

The Gifting Doctrine V. The Absolute Priority Rule

Law360, New York (March 28, 2011) -- On Dec. 6, the U.S. Court of Appeals for the Second Circuit weighed in on the contentious debate over the “gifting doctrine.” The debate centers around the ability of a senior creditor to “gift” property to a junior claimholder over the objection of claimholders situated between the two parties on the priority scale. See *Dish Network Corp. v. DBSD N. Am., Inc.* (In re DBSD N. Am., Inc.), 2010 U.S. App. LEXIS 27007 (2d Cir. Dec. 6, 2010).

The debate gained steam in 1993 after the U.S. Court of Appeals for the First Circuit allowed gifting in the context of a Chapter 7 liquidation. See *In re SPM Manufacturing Corporation*, 984 F.2d 1305 (1st Cir. 1993).

In 2005, the U.S. Court of Appeals for the Third Circuit rejected much of the First Circuit’s reasoning and concluded that gifting in Chapter 11 case runs afoul of the “absolute priority rule.” See *In re Armstrong World Indus., Inc.* 432 F.3d 507, 514 (3d Cir. 2005).

Unlike the First Circuit, the Third Circuit concluded that creditors are generally not free to do whatever they wish with the bankruptcy proceeds they receive. *Id.* In the recent DBSD decision, the Second Circuit sided with the Third Circuit.

The “Gifting Doctrine”

To structure a viable Chapter 11 plan, it is often useful for a secured creditor to give a portion of its collateral (or the value of its collateral) to junior creditors or equity holders to ensure their cooperation and assistance in a reorganization.

However, if a more senior class of creditors will not be paid in full, plan architects must grapple with the absolute priority rule codified in 11 U.S.C. § 1129(b)(2)(B), which states that a plan of reorganization may not give “property” to the holders of any junior claims or interests, including equity holders, “on account of those claims or interests, unless all classes of senior claims either receive the full value of their claims or give their consent.” 11 U.S.C. § 1129(b)(2)(B); see e.g., *In re Armstrong World Indus., Inc.* 432 F.3d 507, 512 (3d Cir. 2005); *In re Coltex Loop Cent. Three Partners, L.P.*, 138 F.3d 39, 42 (2d Cir. 1998). Compliance with the Absolute Priority Rule is a prerequisite for a plan being “fair and equitable” per the requirement of 11 U.S.C. § 1129(b)(1).

“Gifting Doctrine” in the First Circuit

In the landmark decision of *In re SPM Manufacturing Corporation*, the First Circuit gave creditors a tool to work within the Bankruptcy Code’s distribution principles while “gifting” property to junior claimholders — even if a more senior claimholder had not been satisfied in full.

In *SPM*, the First Circuit allowed a senior secured creditor to share its proceeds from an asset sale of the debtor with the official unsecured creditors’ committee (the committee) ahead of priority tax creditors. *SPM*, 984 F.2d at 1309.

The senior secured creditor properly received all of the proceeds from the sale and could agree to share such proceeds with anyone it wished. The distribution scheme of 11 U.S.C. § 726 (and, by implication, the priorities of 11 U.S.C. § 507) did not come into play until all valid liens on the property were satisfied. *Id.* at 1312.

The senior secured creditor “gifted” proceeds to the unsecured creditors after the distribution of estate property. The “gift” did not affect the position of the priority tax claims (i.e. the tax claims would not have been paid in either scenario).

The court essentially allowed the senior secured creditor to enter into an agreement with the committee during the bankruptcy that concerned the parties’ claims against the bankruptcy estate. *Id.* at 1313. Citing Massachusetts law, the court stated, “a right to receive payment is freely transferable and assignable in Massachusetts without the consent of the debtors and without affecting the debtor’s obligation to pay the underlying debt.” *Id.* citing Mass. Gen. Laws ch. 106, § 9-318.

In short, if a creditor receives a valid distribution from a bankruptcy estate, that creditor may sell or share its distribution with anyone it wishes. Absent 1) “bad faith” (i.e., purchasing claims by an affiliate for the sole purpose of blocking the confirmation of a competing plan); 2) a breach of a fiduciary duty; or 3) fraud, “neither the [Bankruptcy] Code nor the [Bankruptcy] Rules prohibit or discourage creditors from receiving cash from nondebtors in exchange for their claims.” *Id.* at 1314.

Dish Network Corporation v. DBSD North America: Equity Holder Given Property over Unsecured Creditor in Plan of Reorganization

[Sprint Nextel Corp.](#) objected to DBSD North America Inc.’s plan of reorganization because the plan gave shares and warrants to DBSD’s owner — whose equity interest was below Sprint’s unsecured claim in priority — in violation of the absolute priority rule of 11 U.S.C. § 1129(b)(2)(B), even though Sprint and other unsecured creditors would be paid far less than their claim amounts. The Second Circuit agreed that the plan violated the absolute priority rule and reversed the district court’s confirmation order. *DBSD*, 2010 U.S. App. LEXIS 27007, at *3.

On May 15, 2009, DBSD (a developer of a mobile communications network) filed a voluntary petition in the U.S. Bankruptcy Court for the Southern District of New York because its communication network had remained in the development stage and it had little, if any, revenue to offset its obligations. *DBSD*, 2010 U.S. App. LEXIS 27002 at *4.

The bankruptcy court confirmed a plan of reorganization whereby 1) the first-priority secured creditor received new obligations; 2) the second-priority secured creditor received the bulk of the shares of the reorganized entity (estimated to be between 51 and 73 percent of their original claims); 3) unsecured creditors received a portion of the remaining shares (of a value estimated to be between 4 and 46 percent of their original claims); and 4) DBSD’s sole shareholder also received shares and warrants.

Adopting the reasoning of the First Circuit, the bankruptcy court concluded that DBSD's sole shareholder could receive these equity interests — even though the unsecured creditors were not paid in full — because the shareholder's recovery could be viewed as a "gift" from the second-priority secured creditor. *In re DBSD North America Inc.*, 419 B.R. 179, 210 (Bankr. S.D.N.Y. 2009).

The bankruptcy court allowed the "gift" because 1) the shares at issue came from a secured creditor; 2) there were understandable reasons for the gift; 3) there were no ulterior, improper ends; and 4) the complaining creditor would get no more if the gift had not been made. *Id.* at 212.

The bankruptcy court concluded that although "the gifting doctrine has not been uniformly followed on a nationwide basis," its allowance in the Chapter 11 context is the "better view." *Id.* The Second Circuit disagreed.

The Second Circuit Rules Against the "Gifting Doctrine"

The Second Circuit in DBSD distinguished the First Circuit's SPM decision, among other things, on the grounds that SPM involved a Chapter 11 case that was ultimately converted into a Chapter 7 liquidation. Unlike a Chapter 7 where "the distribution scheme does not come into play until all valid liens on the property are satisfied," the relevant property in DBSD remained property of the bankruptcy estate and never passed to the secured creditor outright. DBSD, 2010 U.S. App. LEXIS 27002 at *41–*42, quoting *In re SPM*, 984 F.2d at 1312.

The rigid absolute priority rule applied because the shares and warrants passed to the equity holder under the plan itself. The Second Circuit emphasized the text of Section 1129(b)(2)(B)(ii) of the Bankruptcy Code explaining that the absolute priority rule extends to "any property," not simply "any property not covered by a senior creditor's lien." DBSD, 2010 U.S. App. LEXIS 27002 at *40. The rule focuses on who receives property under a plan of reorganization, not who would receive property under a liquidation plan. *Id.*

The Debate

In DBSD, the court acknowledged the strong policy arguments in favor of gifting. Specifically, the court recognized that gifting in certain situations could accelerate Chapter 11 proceedings by incentivizing consensual, nonadversarial behavior. DBSD, 2010 U.S. App. LEXIS 27002 at *46–*47.

However, the court concluded that Congress was aware of such policy merits when it codified the absolute priority rule. DBSD, 2010 U.S. App. LEXIS 27002 at *48.

Although the First Circuit's SPM decision can be distinguished from both the Third Circuit's Armstrong decision and the Second Circuit's DBSD decision because SPM involved a liquidation rather than a plan of reorganization, the underlying principles are identified.

The key question is whether a creditor can control the property distributed to it pursuant to a liquidation plan or a plan of reorganization (absent bad faith, breach of fiduciary duty or fraud) or whether the Bankruptcy Code dictates what parties must ultimately take and retain under a plan.

Although the Circuit Courts are not technically split over the issue of "gifting," the First Circuit has yet to adopt the Second Circuit's strict reading of the absolute priority rule in any meaningful way. Other courts have even expanded the First Circuit's reasoning in SPM to the Chapter 11 context. See, e.g. *In re MCorp Fin. Inc.*, 160 B.R. 941 (S.D. Tex. 1993).

Because these cases based their reasoning on the SPM decision, however, the Second and Third Circuits disposed of these expansions by distinguishing SPM. *Armstrong*, 432 F.3d at 510; *DBSD*, 2010 U.S. App. LEXIS 27002 at *42–*43.

Given the Second and Third Circuit’s view of the gifting doctrine, companies looking to file a Chapter 11 bankruptcy may try to avoid these circuits in the hopes of utilizing more innovative and practical plans of reorganization. The Second and Third Circuit’s strict application of the absolute priority rule may make it more difficult for debtors to confirm plans and may limit debtors’ options.

As an article commenting on the Third Circuit’s *Armstrong* decision states, “the *Armstrong* opinion may have the effect of limiting potential constructive plan structures used by reorganization professionals to achieve consensus among substantially all of the diverse interests that may be involved in a Chapter 11 reorganization.” *Miller and Berkovich*, 55 AM. U. L. REV. at 1349.

DBSD may have the same effect in the Second Circuit. Companies that demand creative reorganizations will likely seek out jurisdictions that have yet to strictly construe and apply the absolute priority rule.

Conclusion

The Second Circuit’s *DBSD* decision adopts a strict constructionist view of the absolute priority rule, which applies to Chapter 11 reorganization plans. Outside of the Second and Third Circuits, it remains to be seen how other courts will interpret and evaluate the many possible factual situations in which “gifting” can occur.

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