



Bankruptcy Advisory

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Second Circuit Prohibits Chapter 11 Gifts to Junior Creditor Classes

BY KEVIN J. WALSH AND ELLA SHENHAV

In re DBSD N. Am., Inc., --- F.3d ---, 2011 WL 350480 (2nd Cir. Feb. 7, 2011)

In a recent decision, the Second Circuit Court of Appeals has cast doubt on the continued viability of the gifting doctrine in the context of a contested Chapter 11 plan—marking yet another carve-out from the doctrine, which gained credence in the *SPM* decision from the First Circuit Court of Appeals. Gifting is a strategy sometimes used in Chapter 11 cases where a senior creditor diverts some of the consideration it would otherwise receive under a plan to a junior class of creditors or equity while bypassing an intervening class of creditors.

Background

In *DBSD*, the court considered an objection to the debtor's proposed plan (the Plan) by Sprint Nextel Corporation (Sprint), which held an unliquidated, unsecured litigation claim. Under the Plan, a relatively significant distribution would be made to existing equity, despite the fact that unsecured creditors, which have a higher payout priority than existing equity, were to receive only a minimal distribution and not their full claim amount.

The distribution to the equity holders was to come from the debtor's second lien creditors (the claims of the first lien creditors were being satisfied in full under the Plan). Defending the Plan, *DBSD* argued that the distribution to existing equity was a "gift" by the second lien creditors, who were senior to the unsecured creditors and who were also not paid in full.

Holding—No Gifting in a Chapter 11 Plan

Rejecting the proposed distribution scheme, the court overturned the lower courts' decisions and held that a Chapter 11 plan cannot override the absolute priority rule, even when a senior class is enabling the distribution by contributing a portion of its own distribution as a gift to a junior class. The absolute priority rule, the court emphasized, was developed by the Supreme Court and codified in the U.S. Bankruptcy Code in order to avoid the exact kind of class-skipping proposed by *DBSD* in its plan.

The absolute priority rule states that unless the class of claims rejecting the plan is paid-in-full on their claims, no junior class of claims or interests can receive or retain any property under the plan on account of their junior claims or interests. The court found that the existing equity of *DBSD* would be receiving property under the Plan on account of their equity interest in violation of the absolute priority rule.

The ruling of the court did leave open the possibility of gifting outside of a Chapter 11 plan, as it distinguished *DBSD* from *In re SPM Manufacturing Corp.*, 984 F.2d 1305 (1st Cir. 1993). In *SPM*, the First Circuit Court of Appeals upheld a Chapter 7 arrangement that provided an undersecured creditor

would share its distribution with the unsecured creditors, thereby bypassing priority tax claims.

Reversing a lower court's finding that such a scheme would have resulted in an end-run around the code's priority scheme, the court held that because the senior creditor would not be paid in full even absent its giving of the gift, the priority tax claims would not have been paid at all regardless of the arrangement between the senior creditor and the unsecured creditors. The court's rationale was that the estate had no right to share in the proceeds of the secured creditor's collateral and that creditor could do as it pleased with its property.

The *DBSD* court emphasized that *SPM* involved Chapter 7, which "does not include the rigid absolute priority rule" found in Chapter 11. Additionally, the property in question in *SPM* was treated by the court as no longer belonging to the estate once relief from the automatic stay was granted to the secured creditor. By contrast, the property in question in *DBSD* was never removed from the estate, and therefore it was not up to the secured creditor to decide how it would be distributed under the Plan.

Potential Impact of the Ruling

Courts have split on whether the *SPM* holding applies in the context of a Chapter 11 plan. The *DBSD* decision raises additional doubts regarding the applicability of the gifting doctrine as a tool in orchestrating efficient distribution arrangements in Chapter 11 cases.

Although junior creditors may have gained some negotiating leverage from the *DBSD* decision, senior creditors likely will develop creative ways to reach their ultimate goal of confirming a plan. For example, senior creditors may come to rely more upon "death trap" provisions in plans that give potential dissenting creditors the option to vote in favor of the plan in exchange for a gift or vote against the plan and receive no distribution. If all classes accept the plan, whether a death trap is used or not, the absolute priority rule is not implicated and the rule of law under *DBSD* will not be violated.

Gifting plans may now be limited, but they will not disappear.

If you have any questions about the gifting doctrine in Chapter 11 cases or any other bankruptcy matter, please call your Mintz Levin attorney.

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