View metadata, citation and similar papers at core.ac.uk

brought to you by CORE

provided by Digital Commons @ American University Washington College of Law

American University Law Review

Volume 55 | Issue 5 Article 3

2006

The Implications of the Third Circuit's Armstrong Decision on Creative Corporate Restructuring: Will Strict Construction of the Absolute Priority Rule Make Chapter 11 Consensus Less Likely?

Harvey R. Miller

Ronit J. Berkovich

Follow this and additional works at: http://digitalcommons.wcl.american.edu/aulr

Part of the Bankruptcy Law Commons, and the Corporation and Enterprise Law Commons

Recommended Citation

Miller, Harvey R. et al. "The Implications of the Third Circuit's Armstrong Decision on Creative Corporate Restructuring: Will Strict Construction of the Absolute Priority Rule Make Chapter 11 Consensus Less Likely?" American University Law Review 55, no.5 (June 2006):1345-1426.

This Article is brought to you for free and open access by the Washington College of Law Journals & Law Reviews at Digital Commons @ American University Washington College of Law. It has been accepted for inclusion in American University Law Review by an authorized administrator of Digital Commons @ American University Washington College of Law. For more information, please contact fbrown@wcl.american.edu.

The Implications of the Third Circuit's Armstrong Decision on Creative Corporate Restructuring: Will Strict Construction of the Absolute Priority Rule Make Chapter 11 Consensus Less Likely?

Keywords
Third Circuit, Corporation, Bankruptcy Code Policy, Confirmation Requirements, Chapter 11, Absolute Priority Rule, Unfair Discrimination Prohibition

This article is available in American University Law Review: http://digitalcommons.wcl.american.edu/aulr/vol55/iss5/3

THE IMPLICATIONS OF THE THIRD CIRCUIT'S *ARMSTRONG* DECISION ON CREATIVE CORPORATE RESTRUCTURING: WILL STRICT CONSTRUCTION OF THE ABSOLUTE PRIORITY RULE MAKE CHAPTER 11 CONSENSUS LESS LIKELY?

HARVEY R. MILLER*
RONIT J. BERKOVICH**

TABLE OF CONTENTS

Introduction 1346
I. Bankruptcy Code Policy and Confirmation Requirements 1350
A. Requirements for Confirmation of a Consensual Plan 1351
B. Requirements for Cramdown: Unfair Discrimination Prohibition and Absolute Priority Rule 1355
C. Creative Strategies for Avoiding The Unfair Discrimination Prohibition and Absolute Priority Rule....1358
1. The New Value Corollary 1358
2. The Gifting Strategy (*Armstrong*) 1359
II. History of the Absolute Priority Rule and Unfair Discrimination Prohibition 1362
A. The Absolute Priority Rule 1362
1. Equity receiverships 1362
2. *Boyd* and the development of the "fixed principle" 1366
3. Innovative structures to avoid *Boyd* 1369
4. The Bankruptcy Act of 1898 1370
5. *Case* and the Absolute Priority Rule 1371
6. The Chandler Act 1371

---

* Harvey R. Miller is Vice-Chairman and a Managing Director of Greenhill & Co., LLC, an Adjunct Professor of Law at *New York University School of Law*, and an Adjunct Lecturer in Law at *Columbia University School of Law*, and was the head of the Business Finance and Restructuring Department of Weil, Gotshal & Manges LLP from 1970-2003. The authors gratefully appreciate the invaluable contribution of Philip Weintraub, an associate with Weil, Gotshal & Manges LLP.
** Ronit J. Berkovich is an associate with Weil, Gotshal & Manges LLP.

7. Further amendments to the Bankruptcy Act............1372
8. The enactment of the Bankruptcy Code 1372
9. The development of the New Value Corollary..........1376
B. The Unfair Discrimination Prohibition 1382
1. Equity receiverships 1383
2. The Bankruptcy Act of 1898......................................1384
3. The Chandler Act 1384
4. Pre-code application of the unfair discrimination prohibition...1385
5. The Bankruptcy Code...1386
6. Unfair discrimination in practice..............................1387
III. The Development of the Gifting Doctrine............................1390
A. Legislative History of Gifting 1390
B. *SPM*...1391
C. *SPM*'s Progeny 1394
1. Secured creditor carveouts..1394
2. Gifting to junior classes under a plan 1396
3. Gifting to equity under a plan...................................1397
4. Gifting to select unsecured classes under a plan.......1398
a. Cases approving selective gifting 1398
b. Cases rejecting selective gifting 1405
5. Rejection of use of *SPM* for improper ends 1408
IV. *Armstrong*: The Plan, The Decision, and The Implications 1412
A. The Armstrong Plan..1412
B. Court Rejection of the Armstrong Plan 1415
C. The Danger of the *Armstrong* Decision 1419
Conclusion 1426

INTRODUCTION

The history of business reorganization under the bankruptcy law in the United States, similar to other areas of law, demonstrates the use of innovative and creative techniques to achieve the intended objectives and policies of a particular statute.[1] Rarely is a statute enacted that encompasses all potential scenarios that may thereafter arise and affect its stated and perceived goals. The application of statutory provisions necessarily involves the construction of their words in the context of the purposes and policies of the legislation.

Perhaps there is no area of law more dynamic and needful of enlightened and flexible construction than bankruptcy reorganization. Bankruptcy reorganizations present socio-economic circumstances and processes that are layered with multiple parties

1. *See* John M. Czarnetzky, *Time, Uncertainty, and the Law of Corporate Reorganizations*, 67 FORDHAM L. REV. 2939, 2969 (1999) (commenting on the evolution of Bankruptcy Law in the United States since its humble beginnings in the early 19th Century).

and diverse interests. Since the enactment of the Bankruptcy Reform Act in 1978, reorganization professionals have grappled with the construction of Bankruptcy Code provisions in order to affect the underlying principles and policies of that statute. In the specific area of Chapter 11 reorganizations, the effort has been devoted to achieving the confirmation of a reorganization plan that would rehabilitate a debtor's business and maximize the value of the debtor's estate for the benefit of its economic stakeholders.[2] Attainment of the statutory objectives has required a flexible approach to the interpretation and application of the Bankruptcy Code.[3] The creativity of professionals has been of significant importance in persuading courts to construe and apply the Bankruptcy Code and its related statutory provisions in a manner that satisfies the legislation's objectives.

The confirmation of a Chapter 11 plan of reorganization may present circumstances that call for creative thinking and constructions that serve the process of reorganization. The challenges become more acute in the context of confirming a Chapter 11 plan of reorganization over the objection of a class of dissenting creditors through the use of the "cramdown" power.[4] The cramdown power implicates the Fair and Equitable Rule or Absolute Priority Rule and the Unfair Discrimination Prohibition, which are incorporated into Chapter 11 of the Bankruptcy Code.[5] The Absolute Priority Rule is a vertical test designed to ensure that no creditor or interest junior to the objecting class of creditors receives any consideration under the plan on account of such junior claims or interests if the objecting class of creditors is not paid in full.[6] The Unfair Discrimination Prohibition is a horizontal test designed to ensure that no class of equal priority or standing to the objecting class of creditors receives a consideration under the plan that is

2. *See* Bank of Am. Nat'l Trust & Sav. Ass'n v. 203 N. LaSalle St. P'ship., 526 U.S. 434, 453 (1999) (recognizing that the two goals of Chapter 11 are "preserving going concerns and maximizing property available to satisfy creditors").

3. *See* William C. Whitford, *What's Right About Chapter 11*, 72 WASH. U. L.Q. 1379, 1406 (1994) (proclaiming that the malleability of Chapter 11 is one of its greatest virtues).

4. *See infra* Part I.B (discussing the requirement for plan approval via "cramdown").

5. *See infra* Part I.B (discussing the Unfair Discrimination Prohibition and the Absolute Priority Rule set forth in section 1129(b) of the Bankruptcy Code).

6. *See generally* Douglas G. Baird & Thomas H. Jackson, *Bargaining After the Fall and the Contours of the Absolute Priority Rule*, 55 U. CHI. L. REV. 738 (1988) (providing an overview of the Absolute Priority Rule).

better than the consideration provided for the objecting class of creditors.[7]

Although the policies underlying the Absolute Priority Rule and the Unfair Discrimination Prohibition are self-evident, often these two rules are confused and impair the ability of parties to reach consensus. In some circumstances, creditors may want to give equity interest holders some consideration in order to retain the old management to continue to operate and manage the reorganized business, or they may want to give a particular class of creditors additional consideration to avoid threatened litigation by that class or for other reasons. A strict construction of the cramdown requirements may lead to the conclusion that such arrangements cannot be sanctioned if there is an objecting class of creditors.

Flexibility and creativity on the part of the professionals and the courts often become imperative and necessary to affect the reorganization of distressed businesses and deal fairly with the parties in interest. Relying on a line of cases that permitted a secured creditor to share collateral proceeds with other classes of creditors, plan proponents have argued and reasoned that if an enhanced recovery to one class of claims or interest were necessary to effect the confirmation of a Chapter 11 plan and that enhanced recovery was provided by a non-debtor, *e.g.*, a vendor, from that non-debtor's recovery or property, the Absolute Priority Rule and the Unfair Discrimination Prohibition should not prevent confirmation of the plan. Thus came to be the "gifting" doctrine.[8] It developed incrementally. Initially a secured creditor shared the proceeds from its collateral security with unsecured creditors in a Chapter 7 liquidation case.[9] Then, a secured creditor shared proceeds from its collateral security with unsecured creditors in the context of a Chapter 11 plan.[10] Next, a secured creditor shared proceeds from its collateral security with equity interest holders as part of the consummation of a plan.[11] Finally, a class of unsecured creditors proposed to share with an equity interest holder a portion of its distribution in order to confirm a plan of reorganization and not

7. *See generally* Bruce A. Markell, *A New Perspective on Unfair Discrimination in Chapter 11*, 72 AM. BANKR. L.J. 227, 228 (1998) (examining the origins of the Unfair Discrimination Prohibition).

8. *See infra* Part III (tracing the history of the gifting doctrine).

9. *See infra* Part III.B (discussing Official, Unsecured Creditors' Committee v. Stern (*In re* SPM Manufacturing. Corp.), 984 F.2d 1305 (1st Cir. 1993)).

10. *See infra* Part III.C.4 (discussing *In re* Parke Imperial Canton, Ltd., 1994 WL 842777 (Bankr. N.D. Ohio 1994)).

11. *See infra* Part III.C.3 (discussing *In re* Genesis Health Ventures, Inc., 266 B.R. 591 (Bankr. D. Del. 2001)).

implicate the Absolute Priority Rule or the Unfair Discrimination Prohibition.[12] It is this most recent expansion of the gifting doctrine that is the primary subject of this Article.

Courts have generally permitted gifting arrangements by citing to the cases that have approved similar schemes, with the recognition, perhaps, that creative deal-making that enables a distressed debtor to emerge from Chapter 11 as a reorganized economic unit is a good result. Unfortunately, it appears that the U.S. Court of Appeals for the Third Circuit has squelched the creative efforts to facilitate Chapter 11 plan confirmations by its textually oriented decision in *In re Armstrong World Industries, Inc.* (*Armstrong II*).[13] In that decision the Third Circuit held that a Chapter 11 plan pursuant to which one class of unsecured creditors gifted a portion of its plan consideration to an equity interest holder while another class of unsecured creditors of co-equal priority was to receive less than 100% satisfaction of their claims violated the Absolute Priority Rule.[14] 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. The decision of the Third Circuit may encourage hold-out behavior by objecting creditors who may complain about an agreement for the transfer of consideration by one creditor class of claims or interests to junior classes, even though the transfer has no direct effect on the value to be received by the objecting creditors.

This Article discusses *Armstrong* in the context of the history of the Absolute Priority Rule and the Unfair Discrimination Prohibition. It concludes that the Chapter 11 plan in *Armstrong*, and in similar cases that used creative structuring to achieve substantial consensus as to the distribution of value, should be encouraged as consistent with both the objectives and the literal language of Chapter 11. This Article contends that the Third Circuit was wrong in its conclusion that the gifting in *Armstrong* violated the Absolute Priority Rule. Alternatively, to the extent that the Absolute Priority Rule or the

---

12. *In re* Armstrong World Indus., Inc., 320 B.R. 523 (E.D. Pa. 2004), *aff'd*, 432 F.3d 507 (3d Cir. 2005).

13. 432 F.3d 507 (3d Cir. 2005).

14. *Id.* The proposed description of warrants to the Class 12 claimant and ultimately to Armstrong Holdings, Inc. would have resulted in a distribution of the warrants to the public stockholders of Armstrong Holdings, Inc. As described in the Disclosure Statement, Armstrong Holdings, Inc., the public company, was to be liquidated. That liquidation would result in the distribution of the warrants to the Holdings' stockholders. *Id.*

Unfair Discrimination Prohibition can be read to prohibit gifting as proposed in *Armstrong*, Congress should amend the Bankruptcy Code to permit explicitly such gifting.

Part I of this Article discusses the policy and process of Chapter 11 plan confirmation. Part II of the Article discusses the history of the Absolute Priority Rule and the Unfair Discrimination Prohibition. Part III discusses the evolution of the gifting doctrine in the cases leading up to *Armstrong*. Part IV discusses the *Armstrong* decision and the reasons why it was erroneously decided.

I. BANKRUPTCY CODE POLICY AND CONFIRMATION REQUIREMENTS

The *sine qua non* of Chapter 11 reorganization is the engagement and negotiation among parties in interest with the ultimate goal of a consensual plan of reorganization.[15] The Bankruptcy Code sets the rules of the game. The rules are designed to assist the implementation of the principle of equality of distribution to creditors of equal rank in accordance with their legal rights. Nonetheless, within the statutory provisions there is elasticity for innovative solutions to accommodate parties in interest as may be necessary to achieve plan confirmation. For years creative restructuring professionals have pushed the bounds of the Bankruptcy Code to achieve the objectives of reorganization. These attempts have met with mixed results. Taking into account that bankruptcy reorganization is a zero-sum game, valuation is a critical factor for participation in the reorganization. Therefore, the party outside the value band often will seek a means to upset the agreement among other parties in the hope of extracting value for itself.[16] Dissidents will argue that the negotiated proposed plan fails to meet the confirmation requirements of the Bankruptcy Code. Adversary proceedings ensue and the issues often wind their way through the appellate courts.

Generally in all matters involving the law, where a party stands depends upon where it falls in the hierarchy of claims or interest. The individual attorneys in a relatively small bankruptcy bar often find themselves, alternatively, arguing for broad or narrow constructions of the Bankruptcy Code depending upon whether their

---

15. *See* Ali M.M. Mojdehi, *Appraising Postconfirmation Leaders: The Underutilized Confirmation Requirement*, 77 AM. BANKR. L.J. 199, 211 (2003) (noting the special emphasis Chapter 11 places on consensual plan reorganization).

16. *See generally* Kerry O'Rourke, *Valuation Uncertainty in Chapter 11 Reorganizations*, 2 COLUM. BUS. L. REV. 403, 432-33 (2005) (explaining that valuation is used as a negotiating tool due to the strong incentives for the parties to reach an agreement on valuation).

clients are in or out of the value band under the pending proposed plan. However, if the plan proponent is able to find a creative way to shift value to the dissenting party, that party's professionals will also shift from arguing for a narrow interpretation of a particular statutory provision to arguing that it should be broadly construed to permit the transferred value to be paid to its client.

Creative professionals who convince courts to accept expansive interpretations of the Bankruptcy Code can change the battlefield. This phenomenon may make consensus and an emergence from Chapter 11 more attainable. Conversely, it is argued that the seemingly straightforward policies underlying the Bankruptcy Code (equality of similarly situated parties, adherence to priorities under state law: secured creditors before senior creditors before junior creditors before equity) are often barely identifiable in the ashes of the give-and-take eggshell deal that is being proposed.

A. *Requirements for Confirmation of a Consensual Plan*

The Bankruptcy Code's requirements for confirmation of a plan are simple—at least on their face. Initially, the plan proponent must classify all creditor claims and equity interests into separate classes for purposes of voting and treatment. There are two rules for classification. First, to be in the same class, a claim or interest must be "substantially similar to the other claims or interests of such class."[17] Second, claims or interests can be placed into separate classes only if there is a "legitimate business reason" for the separate classification[18] and not for the purpose of creating an accepting class of impaired creditors (a "gerrymander").[19]

Plan classification can be a game, and gerrymandering to achieve certain results is a tool of the game, as the proponent's goal is either

---

17. 11 U.S.C. § 1122(a) (2000).

18. Boston Post Rd. Ltd. P'ship v. Fed. Deposit Ins. Corp. (*In re* Boston Post Rd. Ltd. P'ship), 21 F.3d 477, 483 (2d Cir. 1994).

19. *See* John Hancock Mut. Life Ins. Co. v. Route 37 Bus. Park Assocs., 987 F.2d 154, 159 (3d Cir. 1993) (quoting *In re Greystone III Joint Venture*, 948 F.2d 134, 139 (5th Cir. 1992)) ("The one clear rule [that] emerges from otherwise muddled caselaw on § 1122 claims classification" is that "thou shalt not classify similar claims differently in order to gerrymander an affirmative vote on a reorganization plan"); *see also* G. Eric Brunstad, Jr. & Mike Sigal, *Competitive Choice Theory and the Unresolved Doctrines of Classification and Unfair Discrimination in Business Reorganizations Under the Bankruptcy Code*, 55 BUS. LAW. 1, 24-32 (1999) (discussing how classification rules first appeared in the Bankruptcy Act, how they were interpreted by the Supreme Court, and how they evolved through the legislative process into § 1122); Linda J. Rusch, *Gerrymandering The Classification Issue in Chapter Eleven Reorganizations*, 63 U. COLO. L. REV. 163, 189-92 (1992) (explaining that, prior to the Bankruptcy Reform Act of 1978, claims of unsecured creditors could be divided into separate classes even if such claims were "substantially similar").

to obtain votes to accept the plan from all impaired classes (a "consensual" plan) or from at least one impaired accepting class (for a "cramdown" plan). Creative restructuring professionals have sought to expansively construe "substantially similar" or what is a "legitimate reason" to achieve separate classification.[20]

---

20. Most schemes for winning this classification game involve segregating consenting and dissenting creditors to create an impaired class that would vote in favor of the plan. In *In re Boston Post Road,* the debtor attempted two classification maneuvers in an effort to cramdown its plan on its largest creditor. 21 F.3d at 480. In that case the largest unsecured claim, by far, was the deficiency claim of the secured creditor, which was opposed to the debtor's proposed plan of reorganization. *Id.* at 479. The first maneuver attempted by the debtor was to classify the deficiency claim separately from the debtor's other unsecured creditors. *Id.* at 480. Creating two classes of unsecured creditors was done because the deficiency claim was substantially larger than the claims of the other unsecured creditors and if they were put into the same class it would have been "impossible for the [d]ebtor to obtain the affirmative vote of two-thirds in amount of such class as required by Section 1126(c) of the Bankruptcy Code." *Id.* However, the court ruled that the classification was impermissible, as it constituted improper gerrymandering for the purpose of disenfranchising the overwhelmingly largest creditor. *Id.* at 483. The second scheme tried by the debtor involved classifying a class of creditors as impaired even though they were going to receive better treatment under the plan than that to which they were entitled for their claims. *Id.* at 480. The debtor sought to have this class of creditors count as the single class of impaired consenting creditors required under the Bankruptcy Code. Ultimately, because this class of creditors was found to not be entitled to vote for plan confirmation (because their leases had not been assumed or rejected), the court did not need to decide whether or not a class that was not worse off could be classified as "impaired." *Id.* at 484. Impairment is discussed *infra* at note 25.

The debtor in *John Hancock* tried a similar classification tactic by creating a separate class for the unsecured deficiency claim of its undersecured creditors. *See* 987 F.2d at 156. Like in *Boston Post Road*, the court in *John Hancock* invalidated the classification stating that:

> [I]t seems clear that the Code was not meant to allow a debtor complete freedom to place substantially similar claims in separate classes. The critical confirmation requirements set out in [the Code] would be seriously undermined if a debtor could gerrymander classes. A debtor could then construct a classification scheme designed to secure approval by an arbitrarily designed class of impaired claims even though the overwhelming sentiment of the impaired creditors was that the proposed reorganization of the debtor would not serve any legitimate purpose. This would lead to abuse of creditors and would foster reorganizations that do not serve any broader public interest.

Id. at 158. However, the court recognized that, at times, it was clearly reasonable to separate similarly situated creditors into different classes. *Id.* For example, the court recalled that it had endorsed the separate classification of medical malpractice victims, employee benefit plan participants, and trade creditors in the reorganization of a medical center. *Id.* at 159 (citing *In re* Jersey City Med. Ctr., 817 F.2d 1055, 1061 (3d Cir. 1987)). Therefore, the classification game is about making the gerrymandering look reasonable enough that it could be approved by the court. For a court, like the one in *John Hancock*, that would mean that "each class must represent a voting interest that is sufficiently distinct and weighty to merit a separate voice in the decision whether the proposed reorganization should proceed." *Id.* The debtor in that case was unable to persuade the court that either of its proffered justifications for separate classification (that the deficiency claim entitled the secured creditors to unique rights and that combining the unsecured creditors together would give too much power to the deficiency claim) were sufficient reasons to

Once the claims and interests are classified, the plan proponent solicits the acceptance of votes from all "impaired" classes entitled to vote on the plan through the dissemination of a court approved "disclosure statement" and ballots to all holders of claims and interests in such classes.[21] A class is unimpaired if the plan (i) "leaves unaltered the legal, equitable, and contractual rights to which such claim or interest entitles the holder of such claim or interest"[22] or (ii) cures any defaults, reinstates the maturity of the pre-petition claim or interest, compensates the holder for any damages, and does not otherwise alter the legal, equitable, or contractual rights to which such claim or interest entitles the holder.[23] Impairment (or "artificial impairment") is another area in the playground of creative restructuring professionals because only impaired classes are entitled to vote on the plan[24] and, more importantly, to confirm a plan, at least one impaired class of claims must vote to accept the plan (without including acceptances by an insider).[25]

---

approve the classification. *Id.* at 161.

Other courts have been more receptive to creative classification, even when the result is plan confirmation over an objecting creditor. *See, e.g.*, WHBA Real Est. Ltd. P'ship v. Lafayette Hotel P'ship (*In re* Lafayette Hotel P'ship), 227 B.R. 445, 449 (S.D.N.Y. 1998) (holding that "reasonable grounds existed for placing API's unsecured claim into its own class given API's significant non-creditor interests relating to the Debtor's reorganization and API's continuous funding obligations under the Plan").

21. A disclosure statement is the bankruptcy equivalent of an SEC registration statement. It is impermissible to solicit acceptances or rejections of a plan without a disclosure statement approved by the court as containing "adequate information." 11 U.S.C. § 1125(b) (2000). Adequate information is defined as "information of a kind, and in sufficient detail, as far as is reasonably practicable in light of the nature and history of the debtor and the condition of the debtor's books and records, that would enable a hypothetical reasonable investor typical of holders of claims or interests of the relevant class to make an informed judgment about the plan . . . ." 11 U.S.C. § 1125(a).

22. 11 U.S.C. § 1124(1).

23. 11 U.S.C. § 1124(2).

24. *See* 11 U.S.C. § 1126(f).

> [A] class that is not impaired under a plan, and each holder of a claim or interest of such class, are conclusively presumed to have accepted the plan, and solicitation of acceptances with respect to such class from the holders of claims or interests of such class is not required.

11 U.S.C. § 1126(f); *see also* 11 U.S.C. § 1129(a)(10) (stating that the court can confirm a plan only "[i]f a class of claims is impaired under the plan, at least one class of claims that is impaired under the plan has accepted the plan, determined without including any acceptance of the plan by any insider").

25. Because impairment is such a strict test, any alteration in a creditor's treatment, even a token alteration or an improvement, is considered an impairment. *See* L & J Anaheim Assocs. v. Kawasaki Leasing Int'l (*In re* L & J Anaheim Assocs.), 995 F.2d 940, 942 (9th Cir. 1993) (noting Congressional intent to define impairment in "the broadest possible terms"). As such, creative debtors and their attorneys have discovered that they can create a consenting impaired class by isolating otherwise consenting but unimpaired creditors into a separate class, then adjusting those creditors' recovery, making them impaired ever-so-slightly and thus eligible to vote.

After the plan proponent solicits votes, it must demonstrate that it has satisfied the thirteen requirements of section 1129(a) of the Bankruptcy Code.[26] Among those provisions are the voting requirements. First, as noted, section 1129(a)(10) provides that at least one class of impaired claims must have voted to accept the plan (without including the votes of insiders). Second, section 1129(a)(8) provides that every class must either (i) be unimpaired or (ii) have accepted the plan. A class of claims has accepted the plan if creditors holding at least (i) two-thirds in amount and (ii) one-half in number of the allowed claims in the class who have *voted* on the plan have voted to accept the plan.[27]

Although nothing in the Bankruptcy Code prohibits such behavior, courts have found it inequitable and have deemed such "artificial impairment" impermissible; however, courts have been divided on how much alteration in recovery should be considered actual impairment. *See* Daniel J. Carragher, *News at 11: Artificial Impairment Revisited*, 24-1 AM. BANKR. INST. J. 26 (Feb. 2005) (commenting on the artificial impairment debate within the context of the Third Circuit's opinion in *In re* Combustion Eng'g Inc., 391 F.3d 190 (3d Cir. 2004)).

Thus, some courts have allowed mere token alterations to satisfy section 1129(a)(10) regardless of the debtor's motivation or the artificial nature of the impairment. *See In re* Duval Manor Assocs., 191 B.R. 622, 626-29 (Bankr. E.D. Pa. 1996) (allowing for impairment of the barest imaginable degree to satisfy section 1129(a)(10), including a slight delay in payment of half of the recovery amount); *In re* Witt, 60 B.R. 556 (Bankr. N.D. Iowa 1986) (considering payment of $1,600.00 under the plan as opposed to $1,675.00 owed as appropriate impairment); Conn. Gen. Life Ins. Co. v. Hotel Assocs. of Tucson (*In re* Hotel Assocs. of Tucson), 165 B.R. 470, 474-75 (B.A.P. 9th Cir. 1994) (finding a thirty-day delay in payment proper impairment for § 1129(a)(10) but allowing for the motivation behind such token impairment to be considered in looking at the good faith requirement).

In contrast, other courts have taken a hard line against "artificial impairment" by not allowing it for purposes of obtaining an impaired consenting class under § 1129(a)(10). These courts have attempted to draw the line between impermissible and permissible impairment. For example, one court held that "[a] class is artificially impaired if a debtor intentionally alters the class members' rights in order to manipulate the voting process, but it is legitimately impaired if the creditors' rights are altered for a proper business purpose." Beal Bank, S.S.B. v. Waters Edge Ltd. P'ship, 248 B.R. 668, 691 (D. Mass. 2000); *see* Windsor on the River Assocs. Ltd. v. Balcor Real Est. Fin. Inc. (*In re* Windsor on the River Assocs. Ltd.), 7 F.3d 127, 131 (8th Cir. 1993) (holding that clear artificial impairment evidenced by the availability of an alternative plan that would leave only the dissenting class impaired was not permissible because, "[t]o allow manipulation of claims in a reorganization proceeding under Chapter 11 would be contrary to the purpose of the provisions of the bankruptcy code."); *In re* Lettick Typografic, Inc., 103 B.R. 32, 39 (Bankr. D. Conn. 1989) (finding that, where the debtor's plan delayed payment to a consenting creditor by two weeks, "[w]hile the debtor may have achieved literal compliance with § 1129(a)(10), this engineered impairment so distorts the meaning and purpose of that subsection that to permit it would reduce (a)(10) to a nullity").

26. The plan proponent carries the burden of satisfying each requirement by a preponderance of the evidence. Heartland Fed. Sav. Ass'n Enters. v. Briscoe Enters. Ltd. II (*In re* Briscoe Enters. Ltd. II), 994 F.2d 1160, 1164-65 (5th Cir. 1993).

27. 11 U.S.C. § 1126(c). A class of interest has accepted the plan if interest holders holding at least two-thirds in amount of the allowed interests in the class who have voted on the plan have voted to accept the plan. 11 U.S.C. § 1126(d).

B. Requirements for Cramdown: Unfair Discrimination Prohibition and Absolute Priority Rule

While section 1129(a) sets forth the requirements of a consensual plan (i.e., one in which all impaired classes accept the plan), section 1129(b) permits the plan to be confirmed if requested by the plan proponent, via "cramdown" if all the requirements of section 1129(a) other than section 1129(a)(8) (acceptances by all impaired classes) have been satisfied. Specifically, section 1129(b)(1) of the Bankruptcy Code provides that, if all requirements of section 1129(a) other than section 1129(a)(8) are met and the plan proponent has requested application of section 1129(b), the court shall confirm the plan if it meets two requirements as to each impaired class of claims or interests that has not accepted the plan. First, it cannot "discriminate unfairly." Second, it must be "fair and equitable." These two "cramdown" prerequisites are the Unfair Discrimination Prohibition and the Absolute Priority Rule, respectively.

Because the Unfair Discrimination Prohibition and the Absolute Priority Rule are set forth in section 1129(b), they only apply when confirmation of a non-consensual plan is requested. Therefore, a plan that discriminates unfairly or does not comply with the Absolute Priority Rule is confirmable if the classes that are discriminated against vote to accept the plan or the classes of higher priority who are not paid in full vote to accept the plan despite a return being provided to junior classes.[28] As an initial matter, because it is the exception that equity is unimpaired (and indeed, equity usually does not participate in the reorganization value, it is generally deemed to have rejected the plan),[29] a plan proponent will always have to use cramdown as to classes of equity interests. However, as described below, compliance with absolute priority and lack of unfair discrimination is relatively easy to establish when equity is the only impaired rejecting class. Cramming down a class of creditors, particularly an unsecured class of creditors, is the more interesting scenario.

---

28. *See In re* Drimmel, 135 B.R. 410, 414 (D. Kan. 1991) (stating "the absolute priority rule need not be satisfied if there is unanimous consent of the creditor classes . . ."); Herbert Constr. Co., Inc. v. Greater N.Y. Sav. Bank (*In re* 455 CPW Assocs.), 1999 WL 675972, at *4 (S.D.N.Y. 1999) (overruling objection based on Absolute Priority Rule because plan had consent of all creditor classes).

29. Section 1126(g) provides that "a class is deemed not to have accepted a plan if such plan provides that the claims or interests of such class do not entitle the holders of such claims or interests to receive or retain any property under the plan on account of such claims or interests."

The Bankruptcy Code does not provide any guidance on the Unfair Discrimination Prohibition, and as discussed in Part III below, the case law has not set forth a uniform standard for determining when the Unfair Discrimination Prohibition has been violated. Its purpose, however, is fairly clear in light of the classification rules. Because the Bankruptcy Code grants debtors some flexibility in how it allocates its creditors into classes,[30] this flexibility presents debtors with the opportunity to "stack the deck" for voting purposes. The Unfair Discrimination Prohibition was developed to ensure that (non-consenting) creditors were not being unfairly classified, isolated from similarly situated creditors, and treated poorly relative to those similar creditors (or favored creditors were not being similarly isolated for the purposes of some sort of unjustified bonus recovery).

In contrast to the Unfair Discrimination Prohibition, the Bankruptcy Code explicitly sets forth the requirements for the Absolute Priority Rule. There are three variants on the Absolute Priority Rule depending on whether the objecting class, which is being crammed down under the plan, consists of secured creditors, unsecured creditors, or equity holders. This Article focuses on the Absolute Priority Rule as applied to an objecting class of unsecured creditors. However, it is worth noting that to cramdown a class of secured creditors, the plan must provide for one of three scenarios set forth in section 1129(b)(2)(A):

> (i)(I) that [the secured creditors in the class (I)] retain the liens securing such claims . . . to the extent of the allowed amount of such claim; and (II) that each holder of a claim of such class receive . . . deferred cash payments totaling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder's interest in the estate's interest in such property;[31]

---

30. *See generally* 11 U.S.C. § 1122. For example, debtors can also allow creditors of identical priority to be assigned to different classes even if those classes will receive different treatment under the plan. Brunstad & Sigal, *supra* note 19, at 32-37. Brunstad and Sigal observe that the case law is split on exactly how flexible the classification rules are. Generally they found that judges restrict separate classification of creditors with parity by either the "nature of the claim," "nature of the claimant," "business justification," "general fairness," "reasonableness," or they do not enforce any substantial restrictions. *Id.*

31. This provision requires that a crammed-down secured lien holder retain its lien on the attached collateral up to the amount of the allowed secured claim (the portion of the secured claim that is not allowed is considered unsecured because it is not covered by the value of the collateral) and also receive present value of the allowed claim through deferred cash payments. *See generally* Joel L. Tabas, *The § 1111(b) Election: A Decision-making Framework*, 23-1 AM. BANKR. INST. J. 36 (2004) (providing an analytical framework for determining whether making an election under § 1111(b) would be in the unsecured creditor's best interest); David G.

> (ii) for the sale . . . of any property that is subject to the liens securing the [secured creditors'] claims, free and clear of such liens, with the liens attaching to the proceeds of the sale, and the treatment of the liens on the proceeds under clause (i) or (iii) of this subparagraph;[32] or
>
> (iii) for the realization by [the secured creditors] of the indubitable equivalent of such claims.[33]

To cramdown a class of unsecured creditors, section 1129(b)(2)(B) requires that the plan must either (i) pay those creditors in full (technically provide that all creditors in the class receive "property of a value, as of the effective date of the plan, equal to the allowed amount of such claim") or, as is more common, (ii) "the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property [from the debtor's estate]."[34]

Epstein, *Don't Go and Do Something Rash About Cram Down Interest Rates*, 49 ALA. L. REV. 435, 439-43 (1998) (discussing cramdown provisions of secured claims).

32. This provision is enforced if the collateral that is securing the allowed claim of the secured creditor is sold under a plan. To protect the secured creditor, the code requires that the secured creditor's lien carries over to the proceeds of the sale of the collateral and that this new lien remains protected by one of the other provisions of § 1129(b)(2)(A). *See* Arnold & Baker Farms v. United States *ex rel.* United States Farmers Home Admin. (*In re* Arnold & Baker Farms), 85 F.3d 1415, 1420 (9th Cir. 1996).

33. Here a court can force a secured creditor to exchange its lien for its indubitable equivalent. The hallmark of indubitable equivalency is not clearly defined and courts have been allowed to determine as a matter of fact what exactly it means. *In re* James Wilson Assocs., 965 F.2d 160, 172 (7th Cir. 1992).

34. "The [Absolute Priority Rule] has three components: (1) the identification of junior claims or interests; (2) the identification of any property retained by the holders of such claims or interests; and (3) the determination whether the property is retained 'on account of' a junior claim or interest." *In re* 4 C Solutions, Inc., 302 B.R. 592, 596 (Bankr. C.D. Ill. 2003) (citing *In re* Wabash Valley Power Ass'n, Inc., 72 F.3d 1305, 1313 (7th Cir. 1995)). Thus, a plan that proposed to provide the owners of a farm in Chapter 11 with a continuing interest despite that an objecting class of unsecured creditors was not paid in full violated the Absolute Priority Rule. Norwest Bank Worthington v. Ahlers, 485 U.S. 197, 202-03 (1988); *see In re* Drimmel, 135 B.R. 410, 412 (D. Kan. 1991) (noting that the Absolute Priority Rule gives "unsecured creditors [] an absolute priority over equity interests to receive money or property until the unsecured creditors are paid in full"). In *4 C Solutions*, the court held that distribution of equity in the reorganized debtor under a plan of reorganization to the majority shareholder of the debtor's parent, where an impaired class of claims rejected the plan, violated the Absolute Priority Rule. 302 B.R. at 600. "The common thread running through cases involving the Absolute Priority Rule is a refusal to allow prior equity owners to trade on their 'insider' status to acquire new equity for less than its value." *Id.* at 596 (citing *In re* Wabash Valley Power Ass'n, Inc., 72 F.3d 1305, 1315 (7th Cir. 1995).

C. Creative Strategies for Avoiding The Unfair Discrimination Prohibition and Absolute Priority Rule

As applied to an objecting class of unsecured creditors, the Unfair Discrimination Prohibition and the Absolute Priority Rule appear fairly straightforward. The plan cannot provide the objecting class of creditors a distribution that is substantially different from other co-equal classes (horizontal parity) and the plan cannot provide any junior class of claims or interests below the objecting class (generally, equity holders) any distribution (vertical justice). Notwithstanding these seemingly straightforward requirements, innovative structures have been created to soften the hard edges of the Absolute Priority Rule and the Unfair Discrimination Prohibition to enable the reorganization of the debtor.

1. The New Value Corollary

A plan will occasionally provide a distribution to some or all equity holders (despite the existence of an objecting class of creditors) on the grounds that the distribution is not being given to the shareholder "on account of" the equity interest, but was given for "new value" being contributed by the equity holder. The New Value Corollary is also known as the "new value exception." When a shareholder obtains an interest in the reorganized entity as a result of infusing new value, the interest is not truly "on account of" the old shares.[35] Rather, it is "on account of" the new value. As such, the situation is not really an exception to the Absolute Priority Rule. The new investment falls outside of the scope of the Absolute Priority Rule.

The "New Value Corollary" was addressed by the United States Supreme Court in *Bank of America National Trust and Savings Association v. 203 North LaSalle Street Partnership*.[36] In that case, despite the arguments presented, the Supreme Court side-stepped the issue of whether the New Value Corollary survived the enactment of the Bankruptcy Code. The Supreme Court did say that if the New Value Corollary exists, the opportunity to receive a distribution on account of new value must be subject to a market test (i.e., offered to others

---

35. What is prohibited by the Absolute Priority Rule is the receipt or retention under the plan of any property by a junior stakeholder *on account of* its claim or interest.

36. 526 U.S. 434 (1999).

and not made exclusive to old shareholders).[37] The New Value Corollary is discussed in more detail below.[38]

2. The Gifting Strategy (Armstrong)

Another structure designed to achieve plan confirmation, and the topic of this Article, has been to argue that the additional consideration being distributed under the plan to one class of unsecured creditors over another (in seeming violation of the Unfair Discrimination Prohibition) or the consideration being received by equity when an objecting class of creditors is not being paid in full (in seeming violation of the Absolute Priority Rule) is not property of the debtor's estate and is instead being provided or "gifted" or "contributed" consensually by other creditors. Under the most attenuated scenario, the distribution is deemed to be given by the debtor to an accepting class of creditors and, by accepting the plan, that class is deemed to waive that particular distribution in favor of the junior class. Under this argument, the Absolute Priority Rule does not apply to the distribution, because it is being given by non-debtors who have a "right" to do whatever they want with their plan distribution, i.e., their property.

This is exactly what the debtor and its professionals attempted to do in *Armstrong*.[39] As described below, under the plan negotiated among many disparate groups' representatives, including the debtor, the general unsecured creditors' committee, the asbestos personal injury claimants' committee, and others, it was agreed that an equity holder would receive a distribution of warrants in the reorganized debtor.[40] However, to effectuate the agreement reached if the general unsecured creditors rejected the plan, the plan provided that in such case, the warrants would not be issued by the debtor to equity.[41] Instead, the warrants would be technically distributed by the debtor to the class of asbestos personal injury claimants,[42] which the debtor knew would accept the plan. The plan further provided that by accepting the plan, the class of asbestos personal injury claimants would be deemed to have agreed to waive receipt of the warrants and contribute them to the equity holder.[43] Although the end result was

37. *Id.* at 457.
38. *See infra* Part II.A.9.
39. *In re* Armstrong World Indus., Inc. (*Armstrong II*), 432 F.3d 507 (3d Cir. 2005).
40. *In re* Armstrong World Indus., Inc. (*Armstrong I*), 320 B.R. 523, 525-26 (D. Del. 2005).
41. 432 F.3d at 509.
42. *Id.*
43. 320 B.R. at 526 & n.8.

the same as if the debtor had provided the warrants directly to the equity holder, because the plan structure provided for the distribution of the warrants to a class of creditors equal in priority to the objecting general unsecured creditors, with that class contributing the warrants to the equity holder, the debtor believed that the Absolute Priority Rule did not apply.

While the plan in *Armstrong* might appear extreme to an observer inexperienced with the evolution of the Bankruptcy Code since 1978, the *Armstrong* plan was merely the next step in a series of singularly minor but cumulatively major steps since the First Circuit Court of Appeals issued its influential decision in *Official, Unsecured Creditors' Committee v. Stern (In re SPM Manufacturing Corp.)*.[44] *SPM* did not involve the Absolute Priority Rule. In *SPM*, the secured creditor in a Chapter 7 case agreed to give a portion of the proceeds received from the liquidation of its collateral security to general unsecured creditors in exchange for such creditors' agreement to an orderly non-litigious liquidation of the debtor's estate.[45] The First Circuit condoned this agreement, over the objection of a taxing authority, which would have had Bankruptcy Code priority over the general unsecured creditors as to any distribution of proceeds from the debtor's unencumbered property.[46] In oft-quoted language, the court noted "creditors are generally free to do whatever they wish with the bankruptcy dividends they receive, including to share them with other creditors."[47]

Subsequently, many courts relied on this quote from *SPM* to hold that various gifting arrangements were appropriate notwithstanding the Unfair Discrimination Prohibition or the Absolute Priority Rule.[48] With a few exceptions, courts have generally accepted the extensions of *SPM*—from the Chapter 7 context (where the Unfair Discrimination Prohibition and the Absolute Priority Rule do not apply) to Chapter 11 plans (where they do apply), from gifting by secured creditors (whose interest in the collateral is undisputed) to gifting through other unsecured creditors (who receive the distribution only because the debtors agreed to provide it to them), and so on. Courts have generally only refused to apply *SPM* upon finding inappropriate attempts to circumvent protective provisions of the Bankruptcy Code. Nevertheless, the debtor in *Armstrong* went just

44. 984 F.2d 1305 (1st Cir. 1993).
45. *Id.* at 1308.
46. *Id.* at 1313.
47. *Id.*
48. *See infra* Part III.

a step further in proposing a plan providing for alternate distribution schemes for the warrants to get to the equity holder via the "gifting" mechanism only if the class of general unsecured creditors rejected the plan.

Faced with what it believed was brazen flouting of the Absolute Priority Rule (to get to an impermissible end), the District Court for the District of Delaware, in *Armstrong I*, rejected the recommendations of the Bankruptcy Court and denied confirmation of the plan.[49] The Third Circuit concurred.[50] According to the district court, the concept of gifting had gone too far. That court held that while *SPM* may have been appropriate in its limited factual circumstances, the extensions of *SPM* leading up to *Armstrong* generally were not.[51] In the court's view, both the language and legislative history of the Absolute Priority Rule were clear that equity was to get no distribution on account of its equity interests—period.[52] In a fairly short opinion, the Third Circuit adopted the reasoning of the district court;[53] clever plan drafting and skillful creative negotiation by the bankruptcy professionals be damned. From the district court's perspective the plain meaning of the code provisions could not be disregarded on the basis that reorganization is the primary objective of Chapter 11.

The *Armstrong* decision marks a triumph of form over substance and may chill creative solutions to complex multi-party negotiations. The result of this decision is that Chapter 11 plan negotiations may be more difficult, leading to longer periods spent in Chapter 11 by debtors (contrary to the goals of Chapter 11) and more contentious confirmation battles.[54]

---

49. *See Armstrong I*, 320 B.R. at 540 ("Bluntly put, no amount of legal creativity or counsel's incantation to general notions of equity or to any supposed policy favoring reorganizations over liquidation supports judicial rewriting of the Bankruptcy Code. Accordingly, the New Warrants distribution to the Equity Interest Holders under the Fourth Amended Reorganization Plan violates 11 U.S.C. § 1129(b)(2)(B)(ii). The Plan, therefore, cannot be confirmed.").

50. *See Armstrong II*, 432 F.3d at 514 (rejecting the idea that there are no limits on what creditors may do with the bankruptcy proceeds they receive).

51. *Armstrong I*, 320 B.R. at 539-40.

52. *Id.* at 536.

53. *Armstrong II*, 432 F.3d at 514.

54. Even the Third Circuit recognized that, although it was affirming the decision to deny plan confirmation, "the longer that the reorganization process takes, the less likely that the purposes of Chapter 11 (preserving the business as a going concern and maximizing the amount that can be paid to creditors) will be fulfilled." *Id.* at 518. While this statement is not always true (*i.e.*, sometimes quick fixes minimize value), it is generally true. Moreover, it is always a shame for a company to linger in Chapter 11 incurring professionals fees and unable to move on simply due to a technicality that one group is relying on for hold up value.

II. HISTORY OF THE ABSOLUTE PRIORITY RULE AND UNFAIR DISCRIMINATION PROHIBITION

To evaluate the merits of *Armstrong*, one must examine the roots and policy behind the Absolute Priority Rule and the Unfair Discrimination Prohibition.

A. *The Absolute Priority Rule*

1. *Equity receiverships*

The history of the Absolute Priority Rule takes us back to the nineteenth century when the economic distress of the railroads was pervasive.[55] As the railroad industry grew, from the Civil War through World War II, railroads were organized with highly leveraged, unworkable capital structures.[56] As a result of an inability to generate sufficient operating revenue to service its debt, due in part to cutthroat competition, the railroad industry in the United States began to suffer widespread decline and insolvency.[57] By 1915, almost half of all railroads had defaulted on their debt obligations at one time or another and required some sort of financial restructuring.[58]

In light of the size and importance of railroads and the interstate dimension of their operations, federal courts responded to the crisis by creating a form of reorganization known as the equity receivership.[59] The judicially created equity receivership is analogous to modern-day Chapter 11.[60] The equity receivership was a friendly,

---

55. *See* John D. Ayer, *Rethinking Absolute Priority After* Ahlers, 87 MICH. L. REV. 963, 969-70 (1989) (recapitulating the early history of the absolute priority rule).

56. *See* Stephen J. Lubben, *Railroad Receiverships and Modern Bankruptcy Theory*, 89 CORNELL L. REV. 1420, 1433-35 (2004) (noting that the decline of the railroad industry was made worse by three trends: decline in availability of foreign investment, an increased reliance on debt financing, and an increased use of internal funding); Ayer, *supra* note 55, at 970.

57. *See* Lubben, *supra* note 56, at 1428-29 (attributing the decline in railroads to low net revenues that resulted from cutthroat competition in the form of extreme rate cuts and "continued financial rot," by which the author appears to imply corrupt management); Ayer, *supra* note 55, at 970.

58. *See* Bruce A. Markell, *Owners, Auctions, and Absolute Priority in Bankruptcy Reorganizations*, 44 STAN. L. REV. 69, 74 (1991) (explaining that the ineffectiveness of foreclosure as a remedy for defaulted loans gave rise to the alternate remedy of reorganization).

59. *See* Lubben, *supra* note 56, at 1441; DAVID A. SKEEL, JR., DEBT'S DOMINION, 56-57 (Peter Dougherty ed., Princeton Univ. Press 2004) (2001) (explaining that courts created the equity receivership by combining two common-law principles: the court's power to appoint receivers to preserve the value of a debtor's property and the mortgage holder's right to foreclose on property when the debtor defaults); *see also* Markell, *supra* note 58, at 74-75 (asserting that the receivership also emerged out of necessity—it was necessary to reorganize the business as a going concern because no one could afford to buy the railroad assets in a typical disclosure proceeding).

60. *See* SKEEL, *supra* note 59, at 58 (noting that appointing a receiver served

cooperative process commenced by a creditor filing a petition (a "creditor's bill") in federal court asking the court to exercise its equity jurisdiction to appoint a receiver to administer the insolvent debtor's assets.[61] The company, which was required to file an answer, generally admitted to the allegations in the petition and consented to the appointment of the receiver.[62] The court would then grant the petition and appoint a receiver.[63]

Consistent with the appointment of the receiver, the federal court would issue an injunction staying actions against the railroad and its property.[64] The receiver would operate and manage the railroad until the various stakeholders, who usually formed themselves into protective committees, negotiated a plan of reorganization with the assistance of a reorganization manager.[65] The plan would provide for the sale of the railroad property with an upset price to a new company that would continue to operate the railroad.[66] Usually the secured creditors would end up owning the new railroad company and some proceeds of the sale would be distributed under the plan.[67]

Often, the former owners of the railroad would retain an equity interest in the reorganized company despite the failure to satisfy creditors in whole.[68] This happened for several reasons. Sometimes, the secured creditors agreed to buy off the equity to avoid frivolous

---

largely the same purpose as an automatic stay issued in a Chapter 11 proceeding, in that most creditors had to cease their collection attempts). *But see* Lubben, *supra* note 56, at 1424-25 (stating that the equity receiverships were more like workouts than Chapter 11, as they were limited to modest adjustments to the company's capital structure).

61. *See* Ayer, *supra* note 55, at 970; Lubben, *supra* note 56, at 1441-42 (clarifying that the petition had to be filed by an unsecured creditor to ensure that the receiver obtained control over all of the debtor's assets, not just those subject to the secured creditor's liens). State court receiverships did exist and were common, but large creditors preferred federal jurisdiction, which they would obtain through diversity jurisdiction. *See id.* at 1442.

62. *See* Ayer, *supra* note 55, at 970; Lubben, *supra* note 56, at 1442.

63. *See* Lubben, *supra* note 56, at 1442 (noting that courts sometimes appointed multiple receivers). Thus, although the court often appointed an officer or other insider of the company to be the receiver, it would generally also appoint an independent co-receiver to guard against self-dealing. *See id.*

64. *See* SKEEL, *supra* note 59, at 58 (remarking that freezing most of the railroad's debt obligations gave the parties "breathing space" to design a reorganization plan).

65. *See id.* (noting that the committees could take months, or even years, to negotiate a reorganization plan).

66. *See* Lubben, *supra* note 56, at 1444 (pointing out that in most of these sales, the new company was comprised of the reorganization committee).

67. *See* Ayer, *supra* note 55, at 970; Lubben, *supra* note 56, at 1445; Markell, *supra* note 58, at 75-76.

68. *See* Lubben, *supra* note 56, at 1445 (describing how the former shareholders would pay a cash assessment that provided much needed liquidity to the reorganized railroad in exchange for stock in the new entity).

and time-consuming objections to their scheme.[69] Other times, either the old equity holders were the best source of cash that was needed for the reorganization, or the secured creditors believed the old owners were necessary to manage the reorganized enterprise.[70] In yet other cases, the debtor was controlled by management insiders who owned both bonds and stock.[71]

All of these situations involved collusion between the debtor and the secured creditors. At first, the secured creditor would initiate the judicial proceeding, and the debtor would consent to the appointment of a receiver.[72] Later the fiction of a controverted proceeding was dispensed with and the debtor commenced with equity receivership by direct petition.[73] Generally, the appointed receiver would sell the railroad company assets to a "new" entity for less than the amount needed to cover the secured debt, and sometimes less than the actual value of the assets.[74] Importantly, the investors in the new entity were generally the stockholders and secured bondholders of the old company.[75] The secured bondholders could "credit bid" the face amount of their securities.[76] For a contribution (or "assessment") in the new entity, the old equity would end up retaining an interest in the assets worth much more than the size of the contribution.[77]

---

69. *See* Ayer, *supra* note 55, at 971.

70. *See* Markell, *supra* note 58, at 75-76 (explaining that because the old equity holders were often also managers of the railroad, they had knowledge of how to run the entity and they were also willing to invest new cash to save their former investment).

71. *See* Ayer, *supra* note 55, at 971 (noting that it did not matter to these insider-managers if they lost on bonds, but gained on stock). Lubben describes the railroad industry of the era as extremely corrupt. "Most of the great [railroads] had been built by fraudulent construction companies, and if perchance a [rail]road had been honestly built, there was always an opportunity to correct this oversight by disreputable, but highly profitable, manipulation of its securities." Lubben, *supra* note 56, at 1427 (quoting E. G. CAMPBELL, THE REORGANIZATION OF THE AMERICAN RAILROAD SYSTEM 1893-1900 15 (1938)). He cites several examples, including the use of management-owned companies to do the construction and accounting fraud. *Id.*

72. *See* Ayer, *supra* note 55, at 970.

73. *See* Lubben, *supra* note 56, at 1441 n.106 (citing Wabash, St. Louis & Pac. Ry. Co. v. Cent. Trust Co., 22 F. 272, 272-75 (C.C.E.D. Mo. 1884) as the first case in which the debtor initiated its own receivership).

74. Ayer, *supra* note 55, at 970.

75. *Id.*; Lubben, *supra* note 56, at 1445.

76. *See, e.g.*, Louisville Trust Co. v. Louisville, N.A. & C. Ry. Co., 174 U.S. 674, 683 (1899) (acknowledging the general rule that secured creditors were the most likely purchasers in a foreclosure sale because of the high cost of railroads); *see also* Lubben, *supra* note 56, at 1444-45 (recognizing that collusion among bankers may have also prevented outside purchasers from obtaining financing to purchase the assets).

77. *See* Ayer, *supra* note 55, at 970-71 (explaining that while the insider bondholders lose on their secured bond claims by permitting equity to participate, they would benefit on their equity interests, all at the expense of non-insider

The old secured creditors would receive securities in the new company.[78] Sometimes only a subset of the old secured creditors would participate in the reorganized entity, with the other bondholders getting paid in cash from the sale of the assets.[79] As explained below, until the Unfair Discrimination Prohibition was developed, it was possible to treat some secured creditors differently from others, and Unfair Discrimination Prohibition was developed to prevent such outcomes.[80]

Most of the time, however, all secured creditors had an incentive to participate in the sale or otherwise receive a lesser recovery.[81] Specifically, the court would set an "upset price," which was the minimum price for which the railroad's assets could be sold.[82] Claimants were provided an opportunity to either participate in the sale or receive a cash distribution at the upset price.[83] The upset price was set intentionally low to encourage creditors to agree to the plan.[84] Thus, old secured creditors would accept the distribution that provided potentially less than their full secured debt, but with an opportunity to realize higher returns from future operations. The alternative of non-acceptance was a low cash payout.[85] Because the assets were sold for less than the secured debt, unsecured creditors were squeezed out and generally received nothing.[86]

---

bondholders and trade creditors); Markell, *supra* note 58, at 76 (describing how the foreclosure sale made the railroad's assets unreachable by unsecured creditors). Lubben states that the assessment paid by stockholders, though smaller than the value of the stock, was actually high enough to exclude smaller stakeholders, such as unsecured creditors and minority stockholders, who could not afford the assessment. *See* Lubben, *supra* note 56, at 1446.

78. *See Lubben, supra* note 56, at 1445 (noting that existing shareholders would receive preferred stock in the new corporation or subordinated notes in exchange for paying an assessment).

79. *See* Markell, *supra* note 7, at 230 (explaining that the minority groups of secured creditors often opted for cash proceeds from the sale rather than participation in the new entity).

80. *See infra* notes 207-44.

81. *See* Ayer, *supra* note 55, at 970 (emphasizing that the price of the new entity was consistently less than the entity's actual worth); Lubben, *supra* note 56, at 1450 (likening the upset price to an auction reserve).

82. *See* Lubben, *supra* note 56, at 1450 (noting that the court set the upset price, in part to prevent parties from conspiring to pay a price that would defeat the just claims of other secured creditors).

83. *Id.*

84. *See id.* (suggesting that the upset price began as a tool to protect minority creditors, but evolved into a tool to force reluctant creditors to agree to the plan).

85. *See id.* (remarking that most bondholders realized that the securities were worth more than the cash proceeds from the sale).

86. *See* Ayer, *supra* note 55, at 970 (concluding that unsecured creditors were "eliminated" from the transaction); Markell, *supra* note 58, at 76 (explaining that the mortgagor had first priority over the old railroad entity's assets, leaving nothing for remaining creditors). Although without statutory authority, there was no formal discharge of the unsecured debt, the effect was the same as a discharge, as the

In general, the equity receiverships were not wholly successful.[87] Just as the secured creditors were often compelled to provide the old owners with more than they were arguably entitled to, the negotiation usually resulted in the reorganized company taking on a debt burden larger than it could handle.[88] Consequently, many railroad companies that ended up in equity receiverships availed themselves of the process multiple times.[89]

2. Boyd *and the development of the "fixed principle"*

While the collusion between the old owners and the secured creditors led each side to extract as much value as possible from the assets, often at the expense of the health of the company, one commonality that existed in the equity receiverships was the elimination of any recovery for the unsecured creditors.[90] The apparent wrongfulness of equity retaining an interest in the reorganized railroad while unsecured creditors received nothing lead to the establishment of the Absolute Priority Rule, then called the "fixed principle."[91]

Although courts adjudicating railroad cases had long recognized the concept that an equity holder's interest in property of a debtor's

---

unsecured creditors were left to pursue their claims against a shell company with no assets (the former railroad). *See* Lubben, *supra* note 56, at 1444-45.

87. Lubben, *supra* note 56, at 1423.

88. *Id.*

89. *See id.* Lubben found that,

> having undergone a receivership before World War I made a railroad more than two-and-a-half times (or 150%) more likely to undergo another receivership or bankruptcy after the War. The average railroad that organized under a receivership subsequently failed at a rate more than twice as high as railroads that had never gone through a receivership and almost three times as high as modern Chapter 11 debtors.

Id. According to Lubben, the receivership acted as a safe harbor of sorts for railroads during economic downturns. *Id.* at 1451. When a downturn occurred, the railroad would consent to the receivership. *Id.* It would remain in operation during the downturn and emerge from receivership when the economy improved without the needed debt reductions, as those would be opposed by the secured bondholders. *Id.* at 1451-52.

90. *See* Markell, *supra* note 58, at 76 (describing how bondholders and stockholders would collude to protect their interests during the foreclosure sale and the implementation of the reorganization plan, without considering the interests of unsecured creditors).

91. *See In re* Wabash Valley Power Ass'n, 72 F.3d 1305, 1314 (7th Cir. 1995) ("In its origins, the absolute priority rule was a judicial invention designed to preclude the practice in railroad reorganizations of 'squeezing out' intermediate unsecured creditors through collusion between secured creditors and stockholders (who were often the same people).") (citing N. Pac. Ry. Co. v. Boyd, 228 U.S. 482, 482 (1913)). Markell notes that the first attacks by unsecured creditors on the receiver scheme started as fraudulent conveyance arguments, the idea being that shareholders and secured creditors were scheming to transfer assets with the intent to hinder, delay, or defraud creditors. Markell, *supra* note 58, at 76-77.

estate is subordinate to the rights of creditors,[92] the United States Supreme Court officially embraced that "fixed principle" in *Northern Pacific Railway v. Boyd*, a 5-4 decision.[93] In *Boyd*, representatives of the secured creditors (bondholders) and representatives of the stockholders agreed to a plan of reorganization, which was approved by the equity receivership court.[94] In accordance with the plan, the parties transferred property of the old railroad company (the insolvent Northern Pacific Rail*road* Company) to a new company (the newly created Northern Pacific Rail*way* Company).[95] Despite an agreement between the secured creditors and stockholders that the property being transferred had a value of $345,000,000, the price paid for the property was $61,500,000, which was $86,000,000 less than the amount of the secured debts on the company.[96] The old secured bondholders received bonds in the new company and the old equity holders received an equity interest in the Northern Pacific Railway Company.[97] Interestingly, the new railroad company was profitable, and the price of the equity securities rose after the reorganization.[98]

After the sale, a general unsecured creditor of the old company commenced an action against the new company seeking payment on his claim against the old company.[99] He argued that the sale was void because it was made in pursuance of an illegal plan of reorganization between secured bondholders and stockholders under which unsecured creditors were not paid but stockholders received value by receiving shares in the new company.[100]

The United States Supreme Court ruled in favor of the creditor, allowing him to pursue his claim against the new company in light of its ownership by the old equity holders.[101] The Court held that the equity holders and bondholders should not have been able to accomplish in a court proceeding what they could not have accomplished in a private sale.[102] The Court noted that "a transfer by

---

92. *See* Louisville Trust Co. v. Louisville, N.A. & C. Ry. Co., 174 U.S. 674, 684 (1899) ("[A]ny arrangement of the parties by which the subordinate rights and interests of the stockholders are attempted to be secured at the expense of the prior rights of either class of creditors comes within judicial denunciation.").
93. 228 U.S. 482 (1913).
94. *Id.* at 489.
95. *Id.* at 501.
96. *Id.* at 489-90.
97. *Id.* at 488.
98. *Id.* at 491.
99. *Id.* at 501.
100. *Id.*
101. *Id.* at 501-02.
102. *Id.* at 502.

stockholders from themselves to themselves [in a private sale] cannot defeat the claim of a non-assenting creditor. As against him the sale is void in equity, regardless of the motive with which it was made."[103] And, "[t]here is no difference in principle if the contract of reorganization, instead of being effectuated by private sale, is consummated by a master's deed under a consent decree."[104] Further, "[a]ny device, whether by private contract or judicial sale under consent decree, whereby stockholders were preferred before the creditor was invalid."[105] Accordingly, the new company (in the hands of the old stockholders) was subject to the existing liabilities of the old company.[106] Thus, even though the court found there was no fraud and that this was a contractual arrangement between the bondholders and the shareholders, the transfer of assets to the new Northern Pacific Railway Company with old ownership interests becoming the new equity holders subjected the new company to the unsecured debts of the old company.[107]

Interestingly, the plan proponents made an *Armstrong*-gifting-type argument that was rejected by the Court.[108] They argued that because the property was sold for less than the value of the mortgage debt, there would have been nothing left for unsecured creditors even if equity had not received a distribution.[109] Although it does not appear that it was argued explicitly that the secured creditors contributed or gifted their distribution to equity, this could have been implied.

The Court rejected this argument, noting that such an agreement with equity negatively alters the incentives that equity would otherwise have had to side with the general unsecured creditors in asserting a high value for the property:

> In saying that there was nothing for unsecured creditors the argument assumes the very fact which the law contemplated was to be tested by adversary proceeding in which it would have been to the interest of the stockholders to interpose every valid defense. If, after a trial, a sale was ordered, they were still interested in making the property bring its value, so as to leave a surplus for themselves as ultimate owners. Even after sale they could have opposed its confirmation if the bids had been chilled, or other reason existed to prevent is approval. In the present case all these tests and

103. *Id.*
104. *Id.*
105. *Id.* at 504.
106. *Id.* at 507.
107. *Id.*
108. *Id.* at 505.
109. *Id.*

> safeguards were withdrawn. The stockholders, who, in lawfully protecting themselves, would necessarily have protected unsecured creditors, abandoned the defense that the foreclosure suit had been prematurely brought. The law, of course, did not require them to make or insist upon that defense if it was not meritorious, nor does it condemn the decree solely because it was entered by consent. But the shareholders were not merely quiescent. They, though in effect defendants, became parties to a contract with the creditors, who were in effect complainants, by which, in consideration of stock in the new company, they transferred their shares in the railroad to the railway. The latter then owning the bonds of the complainant and controlling the stock in the defendant, became the representative of both parties in interest. In such a situation there was nothing to litigate, and so the demurrer to the bill was withdrawn.[110]

For this reason, the Court held the value of the assets did not matter—rather it announced a "fixed principle" that equity was never to be paid when creditors were not paid in full.[111] If equity participated when creditors were not paid in full, a presumption of collusion arose.[112] However, foreshadowing the future Court's interpretation of the "New Value Corollary," which is discussed below in more detail, the *Boyd* Court suggested that by offering the right to participate to all creditors, the plan proponents could defeat the presumption of collusion.[113]

3. Innovative structures to avoid Boyd

Even though, in prior cases, the Court had articulated the general concept that equity holders could not be paid if creditors were not paid in full, the *Boyd* decision solidified the Absolute Priority Rule as a force in reorganization practice.[114] Although the *Boyd* case sent

---

110. *Id.* at 505-06.

111. *Id.* at 507. The Court wrote,

> The invalidity of the sale flowed from the character of the reorganization agreement regardless of the value of the property, for in cases like this, the question must be decided according to a fixed principle, not leaving the rights of the creditors to depend upon the balancing of evidence as to whether, on the day of the sale, the property was insufficient to pay prior encumbrances.

Id.

112. *Id.*; *see* Markell, *supra* note 58, at 81 (noting that the presumption of collusion was sufficient to create liability of the new entity).

113. *Boyd*, 228 U.S. at 508; *see also* Markell, *supra* note 58, at 81 (characterizing this method to defeat the presumption of collusion as a procedural tool to avoid judicial involvement in evaluating the worth of the entity).

114. *See* Ayer, *supra* note 55, at 973 (arguing that, although the Absolute Priority Rule had been recognized by the Court in other cases, the facts of *Boyd*, particularly that the creditor who brought the suit had very unsympathetic facts, demonstrated

"chills of terror down the spines of the corporate reorganization bar,"[115] clever reorganization professionals developed structures to avoid its full effect.[116] Among those practices were obtaining court approval of the deal to bar later objections.[117] Others were able to convince courts that obtaining acceptance by a substantial majority of senior creditors demonstrated the fairness of the plan and were able to engineer the process to prevent dissent.[118] Certain scholars developed a theory of "relative priority," as opposed to "absolute priority."[119] Other practitioners began asserting something akin to the New Value Corollary.[120] In some of those cases, as suggested by *Boyd*, unsecured creditors were given the same option to participate as equity holders. However in general, the unsecured creditors could not afford the contribution price that sophisticated equity holders were able to pay.[121]

4. The Bankruptcy Act of 1898

The Bankruptcy Act of 1898 did not initially apply to large corporations and explicitly excepted railroads from its provisions.[122] It was not until the 1930s that Congress enacted a federal reorganization statute for large corporations as a reaction to the Great Depression that started in 1929.[123] In 1933, Congress enacted section 77 of the Bankruptcy Act for railroads and in 1934 Congress enacted section 77B of the Bankruptcy Act to apply the corporate

---

that "the Supreme Court [was] more insistent on the principle than it had been before").

115. *Id.* at 972.

116. *See id.* at 973 (remarking that the firmly established practice of reorganization lawyers were destined to overcome the Court's decree in *Boyd*); *see also* Markell, *supra* note 58, at 81 (noting that reorganizations involving the participation of equity owners remained prevalent even after *Boyd*).

117. Ayer, *supra* note 55, at 973.

118. *See id.* (indicating that managers used upset sales to quell dissent).

119. *See id.* (characterizing the relative priority theory as similar to the "share scheme" that existed before *Boyd*); *see also* Markell, *supra* note 58, at 82 ("[The theory of relative priority] did not require allocating participation rights according to the full amount of prereceivership claims. Instead, it adjusted capital structure on the basis of entitlement to future income, assuming no acceleration of senior debt. Equity holders could participate only if the projected earnings of the reorganized company exceeded pre-receivership debt service. Under the relative priority theory, therefore, shareholders who contributed new value through paid assessments could salvage at least some of their original investment.").

120. Ayer, *supra* note 55, at 973.

121. *See* Markell, *supra* note 58, at 81-82 (explaining that the creditors' purchase of the new entities' securities provided much needed capital for the railroads).

122. *See* Lubben, *supra* note 56, at 1440 (noting that the 1867 Bankruptcy Act, repealed in 1878, did not exclude railroads, and that some railroads filed under that Act).

123. *Id.*

reorganization provisions to other corporations.[124] These sections provided "the judge shall confirm the plan if satisfied that . . . it is *fair and equitable* and does not discriminate unfairly in favor of any class of creditors or stockholders and is feasible."[125] The Bankruptcy Act contained no clarification on what Congress meant by "fair and equitable."

5. Case *and the Absolute Priority Rule*

In *Case v. Los Angeles Lumber Products Co.*,[126] the United States Supreme Court held that the phrase "fair and equitable" in section 77B of the Bankruptcy Act was meant to codify the "fixed principle" (or Absolute Priority Rule) set forth in equity receivership cases like *Louisville Trust* and *Boyd*.[127] The Court noted that those cases established the "precedence to be accorded creditors over stockholders in reorganization plans."[128] Thus, determining whether a plan was "fair and equitable" was not merely a factor for the Court to consider, rather, it was a test wholly separate from any voting requirements; a "rule of full or absolute priority."[129]

Consequently, in *Case*, where stockholders received consideration under the plan before bondholders were paid in full, a unanimous Court held that the plan was improperly confirmed, notwithstanding that the bondholder who objected held merely $18,500 in face amount of bonds and that over ninety-two percent of all bondholders consented to the plan.[130] Effectively, the *Case* decision meant that absent the consent of one-hundred percent of creditors, a reorganization could not be achieved at all if the Absolute Priority Rule was violated, regardless of meeting the consent requirements of the Bankruptcy Act.

6. The Chandler Act

The Chandler Act of 1938 repealed the general corporate reorganization section of the Bankruptcy Act (section 77B) and

---

124. *Id.*
125. Bankruptcy Act of 1898 § 77B(f)(1), Pub. L. No. 296, 48 Stat. 911, 919 (repealed 1938) (emphasis added).
126. 308 U.S. 106 (1939).
127. *Id.* at 114-19 (holding that the "fixed principle," enumerated in *Boyd*, was "firmly imbedded" in the Bankruptcy Act of 1898). Although the Bankruptcy Act was amended via the Chandler Act in 1938, see *infra* note 175, *Case* was decided under the pre-Chandler Act Bankruptcy Act, *i.e.*, section 77B. In any case, the Court noted that the "fair and equitable" criterion remained unchanged by the Chandler Act. *Case*, 308 U.S. at 119 n.14.
128. *Id.* at 115-16.
129. *Id.* at 117.
130. *Id.* at 111-14.

created three different chapters of reorganization: Chapter 10 for public companies, Chapter 11 for smaller compositions, and Chapter 12 for real estate partnerships.[131] The "fair and equitable" requirement applied to all three chapters.[132]

7. Further Amendments to the Bankruptcy Act

While the Absolute Priority Rule adopted in *Case* (where equity could in no circumstances receive a distribution if creditors were not paid in full) was practical in the case of a typical large public Chapter 10 debtor, it proved unworkable in the case of a typical Chapter 11 debtor—a distressed sole proprietorship or closely held corporation.[133] In such cases, where management was often the sole equity holder of a "family corporation" and the creditors were its entity's vendors, both parties had an interest in the existing management continuing to run the company.[134] As a result, creditors generally were willing to accept less even though equity retained its interest.[135] The Absolute Priority Rule, by prohibiting the old owners from retaining an equity interest, prevented the reorganization that all parties appeared to want in the Chapter 11 case. Consequently, Congress amended the Bankruptcy Act in 1952 to remove "fair and equitable" (the Absolute Priority Rule) from the requirements for plan confirmation for Chapter 11 debtors,[136] but retained the requirement for Chapter 10 cases.[137]

8. The enactment of the Bankruptcy Code

In 1978, Congress enacted the Bankruptcy Code.[138] The drafters of the Bankruptcy Code had many choices regarding what type of Absolute Priority Rule to enact. For example, they had to decide between (1) the expansive Absolute Priority Rule adopted in *Case*,[139] which would apply on a creditor-by-creditor basis even if all classes

---

131. *See* Markell, *supra* note 7, at 232 (noting that section 77, which had applied to railroads, was not changed by the Chandler Act).
132. *Id.*
133. *See* Ayer, *supra* note 55, at 977 (explaining that this was workable public policy in large corporations, "where equity ownership might come and go").
134. *Id.*
135. *Id.*
136. Act of July 7, 1952, ch. 579, § 35, 66 Stat. 420, 433 (1952) (repealed 1978).
137. *See* Ayer, *supra* note 55, at 978 (citing H.R. REP. NO. 2320, 82d Cong., 2d Sess. 1960, 1982 (1952), which noted that if the Bankruptcy Act was not amended in that way, "no individual debtor and, under Chapter 11, no corporate debtor where the stock ownership is substantially identical with management could effectuate an arrangement except by payment of the claim of all creditors in full").
138. *See generally* Ayer, *supra* note 55, at 978 (reviewing Congress's enactment of the Bankruptcy Code of 1978).
139. Case v. L.A. Lumber Prods. Co., 308 U.S. 106, 106 (1939).

consented or (2) a narrower Absolute Priority Rule that would apply only if there was an objecting class. Congress chose the latter.[140] They also had to decide whether to adopt a strong Absolute Priority Rule with no stated exceptions or a weaker Absolute Priority Rule with enumerated exceptions. In this case, Congress chose the former.[141]

House Document 137 ("1973 Report"),[142] outlining the proposed statute of the National Bankruptcy Commission and serving as a basis for the Bankruptcy Code, actually included a much weakened Absolute Priority Rule.[143] The 1973 Report proposed an Absolute Priority Rule that would have given courts broad powers to provide a distribution to old equity holders under various scenarios even when creditors were not paid in full.[144] For example, it would have permitted a recovery to equity holders based on their contribution of "continued management . . . essential to the business" or other contributions beyond "money or money's worth."[145] It also would have enabled the court to manipulate valuation,[146] and it would have given old equity owners a chance to participate in the upside of the reorganized company for up to five years in the future (an option or warrant of sorts).[147] This proposal was heavily criticized, leading Congress to reject it when it enacted the Bankruptcy Code.[148]

---

140. *See infra* pp. 1362 (analyzing the Bankruptcy Code's Absolute Priority Rule).

141. *See infra* Part II.A.9 (discussing the New Corollary Rule and its impact on the 1978 Bankruptcy Code's Absolute Priority Rule).

142. *See* STAFF OF H. COMM. ON THE JUDICIARY, REPORT OF THE COMM'N ON THE BANKR. LAWS OF THE UNITED STATES, H.R. Doc. No. 93-137 (1973) (recommending a proposed bill and containing related Commission studies).

143. *See* Ayer, *supra* note 55, at 978 (explaining how the 1973 Report contained an insubstantial Absolute Priority Rule).

144. *Id.*

145. H.R. Doc. No. 93-137, pt. 1, at 258.

146. The 1973 Report specifically proposed that courts find that

> there is a *reasonable basis* for the valuation on which the plan is based and the plan is fair and equitable in that there is a *reasonable probability* that the securities issued and other consideration distributed under the plan will fully compensate the respective classes of creditors and equity security holders of the debtor for their respective interests in the debtor or his property.

4 COLLIER ON BANKRUPTCY, LEG. HISTORY OF THE BANKR. REFORM ACT OF 1978 pt. 827 (King 15th rev. ed. 1996) (emphasis added) (discussing proposed section 7-310(d)(2)(B)). The 1973 Report explains that "the court is allowed more leeway in arriving at an informed estimate of valuation in recognition of the difficulty of predicting future earnings and arriving at an appropriate capitalization rate, by the use of the phrases 'reasonable basis for valuation' and 'reasonable probability' of fully compensating prior claims and interests." *Id.* at App. Pt. 4-829.

147. *See* Ayer, *supra* note 55, at 978 (suggesting that the Absolute Priority Rule proposed in the 1973 Report would have given equity owners "in effect, a sort of option or warrant" in the debtor's fortunes if they improved within five years of the confirmation).

148. *See* Norwest Bank Worthington v. Ahlers, 485 U.S. 197, 205-06 & n.5 (1988) (describing sources of criticism); Ayer, *supra* note 55, at 979 (stating that Congress

Instead, a modified version of the Absolute Priority Rule was codified by Congress in § 1129(b)(2)(B)(ii) of the Bankruptcy Code.[149]

The Absolute Priority Rule in the Bankruptcy Code is a middle ground between the extremely loose standards proposed in the 1973 Report and the rigid rule announced in *Case*. Specifically, unlike in *Case*,[150] where a plan that provided a distribution to equity owners could not be confirmed despite its overwhelming general acceptance by all parties,[151] the Absolute Priority Rule in the Bankruptcy Code only applies in "cramdown" where an entire class objects to the plan.[152] It explicitly does not apply if all classes vote to accept the plan.

Although the Bankruptcy Code does not give an individual creditor the right to challenge a distribution to equity if its class accepted the plan, it does protect the individual creditor from the tyranny of a majority that might agree to give away too much. Specifically, Congress adopted the "Best Interests Test" to ensure that a court could not confirm the plan over the objection of a creditor if that creditor did not receive at least as much under the plan as it would in a liquidation.[153]

Essentially, the Bankruptcy Code establishes a two-tier entitlement system.[154] First, the proceeds, up to the liquidation value of the debtor, are distributed in strict conformance with the priority scheme.[155] Any creditor can defeat a plan that does not provide it with its entitled liquidation share.[156] Second, proceeds in excess of

---

abandoned the Absolute Priority Rule proposed in the 1973 Report when it enacted the Bankruptcy Act of 1978 because many legal scholars criticized the Absolute Priority Rule in law review articles).

149. *See* 11 U.S.C. § 1129(b)(2)(B)(ii) (2000) ("[T]he holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property . . . .").

150. 308 U.S. 106 (1939).

151. *See id.* at 114 ("At the outset it should be stated that where a plan is not fair and equitable as a matter of law it cannot be approved by the court even though the percentage of the various classes of security holders required by section 77B, sub. f for confirmation of the plan has consented.").

152. *See* 11 U.S.C. § 1129(b)(1) (instructing the court to confirm a plan upon the request of a proponent of the plan if the plan "does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan").

153. *See* 11 U.S.C. § 1129(a)(7)(A) ("[a court can only confirm a plan if w]ith respect to each impaired class of claims or interests . . . each holder of a claim or interest of such class (i) has accepted the plan; or (ii) will receive or retain under the plan on account of such claim or interest property of a value, as of the effective date of the plan, that is not less than the amount that such holder would so receive or retain if the debtor were liquidated under Chapter 7 of this title on such date.").

154. *See* 11 U.S.C. § 1129 (providing requirements for reorganization plans).

155. *Id.*

156. *Id.*

the liquidation value are negotiated among the debtor, creditors, and often equity holders, and these proceeds are determined by requisite majority votes of the classes.[157]

Congress viewed Chapter 11 reorganization as a composition, or agreement among all stakeholders.[158] As such, the Bankruptcy Code encourages the negotiation of a mutually beneficial plan of reorganization and retains flexibility for various potential outcomes depending on the circumstances of the case. In some cases, for example, creditors may find it beneficial to provide a distribution to the old equity holders to avoid a valuation fight or encourage the old equity holders to stay and manage the reorganized debtor, a primary objective being a consensual plan.[159]

One commentator described the incentive system created by the Bankruptcy Code:

> The debtor [who is given the exclusive right to propose a plan and solicit acceptances thereon for a period at the outset of the cases] must make an offer attractive enough to avoid rejection by a creditor class which, if it occurred, would be followed either by the absolute priority required in a cramdown or by a liquidation. On the other side, the creditors risk liquidation and consequent loss of any share of a going concern surplus if they fail to come to terms. The theory is that the parties will bargain for a composition result which divides the going concern surplus to their mutual advantage.[160]

Similarly, another commentator described the tension underlying the Absolute Priority Rule and the ambiguity surrounding its application. He argues that, in theory, the application of the Absolute Priority Rule should be a simple concept: if a debtor

---

157. *See* Markell, *supra* note 58, at 88 (arguing that the Bankruptcy Code of 1978 changed the Absolute Priority Rule by allowing the remaining value of the debtor to be allocated by votes within and among different classes once the creditor received its liquidation value).

158. *See* John C. McCoid, II, *Discharge: The Most Important Development in Bankruptcy History*, 70 AM. BANKR. L.J. 163, 189 (1996) (tracing the history of bankruptcy laws, primarily as they relate to the concept of discharge). McCoid's central premise is that bankruptcy has evolved from a simple creditor collection remedy (that differed from other creditor collection remedies only in its encouragement of ratable distribution) into a "statutorily mandated composition," which is "an exchange of the collection and distribution of assets to the creditors in which the debtor cooperated in return for a release from further obligation on prebankruptcy debts." *Id.* at 164-65. McCoid argues that in determining what the terms of a bankruptcy should be, one must "[view] bankruptcy as a form of composition rather than as a collective collection device." *Id.* at 165.

159. *See id.* at 189-90 (stating that the theory behind the Bankruptcy Code is that parties will negotiate a plan which will fairly allocate the going concern surplus value of the debtor to all of the parties).

160. *Id.* at 190.

company is insolvent, its owners (i.e., the equity) cannot receive a distribution.[161] If the company is solvent and can pay all of its creditors in full, then the owners take what is left over.[162] He points to where this "simple dichotomy" unravels: if the value of the business is worth more under the management of the current owners or if there is uncertainty (or at least arguable uncertainty) that the owners may exploit to obtain concessions.[163] Under one of those scenarios, or if the new owners are willing to pay new value to obtain a stake in the reorganized company, then it may be appropriate for the equity holders to receive consideration even though all creditors may not be paid in full.[164]

9. The development of the New Value Corollary

The "New Value Corollary" is another method by which creative restructuring professionals have been able to avoid a rigid application of the Absolute Priority Rule. The professionals argue that old equity holders should be allowed to retain an interest in the reorganized company, not "on account of" their old equity interests (as this is expressly prohibited by 11 U.S.C. § 1129(b)), but as a result of new value being contributed by the equity holders. Understanding this New Value Corollary is a prerequisite to analysis of the gifting doctrine.

The principal United States Supreme Court cases that have discussed the Absolute Priority Rule after the enactment of the Bankruptcy Code have done so in connection with the New Value Corollary.[165] Like the gifting doctrine, the New Value Corollary is not in the Bankruptcy Code. Nonetheless, courts have generally accepted its validity. This is because they find that if the conditions for the New Value Corollary are satisfied, the distribution to the junior stakeholder falls outside of the scope of the Absolute Priority Rule. As such, the New Value Corollary illustrates that the gifting scenario

---

161. *See* Markell, *supra* note 58, at 70 (addressing different views on the status and application of the current Absolute Priority Rule).

162. *See id.* (discussing the basic premise that creditors' interests take priority over equity holders' interests).

163. *Id.*

164. *See id.* (explaining ways that owners may continue their participation in the reorganized entity).

165. *See, e.g.*, Bank of Am. Nat'l Trust & Sav. Ass'n v. 203 N. La Salle St. P'ship, 526 U.S. 434, 448-49 (1999) (finding that legislative history does not bar the New Value Corollary exception to the Absolute Priority Rule found in the Bankruptcy Code); Norwest Bank Worthington v. Ahlers, 485 U.S. 197, 206 (1988) (finding that the New Value Corollary exception should not be expanded beyond the Court's decisions at the time Congress enacted the Bankruptcy Code in 1978).

also falls outside of the scope of the Absolute Priority Rule and should likewise be accepted.

The roots of the New Value Corollary appear in the early Supreme Court cases analyzing the Absolute Priority Rule. Both *Boyd*[166] and *Case*[167] suggest that there may be situations in which old equity can participate in the new debtor by contributing new value. In loose dicta, the *Boyd* Court approved such a scenario, as long as the same opportunity to participate was given to other stakeholders. It noted that its decision did not mean it was necessary

> to pay an unsecured creditor in cash as a condition of stockholders retaining an interest in the reorganized company. His interest can be preserved by the issuance, on equitable terms, of income bonds or preferred stock. If he declines a fair offer he is left to protect himself as any other creditor of a judgment debtor, and, having refused to come into a just reorganization, could not thereafter be heard in a court of equity to attack it.[168]

Citing *Boyd*, the Court in *Case* recognized that providing new equity by allowing old equity holders an opportunity to participate by infusing cash was not only permissible, it could be desirable, as old equity may be the only or best source of needed cash for the enterprise.[169] The Court was clear, however, that to avoid running afoul of the Absolute Priority Rule, the interest the old shareholders received in the new company would have to be "reasonably equivalent" to the proposed contribution.[170] The Court found that this additional cash infusion was not only permissible but necessary.[171] This exception, commonly known as the "New Value Corollary," was not codified in the Bankruptcy Code but has generally survived as a judicially determined corollary (or exception) to the Absolute Priority Rule.[172]

---

166. N. Pac. Ry. Co. v. Boyd, 228 U.S. 482, 508 (1913).

167. Case v. L.A. Lumber Prods. Co., 308 U.S. 106, 121 (1939).

168. *Boyd*, 228 U.S. at 508.

169. *Case*, 308 U.S. at 121 (clarifying that under certain circumstances stockholders may participate in the reorganization plan of an insolvent debtor (citing both *Boyd*, 228 U.S. at 504, and Kan. City Terminal Ry. Co. v. Cent. Union Trust Co., 271 U.S. 445 (1926))).

170. *Case*, 308 U.S. at 121-22 ("[T]o accord 'the creditor his full right of priority against the corporate assets' where the debtor is insolvent, the stockholder's participation must be based on a contribution in money or in money's worth, reasonably equivalent in view of all the circumstances to the participation of the stockholder.").

171. *See id.* at 121 (establishing that no objection can be made to old stockholder participation in a reorganization where the success of the reorganization depends on the infusion of new capital and where old stockholders make a fresh contribution in exchange for a reasonably equivalent participation).

172. *See* Harvey R. Miller, John J. Rapisardi & Reginald A. Greene, *Leaving Old Questions Unanswered and Raising New Ones: The Supreme Court Furthers The New Value*

On two occasions the United States Supreme Court has had the opportunity to rule on the continued vitality and scope of the New Value Corollary, but has failed to do so. In *Norwest Bank Worthington v. Ahlers*,[173] the debtors, who operated a family farm, opposed a motion for relief from an automatic stay prohibiting the secured creditor from foreclosing on its collateral.[174] Because the secured creditor was undersecured, the bankruptcy court granted the motion, holding that the debtors did not retain an equity interest in the property, as they could not, given the Absolute Priority Rule, propose a confirmable plan that would provide them with an interest in the property.[175] The district court agreed.[176] The Eighth Circuit Court of Appeals reversed and, citing *Case*, held that the Absolute Priority Rule did not bar a plan that would allow the debtors to retain an interest in the property subject to the secured lender's liens "if they contributed 'money or money's worth' to the reorganized enterprise."[177] It further held that the debtors' "future contributions of 'labor, experience, and expertise' . . . have 'value'" and were sufficient to constitute "money or money's worth."[178]

The United States Supreme Court reversed the Eighth Circuit.[179] However, despite a specific request from the United States as *amicus curiae*, the Court refused to rule that the New Value Corollary discussed in *Case* had not survived the enactment of the Bankruptcy Code.[180] Rather, it noted that "even if the [*Case*] exception to the [A]bsolute [P]iority [R]ule has survived enactment of the Bankruptcy Code, this exception does not encompass [debtors'] promise[s] to contribute their 'labor, experience, and expertise' to the reorganized enterprise . . . [which] is inadequate to gain the benefit of this

---

Controversy in Bank of America National Trust & Savings Ass'n v. 203 North LaSalle Street Partnership, 30 U. MEM. L. REV. 553, 569-78 (2000) (discussing the development and evolution of the New Value Corollary (Exception)).

173. 485 U.S. 197 (1988).

174. *See id.* at 199-200 (detailing that the debtors obtained an automatic stay of their creditors' replevin action when they filed a petition for reorganization under Chapter 11 of the Bankruptcy Code).

175. *See id.* at 200 (stating that the bankruptcy court upheld the creditors' motion for relief from the automatic stay because the debtors' reorganization plan was infeasible).

176. *See id.* (explaining that the district court agreed with the bankruptcy court's initial decision to grant the creditors relief from the automatic stay).

177. *Id.* at 201.

178. *Id.* at 203 (citing *In re* Ahlers, 794 F.2d 388, 402 (8th Cir. 1986)).

179. *See id.* at 206 ("[W]e find no support in the Code or our previous decisions for the Court of Appeals' application of the absolute priority rule in this case.").

180. *See id.* at 203 n.3 (contending that it does not need to determine if any exceptions exist to the 1978 Bankruptcy Code's absolute priority rule to resolve the current dispute).

exception."[181] In more colloquial terms, sweat equity does not rise to money or money's worth. Thus, the Court noted that there are no exceptions to the Absolute Priority Rule in the Bankruptcy Code beyond those that existed in its case law at the time of the 1978 enactment of the Bankruptcy Code.[182]

In *North LaSalle*,[183] the Supreme Court once again balked at definitively stating whether or not the New Value Corollary survived the enactment of the Bankruptcy Code.[184] The Court made clear, however, that if a New Value Corollary exists, the consideration given to the former equity holders in exchange for new value must be subject to a "market test" (i.e., the opportunity to contribute value in exchange for such distribution must be offered to others in a competitive manner, or others must be permitted to file competing plans of reorganization).[185]

North LaSalle was a single-asset partnership real estate case where the debtor proposed a plan in which the bank, an undersecured creditor, was to receive payment over time for the secured portion of its claim and a payment of approximately 16% of value for its separately classified (unsecured) deficiency claim.[186] The other class of unsecured creditors was to be paid 100% of their allowed claims.[187] Under the plan certain former partners of the debtor (old equity) would contribute to the reorganized debtor a present value of approximately $4.1 million over time in exchange for all the equity of the reorganized debtor.[188] The opportunity to contribute value to participate in the reorganized company was exclusive to the former

181. *Id.*

182. *See id.* at 206 (holding that the language of the Bankruptcy Code and its legislative history bar any expansion of exceptions to the Absolute Priority Rule beyond those that existed in 1978, when Congress enacted the Code).

183. Bank of Am. Nat'l Trust & Sav. Ass'n v. 203 N. LaSalle St. P'ship, 526 U.S. 434 (1999).

184. *See id.* at 454 (maintaining that the Court will not decide in this case whether it will recognize the New Value Corollary).

185. *See id.* at 454-55 (discussing reasons why the New Value Corollary must allow others, besides the debtor's partners, an opportunity to compete for equity or propose an alternative reorganization plan, otherwise the New Value Corollary is doomed).

186. *See id.* at 440 (describing key elements of the debtor's plan). Section 506(a) of the Bankruptcy Code defines secured and unsecured status providing that

> [a]n allowed claim of a creditor secured by a lien on property in which the estate has an interest . . . is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property . . ., and is an unsecured claim to the extent that the value of such creditor's interest . . . is less than the amount of such allowed claim

Bankruptcy Code, 11 U.S.C. § 506(a) (2000).

187. *North LaSalle*, 526 U.S. at 440.

188. *See id.* (observing that the plan allowed certain of the debtor's former partners to contribute $6.125 million in new capital over the course of five years).

partners.[189] The plan proponents relied upon the New Value Corollary.

After the bank voted to reject the plan, the debtor sought confirmation under the cramdown provision of § 1129(b) of the Bankruptcy Code.[190] The bank argued that the plan violated the Absolute Priority Rule on its face because the plan provided for old equity to become the equity holder of the reorganized debtor while its unsecured claim was not satisfied in whole.[191] However, the bankruptcy court confirmed the plan, and the district court and the Court of Appeals for the Seventh Circuit affirmed.[192] The Supreme Court then granted certiorari to resolve the split in the courts of appeals over the New Value Corollary and whether it survived the enactment of the Bankruptcy Code.[193]

The Supreme Court noted that the Bankruptcy Code did not refer to or provide for the New Value Corollary.[194] The legislative history, however, was not clear regarding whether this omission meant that Congress rejected the New Value Corollary. Specifically, although early drafts of the House version of the bill that would become the Bankruptcy Code contained explicit language condoning the New Value Corollary, the House bill that emerged did not contain such language.[195] The Court did not, however, view this exclusion as a definitive rejection of the continuing viability of the New Value Corollary. Rather, because the language of the Absolute Priority Rule prohibited old equity holders from receiving any consideration "on account of" their old equity interests if senior classes had not been satisfied or consented, the Court concluded that the New Value

189. *See id.* at 440-41 (discussing that the bank objected to this provision and blocked confirmation of the plan).

190. *See id.* (allowing the debtor to force the plan on the dissenting class).

191. *See id.* at 442 (maintaining that the bank read the Absolute Priority Rule as conflicting with the debtor's plan because it allowed old equity holders in the debtor to have property even though the bank's unsecured claim was not paid in full).

192. *Id.*

193. *See id.* at 443. The Ninth and Seventh Circuits (the latter in *North LaSalle*) had upheld confirmation of plans that provided equity with a distribution under the New Value Corollary. *See id.* (citing *In re* Bonner Mall P'ship, 2 F.3d 899, 910-16 (9th Cir. 1993), *cert. granted*, 510 U.S. 1039, *vacatur denied* and *appeal dismissed as moot*, 513 U.S. 18 (1994)). In contrast, the Second and Fourth Circuits had disapproved similar plans, although they did not explicitly reject the New Value Corollary. *See id.* (citing *In re* Coltex Loop Cent. Three Partners, L.P., 138 F.3d 39, 44-45 (2d Cir. 1998), *In re* Bryson Props., XVIII, 961 F.2d 496, 504 (4th Cir. 1992)).

194. *See North LaSalle*, 526 U.S. at 446 (observing that Congress had an opportunity to include the New Value Corollary into the 1978 Bankruptcy Code, but it chose not to address it).

195. *See id.* at 446-47 (recounting that after an extensive mark-up session, the House produced a bill, which eventually would become the Bankruptcy Code, that no longer contained the New Value Corollary).

Corollary could arguably be implied from the language of the Bankruptcy Code.[196]

The Court then discussed the various possible interpretations of the phrase "on account of," rejecting "in exchange for" and "in satisfaction of" and settling on "because of."[197] The Court also examined two potential interpretations of the causal connection required to trigger the Absolute Priority Rule. First, it looked at a definition that would hold any distribution of consideration to old equity holders to be "on account of" their old equity interests (an interpretation that would essentially destroy the New Value Corollary).[198] Second, a less restrictive definition that would permit equity holders to receive a distribution as long as the distribution was adding at least as much value as could be obtained from an outside source.[199]

The Court strongly hinted that it favored the latter interpretation and that the New Value Corollary, as a result, was a valid corollary to the Absolute Priority Rule.[200] However, the Court refused to decide the issue because the plan in this case failed even under the more permissive definition.[201] Specifically, the Court found that regardless of the value provided by the old equity holders in *North LaSalle*, the plan was flawed. It violated the Absolute Priority Rule by giving such holders the exclusive right to purchase the equity in the reorganized debtor, a valuable right, because of their equity holdings.[202] In

196. *See id.* at 447-49 (finding that it is possible that the Absolute Priority Rule found in the Bankruptcy Code of 1978 may contain the New Value Corollary).

197. *See id.* at 449-51 (arguing that "on account of" means "because of" based on other provisions in the statute where these two phrases mean the same thing).

198. *See id.* at 451-53 (criticizing the definition proposed by the government, which contended that any relationship between earlier interests and retained property will create a bar to a plan providing for retained property, based on the text of the Absolute Priority Rule in the Bankruptcy Code).

199. *See id.* at 453-54 (suggesting that this more flexible reading of "on account of" would bar a plan if old equity obtained or preserved an ownership interest for a price less than what others in the market would have paid).

200. The Court noted that allowing a New Value Corollary would "reconcile the two recognized policies underlying Chapter 11, of preserving going concerns and maximizing property available to satisfy creditors." *Id.* at 453. "A truly full value transaction . . . would pose no threat to the bankruptcy estate not posed by any reorganization, provided of course that the contribution be in cash or be realizable money's worth." *Id.* at 453-54.

201. *See id.* at 454 (rejecting the need to decide which definition of "on account of" should prevail in this case because it is unnecessary for its decision).

202. *See id.* at 454-55 ("At the moment of the plan's approval the Debtor's partners necessarily enjoyed an exclusive opportunity that was in no economic sense distinguishable from the advantage of the exclusively entitled offeror or option holder. This opportunity should, first of all, be treated as an item of property in its own right."). The Court saw no justification for old equity having the exclusive option:

> If the price to be paid for the equity interest is the best obtainable, old equity

connection with the implementation of the New Value Corollary, the Court, in dicta, noted that an exclusive option was inherently flawed because it required the bankruptcy court, rather than the market, to make the determination of whether the value provided by old equity was reasonably equivalent to the consideration to be received.[203] The Court thus held that if the New Value Corollary exists, the old equity holders cannot be permitted to obtain equity in a reorganized debtor unless the opportunity to acquire the equity is subject to a market test.[204]

Lower courts and the Bar have found the Court's opinion in *North LaSalle* less than clear. Not only was the circuit split on the existence of the New Value Corollary left unresolved, but the decision also raised new questions about what exactly a "market test" would entail.[205] For those courts that recognize the New Value Corollary, the generally accepted elements are that the value be "(1) new, (2) substantial, (3) money or money's worth, (4) necessary for a successful reorganization, and (5) reasonably equivalent to the value or interest received."[206] Accordingly, while the New Value Corollary may put junior or equity interests back into "play" in some Chapter 11 scenarios, its requirements are difficult to meet.

B. The Unfair Discrimination Prohibition

The Unfair Discrimination Prohibition (as well as the rules regarding classification of claims) pursues many of the same equitable objectives as the Absolute Priority Rule, but it does so by monitoring the plan treatment of similarly situated creditors. Whereas the Absolute Priority Rule guards against unfair treatment between creditors of different priorities (a vertical test), the Unfair Discrimination Prohibition is concerned with ensuring that similarly

---

> does not need the protection of exclusiveness (unless to trump an equal offer from someone else); if it is not the best, there is no apparent reason for giving old equity a bargain. There is no reason, that is, unless the very purpose of the whole transaction is, at least in part, to do old equity a favor.

Id. at 456.

203. *See id.* at 457 (arguing that one of the 1978 Bankruptcy Code's important changes is that it limits a court's responsibility for making value judgments).

204. *Id.* at 457-58 (contending that for the sake of statutory consistency and policy reasons favoring competition, old equity holders cannot obtain new equity unless their position is subject to a market test).

205. *See* Robert J. Keach, LaSalle, *the "Market Test" and Competing Plans: Still in the Fog*, 21-Jan AM. BANKR. INST. J. 18 (2003) (suggesting that the existence of the New Value Corollary and its corresponding "market test" remain unresolved issues).

206. *See, e.g.*, *In re* Hoffinger Indus., 321 B.R. 498, 510 (Bankr. E.D. Ark. 2005) (citing Bonner Mall P'ship v. U.S. Bancorp Mortgage Co. (*In re* Bonner Mall P'ship), 2 F.3d 899, 908 (9th Cir. 1993)).

situated creditors are treated equally, absent a compelling reason to do otherwise (a horizontal test).[207]

1. Equity receiverships

Like the Absolute Priority Rule, the Unfair Discrimination Prohibition grew out of the equity receiverships of railroads.[208] While railroad secured bondholders and stockholders were squeezing out unsecured creditors through "insider" receivership sales (the behavior that led to the Absolute Priority Rule, as discussed above),[209] they were also forcing out minority secured creditors and equity holders that were not part of the syndicate to reacquire the railroad company. For example, while unsecured creditors were getting paid nothing, and the investor syndicate was getting back its company at bargain prices, other secured creditors and stockholders were being forced to take their share of the proceeds of the receivership sale, which, as noted above, were generally much less than the market value of the assets.[210]

Unsecured creditors initially used fraudulent transfer laws in an attempt to protect their interests before the Absolute Priority Rule was created. In contrast, the secured creditors who were left out did not want the receivership sales voided as fraudulent; they just wanted a larger recovery. Instead of being paid out in cash (at a discount), they wanted a share of the reorganized company. Over time, courts heard their pleas and often agreed that equity required equality of

---

207. *See* Markell, *supra* note 7, at 231 (contending that Unfair Discrimination Prohibition cases present an interesting dichotomy between the vertical and horizontal equity tests, but cautioning that at the time these tests were developed they were not formally recognized).

208. *See* Brunstad & Sigal, *supra* note 19, at 41-43 (explaining that a large portion of equity receivership law is rooted in the historic treatment of insolvent railroads); Markell, *supra* note 7, at 228-29 (discussing the long history of statutory provisions that guard against plans that discriminate unfairly).

209. *See supra* Part II.A.1 (discussing the history and evolution of the Absolute Priority Rule with regard to equity receiverships).

210. *See* Markell, *supra* note 7, at 229-31 (exploring the origin of the Unfair Discrimination Prohibition). In Part I.A of Markell's article, he uses *Ring v. New Auditorium Pier Co.*, 77 A. 1054 (N.J. Ch. 1910) as an example of unfair discrimination. *Id.* at 230. In that case, Ring was a bondholder that held $5,000 of a $75,000 secured bond issuance. *Id.* Ring was not part of the bondholder syndicate that purchased the reorganizing company for only $10,000 at the foreclosure sale. *Id.* Instead of what would have been his share of the new bonds issued by the reorganized company, he was scheduled to receive only his share of the $10,000. *Id.* Ring sued for his share of the new bonds and the court ruled in his favor. *Id.* It cited the lack of full notice to Ring of the foreclosure and the plan to repurchase the company as decisive equitable factors. *Id.* Markell concludes that in *Ring* and other cases, courts "recognized that regardless of the effect on other classes of creditors and stakeholders, reorganizations had to be fair within each class created." *Id.* at 231.

distribution, and, therefore, that they should receive a share of the reorganized company if other similarly situated creditors were also receiving a share of the reorganized company.[211]

2. The Bankruptcy Act of 1898

Section 77 (the railroad provision) did not initially contain an unfair discrimination prohibition when it was added to the Bankruptcy Act in 1933.[212] However, when § 77B, which applied to business corporations, was added in 1934, it required that plans not discriminate unfairly.[213] A year later, Congress amended § 77 to mirror the confirmation requirements of § 77B, which included the Unfair Discrimination Prohibition.[214] While these sections provided that to confirm a reorganization plan, the court had to find that the plan did not discriminate unfairly, no explanation of the Unfair Discrimination Prohibition was provided.[215]

3. The Chandler Act

In 1938, Congress enacted the Chandler Act, which replaced § 77B (the general corporate reorganization provision) with three new debtor relief provisions: Chapters 10, 11, and 12.[216] The Railroad provision, § 77, was not changed by the Chandler Act.[217] The Chandler Act did not include the Unfair Discrimination Prohibition in its new chapters, although the sparse legislative history suggests that the omission was less intentional than it was a result of an erroneous conflation of the Unfair Discrimination Prohibition with the Absolute Priority Rule by the Act's drafters.[218] Specifically, the following questionable explanation was provided:

> Subsection (2) of Section 221 [of the Chandler Act], derived from Section 77B(f)(1) [of the former Bankruptcy Act], provides, as a condition to confirmation of a plan, that the judge be satisfied that it is 'fair and equitable,' and 'feasible.' Implicit in the former

---

211. *See id.* at 230-31 (explaining that since receivership has equity origins, the process needs to provide equal opportunities for shareholders with similar interests).
212. *See id.* at 232 (noting that railroad reorganization plans only had to be "fair" and not necessarily "equitable" according to the language of section 77 when Congress enacted it in 1933).
213. *See id.* at 232 (discussing how section 77B required plans to be both "fair and equitable, and not discriminate unfairly").
214. *See id.*
215. *See* Brunstad & Sigal, *supra* note 19, at 42 (stating that Congress refused to discuss what unfair discrimination meant).
216. *See id.* (citing Chandler Act of 1938, ch. 575, 52 Stat. 840).
217. *See* Markell, *supra* note 7, at 233.
218. *See* Brunstad & Sigal, *supra* note 19, at 42 (citing S. REP. NO. 75-1916, at 35-36 (1938)).

> phrase is a prohibition against any unfair discrimination in the plan in favor of any creditors or stockholders and the express statement to that effect in Section 77B is therefore unnecessary.[219]

4. Pre-code application of the unfair discrimination prohibition

Nevertheless, courts still entertained confirmation objections from creditors arguing that, under the proposed plan, they had been unfairly discriminated against. In two cases in the 1940s, *American United Mutual Life Insurance Co. v. City of Avon Park*[220] and *Mason v. Paradise Irrigation District*,[221] the Supreme Court suggested that the Unfair Discrimination Prohibition survived the enactment of the Chandler Act. Both of the cases related to municipal bankruptcies under Chapter 9.[222]

In *Avon Park*, a fiscal agent performed services for the debtor and received payments pursuant to the plan that objecting similarly situated creditors argued went beyond mere compensation for services and amounted to unfair discrimination. The Court agreed and reversed the confirmation of the plan, stating:

> Compositions under Ch. IX, like compositions under the old §12, *envisage equality of treatment of creditors*. Under that section and its antecedents, a composition would not be confirmed where one creditor was obtaining some special favor or inducement not accorded the others, whether that consideration moved from the debtor or from another . . . In absence of a finding that the aggregate emoluments receivable by the [fiscal agent] interests were reasonable, measured by the services rendered, it cannot be said that the consideration accruing to them, under or as a consequence of the adoption of the plan, likewise accrued to all other creditors, of the same class. Accordingly, the imprimatur of the federal court should not have been placed on this plan.[223]

In *Mason*, the Court heard a similar objection by dissenting creditors; however, the Court found the discrimination in that plan was justified. The Court stated:

> [i]t has long been recognized in reorganization law that those who put new money into the distressed enterprise may be given a participation in the reorganization plan reasonably equivalent to their contribution . . . . Without the inducement new money could not be obtained . . . . The [preferred creditor] contributes

219. *Id.*
220. 311 U.S. 138 (1940).
221. 326 U.S. 536 (1946).
222. These two cases also figure prominently in the development of the rules on classification. *See supra* note 23.
223. *Avon Park*, 311 U.S. at 148-49 (emphasis added).

> something that the [dissenting bondholder] does not . . . . That difference warrants a difference in treatment.[224]

Thus, as long as the special treatment to the co-equal creditor was in exchange for additional value provided by the creditor, such treatment was deemed proper, justified, and fair.[225]

5. The Bankruptcy Code

Although it does not appear that the Unfair Discrimination Prohibition was ever considered by an appellate court between *Mason* and the adoption of the proposal of the Bankruptcy Code,[226] the 1978 Bankruptcy Code codified the Unfair Discrimination Prohibition in cramdown situations. The legislative history of the Unfair Discrimination Prohibition in the Bankruptcy Code does not provide much guidance as to Congress's intentions. It appears that much more thought went into the Absolute Priority Rule and that the Unfair Discrimination Prohibition was often confused with the Absolute Priority Rule during the drafting of section 1129(b).[227] Ultimately, Congress placed the Unfair Discrimination Prohibition in § 1129(b)(1) as an additional requirement to be met in cramdown situations along with the Absolute Priority Rule.[228] In floor comments discussing the proposed Bankruptcy Code, its sponsors noted that the Unfair Discrimination Prohibition was added for "clarity," although it is not clear at all what is meant by clarity.[229]

The only somewhat helpful illustration of the Unfair Discrimination Prohibition is found in the House Report; however, it is only useful in the subordination context. It states that "[f]rom the perspective of unsecured trade claims, there is no unfair discrimination as long as the total consideration given all other classes of equal rank does not exceed the amount that would result from an exact aliquot distribution."[230] The House Report essentially explains that distributions to unsecured classes, which are different

224. *Mason*, 326 U.S. at 542-43.

225. *Id.* at 543 (noting that the plan must be transparent and cannot discriminate unfairly).

226. *See* Markell, *supra* note 7, at 235.

227. *See* Brunstad & Sigal, *supra* note 19, at 37-39.

228. *See id.* at 38.

229. *See* Markell, *supra* note 7, at 236 n.47 (citing 124 CONG. REC. 32,407 & 34,006 (1978) (statements of Rep. Edwards and Sen. DeConcini) ("The requirement of the House bill that a plan not 'discriminate unfairly' with respect to a class is included for clarify; the language in the House report interpreting that requirement, in the context of subordinated debentures, applies equally under the requirements of section 1129(b)(1) of the House amendment.").

230. *See* Brunstad & Sigal, *supra* note 19, at 39-40 (citing H.R. REP. NO. 95-595, at 417 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6373).

from one another as a result of the enforcement of subordination agreements between senior and junior creditors, do not violate the Unfair Discrimination Prohibition, but suggests that any other difference in treatment would be unfair and, consequently, prohibited.[231]

6. Unfair discrimination in practice

Courts considering the Unfair Discrimination Prohibition have applied different interpretations to it, which can be grouped into four different broad categories: (1) courts that apply the rule strictly so that all similarly situated creditors are required to receive the exact same treatment; (2) courts that apply the rule only in the context of subordinated claims or interest; (3) courts that permit discrimination if it is fair and apply some form of a four-part test to determine fairness; and (4) courts that similarly permit fair discrimination but, rather than use the four-part test, apply a reasonableness standard.[232]

A minority of cases apply a strict reading to the Unfair Discrimination Prohibition that bars any discrimination whatsoever.[233]

---

231. *See id.* at 39-40 (citing H.R. REP. NO. 95-595, at 417 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6373). The following is an excerpt from the House Report:

> [I]f trade creditors, senior debt, and subordinate debt are each owed $100 and the plan proposes to pay the trade debt $15, the senior debt $30, and the junior debt $0, the plan would not unfairly discriminate against the trade debt nor would any other allocation of consideration under the plan between the senior and junior debt be unfair as to the trade debt as long as the aggregate consideration is less than $30 . . .
>
> Application of the test from the perspective of senior debt is best illustrated by the plan that proposed to pay trade debt $15, senior debt $25, and junior debt $0. Here the senior debt is being unfairly discriminated against with respect to the equal trade debt even though the trade debt receives less than the senior debt. The discrimination arises from the fact that the senior debt is entitled to the rights of the junior debt which in this example entitle [sic] the senior debt to share on a 2:1 basis with the trade debt.
>
> Finally, it is necessary to interpret the first criterion from the perspective of subordinated debt. The junior debt is subrogated to the rights of senior debt once the senior debt is paid in full. Thus, while the plan that pays trade debt $15, senior debt $25, and junior debt $0 is not unfairly discriminatory against the junior debt, a plan that proposes to pay trade debt $55, senior debt $100, and junior debt $1, would be unfairly discriminatory. In order to avoid discriminatory treatment against the junior debt, at least $10 would have to be recovered by such debt under those facts.

Id.

232. *See* Brunstad & Sigal, *supra* note 19, at 46-48.

233. *See, e.g.*, *In re* Greystone III Joint Venture, 102 B.R. 560, 571 (Bankr. W.D. Tex. 1989), *aff'd*, 127 B.R. 138 (W.D. Tex. 1990), *rev'd on other grounds*, 995 F.2d 1274 (5th Cir. 1992) (upholding a plan that accorded the dissenting trade creditor class the same treatment as another class of equal priority creditors—the deficiency claim of undersecured secured creditors). When the dissenting class objected that the estate could afford to provide it with a better recovery, the court noted that, since a better recovery would come at the expense of the recovery of the similarly situated class of creditors, such a "plan would *prima facie* 'unfairly discriminate.'" The court

This is the most conservative approach, because if the court does not allow any "discrimination" whatsoever, then it can hardly be "unfair."[234] The rigidity of this interpretation of unfair discrimination ultimately undercuts the rehabilitative goals of the Bankruptcy Code by not allowing debtors some flexibility in the "cramdown" context and appears to ignore the fact that the term discrimination in § 1129(b)(1) is modified by the word "unfair."[235]

A different minority of courts has taken a similar strict approach to the Unfair Discrimination Prohibition. These courts hold that the Unfair Discrimination Prohibition only applies if the plan inappropriately involves subordination of claims or interests.[236] Under this rationale, disparate treatment among classes of creditors with equal priority is not subject to scrutiny by the court.[237] If the first line of cases was too restrictive then certainly this line of cases is too relaxed and offers debtors an opportunity to abuse the "cramdown" power.

The majority of courts, however, permit some discrimination, as long as they find that the discrimination is fair. Most of these courts apply some variation of a multiple-part test to determine if discrimination is fair, while other courts forego the rigidity of a test and instead make a general equitable inquiry.[238] The court in *In re WorldCom* articulated a variation of the multiple-part test for unfair

---

relied on legislative history from the House Report, which provided, in an example explaining the Unfair Discrimination Prohibition: "From the perspective of unsecured trade claims, there is no unfair discrimination as long as the total consideration given all other classes of equal rank does not exceed the amount that would result from an exact aliquot distribution." *Id.* (quoting H.R. REP. NO. 595, at 416).

234. *See* Brunstad & Sigal, *supra* note 19, at 47 (noting that "by recognizing no room for differences in treatment among similarly situated claimants, the approach appears to equate 'discrimination' with 'unfairness,' rendering the latter redundant").

235. *Id.*

236. *See, e.g.*, *In re* Acequia, Inc., 787 F.2d 1352, 1364 (9th Cir. 1986) (stating that the alleged disparate treatment between two shareholders regarding their voting rights was irrelevant because the distribution did not involve subordination); *In re* Martin, 66 B.R. 921, 929-30 (Bankr. D. Mont. 1986) (finding disparate treatment between an oversecured creditor and other creditors regarding scheduling of payment irrelevant because it did not involve subordination); *see also* Denise R. Polivy, *Unfair Discrimination in Chapter 11: A Comprehensive Compilation of Current Case Law*, 72 AM. BANKR. L.J. 191, 199-200 (referring to these cases as utilizing a "Restrictive Approach").

237. This reading of the Code is rooted in the legislative history. *In re Acequia*, 787 F.2d at 1364 n.18 (citing Sponsors' Remarks, 124 CONG. REC. Hll, 104 (daily ed. Sept. 28, 1978) (statement of Rep. Edwards); 124 CONG. REC. S17,420 (daily ed. Oct. 6, 1978) (statement of Sen. DeConcini)).

238. *See* Brunstad & Sigal, *supra* note 19, at 47-48 (describing how many courts use a four part test that is highly subjective in nature and that frequently leads to disparate results).

discrimination: "To determine whether a plan discriminates unfairly, courts consider whether (1) there is a reasonable basis for discriminating, (2) the debtor cannot consummate the plan without the discrimination, (3) the discrimination is proposed in good faith, and (4) the degree of discrimination is in direct proportion to its rationale."[239]

In *WorldCom*, the debtors provided disparate treatment to equal priority classes based on different arguments the creditors in the classes would have regarding the effect of substantive consolidation on their claims. Specifically, it appeared that the creditors of the former MCI subsidiaries might be prejudiced by substantive consolidation, as they relied on the credit of MCI, which appeared to have more value than the WorldCom entities. The court permitted discrimination between classes, essentially providing a greater recovery to the creditors of the former MCI entities, noting such discrimination was justified as

> [a] mechanism that enables the Debtors to recognize the unique reliance and prejudice arguments of the holders of [three different types of claims], which those creditors, as parties that extended credit . . . , possess in relation to the substantive consolidation of the WorldCom Debtors[. This] is a valid business justification and reasonable basis for the disparate treatment of [four different types of claims].[240]

Also, the court held that "discrimination among [four classes] under the plan is not unfair because it is appropriate, reasonably proportional to the issues of the case and necessary to the reorganization."[241] The four-part test gives courts the flexibility to look at specific facts and the relationships of similarly situated creditors to the debtor and to the plan of reorganization, although it has been criticized for its lack of predictability, among other reasons.[242]

Those courts that have been relatively open to discrimination but do not confine their reasoning to a multiple-part test typically

---

239. *In re* WorldCom, Inc., 2003 WL 23861928, at *59 (Bankr. S.D.N.Y. 2003); *cf.* *In re* Snyders Drug Stores, Inc., 307 B.R. 889, 895-96 (Bankr. N.D. Ohio 2004) (using a four-part test); *In re* Aztec Co., 107 B.R. 585 (Bankr. M.D. Tenn. 1989).

240. *In re WorldCom*, 2003 WL 23861928, at *59.

241. *Id.* at *60.

242. *See* Brunstad & Sigal, *supra* note 19, at 47-48 (arguing, *inter alia*, that the test will encourage inappropriate hold-out behavior); Polivy, *supra* note 236, at 205-06 ("The four-part test has its critics. Some courts have criticized the test as adding to the uncertainty surrounding the meaning of unfair discrimination. They point out the redundancy in the first and fourth prongs, which both ask whether the extent of discrimination is reasonable."). For a thorough critique of the four-part tests, see Markell, *supra* note 7, at 242-46.

examine the reasonableness and the achievability of a proposed plan.[243] Generally, if the debtor presents an equitable rationale for the discrimination among co-equal classes of creditors, these courts will allow it.[244] The enforcement of the Unfair Discrimination Prohibition in this context ends up being very similar to the four-part test discussed above, but allows for greater elasticity.

III. THE DEVELOPMENT OF THE GIFTING DOCTRINE

As noted, the gifting doctrine did not emerge as a radical proposal. Rather, it developed slowly in incremental steps.

A. *Legislative History of Gifting*

The legislative history leading up to the enactment of the Bankruptcy Code suggests that Congress was uncertain as to whether to permit a senior creditor to circumvent the Absolute Priority Rule or the Unfair Discrimination Prohibition by forgoing (or "gifting") a portion of its distribution in favor of stockholders despite that intervening junior creditors would not be paid in full.

A Senate report written prior to the enactment of the Bankruptcy Code proposed that a senior creditor would be permitted to adjust the value of its disbursement in the plan for the benefit of equity holders despite that the junior creditors were not being paid in full under the plan.[245] Subsequently, two key legislators of the Bankruptcy Code, Representative Don Edwards and Senator Dennis DeConcini explicitly rejected this proposal and stated that "[c]ontrary to the example contained in the Senate report, a senior class will not be able to give up value to a junior class over the dissent of an intervening class unless the intervening class receives the full amount, as opposed to value, of its claims or interests."[246]

---

243. *See* Brunstad & Sigal, *supra* note 19, at 48 (noting that "[this standard] embraces fundamentally the perspective of 'I know it when I see it,' and is thus unlikely to fulfill the underlying purposes of the unfair discrimination doctrine in any defined or systematic way").

244. *See In re* Salen Suede, Inc., 219 B.R. 922, 933-34 (Bankr. D. Mass. 1998) ("Whether a plan unfairly discriminates is tested by an objective standard . . . ; any discrimination must be supported by a legally acceptable rationale, and the extent of the discrimination must be necessary in light of the rationale."); *In re* 203 N. LaSalle St. Ltd. P'ship, 190 B.R. 567, 585-86 (Bankr. N.D. Ill. 1995) ("[I]t is possible at least to lay a framework for measuring the fairness of a discrimination in Chapter 11 plans. First, any discrimination must be supported by a legally acceptable rationale . . . . Second, the extent of the discrimination must be necessary in light of the rationale."), *aff'd*, 195 B.R. 692 (N.D. Ill. 1996), *aff'd*, 126 F.3d 955 (7th Cir. 1997), *rev'd on other grounds subnom.* Bank of Am. Nat'l Trust Sav. Ass'n v. 203 N. La Salle St. P'ship, 526 U.S. 434 (1999).

245. S. REP. NO. 95-989, at 127 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5913.

246. 124 CONG. REC. S. 34007 (Oct. 5, 1978) (remarks of Sen. DeConcini); 123

The House Report, in connection with the bill that became the Bankruptcy Code, described the effects of the Absolute Priority Rule, but was silent about whether it would apply to a gift by one group of creditors to the other:

> The court may confirm [a plan] over the dissent of a class of unsecured claims, including priority claims, only if the members of the class are unimpaired, if they will receive under the plan property of a value equal to the allowed amount of their unsecured claims, or if no class junior will share under the plan. That is, if the class is impaired, then they must be paid in full or, if paid less than full, then no class junior may receive anything under the plan. This codifies the absolute priority rule from the dissenting class on down.[247]

Although the statements by the bill's sponsors appear to suggest that they did not agree with the gifting concept, they are not authoritative. There is nothing in the Bankruptcy Code prohibiting creditors from agreeing to give up their distributions and transferring that consideration to other classes of claims or interests.

B. SPM

The case of *Official Unsecured Creditors' Committee v. Stern (In re SPM Manufacturing. Corp.)*[248] started the trend of condoning the ability of creditors to "gift" around the requirements of the Bankruptcy Code. In *SPM*, the First Circuit held that creditors are generally free to do as they please with their bankruptcy dividends, including sharing them with other creditors, and that any resulting distribution does not violate the distribution scheme of the Bankruptcy Code.[249] The facts in *SPM* clearly supported that conclusion.

In *SPM*, the debtor owed $5.5 million to general unsecured creditors and $9 million to Citizens Savings Bank, the holder of a perfected first priority security interest in substantially all of the debtor's assets.[250] The IRS held an unsecured priority claim for $750,000, which was personally guaranteed by the debtor's president and members of his family.[251]

During the Chapter 11 case, in an effort to maximize the value of the debtor's estate through cooperation, Citizens Savings Bank and

CONG. REC. H. 32408 (Sept. 28, 1978) (remarks of Rep. Edwards).

247. H.R. REP. NO. 95-595, at 413 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6369.

248. 984 F.2d 1305 (1st Cir. 1993).

249. *Id.* at 1313.

250. *Id.* at 1307.

251. *Id.*

the official committee of unsecured creditors entered into a formal agreement providing that they would work together to formulate a plan of reorganization.[252] In consideration, Citizens Savings Bank agreed to share whatever proceeds it received from its collateral security with general unsecured creditors in a specified manner.[253] As a result of the agreement, general unsecured creditors would receive a dividend even though the priority unsecured tax creditors, including the IRS, would not.[254]

After it became clear that SPM could not be successfully reorganized, the bankruptcy court appointed a receiver, the debtor's assets were sold for $5 million, and the debtor's Chapter 11 case was converted to a Chapter 7 liquidation.[255] Citizens Savings Bank and the creditors' committee then filed a joint motion requesting distribution of the net sales proceeds to Citizens Savings Bank on account of its first priority lien and providing that Citizens Savings Bank would distribute a portion of the net proceeds to the creditors' committee in accordance with the agreement of the parties.[256] The debtor and its management, which would have been personally liable for whatever portion of the IRS claim that was not paid out of the estate, objected, arguing that the participation of general unsecured creditors in the liquidation proceeds ahead of priority tax creditors violated the distribution scheme under the Bankruptcy Code.[257]

The bankruptcy court agreed and ordered that the net proceeds be distributed to Citizens Savings Bank and that Citizens Savings Bank pay that the portion of the proceeds that would have otherwise been distributed to the unsecured creditors under the agreement to the Chapter 7 trustee for distribution to unsecured creditors in accordance with the priority scheme under the Bankruptcy Code.[258] The effect of the order was that priority creditors and the insiders who would be personally liable for the debtor's obligation to the IRS would benefit, while the general unsecured creditors would be

---

252. *See id.* at 1307-08 (recognizing that liquidation would not satisfy any of the creditor's claims).
253. *Id.* at 1308.
254. *Id.*
255. *Id.* at 1309.
256. *Id.*
257. *Id.* (citing 11 U.S.C. §§ 724-726). Section 726 of the Bankruptcy provides that in a Chapter 7 case (as in a Chapter 11 case) certain tax claims have priority over general unsecured claims. 11 U.S.C. §§ 724-726 (2000).
258. *Id.* at 1309-10 ("[O]nce the committee was in operation it had to, it's require by law, to act for the benefit of the entire estate.").

deprived of any recovery.[259] The district court affirmed, and the creditors' committee appealed.[260]

The United States Court of Appeals for the First Circuit reversed, rejecting the argument that the agreement violated the distribution scheme of the Bankruptcy Code.[261] The court noted that as a secured creditor, Citizens Savings Bank was entitled to receive all proceeds from the sale of the debtor's assets, as such proceeds were not sufficient to satisfy its liens in full.[262] Further, "no one else had any claim of right under the Bankruptcy Code" to Citizens Savings Bank's $5 million distribution.[263] Because Citizens Savings Bank was entitled to receive all such proceeds, it was free to do as it pleased with such recoveries, including to distribute them to general unsecured creditors. In oft-quoted language, the court noted: "*While the debtor and the trustee are not allowed to pay nonpriority 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.*"[264] Further, "[t]here is nothing in the Code forbidding Citizens to have voluntarily paid part of these monies to some or all of the general, unsecured creditors *after* the bankruptcy proceedings finished."[265]

Critical to the court's reasoning was that once the net proceeds were properly distributed to Citizens Savings Bank on account of its secured claim, the proceeds were no longer property of the estate.[266] Moreover, the "sharing between Citizens and the general, unsecured creditors was to occur after distribution of the estate property, having no effect whatever on the bankruptcy distribution to other creditors."[267] Until all liens on a debtor's property are satisfied, the distribution scheme under the Bankruptcy Code does not come into play.[268] Accordingly, the court found that the agreement did not distribute the debtor's property "at the expense of priority creditors"[269] and upheld the agreement.[270]

259. *Id.* at 1310.
260. *Id.*
261. *Id.* at 1313.
262. *Id.* at 1312.
263. *Id.*
264. *Id.* at 1313 (emphasis added).
265. *Id.*
266. *Id.*
267. *Id.* at 1312.
268. *Id.*
269. *Id.*
270. *Id.* at 1313-14, 1318-19.

C. SPM*'s Progeny*

In many respects, the *SPM* holding could be viewed as limited. First, it involved a secured creditor whose entitlement to the proceeds at issue was undisputed. Furthermore, the distribution of proceeds to general unsecured creditors occurred outside of a Chapter 11 plan and, as the court noted "*after* distribution of the estate property."[271] In fact, the initial physical distribution was to be made to the secured creditor, and the secured creditor would then make a physical distribution to the creditors' committee.[272] Under these circumstances, the court noted that the Bankruptcy Code did not prevent the secured creditor from transferring value to the general unsecured creditors "after the bankruptcy proceedings finished."[273]

Despite the limited holding of *SPM*, bankruptcy professionals pushed the envelope by using some of the broader language of *SPM* to justify actions that would otherwise appear to be forbidden by the Bankruptcy Code, at least facially. Courts have generally obliged. Specifically, "creditors are generally free to do whatever they wish with the bankruptcy dividends they receive, including to share them with other creditors,"[274] has often been used to justify distributions that, on their face, seem to violate either the Absolute Priority Rule (by providing juniors with a recovery when an objecting class of seniors is not paid in full) or the Unfair Discrimination Prohibition (by providing a greater recovery to some creditors over the objection of a less fortunate co-equal class). The *SPM* doctrine of "gifting" has been expanded well beyond the concept that a secured creditor can agree to share a portion of its recovery to other creditors after receipt of proceeds in a Chapter 7 liquidation.

1. Secured creditor carveouts

The least controversial use of *SPM* is to permit carveouts of secured creditors' collateral. A typical carveout is an arrangement under which secured creditors permit the use of a portion of their collateral to pay administrative costs, such as attorney fees and possible subsequent Chapter 7 expenses.[275] Carveouts are usually negotiated as part of a Debtor-In-Possession ("DIP") financing or cash collateral agreements where, in the event of default on the DIP loan or cash

---

271. *Id.* at 1312.
272. *Id.* at 1309.
273. *Id.* at 1313.
274. *Id.*
275. *See generally* Richard B. Levin, *Almost All You Ever Wanted To Know About Carve Out*, 76 AM. BANKR. L.J. 445 (2002).

collateral agreement and resulting administrative insolvency of the debtor, the DIP or secured lender agrees to a capped amount of money extracted from the collateral (or in some cases added to the secured debt) that will be used to pay administrative fees.[276] The secured creditor's motivation in providing this kind of protection is to add value to the loan, add value to the debtor, and help ensure a smooth administration of the estate. The theory is that certain administrative creditors, especially professionals, would be unwilling to provide services to a potentially administratively insolvent debtor. The secured creditor with a lien on all the debtor's assets is willing to agree to the carve out because it believes that the value of the debtor's assets, and therefore its secured claim, will be increased by the services provided by certain administrative creditors.[277]

In *In re Nuclear Imaging Systems, Inc.*,[278] the court held that a secured creditor may agree to a carveout from its secured claim to pay certain administrative creditors of its choosing, without having to give the proceeds to a Chapter 7 trustee to distribute in accordance the Chapter 7 priority scheme.[279] Specifically, pursuant to a court-approved cash collateral stipulation, the secured creditor agreed to a carveout of $125,000 from its secured claim for postpetition professionals' fees of the debtor's attorneys.[280] The debtor's counsel had possession of the $125,000 and requested approval of such amounts in a fee application.[281] Another administrative creditor objected, arguing that such amounts must instead be distributed to the Chapter 7 trustee to distribute pro rata to all administrative expense claimants.[282] The court overruled the objection and, citing *SPM*, held that a secured creditor is free to contract with any creditor to pay such creditor from proceeds of the secured creditor's collateral.[283] The court explained that nothing in the Bankruptcy Code requires that "proceeds—which would otherwise be payable solely to the secured creditor but for its consent to transfer property to a particular administrative claimant—must be paid to the trustee as

276. *See id.* at 445-46.
277. *See id.* ("[T]he carve out . . . may benefit the secured creditor, which might have concluded that an orderly liquidation or restructuring process is likely to result in the highest net recovery on its claim, even after payment of care out expenses.").
278. 270 B.R. 365 (Bankr. E.D. Pa. 2001).
279. *Id.* at 371-73.
280. *Id.* at 369.
281. *Id.* at 370.
282. *Id.*
283. *Id.* at 379-81.

estate property."[284] The court explicitly stated that the secured creditor's claim was not estate property.[285]

2. Gifting to junior classes under a plan

The case of *In re MCorp. Financial, Inc.*[286] expanded *SPM* even further, permitting gifting (1) by an unsecured creditor, (2) directly from the debtor's estate (as opposed to directly from the gifting creditor), and (3) under a Chapter 11 plan (where the Absolute Priority Rule and the Unfair Discrimination Prohibition are applicable).[287] In *MCorp.*, senior unsecured bondholders negotiated a Chapter 11 plan of liquidation with the debtors and the creditors' committee, whereby the senior bondholders agreed to accept less than the full amount of their claims, while providing a nominal recovery to junior bondholders and a recovery to the FDIC, the latter being in settlement of prepetition litigation.[288] The senior bondholders agreed to pay the FDIC despite that they were not being paid in full, because they decided they would be better off settling with the FDIC and receiving an earlier recovery than spending years litigating with the FDIC.[289]

The junior bondholders rejected the plan and argued that it violated the Bankruptcy Code's cramdown provisions (the Absolute Priority Rule and the Unfair Discrimination Prohibition),[290] because the FDIC, which was arguably junior in priority to the junior bondholders, was receiving a recovery before the junior bondholders were paid in full.[291] The court rejected the junior bondholders' arguments, and, citing *SPM*, held that the recovery to the FDIC was proper because it was being paid by the senior bondholders out of their higher priority distribution.[292] The court appeared to adopt a

284. *Id.* at 379.

285. *Id.* at 380; *see In re* White Glove, Inc., 1998 WL 731611, *7 (Bankr. E.D. Pa. 1998) (citing *SPM* to support holding that a secured creditor in Chapter 7 is permitted to carve out a portion of the proceeds of its collateral to pay some administrative creditors of its choosing).

286. 160 B.R. 941 (S.D. Tex 1993).

287. *See id.*

288. *Id.* at 948.

289. *Id.*

290. They actually appear to have confused the two provisions, but the result is the same. *See id.* at 960 (using the Unfair Discrimination Prohibition in conjunction with 11 U.S.C. § 1129(b)(2)(B)(ii), which describes the conditions a plan must meet to be fair and equitable with respect to a class of unsecured claims, to determine that the plans pass the statutory test).

291. *See id.* (detailing the juniors' argument that the requirement in the Code that a plan does not discriminate unfairly means that the junior bondholders, by statute, should get paid before the FDIC).

292. *See id.* (determining that as long as the juniors receive as much as they are supposed if the seniors did not share their higher priority share then the regulation

general rule that a senior class of unsecured creditors may share its distribution under a debtor's Chapter 11 plan with a junior class of creditors, as long as the classes between the two receive "at least as much as what they would without the sharing."[293] The court similarly implied that unfair discrimination is not implicated when a senior class of creditors chooses to share its distribution with one junior class of creditors while not sharing anything with another class of creditors of equal priority to the junior class of creditors.[294]

The court explicitly stated that the fact that the senior creditor in *SPM* was secured was "not relevant;" rather, "it was the creditor's status as prior to the IRS that allowed it to share with those under the IRS, just as the seniors' priority over the juniors allows them to fund the FDIC settlement."[295] In addition, implicit in the *Mcorp.* court's ruling were: (1) the fact that the distribution in *SPM* was outside a plan was not relevant; and (2) the fact that the distribution to unsecured creditors in *SPM* was to be paid directly from the senior creditor to the junior creditor, as opposed to from the debtor's estate, was not relevant.[296]

3. Gifting to equity under a plan

The *SPM* doctrine was further expanded in *In re Genesis Health Ventures, Inc.*[297] to condone a distribution to equity holders, "gifted" by senior secured lenders, while creditors were not being paid in full.[298] In *Genesis*, the debtor's proposed plan of reorganization included a distribution under a new management incentive plan to certain directors and officers, who were prepetition equity holders, which included stock, loan forgiveness, waivers, releases, exculpation, and other value.[299] The court held that the Absolute Priority Rule was not violated by this distribution under the New Management Incentive Plan even though creditors were not being paid in full, because the distribution "represents an allocation of the enterprise value

is not violated).

293. *Id.*

294. *See id.* (noting that all equity is treated alike under the plan where the claims are paid before equity is paid).

295. *Id.*

296. *See id.* (indicating the only relevant factor in the *SPM* opinion in evaluating the junior bondholders' claim is that the secured creditor could share its proceeds with a creditor of a lower priority than the IRS).

297. *In re* Genesis Health Ventures, Inc., 266 B.R. 591 (Bankr. D. Del. 2001).

298. *See id.* at 617-18 (allowing Senior Lenders to determine how to allocate their value without violating the fair and equitable requirement of the Code).

299. *See id.* at 617 (describing the New Management Incentive Plan which provided benefits among forty-three management employees whose benefits were derived from value that would have gone to the Senior Lenders).

otherwise distributable to the Senior [secured] Lenders, which the Senior Lenders have agreed to offer to [management] . . . . The Senior Lenders are free to allocate such value without violating the 'fair and equitable' requirement."[300]

4. Gifting to select unsecured classes under a plan

a. Cases approving selective gifting

Courts have similarly applied *SPM*'s gifting doctrine to approve distributions under Chapter 11 plans that would otherwise violate the Unfair Discrimination Prohibition. Specifically, in *In re Parke Imperial Canton, Ltd.*,[301] the court held that the secured creditors' allocation of a portion of their distribution from the plan of reorganization to one class of unsecured creditors but not another class of unsecured creditors does not constitute unfair discrimination under § 1129(b) of the Bankruptcy Code.[302] In that case, the secured creditors proposed a plan that divided the unsecured creditors into two Classes—13 and 14.[303] Although both classes would share pro rata in

300. *Id.* at 618. The District Court for the Southern District of New York also recently held that the Absolute Priority Rule is not implicated when a senior (secured) creditor shares its distribution. Specifically, the court in *Motorola, Inc. v. Official Comm. of Unsecured Creditors* (*In re* Iridium Operating LLC) held that a secured creditor's agreement to fund a litigation trust to pursue litigation against a particular unsecured creditor and share the proceeds of the litigation trust with the debtor's estate does not violate the Absolute Priority Rule. No. 01Civ.5429(GBD), 2005 WL 756900, at *7 (S.D.N.Y. Apr. 4, 2005). In *Iridium*, the statutory committee of unsecured creditors and the agent for the debtor's senior secured lenders entered into a settlement agreement whereby the creditors' committee agreed not to contest the validity of the lenders' liens and the lenders agreed that the estates could use $47 million that they would have otherwise received on account of their secured claims to fund a litigation trust to sue Motorola, an administrative creditor. *Id.* at *2. The settlement agreement further provided that the proceeds of the litigation trust would be shared in a specified manner between the lenders and the debtor's estates. *Id.* The bankruptcy court approved the settlement agreement, and Motorola appealed, arguing that the $47 million used to fund a litigation trust to pursue litigation against Motorola is an improper distribution of estate moneys. *Id.* at *3-5. The district court rejected Motorola's argument, holding that, under *SPM*, the $47 million used to fund the litigation trust belonged to the lender and was not estate money; therefore, the priority scheme for distribution of estate assets under the Bankruptcy Code was not implicated. *Id.* at *7. In dicta, the court stated that *SPM* cannot be used to violate the Bankruptcy Code's priority scheme, but rested its holding on the fact that the $47 million was not estate money: "On these facts, the priority scheme for the distribution of estate assets under the Bankruptcy Code is not implicated, let alone violated." *Id.*

301. *In re* Parke Imperial Canton, Ltd., No. 93-61004, 1994 WL 842777 (Bankr. N.D. Ohio Nov. 14, 1994).

302. *See id.* at *11 (noting that the "cramdown" requirements of the Bankruptcy Code applied in this plan because several classes were impaired under the plan, and therefore the plan could not discriminate unfairly).

303. *See id.* at *2 (outlining all of the classes of the plan including Class 13, a class of unsecured claims that most of the other 12 classes paid into, and Class 14 which

the remaining proceeds after compensation of the secured claims, the secured creditors agreed to contribute up to $10,000 to guarantee that Class 13, but not Class 14, would receive at least a ten percent recovery.[304] The court cited *SPM* in rejecting an argument that this additional recovery to only one of two equal priority classes violated the Unfair Discrimination Prohibition.[305]

The *WorldCom* Court took *SPM* further than any other court up to that point, by finding that by voting to accept a plan of reorganization, a class of claims can be "deemed" to have "gifted" a portion of its recovery to another class of creditors, and that the additional recovery received by the recipients is not subject to attack as unfair discrimination or, presumably, as violative of the Absolute Priority Rule.[306] In *WorldCom*, an Ad Hoc Committee of Trade Creditors, consisting of some but not all trade creditors of the substantively consolidated debtors, objected to the plan of reorganization as originally filed.[307] To settle the objection, representatives of classes consisting of certain senior and subordinated bond claims agreed that their classes would forgo a portion of the plan consideration allocated to them and would provide such consideration to the members of the Ad Hoc Committee of Trade Creditors.[308]

The debtors thereafter amended the plan to provide that acceptances of the plan by the classes of bond claims would constitute an agreement by all holders of claims in such classes to distribute a portion of their recovery to members of the ad hoc trade committee.[309] The debtors solicited the votes of the classes of bond claims again, which were to receive a lower recovery as a result of the agreement made by certain bondholders, representatives on their

---

was the other unsecured claim class).

304. *Id.*

305. *See id.* at *11 (taking note that the 10 percent guarantee will not be paid from the estate, so *SPM* controls because Classes 13 and 14 are sharing equally in the distribution of proceeds).

306. *See In re* WorldCom, Inc., 2003 WL 23861928, at *60 (Bankr. S.D.N.Y. 2003) (reasoning that the discrimination among the classes in the reorganization plan is not unfair because it is "appropriate, reasonably proportional to the issues of the case and necessary to the reorganization").

307. *See id.* at *14 (noting that the Ad Hoc Trade Claims Committee was not the only objecting party, the Ad Hoc Committee of Dissenting Bondholders, Platinum Fund, a German back, and HSBC all objected to the original plan as well).

308. *See id.* at *14-15 (arguing a that it relied on pre-merger trade claims, the Ad Hoc Trade Claims Committee settled its objections by treating debt claims by reducing the recovery of the holders of those claims).

309. *See id.* (classifying these claims as MCI Pre-merger claims to allow for additional recoveries by the classes that had reliance claims).

behalf, and both such classes overwhelmingly voted to accept the plan.[310]

Upon request of the court, the debtors deemed the Ad Hoc Committee of Trade Creditors to be a separate class from the debtors' other trade creditors and deemed the class of other trade creditors to reject the plan.[311] As a result, the debtors pursued confirmation of the plan under the cramdown provisions of § 1129(b).[312]

The court then confirmed the plan, holding that it satisfied § 1129(b)(2) with respect to the deemed rejecting class.[313] Citing *SPM*, the court held that the enhanced recovery for the Ad Hoc Committee of Trade Creditors did not constitute "unfair discrimination" in violation of the Bankruptcy Code,

> because the Contributions are the result of other creditors . . . voluntarily sharing their recovery under the Plan with the members of the Ad Hoc MCI Trade Claims Committee . . . . The greater value received by the members of the Ad Hoc MCI Trade Claims Committee is not the result of the Debtors' distribution of estate

---

310. *See id.* at *75-76 (describing the voting procedures that allowed the senior debtors to reconsider their vote since they were going to get less recovery because of the compromise to allow for recovery to the Ad Hoc Trade Claims Committee to come from holders of debt claims).

311. *See id.* at *18-19 (determining that separating Class 6 into Class 6A [MCI Pre-Merger Claims] and 6B [Ad Hoc Trade Claims Committee] made the voting procedures fairer because although the two groups recovered the same, the Ad Hoc Trade Claims Committee could potentially have undue influence over the rest of the class). Although facially, it would appear that some members of a class receiving a greater recovery under a plan than other members of the class would violate section 1123(a)(4) of the Bankruptcy Code, the court held that the Ad Hoc Committee members were receiving the same treatment as the trade creditors under the plan. *Id.* at *17-18. *See generally* 11 U.S.C. § 1123(a)(4) (2000) ("a plan shall . . . provide the same treatment for each claim or interest of a particular class, unless the holder of a particular claim or interest agrees to a less favorable treatment of such particular claim or interest."). "Any enhanced value received by holders of [claims in the class of members of the Ad Hoc committee] on account of contributions from other Classes is not a treatment of these Claims under the plan and does not constitute unfair discrimination." *WorldCom*, 2003 WL 23861928, at *60. It appears that because the additional recovery to the members of the Ad Hoc Committee was coming through a "contribution" from other classes, the court did not consider it to be a distribution to such creditors for treatment purposes. *Id.* In fact, although separate classification of the Ad Hoc Trade Committee would generally have raised concerns under section 1122, the court simply ignored these by finding that the claims of the Ad Hoc Committee members "are separately classified for voting purposes and not for treatment purposes." *Id.*

312. *See id.* at *45 (noting that the cramdown mechanism allows the debtors to recognize the discrimination arguments of different classes, but still allows for the plan to go through because there is a reasonable basis for disparate treatment).

313. *See id.* at *60 (ruling that the discrimination among the various classes of unsecured claims is not unfair discrimination because there is a reasonable basis for the discrimination between the classes and the discrimination is needed to execute the reorganization plan).

> property to such creditors. Creditors are generally free to do whatever they wish with the bankruptcy dividends they receive, including sharing them with other creditors, so long as recoveries received under the Plan by other creditors are not impacted.[314]

The court noted that the contributions were "not coming from or diminishing the estate, but rather, [were] coming from and diminishing the previously accepted recovery of the holders of [senior and subordinated bond claims]."[315] Moreover, "[i]f the Contributions were not made, the amounts represented thereby would not inure to the benefit of any [claims in the class deemed to reject], but rather would be paid under the Plan and remain available to the Classes contributing the respective amounts."[316]

The court also held that the plan of reorganization did not violate the Absolute Priority Rule because no class of claims or equity interests junior to the deemed rejected class was receiving any property of the debtor under the plan.[317] The court noted that the "absolute priority rule is inapplicable to contributions of Plan recoveries made by certain creditors to other creditors. Agreements by creditors to share their recoveries under a plan of reorganization with other creditors need not benefit an entire class. Moreover, the contributing creditor need not be a secured creditor."[318]

Although WorldCom and the court were insistent that the additional recovery to the members of the Ad Hoc Trade Claims Committee was not estate property, and that they were getting the same "treatment" as other trade creditors, the use of the plan process to achieve this "gifting" for the benefit of some trade creditors, but not others, makes *WorldCom* different from other cases.[319] First, the agreement by the bondholders to contribute consideration to the

---

314. *Id.* at *61 (citing *In re* SPM Mfg. Corp., 984 F.2d 1305, 1313 (1st Cir. 1993)) (other citations omitted).

315. *Id.* at *24.

316. *Id.* at *25.

317. *See id.* at *61 (citing *SPM* for the proposition that creditors are free to do what they want with the proceeds as long as it does not diminish the recovery of other creditors, and the increased recovery for the Ad Hoc Trade Claims Committee is not the result of distribution of estate property).

318. *Id.* (internal citations omitted).

319. *See id.* (recognizing that the contribution is not coming from the estate, but rather the recovery of the holders of the Senior Debt Claims, and citing to *SPM* to support the proposition that the distribution to the Ad Hoc Trade Committee is not a distribution of estate property but rather a distribution of the creditors' own bankruptcy dividends). *But see In re* Snyders Drug Stores, Inc., 307 B.R. 889, 894 (Bankr. N.D. Ohio 2004) (rejecting the argument from a secured creditor that a plan to distribute assets to one class of unsecured creditors and not another was not a distribution of the estate because the distribution specifically includes assets that are part of litigation claims of the secured creditors against the debtors).

trade committee was a "deemed" contribution, achievable only through the plan process.[320] Unlike other cases where the creditors making the contribution explicitly agreed to do so, in *WorldCom*, certain large members of the classes agreed that the entire class would make the contribution, and by voting to accept the plan, the class was "deemed" to have agreed to make the contribution.[321] Although the class overwhelmingly voted to accept the plan, it did not do so unanimously. Thus, unlike in any other case expanding *SPM*, a creditor that did not want to make the distribution was forced to do so.[322] Moreover, unlike those other cases where the "gift" could have at least happened outside the plan context, in *WorldCom*, the gift was dependent on the plan solicitation process and plan voting guidelines.

In addition, the WorldCom Chapter 11 plan made the distinction between the creditors receiving the distribution (i.e., the noisy objectors) and those that did not (i.e., the dispersed smaller creditors). It classified them separately, and although the plan distribution section was careful to provide them with the same recovery, at least facially, the rest of the plan ensured that they were actually "treated" differently. Specifically, §§ .07 and 4.09 of the plan provided that holders in the trade committee class and holders of other general unsecured claims would each receive "(i) 7.14 shares of New Common Stock for each one thousand ($1,000) dollars of such holder's [allowed claim] and (ii) Cash in an amount equal to .1785 multiplied by the Allowed amount of such [claim]."[323]

---

320. *See Worldcom*, 2003 WL 2386198, at *24 (describing the plan process after the Senior Debt Claims holders voted to approve a contribution to the Ad Hoc Trade Claims Committee which included having all of the other classes reconsider their vote because all impaired classes have to vote on a plan that would discriminate against one class).

321. *See id.* at *49 (outlining the voting process where members of voting classes received a supplement of information regarding the treatment of the various unsecured claims, including the Ad Hoc Trade Claims Committee, and determining that the supplement supplied adequate information for all voting members to decide whether to accept or reject the plan including the contribution).

322. For example, a creditor might believe that it is unfair to provide extra consideration to certain large creditors in a class, simply because they are large and have the money and ability to hire counsel to stage a noisy, difficult objection. *See id.* at *17 (describing the voting procedures where more than one-half in number of claims voted in favor of the settlement, leaving some claims not in favor of the settlement).

323. WorldCom Plan, October 21, 2003 (the "WorldCom Plan"), §§ 4.07, 4.09. Section 4.08 of the WorldCom Plan concerned the treatment of another class of general unsecured claims—the "MCI Pre-Merger Claims," whose recovery was also heavily disputed and resolved by settlement. The treatment of that class is irrelevant for this analysis.

The additional recovery to holders of the trade committee claims was achieved through a different means. The "treatment" section for classes deemed to contribute provided for a recovery but added:

> provided, however, that the acceptance of the Plan by [the class] shall constitute an agreement by the holders of [allowed claims in the class] to contribute to the members of the Ad Hoc MCI Trade Claims Committee on a pro rata basis New Notes in an aggregate principal amount of $[X] out of the aggregate distribution provided to the holders of [allowed claims in the class], which contributions shall be distributed as set forth in Section 6.06 of the Plan.[324]

Section 6.12 of the WorldCom Plan further suggested that the distribution was being made under the plan: "The distributions of the contributions to the members of the Ad Hoc MCI Trade Claims Committee, pursuant to sections 4.12 and 4.13 of the Plan shall be distributed by the Disbursing Agent in the manner, and in such amounts, as determined by the Ad Hoc MCI Trade Claims Committee."[325]

When a secured creditor "gifts" a recovery that would concededly go to such creditor, it might be fair to say that the recovery should not be considered "estate property."[326] In *WorldCom*, in contrast, the recovery "gifted" by the bondholders was not necessarily a recovery the debtors were required to give to them. Rather, the recovery consisted of property of the debtors remaining after paying all secured claims.[327] The debtors could have divided those proceeds in numerous ways among its unsecured classes, not all of which would have resulted in the gifting classes receiving those proceeds. As such, these proceeds appear more like estate property than the recoveries gifted by secured creditors in the majority of the cases following *SPM*.[328]

---

324. *Id.* §§ 4.12, 4.13. The amount of the contribution of New Notes to the members of the ad hoc trade committee was $21.2 million in principal amount by holders of the MCI senior bonds and $19 million in principal amount by holders of the MCI junior bonds. *Id.*

325. *Id.* § 6.06.

326. In reality, even the property in which a secured creditor has a valid first priority lien is property of the estate under section 541 of the Bankruptcy Code. *See* 11 U.S.C. § 541(a) (2000) (listing an all-embracing definition of property of the estate created after filing for Chapter 11 bankruptcy).

327. *See WorldCom*, 2003 WL 23861928, at *22-23 (evaluating the contribution to the Ad Hoc Trade Claims Committee as a reduction in the recovery of the secured creditors after the secured creditors were paid in full according to the plan).

328. *See In re* Sentry Operating Co. of Tex., Inc., 264 B.R. 850, 863-64 (Bankr. S.D. Tex. 2001) (rejecting a plan that called for a 99% distribution to one class of unsecured creditors and a 1% distribution to the other class because it violated the Unfair Discrimination Rule, and determining that this distribution of assets from a

In addition, arguments may be made that *WorldCom* took *SPM* too far, because the gift could not have been made outside of the plan. Specifically, the MCI bondholders could not have made the contribution outside of the plan without unanimous consent of all the bondholders. It was only because of the unique Chapter 11 plan provisions allowing a vote of one-half in number and two-thirds in amount to force a recovery on a dissenting minority that the deal with the objecting trade creditors was able to be accomplished.[329] Without the benefit of the plan process, perhaps the largest bondholders would have agreed to make the distribution to the objecting trade committee on their own outside of the plan process. Similarly, without the benefits of *SPM*, the gift would have had to have been made to all trade creditors similarly situated with the Ad Hoc Trade committee.[330] The combination of the *SPM* doctrine and the plan process enabled the larger parties negotiating to spread the cost of resolving the objection among all bondholders, but limit the benefit of the contribution to the actual objecting parties.

While one might argue that this unfairly benefits those creditors who have the money and power to file and litigate a difficult objection, without the arrangement being sanctioned by the bankruptcy court, it is uncertain whether an agreement could have been reached at all, as it would undoubtedly have been much more expensive, perhaps prohibitively so, to pay all trade creditors the "asking price" of the objecting trade creditors.[331] It is also very important to note that, as is common in the gifting cases, the "objecting class," the trade creditors not on the trade committee, fared no worse as a result of the gift.[332] As such, it appears that the expansive use of *SPM* was not prejudicial to anyone and was beneficial to the plan process and the goal of Chapter 11, which is a consensual Chapter 11 plan. It allowed for creative plan drafting and

---

lien is part of the estate property).

329. *See* 11 U.S.C. § 1126(c), (f) (2000) (deeming an unimpaired class to accept the plan in total if one-half in number of creditors and the holders of two-thirds amount in claims accept the plan).

330. *See In re* SPM Mfg. Corp., 984 F.2d 1305, 1312 (1st Cir. 1993) (ruling that a creditor can distribute it's own dividends however it wants as long as it does not pay nonpriority creditors ahead of priority creditors).

331. *See WorldCom*, 2003 WL 23861928, *47 (discussing the strong position of the Ad Hoc Trade Claims Committee because they had "unique reliance claims" that differentiated their need for distribution from other unsecured creditors, and allowing for an amended plan that put the Ad Hoc Trade Claims Committee in a better position).

332. *See id.* at *5 (describing the plan that divided Class 6 into 6A which were pre-merger claims and 6B which were the Ad Hoc Trade Claims Committee claims, but elaborating that each member of the two classes would receive the same treatment under the plan: 7.14 shares of new stock and a cash payout).

negotiations that enabled the parties to avoid a long, costly, and protracted confirmation battle and paved the way for a much earlier emergence from Chapter 11 for WorldCom than would otherwise have been possible.[333] This inured to the benefit of all stakeholders and the debtor.

b. Cases rejecting selective gifting

Faced with similar facts to those in *WorldCom*, the court in *In re Sentry Operating Co. of Texas, Inc.*[334] came to a different conclusion.[335] Specifically, the *Sentry* Court held that a secured creditor's "gifting" a distribution under a plan of reorganization to one class but not another of equal priority is insufficient to overcome an objection by the rejecting class contending that the plan violates the Unfair Discrimination Prohibition.[336]

In *Sentry*, the debtors and the secured creditor jointly proposed a plan that paid the class of unsecured trade creditors 100% of their claims, while other unsecured creditors would receive only 1% of their claims.[337] The less favored creditor class rejected the plan and creditors in the class objected to the plan on the basis that it discriminated unfairly in violation of § 1129(b) of the Bankruptcy Code.[338] The secured creditor argued that the uneven distributions were not "unfair discrimination," because the secured creditor was giving up part of its entitlement in order to pay the trade creditor class, and the less favored class would not receive any distribution if the secured creditor merely foreclosed on its liens and security interests.[339]

---

333. *See generally* Paul Davidson, *WorldCom's Black Cloud About to Lift*, USA TODAY, Apr. 19, 2004, at 1B (discussing WorldCom's "astonishing" emergence out of Chapter 11 after being under it for twenty-one months despite the $11 billion accounting fraud when the average bankruptcy filing lasts thirty months).

334. 264 B.R. 850, 853 (Bankr. S.D. Tex. 2001).

335. *See id.* at 853 (determining that a plan did not draw the classes narrowly enough to overcome the statutory requirement of fair and equitable distribution).

336. *See id.* at 864 (ruling that there was no justification for discrimination that resulted in a ninety-nine percent pay differential between equally situated classes).

337. *See id.* at 855-56 (noting that most creditors in Class 3 had small claims and were mostly national entities and Class 4 included smaller creditors who would only get 1 percent of their claims paid out).

338. *See id.* at 859, 863 (discussing the purpose of the Unfair Discrimination Prohibition to ensure equal treatment, but that does not mean that some discrimination is impermissible because not all creditors are situated equally all the time).

339. *See id.* at 862-64 (detailing the secured creditors' argument which was premised on the fact that they had a lien on all assets, so the disfavored class had no legal right to complain about the distribution).

The court rejected the argument and held that the plan discriminated unfairly.[340] The court held that *MCorp.* was distinguishable, because it did not involve payments to a class of creditors under a plan; rather it involved a settlement, albeit through confirmation of a plan.[341] The court further noted that a "secured [creditor] cannot simply purchase the assent of an unsecured class by giving up part of its claim."[342]

The court reasoned that, although the secured creditor could have foreclosed on the collateral and used the proceeds as it wished without regard to the requirements of section 1129, the decision to use the "powerful equitable tools" in a Chapter 11 reorganization results in a price to be paid, namely

> negotiation to win over the acceptance of an impaired class and treatment of all non-accepting classes fairly, equitably, and without unfair discrimination. [The secured creditor] proposes to obtain the benefit of equitable tools without paying the price. The statute has no provision for that, and the Court is unwilling to read these requirements out of the Code.[343]

Important to the court was a view that "[i]n general, the Bankruptcy Code is premised on the rule of equality of treatment. Creditors with claims of equal rank are entitled to equal distribution.[344] The *Sentry* court would not have likely approved the distribution scheme in *WorldCom*. Perhaps the different result in these two cases can be attributed to the possibility that had the court not approved the deal in *WorldCom*, the case might have lingered in litigation over substantive consolidation for years, causing serious damage to the debtors,

---

340. *See id.* at 864 (using the "Markell" test to determine that the plan proponents did not overcome the presumption of unfair discrimination because the plan seemed to pay the class of national creditors for "reasons other than preservation of value" of the plan).

341. *See id.* at 863 (further distinguishing *Mcorp.* by pointing out that the court never addressed the priorities between the FDIC and the junior bondholders).

342. *Id.* at 864.

343. *Id.* at 866. The court appeared to worry about allowing what it viewed to be exceptions to the Chapter 11 plan requirements:

> To accept [the secured creditor's] argument that a secured lender can, without any reference to fairness, decide which creditors get paid and how much those creditors get paid, is to reject the historical foundation of equity receiverships and to read the § 1129(b) requirements out of the Code. If the argument were accepted with respect to § 1129(b) 'unfair discrimination requirement,' there is no logical reason not to apply it to the § 1129(b) 'fair and equitable' requirement [*i.e.*, the Absolute Priority Rule], or to the § 1129(a)(10) requirement that at least one class has accepted the plan. To accept that argument is simply to start down a slippery slope that does great violence to history and to positive law.

Id. at 865.

344. *Id.* at 863.

their estates, and all parties in interest. In contrast, in *Sentry*, the court may have believed the plan would have been easily confirmed without "unfairly" paying trade creditors or if the secured creditor agreed to provide a similar contribution to all unsecured creditors.

Similar to *Sentry*, but unlike *WorldCom*, the court in *In re Snyders Drug Stores, Inc.*,[345] held that a plan discriminated unfairly against an objecting class of unsecured creditors by providing a distribution only to other classes of unsecured creditors.[346] As part of the plan, the secured creditor agreed "to allow some of the money that it believe[d] would otherwise be paid on its secured claim to instead be set aside and paid to two junior classes of unsecured creditors."[347] As a result, the unsecured creditors in Class 10 (generally trade creditors with whom the reorganized debtor intended to do business and lessors of stores it intended to continue to operate) would receive $3.75 million in cash, excess from a reclamation fund, and recoveries from preserved litigation claims.[348] In contrast, Class 12, which consisted of other lessor claims, would receive nothing.[349]

The court rejected the proponents' argument that the distribution to the unsecured creditors was not property of the estate, but constituted an agreement by the senior secured creditor to share some of its recovery with other creditors.[350] The court noted first that, because the distribution included recoveries from preserved litigation claims (presumably not subject to the secured creditor's liens), the distribution is property of the estate and must be made in accordance with the Bankruptcy Code.[351] The court held that *SPM* was distinguishable because (1) it dealt with property that was not property of the estate and (2) it concerned an agreement that "was not proposed as part of a plan of reorganization, but was instead in the nature of a partial assignment or subordination agreement that was not subject to the code's confirmation requirements."[352] The

345. 307 B.R. 889 (Bankr. N.D. Ohio 2004).
346. *See id.* at 891 (outlining the objections to the reorganization plan of a drug store chain that included an unfair discrimination claim and an Absolute Priority Rule violation, and upholding the unfair discrimination claim).
347. *Id.* at 892.
348. *See id.* (explaining that the $3.75 million is a six to seven percent distribution of the recovery to the secured creditor, and noting that another class of unsecured creditors with reclamation claims will get a twenty-seven percent distribution).
349. *See id.* (recognizing that this class consisted of landlords that had claims arising from lease rejections of nonresidential real property and personal property).
350. *Id.* at 894.
351. *See id.* (using 11 U.S.C. § 541 to determine that recoveries from preserved litigation claims is by statute part of the estate and therefore must be distributed as part of the reorganization plan).
352. *Id.* at 896 n.11.

court was not clear about whether it would have allowed the gifting had the recoveries to Class 10 been clearly out of funds that would otherwise have gone to secured creditors.[353] Unlike the *WorldCom* court, the *Snyders* court appeared to have a fundamental problem with the use of an *SPM* gifting scenario to overcome the Bankruptcy Code's Chapter 11 cramdown confirmation requirements.[354] As such, like the court in *Sentry*, it is unlikely that the court in *Snyders* would have approved the WorldCom Plan. Again, it is possible that the court in *Snyders* believed that under the facts of that case, unlike in *WorldCom*, by rejecting the proposed deal, a new, "more fair" deal could easily be reached.[355]

5. Rejection of use of SPM *for improper ends*

Other than *Sentry* and *Snyder*, the latter of which is not as strong as the former,[356] courts that have rejected the use of *SPM* to circumvent the confirmation requirements of a Chapter 11 plan have generally done so only when faced with particularly nefarious attempts by parties to favor certain parties over others rather than an attempt to "get a deal done."

For example, in *In re CGE Shattuk, LLC*,[357] the court held that a secured creditor cannot offer to pay some unsecured creditors to reject a plan and force a Chapter 7 conversion to circumvent the requirements of confirmation of a Chapter 11 plan.[358] In *CGE*, the debtor and the secured creditor filed competing Chapter 11 plans.[359] The secured creditor thereafter withdrew its plan and, in an effort to obtain rejection of the debtor's plan, offered to give certain creditors

---

353. *See id.* at 895 (focusing the analysis of Class 10 on the fact that it included lessors just like Class 12, and there was no reasonable basis for the discrimination between the lessors in Class 10 and the lessors in Class 12 because the Class was not narrowly tailored to the goals of the plan).

354. *See id.* at 894-96 (relying on a four-factor test to determine whether the discrimination was unfair instead of relying on *SPM*: (1) is there a reasonable basis for the discrimination, (2) whether the plan can be achieved without the discrimination, (3) whether the discrimination is in good faith, and (4) how the discriminated class is treated).

355. *See id.* at 895-96 (noting that under the current plan the discriminated class has no meaningful opportunity for recovery because it does not get any distribution, and that the plan can be confirmed without the discrimination).

356. One could limit *Sentry* to its facts because of the court's expressed concern that the recovery being "gifted" did not actually belong to (*i.e.*, was not subject to the lien of) the secured creditor.

357. 254 B.R. 5 (Bankr. D.N.H. 2000).

358. *See id.* at 13 (denying the plan of the debtor and secured creditor to pay portions of the recovery because the disclosure was an attempt to subvert the Chapter 11 provisions).

359. *See id.* at 7 (explaining that the secured creditor filed a second plan because it felt that the debtor's plan would not be confirmed by all creditors, and the secured creditor wanted to maximize the value of the debtor's assets).

a payment if, by a certain date, the secured creditor was either granted relief from the stay or the case was converted to Chapter 7.[360] Patently, the secured creditor was seeking to buy the support of such creditors to block the reorganization efforts of the debtor.[361]

Citing *SPM*, the secured creditor, "NCC," argued that it should be permitted to pay anyone it wished out of the proceeds of its collateral.[362] The bankruptcy court rejected this argument and held that *SPM* was distinguishable because it involved a formally executed agreement between a secured creditor and the creditors' committee that specifically called for the parties to work toward negotiating a plan of reorganization and to work cooperatively to maximize the value of the debtor's estate as well as assure a return to general unsecured creditors.[363]

The court noted that, while the secured creditor's commitment was somewhat similar to a Chapter 11 plan, it was an attempt to avoid the requirements of Chapter 11 associated with plan proposal and confirmation, including: (1) classification of claims (11 U.S.C. § 1122), (2) equality of treatment of members of the same class (11 U.S.C. § 1123(a)(4)), and (3) confirmation standards (11 U.S.C. § 1129).[364] "In effect, by withdrawing the NCC amended plan, and making minor changes to the NCC Commitment [to make a distribution to certain creditors], NCC seeks to obtain for itself the economic benefits of the withdrawn plan without complying with the requirements for confirming a Chapter 11 plan of reorganization."[365] The court noted specifically that the distribution scheme enacted by the secured creditor's proposal would permit different treatment of creditors in the same class in violation of section 1123(a)(4) of the Bankruptcy Code.[366] Accordingly, "[e]ven assuming that the

---

360. *See id.* at 8-9 (recognizing that the secured creditor withdrew its propose plan but filed a commitment to pay fifty percent of the claims to certain creditors if they were granted the stay or the case was converted to Chapter 7).

361. *See id.* at 9 (taking note that the amended commitment to pay the fifty percent dividend was a clear inducement for the unsecured creditors to reject the debtor's plan in favor of the fifty percent dividend).

362. *See id.* at 10 (disregarding the label the secured creditor put on its proposal (a plan to pay collateral), and stating that the substance of a proposal determines whether the proposal is a distribution of collateral or a reorganization plan).

363. *See id.* at 10-11 (noting that, in the current case, there was no formal agreement and no commitment to generate a joint plan).

364. *See id.* at 10 (defining a plan of reorganization as a plan that is an offer by a party in interest to make a distribution to creditors and subject to confirmation by the creditors and then approval by the bankruptcy plan, and noting that the secured creditor's commitment is a plan that is an offer of a party in interest to make a distribution but it is not subject to the requirements of a plan of reorganization under Chapter 11).

365. *Id.* at 13.

366. *See id.* at 11 (elaborating that the commitment is a reorganization plan

differences between the facts of *SPM* and this case are not pertinent, the decision in *SPM* is not authority for the proposition that parties in a bankruptcy proceeding may avoid the requirements of the Bankruptcy Code by private agreement."[367]

Similarly, the court in *In re Goffena*[368] refused to uphold an agreement between a secured creditor and a Chapter 7 trustee under which the secured creditor would allocate and pay the Chapter 7 trustee's fees from the collateral proceeds while other administrative and priority claimants would not be satisfied.[369] The court held that *SPM* was inapposite, because unlike *SPM*, despite making the payment from the bank's collateral, the property in *Goffena* remained property of the estate.[370] The bankruptcy court reasoned that the secured creditor had withdrawn its motion for stay relief and, therefore, the encumbered property constituted property of the estate.[371] Accordingly, the proceeds thereof "came into the bankruptcy estate to be distributed according to the provisions of the Bankruptcy Code, including Sections 506(c) and 726."[372] The court also held that the purportedly gifted amount to the Chapter 7 trustee was not an assignment or subordination of the secured creditor's sale proceeds to a creditor, but was a payment to the "estate to facilitate its interests in a quick sale at a favorable market price."[373] The court concluded that "[h]aving so rewarded the estate (and not the Trustee individually, for the Trustee is a fiduciary for the estate), the sum

because the economic substance of the plan effectuates the same result as a Chapter 11 plan while directly subverting the requirements of Chapter 11, and refusing to permit a plan that is clearly against statutory requirements and controlling case law).

367. *Id.*

368. 175 B.R. 386 (Bankr. D. Mont. 1994).

369. *See id.* at 389-92 (allowing the secured creditor and the trustee to agree to an assignment of sales proceeds, as long as the agreement was not contrary to the requirements of the Bankruptcy Code like the current requirement).

370. *See id.* at 391 (further distinguishing *SPM* by noting that the Chapter 7 trustee is not a creditor of the estate unlike the unsecured creditors in *SPM* who were creditors of the estate of the debtor, and noting that *SPM* does not even involve a determination of the priorities of estate property under the Bankruptcy Code).

371. *See id.* (realizing that once the motion for stay relief was abandoned, the property remained the bank's collateral, which is part of the estate according to the Bankruptcy Code).

372. *Id.* Section 726 of the Bankruptcy Code governs the priority of distributions in a case under Chapter 7. It provides that property of the estate is to be distributed first to holders of claims in the priority specified in section 507 of the Bankruptcy Code. 11 U.S.C. § 726(a)(1) (2000). The *Goffena* court also seemed bothered by the agreement's attempting to set the Chapter 7 trustee's fees in circumvention of section 326 of the Bankruptcy Code which provides for the fees to be paid to trustees. 175 B.R. at 391.

373. *Id.* at 392.

allocated for the Trustee's fee is property of the bankruptcy estate to be distributed pursuant to § 726."[374]

The bankruptcy court in *In re Scott Cable Communications, Inc.*[375] similarly rejected an attempted use of *SPM* to overcome the requirements of Chapter 11. In that case the plan proposed to avoid paying taxing claims in violation of § 1129(d) of the Bankruptcy Code.[376] The plan of liquidation of Scott Cable contemplated that the debtor's assets would be sold pursuant to the plan of liquidation but *after* confirmation.[377] The plan provided that all administrative, priority, and general unsecured creditors would be paid from the recoveries otherwise distributable to the subordinated secured creditors.[378] However, the plan was structured to avoid the payment of capital gains taxes attributable to the sale.[379] The debtor argued that those taxes did not have to be paid under the plan, because the sale would occur after confirmation.[380]

The IRS objected to the plan. It argued, *inter alia*, that the plan violated § 1129(a)(9) and encompassed a tax avoidance scheme proscribed by § 1129(d) of the Bankruptcy Code.[381] The debtor argued that *SPM* supported the subordinated secured creditors' right to pay other unsecured creditors from their distribution without paying the IRS.[382] The court rejected the argument, noting that "*SPM*[, a Chapter 7 liquidation,] is inapplicable because Chapter 7 does not require a plan and, therefore, is not subject to the confirmation requirements of § 1129."[383] The court concluded that, on the facts before it, the principal purpose of the plan was avoidance

---

374. *Id.* The holding in *Goffena* could, however, be limited to its facts, as the court appeared to have real concerns about the fact that the Chapter 7 trustee, while securing payment of its own fees, failed to send notice to the taxing authorities about the sale of collateral, which contained the agreement to pay the trustee's fees. *See id.* at 389-90.

375. 227 B.R. 596 (Bankr. D. Conn. 1998).

376. *Id.* at 601, 603.

377. *Id.* at 598.

378. *Id.*

379. *Id.* at 599. The plan also provided that the subordinated secured creditors and others would receive releases, including releases from any tax liability to the IRS. *Id.*

380. *Id.*

381. *Id.*; *cf. id.* at 603 ("Section 1129(d) provides[that n]otwithstanding any other provision of this section, on request of a party in interest that is a governmental unit, the court may not confirm a plan if the principal purpose of the plan is the avoidance of taxes. . . .").

382. *See id.* at 603 (explaining that the debtor tried to justify its nonpayment to the IRS on the authority of *SPM*).

383. *Id.*

of tax liability, in violation of § 1129(d) of the Bankruptcy Code.[384] Accordingly, it denied confirmation.[385]

IV. *ARMSTRONG*: THE PLAN, THE DECISION, AND THE IMPLICATIONS

Against the backdrop of the foregoing cases, the Third Circuit Court of Appeals in *Armstrong* was asked to decide, in the context of a heavily litigated confirmation battle, whether the *SPM* doctrine could be stretched to its extreme, but logical, limits: permitting the deemed gifting from one class of unsecured creditors to equity through a plan of reorganization over the objection of another class of unsecured creditors.[386] The *Armstrong* court was unwilling to go that far. It not only held that the gifting iteration in the debtor's plan violated the Absolute Priority Rule, but upheld the district court's decision, which suggested that lesser iterations were also impermissible, despite decisions by other courts.[387]

A. *The Armstrong Plan*

Armstrong World Industries Inc. ("Armstrong") and its subsidiaries design, manufacture, and sell flooring products, kitchen and bathroom cabinets, and ceiling systems around the world.[388] Armstrong commenced its Chapter 11 case in 2000 after being bombarded with asbestos-related personal injury and wrongful death claims.[389] The United States Trustee appointed three separate creditors' committees pursuant to § 1102(a) of the Bankruptcy Code: the official or statutory committee of unsecured creditors (the "Unsecured Creditors"), the official committee of asbestos personal injury claimants (the "Asbestos PI Claimants"), and the official committee of asbestos property damage claimants.[390] The asbestos

384. *Id.* at 604. *Scott Cable* can likely be limited to its facts because court held that if the sale of the collateral were to occur outside of bankruptcy, or before plan confirmation, or in the plan itself, the tax liability resulting would be so substantial as to deny any recovery to the subordinated secured creditors. *Id.* at 603. As such, the subordinated secured creditors were not actually entitled to the recovery being provided to them under the plan and which they sought to use to pay other creditors.

385. *Id.*

386. *See generally In re* Armstrong World Indus., Inc. (*Armstrong II*), 432 F.3d 507 (3d Cir. 2005).

387. *See infra* Part IV.B (describing the district court and court of appeal's decision).

388. *Armstrong II,* 432 F.3d at 509.

389. *Id.*; Brief of Appellant Armstrong World Indus., Inc. at 7, *In re* Armstrong World Indus., Inc. (*Armstrong II*), 432 F.3d 507 (3d Cir. 2005) (No. 05-1881)).

390. *In re* Armstrong World Indus., Inc.(*Armstrong I*), 320 B.R. 523, 525 (Bankr. E.D. Pa. 2005).

property damage claimants committee was disbanded during the Chapter 11 case.[391]

After extended negotiation, Armstrong reached an agreement with its committees on the terms of a plan of reorganization and filed its Fourth Amended Plan of Reorganization (the "Armstrong Plan").[392] The Armstrong Plan included the following classes and projected recoveries, among others: Class 6—Unsecured Creditors (approximate 59.5% recovery), Class 7—Asbestos PI [Personal Injury] Claimants (approximate 20% recovery), Class 12—Equity Interest Holder (New Warrants valued at approximately $35 million to $40 million).[393] The only equity interest holder of Armstrong is Armstrong's parent company, Armstrong Worldwide, Inc., which is, in turn, wholly owned by Armstrong Holdings, Inc.[394] If the Armstrong Plan would be confirmed and consummated, the New Warrants ultimately would be distributed to the public shareholders of Armstrong Holdings, Inc.

Recognizing that a recovery to the equity holder would violate the Absolute Priority Rule unless all classes of creditors voted to accept the Armstrong Plan, the plan provided for a contingent alternative if Class 6 rejected it. If Class 6 voted to reject the Armstrong Plan, the New Warrants would be distributed to the holders of Class 7 claims, who would then be deemed, by virtue of voting to accept the Armstrong Plan, to have waived the right to receive the New Warrants and to agree to contribute such warrants to the equity holder.[395]

Specifically, § 3.2(1) of the Armstrong Plan provided:

> On or as soon as practicable after the Effective Date, Reorganized AWI shall issue the New Warrants in respect of the Equity Interests in AWI as provided in section 7.24 hereof; *provided, however*, that, if Class 6 votes to reject the Plan, no distribution shall be made under the Plan from AWI's estate in respect of the Equity Interests in AWI but, in such event, Reorganized AWI shall issue the New Warrants as provided in section 7.24 hereof in respect of the Asbestos Personal Injury Claims and in accordance with section 10.1(b) hereof.[396]

Further, § 10.1(b) of the Armstrong Plan provided

> In addition, if Class 6 has voted to reject the Plan, the New Warrants shall be issued by Reorganized AWI on account of the

391. *Id.* at 525 n.4.
392. *Id.* at 525.
393. *In re* Armstrong (*Armstrong II*), 432 F.3d at 509.
394. *Id.*
395. *Id.*
396. *In re Armstrong* (*Armstrong I*), 320 B.R. at 526 n.7.

> Asbestors Personal Injury Claims; however, such claimants have waived on behalf of themselves and the Asbestos PI Trust any right to the New Warrants. The New Warrants shall be issued by Reorganized AWI to AWWD (or to Holdings as the successor to AWWD under the Holdings Plan of Liquidation), consistent with section 7.24 hereof (and shall never be issued or delivered to the Asbestors PI Trust), without any action being required of, or any direction by, the Asbestos PI Trust or the Asbestos PI Trustees in such regard.[397]

Although the Unsecured Creditors had negotiated and supported the Armstrong Plan, it could not bind the individual unsecured creditors.[398] In addition, the committee began to have reservations about the advantages of the Armstrong Plan to Unsecured Creditors as the voting deadline approached.[399] The reason for the Unsecured Creditors' change in course was that the Senate Judiciary Committee had approved legislation, the Fairness in Asbestos Injury Resolution Act (the "FAIR Act"),[400] and the Committee believed that the FAIR Act might be enacted in the very near future. If that occurred, Armstrong's liability for asbestos injury claimants would be reduced making more money available for unsecured creditors.[401] As a result, the parties obtained an extension of the voting deadline.[402] However,

---

397. *Id.* at 526 n.8.

398. *See In re Armstrong* (*Armstrong II*), 432 F.3d at 509 (explaining that, because the plan would issue the new warrants to AWI's equity interest holders without fully satisfying the claims of the unsecured creditors, all "impaired" unsecured creditors were required to approve the plan under section 1129(a)(8)).

399. *In re Armstrong* (*Armstrong I*), 320 B.R. at 527.

400. *Id.* at 527-28.

401. *In re Armstrong* (*Armstrong II*), 432 F.3d at 510. Specifically, the FAIR Act would provide an

> exclusive administrative forum for addressing asbestos claims . . . [and] would create a no-fault, administrative compensation system for asbestos claims that would replace civil litigation in the state and federal courts. A claims process under the supervision of the United States Court of Federal Claims would determine eligibility for compensation, and eligible claimants would be paid from a Fund financed by contributions from insurers and from defendant companies.

In re Armstrong (*Armstrong I*), 320 B.R. at 527-28 (quoting Patrick M. Hanlon, *Asbestos Litigation in the 21st Century/Asbestos Legislation: Federal and State*, SJ031 A.L.I.-A.B.A. 549, 556 (2003)). It appears that the creditors' committee believed that Armstrong's contribution to the trust created as a result of the FAIR Act would be less than its payout to the personal injury claimants in class 7, resulting in more assets in the estate to be distributed to general unsecured creditors. Armstrong's mandatory contribution to the trust created by FAIR was estimated to range from $520 million to $805 million, while Armstrong's contribution to such a trust under the plan was over $1.8 billion in cash, notes, and common stock in the reorganized debtor. *In re Armstrong* (*Armstrong II*), 432 F.3d at 510.

402. *In re Armstrong* (*Armstrong II*), 432 F.3d at 510.

neither the debtor nor the court was willing to extend the date of the hearing to consider confirmation of the Armstrong Plan.[403]

As of the voting deadline, all impaired classes voted to accept the Armstrong Plan, except Class 6.[404] Although the requisite majority of Class 6 claims in number voted to accept the plan (88.03%), less than the requisite two-thirds in amount of Class 6 claims voted to accept the plan (23.21%).[405] In addition, the Unsecured Creditors filed a timely objection to the Armstrong Plan, arguing, among other things, that (1) the Armstrong Plan should not be confirmed until the fate of the FAIR Act was determined, and (2) the Armstrong Plan could not be confirmed over their objection, as it could not satisfy the cramdown requirements of § 1129(b).[406]

B. Court Rejection of the Armstrong Plan

After an extended hearing, the bankruptcy court issued proposed findings of fact and conclusions of law and a proposed confirmation order, and a recommendation to the district court that the Unsecured Creditors' objection be overruled and the Armstrong Plan be confirmed.[407] The Unsecured Creditors filed at the district court

---

403. *In re Armstrong* (*Armstrong I*), 320 B.R. at 528 & n.10. In any event, as noted by the district court, "[w]hile both the parties' perceptions of whether legislation would help or hinder their respective positions and of the likelihood that the legislation would be enacted may have influenced their decision to support or oppose the Plan, these political calculations have no bearing on the legal issues before the Court." *Id.* at 528.

404. *See id.* at 528 (recounting that Classes 3, 7, and 12 voted to accept the plan, while Class 6 voted to reject it).

405. *In re Armstrong* (*Armstrong II*), 432 F.3d at 510; *cf.* 11 U.S.C. § 1126(c) (2000) ("A class of claims has accepted a plan if such plan has been accepted by creditors . . . that hold at least two third in amount and more than one-half in number of the allowed claims of such class held by creditors . . . that have accepted or rejected such plan.").

406. *See In re Armstrong* (*Armstrong II*), 432 F.3d at 510 (stating that the Unsecured Creditors' objection was based on (1) the perceived consequences of the proposed FAIR Act, and (2) the applicability of the Absolute Priority Rule).

407. *Id.* The bankruptcy court indicated that because the plan included a channeling injunction under § 524(g) of the Bankruptcy Code, it did not have jurisdiction to enter a final order confirming the plan; rather, it could only issue proposed findings of fact and conclusions of law to the district court. Brief of Appellee Official Comm. of Unsecured Creditors of Armstrong World Indus., Inc. et al., at 11, *In re* Armstrong World Indus., Inc., 432 F.3d 507 (3d Cir. 2005) (No. 05-1881) (citing 11 U.S.C. § 524(g)(3)(A) (2000) (providing that a channeling injunction shall be valid if an order confirming the plan "was issued or affirmed by the district court that has jurisdiction over the reorganization case"); 28 U.S.C. § 157(c)(1), which states:

> A bankruptcy judge may hear a proceeding that is not a core proceeding but that is otherwise related to a case under title 11. In such proceeding, the bankruptcy judge shall submit proposed findings of fact and conclusions of law to the district court, and any final order or judgment shall be entered by the district judge after considering the bankruptcy judge's proposed findings

objections to the bankruptcy court's findings, conclusions, and recommendation.[408] After holding a hearing, the district court denied confirmation, holding that the Plan violated the Absolute Priority Rule.[409] The Third Circuit affirmed.[410]

The Third Circuit began its statutory construction and analysis by referring to the words of the statute, noting that "[i]f the meaning is plain, we will make no further inquiry unless the literal application of the statute will end in a result that conflicts with Congress's intentions."[411] The court stressed that the intentions of Congress control.[412] The court then stated that the plain language of the statute made it clear that "a plan cannot give property to junior claimants over the objection of a more senior class that is impaired," and that nothing in the legislative history demonstrates that such plain meaning conflicts with Congress's intent.[413]

The Court of Appeals then rejected Armstrong's argument that the gifting provided for in the plan is permissible under the precedents established in *SPM*, *MCorp.*, and *Genesis*. Without much explanation, the appellate court adopted the district court's interpretation of those cases and agreed that "they do not stand for the unconditional proposition that creditors are generally free to do whatever they wish with the bankruptcy proceeds they receive."[414]

The district court had addressed those cases in a section entitled "Cases That Do Not Strictly Apply Section 1129(b)(2)(B)(ii) Are Distinguishable or Wrongly Decided."[415] After a detailed discussion of *SPM*, the court held that *SPM* was inapposite to the Armstrong Plan for various reasons. First, *SPM* occurred in a Chapter 7 case, where the Absolute Priority Rule does not apply.[416] Second, because *SPM* involved a secured creditor with a perfected, first priority lien in

---

> and conclusions and after reviewing de novo those matters to which any party has timely and specifically objected.

28 U.S.C. § 157(c)(1).

408. *In re Armstrong* (*Armstrong II*, 432 F.3d at 510).
409. *Id.* at 510-11.
410. *Id.* at 518.
411. *Id.* at 512.
412. *Id.*
413. *Id.* at 513. Armstrong had argued that the statements of the bill's sponsors that a senior creditor shall not be able to give up consideration to a junior class over the objection of an "intervening class" meant that gifting was proper when a senior class gives up consideration to a junior class over the objection of a co-equal (rather than intervening) class. *Id.* The court rejected this argument as contrary to the plain meaning of the statute and to other statements in the legislative history. *See id.* (concluding that the plain language of the statute and legislative history do "not indicate that the objecting class must be an intervening class").
414. *Id.* at 514.
415. *In re Armstrong* (*Armstrong I*), 320 B.R. 523, 537 (3d Cir. 2005).
416. *Id.* at 538.

almost all of the debtor's assets, which were sold, the proceeds were not subject to distribution under the Bankruptcy Code's priority scheme (section 726 for Chapter 7 cases).[417] The district court disagreed with those courts that have held that the collateral security of secured creditors is not property of the estate.[418]

Third, the sharing agreement in *SPM* was akin to an ordinary carveout.[419] "Unlike the Debtor in the instant case, the secured lender in *SPM* had a *substantive right* to dispose of its property, including the right to share the proceeds subject to its lien with other classes."[420]

The district court also distinguished *WorldCom*, *Genesis*, and *MCorp*. It noted accurately that *WorldCom* involved distributions between classes of equal priority (a question of the Unfair Discrimination Prohibition), which did not implicate the Absolute Priority Rule.[421] This is a weak distinction, because either a gift or transfer of value from one creditor class to another constitutes plan treatment or it does not. If it does, as the *Armstrong* court appears to believe, then such a gift would implicate the Unfair Discrimination Prohibition just as much as it would implicate the Absolute Priority Rule. The *WorldCom* court apparently believed such a gift did not constitute plan treatment and, therefore, did not implicate either the Unfair Discrimination Prohibition or the Absolute Priority Rule.

The court distinguished *Genesis* asserting that the distribution to equity holders through the management incentive plan involved an acceptable carveout from the secured creditor's recovery.[422]

---

417. *Id.* at 538 & n.29.

418. *See id.* at 538 (reasoning that the agreement between the secured lender and the unsecured creditors involved property of the estate). The court cited § 541 of the Bankruptcy Code, *id.* at 538 n.28, which defines property of the estate to include "all legal or equitable interests of the debtor in property as of the commencement of the case." 11 U.S.C. § 541(a)(1) (2000). The court was correct, as even *SPM* noted that property subject to the secured lender's lien is property of the estate until that property is distributed to the secured lender. *See* Official, Unsecured Creditors Comm. v. Stern (*In re* SPM Mfg. Corp.), 984 F.2d 1305, 1313 (1st Cir. 1993) (where the court stated:

> In this case, the proceeds of the sale of SPM's assets pursuant to 11 U.S.C. § 363 were property of the estate and thus the Code governed their use and distribution. However, once the court lifted the automatic stay and ordered those proceeds distributed to [the secured creditor] in proper satisfaction of its lien, that money became property of [the secured creditor], not of the estate).

419. *In re Armstrong* (*Armstrong I*), 320 B.R. at 538-39.

420. *Id.* at 539 (emphasis added).

421. *Id.*

422. *See id.* (reasoning that because the property distributed to the junior class in *Genesis* was subject to senior lenders' liens, it did not violate the Absolute Priority Rule) (citing *Genesis*, 266 B.R. 591, 617-18 (Bankr. D. Del. 2001)).

The court's distinction of *MCorp.* was even weaker, noting that the distribution approved in that case was made "to fund settlement of pre-petition litigation between the debtor and a third party."[423] After spending pages describing the importance of a strict application of the Absolute Priority Rule, the district court in *Armstrong* did not adequately justify why a diversion of consideration to junior stakeholders to resolve litigation is an appropriate exception to the Absolute Priority Rule while a gift from another creditor is not.

Apparently recognizing that its distinctions of the above cases were weak, the district court in *Armstrong* suggested that those cases are wrongly decided. According to the court,

> to the extent that *In re WorldCom*, *In re Genesis Health Ventures*, and *In re MCorp Financial* read *SPM* to stand for the unconditional proposition that 'creditors are generally free to do whatever they wish with the bankruptcy dividends they receive, including sharing them with other creditors, so long as recoveries received under the plan are not impacted,' . . . without adherence to the strictures of 11 U.S.C. § 1129(b)(2)(B)(ii), that contention is flatly rejected here.[424]

The both the district and circuit courts in *Armstrong* unequivocally rejected the strong policy arguments in favor of permitting the structure in the Armstrong Plan to enable the reorganization of Armstrong and its emergence from Chapter 11. According to the district court, "no amount of legal creativity or counsel's incantation to general notions of equity or to any supposed policy favoring reorganizations . . . supports judicial rewriting of the Bankruptcy Code."[425] The Court of Appeals endorsed the district court's flat rejection of a liberal construction of the Bankruptcy Code in order to achieve its objective of successful business reorganization.[426] It added its own death blow to liberal construction, stating that "[a]llowing this particular type of transfer 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."[427]

---

423. *Id.*

424. *Id.* at 539-40 (quoting *WorldCom*, 2003 WL 23861928, *59, 174-75 (Bankr. S.D.N.Y. 2003); citing *In re* Sentry Operating Co., 264 B.R. 850, 865 (Bankr. S.D. Tex. 2001); citing *In re* Snyders Drug Stores, Inc., 307 B.R. 889, 896 n.11 (Bankr. N.D. Ohio 2004)).

425. *Id.* at 540.

426. *Cf. In re* Armstrong World Indus., Inc. (*Armstrong II*), 432 F.3d 507, 514 (3d Cir. 2005) (adopting the district court's interpretation of *SPM*, *Genesis*, and *Mcorp.*).

427. *Id.* at 514-15.

C. The Danger of the Armstrong *Decision*

The Third Circuit's decision was wrong both from a statutory and policy perspective. The bottom line is that *no one would have been harmed* by the proposed gifting in *Armstrong*. The rejecting class was not entitled to the value that was to be transferred to the equity holder. As a result, it should have had no right to hold up confirmation on the basis of the value being provided by one class to another. Under the Armstrong Plan that was denied confirmation, the Class 6 Unsecured Creditors were going to receive a distribution worth approximately 59.5% of their claims.[428] If Armstrong amended its plan based upon the Third Circuit's decision and removed the gift of the warrants to equity absent a different agreement among the parties, Class 6 would receive approximately 59.5% of its claims—*the exact same amount* as originally proposed.[429]

Significantly, Class 6 would have no basis under which to object to the warrants being distributed to and retained by Class 7. This is because under the plan, Class 7 is estimated to recover twenty percent of its claims.[430] If Class 7 kept the warrants, the recovery to Class 7 would still be well under thirty percent[431]—substantially less than the nearly sixty percent recovery being provided to the equal

428. *Id.* at 509.

429. In fact, after the Armstrong II decision, the district court entered a scheduling order, dated February 8, 2006 (the "Armstrong Scheduling Order") (upon joint motion of Armstrong, the Unsecured Creditors, the Asbestos PI Claimants, and others) requiring Armstrong to file a modified plan by February 21, 2006 and scheduling the hearing to consider confirmation of the modified Armstrong Plan for May 23, 2006. In re Armstrong World Indus, Inc., Chapter 11 Case No.: 00-4471 (JKF) (Bankr. D. Del.), docket # 9060. The Armstrong Scheduling Order provided that, apart from certain technical modifications, the Armstrong Plan "shall only be modified to delete the provisions regarding the receipt of 'New Warrants' by the holders of Equity Interests in Class 12 of the [Armstrong] Plan." *Id.* It further provided that the Unsecured Creditors acknowledge that the sole objection they will be pursuing is that the Armstrong Plan discriminates unfairly with respect to Class 6 (by overestimating Armstrong's asbestos personal injury liability and thus allocating too much of its assets to Class 7). *Id.* The Armstrong Scheduling Order further set forth a discovery schedule relating to the Unsecured Creditors' objection. *Id.* The district court held the confirmation hearing on May 23-25, 2006. Subsequent to the hearing, on May 30, 2006, the district court entered a post-trial scheduling order requiring the parties to submit post-trial briefs and proposed findings of fact and conclusions of law by certain dates and ordering that closing arguments shall be held on July 11, 2006. *Id.* Therefore, as of the date of the publication of this Article, a chapter 11 plan for Armstrong has not been confirmed. Armstrong remains in chapter 11. *Id.*

430. *Id.*

431. The warrants, estimated to be worth $35 to $40 million, amounted to 1.1%-1.3% of Class 7's $3.146 billion in claims. *Cf. In re Armstrong* (*Armstrong I*), 320 B.R. at 525 (providing a figure for Class 7's claims). Thus, if Class 7 had retained the warrants, its recovery would have been approximately 21% of its claims.

priority Class 6.[432] Class 6 could not, therefore, assert that the plan violated the Unfair Discrimination Prohibition with respect to Class 6 (and, in fact, Class 6 conceded that point).[433]

The facts of *Armstrong* demonstrate why gifting may be both voluntary and non-prejudicial. A class that is discriminated against by not receiving as much under the plan as a class of equal priority, has a right to reject the plan and oppose its confirmation under the Unfair Discrimination Prohibition.[434] Class 7, therefore, could have rejected the Armstrong Plan and opposed confirmation (regardless of the whether or not claimants in the class received the warrants, as they were receiving less than Class 6). Class 7 not only accepted the plan, but agreed to give a portion of its own distribution to others.[435] The gifting structure of Armstrong was feasible because of Class 7's voluntary agreement to give up to the equity holder a portion of its recovery (i.e., the warrants).

Once it is conceded that Class 7 was entitled to the warrants, it is somewhat illogical to say that Class 7 cannot transfer those warrants to Class 12 equity as part of the plan implementation. Clearly, a Class 7 claimant could, on its own after the plan became effective and it received the warrants, gift them to the equity holder. If the Class 7 claimant can make that distribution at a future date, it should be allowed to do so through the plan. To hold otherwise would be to elevate form over substance.

Therefore, a clear and distinct conclusion can be drawn between what is permissible and what is impermissible: if the gift is an amount to which the gifting class is entitled (such that the objecting class is no worse off as a result of the gift), it should be permitted.[436]

The *Armstrong* Court's holding either leaves professionals without clear guidance or draws a formalistic line of demarcation: if the transfer is after the effective date of a plan, it's fine; if the transfer is

---

432. *In re Armstrong* (*Armstrong II*), 432 F.3d at 509.

433. Brief of Appellant, *supra* note 389, at 29-30.

434. *Cf.* 11 U.S.C. § 1129(a)(8) (2000) (providing an impaired class with a right to reject a plan in the confirmation process).

435. *See In re Armstrong* (*Armstrong II*), 432 F.3d at 509-10 (explaining that if Class 7 received the warrants under the plan, it would automatically waive receipt of them, and that Class 7 accepted the plan).

436. The answer would be different if the distribution in the hands of the gifting class would violate the Unfair Discrimination Prohibition. Thus, in *Armstrong II*, the court should have considered whether it would have been improper (due to the Absolute Priority Rule, the Unfair Discrimination Prohibition, or otherwise) for Class 7 to retain the warrants. Once the court made the determination that it would not be improper for Class 7 to keep the distribution, it should have held that it was not improper for Class 7 to gift the distribution—regardless of the identity of the recipient.

under a plan, it's improper; if the value transferred comes from the collateral security of a secured creditor, it's fine; if the value transferred is not collateral proceeds of a secured creditor, it's improper, etc. The *Armstrong* decision essentially limits the ability of debtors and parties in interest to find ways in Chapter 11 to achieve the mutually advantageous goal of reorganization and return to the economic world simply because a party *that does not suffer as a result* is able to assert a technical objection as to the form of the other parties' recovery. The decision adds grist to the mill of dissidents to frustrate the objectives of Chapter 11.

The facts in *Armstrong* illustrate the point. The creditors' committee (Class 6) was not truly opposed to equity receiving the warrants—the committee had agreed to that granting of value.[437] The Unsecured Creditors subsequently changed their mind about the plan, because they perceived an increase in the likelihood of the passage of the FAIR Act, which, in their view, would have lowered the recovery to Class 7 and provided Class 6 with a greater recovery,[438] a rationale unrelated to the transfer of value to Class 12, the equity holder. The Absolute Priority Rule objection raised by the Unsecured Creditors appears almost as an afterthought.[439] The distribution to equity had nothing to do with the reason the Unsecured Creditors were opposed to the plan.

Had the agreement the Unsecured Creditors reached with the other parties in *Armstrong* not included the distribution to equity, it appears they still would have changed their position in the fall of 2003 based on the possible passage of the FAIR Act.[440] The proposed distribution to equity only gave the Unsecured Creditors a formal statutory basis (pretext) on which to interpose an objection. This reliance on the Absolute Priority Rule—to kill a way out of Chapter 11 for reasons that had nothing to do with the statutory basis for the objection (provision of warrants to equity)—certainly has no basis in

---

437. *See In re Armstrong* (*Armstrong II*), 432 F.3d at 510 (stating that the creditors' committee, which represented Class 6, initially approved of the plan in May 2003).

438. *See supra* notes 400-401 and accompanying text (explaining that, according to the Unsecured Creditors, passage of the FAIR Act was likely because the Senate Judiciary Committee had approved it, and Armstrong's contribution to the trust created by the Act would have been less than its payout to the Class 7 asbestos injury claimants under the plan, making more money available for the Unsecured Creditors).

439. *See In re Armstrong* (*Armstrong II*), 432 F.3d at 510 (discussing, in detail, the anticipated effects of the FAIR Act as the unsecured creditors' first objection to the plan, and briefly mentioning the "possible applicability of the absolute priority rule" as their second objection).

440. *Cf. supra* note 439 and accompanying text (portraying the anticipated effects of the Fair Act as the Unsecured Creditors' primary objection to the plan).

the history of the development of the Absolute Priority Rule. The result in *Armstrong* merely encourages dissidents to interpose technical objections in order to extract hold up value.[441]

The foregoing can be demonstrated with an example. Assume a debtor has assets with a value of $60. The debtor has the following creditors with the following claims: (1) Secured Class ($20), (2) Class A ($40), and (3) Class B ($80).

This debtor is clearly insolvent. Under a typical scenario, the debtor's $60 of value would be allocated as follows: (1) Secured Class—$20 (100%), (2) Class A—$13 (33%), (3) Class B—$27 (33%), and (4) Equity—$0.

If either Class A or Class B (but not both) rejects the plan, the plan could be confirmed over the class' objection, as there is no unfair discrimination (the equal priority classes are getting the same recovery) and there is no violation of the Absolute Priority Rule (as equity is not receiving a distribution).

Assume Class B wants equity to get a recovery. This could be for many reasons: Class B could be the new owners of the reorganized debtor and believe that the former shareholders (who are also the management of the debtor) would add more value to the reorganized enterprise if they received a recovery. Class B also could believe that providing equity with a recovery will expedite the debtor's Chapter 11 case and avoid lengthy or costly litigation. The reason does not really matter.[442] To achieve its desired outcome,

441. Of course, to take away Class 6's leverage, Class 7 could have insisted that the distribution of warrants to equity only occur if all impaired classes accepted the plan, but this would not have achieved Class 7's goal of providing a recovery to equity. However, the result in *Armstrong* instructs parties such as Class 7 in the future that if they agree to a plan providing value to equity when creditors are not paid in full, they should make the distribution to equity conditioned on acceptance by all senior classes so that the plan can be confirmed under § 1129(b) of the Bankruptcy Code if a senior class rejects it.

442. Although one could argue that the reason does matter because, for example, value for future management is not "on account of" management's old equity interests. *See generally supra* pp. 1358-69 (discussing the New Value Corollary, an exception to the Absolute Priority Rule that permits a distribution to equity holders on the grounds that the distribution is not being given to them on account of their equity interests, but for new value being contributed by them). This argument would fail because sweat equity does not comply with the requirements of the New Value Corollary. *See supra* pp. 1373-74 (explaining that in *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197 (1988), the Supreme Court stated that the New Value Corollary does not include a promise to contribute "labor, experience, and expertise" to the reorganized entity).

In addition, for purposes of this example, the reason does not matter. Even if the creditors in Class B wanted to give a distribution to certain stockholders because of the stockholders' beauty (and they like having beautiful shareholders), the result should be the same.

Class B could decide that it is willing to give $3 of its distribution of $27 to equity.

The recoveries would now be as follows: (1) Secured Class—$20 (100%), (2) Class A—$13 (33%), (3) Class B—$24 (30%), and (4) Equity—$3.

Class B could reject the plan and decide it does not want to make the gift to equity. This plan could not then be confirmed. If Class B consents, however, the plan should be confirmed, as it is clear that Class B is voluntarily transferring value to which it is otherwise entitled.[443] Under this scenario, to enable Class A to hold up confirmation of the plan on the basis that it violates the Absolute Priority Rule is counterproductive to the reorganization and the interests of other stakeholders. Class A should be indifferent as between the plan where equity gets a gift and the plan where equity does not get a gift. In either case, Class A gets thirty-three percent. Nothing in the history or the policy of the Absolute Priority Rule is intended to protect Class A in this situation. Class A is using its position for hold up value. It is saying: "Class B, if you want to give equity $3, you must give us something too." This gives Class A too much leverage to extract value from others and delay emergence.

The same example can be used to demonstrate that the gifting strategy cannot be abused by debtors or stockholders as some have suggested. Assume the debtor is the party wanting to provide a recovery for equity. Therefore, it allocates its value as follows: (1) Secured Class—$20 (100%), (2) Class A—$12 (30%), (3) Class B—$24 (30%), and (4) Equity—$4.

If Class A and Class B both accept the plan, then there is no issue. The Absolute Priority Rule only applies in the cramdown situation (i.e., where there is a rejecting class).[444] If either Class A or Class B rejects the plan, this plan cannot be confirmed, because it would violate the Absolute Priority Rule. Assume Class A rejects and Class B accepts. An argument by the debtor or Class B that the distribution was actually a gift from Class B would not work. This is because distributing the $4 to Class B to then gift to equity would provide Class B with a recovery of $28 (thirty-five percent). Class A could

443. Class B could do this outside of a plan. *Cf. supra* pp. 1344-45 (reasoning that a class entitled to recovery under a plan could, once the plan becomes effective and it receives its recovery, gift part of its recovery to an equity holder once, unless Class B is widely disbursed and/or not yet even identified (for example, the *Armstrong* Class 7 potential asbestos personal injury claimants)).

444. *See supra* pp. 1355-56 (stating that because the Absolute Priority Rule is contained § 1129(b) of the Bankruptcy Code, it only applies to nonconsensual plans).

then assert a meritorious objection that the distribution to Class B violates the Unfair Discrimination Prohibition.

This example illustrates that gifting is not bound to be the norm, because it can only be practiced as a voluntary distribution from one group to another. No class can be forced to gift against its will, and the objecting class should never be harmed by the gift. The gift is inherently something that the gifting class is entitled to receive and is voluntarily distributing to another party.[445] Arguably, this gives the debtor too much leverage to hold up the plan process to demand a "gift" for equity. However, this position may always be asserted by a debtor. The debtor can always tell both classes that it may not propose a plan that does not provide a recovery to equity. The classes can decide to accept the plan anyway, and it can be confirmed under § 1129(a). Alternatively, one or more creditors may file a motion seeking to terminate the debtor's exclusive right to file a plan on the basis that the debtor is using exclusivity as a sword rather than a shield.[446] If exclusivity is terminated, any party can file a plan that extinguishes equity.[447]

---

445. Some might argue that the increased ability to "make a deal" is not worth the inefficiency it introduces into the capital markets, and that the markets might have to factor in uncertainty as to whether a claim will be diluted by a junior claim or interest. This concern is, for the most part, misplaced. No claim is diluted unless the class voluntarily agrees to forgo its distribution. The class can always insist on the full amount to which it is entitled. The concern is not, however, entirely misplaced. If gifting is readily permitted, an individual creditor could be forced, by virtue of the democratic class voting mechanism, to gift a portion of its recovery if the majority of the class accepts. But, once again, this situation is not unique to gifting. If all impaired creditor classes accept a plan, equity can receive a distribution, the minority dissenting creditors notwithstanding. *See* 11 U.S.C. § 1129(a) (2000) (providing that a plan should be confirmed if certain requirements are met, including acceptance by impaired classes).

446. Under the Bankruptcy Code, the debtor is granted the exclusive right to file a plan in the first 120 days of a Chapter 11 case. 11 U.S.C. § 1121(a) (2000). The period can be extended by the debtor or shortened by another party in interest for cause. 11 U.S.C. § 1121(d)(1) (2000). Under the recent amendments to the Bankruptcy Code, for Chapter 11 cases filed on or after October 17, 2005, the debtor's exclusive right to file a plan may not be extended beyond 18 months from the entry of the order for relief. 11 U.S.C. § 1121(d)(2)(A) (2005). After the debtor's exclusive period has terminated (or been terminated), any party in interest can file a plan. 11 U.S.C. § 1121(c) (2000). A finding that the debtor is using exclusivity to pressure creditors to accede to its reorganization demands constitutes cause for terminating exclusivity. *See In re* Situation Mgmt. Sys., 252 B.R. 859, 863 (Bankr. D. Mass. 2000) (asserting that a debtor's use of exclusivity to force creditors to accept an otherwise unacceptable plan is one factor courts consider when determining cause); *see also In re* McLean Indus., Inc., 87 B.R. 830, 834 (Bankr. S.D.N.Y. 1987) (stating that courts also consider whether creditors have an opportunity to review and negotiate an acceptable plan, and whether they are provided with substantial financial information about any proposed plan so that they can make an informed decision).

447. *See* 11 U.S.C. § 1121(c) (providing that "any party in interest" can file a plan after the exclusivity period).

In addition to risking loss of exclusivity, the debtor does not truly have the power to force any class to make a gift, because that class would necessarily, as explained above, have to accept less than that to which it was entitled. Each class would prefer that the other class make the gift. The result is either that no class makes the gift or that both agree that equity gets a recovery (which, as noted, gives the debtor or equity no greater leverage than it has under existing law to demand a recovery for equity in a consensual plan).

The best, and perhaps the only, argument supporting the decision in *Armstrong* is that the Bankruptcy Code is unambiguous and does not permit a recovery to equity under a cramdown plan—gifting or not.[448] The same argument could be made against the New Value Corollary. Yet, the Supreme Court has already suggested that the New Value Corollary to the Absolute Priority Rule has vitality, even though it is not expressly authorized in the words of the Bankruptcy Code.[449] Gifting should be permitted for the same reasons. Distributions that are made on account of new value being contributed or through gifting by other stakeholders are not really exceptions to the Absolute Priority Rule (or the Unfair Discrimination Prohibition); they are merely distributions outside of the scope of those provisions. Moreover, as such distributions do not implicate the concerns underlying the Absolute Priority Rule and the Unfair Discrimination Prohibition, there may be no substantive reason to disallow them. To the contrary, there are very good policy reasons to allow these creative structures and solutions to effective reorganization plans. Therefore, to the extent that such creativity is

---

If the debtor, an equity holder, or another party tries to use the gifting doctrine to extract value in a manner constituting bad faith or that is otherwise contrary to the purposes of the Bankruptcy Code, there are other provisions in the Bankruptcy Code that can be used by others to combat such conduct. *E.g.*, 11 U.S.C. § 1129(a)(3) (2000) (providing that in order to confirm a plan, a court must find that the plan has been proposed in good faith).

448. *Cf. In re* Armstrong World Indus., Inc. (*Armstrong II*), 432 F.3d 507, 512 (3d Cir. 2005) (applying the plain meaning of the Absolute Priority Rule to affirm the district court's decision to deny confirmation of the Armstrong Plan).

449. *See supra* pp. 1376-82 (explaining that, in *Bank of Am. Nat'l Trust & Sav. Ass'n v. 203 N. LaSalle St. P'ship*, 526 U.S. 434 (1999), the Supreme Court concluded that the New Value Corollary could arguably be implied from the language of the Bankruptcy Code, and that if it were implied, consideration given to former equity holders in exchange for new value would be subject to a "market" test). Moreover, the fact that the New Value Corollary is generally accepted, see *supra* pp. 1376-82, even though language explicitly setting forth the New Value Corollary was introduced but rejected by Congress in enacting the Bankruptcy Code, see *Bank of Am. Nat'l Trust & Sav. Ass'n*, 526 U.S. at 446-47, is further proof that similar arguments relating to the gifting doctrine are not determinative. Thus, *In re Armstrong World Indus., Inc.* (*Armstrong II*), 432 F.3d 507, should not bar its acceptance.

blunted by blind adherence to strict construction of the statute, a legislative remedy should be obtained.

CONCLUSION

Bankruptcy negotiations are unlike any other in the sense that they are rarely bilateral. Rather, they are multilateral, with many parties with diverse interests pulling in different directions with the debtor the cynosure of all parties' attentions. Although consensus might appear unachievable under such circumstances, the advantage of Chapter 11 is that it creates a framework and tools that parties may use to reach a consensus. By its nature, consensus is often a middle ground—no party will ever walk away from the process achieving everything it wanted. Permitting gifting of the sort approved by the courts in *MCorp.*, *Genesis*, and *WorldCom* (but rejected by the court in *Armstrong*) opened up the boundaries within which parties could achieve the objectives of Chapter 11 and not allow hold-outs to dominate and possibly cause harm to the reorganization effort and the debtor's estate. In those extremely complicated cases, innovative creative solutions should be applauded. It is in such situations that bankruptcy professionals add value. The value added should be recognized by the courts and evaluated in perspective of the policies and objectives of Chapter 11.