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Clarity in Gifting Doctrine Is Elusive

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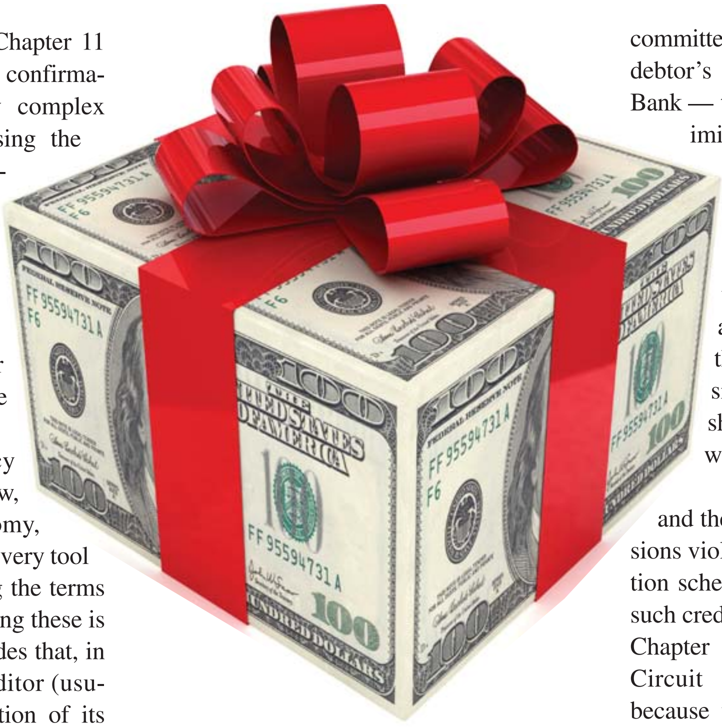

The formation of a complex Chapter 11 plan and the subsequent plan confirmation process are inherently complex endeavors aimed at addressing the disparate interests of various creditors and other parties in interest. To successfully navigate these troubled waters, a restructuring professional must have both a solid understanding of the rules of the game as well as an appreciation for the interests of each party at the negotiating table.

With changes to bankruptcy laws, constantly evolving case law, and a relatively unstable economy, restructuring professionals rely on every tool available to them when negotiating the terms of a reorganization plan. Chief among these is the "gifting doctrine," which provides that, in certain circumstances, a senior creditor (usually secured) may give up a portion of its recovery to a lower class of creditors, notwithstanding the objection of an intervening class of higher priority.

However, because this transfer may circumvent certain statutory protections under the U.S. Bankruptcy Code, such as the absolute priority rule, courts have failed to take a uniform stance regarding the applicability of the doctrine. With Chapter 11s growing more intricate and liquidations more frequent, restructuring professionals are left to bemoan the uncertainty surrounding the applicability of the gifting doctrine.

To confirm a plan absent each class of creditors voting to accept it, the plan must be "crammed down" on the dissenting classes under Section 1129(b) of the Bankruptcy Code. Section 1129(b) requires that all other provisions of Section 1129(a) of the Bankruptcy Code be satisfied, other than all impaired classes voting to accept the plan, and that the plan is fair and equitable to the dissenting class and does not unfairly discriminate against the dissenting class.

The "fair and equitable" requirement has been termed the "absolute priority rule" and provides that no junior class of creditors or interest holders can receive anything under the plan until the senior dissenting class is paid in full. The unfair discrimination requirement prohibits treating similar claims differently without a reasonable basis.

In gifting cases, the absolute priority rule is implicated when a creditor with intervening priority objects to the senior class making the gift to the junior class before the objecting party's class of creditors is paid in full. The unfair discrimination prohibition arises where an equally ranking creditor does not receive (may also be offered) the gift.

The gifting doctrine grew out of a case that dealt neither with the Bankruptcy Code's absolute priority rule nor the unfair discrimination standard. *Official Unsecured Creditors' Committee v. Stern (In re SPM Manufacturing Corp.)* was a relatively contentious case that led two otherwise dissimilar parties — the committee of unsecured creditors and the debtor's principal secured creditor, Citizens Bank — to collaborate in their efforts to maximize the value of their claims. 984 F.2d 1305 (1st Cir. 1993).

Citizens held a first priority secured interest on substantially all of the debtor's assets but agreed to work with the committee to effectuate a plan. The agreement between these parties included a gifting provision, subject to which Citizens would share a percentage of its distribution with the general unsecured creditors.

However, both the bankruptcy court and the district court found that such provisions violated the Bankruptcy Code's distribution scheme and that all funds earmarked for such creditors would instead be directed to the Chapter 7 trustee. On appeal, the 1st U.S. Circuit Court of Appeals reasoned that because the proceeds rightfully belonged to Citizens and were therefore not part of the bankruptcy estate, Citizens could gift them to another class of creditors.

Loosely Defined Rules of the Game

After *SPM*, other courts have taken the gifting doctrine further, holding that a gift from unsecured creditors and from debtor assets was proper under a plan. At the same time, some courts have rejected gifts under similar circumstances. How to predict what a court might do depends on several factors. The following indicators have proven helpful in determining how a court may decide when faced with an objection to a gift:

- ***The Gift Is a True Carve-Out.*** Courts have approved gifts in cases in which it is clear that the gift is truly a carve-out from a secured lender's collateral. A gift is more likely to be deemed a true carve-out when it comes from a secured lender and the validity of that lender's liens is not in question.

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Also important is that the secured lender is undersecured. In such a case, unsecured creditors are out of the money anyway and have no valid complaint if only certain creditors receive a gift of the secured lender's collateral. Logically, the fact that the gift is a carve-out from the secured lender's collateral should be solely determinative — a complaining creditor has no valid complaint because it is no worse off for the gift having been made out of non-estate assets. However, when other factors are at play, a court may still reject a gift, even when it is clear it is coming solely from the collateral of an undersecured creditor.

■ ***The Gift Is to Unsecured Creditors Rather Than to Equity.*** Only one reported case in which a gift was approved involved a gift to equity. See *In re Genesis Health Ventures, Inc*., 266 B.R. 591 (Bankr. D. Del. 2001). However, in *Genesis Health Ventures*, there was no absolute priority rule objection, only an objection based on the unfair discrimination prohibition. This distinction is significant because an objection based on unfair discrimination invokes a far less stringent legal test than one based on the absolute priority rule. In all other cases in which a gift was proposed to equity, the gift was not approved.

■ ***In Unfair Discrimination Cases, There Is a Good Justification for the Gift.*** If a co-ranking class objects to a gift, the objection is based on the Bankruptcy Code's unfair discrimination prohibition and the absolute priority rule is not implicated. In cases in which there was a reasonable justification for the unequal treatment, the gift was approved. Gifts may not be approved without a reasonable justification for discrimination.

■ ***All Creditors in the Gifting Class Voluntarily Make the Gift.*** Courts have found grounds to reject a gift in cases in which all members of the gifting class did not agree to make the gift. However, in *In re WorldCom, Inc*., 2003 WL 23861928 (Bankr. S.D.N.Y. Oct. 31, 2003), the court did approve a gifting plan that did not receive unanimous support from all of the affected creditors.

■ ***The Gift Is Not Made for an Improper Purpose.*** Finally, courts will not approve gifts made for improper purposes.

Ambiguity Remains

In two recent cases, U.S. Bankruptcy Courts for the Northern District of Ohio and the Southern District of New York considered the applicability of the gifting doctrine.

In *In re Schwab Industries, Inc*., Case No. 10-60702 (Bankr. N.D. Ohio), the Bankruptcy Court approved a settlement between the senior secured lenders and the official committee of unsecured creditors contained in the context of a Section 363 sale. Prior to the consummation of a sale of substantially all of the debtors' assets, the committee had raised certain issues regarding the perfection of the pre-petition secured lenders' liens in certain assets. However, in connection with the approval of the 363 sale, the lenders and the committee reached a global settlement in which the committee agreed to the validity of the lenders' liens in exchange for a carve-out of the lenders' recovery on its collateral (the assets being sold at the sale).

> And if the secured creditor class is undersecured, that will mean, at least in most cases (as it does here), that any complaining creditor would get nothing anyway, whether or not the gift had been made…

A few months after the consummation of the sale, the debtors and the committee proposed a joint liquidation plan, which included the carve-out earmarked for general unsecured creditors. The U.S. Internal Revenue Service (IRS) objected to the plan, arguing that it was impermissible for unsecured creditors to recover anything before priority creditors, such as the IRS, were paid in full. After oral argument at the plan confirmation hearing, the court overruled the IRS's objection and confirmed the plan.

The gift in *Schwab* came from the secured lenders' collateral and was provided outside of the plan process, in the context of a 363 sale. The secured lenders were undersecured and the gift was held by the committee and ultimately earmarked for general unsecured creditors under the liquidation. The lenders' liens were held to be validly perfected in the sale order, and the gift was made to unsecured creditors and was agreed to by all members of the gifting class.

At the other end of the spectrum, the 2d U.S. Circuit Court of Appeals recently reversed a bankruptcy court order confirming a plan that included a gift to the debtors' equity holder in *In re DBSD North America, Inc*. See *Sprint Nextel Corp. v. DBSD N. Amer., Inc. (In re DBSD N. Amer., Inc.)*, 2011 WL 350480 (2d Cir. Feb. 7, 2011) (Lynch, J) (explaining *In re DBSD. N. Amer., Inc*. 627 F.3d 496 (2d Cir. 2010)). In *DBSD*, a case from the Southern District of New York, the debtors sought confirmation of their Chapter 11 plan, pursuant to which the debtor's senior secured creditors agreed to gift part of their distribution to a class of junior stakeholders. The agreement, however, drew an objection from Sprint-Nextel Corporation, one of the debtor's unsecured creditors.

In rendering its decision, the *DBSD* Bankruptcy Court held that the controlling factor was that the gifting class was fully secured and:

> may generally do whatever it wishes with such property, including transferring it to other holders of claims or interests….[W]hen the gift comes from a class with one or more duly perfected secured creditors, the rationale for the doctrine is particularly strong, as the secured creditors class has a property interest in the property it has elected to gift, and if it were to enforce its security interest, the property would never become part of the estate to be subject to distribution to unsecured creditors under a plan. And if the secured creditor class is undersecured, that will mean, at least in most cases (as it does here), that any complaining creditor would get nothing anyway, whether or not the gift had been made — making it difficult, if not impossible, to see how the complaining creditor can be legitimately aggrieved by the gift.
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> – *In re DBSD North America, Inc*., 419 B.R. 179, 211 (Bankr. S.D.N.Y. 2009), aff'd, 2010 US Dist. LEXIS 33253 (S.D.N.Y. Mar. 24, 2010), rev'd, 2010 WL 4925878 (2d Cir. Dec. 6, 2010).

Unlike *Schwab*, the gift in *DBSD* constituted warrants, which arguably were estate property and were to be held by the debtors. The gift was to originate from the senior secured lender through the plan process, and the holders of second lien debt in the case were unquestionably undersecured. Finally, the shareholder recipients were to receive new stock on account of their existing interest. Accordingly, in its opinion filed February 7, 2011, the 2d Circuit reversed the lower court's decision, holding 2-1 that the gift violated the absolute priority rule.

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In *dicta*, the 2d Circuit suggested that despite its decision that the gift in *DBSD* violated the absolute priority rule, the gifting doctrine remained alive. Specifically, the court noted, "[w]e need not decide whether the Code would allow the existing shareholder and Senior Noteholders to agree to transfer shares outside of the plan." *In re DBSD*, 2011 WL 350480 at *11. Accordingly, a gift might elude the strictures of the absolute priority rule so long as the gift takes place outside of the plan. Moreover, the 2d Circuit cited the Supreme Court, which stated, "[I]t is up to the creditors — and not the courts — to accept or reject a reorganization plan which fails…to honor the absolute priority rule." *Id*. at *8 (quoting *Norwest Bank v. Ahlers*, 485 U.S. 197, 207 (1989)). Therefore, should no impaired class object, the absolute priority rule would not come into effect.

Two key differences between *DBSD* and *Schwab* were that in *DBSD*, the gift was made to equity and was not agreed to by all members of the gifting class. The combination of these two factors, plus the fact that the gift was not clearly of the secured lenders' collateral (*i.e*., the warrants) and was dependent on the plan process, reveals in part why the *DBSD* gift was ultimately rejected by the 2d Circuit as a violation of the absolute priority rule.

Even so, the 2d Circuit's broad reading of the absolute priority rule certainly did not shut the door on the gifting doctrine in the jurisdiction. Nevertheless, *Schwab* and *DBSD* serve to remind practitioners that the rules of the game are always changing; and furthermore, the disparate interpretations of various sections of the Bankruptcy Code between circuits require that practitioners pay special attention to their venue.

Structure Is Key

Gifting is a method by which a committee may obtain real value for out-of-the-money unsecured creditors. But an objecting class of intervening priority may seek to frustrate a gift using the negative legal authority on the issue. By structuring the gift so it contains as many of the approved factors as possible, it is more likely a court will approve the gift over a disgruntled creditor's objection.

In both *Schwab* and *DBSD*, the complaining intervening priority creditor stood nothing to gain by the absence of the gift, since the secured lenders were undersecured. Logic suggests that in such a case, the gift should be approved based on this fact alone. However, some courts, especially at the circuit level, hold gifts to the strictures of the absolute priority rule or unfair discrimination standard. Accordingly, professionals must continue to work within these loosely defined parameters when using the gifting doctrine.

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