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Chapter 11 Plans with Third-Party Releases and Exculpation Provisions

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CONCURRENT SESSION

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Chapter 11 Plans:
Third Party Releases and Exculpation Provisions

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❖ **Background:**

- A chapter 11 bankruptcy often culminates with the confirmation of a plan, upon which the debtor is entitled to a discharge. *See* 11 U.S.C. § 1141(d)(1). In some plans, the debtor seeks to release non-debtor parties who participated in the bankruptcy—such as officers, directors, co-debtors, guarantors, lenders, affiliates, and professionals—from third party claims and/or to exculpate such non-debtors for actions taken during the bankruptcy case.

- This material focuses primarily on non-debtor releases (as opposed to exculpation provisions), as exculpation provisions tend to be generally acceptable and less controversial (exculpation provisions are discussed briefly below). Permissibility of non-debtor releases in plans, on the other hand, has been a hot topic for decades.

- The justification for non-debtor releases is that non-debtors are often able to assert post-confirmation indemnification claims against the debtor or are a source of funding for the plan. The releases can thus be an important negotiating tool for a debtor.

- Critics of non-debtor release provisions argue that such provisions permit non-debtors to benefit from the debtor's bankruptcy without undertaking the obligations associated with it and are unfair to claimants who may have claims against the non-debtors.

❖ **Statutory Conflict and Circuit Split:**

- The dispute over the permissibility of non-debtor releases stems from two sections of the Bankruptcy Code. While the debtor is entitled to discharge upon plan confirmation, Bankruptcy Code section 524(e) provides that the "discharge of a debt of a debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt." 11 U.S.C. § 524(e). On the other hand, Bankruptcy Code section 105(a) grants bankruptcy judges broad equitable powers to take any action necessary to implement the code. 11 U.S.C. § 105(a).

- The interplay between sections 524(e) and 105(a) has resulted in a circuit split as to the permissibility of non-debtor releases in plans. The

Fifth, Ninth and Tenth Circuits have found such releases impermissible, relying on Bankruptcy Code section 524(e). Other jurisdictions, such as the Second, Third, Fourth, Sixth, Seventh and Eleventh Circuits, allow non-debtor release provisions in certain circumstances, relying on their broad equitable powers in Bankruptcy Code section 105(a). However, even the permissive circuits have recently become more restrictive in permitting such releases under a plan.

❖ **Exculpation Provisions:**

- It is fairly typical for a chapter 11 plan to include a provision that exculpates certain parties for actions taken during the bankruptcy case, other than for willful misconduct or gross negligence.

- As the Third Circuit Court of Appeals explained, exculpation provisions tend not to be controversial when applied to estate fiduciaries, such as the debtor's directors and officers, estate professionals and creditors' committees and their members, because the provisions merely state the standard to which such estate fiduciaries were held in a chapter 11 case. *In re PWS Holding Corp.*, 228 F.3d 224, 246 (3d Cir. 2000);

  - *see also In re Washington Mut., Inc.*, 442 B.R. 314 (Bankr. D. Del. 2011) (permitting exculpation of estate fiduciaries but not others);

  - *see also In re Airadigm Commc'ns, Inc.*, 519 F.3d 640, 657 (7th Cir. 2008) (approving exculpation in plan, stating "the limitation itself is narrow: it applies only to claims 'arising out of or in connection with' the reorganization itself and does not include 'willful misconduct.' . . . This is not 'blanket immunity' for all times, all transgressions, and all omissions.");

  - *but see In re Morreale Hotels, LLC*, Case No. 12-35230-TBM (Bankr. D. Colo. May 18, 2016) (held that an exculpation clause rendered a plan unconfirmable).

❖ **Case Law—Non-Debtor Releases Impermissible**

➢ Tenth Circuit

- *Landsing Diversified Properties-II v. First Nat'l Bank and Trust Co. of Tulsa (In re Western Real Estate Fund, Inc. et al.)*, 922 F.2d 592 (10th Cir. 1990), *modified on other grounds*, *Abel v. West*, 932 F.3d 898 (10th Cir. 1990).

  - Tenth Circuit rejected bankruptcy court's reliance on section 105(a) and broad equitable powers as basis to permanently enjoin debtor's former attorney from pursuing his claim for attorneys' fees against a secondary source to the extent such fees were not paid in the bankruptcy case. Tenth Circuit found such an injunction to be improper under section 524(e): "Obviously, it is the debtor, who has invoked and submitted to the bankruptcy process, that is entitled to its protections; Congress did not intend to extend such benefits to third party bystanders." *Id.* at 600.

➢ Fifth Circuit

- *In re Pac. Lumber Co.*, 584 F.3d 229, 252-53 (5th Cir. 2009) (non-debtor exculpation and release clause in plan impermissible under section 524(e)).

➢ Ninth Circuit

- *Resorts Int'l, Inc. v. Lowenschuss (In re Lowenschuss)*, 67 F.3d 1394, 1401 (9th Cir. 1995) ("This court has repeatedly held, without exception, that § 524(e) precludes bankruptcy courts from discharging the liabilities of non-debtors.").

❖ **Case Law—Non-Debtor Releases Permissible**

➢ Second Circuit

- *Deutsche Bank AG v. Metromedia Fiber Network, Inc. (In re Metromedia Fiber Network, Inc.)*, 416 F.3d 136 (2nd Cir. 2005)
  - Chapter 11 plan provisions that enjoin a creditor from suing a non-debtor third party should not be approved absent the finding that truly unusual circumstances render the release terms important to the success of the plan.
  - It is not enough that one of the parties to be released was making a "material contribution" to the estate.
  - Analyzed factors similar to that enumerated by the Sixth Circuit in *Dow Corning*, discussed below.

➢ Third Circuit

- *Gillman v. Continental Airlines (In re Continental Airlines)*, 203 F.3d 203 (3d Cir. 2000) (held nonconsensual third-party releases may be permitted, but there must be specific factual findings that they are fair and necessary to the plan of reorganization, but the court did not establish a defined standard to apply in such analysis leading to subsequent conflicting rulings within the Third Circuit, discussed below).

- *In re Washington Mut., Inc.*, 442 B.R. 314 (Bankr. D. Del. 2011) (in applying multi-factor test, denied a non-debtor release in favor of noncontributing directors and officers and found that a director or officer's potential indemnification claim against the debtor is insufficient grounds for a release because it would justify releases of directors and officers in every case.).

- *In re Millennium Lab Holdings II, LLC, et al.*, Case No. 15-12284 (LSS) (Bankr. D. Del. 2015) (relying on *Continental Airlines*, approved plan containing non-debtor releases over lenders' objection, based in large part on significant contributions from

released parties and the need to avoid lengthy contentious litigation).

- Fourth Circuit

  - *Nat'l Heritage Found., Inc. v. Highbourne Found.*, 760 F.3d 344, 347 (4th Cir. 2014) (held non-debtor releases may be approved "cautiously and infrequently" and adopted factors enumerated by the Sixth Circuit in *Dow Corning* factors).

- Sixth Circuit

  - *Class Five Nevada Claimants v. Dow Corning Corp. (In re Dow Corning Corp.)*, 280 F.3d 648, 658 (6th Cir. 2002).

    - "We hold that when the following seven factors are present, the bankruptcy court may enjoin a non-consenting creditor's claims against a non-debtor: (1) There is an identity of interests between the debtor and the third party, usually an indemnity relationship, such that a suit against the non-debtor is, in essence, a suit against the debtor or will deplete the assets of the estate; (2) The non-debtor has contributed substantial assets to the reorganization; (3) The injunction is essential to reorganization, namely, the reorganization hinges on the debtor being free from indirect suits against parties who would have indemnity or contribution claims against the debtor; (4) The impacted class, or classes, has overwhelmingly voted to accept the plan; (5) The plan provides a mechanism to pay for all, or substantially all, of the class or classes affected by the injunction; (6) The plan provides an opportunity for those claimants who choose not to settle to recover in full and; (7) The bankruptcy court made a record of specific factual findings that support its conclusions."

    - Held third party releases to be impermissible because the "bankruptcy court provided no explanation or discussion of the evidence underlying these findings. Moreover, the

finding did not discuss the facts as they related specifically to the various released parties, but merely made sweeping statements as to all released parties collectively." *Id.* at 658.

- Seventh Circuit

  - *In re Specialty Equip. Co.*, 3 F.3d 1043, 1045-48 (7th Cir. 1993) (finding that "section 524(e) provides only that a discharge does not affect the liability of third parties. This language does not purport to limit or restrain the power of the bankruptcy court to otherwise grant a release to a third party.").

- Eleventh Circuit

  - *In re Seaside Eng'g & Surveying, Inc.*, 780 F.3d 1070, 1079 (11th Cir. 2015) (confirming plan of reorganization containing third party releases in favor of former principals of the debtor who would act as key employees of the debtor, finding that pursuant "to § 524(e), the discharge of the debtor's debt does not itself affect the liability of a third party, but § 524(e) says nothing about the authority of the bankruptcy court to release a non-debtor from a creditor's claims.").

Chapter 11 Plans:

Class Gifting

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1. Overview

a. What is Class Gifting

Class gifting occurs when a senior creditor shares or "gifts" property to junior claimants that would otherwise be prohibited by the absolute priority rule or the unfair discrimination provision. Generally, the purpose of a gift is to garner support from a junior class for plan confirmation, a § 363 sale or a settlement that results in a structured dismissal. The genesis of court approval for class gifting is *In re SPM Manufacturing Corp.*, 984 F.2d 1305 (1st Cir. 1993). The basic reasoning supporting *SPM* is that "creditors are generally free to do whatever they wish with the bankruptcy dividends they receive, including to share them with other creditors." *Id.* at 1313. Courts departing from *SPM* generally do so on the basis that class gifting violates either the absolute priority rule under § 1129(b)(2)(B)(ii) or the unfair discrimination provision under § 1129(b)(1).

b. Absolute Priority Rule

The absolute priority rule provides that senior claimants must be paid in full before junior claimants are paid. The absolute priority rule is encapsulated in § 1129(b)(2)(B)(ii). Section 1129(b)(2)(B) provides that with respect to unsecured claims, plan treatment is fair and equitable if the allowed value of the claim is paid in full, pursuant to § 1129(b)(2)(B)(i), or, if "the holder of any claim or interest that is junior to claims of such class will not receive or retain under the plan on account of such junior claim or interest any property." § 1129(b)(2)(B)(ii). The court in *In re Jevic Holding Corp.*, 787 F.3d 173 (3rd Cir. 2015), *cert. granted by Czyzewski v. Jevic Holding Corp.*, 136 S.Ct. 2541 (June 28, 2016), held that the absolute priority rule is not implicated when the settlement is outside of the plan. The Fifth Circuit does not follow this approach. *Matter of AWECO, Inc.*, 725 F.2d 293 (5th Cir. 1984). The absolute priority rule comes into play when a gift skips a class.

c. Unfair Discrimination

Absent a reasonable basis for different treatment, § 1129(b)(1) prohibits unfair discrimination in cramdown to prevent debtor from treating dissenting similar claims differently. If there are two creditors of the same priority, and only one is receiving the gift, some courts allow the gift in light of extraordinary circumstances or a reasonable basis for the disparate treatment. *See In re Journal Register Company.* 407 B.R. 520 (S.D.N.Y. 2009) (allowing gift from secured creditor to trade creditor that was critical to post petition operations over objection of general unsecured creditor in same class). Unfair discrimination generally comes into play when a creditor gifts to one creditor and not another of the same or similar class.

2. Gifting in the Context of a Settlement/Structured Dismissal

a. *In re Jevic Holding Corp.*, 787 F.3d 173 (3rd Cir. 2015), *cert. granted by Czyzewski v. Jevic Holding Corp.*, 136 S.Ct. 2541 (June 28, 2016)

Absolute priority rule is not implicated when settlement is presented as separate from plan of reorganization. Jevic Transportation, Inc. ("Jevic") was a trucking company. With the forbearance agreement with its senior secured lender about to expire, Jevic filed for bankruptcy relief under Chapter 11 and terminated all of its employees. Jevic owed about $53 million to its secured lender and about $10 million to tax and general unsecured creditors. Two lawsuits were filed in the bankruptcy case. First, a group of Jevic's terminated drivers (the "Drivers") filed a class action under the Worker Adjustment and Retraining Notification (WARN) Act, which requires Jevic to provide employees 60 days' written notice before a mass layoff. Second, the Committee filed a fraudulent conveyance and preference action against the secured lender for the secured lenders' "ill-advised" financing of the Jevic's prepetition leveraged buyout.

Jevic, the Committee and the secured lender reached a settlement wherein secured lender would pay $2 million for Jevic and the Committee's legal fees and other administrative expenses. Secured lender would assign its lien on Jevic's remaining $1.7 million in cash (its sole asset) to pay tax and administrative creditors first then general unsecured creditors. However, the settlement did not account for the undisputed employee WARN Act claims which consisted of an estimated $8.3 million priority wage claim and a $4.1 million general unsecured claim. The settlement skipped over the priority wage claim. Approval of the settlement would result in a structured dismissal of the case. The Drivers and the UST objected to the settlement arguing that the settlement was in derogation of the priority scheme.

The *Jevic* court agreed with the Second Circuit in *In re Iridium Operating LLC*, 478 F.3d 452 (2nd Cir. 2007) that "compliance with the Code priorities will usually be dispositive of whether a proposed settlement is fair and equitable. Settlements that skip objecting creditors in distributing estate assets raise justifiable concerns about collusion among debtors, creditors, and their attorneys and other professionals." *Jevic Holding Corp.*, 787 F.3d at 184 (internal citations omitted). However, the *Jevic* court held that the absolute priority rule does not apply to settlements and may therefore deviate from the priority rules of § 507 as long as there are "'specific and credible grounds to justify [the] deviation.'" *Id.* (*quoting In re Iridium Operating LLC*, 478 F.3d at 466). The court went on to remark that this was the "least bad alternative" because there was no prospect of a plan being confirmed and a Chapter 7 would have resulted in the secured creditor taking all the assets of the estate.

b. *In re Iridium Operating LLC*, 478 F.3d 452 (2nd Cir. 2007)

Settlement agreement may be approved even though it is contrary to the priority scheme when compelling factors weigh in favor of approval.

Debtor was a voice and data communication company that had been spun off by its parent company Motorola, Inc. ("Motorola"). Abysmal sales resulted in Debtor filing for relief under Chapter 11. In the months leading to Debtor's collapse, it borrowed $1.55 billion from a

consortium of lenders (the "Lenders"). Lenders asserted valid, enforceable, properly perfected liens on all of Debtor's assets. The Committee asserted that some of the security interests were avoidable under § 547(b). If successful, the Committee estimated that it would recover at least $260 million. There were additional claims regarding the avoidability of prepetition interest payments and liens resulting from cash collateral stipulations. The Committee also asserted claims against Motorola for breach of contract, breach of fiduciary duty and avoidance of fraudulent conveyances. The Committee and the Lenders entered into a settlement agreement wherein the Debtor's assets would be distributed to the Lenders on account of their liens and to a litigation trust to fund the lawsuit against Motorola. Motorola objected to the settlement because the money used to fund the litigation trust skipped Motorola's administrative claims in derogation of the absolute priority rule and therefore the settlement is not "fair and equitable."

The Court rejected the holding in *Matter of AWECO, Inc.* 725 F.2d 293 (5th Cir. 1984) wherein the Fifth Circuit refused to approve a settlement agreement that did not comply with the priority scheme because it was not "fair and equitable." The Court adopted a flexible test. Although the priority scheme is an important factor in determining whether to approve a settlement agreement, it is not dispositive as long as there are compelling business reasons to justify the settlement. Here, the business justifications included: (1) Motorola did not object to the validity of the Lenders' liens; (2) litigation with the Lenders would be devastating to the estate if the Committee lost; (3) a well-funded litigation fund is preferable to hiring counsel on a contingent fee basis; and (4) the settlement represented a better potential recovery for all creditors as opposed to protracted and uncertain litigation.

c. *Matter of AWECO, Inc.*, 725 F.2d 293 (5th Cir. 1984)

The Court rejected a settlement agreement that did not comply with the priority scheme by extending the "fair and equitable" standard to settlement agreements. Debtor entered into a settlement agreement wherein it proposed transferring $5.3 million to an unsecured creditor despite the IRS having priority tax claims and another creditor having a judgment lien. The Court extended the "fair and equitable" standard to pre-plan settlements citing underlying notions of fairness inherent in the Bankruptcy Code and rejected the settlement agreement.

d. *In re SPM Manufacturing Corp.*, 984 F.2d 1305 (1st Cir. 1993)

The Court allowed class gifting in a Chapter 7 case when the gift was a carve-out of secured creditor's collateral. Debtor owed secured creditor $19 million (the "Lender"), which was secured by an uncontested senior perfected lien on all of Debtor's assets except real estate. Lender was undersecured. IRS had a priority tax claim of $750,000. General unsecured creditors were owed $5.5 million. The Committee and Lender entered into a settlement agreement whereby the Debtor's assets would be liquidated and shared amongst the Lender and the general unsecured creditors in derogation of the priority scheme of § 507 because the IRS's priority tax claim would not receive any proceeds.

The Court approved the agreement because the gift came from an undersecured creditor and the gift was not property of the estate because Lender had been granted relief from stay and subsequently liquidated the estate. IRS conceded that the Bankruptcy Court had no authority to

direct Lender's disposition of the proceeds once it receives them. Additionally, the Bankruptcy Court likened the deal to an assignment of claims, which is not generally prohibited by the Bankruptcy Code.

3. Gifting in the Context of a Plan

a. *In re DBSD North America, Inc.*, 634 F.3d 79 (2nd Cir. 2011)

Court applied absolute priority rule to deny plan confirmation. Debtor's plan proposed to pay in full first lien holder; the second lien holder would receive shares of the reorganized debtor with a value between 51% and 73% of the original claims; unsecured claims would receive shares with an estimated value of between 4% and 46% of their original claims; and the existing shareholders would receive shares and warrants of the reorganized entity. One of the unsecured creditors, Sprint, objected to the Plan arguing the Plan violates the absolute priority rule because the existing shareholders were receiving property before senior claims (Sprint) were paid in full.

Senior lender argued that, pursuant to *SPM*, an undersecured senior creditor may distribute property subject to its lien in any manner to junior claimants. Distinguishing *SPM*, the Court disagreed on two grounds. First, the absolute priority rule extends to "any property" including property subject to liens. Second, the holding in *SPM* is not applicable to Chapter 11 cases because, unlike Chapter 7 cases, the absolute priority rule does apply in Chapter 11. The Court then rigidly applied the absolute priority rule and observed that "a weakened absolute priority rule could allow for serious mischief between senior creditors and existing shareholders." *In re DBSD North America, Inc.*, 634 F.3d 79, 100 (2nd Cir. 2011). However, the Court did leave the door open for gifting when intermediate classes consent, are paid in full or are unimpaired.

b. *In re Armstrong World Industries, Inc.*, 432 F.3d 507 (3rd Cir. 2005)

The Court applied the absolute priority rule to deny plan confirmation. The Plan proposed to distribute warrants to an equity class even though a senior general unsecured class ("Class 6") would recover about 59.5% of its claims. Although 88.03% of Class 6 voted for the Plan, only 23.21% of the claims voted to accept the Plan. Consequently, Class 6 rejected the Plan.

The Court distinguished SPM by remarking that *SPM* involved a Chapter 7 case, which did not trigger the absolute priority rule; the gifted property was not subject to distribution because it was subject to a lien; and the distribution was a "carve-out." The Court remarked that payment to equity over an impaired non-consenting class "would encourage parties to impermissibly sidestep the carefully crafted strictures of the Bankruptcy Code, and would undermine Congress's intention to give unsecured creditors bargaining power in this context." *In re Armstrong World Industries, Inc.*, 432 F.3d 507, 515 (3rd Cir. 2005). Recognizing that denying the Plan may have negative consequences to preserving the going concern value of the Debtor and therefore jeopardize the amount paid to creditors, nevertheless, the absolute property rule applies and cannot be circumvented in the Plan.

c. *In re Journal Register Company.* 407 B.R. 520 (S.D.N.Y. 2009)

The Court approved a Plan wherein secured creditor made gift to unsecured trade creditor, but not to other general unsecured creditors. Undersecured lender with security interests in substantially all of Debtor's assets proposed to fund a "gift" to trade creditors whose continued business was necessary to Debtor's postconfirmation success. Trade creditors were in same class as other general unsecured creditors that would receive a 9% distribution, but secured lender established a separate "trade account" with non-estate property to fund the payments.

The Court allowed the "gift" because it was being made outside the Plan and the Chapter 11 process from property that belonged to the secured lender. There is nothing in the Code prohibiting third-parties from paying Debtor's debts. While the Plan facilitated the distribution, the distribution did not implicate the classification scheme and was therefore not a distribution under the Plan.

d. *In re MCorp Financial, Inc.*, 160 B.R. 941 (S.D. Tex. 1993)

The Court confirmed a Plan wherein unsecured creditors gifted part of their recovery to the FDIC to conclude longstanding and contentious litigation. FDIC was junior to the unsecured creditors. A class junior to unsecured creditors, but senior to the FDIC, objected. Citing *SPM*, the Court concluded that a senior class may share its proceeds so long as a junior class is receiving as much as they would absent the gifting.

4. Gifting in the Context of a § 363 Sale

a. *In re World Health Alternatives, Inc.*, 344 B.R. 291 (Bankr. D. Del. 2006)

Court approved settlement agreement in connection with a sale where unsecured creditor capped its claim and provided a carve-out to unsecured creditors thereby skipping priority tax claims. The carve-out permitted the unsecured creditors to pursue claims against other parties. In the settlement, the unsecured creditors agreed to withdraw their objection to the sale of Debtor's assets. Relying on *Armstrong*, the UST objected.

The Court relied on *SPM* to approve the agreement and noted that *Armstrong* distinguished rather than rejected *SPM*. The Court held that the absolute priority rule is not implicated in a sale as opposed to a plan.

b. *In re On-Site Sourcing, Inc.*, 412 B.R. 817 (Bankr. E.D. Va. 2009)

The Court disapproved a sale where purchaser would fund a trust for the benefit of unsecured creditors allowing general unsecured creditors to be paid before administrative and priority claimants. The Court was primarily concerned with the effect on the Chapter 11 process. Notably, "the provision effectively predetermines, in significant part, the structure of an as yet to be drafted plan of reorganization and effectively evades the 'carefully crafted scheme' of the

chapter 11 plan confirmation process." *In re On-Site Sourcing, Inc.*, 412 B.R. 817, 826 (Bankr. E.D. Va. 2009).

The Court was further concerned with the activities of the purchaser that suggested it was buying junior creditor approval to ensure a quick sale at the expense of senior creditors. The Court was critical of the Debtor's handling of the sale: "They do not advance the debtor's chapter 11 efforts. They distort the chapter 11 process. They compromise the debtor's fiduciary duties which run to all creditors, not simply a portion of the creditors. It is difficult to imagine any business reason furthered by the proposed general unsecured creditors trust other than appeasement of 'the hue and cry of the most vocal special interest groups.'" *Id.* at 829 (internal citation omitted).

Restructuring Support Agreements

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Relevant Bankruptcy Code Provisions

- Section 1125(b)
    - An acceptance or rejection of a plan may not be solicited after the commencement of the case under this title from a holder of a claim or interest with respect to such claim or interest, unless, at the time of or before such solicitation, there is transmitted to such holder the plan or a summary of the plan, and a written disclosure statement approved, after notice and a hearing, by the court as containing adequate information.
- Section 1125(g)
    - [A]n acceptance or rejection of the plan may be solicited from a holder of a claim or interest if such solicitation complies with applicable nonbankruptcy law and if such holder was solicited before the commencement of the case in a manner complying with applicable nonbankruptcy law.
- Section 1126(b)
    - [A] holder of a claim or interest that has accepted or rejected the plan before the commencement of the case under this title is deemed to have accepted or rejected such plan, as the case may be, if--(1) the solicitation of such acceptance or rejection was in compliance with any applicable nonbankruptcy law, rule, or regulation governing the adequacy of disclosure in connection with such solicitation; or (2) if there is not any such law, rule, or regulation, such acceptance or rejection was solicited after disclosure to such holder of adequate information, as defined in section 1125(a) of this title.
- Section 1126(e)
    - On request of a party in interest, and after notice and a hearing, the court may designate any entity whose acceptance or rejection of such plan was not in good faith, or was not solicited or procured in good faith or in accordance with the provisions of this title.

➢ **What is a restructuring support agreement?**

- A restructuring support agreement ("RSA") is an agreement between a company and its significant stakeholders that binds the parties to support a proposed restructuring. An RSA will include the general terms of the restructuring and is typically executed

prepetition, before the specific bankruptcy papers and orders are drafted. RSAs often permit parties to seek specific performance as a remedy for breach of the RSA and compel a party to support a given chapter 11 plan. RSAs may require the debtor to file bankruptcy in a certain jurisdiction, designate the relief sought in the first-day motions, and set forth milestones and procedures for the debtor to follow in seeking confirmation of the plan. *See* Morris J. Massel, *How to Negotiate a Ch. 11 Plan Support Agreement*, Law360 (Oct. 16, 2013).

- **What are the benefits of entering into an RSA?**

  - RSAs are the result of negotiations and broad consensus reached by the debtor and various creditor and equity constituencies. RSAs can offer a number of benefits, including (i) helping parties avoid the significant cost of substantive participation and litigation in a chapter 11 bankruptcy case; (ii) affording parties a relative level of certainty regarding the outcome of a restructuring, and (iii) minimizing involvement by a bankruptcy court.

- **What are the drawbacks of entering into an RSA?**

  - Creditors who enter into an RSA before the commencement of a bankruptcy case do not benefit from the disclosure requirements that the Bankruptcy Code imposes on debtors and other plan proponents. Debtors must file bankruptcy schedules and statements of financial affairs and make other disclosures as a matter of course. A plan proponent must prepare a disclosure statement with "adequate information" about the plan and obtain approval of the statement by the bankruptcy court before it can solicit votes in favor of the plan. *See* 11 U.S.C § 1125(b). Prepetition RSAs permit plan proponents to circumvent these rules and obtain binding support in favor of a plan without making these disclosures. Conversely, creditors run the risk of committing to a restructuring without complete information.

- **Enforceability of "lock-up" RSAs**

  - A "lock-up" agreement is a provision in an RSA "in which the creditor becomes legally bound to vote for a plan of reorganization so long as certain key plan provisions are included." *Official Committee of Unsecured Creditors v. New World Pasta Co.*, 322 B.R. 560, 569 (M.D. Pa. 2005). "Typical operative language in a lock-up agreement provides that a significant stakeholder agrees to support a restructuring plan subject to various terms and conditions." *Id.*

  - The enforceability of a lock-up provision may depend on whether the plan proponent violated the solicitation rules in § 1125 of the Bankruptcy Code. The timing of the RSA

is key to this determination. The lock-up is enforceable if the parties entered into it prepetition and the agreement otherwise complies with non-bankruptcy law. *See* 11 U.S.C. § 1126(b). However, some precedent suggests that the lock-up is unenforceable if entered into postpetition. *See* Daniel J. DeFranceschi, *Delaware Bankruptcy Court Announces Bright-Line Rule for Use of Lock-Up Agreements in Chapter 11 Cases*, Am. Bankr. Inst. J., February 2003, at 16 ("[V]otes to accept a reorganization plan cast by a party that signed a lock-up agreement prior to the petition date may be counted for plan confirmation, while votes cast by parties who entered lock-up agreements post-petition and prior to the court having approved a written disclosure statement may not be counted.").

- Few cases discuss the enforceability of postpetition lock-up agreements. Two early cases involving postpetition lock-up provisions are reflected in a pair of unreported decisions from the U.S. Bankruptcy Court for the District of Delaware. *See In re NII Holdings, Inc.,* Case No. 02-11505 (Bankr. D. Del. Oct. 25, 2002) (Order dated October 25, 2002) (D.I. 367); *In re Stations Holdings Co., Inc.,* Case No. 02-10882 (Bankr. D. Del. Sept. 30, 2002). In those cases, the bankruptcy court held that votes to accept a reorganization plan cast by a creditor pursuant to a lock-up agreement signed after the petition date, but prior to approval and circulation of a disclosure statement, violated the solicitation procedures under § 1125. As such, the offending votes were "designated" under § 1126 of the Code and were not counted for purposes of determining acceptance or rejection of the plan.

- Subsequent opinions have eroded the holdings of *NII Holdings* and *Stations Holdings*. One court has distinguished the RSAs at issue in those cases as binding the creditors to vote for the plan. *New World Pasta*, 322 B.R. at 568–69. Another court found that "the prohibition against pre-disclosure statement solicitation is simply inapplicable . . . where the entities allegedly 'solicited' . . . are co-proponents of the plan." *In re Heritage Org., L.L.C.*, 376 B.R. 783, 791 (Bankr. N.D. Tex. 2007). Finally, in *In re Indianapolis Downs LLC,* the bankruptcy court permitted a lock-up provision in an RSA that was entered into during the bankruptcy case but before the disclosure statement was approved, and which required the parties to vote in favor of the plan. 486 B.R. 286, 296-97 (Bankr. D. Del. 2013). The bankruptcy court refused to designate the votes of the parties to the RSA, emphasizing the Bankruptcy Code's emphasis on negotiation, the complexity of the particular reorganization, and the necessity for each party to the RSA to know that other parties would vote in favor of the plan.

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1. Overview

a. What is Class Gifting

Class gifting occurs when a senior creditor shares or "gifts" property to junior claimants that would otherwise be prohibited by the absolute priority rule or the unfair discrimination provision. Generally, the purpose of a gift is to garner support from a junior class for plan confirmation, a § 363 sale or a settlement that results in a structured dismissal. The genesis of court approval for class gifting is *In re SPM Manufacturing Corp.*, 984 F.2d 1305 (1st Cir. 1993). The basic reasoning supporting *SPM* is that "creditors are generally free to do whatever they wish with the bankruptcy dividends they receive, including to share them with other creditors." *Id.* at 1313. Courts departing from *SPM* generally do so on the basis that class gifting violates either the absolute priority rule under § 1129(b)(2)(B)(ii) or the unfair discrimination provision under § 1129(b)(1).

b. Absolute Priority Rule

The absolute priority rule provides that senior claimants must be paid in full before junior claimants are paid. The absolute priority rule is encapsulated in § 1129(b)(2)(B)(ii). Section 1129(b)(2)(B) provides that with respect to unsecured claims, plan treatment is fair and equitable if the allowed value of the claim is paid in full, pursuant to § 1129(b)(2)(B)(i), or, if "the holder of any claim or interest that is junior to claims of such class will not receive or retain under the plan on account of such junior claim or interest any property." § 1129(b)(2)(B)(ii). The court in *In re Jevic Holding Corp.*, 787 F.3d 173 (3rd Cir. 2015), *cert. granted by Czyzewski v. Jevic Holding Corp.*, 136 S.Ct. 2541 (June 28, 2016), held that the absolute priority rule is not implicated when the settlement is outside of the plan. The Fifth Circuit does not follow this approach. *Matter of AWECO, Inc.*, 725 F.2d 293 (5th Cir. 1984). The absolute priority rule comes into play when a gift skips a class.

c. Unfair Discrimination

Absent a reasonable basis for different treatment, § 1129(b)(1) prohibits unfair discrimination in cramdown to prevent debtor from treating dissenting similar claims differently. If there are two creditors of the same priority, and only one is receiving the gift, some courts allow the gift in light of extraordinary circumstances or a reasonable basis for the disparate treatment. *See In re Journal Register Company*. 407 B.R. 520 (S.D.N.Y. 2009) (allowing gift from secured creditor to trade creditor that was critical to post petition operations over objection of general unsecured creditor in same class). Unfair discrimination generally comes into play when a creditor gifts to one creditor and not another of the same or similar class.

2. Gifting in the Context of a Settlement/Structured Dismissal

a. *In re Jevic Holding Corp.*, 787 F.3d 173 (3rd Cir. 2015), *cert. granted by Czyzewski v. Jevic Holding Corp.*, 136 S.Ct. 2541 (June 28, 2016)

Absolute priority rule is not implicated when settlement is presented as separate from plan of reorganization. Jevic Transportation, Inc. ("Jevic") was a trucking company. With the forbearance agreement with its senior secured lender about to expire, Jevic filed for bankruptcy relief under Chapter 11 and terminated all of its employees. Jevic owed about $53 million to its secured lender and about $10 million to tax and general unsecured creditors. Two lawsuits were filed in the bankruptcy case. First, a group of Jevic's terminated drivers (the "Drivers") filed a class action under the Worker Adjustment and Retraining Notification (WARN) Act, which requires Jevic to provide employees 60 days' written notice before a mass layoff. Second, the Committee filed a fraudulent conveyance and preference action against the secured lender for the secured lenders' "ill-advised" financing of the Jevic's prepetition leveraged buyout.

Jevic, the Committee and the secured lender reached a settlement wherein secured lender would pay $2 million for Jevic and the Committee's legal fees and other administrative expenses. Secured lender would assign its lien on Jevic's remaining $1.7 million in cash (its sole asset) to pay tax and administrative creditors first then general unsecured creditors. However, the settlement did not account for the undisputed employee WARN Act claims which consisted of an estimated $8.3 million priority wage claim and a $4.1 million general unsecured claim. The settlement skipped over the priority wage claim. Approval of the settlement would result in a structured dismissal of the case. The Drivers and the UST objected to the settlement arguing that the settlement was in derogation of the priority scheme.

The *Jevic* court agreed with the Second Circuit in *In re Iridium Operating LLC*, 478 F.3d 452 (2nd Cir. 2007) that "compliance with the Code priorities will usually be dispositive of whether a proposed settlement is fair and equitable. Settlements that skip objecting creditors in distributing estate assets raise justifiable concerns about collusion among debtors, creditors, and their attorneys and other professionals." *Jevic Holding Corp.*, 787 F.3d at 184 (internal citations omitted). However, the *Jevic* court held that the absolute priority rule does not apply to settlements and may therefore deviate from the priority rules of § 507 as long as there are "'specific and credible grounds to justify [the] deviation.'" *Id.* (*quoting In re Iridium Operating LLC*, 478 F.3d at 466). The court went on to remark that this was the "least bad alternative" because there was no prospect of a plan being confirmed and a Chapter 7 would have resulted in the secured creditor taking all the assets of the estate.

b. *In re Iridium Operating LLC*, 478 F.3d 452 (2nd Cir. 2007)

Settlement agreement may be approved even though it is contrary to the priority scheme when compelling factors weigh in favor of approval.

Debtor was a voice and data communication company that had been spun off by its parent company Motorola, Inc. ("Motorola"). Abysmal sales resulted in Debtor filing for relief under Chapter 11. In the months leading to Debtor's collapse, it borrowed $1.55 billion from a

consortium of lenders (the "Lenders"). Lenders asserted valid, enforceable, properly perfected liens on all of Debtor's assets. The Committee asserted that some of the security interests were avoidable under § 547(b). If successful, the Committee estimated that it would recover at least $260 million. There were additional claims regarding the avoidability of prepetition interest payments and liens resulting from cash collateral stipulations. The Committee also asserted claims against Motorola for breach of contract, breach of fiduciary duty and avoidance of fraudulent conveyances. The Committee and the Lenders entered into a settlement agreement wherein the Debtor's assets would be distributed to the Lenders on account of their liens and to a litigation trust to fund the lawsuit against Motorola. Motorola objected to the settlement because the money used to fund the litigation trust skipped Motorola's administrative claims in derogation of the absolute priority rule and therefore the settlement is not "fair and equitable."

The Court rejected the holding in *Matter of AWECO, Inc.* 725 F.2d 293 (5th Cir. 1984) wherein the Fifth Circuit refused to approve a settlement agreement that did not comply with the priority scheme because it was not "fair and equitable." The Court adopted a flexible test. Although the priority scheme is an important factor in determining whether to approve a settlement agreement, it is not dispositive as long as there are compelling business reasons to justify the settlement. Here, the business justifications included: (1) Motorola did not object to the validity of the Lenders' liens; (2) litigation with the Lenders would be devastating to the estate if the Committee lost; (3) a well-funded litigation fund is preferable to hiring counsel on a contingent fee basis; and (4) the settlement represented a better potential recovery for all creditors as opposed to protracted and uncertain litigation.

c. *Matter of AWECO, Inc.*, 725 F.2d 293 (5th Cir. 1984)

The Court rejected a settlement agreement that did not comply with the priority scheme by extending the "fair and equitable" standard to settlement agreements. Debtor entered into a settlement agreement wherein it proposed transferring $5.3 million to an unsecured creditor despite the IRS having priority tax claims and another creditor having a judgment lien. The Court extended the "fair and equitable" standard to pre-plan settlements citing underlying notions of fairness inherent in the Bankruptcy Code and rejected the settlement agreement.

d. *In re SPM Manufacturing Corp.*, 984 F.2d 1305 (1st Cir. 1993)

The Court allowed class gifting in a Chapter 7 case when the gift was a carve-out of secured creditor's collateral. Debtor owed secured creditor $19 million (the "Lender"), which was secured by an uncontested senior perfected lien on all of Debtor's assets except real estate. Lender was undersecured. IRS had a priority tax claim of $750,000. General unsecured creditors were owed $5.5 million. The Committee and Lender entered into a settlement agreement whereby the Debtor's assets would be liquidated and shared amongst the Lender and the general unsecured creditors in derogation of the priority scheme of § 507 because the IRS's priority tax claim would not receive any proceeds.

The Court approved the agreement because the gift came from an undersecured creditor and the gift was not property of the estate because Lender had been granted relief from stay and subsequently liquidated the estate. IRS conceded that the Bankruptcy Court had no authority to

direct Lender's disposition of the proceeds once it receives them. Additionally, the Bankruptcy Court likened the deal to an assignment of claims, which is not generally prohibited by the Bankruptcy Code.

3. Gifting in the Context of a Plan

a. *In re DBSD North America, Inc.*, 634 F.3d 79 (2nd Cir. 2011)

Court applied absolute priority rule to deny plan confirmation. Debtor's plan proposed to pay in full first lien holder; the second lien holder would receive shares of the reorganized debtor with a value between 51% and 73% of the original claims; unsecured claims would receive shares with an estimated value of between 4% and 46% of their original claims; and the existing shareholders would receive shares and warrants of the reorganized entity. One of the unsecured creditors, Sprint, objected to the Plan arguing the Plan violates the absolute priority rule because the existing shareholders were receiving property before senior claims (Sprint) were paid in full.

Senior lender argued that, pursuant to *SPM*, an undersecured senior creditor may distribute property subject to its lien in any manner to junior claimants. Distinguishing *SPM*, the Court disagreed on two grounds. First, the absolute priority rule extends to "any property" including property subject to liens. Second, the holding in *SPM* is not applicable to Chapter 11 cases because, unlike Chapter 7 cases, the absolute priority rule does apply in Chapter 11. The Court then rigidly applied the absolute priority rule and observed that "a weakened absolute priority rule could allow for serious mischief between senior creditors and existing shareholders." *In re DBSD North America, Inc.*, 634 F.3d 79, 100 (2nd Cir. 2011). However, the Court did leave the door open for gifting when intermediate classes consent, are paid in full or are unimpaired.

b. *In re Armstrong World Industries, Inc.*, 432 F.3d 507 (3rd Cir. 2005)

The Court applied the absolute priority rule to deny plan confirmation. The Plan proposed to distribute warrants to an equity class even though a senior general unsecured class ("Class 6") would recover about 59.5% of its claims. Although 88.03% of Class 6 voted for the Plan, only 23.21% of the claims voted to accept the Plan. Consequently, Class 6 rejected the Plan.

The Court distinguished SPM by remarking that *SPM* involved a Chapter 7 case, which did not trigger the absolute priority rule; the gifted property was not subject to distribution because it was subject to a lien; and the distribution was a "carve-out." The Court remarked that payment to equity over an impaired non-consenting class "would encourage parties to impermissibly sidestep the carefully crafted strictures of the Bankruptcy Code, and would undermine Congress's intention to give unsecured creditors bargaining power in this context." *In re Armstrong World Industries, Inc.*, 432 F.3d 507, 515 (3rd Cir. 2005). Recognizing that denying the Plan may have negative consequences to preserving the going concern value of the Debtor and therefore jeopardize the amount paid to creditors, nevertheless, the absolute property rule applies and cannot be circumvented in the Plan.

c. *In re Journal Register Company*. 407 B.R. 520 (S.D.N.Y. 2009)

The Court approved a Plan wherein secured creditor made gift to unsecured trade creditor, but not to other general unsecured creditors. Undersecured lender with security interests in substantially all of Debtor's assets proposed to fund a "gift" to trade creditors whose continued business was necessary to Debtor's postconfirmation success. Trade creditors were in same class as other general unsecured creditors that would receive a 9% distribution, but secured lender established a separate "trade account" with non-estate property to fund the payments.

The Court allowed the "gift" because it was being made outside the Plan and the Chapter 11 process from property that belonged to the secured lender. There is nothing in the Code prohibiting third-parties from paying Debtor's debts. While the Plan facilitated the distribution, the distribution did not implicate the classification scheme and was therefore not a distribution under the Plan.

d. *In re MCorp Financial, Inc.*, 160 B.R. 941 (S.D. Tex. 1993)

The Court confirmed a Plan wherein unsecured creditors gifted part of their recovery to the FDIC to conclude longstanding and contentious litigation. FDIC was junior to the unsecured creditors. A class junior to unsecured creditors, but senior to the FDIC, objected. Citing *SPM*, the Court concluded that a senior class may share its proceeds so long as a junior class is receiving as much as they would absent the gifting.

4. Gifting in the Context of a § 363 Sale

a. *In re World Health Alternatives, Inc.*, 344 B.R. 291 (Bankr. D. Del. 2006)

Court approved settlement agreement in connection with a sale where unsecured creditor capped its claim and provided a carve-out to unsecured creditors thereby skipping priority tax claims. The carve-out permitted the unsecured creditors to pursue claims against other parties. In the settlement, the unsecured creditors agreed to withdraw their objection to the sale of Debtor's assets. Relying on *Armstrong*, the UST objected.

The Court relied on *SPM* to approve the agreement and noted that *Armstrong* distinguished rather than rejected *SPM*. The Court held that the absolute priority rule is not implicated in a sale as opposed to a plan.

b. *In re On-Site Sourcing, Inc.*, 412 B.R. 817 (Bankr. E.D. Va. 2009)

The Court disapproved a sale where purchaser would fund a trust for the benefit of unsecured creditors allowing general unsecured creditors to be paid before administrative and priority claimants. The Court was primarily concerned with the effect on the Chapter 11 process. Notably, "the provision effectively predetermines, in significant part, the structure of an as yet to be drafted plan of reorganization and effectively evades the 'carefully crafted scheme' of the

chapter 11 plan confirmation process." *In re On-Site Sourcing, Inc.*, 412 B.R. 817, 826 (Bankr. E.D. Va. 2009).

The Court was further concerned with the activities of the purchaser that suggested it was buying junior creditor approval to ensure a quick sale at the expense of senior creditors. The Court was critical of the Debtor's handling of the sale: "They do not advance the debtor's chapter 11 efforts. They distort the chapter 11 process. They compromise the debtor's fiduciary duties which run to all creditors, not simply a portion of the creditors. It is difficult to imagine any business reason furthered by the proposed general unsecured creditors trust other than appeasement of 'the hue and cry of the most vocal special interest groups.'" *Id*. at 829 (internal citation omitted).