Should We Look the Gift Horse in the Mouth? A Circuit Split Regarding Whether the Absolute-Priority Rule in Chapter 11 Bankruptcy May be Circumvented by Secured Lenders "Gifting" to Junior Classes?

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Not all creditors are treated equally in bankruptcy. The Bankruptcy Code envisions a seniority-based system where secured claims receive distributions first, priority claims receive distributions second, unsecured claims receive distributions third, and (in the case of a corporate bankruptcy) pre-petition equity holders in the debtor receive distributions last.1

The absolute-priority rule codified at 11 U.S.C. § 1129(b)(2)(B)(ii) is consistent with the priority-scheme of the Bankruptcy Code. Under the absolute-priority rule, unless each class of impaired2 creditors accepts a plan of reorganization, a Chapter 11 plan may not be confirmed unless "the holder of any claim or interest that is junior to the claims of such [impaired] class will not receive or retain under the plan on account of such junior claim or interest any property."3 In other words, creditors may insist on priority of payment: secured creditors4 must be paid in full before unsecured creditors receive or retain any property from the plan, and unsecured creditors must likewise be paid in full before equity holders can receive or retain any property.5

Creditors often attempt to circumvent the absolute-priority rule through "gifting." Gifting is best explained by a hypothetical. Suppose a shareholder owns 100% of Debtor XYZ Corp. XYZ Corp. has only two creditors, a secured creditor with a $10 Million claim and an unsecured creditor with a $5 Million claim. Now suppose that XYZ Corp. proposes a plan that will pay the secured creditor $9 Million over 10 years (i.e. less than secured creditor's claim) and the unsecured creditor $2 Million over 20 years. However, the plan also proposes that the shareholder will receive 100% of the common stock of the reorganized company. On its face, the plan violates the absolute-priority rule because the unsecured creditor is being paid less than the full amount of its claim, but the shareholder is receiving “property” in the form of shares in the reorganized debtor. Can the debtor and secured creditor circumvent the absolute-priority rule by arguing that the secured creditor is “gifting” a portion of its claim ($1 Million) to the shareholder?

The 1993 landmark decision from the First Circuit Court of Appeals in Matter of SPM Mfg. Corp.,6 which involved a Chapter 7 case, indicates the answer is “Yes.” In that case, a secured creditor was entitled to all proceeds from a § 363 sale of the debtor’s assets because the sales proceeds were insufficient to pay the entire secured claim. The secured creditor and the
unsecured creditors’ committee agreed that a portion of the proceeds would be paid to general unsecured creditors and priority tax creditors would be bypassed. Similar to the absolute-priority rule, § 726 of the Bankruptcy Code mandates in a chapter 7 case that priority claims are paid in full before unsecured creditors receive any distribution. In reversing the bankruptcy court and the district court, the First Circuit held that, while the debtor and the trustee are not allowed to pay non-priority creditors ahead of priority creditors, “creditors are generally free to do whatever they wish with the bankruptcy dividends they receive, including to share them with other creditors.”

SPM Mfg. Corp. paved the way for many lower courts to accept the gifting doctrine, but this decision has not been without controversy. Within the past few years, both the Second and Third Circuits have rejected the gifting doctrine. In Matter of DBSD N. Am, Inc., the Second Circuit reversed the bankruptcy court’s confirmation order which permitted the shareholders in the debtor to receive shares and warrants in the reorganized debtor, but where unsecured creditors would not be paid in full. The Second Circuit rejected the debtor’s argument that the secured lender was free to do with its claim what it wished, and held that “the secured creditors could have demanded a plan in which they received all of the reorganized corporation, but, having chosen not to, they may not ‘surrender’ part of the value of the estate for distribution ‘to the stockholder[,]’ as ‘a gift.’ … Whatever the secured creditors here did not take remains in the estate.”

The Seventh Circuit has not ruled on the issue, but it is likely only a matter of time before the Supreme Court resolves the issue for all Circuits. Whether or not gifting is permitted under the Bankruptcy Code will substantially impact whether, absent creditor consent, the pre-petition shareholders will be permitted to retain equity interests in a reorganized debtor unless unsecured creditors are paid in full.

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2 As a practical matter, creditors are almost always considered “impaired.” 11 U.S.C. § 1124 provides that a creditor is impaired unless the plan “leaves unaltered the legal, equitable, and contractual rights to which such claim or interest entitles the holder of such claim or interest.”
4 Importantly, a creditor is only a secured creditor to the extent of the value of its collateral securing its claim. 11 U.S.C. § 506(a). It is quite common for a secured creditor to be “undersecured” in which case it has a secured claim and an unsecured claim.
5 Wilkow v. Forbes, Inc., 241 F.3d 552, 554 (7th Cir. Ill. 2001)
6 In re SPM Mfg. Corp., 984 F.2d 1305, 1309 (1st Cir. Mass. 1993)
7 Id. at 1313.
8 Dish Network Corp. v. DBSD N. Am., Inc. (In re DBSD N. Am., Inc.), 634 F.3d (2d Cir. N.Y. 2010)
9 In re Armstrong World Indus., Inc., 432 F.3d 507, 512 (3d Cir. 2005).
10 Dish Network Corp. v. DBSD N. Am., Inc. 634 F.3d at 99.
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