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Brianna Walsh

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Giftng & The Absolute Priority Rule

Brianna Walsh, J.D. Candidate 2016

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Introduction

The absolute priority rule sets forth a hierarchical scheme for the distribution of proceeds obtained through liquidating the assets of a debtor. The scheme provides that property of an estate shall be distributed to secured creditors, then to administrative and priority unsecured creditors, then to unsecured creditors, and lastly to equity holders.¹ Under Chapter 11, section 1129(b)(2)(B)(ii) for a dissenting class of impaired creditors, a plan is "fair and equitable" only if the allowed value of such creditors claims are paid in full, or the holder of any claim or equity that is junior to the dissenting creditors will not retain any property under the plan on account of such junior creditors claim.² It must be noted that the absolute priority rule applies only to dissenting classes of creditors.³ If the class consents, the absolute priority rule does not apply, even with respect to the claims of a dissenting creditor in that class.⁴ In many cases, the strict application of the absolute priority rule will prevent the confirmation of an otherwise confirmable plan. This is particularly true in chapter 11 cases in which the continued participation of the credit and equity holders is vital to the reorganization. Other parties will try

¹ 11 U.S.C. § 507.

² 11 U.S.C. § 1129.

³ *Id.*

⁴ *Id.*

to use gifting as a method for confirming a plan that would otherwise violate the absolute priority rule over objecting classes of creditors. Such a plan may be essential to the debtor's reorganization, especially if the junior creditors and equity holders are vital for the debtor's reorganization.

"Gifting," in the context of bankruptcy, occurs when a senior creditor voluntarily relinquishes a portion of its distribution, provided for in a plan of reorganization, in favor of junior creditors or equity holders.⁵ The "gifting doctrine" is a concept that emerged as a result of attempts by creditors and equity holders to circumvent the absolute priority rule.⁶ Senior creditors agree to "gift" a portion of their distribution to junior creditors or equity holders in order to streamline the confirmation of reorganization plans and disregard the distribution scheme required by the Bankruptcy Code.⁷ While gifting sometimes violates the absolute priority rule,⁸ recent case law suggests that there ways to "gift" which are allowable by the courts.⁹

Moreover, by providing a junior class of creditors or equity holders with a greater recovery, a gifting plan encourages such creditors of creditors to vote to approve the reorganization plan, allowing the debtor to confirm the plan over an objecting class. This can be particularly beneficial to a senior creditor, if such creditor would receive substantially more under the plan, even after accounting for the gifting than it would if the debtor liquidates. A court may hold, however, that such gifting is impermissible because it violates the absolute priority rule. Gifting in violation of the absolute priority rule is impermissible, but gifting is permitted if the "gift" does not violate the absolute priority rule.

⁵ Mitchel Appelbaum & Elisabetta G. Gasparini, "Gifting" to Junior Classes: Can It Be Done?, *Am. Bankr. Inst. J.*, February 2007, at 16, 17.

⁶ *Id.*

⁷ *Id.*

⁸ *Id.*

⁹ *Id.*

This Article will discuss the permissibility of “gifting” in chapter 11 bankruptcy distributions. First, Part I explains impermissible gifting using case analyses. Part II discusses permissible gifting. Finally, Part III discusses the implications of the current state of the gifting doctrine and the absolute priority rule.

I. Impermissible Gifting

While gifting often leads to a quicker resolution, gifting through a plan is impermissible when it violates the absolute priority rule. For example, the Second Circuit, restricted ability to confirm a gifting plan in *In re DBSD North America, Inc.*,¹⁰ holding that the plan of reorganization violated the absolute priority rule because the plan provided that junior classes of creditors and equity holders would receive warrants on account of their junior claims and interests even though an objecting class of senior creditors was not being paid in full under the plan.¹¹ The plan provided that senior secured creditors would be paid in cash under new debt, junior creditors were to be paid in part, but not in full, in shares of the reorganized debtor, and equity holders were to receive warrants.¹² The unsecured creditor, that was a member of the class that rejected the plan, objected to the plan.¹³ Lastly, the existing shareholder, consisting a company, which almost wholly owned DSDB, would receive shares and warrants in the reorganized entity.¹⁴

In holding that the plan violated the absolute priority rule, the Second Circuit noted that “[f]or a district court to confirm a plan over the vote of a dissenting class of claims, the [Bankruptcy] Code demands that the plan be ‘fair and equitable, with respect to each class of

¹⁰ *In re DBSD North America*, 634 F.3d 79 (2d Cir. 2011).

¹¹ *Id.* at 94.

¹² *Id.*

¹³ *Id.*

¹⁴ *In re DBSD N. Am., Inc.*, 634 F.3d 79, 86 (2d Cir. 2011).

claims . . . that is impaired under, and has not accepted, the plan.”¹⁵ The debtor’s plan of reorganization provided for distributions to first and second lien debt holders, and to holders of unsecured claims, which would receive shares worth a portion of its claims.¹⁶ The last provision of the plan of reorganization provided that the debtor’s existing shareholder would receive shares and warrants in the reorganized debtor, notwithstanding the fact that some senior creditors would not be paid in full.¹⁷ One of the unsecured creditors which was a member of the class that the neither approved the plan nor received the full value of its claim objected to the plan, arguing that the plans gifting provisions violated the absolute priority rule.¹⁸

The Second Circuit held that the plan violated section 1129,¹⁹ finding that the proposed gifting violated the absolute priority rule, notwithstanding the economic reasons that might have contributed to the decision to award property to old equity, because the existing shareholder could not have gains its new position without its prior equity position, and the Bankruptcy Code²⁰ specifically stated that secured creditors cannot gift their shares to an existing shareholder.²¹

¹⁵ *Id.* (citing 11 U.S.C. § 1129(b)(1)).

¹⁶ 2011 Ann. Surv. of Bankr.Law 9 citing *In re DBSD North America, Inc.*, 634 F.3d 79, 86 (2d Cir. 2011).

¹⁷ *Id.*

¹⁸ *In re DBSD North America, Inc.*, 634 F.3d 79, 86 (2d Cir. 2011).

¹⁹ 11 U.S.C. § 1129 (stating that a plan is not fair and equitable regarding a class of unsecured claims unless “the plan provides that each holder of a claim of such class receive or retain on account of such claim property of value, as of the effective date of the plan, equal to the allowed amount of such claim.” If such class of unsecured claims does not receive a distribution equal to the allowed amount of such claim the plan is not fair and equitable unless “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.”).

²⁰ 11 U.S.C. § 1129(b)(2)(B).

²¹ *In re DBSD North America, Inc.*, 634 F.3d 79, 86 (2d Cir. 2011) (stating that “[t]he Code extends the absolute priority rule to ‘any property,’ not ‘any property not covered by a senior creditor’s lien.’ The Code focuses entirely on who ‘receive[s]’ or ‘retain[s]’ the property ‘under the plan,’ not on who *would* receive it under a liquidation plan. And it applies the rule to any distribution ‘under the plan on account of’ a junior interest, regardless of whether the distribution could have been made outside the plan, and regardless of whether other reasons might support the distribution in addition to the junior interest.”).

Similarly, the Third Circuit has held that gifting through a plan is impermissible if it violates the absolute priority rule. In *In re Armstrong World Indus. Inc.*,²² the Third Circuit found that “gifting” under a chapter 11 plan of reorganization violated the absolute priority rule and therefore the plan could not be confirmed.²³ Under the plan, senior creditors were to be paid in less than the full and junior equity was going to receive warrants to purchase new stock.²⁴ The Plan also provided that senior creditors would automatically waive receipt of the warrants, which would then be issued to the equity holders of class 12.²⁵

The Third Circuit reasoned that notwithstanding the fact that a numerical majority of senior class’s members accepted the plan, equitable considerations did not warrant approval of the proposed plan.²⁶ Further, the Third Circuit reasoned that the absolute priority rule cannot be evaded by the fiction that “an unsecured creditor class would receive and automatically transfer warrants to the holder of equity interests in the event that its co-equal class rejects the reorganization plan.”²⁷ Finally, the Court noted that the structure of the plan was clearly devised to ensure that one class received warrants with or without another class’s consent and allowing this type of transfer would encourage parties to impermissibly sidestep the Bankruptcy Code.²⁸

II. Gifting is Permissible

Gifting is permissible, notwithstanding the absolute priority rule, if an agreement is reached outside the plan. Moreover, gifting is also permissible under the plan, in limited circumstances where such gifting does not violate the absolute priority rule. For example, the

²² *In re Armstrong World Indus., Inc.*, 432 F.3d 507 (3d Cir. 2005).

²³ *Id.* 513.

²⁴ *Id.*

²⁵ *Id.*

²⁶ *Id.* at 516.

²⁷ *Id.* at 514.

²⁸ *Id.*

First Circuit, in *In re SPM Manufacturing Corporation* found that while debtors and trustees are not allowed to pay non-party creditors ahead of priority creditors, there is generally nothing in the Bankruptcy Code that prevents creditors from doing what they wish with the bankruptcy dividends they receive, including sharing them with other creditors.²⁹ In *SPM*, a secured creditor and official unsecured creditors committee entered into an agreement to share the distributions they received as a result of liquidation or reorganization in accordance with the terms of the agreement.³⁰

The First Circuit held that the plan did not violate the absolute priority rule, reasoning that while the Bankruptcy Code governed distribution of proceeds from the sale of assets, once the distribution was made to a creditor, the Bankruptcy Code no longer controlled any further disposition of the proceeds.³¹ The First Circuit concluded that “[t]here is nothing in the [Bankruptcy] Code forbidding [creditors] to have voluntarily paid part of these monies to some or all of the general, unsecured creditors after the bankruptcy proceedings finished.”³²

Further, the First Circuit rejected the debtor’s argument that a secured creditor could not enter into a contract during bankruptcy in which it promises to share its proceeds with non-priority creditors after bankruptcy, finding that such arguments lacked statutory support.³³ The First Circuit concluded that “[t]he agreement did not affect estate property, i.e., the sale proceeds, but only concerned the contracting parties’ claims against the estate, i.e., their rights to

²⁹ *In re SPM Mfg. Corp.*, 984 F.2d 1305 (1st Cir. 1993) (stating “[w]hile 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.”).

³⁰ *Id.*

³¹ *In re SPM Mfg. Corp.*, 984 F.2d 1305, 1313 (1st Cir. 1993).

³² *Id.*

³³ *Id.*

be paid by the estate. [The First Circuit found] no support in the [Bankruptcy] Code for banning this type of contractual assignment in all cases.”³⁴

The Second Circuit, in *In re 56 Walker*, upheld a secured creditor’s proposed distribution scheme, which provided that secured creditors may “gift” some of its distribution to a junior class.³⁵ In *56 Walker*, the debtor pledged its sole asset, as security for a mortgage loan.³⁶ Following default on a loan and the commencement of a foreclosure action, the debtor, filed for bankruptcy under chapter 11 of the Bankruptcy Code in order to stay the foreclosure proceeding.³⁷ This first case was ultimately dismissed.³⁸ Following dismissal of the debtor’ first chapter 11 case, the bank resumed the foreclosure action in state court and moved for summary judgment.³⁹ Prior to the state court entering the bank’s proposed judgment of foreclosure, the debtor filed a second chapter 11 case.⁴⁰ Ultimately, the debtor was able to confirm a consensual plan of reorganization and to sell its real property at 56 Walker for \$18 million.⁴¹ After selling the property, the debtor objected to, among others, the bank’s claim.⁴² In its decision, the Second Circuit overruled the debtor’s objection and directed the bank to settle an order to provide for the distribution of the sales proceeds.⁴³

The bank then filed a proposed order, providing that the senior secure creditor would agree to forgo part of its recovery in order to pay junior secured creditors, with the remaining funds going to the unsecured creditors.⁴⁴ Under the plan, equity was to receive nothing. Equity

³⁴ *Id.* at 1313-14.

³⁵ *Id.*

³⁶ *In re 56 Walker LLC*, 2014 WL 1228835 (Bankr. S.D.N.Y. Mar. 25, 2014).

³⁷ *Id.*

³⁸ *Id.*

³⁹ *Id.*

⁴⁰ *56 Walker LLC*, 2014 WL at 1 (Bankr. S.D.N.Y. Mar. 25, 2014).

⁴¹ *Id.*

⁴² *Id.* at 2.

⁴³ *Id.*

⁴⁴ *Id.*

objected arguing that the plan violated absolute priority.⁴⁵ However, the court held that absolute priority was not violated because no junior creditor was being paid before a senior creditor.⁴⁶ Equity would not receive any distribution under the proposed order.⁴⁷ The debtor objected to the proposed order, arguing, among other things, that distribution to a mechanic's lien holder was premature because the debtor's previous objection to the mechanic's lien holder's claim was still pending.⁴⁸ The court, however, overruled the debtor's objection to the proposed order, noting that the only reason the mechanic's lien holder would receive anything was the bank's willingness to forgo part of its claim and "gift" it to the junior secured creditors.⁴⁹ The court held that this was not in violation of the absolute priority rule because all senior creditors were paid in full under the plan.⁵⁰

III. Implications

As illustrated by the different factual circumstances in which these cases have arisen, there are situations where "gifting" is appropriate and more equitable than enduring seemingly endless litigation. By electing to take less, a creditor can avoid further expense, delay, and uncertainty by convincing the court to authorize distributions of sale proceeds notwithstanding the fact that litigation with the borrower is ongoing. However, the invocation of the absolute

⁴⁵ *Id.*

⁴⁶ *In re 56 Walker LLC*, 2014 WL 2927809 (Bankr. S.D.N.Y. June 27, 2014).

⁴⁷ *Id.*

⁴⁸ *In re 56 Walker LLC*, 2014 WL 1228835 (Bankr. S.D.N.Y. Mar. 25, 2014) (The Court addressed various other issues that are not relevant to this analysis. The debtor's first objection focused on an ongoing dispute with the purchaser regarding water damage and the costs related to the damage, which occurred before closing the sale. Other objections were to the capping of counsel fees at \$250,000 and that making any payments to the bank was improper due to the alleged additional information showing that the bank acted wrongfully.).

⁴⁸ *In re 56 Walker LLC*, 2014 WL at 3 (Bankr. S.D.N.Y. June 27, 2014).

⁴⁹ *Id.*

⁵⁰ *Id.*

priority rule can make it difficult to confirm a plan that would otherwise be confirmable. Thus, parties often form agreements outside of the plan of reorganization in order to get the plan approved.

Moreover, the absolute priority rule makes it difficult to confirm a plan that provides for old equity to be maintained, such as workers with special skills or knowledge because equity is most junior party in the priority scheme. However, oftentimes such skills and knowledge are necessary to reorganize. Therefore, if a more senior class rejects and the equity holders do not get receive anything under, reorganization may be difficult, if not impossible.

In many cases, a creditor may determine that it will receive more under plan than it would through liquidation, thus encouraging senior creditors to come to settle with junior creditors. As a result, in many cases, an objecting class or creditor's reason for objecting might be to pressure the more senior creditors to agree to give them something in exchange for their vote in favor of the plan.

Conclusion

While “gifting” is not permitted if doing so would the absolute priority rule, a creditor can voluntarily relinquish a portion of its distribution to a junior creditor so long as there no creditor in between the senior creditor and the junior creditor receiving the gift.⁵¹ In essence, if a senior creditor can develop a distribution plan, which provides a portion of the distribution to junior creditors, without violating the absolute priority rule, this might be the most efficient and inexpensive method of settling the dispute.

⁵¹ *In re* 56 Walker LLC, 2014 WL 1228835 (Bankr. S.D.N.Y. Mar. 25, 2014) [American Bankruptcy Institute Law Review](#) | St. John's School of Law, 8000 Utopia Parkway, Queens, NY 11439