the Fifth Circuit vacated an order approving a settlement agreement between the debtor and an unsecured creditor, which provided for the transfer of certain funds to an unsecured creditor in settlement of pending litigation. The Fifth Circuit reasoned that the "fair and equitable" requirement applies to settlements prior to plan confirmation, and that the bankruptcy court lacked sufficient facts to determine whether the debtor had adequate assets to ensure that the settlement was fair and equitable.[67]

c. Plan

The Second and Third Circuits have rejected gifting plans.[68] The Third Circuit addressed the tension between the absolute priority rule and the gifting doctrine and in *Armstrong*.[69] The Chapter 11 plan in *Armstrong* provided that the debtor's unsecured creditors would not be paid in full. However, it also provided that the debtor's direct and indirect equity interest holders would be issued warrants valued at approximately $35-$40 million dollars to purchase common stock in the reorganized debtor.[70] If one class of unsecured creditors rejected the plan, a co-equal class would receive and automatically transfer the warrants to the debtor's equity interest holders.[71] Because the Chapter 11 plan would make a distribution to equity without fully paying off unsecured claims, the court held it could not be confirmed over the objection of the unsecured creditors.[72] The court observed 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."[73] The court distinguished *SPM* as involving (i) a Chapter 7 settlement agreement; (ii) a secured creditor's perfected security interest; and (iii) a distribution from a carve-out of a secured creditors collateral.

Likewise, in *Dish Network Corp. v. DBSD North America, Inc.*, the Second Circuit held that, where a senior class voted against the plan, the distribution of shares and warrants to the debtor's equity holder violated the absolute priority rule.[74] The Chapter 11 plan in *DBSD* proposed that the holders of unsecured claims would receive shares estimated to be worth between 4% and 46% of their original claims. The current equity holder would receive shares and warrants.[75] As the second lien debt holders were senior to the objecting creditor, but would not be receiving the full value of their claims, the bankruptcy court characterized the equity holder's receipt of shares and warrants as a "gift" from second lien debt holders.[76] 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. However, 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 Second Circuit observed that "a weakened absolute priority rule could allow for serious mischief between senior creditors and existing shareholders."[77] The court adopted the Third Circuit's view in *Armstrong* and held that the bankruptcy court erred in confirming the Chapter 11 plan.[78]

In *DBSD*, a senior class voted against the plan. If all voting classes accept the plan, however, the gifting can likely be accomplished; the Court could confirm the plan under section 1129(a) and would not have to find that the plan complies with the "absolute priority rule" under section 1129(b)(2)(B).

Other courts have confirmed gifting plans, in some cases distinguishing the *Armstrong and DBSD* rulings.[79] For example, as discussed above, in *In re MCorp. Financial, Inc.*,[80] the district court for the Southern District of Texas confirmed a liquidating plan which included a gift from a senior unsecured creditor to the Federal Deposit Insurance Corporation (the "FDIC"). After protracted litigation among the debtors and the FDIC, the court implemented mediation among the key parties aimed at achieving a global settlement. The debtors proposed a settlement in connection with Chapter 11 plans for each debtor's estate, which included a gift of approximately $33 million dollars from senior unsecured creditors to the FDIC. The court noted that it was clear to the senior unsecured creditors that no progress could be made until the FDIC litigation was resolved, and they would lose more in interest in the coming years than the amount they were gifting to the FDIC. A class of junior unsecured creditors objected to the plans, arguing that the value of claims against the FDIC had been materially undervalued and that the cost to creditors and the estates of further litigation has been materially overstated. The funds available to pay creditors were just enough to pay senior unsecured creditors, which were owed over $354 million dollars. However, junior unsecured creditors were only scheduled to receive approximately 5% of their claims. The court observed that if the debtors were to succeed in their litigation with the FDIC, their gain "could be huge," although the estates would be faced with costs associated with litigation and the potential of an FDIC affirmative recovery greater than $34 million dollars (the FDIC brought claims against the debtors totaling between $262 and $305 million dollars). Accordingly, the court noted that while it was in the seniors' best interests to receive a payout now and settle the FDIC claim, it was in the juniors' interests to continue litigating.[81] The court conducted an extensive analysis of the costs and likelihood of success in the FDIC litigation. Ultimately, in addressing whether the plan could be crammed down on the junior dissenting class, the court concluded that a senior creditor can do what it wishes with proceeds, including sharing its distribution with junior creditors.[82] It was significant to the court's decision that the junior creditors being crammed down agreed in the indenture to have their claims be lower in priority to those of the senior unsecured creditors. Thus, there was no manipulation or gerrymandering of classes. The court concluded that as the junior creditors "will be paid the assets that exceed the claims prior to theirs, and they will be paid their claims before equity is paid…[t]he plans survive under the statutory test."[83]

iii. Additional Concerns Regarding Gifting

Courts have declined to allow "gifting" if it suspects that gifting was proposed for an improper purpose. For example, in *In re Scott Cable Communications*, *Inc.*,[84] the bankruptcy court for the District of Connecticut sustained the objection of the IRS and denied confirmation of a prepackaged liquidating Chapter 11 plan which provided for payment of administrative, priority and unsecured claims from recoveries that would otherwise be payable to secured creditors, but did not provide for payment of any federal or state tax liability.[85] The court reasoned that the plan was proposed to avoid taxes in contravention of Bankruptcy Code section 1129(d) and was thus made for an improper purpose.[86]

Conclusion

Gifts have been used in a variety of contexts, including section 363 sales, preplan settlements and Chapter 11 plans. While generally made by secured creditors, gifts also have been made by unsecured creditors under certain circumstances. Courts have differed widely on when and whether gifting will be approved. As such, parties interested in using gifting as a tool to gain consensus should look closely at the contexts in which courts have approved gifting in their jurisdiction(s) in order to fashion a successful strategy.

Notes

1. Official Unsecured Creditors Comm. v. Stern (In re SPM Mfg. Corp.), 984 F.2d 1305, 1313, 23 Bankr. Ct. Dec. (CRR) 1529, 28 Collier Bankr. Cas. 2d (MB) 451, Bankr. L. Rep. (CCH) P 75090 (1st Cir. 1993) (internal citation omitted).

2. This article is designed to provide a survey of recent case law and suggested strategies for practitioners. It is not intended to, and does not, express the view of the authors or Cole Schotz as to whether or to what extent gifting should be allowed.

3. SPM, 984 F.2d at 1313.

4. See, e.g., Dish Network Corp. v DBSB N. America, Inc. (In re DBSD North America, Inc.), 634 F.3d 79, 65 Collier Bankr. Cas. 2d (MB) 201, Bankr. L. Rep. (CCH) P 81933 (2d Cir. 2011); In re Armstrong World Industries, Inc., 432 F.3d 507, 45 Bankr. Ct. Dec. (CRR) 222, 55 Collier Bankr. Cas. 2d (MB) 789, Bankr. L. Rep. (CCH) P 80434 (3d Cir. 2005); = Carnevale, Comment: Is Gifting Dead in Chapter 11 Reorganizations? Examining Absolute Priority in the Wake of the Second Circuit's No-Gift Rule in In re DBSD, 15 U. Pa. J. Bus. L. 225 (2012); Miller & Berkovich, The Implications Of The Third Circuit's Armstrong Decision On Creative Corporate Restructuring: Will Strict Construction Of The Absolute Priority Rule Make Chapter 11 Consensus Less Likely? 55 Am. U. L. Rev. 1345 (2006).

5. References to the "Bankruptcy Code" refer to 11 U.S.C.A. §§ 101, et seq.

6. See 11 U.S.C.A. §§ 726 and 1129(b)(2)(B).

7. See, e.g., DBSD, 634 F.3d 79 (denying confirmation of gifting plan); Armstrong., 432 F.3d 507 (same).

8. See SPM, 984 F.2d 1305 (holding that, in Chapter 7 case, secured creditor could gift property to unsecured creditors, ahead of priority creditor).

9. For an extensive article in support of the gifting doctrine, see Miller & Berkovich, 55 Am. U. L. Rev. 1345.

10. See 11 U.S.C.A. §§ 726, 1129(b)(2)(B).

11. Miller & Berkovich, 55 Am. U. L. Rev. at 1348 ("In some circumstances, creditors may want to give equity interest holders some consideration in order to retain the old management to continue to operate and manage the reorganized business, or they may want to give a particular class of creditors additional consideration to avoid threatened litigation by that class or for other reasons.")

12. Compare DBSD, 634 F.3d 79 (denying confirmation of gifting plan) and Armstrong, 432 F.3d 507 (same) with SPM, 984 F.2d 1305 (permitting gift from secured creditor).

13. Separate classification cannot be done for the purpose of "gerrymandering" to obtain an impaired accepting class. See Miller, supra note 4 at n.19 (citing John Hancock Mut. Life Ins. Co. v. Route 37 Business Park Associates, 987 F.2d 154, 159, 23 Bankr. Ct. Dec. (CRR) 1537, 28 Collier Bankr. Cas. 2d (MB) 440, Bankr. L. Rep. (CCH) P 75104 (3d Cir. 1993); Matter of Greystone III Joint Venture, 948 F.2d 134, 139, 22 Bankr. Ct. Dec. (CRR) 452, 22 Bankr. Ct. Dec. (CRR) 1114, 26 Collier Bankr. Cas. 2d (MB) 220, Bankr. L. Rep. (CCH) P 74351 (5th Cir. 1991), republished as corrected at 995 F.2d 1274; Brunstad, Jr. & Sigal, Competitive Choice Theory and the Unresolved Doctrines of Classification and Unfair Discrimination in Business Reorganizations Under the Bankruptcy Code, 55 Bus. Law. 1, 24-32 (1999); Rusch, Gerrymandering The Classification Issue in Chapter Eleven Reorganizations, 63 U. Colo. L. Rev. 163, 189-92 (1992)).

14. A claim or interest is impaired unless the plan:

(1) leaves unaltered the legal, equitable, and contractual rights to which such claim or interest entitles the holder of such claim or interest; or

(2) notwithstanding any contractual provision or applicable law that entitles the holder of such claim or interest to demand or receive accelerated payment of such claim or interest after the occurrence of a default—

  (A) cures any such default that occurred before or after the commencement of the case under this title, other than a default of a kind specified in section 365 (b)(2) of this title or of a kind that section 365 (b)(2) expressly does not require to be cured;

  (B) reinstates the maturity of such claim or interest as such maturity existed before such default;

  (C) compensates the holder of such claim or interest for any damages incurred as a result of any reasonable reliance by such holder on such contractual provision or such applicable law;

  (D) if such claim or such interest arises from any failure to perform a nonmonetary obligation, other than a default arising from failure to operate a nonresidential real property lease subject to section 365 (b)(1)(A), compensates the holder of such claim or such interest (other than the debtor or an insider) for any actual pecuniary loss incurred by such holder as a result of such failure; and

  (E) does not otherwise alter the legal, equitable, or contractual rights to which such claim or interest entitles the holder of such claim or interest.

11 U.S.C.A. § 1124.

15. 11 U.S.C.A. § 1129(b).

16. 11 U.S.C.A. § 1129(b)(1).

17. 11 U.S.C.A. § 1129(b)(2)(B)(ii) (providing that for a plan to be "fair and equitable" with respect to a dissenting class of unsecured claims includes the following requirement: "the

holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property"); DBSD, 634 F.3d at 94 ("The [Bankruptcy] Code does not define the full extent of 'fair and equitable,' but it includes a form of the absolute priority rule as a prerequisite."); see Bank of America Nat. Trust and Sav. Ass'n v. 203 North LaSalle Street Partnership, 526 U.S. 434, 441-42, 119 S. Ct. 1411, 143 L. Ed. 2d 607, 34 Bankr. Ct. Dec. (CRR) 329, 41 Collier Bankr. Cas. 2d (MB) 526, Bankr. L. Rep. (CCH) P 77924 (1999) ("As to a dissenting class of impaired unsecured creditors, such a plan may be found to be 'fair and equitable' only if the allowed value of the claim is to be paid in full, § 1129(b)(2)(B)(i), or, in the alternative, if 'the holder of any claim or interest that is junior to the claims of such [impaired unsecured] class will not receive or retain under the plan on account of such junior claim or interest any property,' § 1129(b)(2)(B)(ii). That latter condition is the core of what is known as the "absolute priority rule."). Section 1129(b)(2)(A) and (C) set forth the cramdown requirements for classes of secured claims and interests, respectively.

18. For a discussion of the origins of the absolute priority rule, see Carnevale, 15 U. Pa. J. Bus. L. at 227-29; Miller & Berkovich, 55 Am. U. L. Rev. at 1362-76; see also Bussel & Klee, Recalibrating Consent in Bankruptcy, 83 Am.Bankr.L.J. 663, 695, 710-11 (2009).

19. DBSD, 634 F.3d 79; Armstrong, 432 F.3d 507.

20. H.R. Rep. 95-595, 1978 U.S.C.C.A.N. 5963, 6372 (1977) (noting that the absolute priority rule was "designed to prevent a senior class from giving up consideration to a junior class unless every intermediate class consents, is paid in full, or is unimpaired").

21. See Miller & Berkovich, 55 Am. U. L. Rev. at 1356 ("The Unfair Discrimination Prohibition was developed to ensure that (non-consenting) creditors were not being unfairly classified, isolated from similarly situated creditors, and treated poorly relative to those similar creditors (or favored creditors were not being similarly isolated for the purposes of some sort of unjustified bonus recovery)"). For an extensive discussion of the unfair discrimination prohibition, see Miller & Berkovich, 55 Am. U. L. Rev. at 1382-90.

22. As noted in Andrews, et al., Lockups, Deathtraps and the Gifting Doctrine: A Discussion of Plan Confirmation Issues, American Bankruptcy Institute 28th Annual Spring Meeting, National Harbor, Maryland, 255, 262 (2010):

> The majority of Courts apply a four factor test: "(1) whether the discrimination is supported by a reasonable basis; (2) whether the debtor can confirm and consummate a plan without the discrimination; (3) whether the discrimination is proposed in good faith and (4) the treatment of the classes discriminated against." A minority of Courts follow a more conservative approach to § 1129(b)(1) that shifts the burden and typically bars discrimination regardless of whether it is fair or reasonable.

(Internal citations omitted).

23. For an extensive discussion of the history of gifting, see Miller & Berkovich, 55 Am. U. L. Rev. at 1390-1425; see also Carnevale, 15 U. Pa. J. Bus. L. at 227-29.

24. Miller & Berkovich, 55 Am. U. L. Rev. at 1390 (citing Senate report proposing gifting be allowed, S. Rep. No. 95-989, at 127 (1978), reprinted in 1978 U.S.C.C.A.N. 5787, 5913, and subsequent rejection by two legislators, 124 Cong. Rec. S. 34007 (Oct. 5, 1978) (remarks of Sen. DeConcini); 123 Cong. Rec. H. 32408 (Sept. 28, 1978) (remarks of Rep. Edwards)).

25. Miller & Berkovich, 55 Am. U. L. Rev. at 1390-91.

26. SPM, 984 F.2d 1305.

27. See, e.g., DBSD, 634 F.3d 79; Armstrong, 432 F.3d 507.

28. Armstrong, 432 F.3d at 514.

29. Armstrong, 432 F.3d at 514.

30. See, e.g., In re World Health Alternatives, Inc., 344 B.R. 291, 298-99,46 Bankr. Ct. Dec. (CRR) 204 (Bankr. D. Del. 2006) (holding carve out agreements in which a secured creditor gives up a portion of its lien for the benefit of unsecured junior creditors do not offend the absolute priority rule); In re Journal Register Co., 407 B.R. 520, 532 (Bankr. S.D. N.Y.

2009) (distinguishing *Armstrong* as *Journal Register* case did not "force[] distribution from one class to a junior class over the objection of an intervening dissenting or objecting class").

31. DBSD, 634 F.3d at 97-98 (distinguishing *SPM* as (i) involving Chapter 7, rather than Chapter 11 and (ii) a case where the court had granted the secured creditor relief from the automatic stay and treated the property as "no longer part of the estate").

32. See generally Levin, Almost All You Ever Wanted to Know About Carve Out, 76 Am. Bankr.L.J. 445 (2002).

33. Miller & Berkovich, 55 Am. U. L. Rev. at 1394 ("The least controversial use of SPM is to permit carveouts of secured creditors' collateral. A typical carveout is an arrangement under which secured creditors permit the use of a portion of their collateral to pay administrative costs, such as attorney fees and possible subsequent Chapter 7 expenses.").

34. Miller & Berkovich, 55 Am. U. L. Rev. at 1395 ("The secured creditor with a lien on all the debtor's assets is willing to agree to the carve out because it believes that the value of the debtor's assets, and therefore its secured claim, will be increased by the services provided by certain administrative creditors."); see In re Nuclear Imaging Systems, Inc., 270 B.R. 365, 47 Collier Bankr. Cas. 2d (MB) 932, Bankr. L. Rep. (CCH) P 78576 (Bankr. E.D. Pa. 2001) (granting application for administrative expense and payment out of proceeds of secured creditor's collateral pursuant to surcharge agreement between parties).

35. In re Worldcom, Inc., 2003 WL 23861928 at *61 (Bankr. S.D. N.Y. 2003) ("The absolute priority rule is inapplicable to contributions of Plan recoveries made by certain creditors to other creditors. Agreements by creditors to share their recoveries under a plan of reorganization with other creditors need not benefit an entire class. Moreover, the contributing creditor need not be a secured creditor.") (citing SPM, 984 F.2d at 1313; In re MCorp Financial, Inc., 160 B.R. 941, 960 (S.D. Tex. 1993); In re White Glove, Inc., 1998 WL 731611 (Bankr. E.D. Pa. 1998); In re Parke Imperial Canton, Ltd., 1994 WL 842777 (Bankr. N.D. Ohio 1994)).

36. See Miller & Berkovich, 55 Am. U. L. Rev. at 1402.

37. Worldcom, 2003 WL 23861928 at *61; see Miller & Berkovich, 55 Am. U. L. Rev. at 1388-89, 1399-1404 for a discussion of the *Worldcom* plan.

38. See Miller & Berkovich, 55 Am. U. L. Rev. at 1404.

39. For further discussion of DBSD, see infra notes 74-78.

40. MCorp, 160 B.R. 941.

41. MCorp, 160 B.R. at 960.

42. MCorp, 160 B.R. at 960.

43. MCorp, 160 B.R. at 960.

44. World Health, 344 B.R. at 294-96.

45. Armstrong, 432 F.3d 507.

46. World Health, 344 B.R. at 295.

47. World Health, 344 B.R. at 296. Other courts in the Third Circuit post-*Armstrong* have allowed gifting in the context of a sale of the debtor's assets. See, e.g., In re Kainos Partners Holding Co., LLC, 2012 WL 6028927 (D. Del. 2012); In re Avado Brands, Inc., Case No. 07-11276 (Bankr. D. Del. Jan. 11, 2008) (MFW); PSA Successor Corp., Case No. 04-13030 (Bankr. D. Del. 2004) (MFW).

48. World Health, 344 B.R. at 298. The court also observed that, like *SPM*, which was in the Chapter 7 context, the *World Health* case was moving toward conversion to Chapter 7.

49. In re TSIC, Inc., 393 B.R. 71, 75-77, 60 Collier Bankr. Cas. 2d (MB) 962 (Bankr. D. Del. 2008).

50. TSIC, Inc., 393 B.R. at 74.

51. TSIC, Inc., 393 B.R. at 75 n.3, 77.

52. In re Warren, 2011 WL 3299819 at *6 (B.A.P. 9th Cir. 2011) (Chapter 7).

53. Warren, 2011 WL 3299819 at *5.

54. Warren, 2011 WL 3299819 at *5 n.4.

55. In re On-Site Sourcing, Inc., 412 B.R. 817, 825-26, 51 Bankr. Ct. Dec. (CRR) 218 (Bankr. E.D. Va. 2009).

56. On-Site Sourcing, Inc., 412 B.R. at 826.

57. On-Site Sourcing, Inc., 412 B.R. at 827.

58. On-Site Sourcing, Inc., 412 B.R. at 827-28.

59. On-Site Sourcing, Inc., 412 B.R. at 828. The opinion references an objection filed by the U.S. Trustee, but it does not appear that any creditors objected to the sale. See also In re Braniff Airways, Inc., 700 F.2d 935, 10 Bankr. Ct. Dec. (CRR) 933, 8 Collier Bankr. Cas. 2d (MB) 522 (5th Cir. 1983) (holding that order approving sale must be reversed as sale was sub rosa plan).

60. In re Iridium Operating LLC, 478 F.3d 452, 47 Bankr. Ct. Dec. (CRR) 243, Bankr. L. Rep. (CCH) P 80874 (2d Cir. 2007).

61. Iridium, 478 F.3d at 459.

62. Iridium, 478 F.3d at 460.

63. Iridium, 478 F.3d at 460.

64. Iridium, 478 F.3d at 464-65.

65. Iridium, 478 F.3d at 466.

66. Matter of AWECO, Inc., 725 F.2d 293, 299, 11 Bankr. Ct. Dec. (CRR) 953, Bankr. L. Rep. (CCH) P 69722 (5th Cir. 1984).

67. AWECO, Inc., 725 F.2d at 299-300.

68. DBSD, 634 F.3d 79 (approving both *Armstrong* and *SPM*, and appearing to distinguish gifting in Chapter 7 and Chapter 11 cases); Armstrong, 432 F.3d 507 (distinguishing *SPM*).

69. Armstrong, 432 F.3d 507.

70. Armstrong, 432 F.3d at 509.

71. Armstrong, 432 F.3d at 509.

72. Armstrong, 432 F.3d at 513-14.

73. Armstrong, 432 F.3d at 514-15.

74. DBSD, 634 F.3d at 100-01.

75. DBSD, 634 F.3d at 86.

76. DBSD, 634 F.3d at 87.

77. DBSD, 634 F.3d at 100.

78. DBSD, 634 F.3d at 100-01.

79. See, e.g., Journal Register Co., 407 B.R. at 533-34 (approving plan where gift was voluntarily made from secured creditors to trade creditors. Distributions were placed in a "so-called trade account" that was designated as non-debtor property).

80. MCorp, 160 B.R. 941.

81. MCorp, 160 B.R. at 950 ("[The juniors'] amount at risk is relatively low and their gain could be huge").

82. MCorp, 160 B.R. at 960.

83. MCorp, 160 B.R. at 960; see also In re Idearc Inc., 423 B.R. 138, 151 (Bankr. N.D. Tex. 2009), subsequently aff'd, 662 F.3d 315 (5th Cir. 2011), cert. denied, 132 S. Ct. 1604, 182 L. Ed. 2d 173 (2012) (approving gifting plan where administrative agent and lenders agreed to gift distribution to certain classes of unsecured claims where absent arrangements, it was uncertain whether the parties would have been able to finalize a global settlement). But see In re Sentry Operating Co. of Texas, Inc., 264 B.R. 850, 853, 38 Bankr. Ct. Dec. (CRR) 68 (Bankr. S.D. Tex. 2001) (denying confirmation of gifting plan which provided gift to one class but not another of equal priority). For a further discussion of gifting in the Fifth Circuit, see generally McDivitt, What Do You Mean There Won't Be Gifts This Year?: Why Practitioners Cannot Rely Upon Gifting Provisions In Chapter 11 Reorganization Plans In The Fifth Circuit, 44 Tex. Tech L. Rev. 1019 (2012).

84. In re Scott Cable Communications, Inc., 227 B.R. 596, 33 Bankr. Ct. Dec. (CRR) 702, 99-1 U.S. Tax Cas. (CCH) P 50288, 83 A.F.T.R.2d 99-1028 (Bankr. D. Conn. 1998).

85. Scott Cable, 227 B.R. at 598-99.

86. Scott Cable, 227 B.R. at 603; see also In re CGE Shattuck, LLC, 254 B.R. 5, 9, 36 Bankr. Ct. Dec. (CRR) 975, 45 Collier Bankr. Cas. 2d (MB) 24, 2000 BNH 34 (Bankr. D. N.H. 2000) (declining to approve gift proposed by secured creditor to force conversion to Chapter 7); In re Goffena, 175 B.R. 386, 390-92 (Bankr. D. Mont. 1994) (holding that Chapter 7 trustee could not circumvent the requirements of §§ 506(c) and 726 of the Bankruptcy Code through a private agreement with a secured creditor); see also Miller & Berkovich, supra note 4, at n.19 (citing John Hancock, 987 F.2d at 159 (3d Cir. 1993); Greystone III, 948 F.2d at 139; Brunstad, Jr. & Sigal, 55 Bus. Law. at 24-32 (1999); Rusch, Gerrymandering The Classification Issue in Chapter Eleven Reorganizations, 63 U. Colo. L. Rev. at 189-92)).