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Client Alert

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Beware of Creditors Bearing Gifts: the Second Circuit's Recent Decision in *In re: DBSD North America, Inc.* Casts Significant Doubt on "Gift" Plans

"The DBSD opinion contains a near categorical rejection of 'gifting' in the context of Chapter 11 plans of reorganization. . . . While the *DBSD* decision may not represent the definitive end of 'gifting' as a restructuring tool, it will no doubt inspire and require creative lawyering to implement gifting agreements."

On February 7, 2011 the United States Court of Appeals for the Second Circuit issued its eagerly awaited opinion in the consolidated appeal *In re: DBSD North America, Inc.*, Docket Nos. 10-1175, 10-1201, 10-1352, 2010 U.S. App. LEXIS 27007. The Second Circuit's opinion in *DBSD* reversed orders from the United States District Court and Bankruptcy Court for the Southern District of New York approving DBSD's plan of reorganization.[1] The Second Circuit rejected DBSD's plan as a violation of the absolute priority rule, which requires that a plan of reorganization pay non-consenting senior classes of creditors in full before junior classes can receive a distribution. The DBSD plan had attempted to side-step the requirements of the absolute priority rule by structuring a non-conforming distribution as a "gift" from senior secured lenders.

The *DBSD* opinion is likely to have a significant impact on restructuring negotiations inside and outside bankruptcy because it contains a near categorical rejection of "gifting" in the context of Chapter 11 plans of reorganization. The type of gifting at issue in *DBSD* — a senior secured lender's gift of distributions under a plan to a junior class (in the case of *DBSD*, the equity holders) and skipping over intermediate classes — has long been the subject of debate as to whether it violated the requirements of the Bankruptcy Code if the intermediate class rejected the plan. But until now, this type of gift had not been rejected outright, and gifting in one form or another has been a frequent cornerstone of inter-creditor settlements, including plan and sale support agreements in prenegotiated bankruptcies. The ruling in *DBSD* means that plans including such gifts to former equity holders will no longer be condoned in the Second Circuit and will likely be challenged in other jurisdictions. However, the decision does not necessarily spell the end for the practice of gifting; the *DBSD* decision specifically leaves open the possibility that gifting will continue to be a viable practice as long as it occurs outside of a plan of reorganization. That said, it is likely that *DBSD* will cause significant uncertainty until its full ramifications are better understood by courts and practitioners.

"Gifting" and the "gift doctrine" refer to the practice of a senior creditor voluntarily directing a portion of its actual or potential recovery from the estate to junior creditors or existing equity before an intermediate class is paid in full. If the estate made such payments directly without the consent of the intermediate class, the payments would be clearly inconsistent with the Bankruptcy Code's distribution scheme and the absolute priority rule. The premise of the gift doctrine is that the senior lender can make whatever use it wants of the distributions to which it is entitled and is free to gift such distributions to other stakeholders in the manner it sees fit.

Gifting as we know it today grew out of the First Circuit's decision in *In re SPM Mfg. Corp.*, 984 F.2d 1305 (1st Cir. 1993). *SPM* involved an agreement between the secured lender holding a severely underwater lien on all of the debtors' assets and the unsecured creditors committee. Because of the amount of its lien and the value of the property securing such lien, it was undisputed that the senior lender was entitled to all distributions from the estate. The senior lender entered into a support agreement with the creditors' committee whereby the senior lender agreed to share a portion of its proceeds with unsecured creditors. The agreement skipped over a class of priority tax claimants who, under the normal distribution scheme in the Bankruptcy Code, would have been paid ahead of the general unsecured creditors. After the debtor's assets were sold and the remaining estate (including all sale proceeds) was put into Chapter 7 liquidation, the bankruptcy court in *SPM* authorized a Chapter 7 liquidating plan that distributed value in accordance with the agreement between the secured lender and the committee. The First Circuit held that this was appropriate because, "[c]reditors are generally free to do whatever they wish with the bankruptcy dividends they receive, including to share them with other creditors." *Id.* at 1313.

The *SPM* court's holding that a secured lender could consent to distributions of collateral proceeds outside the strict confines of the Bankruptcy Code's distribution scheme led to courts and practitioners expanding the use of such gifts to a myriad of contexts beyond the Chapter 7 liquidation at issue in *SPM*. For example, senior secured lenders may agree with a debtor to structure a plan that provides for payments to trade creditors even though the junior secured creditor receives no distributions at all. Gifting practice has also included, most controversially, gifts to equity holders of the debtor.

In all of these contexts, the senior lender agrees to accept a less-than-full recovery and to have a portion of the money it was otherwise entitled to receive distributed to a junior class. The senior lender's reasons for agreeing to the distribution to junior claimants can range from a "tip" given in exchange for cooperation in the bankruptcy process to a negotiated settlement of claims the junior claimant may have against the senior lender. The benefits of locked-up consent from out-of-the-money junior creditors can be significant, especially where such junior creditor is in a position to delay or block the reorganization.

In contrast to such negotiated "gifts," the absolute priority rule limits parties' ability to arrange plan distributions by dictating that a plan of reorganization cannot be imposed on an impaired and dissenting class of claimants unless either (x) the nonconsenting class has its claims paid in full or (y) no claim or interest junior to the dissenting class receives or retains property "under the plan on account of such junior claim or interest." *See* 11 U.S.C. § 1129(b)(2)(B).

The first major case to use the absolute priority rule to invalidate a gift plan was *In re Armstrong World Indus., Inc.*, 432 F.3d 507, 512 (3d Cir. 2005). *Armstrong* involved a gift of new equity warrants from one unsecured class to another unsecured class. The Third Circuit found that such a gift was impermissible; however, it did not flatly prohibit gifting.

Instead, the Third Circuit distinguished *SPM* by noting that the gifting creditor in *SPM* was a secured lender gifting the proceeds of its collateral in a Chapter 7 liquidation.

The Second Circuit's *DBSD* opinion takes *Armstrong* a significant step further by invalidating a gift from an underwater **secured** creditor. DBSD North America, Inc. (DBSD) was founded in 2004 to develop a mobile communications network using both satellites and land-based transmission towers. It filed for bankruptcy in May 2009 and reported significantly more liabilities ($813 million) than assets ($627). DBSD's primary indebtedness included two tranches of secured debt — a $40 million first lien facility and $650 million in convertible second-priority senior secured notes. DBSD's plan of reorganization sought to pay the first lien lenders in full by replacing the pre-petition facility with a post-petition facility that the Bankruptcy Court found was the "indubitable equivalent" of the pre-petition facility. Because the Bankruptcy Court concluded that the reorganized company (as encumbered by its new post-reorganization debt facility) would be worth less than the second lien lenders' claim, the second lien lenders were entitled to all remaining value to be distributed via the reorganization (*i.e.*, 100 percent of the reorganized company's equity). However, in order to ensure a consensual restructuring, the second lien lenders reached an agreement with various constituencies whereby the second lien lenders gifted a blended equity/cash recovery to general unsecured creditors and a pure equity recovery to the debtors' former equity holders.[2]

Sprint Nextel Corporation, a holder of unliquidated claims on account of potential litigation recoveries against DBSD,[3] objected to the agreed plan because DBSD's former equity holders would receive value before Sprint was paid in full. Sprint argued that this arrangement violated the plain text of the absolute priority rule's statutory codification in 11 U.S.C. § 1129(b)(2)(B). In response, DBSD argued that the "property" to be transferred to former equity would not exist in the estate but for the secured lenders' gift and that the transfer was not "on account of" former equity's claims as equity holders. Instead, DBSD argued that the transfer was "on account of" the added value of ensuring a consensual restructuring. The Bankruptcy Court confirmed the plan over Sprint's objection, and Sprint appealed. The District Court affirmed, but the Second Circuit agreed with Sprint and reversed the Bankruptcy Court's confirmation of the plan.

In rejecting the DBSD gift arrangement as a violation of the absolute priority rule, the Second Circuit emphasized the plain text of 11 U.S.C. 1129(b)(2)(B) — a plan cannot be confirmed over the rejection by a class of creditors that is not being paid in full if any junior class "receive[s] or retain[s] under the plan on account of such junior claim or interest any property." The Court then applied that plain language to the facts before it.

First, it was undisputed that Sprint's class of claims would receive less than a full recovery under the plan. Second, the existing equity holders would receive "property" in the form of new stock and warrants. The Court held that such distribution was "under the plan" because the plain terms of DBSD's plan provided for the creation of the equity and its distribution to former equity. In its ruling, however, the Second Circuit specifically stated that it was *not* ruling on the impact of agreements between creditors to reallocate distributions outside of a plan. Finally, and most interestingly, the Second Circuit held that the distribution was "on account of" the former equity holders' interests as equity holders. The Bankruptcy Court had found as a matter of fact that good business justifications existed for the distribution to former equity, and thus the distribution was not "on account of" the equity interests. *See In re DBSD N. Am., Inc.*, 419 B.R. 179, 212 (Bankr. S.D.N.Y. 2009). The Second Circuit side-stepped a direct challenge to the Bankruptcy Court's factual findings and instead held that "a transfer partly on account of factors other than the prior interest is still partly 'on account of' that interest." *See In re DBSD North America, Inc.*, 2010 U.S. App. LEXIS 27007 at * 35 (2d Cir. Dec. 6, 2010). The Second Circuit also held that any assistance that former equity could provide towards a consensual restructuring (the stated goal of the plan settlement) was "useful only because of the shareholder's position as equity holder and 'the rights emanating from that position.'" *Id.* at * 36. "Future labor, management or expertise," standing alone, was not sufficient to justify a violation of the absolute priority rule. *Id.* at *37.

The Second Circuit rejected entirely the concept that a secured creditor's collateral (or proceeds therefrom) was free from the absolute priority rule's constraints. It distinguished *SPM* by (1) noting that *SPM* was decided in the context of a Chapter 7 liquidation and Chapter 7 does not have the same "rigid" absolute priority rule as Chapter 11 and (2) noting that the secured creditor in *SPM* had already been granted relief from the automatic stay, which allowed it to foreclose on its collateral.

DBSD thus results in two major new restrictions on "gifting" in contravention of the absolute priority rule. First, at least in the Chapter 11 plan confirmation context, there is no difference between a secured creditors' non-foreclosed-upon collateral and property of the estate. Second, the convenience of a consensual reorganization is *not* a sufficient justification for a gift in violation of the absolute priority rule.

This, of course, begs the question as to what types of gifts remain viable. First, it appears that a Chapter 7 gift under the circumstances in *SPM* would not violate the Second Circuit's construction of the absolute priority rule.[4] Second, the Second Circuit is explicit that the absolute priority rule would not restrict a distribution to junior classes before senior classes are paid in full if such distribution was on account of new value provided by the junior creditor. However, the Second Circuit emphasized that this new value must be substantiated through market testing. Because the gift cannot be partially on account of new value and partially on account of the recipients' claim or interest in the bankruptcy estate, the Second Circuit's emphasis on market testing may become a significant (and heavily litigated) requirement. The court also stated that a contribution of "labor, management or expertise" is likely not sufficient new value to justify a violation of the absolute priority rule.

Finally, the Second Circuit leaves open the possibility that the gift in violation of the absolute priority rule might be made *outside* a plan of reorganization. *See In re DBSD North America, Inc.*, 2010 U.S. App. LEXIS 27007 at * 33. Because consensual gift arrangements have proven to be efficient and valuable in practice, the contours and extent of this last exception — whether gifts can be effectuated outside a plan — will likely be heavily tested in the coming years. A distribution outside the plan could be arranged in a side-agreement between the gifting class and the receiving class. However, this presents additional issues such as: What mechanics are necessary to bind the entire class outside of a plan? Must the agreement be disclosed in the disclosure statement accompanying the plan and would this disclosure alone be sufficient for a party to challenge the gift? Does an agreement to distribute property outside of a plan implicate tax obligations not present in a plan distribution? If the recipient of the gift is a diffused class of creditors (such as trade creditors), how can the gift be implemented outside of the plan process?

Interpretation of *DBSD* and resolution of these issues will require time and is likely to result in conflicting and contradictory opinions. While the *DBSD* decision may not represent the definitive end of "gifting" as a restructuring tool, it will no doubt inspire and require creative lawyering to implement gifting agreements.

Endnotes

[1] Previously, on December 6, 2010, the Second Circuit reversed the orders from lower courts confirming DBSD's plan of reorganization. In its December 2010 reversal, the Second Circuit stated without explanation, that (1) the gift provisions of DBSD's plan violated the absolute priority rule and (2) that the lower courts did not commit error by designating (*i.e.,* disregarding) a creditor's vote after finding that the creditor's vote was not made in good faith. The Second Circuit also noted that a full written opinion would follow.

[2] Interestingly, the Second Circuit noted its concern with the fact that former equity would receive 5 percent of new equity under the plan but the entire general unsecured claims pool was entitled to receive only 1.5 percent of equity (divided pro rata between allowed general unsecured claimants). *See In re DBSD North America, Inc.*, 2010 U.S. App. LEXIS 27007 at *47 - *48.

[3] The Second Circuit separately addressed various challenges to Sprint's standing to appeal. Over a vigorous dissent by Judge Pooler, the Second Circuit held that Sprint's potential claims and potential for better treatment under an alternate plan was sufficient to satisfy the standards for appellate standing. Judge Pooler stressed the remoteness of any potential recovery to Sprint under any alternate plan and argued that Sprint had an insufficient economic stake in the appeal to satisfy standing requirements.

[4] Because secured creditor "carveouts" are based on the possibility that the creditor forecloses on the collateral in question, this aspect of "gift" practice will likely not be impacted by *DBSD*, which is careful to distinguish between liquidation distributions and reorganization distributions.

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