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# *SPM Manufacturing* to *Journal Register*: Indicators of a Successful "Gift Plan"

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In *In re Journal Register Co.*, 09-10769, 2009 Bankr. LEXIS 1737 (Bankr. S.D.N.Y. July 7, 2009), Judge **Allan Gropper** of the U.S. Bankruptcy Court for the Southern District of New York confirmed a plan of reorganization that involved a "gift" distribution by senior secured creditors to a group of unsecured trade creditors over the objection of a non-trade unsecured creditor. So-called "gift plans" are often contentious and have resulted in a long string of published decisions by bankruptcy and higher courts over the past 16 years.

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While the facts, legal analysis and holdings of these decisions vary (both among and even within courts and circuits), two discrete indicators often appear in the courts' reasoning and are often predictive of the courts' ultimate holdings. These indicators are (1) whether the distribution to be made to the favored group is a true gift (*i.e.,* whether it is made out of property that clearly belongs to the senior creditor gift-giving class), and (2) whether the gift has been supported by a strong and credible business justification.

Where these two indicators are present, as they were in *Journal Register*, courts seem to be more likely to approve a gift plan, and this may be for good reason. To the extent that a senior creditor that will not be paid in full in connection with a plan is willing to give a portion of its recovery to junior creditors for good business reasons, the creditor is acting like the equity owner of the reorganized business, and courts seem willing to permit that.

As debtors with increasingly complex and extensive prepetition balance sheets seek to reorganize, senior creditors will more often need to be able to customize plans of reorganization to favor certain constituencies over others in ways not in strict conformity with the absolute priority. The ability to predict whether a given gift plan is likely to be approved over objections by disfavored creditors will become increasingly important. This article will illustrate that, based on case law to date, the presence or absence of these indicators may be helpful in making such predictions.

**Feature**

## *Origin of the Gift Plan Doctrine:* SPM Manufacturing

In order to understand how the case law on gift plans has developed, one must start at the beginning: the 1993 decision of *In re SPM Manufacturing Corp.,* 984 F.2d 1305 (1st Cir. 1993). In this case, a senior secured creditor, Citizens Savings Bank, entered into an agreement with the unsecured creditors' committee appointed in the case to cooperate in formulating a plan of reorganization and to share any proceeds received as a result of the reorganization or liquidation of the debtor. *Id.* at 1308.

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When attempts at reorganization failed, the debtor's case was converted a chapter 7 and the debtor's assets were sold for less than the amount of Citizens' claim. *Id.* at 1308–09. Citizens and the debtor's unsecured creditors sought to have the sale proceeds distributed in accordance with their agreement, but the debtor objected, arguing that it would violate the absolute-priority rule to permit general unsecured creditors to receive any recovery while priority tax claims (for which the debtor's principal officers would be personally liable) remained unpaid. *Id.* The First Circuit approved the distribution scheme over the debtor's objection, holding that the sale proceeds were Citizens' property as an undersecured senior creditor and that Citizens was entitled to distribute those proceeds in any manner it chose, including to junior creditors over the objection of an intermediate class. *Id.* at 1313-14.

## *Development of the Gift Plan Doctrine*

### Decisions Approving Gift Plans

Since *SPM Manufacturing,* a number of decisions has approved plans of reorganization involving gift distributions. In these cases, the two indicators discussed above are commonly present: (1) the gifted property is not in substance property of the

1 The authors would like to thank Wei Deng for her extensive assistance in the preparation of this article.

debtor's estate because it belongs to the senior creditor gift-giving class (*i.e.,* it is a "true gift"); and (2) there exists a strong and credible business justification for the gift, such as preserving or enhancing the enterprise value of the reorganized debtor.

In *In re MCorp Financial Inc.,* 160 B.R. 941 (S.D. Tex. 1993), a district court approved a plan that included an agreement under which senior bondholders would gift a portion of their claim to fund a settlement between the debtors and the Federal Deposit Insurance Corporation (FDIC). *Id.* at 944. Junior bondholders, senior in priority to the FDIC, were not to be paid in full and objected to the plan, alleging that the plan violated the absolute-priority rule. *Id.* at 948, 961. The court approved the gift plan on the basis that the gift was a carve-out from proceeds that were otherwise clearly allocable to the senior bondholders. *Id.* at 960. The court reasoned that "the seniors may share their proceeds with creditors junior to the juniors, as long as the juniors continue to receive at least as much as what they would without the sharing." *Id.* (citing *SPM Manufacturing*). Furthermore, the court found that a strong and credible business justification existed for the gift in that the distribution was part of a settlement advantageous to the reorganized debtor. *Id.* at 951–57.

Similarly, in *In re Genesis Health Ventures Inc.,* 266 B.R. 591 (Bankr. D. Del. 2001), a bankruptcy court approved a plan of reorganization providing subordinated debt-holders with a 14 percent recovery while certain holders of claims senior to the subordinated debt were to receive no distribution. *Id.* at 602. The plan also provided for new common stock and options to be distributed to the management based partially, in the court's view, on their status as prepetition equityholders. *Id.* at 616-18. The court held that the value to be distributed to the junior creditors was clearly property of senior lenders, thus rendering the transaction a true gift. *Id.* at 602. The court determined that the objecting class would not have been entitled to any distribution under the plan in any event, so the senior lenders' gift did not harm them. *Id.* With regard to the stock and warrants to be issued to management, the court held that the issuance "represents an allocation of the enterprise value otherwise distributable to the senior lenders, which the senior lenders have agreed to offer to the top executives as further incentive to them to remain and effectuate the debtors' reorganization." *Id.* at 618.

Finally, in *In re Union Financial Services Group,* 303 B.R. 390 (Bankr. E.D. Mo. 2003), the bankruptcy court similarly upheld the principle that senior lenders are entitled to distribute their own proceeds as they see fit in order to enhance the value of the reorganized debtors. In confirming a gift plan in which the senior secured lenders and debtor-in-possession (DIP) lenders earmarked and assigned funds to pay certain general unsecured creditors as a voluntary assignment of their cash collateral, the court held that "[t]here is no unfair discrimination in a Plan provision that allows the Senior Secured Lenders and the DIP Lenders voluntarily to assign to unsecured creditors cash collateral proceeds that otherwise would rightfully belong to the secured creditors, particularly in the context of a reorganization where continued relations with those unsecured creditors are important to the future business of the reorganized Debtors." *Id.* at 423. As in the other decisions discussed herein, the court focused on the existence of both a "true gift" and a strong business justification in approving the gift plan before it. *Id.*

## Decisions Rejecting Gift Plans

Where courts have refused to uphold gift distributions to junior creditors, they have often found either or both of the "true gift" and/or the "strong business purpose" indicators lacking. For instance, in *In re Sentry Operating Co. of Texas Inc.,* 264 B.R. 850 (Bankr. S.D. Tex. 2001), the debtors' proposed plan of reorganization called for senior secured lenders to recover 61 percent on account of their claims, while trade creditors would be fully paid and other unsecured creditors would recover approximately 1 percent. *Id.* at 855. Although the debtors argued that the supplemental distribution to trade creditors was necessary to preserve relationships with them and preserve the value of the reorganized debtors' business, the court did not believe the debtors' justification and refused to confirm the plan. *Id.* at 861. The court noted that many trade creditors "appear to be paid for reasons other than preservation of value." *Id.* at 861, 864.

In *In re Snyders Drug Stores Inc.,* 307 B.R. 889 (Bankr. N.D. Ohio 2004), certain favored junior classes, including reclamation claimants and trade creditors, were to receive an enhanced recovery, while certain other general unsecured claims would receive no recovery. *Id.* at 892. The enhanced recovery included value that would otherwise have gone to the debtors' senior lenders and the right to receive proceeds from certain litigation claims, including certain avoidance actions. *Id.* In defending the proposed plan, the debtors argued that because the senior lenders were undersecured and would not be paid in full in any event, objecting creditors were entitled to receive nothing under the plan and the special treatment to the favored creditors was justified by the debtors' post-emergence business needs. *Id.* at 894. The court refused to confirm the plan. *Id.* at 896. It held that the litigation claims were property of the estate, rather than property of the senior lenders, and there was no evidence that the favored creditors would refuse to do business with the reorganized debtors in the absence of the special treatment. *Id.* at 894-95.

The oft-cited bankruptcy court decision in *In re Armstrong World Industries Inc.,* 320 B.R. 523 (E.D. Pa. 2005), *aff'd,* 432 F.3d 507 (3d Cir. 2005), also appears to be grounded in part on the "strong business justification" indicator. In rejecting a plan that would have provided new warrants to certain prepetition equity-holders, the court held that the plan was not "'fair and equitable' if a class of creditors that is junior to the class of unsecured creditors receives debtor's property while the allowed claims of the class of unsecured creditors have not been paid in full." *Id.* at 536. The court famously went on to hold that "to accept the [secured lender's] argument that [it] can, without any reference to fairness, decide which creditors get paid and how much those creditors get paid, is to reject the historical foundation of receiverships and to read the §1129(b) requirements out of the [Bankruptcy] Code." *Id.* at 540 (citing *Sentry Operating,* 264 B.R. at 865). Notably, however, the court rejected the gift of warrants primarily because of a lack of an adequate business justification for the gift. *Id.* Although the debtor argued that the warrants were to be granted in exchange for the release of certain claims, the court found that the estimated value of the warrants far exceeded the value of the claims. *See id.* at 536.

Finally, even the decision in *In re Iridium Operating LLC,* 478 F.3d 452 (2d Cir. 2007), relies in part on the same two indicators. In this case, the court held that pre-plan settlements approved under Bankruptcy Rule 9019 must generally comply with the absolute priority rule. *Id.* at 461-62. At issue was a pre-plan settlement agreement pursuant to which the unsecured creditors' committee conceded the validity and priority of certain secured-

lender claims in exchange for $37.5 million to fund litigation against Motorola, the former parent of the debtor and also an unsecured creditor. *Id.* at 459. The court distinguished *SPM Manufacturing* on the basis that the validity of the claims of the secured lenders in *Iridium* was contested, so the property to be gifted did not clearly belong to the secured lenders. *Id.* at 461. Furthermore, the court questioned the actual justification for the gift, since the funds remaining in the trust after the litigation was completed were to be distributed to the creditors' committee rather than to the senior lenders. *Id.* at 465-66. Even though *Iridium* involved a pre-plan settlement and not plan confirmation, the court's analysis still underscores the importance of the "true gift" and "strong business justification" principles.

## *The* Journal Register *Decision*

Judge Gropper's recent decision confirming the gift plan in *Journal Register* is the latest in a long line of decisions focusing, in part, on the "true gift" and "strong business justification" principles. Journal Register is a national media company that owns and operates newspapers, other publications, Web sites and printing facilities. Its prepetition capital structure consisted of $695 million of senior debt secured by substantially all of the company's assets, approximately $27 million of unsecured debt and one class of common stock. The enterprise value of Journal Register was estimated at approximately $300 million. *In re Journal Register Co.,* 2009 Bankr. LEXIS 1737 at *9.

Under the debtors' proposed plan of reorganization, the senior lenders were to receive 100 percent of the new common stock of the reorganized company and new secured notes. *Id.* at *8. General unsecured creditors were to share a $2 million cash distribution. In addition to the general distribution, certain general unsecured creditors (specifically trade creditors) were to receive a separate distribution of approximately $6.6 million (trade creditor distribution). *Id.* at *12.

Central States, a multiemployer pension plan that held a general unsecured claim of $4.3 million, objected to confirmation of the plan. *Id.* at *15–16. It contended that the trade creditor distribution effectively and improperly created two classes of general unsecured creditors, and that this led to unfair discrimination against the nontrade general unsecured creditors. *Id.* at *17-18.

Judge Gropper overruled each of Central States' objections. First, he held that because all general unsecured claims were classified together, there was no improper classification. *Id.* at *28. With regard to alleged discrimination, Judge Gropper pointed out that the Code provision relied upon by Central States, §1129(b), prohibits unfair discrimination between different classes of creditors. *Id.* at *26 (citing *Kane v. Johns-Manville Corp.,* 843 F.2d 636, 636 (2d Cir. 1988)). Since Central States' objection was about certain unsecured creditors (the preferred trade creditors) receiving a greater distribution than other general unsecured creditors, Judge Gropper found that there was "no charge of unfair discrimination between classes of creditors." *Id.*

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Lastly, Judge Gropper considered whether the plan might be read to run afoul of Code §1123(a)(4), which requires that a plan "provide the same treatment for each claim or interest of a particular class, unless the holder of a particular claim or interest agrees to a less-favorable treatment of such particular claim or interest." In a discussion that relied in significant part on the "true gift" and "strong business justification" principles seen in previous case law, Judge Gropper held that it did not. *Id.* at *29-32.

Judge Gropper first pointed out that the trade creditor distribution was property of the senior lenders. The senior lenders' liens on substantially all of the debtor's assets were unchallenged, the senior lenders were not paid in full, and any residual amounts left after payment of the trade creditor distribution were to revert to the senior lenders. *Id.* at *9.

Noting that the senior lenders would be permitted outside of bankruptcy to gift their property as they chose, Judge Gropper held that merely using a plan as a "means of execution" for that gift does not make the gift invalid. *Id.* at *30. Judge Gropper also found that the trade creditor distribution was justified by the senior lenders' desire to preserve the going concern value of the reorganized debtors. *Id.* at *31. Specifically, he credited the testimony of the debtors' chief restructuring officer that the gift was "necessary to ensure the goodwill of trade creditors essential to the Debtors' post-confirmation survival." *Id.*

Finally, as a practical matter, Judge Gropper noted that the alternative to confirmation of the plan was a more negative result in that the senior lenders would propose a plan providing for no recovery for unsecured creditors, or the secured lenders could attempt to foreclose outside of the bankruptcy process entirely, thus jeopardizing the recoveries of all unsecured creditors (which as a class had voted overwhelmingly in support of the plan). *Id.*

## Conclusion

The case law on gift plans is famously cluttered and difficult to decipher. In today's restructuring world, with growing numbers of highly-leveraged debtors filing for chapter 11 with increasingly complex balance sheets, gift plans are likely to be increasingly relied upon as a tool for achieving confirmation of consensual plans of reorganization.

The two indicators discussed in this article—the true gift and strong business-justification concepts—appear time and again in decisions upholding gift plans, and this makes sense. A senior creditor that will not be paid in full in connection with a plan gifting part of its distribution to junior creditors for valid business reasons is exactly the type of "owner-like" behavior that courts may well want to encourage. Judge Gropper's *Journal Register* decision is the most recent in this line of cases and, together with the decisions that precede it, suggests that these two indicators may be useful as partial predictors of the likely result of a contested confirmation hearing involving a gift plan. ■

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