Viewpoint

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The Final Round For Gift Plans?

By Damian S. Schaible and Michelle M. McGreal

The era of the non-consensual "gift plan" may be over. The Third U.S. Circuit Court of Appeals dealt a blow to the practice in 2005 in *In re Armstrong World Indus., Inc.,* 432 F.3d 507 (3d Cir. 2005), and in its recent decision in *In re DBSD N.A., Inc.,* 2011 WL 350480 (2d Cir. Feb. 7, 2011), the Second Circuit may have delivered the knockout punch. Practitioners with Chapter 11 cases in one of these circuits are now left to contemplate alternatives to non-consensual gift plans.

Under such a plan, a senior creditor class transfers a portion of its recovery under a plan of reorganization to one or more junior creditor classes or, as is often the case, to the debtor's existing equity holders, over the objection of a class of intermediate creditors that are not being paid in full under the plan. The practice is often used to try to achieve a consensual plan of reorganization and address out-of-the-money constituencies that might otherwise have an incentive to seek to delay or block confirmation of a plan.

A number of courts have approved of gift plans. The case most often cited in support of the practice is *Official Unsecured Creditors Comm. v. Stern (In re SPM Mfg. Corp.), 984 F.2d 1305* (First Cir. 1993), where the First U.S. Circuit Court of Appeals held that creditors can generally do whatever they want with their recovery, including giving it away to whichever creditors they choose. Although it was in the Chapter 7 context, other courts have relied on *SPM* to approve of Chapter 11 gift plans.

Notwithstanding the helpful language in *SPM* and prior case law, the practice of gifting has been called into question in Chapter 11 cases as a violation of section 1129(b)(2)(B), the codified version of the common law rule referred to as the "absolute priority rule," which does not apply in Chapter 7 cases. Thus, unlike a Chapter 7 liquidating plan, a Chapter 11 plan may not be confirmed over the objection of an impaired class of unsecured creditors if the plan distributes property to any subordinate class of creditors or interest holders on account of such subordinate creditors' or interest holders' claims or interests.

The Third Circuit began chipping away at the gifting doctrine in *Armstrong*, when it held that *SPM* does not in fact stand for the proposition that creditors may do whatever they want with their plan recovery. However, the decision did not mean the end of gift plans. This is because the court did not disapprove of *SPM* outright; rather, the Third Circuit, in adopting the district court's reading of *SPM*, focused, in part, on the fact that, in *SPM*, unlike in *Armstrong*, the gifting creditor was a secured creditor, essentially "carving out" a portion of its lien proceeds. In fact, after *Armstrong*, bankruptcy courts, including those in the Second Circuit, routinely approved gift plans where the gifting class was secured.

The theory that a secured creditor class has the right to carve out and distribute value from its collateral was finally considered by the Second Circuit in *DBSD*, and it was soundly rejected. In *DBSD*, Sprint Nextel Corp., an unsecured creditor, appealed the bankruptcy court's confirmation of a plan that would have provided DBSD's former shareholders with approximately 5% of the equity in the reorganized debtor, while general unsecured creditors would only receive approximately 0.15% of the new equity. The distribution to the existing equity holders was approved by the bankruptcy court and the district court as a gift from DBSD's undersecured creditors.

The Second Circuit reversed the lower courts' decisions, holding that the purported gift violated the clear language of section 1129(b)(2)(B). According to the Second Circuit, because the gifting creditors chose to forgo receipt of the property, it remained property of the estate and was therefore subject to section 1129(b)(2)(B).

In light of *Armstrong* and *DBSD*, a traditional gift plan is likely no longer confirmable in the Second or Third Circuits, absent the consent of any intermediate classes. This is unfortunate because, as the Second Circuit noted, its ruling may encourage strategic holdout behavior by junior creditors. This is particularly unfortunate given that the concern underpinning the absolute priority rule, namely, to protect against collusion among classes at the expense of other creditors, is not implicated by many of the gift plans filed in large Chapter 11 cases.

However, even in the wake of *Armstrong* and *DBSD*, there are a number of alternative mechanisms, some expressly recognized by the Second Circuit in *DBSD*,

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that practitioners might utilize to accomplish the same results as a gift plan without violating the absolute priority rule.

As an initial matter, there are a number of scenarios where the absolute priority rule plainly does not apply. Just as section 1129(b)(2)(B) does not apply in Chapter 7 cases, it also does not apply to consensual plans.

Another option may be for the secured creditor to first obtain relief from the automatic stay to foreclose on its collateral or enter into a stipulation with the debtor as to the ownership of the collateral. In that way, the property to be distributed would no longer be property of the debtor's estate, and the Chapter 11 distribution scheme would not apply.

Along these same lines, it would appear that a gift could still be accomplished if the property to be gifted was first sold pursuant to section 363. The secured creditor could persuade the debtor to seek court approval to sell the property and, as part of the order approving the sale, have the sale proceeds distributed as the secured creditor directs.

Another option might be to effectuate a gifting structure outside of a plan, for example in the form of an agreement whereby a creditor agrees to gift a portion of its plan recovery after confirmation in exchange for a favorable plan vote. In *DBSD*, the Second Circuit expressly left these options open, and bankruptcy courts in the Third Circuit have approved distributions to junior classes under pre-plan settlements pursuant to Bankruptcy Rule 9019. Any such agreement would need to be approached with caution, however, as it may create other problems, especially if such an agreement were entered into without approval by the bankruptcy court.

The Second Circuit also acknowledged the so-called new value exception to the absolute priority rule. Under this judicially created doctrine, the plan distribution to junior creditors or equity holders is given on account of new consideration provided by such junior creditors or equity holders. However, this approach comes with some risk, as the Supreme Court has never expressly approved of the new value exception and has set a high threshold on what consideration, if any, would be sufficient to constitute the requisite new value.

A final option might be for the gifting creditors to purchase the claims of the junior creditors or the interests of the equity holders. This option, however, carries with it the risk of vote designation if a court finds that the purchase lacked good faith, as a court might if the purchase were made solely as a means to avoid the absolute priority rule.

The Second Circuit's decision in *DBSD* has generated a lot of controversy in the restructuring community and may have serious implications in Chapter 11 cases to come. However, just as the doctrine of gifting derived from creative lawyering, there is no reason to believe that creativity will not lead to permissible and effective alternatives.

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