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Alert

Second Circuit Holds That Senior Creditors' "Gifting" of Value to Existing Shareholder Under Reorganization Plan Violates Absolute Priority Rule

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The U.S. Court of Appeals for the Second Circuit, on Feb. 7, 2011, held that senior creditors could not "gift" part of their reorganization plan recovery to existing shareholders of the debtor. *In re DBSD N. Am., Inc.*, __ F.3d __, 2011 WL 350480 (2d Cir. Feb. 7, 2011) (2-1) (Lynch, J.) (explaining *In re DBSD N. Am., Inc.*, 627 F.3d 496 (2d Cir. 2010) (summary opinion)). Its extensive 62-page opinion explained the court's previous two-page summary ruling of Dec. 9, 2010, which held, among other things, that the Chapter 11 debtor's reorganization plan violated the established "absolute priority" rule. As we described in a prior article, the Second Circuit's two-page ruling had also affirmed the bankruptcy court's designation (*i.e.*, disqualification) of a secured lender's vote when the lender voted "not as a traditional creditor seeking to maximize its return on the debt it holds, but ... 'to establish control over [the debtor, as a] strategic asset.'" *In re DBSD N. Am., Inc.*, 421 B.R. 133, 137 (Bankr. S.D.N.Y. 2009), *quoted in DBSD*, 2011 WL 35048, at *3. *See* Michael L. Cook and Joseph E. Bain, *Second Circuit Affirms Designation of Secured Lenders' Vote and Effective Cram Down: Warning to Vultures*, *Bankruptcy Strategist* (February 2011).

We limit our discussion here to the "gifting" issue — when a secured lender shares its plan recovery with pre-bankruptcy equity holders although an intermediate class of unsecured creditors remains unpaid in full. The Second Circuit's Feb. 7 opinion shows why a senior noteholder's "gift" of stock and warrants to an existing shareholder violated the absolute priority rule contained in Bankruptcy Code ("Code") § 1129(b)(2)(B)(ii) (for plan to be "fair and equitable" over objection of unsecured creditor class, a "junior ... claim or interest" may not "receive or retain under the plan ... any property"), thus making the debtor's plan unconfirmable. The dissent in *DBSD* argued that the objecting appellant, "an out-of-the-money unsecured creditor with an unliquidated claim," lacked standing to appeal because it could not "show ... it suffered a pecuniary injury as a result of the" plan's being confirmed. 2011 WL 350480, at *26.

Facts
ICO Global Communications ("ICO") founded DBSD North America, Inc. ("DBSD") in 2004 as a mobile communications company, with satellites and land-based transmission towers. When developing its network, DBSD accumulated at least $813 million of debt. After its network failed to become operational, DBSD filed a Chapter 11 petition on May 15, 2009. DBSD's primary creditors included holders of a first lien revolving credit facility [owed more than $40 million]; holders of second lien secured notes (the "noteholders") [owed more than $650 million]; and Sprint Nextel Corporation ("Sprint"), who held an unliquidated, unsecured damage claim for $211 million. *Id.* at *1-2.

DBSD's proposed plan (the "plan") gave first lien debt holders new loans, with interest to be paid in kind over four years — a classic "cramdown." Meanwhile, second lien noteholders would receive the "bulk" of the shares of the reorganized entity. Unsecured creditors, like Sprint, "would receive shares estimated as worth

between 4% and 46% of their original claims. Finally, the existing shareholder (effectively just [ICO], ... which owned 99.8% of DBSD) would receive shares and warrants in the reorganized entity." *Id.* at *2.

Lower Courts' Rulings
Sprint argued that the plan "violated the absolute priority rule by giving shares and warrants to a junior class (the existing shareholder) although a more senior class (Sprint's class [of unsecured creditors]) neither approved the plan nor received the full value of its claims." *Id.* at *9. Nonetheless, the bankruptcy court confirmed the plan on Dec. 21, 2009, estimating DBSD's value at "not worth enough ... to cover even the secured lenders' claims, much less those of unsecured creditors like Sprint." *Id.* at *13 (noting that Sprint had failed to appeal the bankruptcy court's factual finding regarding DBSD's value). The District Court affirmed the bankruptcy court's rulings on March 24, 2010. *See In re DBSD N. Am.*, 2010 WL 1223109 (S.D.N.Y. March 24, 2010).

Absolute Priority Rule — Code § 1129(b)(2)(B)(ii)
The absolute priority rule of Code § 1129(b)(2)(B)(ii) requires that "[a]bsent the consent of all impaired classes of unsecured claimants, ... a confirmable plan must ensure either (i) that the dissenting class receives the full value of its claim, or (ii) that no classes junior to that class receive any property under the plan on account of their junior claims or interests." 2011 WL 350480, at *11. As explained by the court, the Code's absolute priority rule originates from the Supreme Court's "fixed principle ... that all 'creditors were entitled to be paid before the stockholders could retain [shares] for any purpose whatever.'" *Id.* at *10 (quoting *N. Pac. Ry. Co. v. Boyd*, 228 U.S. 482, 507-08 (1913)).

"Gifting Doctrine"
The noteholders — joined by ICO and DBSD — argued that, under the so-called "gifting doctrine," "the shares and warrants rightfully belonged to the secured creditors, who were entitled to share them with the existing shareholder as they saw fit." *Id.* at *13. Moreover "until the debts of the secured creditors 'are paid in full, the Bankruptcy Code's distributional priority scheme, as embodied in the absolute priority rule, is not implicated.'" *Id.* (quoting *In re SPM Mfg. Corp.*, 984 F.2d 1305 (1st Cir. 1993)). As stated by the bankruptcy court, "the 'Gifting' Doctrine — under which senior secured creditors voluntarily offer a portion of their recovered property to junior stakeholders (as the senior noteholders did here) — defeats Sprint's Absolute Priority Rule objection." *DBSD*, 419 B.R. at 210.

The Second Circuit, however, held that the lower court's analysis did not "square with the text of the Bankruptcy Code." 2011 WL 350480, at *13. "The Code extends the absolute priority rule to 'any property,' ... not 'any property not covered by a senior creditor's lien.' The Code focuses entirely on who 'receive[s]' or 'retain[s]' the property 'under the plan' ... not on who would receive it under a liquidation plan. And it applies the rule to any distribution 'under the plan on account of' a junior interest ... regardless of whether the distribution could have been made outside the plan, and regardless of whether other reasons might support the distribution in addition to the junior interest." *Id.*

***SPM* Distinguished**
The court distinguished this case from *In re SPM Mfg. Corp.*, an opinion on which the bankruptcy court relied to support its application of the "gifting doctrine." *DBSD*, 419 B.R. at 210 (citing *In re SPM Mfg. Corp.*, 984 F.2d 1305 (1st Cir. 1993)) (*SPM* was "the case from which the doctrine first evolved"). In *SPM*, the First Circuit held that a bankruptcy court lacked authority to bar a secured creditor from sharing its recovery in a Chapter 7 liquidation with unsecured creditors, "even at the expense of a creditor who would otherwise take priority over those unsecured creditors." 2011 WL 350480, at *13 (quoting *SPM*, 984 F.2d at 1312-19).

According to the Second Circuit, "*SPM* involved Chapter 7, not Chapter 11, and thus involved a liquidation of the debtor, not a reorganization." *Id.* The "distribution scheme" of Chapter 7, as the First Circuit noted in *SPM*, "does not come into play until all valid liens on the property are satisfied." *Id.* at *14 (quoting *SPM*, 984 F.2d at 1312). Furthermore, the First Circuit "repeatedly emphasized the 'lack[ ]' of 'statutory support' for the argument against gifting in Chapter 7." *Id.* (quoting *SPM*, 984 F.2d at 1313-14).

"Under Chapter 11, in contrast, [Code § 1129(b)] provides clear 'statutory support' to reject gifting in this case, and the distribution scheme of Chapter 11 ordinarily distributes all property in the estate (as it does here), including property subject to security interests." *Id.* (citing Code §§ 1129(b)(2)(A)-(b)(2)(B)); *see also In re*

Armstrong World Indus., 432 F.3d 507, 514 (3d Cir. 2005) (*SPM* and its progeny "do not stand for the unconditional proposition that creditors are generally free to do whatever they wish with the bankruptcy proceeds they receive;" *held*, absolute priority rule prevented bankruptcy court from confirming plan). *But see In re World Health Alternatives, Inc.,* 344 B.R. 291, 297 (Bankr. D.Del. 2006) (*held*, *Armstrong* inapplicable when secured lender, as part of settlement, carves out part of its collateral for exclusive benefit of unsecured creditors).

Comments and Considerations

1. According to the Second Circuit, the Supreme Court has "left open the possibility that old equity could take under a plan if it invests new value in the reorganized entity, at least as long as a 'market valuation' tests the adequacy of its contribution." *DBSD*, 2011 WL 350480, at *12 n.6 (citing *Bank of Am. Nat'l Trust & Sav. Ass'n v. 203 N. LaSalle St. P'ship*, 526 U.S. 434, 458 (1999)). In that situation, the party receiving the property may argue that it received equity "on account of" its new investment. Because ICO made no contribution under the DBSD plan, however, the Second Circuit could avoid discussing the availability of this option. *Id.*

2. The court stressed the reorganization plan's provision for the distribution to the pre-bankruptcy equity. Arguably, a senior secured lender could receive its plan distribution and then agree separately to share it with old equity. That agreement, however, would have to be disclosed. *See*, *e.g.*, Code §§ 1123(a)(3); 1125(a)(1); 1129(a)(4). A court could then find, relying on *DBSD*, that the agreement was an effective evasion of Code § 1129(b)'s prohibition against bypassing unpaid intermediate creditors in order to benefit equity.

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