WHAT DO YOU MEAN THERE WON'T BE GIFTS THIS YEAR?: WHY PRACTITIONERS CANNOT RELY UPON GIFTING PROVISIONS IN CHAPTER 11 REORGANIZATION PLANS IN THE FIFTH CIRCUIT

Comment*

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I. THE UNCERTAIN FUTURE OF GIFT PLANS

Twinkies and airplane travel: two things that do not seem to have much in common. But in fact, they do share at least one commonality.[1] The companies that provide these goods and services—Hostess Brands, the makers of Twinkies and other sweet treats, and AMR, the parent company of airline giant American Airlines—are each in the midst of Chapter 11 bankruptcy proceedings.[2] And they are not alone in their decisions.[3] For many corporations, filing for Chapter 11 bankruptcy protection is an important financial tool—a way to keep their doors open and people employed in the face of hard economic times.[4] But filing for bankruptcy does not come without great costs.[5]

Once a company files a Chapter 11 bankruptcy petition, it enters into a lengthy, expensive, and contentious process on the complex road (hopefully) to reorganization.[6] Obtaining confirmation of a Chapter 11 plan of reorganization often takes some creative thinking and a little bending—or, in the eyes of some, a blatant disregard—of the rules laid out in the Bankruptcy Code and the precedent in case law.[7] One excellent example of the creativity of debtors and their counsel is the creation of the "gifting doctrine."[8]

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1. *See* Dennis Cauchon, *Bankruptcy a Reprieve for Some Companies*, USA TODAY (Jan. 22, 2012, 6:03 PM), http://www.usatoday.com/money/companies/management/story/2012-01-22/bankruptcy-a-reprieve-for-some-companies/52745792/1.

2. *See id.*

3. *See id.* (referencing the recent filings of Hostess and AMR, as well as Eastman Kodak and General Motors).

4. *See infra* notes 17-20 and accompanying text; *see also* Cauchon, *supra* note 1 (noting that many American companies use Chapter 11 as a tool for "shedding legal debts and obligations" and calling Chapter 11 the "darling of the international business world" (second quote quoting Professor John Pottow, Univ. of Mich.)).

5. *See* HON. W. HOMER DRAKE, JR. & CHRISTOPHER S. STRICKLAND, CHAPTER 11 REORGANIZATIONS 57 (2d ed. 2011).

6. *See id.*

7. *See, e.g.*, Harvey R. Miller & Ronit J. Berkovich, *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?*, 55 AM. U. L. REV. 1345, 1347-48 (2006) ("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."); Ralph Brubaker, *Taking Chapter 11's Distribution Rules*

Practitioners use the gifting doctrine, which evolved through case law, as a way of avoiding the absolute priority rule.[9] The absolute priority rule, codified in § 1129(b)(2)(B)(ii) of the U.S. Bankruptcy Code of 1978 (Code), requires that no class of creditors junior to the creditor objecting to the plan of reorganization "receive or retain" property under the plan on account of its "claim or interest."[10] But under a gift plan, senior creditors "gift" a portion of their distribution proceeds to junior creditors—usually equity holders—over the objection of, and at the expense of, intermediate creditors.[11]

This Comment analyzes the evolution of the gifting doctrine and its uncertain future as a result of the Second Circuit's holding in *DBSD North America*.[12] Parts II and III provide a brief explanation of the Chapter 11 reorganization process, as well as a history of the absolute priority rule and the cases that led up to the *DBSD* opinion. Next, Part IV discusses the *DBSD* decision and its implications on the practice of gifting.[13]

Although the Fifth Circuit has not directly addressed the validity of gift plans, Part V discusses the possibility of using gift plans in the Fifth Circuit in light of two cases—*AWECO* and *OCA*.[14] Both of these cases call into question the practice of gifting; thus, they provide important insight into how the Fifth Circuit might decide a gifting case.[15] This Comment argues that because of the Second Circuit's decision in *DBSD North America*, the holdings in *OCA* and *AWECO*, and the clear language of § 1129(b)(2)(B)(ii), the Fifth Circuit would likely deny a gifting provision in a Chapter 11 reorganization plan. Therefore, bankruptcy practitioners should develop alternative ways of encouraging plan confirmation, and Part VI concludes with several potential alternatives to gifting plans.

Seriously: "Inter-Class Gifting Is Dead! Long Live Inter-Class Gifting!," 31 No. 4 BANKR. L. LETTER 1 (2011) ("One very telling indicator of the sophistication of the Chapter 11 bar is the extent to which they manage to continually resurrect practices that are manifestly inconsistent with positive law, sometimes even in the face of outright prohibitions of said practices by Congress and the Supreme Court.").

8. *See generally* Brubaker, *supra* note 7 (defining the gifting doctrine and its development); *infra* Part III (discussing the gifting doctrine and its history).

9. *See* discussion *infra* Parts II.D-E, III.

10. 11 U.S.C. § 1129(b)(2)(B)(ii) (2006).

11. *See generally* Miller & Berkovich, *supra* note 7, at 1359 (explaining the gifting doctrine); Part III (discussing the gifting doctrine).

12. DISH Network Corp. v. DBSD N. Am., Inc. (*In re* DBSD N. Am., Inc.), 634 F.3d 79, 85 (2d Cir. 2011).

13. *See id.*

14. United States v. AWECO, Inc. (*In re* AWECO, Inc.), 725 F.2d 293, 295 (5th Cir. 1984); *In re* OCA, Inc., 357 B.R. 72, 74 (Bankr. E.D. La. 2006).

15. *See* discussion *infra* Part V.

II. CHAPTER 11 REORGANIZATION: REHABILITATING FINANCIALLY TROUBLED DEBTORS

A. Chapter 11 Principles

At the outset, the underlying principles and goals of Chapter 11 bankruptcy give helpful insight into the policies and competing views behind bankruptcy, the absolute priority rule, and gifting.[16] Filing a Chapter 11 petition allows the debtor time to reorganize its business without the threat of creditors exercising their state law collection remedies.[17] Ideally, this breathing room allows the debtor to reemerge as a productive entity that can meet its financial obligations and provide jobs for its employees.[18] Indeed, the legislative history to the Code notes that "[t]he purpose of a business reorganization case, unlike a liquidation case, is to restructure a business's finances so that it may continue to operate, provide its employees with jobs, pay its creditors, and produce a return for its stockholders."[19] Thus, Chapter 11 is premised on the idea that a rehabilitated business is often worth more to the debtor, its creditors, and the community than a liquidated business.[20]

To help achieve a successfully rehabilitated business, the Code sets out an orderly distribution scheme, which is used in reorganization and liquidation bankruptcies.[21] The Code's hierarchy of rights and distribution, which mimics state law, mandates that secured creditors receive payment on their claims first, even before the Code's distribution scheme comes into play.[22] Once the secured creditors are paid, § 726 and § 507 dictate how the remaining proceeds should be distributed.[23] For example, all priority claims in § 507, including domestic support obligations, are paid before general, allowed unsecured

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16. *See infra* notes 17-24 and accompanying text.

17. *See* 11 U.S.C. §§ 362(a), 1101-1146 (2006). The automatic stay in § 362 prohibits creditors from attempting to collect on a pre-petition debt and goes into effect immediately upon the filing of the petition. *See id.* § 362(a).

18. *See* DRAKE & STRICKLAND, *supra* note 5, at 1-4.

19. H.R. REP. NO. 95-595, at 220 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6179.

20. *See* Charles J. Tabb, *The Future of Chapter 11*, 44 S.C. L. REV. 791, 802-04 (1993) (noting that the interests of the debtor, creditors, and the public have always been a consideration in bankruptcy policy); *see also* W. Michael Schuster, *For the Greater Good: The Use of Public Policy Considerations in Confirming Chapter 11 Plans of Reorganization*, 46 HOUS. L. REV. 467, 476 (2009) (arguing that in considering whether a plan of reorganization is consistent with public policy, courts should consider sources such as "state constitutions, acts of Congress, acts of state legislatures, and judicial decisions").

21. *See* 11 U.S.C. §§ 503, 507, 726 (2006). The absolute priority rule, codified in § 1129(b), similarly reflects the Code's concern with respecting the state law hierarchy of rights. *See id.* § 1129(b)(2)(B)(ii); *see also infra* Part II.D.2 (discussing the absolute priority rule in detail). The absolute priority rule, and its respect of the distribution scheme, underpins creditors' complaints in dealing with gifting plans. *See infra* Part III. At the heart of every dispute involving a gifting plan is a creditor's complaint that a creditor more junior—for example, a shareholder—was paid before it was paid in full. *See infra* Part III.

22. *See* Official, Unsecured Creditors' Comm. v. Stern (*In re* SPM Mfg. Corp.), 984 F.2d 1305, 1312 (1st Cir. 1993); *see also* 11 U.S.C. § 506(a)(1) (2006) (defining an allowed secured claim as a claim "secured by a lien on property in which the estate has an interest").

23. *See* §§ 507(a), 726(a); *SPM Mfg.*, 984 F.2d at 1312.

claims, and all general, allowed unsecured claims are paid before the equity holders' interests.[24] While the principles underlying the Code are an important first step to understanding bankruptcy law, the Code provides the specific statutory rules for a Chapter 11 proceeding.[25]

B. Chapter 11 Mechanics

After careful consideration of all possible alternatives, a debtor–business may elect to file a Chapter 11 bankruptcy petition.[26] In Chapter 11 reorganization, the debtor is permitted to retain its property and run its business as usual while negotiating the reorganization.[27] A voluntary bankruptcy case commences upon the debtor's filing of a petition in bankruptcy court.[28] Initially, the debtor has the exclusive right to file a proposal for a plan of reorganization, but a "party in interest" may request the court to terminate the exclusivity period.[29] Once the bankruptcy court confirms the plan of reorganization, it is binding on the debtor, creditors, equity holders, and any entity issuing securities or acquiring property under the plan.[30] And notably, the plan's terms are binding on *all* of these entities, whether the individual entity voted in favor of the plan or dissented.[31]

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24. *See* §§ 507, 726.

25. *See infra* Part II.B.

26. *See* 11 U.S.C. § 301(a) (2006); DOUGLAS G. BAIRD, ELEMENTS OF BANKRUPTCY 251 (4th ed. 2006). Despite a common misperception, filing for bankruptcy protection is hardly ever the first option a company reaches to, or should reach to, in times of economic trouble. *See* DRAKE & STRICKLAND, *supra* note 5, at 31; Tabb, *supra* note 20, at 805. Often, a company will attempt to negotiate some type of a workout arrangement with its creditors, such as a forbearance agreement or a modification of the financing terms, to avoid filing for bankruptcy. *See infra* note 251 and accompanying text; *see also* DRAKE & STRICKLAND, *supra* note 5, at 32-57 (listing various alternatives to filing a Chapter 11 petition). Negotiating with creditors outside of bankruptcy is not always an option for companies, however, because either they do not have the financial resources and time to negotiate or their creditors are unwilling to reach an agreement. *See* DRAKE & STRICKLAND, *supra* note 5, at 45-47; *infra* notes 261-64 and accompanying text. At that point, a company may use bankruptcy as a way of shedding its debt and strengthening its financial position. *See* DRAKE & STRICKLAND, *supra* note 5, at 56-57; *see also* Cauchon, *supra* note 1 (positing that AMR and Hostess filed for bankruptcy "to relieve them of their pension promises" to their employees).

27. *See* 11 U.S.C. § 1107 (2006). A Chapter 7 or Chapter 11 liquidation, on the other hand, provides for liquidation of the debtor's assets, meaning that all of the debtor's nonexempt assets are gathered and sold by the trustee, who then distributes the proceeds to the creditors in accordance with the Code's provisions. *See* §§ 701-727, 1123(b)(4) (2006); BAIRD, *supra* note 26, at 19.

28. § 301(a).

29. *Id.* § 1121(b), (d)(1) (2006). The bankruptcy court may also extend the period of exclusivity; however, if the debtor does not propose a plan within eighteen months from the time of filing the petition, other parties in interest may propose their own plans. *See* § 1121(c)-(d)(2).

30. *Id.* § 1141(a) (2006). The plan of reorganization restructures the debtor's debts so that the debtor may continue to operate successfully and generate positive income earnings, while paying its past debts over time out of its future earnings. *See* DRAKE & STRICKLAND, *supra* note 5, at 698-703.

31. *See* § 1141(a).

C. Requirements of a Chapter 11 Plan of Reorganization

The proponent of a reorganization plan must follow the specific requirements laid out in § 1123 and § 1129 of the Code.[32] Importantly, the plan must designate the various claims and interests into classes for voting and treatment purposes.[33] This includes designating the classes, specifying any classes that are not impaired under the plan, specifying a treatment for those classes that are impaired under the plan, and providing the same treatment for all claims or interests in a class, unless the holder of the claim agrees otherwise.[34] Section 1122 specifies that only claims or interests that are "substantially similar" may be placed in the same class.[35] Thus, claims and interests are typically sorted by priority of payment.[36] Classifying creditors is important because, except for certain priority claims, only classes of creditors vote—not individual creditors.[37]

For a bankruptcy court to confirm a plan, the plan must also comply with the sixteen requirements listed in § 1129(a), which include the voting requirements.[38] Section 1129(a)(8) requires that *each* designated class must either (1) vote in favor of the plan or (2) not be "impaired" by the plan under

32. *See id.* §§ 1123, 1129 (2006).

33. *See* § 1123(a).

34. *See* § 1123(a)(1)-(4).

35. *Id.* § 1122(a) (2006); *see* BAIRD, *supra* note 26, at 258-59. The Code gives little direction as to what substantially similar means. *See* § 1122. The Fifth Circuit has noted, though, that a debtor may not classify claims "in order to gerrymander an affirmative vote on a reorganization plan." Phx. Mut. Life Ins. Co. v. Greystone III Joint Venture (*In re* Greystone III Joint Venture), 995 F.2d 1274, 1279 (5th Cir. 1991), *modified on reh'g*, 995 F.2d 1274, 1284 (1992). Thus, at the very least, "classification seeks to place similar interests together in order to obtain a representative vote," not to facilitate plan confirmation. DRAKE & STRICKLAND, *supra* note 5, at 774 & n.1, 775 (citing Bank of N.Y. Trust Co. v. Official Unsecured Creditors' Comm. (*In re* Pac. Lumber Co.), 584 F.3d 229, 251 (5th Cir. 2009)).

36. *See* § 1122(a). For example, secured creditors are typically placed in classes by themselves, while unsecured creditors are sorted by priority as specified in § 507(a). *See id.* § 507(a) (2006); BAIRD, *supra* note 26, at 258-59; *see also supra* notes 21-24 and accompanying text (discussing priority of payment).

37. *See* 11 U.S.C. §§ 1126, 1129(a)(9) (2006). In certain circumstances, such as the case of a single-asset real estate debtor, a large, unsecured creditor may be able to single-handedly veto a plan unless the plan proponent is able to place the large, unsecured creditor in one class and create a separate class for the smaller unsecured creditors. *See, e.g.*, Heartland Fed. Sav. & Loan Ass'n v. Briscoe Enters., Ltd., II (*In re* Briscoe Enters., Ltd., II), 994 F.2d 1160, 1166 (5th Cir. 1993). Although the majority of courts hold that a plan proponent may not "gerrymander" classifications to obtain "an affirmative vote on a reorganization plan," these courts have recognized that sometimes there may be "good business reasons" to justify separate classifications. *Id.* at 1167 (citing *Greystone III*, 995 F.2d at 1279); *see also* Bos. Post Rd. Ltd. P'ship v. FDIC (*In re* Bos. Post Rd. Ltd. P'ship), 21 F.3d 477, 483 (2d Cir. 1994) (holding that the Second Circuit, like other circuits such as the Fifth Circuit, will require "credible proof of a legitimate reason for separate classification of similar claims"); *In re* Wabash Valley Power Ass'n, 72 F.3d 1305, 1321 (7th Cir. 1995) (noting that claims may be "separately classified if there are 'good business reasons' to do so" (quoting *Briscoe Enters.*, 994 F.2d at 1167)). Hence, classification of claims is an important part of developing a reorganization plan because it can determine whether the plan will ultimately succeed or fail. *See Greystone III*, 995 F.2d at 1279.

38. *See* § 1129(a).

§ 1124.[39] If the class votes in favor of the plan or is not impaired by the plan, the Code deems the class to have accepted the plan.[40] If at least one class of creditors is impaired, though, the plan proponent must demonstrate that at least one of the impaired classes voted in favor of the plan.[41] Even if all of the impaired classes do not accept the plan, however, the bankruptcy court may still confirm the plan under what is known as a "cramdown" plan, as long as the other requirements in § 1129(a) are satisfied and the plan meets the additional requirements found in § 1129(b).[42] A cramdown plan under § 1129(b) only arises if all of the impaired classes do not vote in favor of the plan.[43]

D. Section 1129(b): Cramdown Plan Requirements

A plan that is confirmed over the objection of dissenting, impaired classes is known as a cramdown plan.[44] Upon the plan proponent's request, the court may confirm a cramdown plan if it meets the two requirements found in § 1129(b).[45] A cramdown plan may be confirmed over the objection of an impaired class only if the plan (1) "does not discriminate unfairly" and (2) is "fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan."[46]

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39. § 1129(a)(8). The plan proponent solicits votes by distributing a court approved "disclosure statement." *Id.* § 1125(b) (2006). The Code does not require that all creditors within a class vote for the plan for the class to accept it. *See* § 1126(c)-(d). Rather, for creditors holding claims, a majority in number and two-thirds in dollar amount must vote affirmatively for the plan. § 1126(c). Or, for creditors holding interests, two-thirds in dollar amount must vote affirmatively for the plan. § 1126(d). If the requisite number of creditors in a class votes affirmatively for the plan, the decision is then binding upon the dissenting creditors. *See* § 1126(c)-(d).

40. §§ 1126(c)-(d), 1129(a)(8). A claim is impaired if there is *any* alteration to the creditor's claim, whether the alteration improves the creditor's status or the alteration is to the creditor's detriment. *See* Bank of Am. Nat'l Trust & Sav. Ass'n v. 203 N. LaSalle St. P'ship, 526 U.S. 434, 442 n.14 (1999) (citing 11 U.S.C. § 1124 (1994)) ("Claims are unimpaired if they retain all of their prepetition legal, equitable, and contractual rights against the debtor."); *In re* Armstrong World Indus., Inc., 432 F.3d 507, 511 n.2 (3d Cir. 2005) (citing § 1124 (2005)) ("A class is impaired if its legal, equitable, or contractual rights are altered under the reorganization plan."); L & J Anaheim Assocs. v. Kawasaki Leasing Int'l, Inc. (*In re* L & J Anaheim Assocs.), 995 F.2d 940, 942 (9th Cir. 1993) (explaining that "any alteration of the rights [of a claim or interest holder] constitutes impairment even if the value of the rights is enhanced" (quoting Acequia, Inc. v. Clinton (*In re* Acequia, Inc.), 787 F.2d 1352, 1363 (9th Cir. 1986))).

41. § 1129(a)(10).

42. *See* § 1129(b).

43. *See* § 1129(b)(1).

44. BAIRD, *supra* note 26, at 251; *see also* Richard B. Levin, *Almost All You Ever Wanted to Know About Carve Out*, 76 AM. BANKR. L.J. 445, 445 (2002) (noting that the term "cram down" does not appear anywhere in the Code, but it has a "relatively well-defined meaning derived from § 1129(b) of the Bankruptcy Code").

45. § 1129(b)(1).

46. *Id.* For example, in *Gulf Coast Holdings*, the bankruptcy court approved a cramdown plan because the plan did not distribute estate property to any junior interest (in compliance with § 1129(b)(2)(C)), the plan put the creditors in a better position than they would have been in without the plan, and "virtually all creditors . . . voted in favor of the [p]lan." *In re* Gulf Coast Holdings, Inc., No. 06–31695–BJH–11, 2007 WL 1340802, at *8-9 (Bankr. N.D. Tex. Apr. 30, 2007). Therefore, the plan was fair and equitable and did not discriminate unfairly against any claim or interest. *See id.*

1. *Does the Plan "Discriminate Unfairly"?*

Although the Code does not define the term "discriminate unfairly," courts have developed tests to determine whether a plan violates the provision.[47] Where "there is [no] reasonable basis for the discrimination," or where "the debtor can confirm and consummate a plan without the proposed discrimination," a court may find that the plan unfairly discriminates.[48] Essentially, a plan must treat similarly situated classes—including the dissenting classes—the same, absent consent from a class.[49] A bankruptcy court must not only consider whether the proposed plan discriminates unfairly though; it must also evaluate whether the plan is "fair and equitable."[50]

2. *Is the Plan "Fair and Equitable"?*

Each impaired class that rejects the plan must be treated fairly and equitably.[51] Unlike the unfair discrimination prong, the fair and equitable standard is further delineated within the Code.[52] The absolute priority rule, embodied within § 1129(b)(2)'s fair and equitable language, requires that all senior dissenting classes be paid in full before the junior classes may receive compensation.[53] The absolute priority rule only applies when a bankruptcy court is confirming a plan over the objection of a class of dissenting claims or interests and applies only to the claims or interests held by the dissenting class.[54] Interestingly, the absolute priority rule originated long before Congress enacted the Code.[55]

E. Brief History of the Absolute Priority Rule

The absolute priority rule first appeared in case law in the nineteenth century with the failure, and subsequent reorganization, of the railroads.[56] To aid in the reorganization of the railroads, federal courts created equity

47. *See* Miller & Berkovich, *supra* note 7, at 1387-90 (discussing the various tests courts use in interpreting the unfair discrimination prong of § 1129(b)).

48. *In re* Genesis Health Ventures, Inc., 266 B.R. 591, 611 (Bankr. D. Del. 2001) (citing Liberty Nat'l Enters. v. Ambanc La Mesa Ltd. P'ship (*In re* Ambanc La Mesa Ltd. P'ship), 115 F.3d 650, 656 (9th Cir. 1997)).

49. *See* BAIRD, *supra* note 26, at 82; *In re Genesis Health*, 266 B.R. at 599.

50. § 1129(b)(1).

51. *Id.*

52. *See* § 1129(b)(2).

53. *See* § 1129(b)(2)(B)(ii); Douglas E. Deutsch & Eric Daucher, *Chapter 11 Plan Confirmation Issues: Settlements, Releases, Gifting and Death Traps*, 29 AM. BANKR. INST. J. 54, 91 (Oct. 2010).

54. *See* § 1129(b); Charles H. Jeanfreau, *In re* DBSD North America, Inc.*: Congress Meant What It Said and Said What It Meant, Absolute Priority One Hundred Percent*, 20 NORTON J. BANKR. L. & PRAC. No. 3, 319, 319 (2011).

55. *See infra* Part II.E.

56. *See* Jeanfreau, *supra* note 54, at 320; Miller & Berkovich, *supra* note 7, at 1362.

receiverships, which were similar to modern Chapter 11 reorganizations.[57] In an equity receivership, a secured creditor filed a petition requesting the appointment of a receiver "to administer the insolvent debtor's assets," to which the debtor filed an answer and typically consented to the appointment of a receiver.[58] The only problem with the receivership, though, was that it often involved a collusive agreement between the debtor and the secured creditors.[59] As a result, the old railroad entity was sold at a foreclosure sale to a "new" entity—in reality, the investors in the new entity were simply the stockholders and secured bondholders of the old entity—for a greatly reduced price.[60] In fact, the old entity was sometimes even sold for less than the actual value of the entity.[61] The general unsecured creditors, meanwhile, received "little or nothing" on their claims because the assets were sold for less than the value of the secured claims.[62]

The Supreme Court severely limited this type of arrangement in a series of cases—the most notable of which was *Northern Pacific Railway Company v. Boyd*.[63] In *Boyd*, the bondholders (secured creditors) and stockholders agreed to a plan of reorganization that sold the old railroad entity to a new company owned by the very same bondholders and stockholders.[64] The old railroad sold at a foreclosure auction for "$61,500,000, or $86,000,000 less than the secured debts."[65] As a result, the unsecured creditors were not paid on their claims.[66]

One of the unsecured creditors subsequently filed suit against the new railroad entity, arguing that the foreclosure sale was void because it was "made in pursuance of an illegal plan of reorganization, between bondholders and stockholders of the railroad, in which, though no provision was made for the payment of unsecured creditors, the stockholders retained their interest by receiving an equal number of shares in the new railway."[67] The Supreme Court agreed with the unsecured creditor, holding that "[a]ny device, whether by

57. *See* Miller & Berkovich, *supra* note 7, at 1363.

58. *Id.* at 1363-64.

59. *See id.* at 1363.

60. *Id.*

61. *See* Jeanfreau, *supra* note 54, at 321; Miller & Berkovich, *supra* note 7, at 1363.

62. Jeanfreau, *supra* note 54, at 321; *see also* Bruce A. Markell, *A New Perspective on Unfair Discrimination in Chapter 11*, 72 AM. BANKR. L.J. 227, 229 (1998) (explaining that "[a]lthough the effect of this type of reorganization [an equity receivership] might have been to eliminate unsecured creditors from participation, the device was not intended to be fraudulent"); Miller & Berkovich, *supra* note 7, at 1365 ("Because the assets were sold for less than the secured debt, unsecured creditors were squeezed out and generally received nothing.").

63. N. Pac. Ry. Co. v. Boyd, 228 U.S. 482, 507 (1913); *see also* Louisville Trust Co. v. Louisville, New Albany & Chi. Ry. Co., 174 U.S. 674, 684 (1899) (stating that, generally, a "stockholder's interest in the property is subordinate to the rights of creditors"); Chi., Rock Island & Pac. R.R. v. Howard, 74 U.S. (7 Wall.) 392, 409-10 (1868) (holding that more senior creditors must be paid before the bondholders).

64. *See Boyd*, 228 U.S. at 488-91.

65. *Id.* at 490.

66. *See id.* at 489, 501.

67. *Id.* at 501.

private contract or judicial sale under consent decree, whereby stockholders were preferred before the creditor, was invalid."[68]

The "fixed principle," as the Court termed its holding, embraced a principle that prior cases such as *Howard* and *Louisville Trust Company* had suggested, but never expressly named.[69] The Court explained that the outcome —whether the unsecured creditors should receive a distribution on their claims—should be the same whether the sale of the old railroad was a private sale or a sale pursuant to a plan of reorganization.[70] After all, the validity of a reorganization agreement and "the rights of the creditors" should not be left "to depend upon the balancing of evidence as to whether" there was sufficient property "to pay prior encumbrances."[71] Rather, the validity of the agreement should be determined based upon a fixed principle—more senior creditors should always be paid in full before paying junior creditors and equity.[72] The fixed principle articulated in *Boyd* firmly established the concept that is known as the absolute priority rule.[73]

Consequently, Congress followed the Court's precedent in cases such as *Boyd* when it enacted the Code in 1978 and codified the absolute priority rule, albeit in a slightly modified form.[74] But, despite the long and firmly established history of the absolute priority rule, bankruptcy practitioners have sought ways around it using means such as gifting plans.[75]

III. THE GIFT THAT KEEPS ON GIVING

To avoid the absolute priority rule's requirements, practitioners developed gifting as a way to comply with § 1129(b) while still encouraging plan confirmation.[76] The gifting doctrine goes by many names—carve outs, gifting,

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68. *Id.* at 504.

69. *Id.* at 507; *see* Louisville Trust Co. v. Louisville, New Albany & Chi. Ry. Co., 174 U.S. 674, 684 (1899); Chi., Rock Island & Pac. R.R. v. Howard, 74 U.S. (7 Wall.) 392, 409-10 (1868).

70. *See Boyd*, 228 U.S. at 489, 502, 507.

71. *Id.* at 507.

72. *See id.*

73. *See* Miller & Berkovich, *supra* note 7, at 1369. In *Case v. Los Angeles Lumber Products Co.*, another Supreme Court case issued twenty-six years after *Boyd*, the Supreme Court further articulated its definition of the absolute priority rule. *See* Case v. L.A. Lumber Prods. Co., 308 U.S. 106, 117 (1939). *Case* is "generally considered to have established the modern absolute priority rule." Jeanfreau, *supra* note 54, at 322. In *Case*, the Court explained that determining whether a reorganization plan was fair and equitable—a standard first enunciated in the Bankruptcy Act of 1898—meant applying the "rule of full or absolute priority." *Case*, 308 U.S. at 117. Thus, the Court held that the fair and equitable standard in the Bankruptcy Act simply codified the fixed principle articulated in cases like *Boyd*. *Id.* at 114-19.

74. *See* John D. Ayer, *Rethinking Absolute Priority After* Ahlers, 87 MICH. L. REV. 963, 969-79 (1989) (giving a history of the absolute priority rule, including its adoption into the Bankruptcy Code of 1978).

75. *See* Jeanfreau, *supra* note 54, at 323 (noting that bankruptcy practitioners "sought to discover exceptions and corollaries which would permit reorganization plans which seemed at first glance to violate the absolute priority rule," including the gifting doctrine).

76. *See* Daniel J. Bussel & Kenneth N. Klee, *Recalibrating Consent in Bankruptcy*, 83 AM. BANKR. L.J. 663, 711 (2009) (explaining that when attorneys realized some courts were willing to approve gifting plans, "SPM-ing [gifting] became all the rage"); Miller & Berkovich, *supra* note 7, at 1358-59 (noting that although

give ups, *SPM* gifts—and it is well-known among bankruptcy practitioners, creditors, and courts.[77] Yet, the term "gifting" never appears in the Code itself.[78] There are many variations on gift plans, but under the typical plan, a senior creditor shares a portion of its own distribution with an equity holder, despite the objection of an intermediate creditor.[79] Although this type of arrangement seems to violate the absolute priority rule, gift plans are well-established in case law.[80]

A. Establishing the Gifting Doctrine

1. SPM Manufacturing Corporation*: Chapter 11 Gifting Is Born*

SPM established the gifting doctrine practitioners currently use in Chapter 11 plans of reorganization and upon which courts rely in evaluating gifting plans.[81] In *SPM*, the bankruptcy court rejected an agreement between the secured creditor, Citizens Savings Bank (Bank), which held a perfected, first security interest in virtually all of the debtor's assets, and the Official Unsecured Creditors' Committee (Committee).[82] The agreement provided that the Bank would share a portion of the proceeds it received with the general unsecured creditors of the Committee.[83] But, this agreement essentially skipped over the Internal Revenue Service (IRS), which held an unsecured priority claim that should have received payment in full before any of the proceeds went to the general unsecured creditors.[84] Two unsecured "insider" creditors—individuals who would have been personally liable for tax claims not paid by the estate—argued such a plan violated the statutory distribution scheme in the

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§ 1129(b)'s requirements seem straightforward, debtors and practitioners developed "innovative structures" to get around the "hard edges of the Absolute Priority Rule . . . to enable the reorganization of the debtor").

77. *See, e.g.*, Brubaker, *supra* note 7 (using the term "give ups"); Jeanfreau, *supra* note 54, at 320 (using the term "gifting"); Levin, *supra* note 44, at 445 (using the term "carve out"); Richard E. Mikels & Andrea B. Schwartz, *Pre-Plan Settlements and "Gift Plans" 15 Years After* In re SPM Manufacturing Corp.*: Still no Bright Lines, Only Sympathetic Winners*, 28 AM. BANKR. INST. J. 54, 67 (Feb. 2009) (using "*SPM*-type arrangements").

78. Levin, *supra* note 44, at 445 (noting that "'carve out' is one of those uniquely bankruptcy phrases" but it does not come from the Bankruptcy Code (quoting *In re* White Glove, Inc., No. 98-12493DWS, 1998 WL 731611, at *6 (Bankr. E.D. Pa. Oct. 14, 1998))).

79. *See* Brubaker, *supra* note 7; Miller & Berkovich, *supra* note 7, at 1348. Practitioners are fond of gift plans because they appease equity holders who may otherwise "disrupt and delay plan negotiations." Tabb, *supra* note 20, at 846.

80. *See infra* Part III.A.

81. *See* Official, Unsecured Creditors' Comm. v. Stern (*In re* SPM Mfg. Corp.), 984 F.2d 1305, 1313 (1st Cir. 1993); Jeanfreau, *supra* note 54, at 323 (noting that *SPM* is "the first judicial approval of something resembling the modern gifting doctrine"); Miller & Berkovich, *supra* note 7, at 1391 (*SPM* "started the trend of condoning the ability of creditors to 'gift' around the requirements of the Bankruptcy Code.").

82. *See SPM Mfg.*, 984 F.2d at 1307-09.

83. *See id.* at 1308.

84. *Id.* at 1307.

Code.[85] The bankruptcy court agreed with the insiders and refused to approve the agreement between the Bank and the Committee.[86] The district court affirmed.[87]

On appeal, however, the First Circuit held that because the proceeds from the liquidation sale did not pay the Bank's lien in full, and because § 726's distribution scheme was not implicated until "all valid liens on the property [were] satisfied," the Bank was entitled to all of the sale proceeds to satisfy its priority secured claim.[88] Once the proceeds were distributed to the Bank, the court reasoned that they were no longer property of the estate, and the Bank was free to assign a portion of its proceeds as it wished.[89]

And thus, the *SPM* gifting doctrine was born.[90] But ironically, the *SPM* case involved a Chapter 7 case, not a Chapter 11 case.[91] Therefore, the plan in *SPM* never implicated the absolute priority rule because the rule only applies in Chapter 11 cases.[92] Nevertheless, many practitioners began using the First Circuit's language to justify gifting provisions in Chapter 11 reorganization plans, and courts used *SPM*'s language to approve such provisions.[93]

2. MCorp Financial*:* SPM *Gifting Applied in the Chapter 11 Context*

Soon after the First Circuit issued its opinion, the District Court for the Southern District of Texas seized upon the language in *SPM* and applied its gifting doctrine to a Chapter 11 reorganization plan.[94] In *MCorp Financial*, the prospect of reorganization had long since faded due to years of litigation—the debtors were no longer productive entities.[95] Thus, the parties proposed plans to liquidate the debtors' assets, just as in *SPM*.[96] But unlike in *SPM*, the agreement the parties reached in *MCorp Financial* was a settlement agreement

85. *See id.* at 1311-12. The Code provides that "property of the estate shall be distributed" first, to creditors with claims under § 507 and, second, to "any allowed unsecured claim." 11 U.S.C. § 726(a)(1)-(2) (2006). Section 507 lists, in order of rank, the distribution scheme for certain priority claims, including the payment of unsecured, pre-petition tax claims. *See id.* § 507(a) (2006). Thus, under the Code, the IRS should have received a distribution from the liquidated estate prior to the non-priority unsecured claims. *See* §§ 507(a), 726(a)(2).

86. *SPM Mfg.*, 984 F.2d at 1309-10, 1312.

87. *Id.* at 1310, 1312.

88. *Id.* at 1312, 1315.

89. *Id.* at 1313-14.

90. *See* Bussel & Klee, *supra* note 76, at 711.

91. *SPM Mfg.*, 984 F.2d at 1309.

92. *See* 11 U.S.C. § 1129(b) (2006).

93. *See, e.g.*, *In re* MCorp Fin., Inc., 160 B.R. 941, 960 (S.D. Tex. 1993); *In re* Genesis Health Ventures, Inc., 266 B.R. 591, 616-18 (Bankr. D. Del. 2001).

94. *In re MCorp Fin.*, 160 B.R. at 960 (citing *SPM Mfg.*, 984 F.2d at 1312).

95. *Id.* at 944. Indeed, Judge Lynn Hughes's opinion opens with the following colorful language: "After four years of complex bankruptcy litigation, the prospect of a vitalizing reorganization disappeared long ago. The debtors' estates are mere shells holding assets to distribute to their creditors." *Id.*

96. *See id.* (acknowledging that the parties proposed to liquidate the debtor's assets "without converting the case formally to a liquidation proceeding"); *SPM Mfg.*, 984 F.2d at 1308 (detailing the liquidation plan the parties proposed).

intended to resolve the litigation between the senior bondholders and the FDIC.[97] Under the proposed agreement, the senior bondholders would hand over a portion of their proceeds from the liquidation to the FDIC in exchange for the FDIC's agreement to set aside the lawsuit against the debtor.[98] The junior bondholders argued that this agreement violated the Code because, under the Code, their claims had a higher priority than the FDIC's unsecured claim.[99] Therefore, the plan should have paid the junior bondholders' claims in full before the FDIC received anything.[100]

Using reasoning similar to that of the First Circuit in *SPM*, the district court dismissed the junior bondholders' argument that the settlement violated the Code.[101] The court explained that the senior bondholders' priority within the distribution scheme allowed them to "share their proceeds with creditors junior to the juniors, as long as the juniors continue[d] to receive as least as much as what they would without the sharing."[102] Hence, the proceeds belonged to the senior bondholders, not the bankruptcy estate, and the bondholders could allocate the proceeds as they chose.[103] The way in which the court defined what was "property of the estate[]" was crucial to the decision not only in *MCorp Financial* but also in *Genesis Health Ventures*.[104]

3. Genesis Health Ventures*: Is Gifting Here to Stay?*

Genesis Health is another notable and oft-cited case in support of *SPM*-type gifting.[105] The debtors proposed a joint plan of reorganization providing

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97. *See In re MCorp Fin.*, 160 B.R. at 947-48, 964; *SPM Mfg.*, 984 F.2d at 1309 (explaining that the bankruptcy court granted a secured creditor's motion to appoint a receiver and liquidate the debtor's assets once "it became apparent that SPM [the debtor] could not be successfully reorganized").

98. *In re MCorp Fin.*, 160 B.R. at 947-48.

99. *Id.* at 960; *see* 11 U.S.C. § 726 (2006).

100. *See In re MCorp Fin.*, 160 B.R. at 960; 11 U.S.C. § 1129(b)(2)(B)(ii) (2006).

101. *See In re MCorp Fin.*, 160 B.R. at 960 (citing *SPM Mfg.*, 984 F.2d at 1312).

102. *Id.*

103. *See id.*

104. *See id.* at 945; *infra* Part III.A.3. To be sure, the way a court characterizes what is property of the estate is one of the main factors in determining the outcome of a gifting case. *Compare In re MCorp Fin.*, 160 B.R. at 960 (finding the senior bondholders' proceeds were not property of the estate), *and In re* Genesis Health Ventures, Inc., 266 B.R. 591, 617-18 (Bankr. D. Del. 2001) (finding that the proceeds were "otherwise distributable to the Senior Lenders," so they could share their proceeds as they wished), *with* DISH Network Corp. v. DBSD N. Am., Inc. (*In re* DBSD N. Am., Inc.), 634 F.3d 79, 95-98 (2d Cir. 2011) (interpreting the meaning of the term "property of the estate" broadly). When a debtor files a bankruptcy petition, all of the debtor's legal and equitable interests become property of the bankruptcy estate. 11 U.S.C. § 541(a) (2010). The estate protects the property from creditors and ensures an orderly distribution. *See id.* § 362 (2006); § 541(a); *see also* DRAKE & STRICKLAND, *supra* note 5, at 301 ("In short, 'the estate' is nothing more than that pool of assets which are protected, administered, and distributed in the bankruptcy process."). Therefore, if a court finds that the property at issue is property of the estate, it is subject to the Code's distribution scheme, but if the property is not of the estate, then a creditor may be free to do with the property what it wishes. *See, e.g.*, *In re MCorp Fin.*, 160 B.R. at 960; *DBSD N. Am., Inc.*, 634 F.3d at 95-98.

105. *See, e.g.*, *In re* Union Fin. Servs. Grp., Inc., 303 B.R. 390, 423 (Bankr. E.D. Mo. 2003) (agreeing with the *Genesis Health* holding that secured creditors may share their proceeds); *In re* Worldcom, Inc., No.

for the senior creditors' voluntary relinquishment of a portion of their proceeds "to the holders of unsecured and subordinated claims."[106] Furthermore, the plan granted, among other things, a distribution of stock and forgiveness of loans to existing employees of the business—a deal that objectors to the plan characterized as "payments to management on account of their pre-petition equity interests."[107] The objecting creditors argued this distribution scheme skipped over certain creditors—specifically, the punitive damages claimants.[108]

Following *SPM*, as well as *MCorp Financial*, the *Genesis Health* bankruptcy court approved the debtors' plan with small modifications.[109] The court explained that the senior creditors were simply allocating assets that were rightly theirs under the Code's distribution scheme.[110] To be sure, the court noted that the plan did not discriminate unfairly because the senior creditors were distributing assets to which they otherwise would be entitled, and the plan met the fair and equitable requirement and did not violate the absolute priority rule.[111]

B. One Gift, Two Creditors: The Fight over Gift Plans

Relying upon the above cases, many practitioners and courts believed that *SPM*-type gifting was an exception to the absolute priority rule—a workaround for the Code's distribution scheme.[112] Not all courts blindly jumped on the *SPM* gifting bandwagon, though.[113]

1. Armstrong World Industries*: Reevaluating* SPM *Gifting*

Only four years after the Bankruptcy Court for the District of Delaware issued its opinion in *Genesis Health*, the Third Circuit called the opinion into

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02-13533, 2003 WL 23861928, at *61 (Bankr. S.D.N.Y. Oct. 31, 2003) (citing *SPM Mfg.*, 984 F.2d at 1312; *In re MCorp Fin.*, 160 B.R. at 960; *In re Genesis Health*, 266 B.R. at 599).

106. *In re Genesis Health*, 266 B.R. at 601-02.

107. *Id.* at 617.

108. *See id.* at 601-02.

109. *Id.* at 612, 621 (citing *SPM Mfg.*, 984 F.2d at 1313; *In re MCorp Fin.*, 160 B.R. at 944). The modifications the court proposed pertained to the release and exculpation clauses in the plan, not to the gifting provision. *See In re Genesis Health*, 266 B.R. at 607-09. The modifications are therefore immaterial to this Comment. *See id.*

110. *See In re Genesis Health*, 266 B.R. at 617-18.

111. *See id.* at 611-20.

112. *See* Brubaker, *supra* note 7 (remarking that prior to the Second Circuit's decision in *DBSD*, gifts seemed "perfectly appropriate, entirely unproblematic, and essentially an exception to the absolute priority rule"); Jeanfreau, *supra* note 54, at 320 (noting that the Second Circuit's ruling in *DBSD* "called into question the viability of many lower court rulings upholding the so-called 'gifting' doctrine"). To be sure, gift plans—at least upon first blush—may help garner support for a proposed reorganization plan and ultimately lead to a successful reorganization. *See, e.g.*, David R. Doyle, *Gift Plans in Doubt After* DBSD North America, 30 AM. BANKR. INST. J. 38, 38 (May 2011). The absolute priority rule bars such provisions though, which can result in additional litigation, delay in the confirmation of a plan, and if an alternative agreement cannot be made, may even force the debtor to liquidate its assets. *See* Jeanfreau, *supra* note 54, at 334-35.

113. *See* discussion *infra* Parts III.B.1-2, IV.

question in *Armstrong World Industries, Incorporated*.[114] In *Armstrong*, the debtor, Armstrong Worldwide Industries, and two of its subsidiaries filed for Chapter 11 protection.[115] After negotiating with numerous parties in interest, the debtor filed its fourth amended plan of reorganization, which became the subject of the dispute.[116] The plan divided the creditors into eleven classes, and the debtor's equity interest holders—who owned the debtor's common stock—comprised the twelfth class.[117] Only three of those classes—a class of unsecured creditors, a class of present and future asbestos claimants, and the equity interest holders—were relevant to the appeal.[118]

Under the proposed plan, the class of unsecured creditors would recover approximately sixty percent of its claims, while the class of asbestos claimants would only receive about twenty percent.[119] Nevertheless, the equity interest holders would receive new warrants to purchase the new common stock, estimated to be worth $35 million to $40 million.[120] The proposed plan recognized that such provisions might violate the absolute priority rule if all of the classes of creditors did not vote to confirm the plan.[121] Thus, the plan also contained a provision that distributed the new warrants to the asbestos claimants in the event that the unsecured creditors rejected the plan.[122] In that situation though, the plan stipulated that the asbestos claimants would automatically waive their receipt of the new warrants, and the warrants would pass to the equity holders.[123]

The unsecured creditors objected to this plan, but the bankruptcy court found that the plan did not violate the absolute priority rule and recommended that the district court confirm the plan.[124] The district court, however, denied

114. *See In re* Armstrong World Indus., Inc., 432 F.3d 507, 513-14 (3d Cir. 2005); *In re Genesis Health*, 266 B.R. at 611-20.

115. *In re Armstrong*, 432 F.3d at 509.

116. *Id.*

117. *Id.*; *see also supra* notes 21-24 and accompanying text (discussing the distribution scheme in bankruptcy).

118. *See In re Armstrong*, 432 F.3d at 509. Armstrong initially filed a Chapter 11 petition because numerous plaintiffs brought asbestos-related personal injury and wrongful death claims against it. *See* Brief of Appellant Armstrong World Indus., Inc. at 7, *In re* Armstrong World Indus., Inc., 432 F.3d 507 (3d Cir. 2005) (No. 05-1881). In its brief, Armstrong noted that at the time of filing, it had over 170,000 claims pending against it. *See id.*

119. *In re Armstrong*, 432 F.3d at 509.

120. *Id.*

121. *See id.* When all classes of creditors vote in favor of the plan, the absolute priority rule is not implicated. *See* 11 U.S.C. § 1129(a) (2006); *supra* Part II.C-D. Therefore, if all of the classes of creditors did not vote in favor of the plan in *Armstrong*, but the plan nevertheless distributed proceeds to equity holders (over the objection of dissenting, more senior creditors), such a plan would have violated the absolute priority rule. *See* § 1129(b)(2)(B)(ii); *In re Armstrong*, 432 F.3d at 509. Consequently, the plan contained a contingency clause to prevent such a violation. *See In re Armstrong*, 432 F.3d at 509.

122. *In re Armstrong*, 432 F.3d at 509.

123. *Id.*

124. *Id.* at 510. The bankruptcy court cited *Genesis Health* for the proposition that the absolute priority rule was not violated because the warrants passed to the equity holders only because the asbestos claimants had "waived," or given up, their receipt. *Id.* In other words, the asbestos claimants—who were arguably free to allocate their proceeds as they wished—voluntarily gifted their warrants to the equity holders. *See id.* Such

confirmation of the plan because "(1) the issuance of warrants to the equity interest holders violated the absolute priority rule, and (2) no equitable exception to the absolute priority rule applied."[125] The Third Circuit affirmed the district court's opinion.[126]

On appeal to the Third Circuit, the debtor argued that the absolute priority rule did not apply because an intermediate class was not being "squeezed out."[127] Rather, the asbestos claimants were sharing proceeds with a lower priority class—the equity holders—over the objections of the unsecured creditors, who were not an intervening class because they shared the same priority level as the asbestos claimants.[128] The Third Circuit rejected this argument, noting that the plain language of the absolute priority rule, as codified in § 1129(b)(2)(B)(ii) of the Code, revealed that the rule prohibits a plan from giving "property to junior claimants over the objection of a more senior class that is impaired."[129] The court concluded that the legislative intent also indicated that a "give-up" from a senior class to a junior class was prohibited, whether or not the objecting class was an intervening class, as the debtor argued.[130]

The Third Circuit then addressed the debtor's contention that the *SPM*, *MCorp Financial*, and *Genesis Health* cases all supported the plan's proposal because the warrants were the rightful proceeds of the asbestos claimants, who could then disburse the property as they wished.[131] The court summarily rejected this argument and adopted the district court's interpretation of those cases.[132] Noting that the cases did not "stand for the unconditional proposition

a voluntary give-up was permissible under the *Genesis Health* holding. *See In re* Genesis Health Ventures, Inc., 266 B.R. 591, 616-18 (Bankr. D. Del. 2001).

125. *In re Armstrong*, 432 F.3d at 510-11 (citing *In re* Armstrong World Indus., Inc. (*Armstrong 1*), 320 B.R. 523 (D. Del. 2005)).

126. *Id.* at 518.

127. *Id.* at 513.

128. *See id.*

129. *Id.*

130. *See id.* (arguing that the legislative history of the absolute priority rule indicates that § 1129(b) should be interpreted broadly and prevents gifting "from the dissenting class on down" (quoting H.R. REP. NO. 95-595, at 413 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6369)).

131. *See id.* at 513-14 (citing Official, Unsecured Creditors' Comm. v. Stern (*In re* SPM Mfg. Corp.), 984 F.2d 1305, 1312-14 (1st Cir. 1993); *In re* MCorp Fin., Inc., 160 B.R. 941, 948 (S.D. Tex. 1993); *In re* Genesis Health Ventures, Inc., 266 B.R. 591, 617-18 (Bankr. D. Del. 2001)).

132. *See id.* at 514. The court did not go into a detailed discussion of the *SPM*, *MCorp*, and *Genesis Health* cases. *See id.* at 513-15. Rather, the court recited the district court's readings of the cases because it found them compelling and adopted them. *See id. But cf.* Miller & Berkovich, *supra* note 7, at 1417-18 (criticizing the district court's "weak" distinctions between *SPM*, *MCorp*, and *Genesis Health* and the plan in *Armstrong*, its unequivocal rejection of the "strong policy arguments in favor of permitting" the plan, and the Third Circuit's subsequent adoption of such an interpretation). The district court distinguished *SPM* from the case at bar in three ways:

> (1) *SPM* involved a distribution under Chapter 7, which did not trigger 11 U.S.C. § 1129(b)(2)(B)(ii); (2) the senior creditor had a perfected security interest, meaning that the property was not subject to distribution under the Bankruptcy Code's priority scheme; and (3) the distribution was a "carve out," a situation where a party whose claim is secured by assets in the bankruptcy estate allows a portion of its lien proceeds to be paid to others.

that creditors are generally free to do whatever they wish with the bankruptcy proceeds they receive," the court held that the debtor's plan "encourage[d] parties to impermissibly sidestep" the statutory requirements and violated the absolute priority rule.[133] In so holding, the Third Circuit called into question a practice that debtors and practitioners had relied upon since the *SPM* decision.[134] The *Armstrong* court was not unique in its decision, though, because it was not the first opinion to call into question the practice of gifting.[135]

2. Armstrong *Was Not the First Decision to Reject a Gift Plan, nor Would It Be the Last*

Prior to *Armstrong*, several lower courts had already struck down gifting provisions.[136] For example, *Snyders Drug Stores* involved a gift plan in which the secured creditor agreed to share funds it would have received with two classes of unsecured creditors.[137] Another class of unsecured creditors objected, arguing that the plan unfairly discriminated against it in violation of § 1129(b)(1).[138] The bankruptcy court agreed with the objecting creditor and ultimately rejected the gift plan, holding that the plan failed to meet the requirements of § 1129(b)(1).[139]

In another example, the Bankruptcy Court for the Southern District of Texas rejected a plan that proposed to distribute one percent of claims to one group of unsecured creditors and one hundred percent to another, similarly situated group of unsecured creditors because the plan discriminated unfairly.[140]

In re Armstrong, 432 F.3d at 514 (citing *In re* Armstrong World Indus., Inc. (*Armstrong 1*), 320 B.R. 523, 539 (Bankr. D. Del. 2005)). Similarly, the district court distinguished *Genesis Health* because the plan involved senior secured creditors giving up a portion of their lien proceeds to junior creditors, unlike the plan in *Armstrong*, which involved unsecured creditors giving up warrants in the newly reorganized entity. *See id.* (citing *Armstrong 1*, 320 B.R. at 539). And finally, the district court distinguished *MCorp* from the facts of the *Armstrong* plan because the *MCorp* plan intended to settle pre-petition litigation. *See id.* (citing *Armstrong 1*, 320 B.R. at 539).

133. *In re Armstrong*, 432 F.3d at 514.

134. *See* Miller & Berkovich, *supra* note 7, at 1419-26 (noting courts' reliance on the language in *SPM* to support gifting provisions and giving a detailed discussion of the implications of the *Armstrong* holding); discussion *supra* Part III.A.

135. *See* Mikels & Schwartz, *supra* note 77, at 63-64. In an attempt to predict the outcome of gifting cases, some scholars tried to find commonalities between the *SPM*-type gifting cases. *See, e.g.*, *id.* at 66-67. In their article, Mikels and Schwartz charted each case involving an *SPM*-type arrangement, and from the results, they attempted to identify commonalities between the cases. *See id.* Interestingly, the only common thread that Mikels and Schwartz were able to identify between the cases they examined was that the more sympathetic party always won. *See id.*

136. *See, e.g.*, *In re* Snyders Drug Stores, Inc., 307 B.R. 889, 896 (Bankr. N.D. Ohio 2004); *In re* Sentry Operating Co. of Tex., 264 B.R. 850, 866 (Bankr. S.D. Tex. 2001).

137. *In re Snyders Drug Stores*, 307 B.R. at 892.

138. *See id.* at 894-95. This case focused on the unfair discrimination prong of § 1129(b) rather than the absolute priority rule. *See id.* at 895-96. Regardless, the case is significant because it shows that not all courts accepted gift plans. *See id.* at 896; Jeanfreau, *supra* note 54, at 326.

139. *In re Snyders Drug Stores*, 307 B.R. at 896.

140. *In re Sentry Operating*, 264 B.R. at 862-64.

Although the facts in *Sentry Operating* were slightly different than in other gifting cases, the plan in question was nevertheless a gifting plan, and the bankruptcy court took issue with the unequal distribution to creditors that held equal rank.[141] The court rejected the plan because "the Bankruptcy Code is premised on the rule of equality of treatment" and the proposed plan did not provide for equal treatment.[142] More specifically, the court explained that "[t]o accept [the secured lender'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."[143] Importantly, these cases illustrate one of the main problems the Second Circuit had with the debtor's proposed plan in *DBSD North America*—that the plan defied the general principle of equality among similarly situated creditors within bankruptcy.[144]

IV. *DBSD NORTH AMERICA*: THE SECOND CIRCUIT DEFINITIVELY REJECTS *SPM* GIFTING

The plan at issue in *DBSD North America* included a classic gifting provision: the plan provided that the existing shareholder—whose claim was junior to those of the general unsecured creditors—would "receive substantial quantities of shares and warrants" in the reorganized entity, but the general unsecured creditors would not receive the full value of their claims.[145] Simply put, the plan skipped over the general unsecured creditors.[146]

Sprint Nextel Corporation (Sprint), one of the unsecured claim holders, objected to the plan that the debtor, DBSD North America and its subsidiaries (DBSD), proposed.[147] Sprint argued that the "plan violated the absolute priority rule by giving shares and warrants to a junior class (the existing shareholder) although a more senior class (Sprint's class) neither approved the plan nor received the full value of its claims."[148] Nevertheless, the bankruptcy

141. *See id.* In *Sentry Operating*, the dispute was between two equally ranked classes of unsecured creditors rather than a senior and junior creditor, as in *Genesis Health* or *Armstrong*. *See id.* at 859; *In re* Armstrong World Indus., Inc., 432 F.3d 507, 509 (3d Cir. 2005); *In re* Genesis Health Ventures, Inc., 266 B.R. 591, 601-02 (Bankr. D. Del. 2001). Thus, like *Snyders Drug Stores*, the plan did not implicate the absolute priority rule—the objecting creditors argued the plan unfairly discriminated against them. *See* 11 U.S.C. § 1129(b)(1) (2006); *In re Synders Drug Stores*, 307 B.R. at 896; *In re Sentry Operating*, 264 B.R. at 859. Nevertheless, the court's holding is significant because its respect for the principle that "[c]reditors with claims of equal rank are entitled to equal distribution" led it to reject the gift plan. *In re Sentry Operating*, 264 B.R. at 863.

142. *In re Sentry Operating*, 264 B.R. at 863-64.

143. *Id.* at 865.

144. *See* DISH Network Corp. v. DBSD N. Am., Inc. (*In re* DBSD N. Am., Inc.), 634 F.3d 79, 99-100 (2d Cir. 2011).

145. *Id.* at 86-87.

146. *See id.* at 87.

147. *Id.*

148. *Id.* at 93-94.

court held that the gifting provision did not violate the absolute priority rule because the second priority secured creditors were merely giving up a portion of their recovery to which they were entitled.[149] In addition, there were "no ulterior, improper ends" and the "complaining creditor [Sprint] would get no more if the gift had not been made."[150] Consequently, the bankruptcy court approved the plan, and the district court, adopting the reasoning of the bankruptcy court, affirmed.[151]

On appeal, however, the Second Circuit held that the bankruptcy court erred in confirming the plan of reorganization because the plan violated the absolute priority rule.[152] The court began its analysis by examining the language of § 1129(b)(2)(B), noting that, unless all of the impaired classes consent to the plan, the bankruptcy court may only confirm a plan if "the dissenting class receives the full value of its claim" or if "no classes junior to that class receive any property under the plan on account of their junior claims or interests."[153] Sprint did not consent to the plan nor did it receive the full value of its claim.[154] Therefore, the court reasoned that the bankruptcy court should have confirmed the plan only if those creditors that held claims junior to Sprint's did "not receive or retain under the plan . . . any property"—a requirement that was not met.[155] Hence, the plan violated the absolute priority rule.[156]

Importantly, the Second Circuit relied on several factors in making its decision. First, the court discussed the definition of "property."[157] Citing the Supreme Court's decision in *Norwest Bank Worthington v. Ahlers*, the court explained that "[t]he term 'property' in § 1129(b)(2)(B) is meant to be interpreted broadly."[158] While the court did not give examples of items that would or would not be property, the court stated that there was "no doubt" that the "shares and warrants" at issue in *DBSD* were property.[159] In so stating, the court indicated that it would have considered a lesser interest property as well.[160]

Second, the court addressed the absolute priority rule's requirement that "no classes junior to that class [the dissenting class] receive any property under

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149. *See id.* at 87.

150. *In re* DBSD N. Am., Inc. (*DBSD I*), 419 B.R. 179, 212 (Bankr. S.D.N.Y. 2009) (quoting *In re* Journal Register Co., 407 B.R. 520, 531 (Bankr. S.D.N.Y. 2009)) (internal quotation marks omitted).

151. *See DBSD N. Am., Inc.*, 634 F.3d at 86, 93-94.

152. *Id.* at 95.

153. *Id.*

154. *Id.*

155. *Id.* (quoting 11 U.S.C. § 1129(b)(2)(B)(ii) (2006)).

156. *See id.*

157. *See id.*; *see also supra* note 104 and accompanying text (discussing the importance of the definition of property of the estate).

158. *DBSD N. Am., Inc.*, 634 F.3d at 95 (citing Norwest Bank Worthington v. Ahlers, 485 U.S. 197, 208 (1988)).

159. *Id.*

160. *See id.*

the plan on account of their junior claims or interests."[161] But, the existing shareholder, under the terms of the plan, received property "on account of its prior interest" in DBSD.[162] And more importantly, the existing shareholder did not contribute "new value"—a contribution of capital to the reorganized debtor.[163] Relying on two Supreme Court opinions that have addressed the absolute priority rule in the context of contributions of new value, the court reasoned that it was unlikely the Court would permit a plan like the one at issue because the existing shareholder did not contribute new value.[164]

Third, the court distinguished *SPM* on two grounds, but the court did not expressly overrule *SPM*.[165] First, *SPM* was a Chapter 7 case, not a Chapter 11 case.[166] Thus, *SPM* dealt with the liquidation of property rather than reorganization.[167] And notably, *SPM* did not implicate the absolute priority rule because there is no "statutory support" for the rule in Chapter 7.[168] Second, because the *SPM* court granted "the secured creditor relief from the automatic stay," the creditor was free to do with the property as it wished because the property was no longer part of the estate.[169] Thus, the secured creditor was free to distribute its proceeds to junior classes, unlike the senior class in *DBSD*.[170]

Finally, the *DBSD* court briefly discussed the policy arguments for and against the absolute priority rule.[171] Although it acknowledged that "[g]ifting may be a 'powerful tool in accelerating an efficient and non-adversarial . . . chapter 11 proceeding,'" the court observed that shareholders have great

161. *Id.*; *see* 11 U.S.C. § 1129(b)(2)(B)(ii) (2006).

162. *DBSD N. Am., Inc.*, 634 F.3d at 96 (internal quotation marks omitted).

163. *See id.*

164. *See id.* at 97. The court cited *203 North LaSalle* and *Ahlers* for the proposition that, given the Court's hesitancy "to allow old owners to receive new ownership interests even when contributing new value," it is unlikely that the Court would permit an exception for a gifting provision that gives property to an old shareholder without the shareholder contributing new value. *Id.* (citing Bank of Am. Nat'l Trust & Sav. Ass'n v. 203 N. LaSalle St. P'ship, 526 U.S. 434, 458 (1999); Norwest Bank Worthington v. Ahlers, 485 U.S. 197, 208 (1988)). Nevertheless, the *DBSD* court did not foreclose the possibility of a plan in which the party makes a contribution of new value and receives property under the reorganization plan. *Id.* at 96 n.6. Indeed, the court noted that such a provision might not violate the absolute priority rule because it could be argued that the party is not receiving property "on account of its interest," but is rather receiving it "on account of its new investment." *Id.* (internal quotation marks omitted); *see* discussion *infra* Part VI.A.

165. *See DBSD N. Am., Inc.*, 634 F.3d at 98.

166. *Id.* (citing Official, Unsecured Creditors' Comm. v. Stern (*In re* SPM Mfg. Corp.), 984 F.2d 1305, 1309 (1st Cir. 1993)).

167. *See id.*

168. *See id.* (quoting *SPM Mfg.*, 984 F.2d at 1313).

169. *Id.* Again, the distinction between property of the estate and property not of the estate is an important one, both in this case and in other gifting cases. *See id.*; *supra* note 104 and accompanying text. If the court has not granted relief from the automatic stay, the property—property that is intended to benefit all creditors with allowed claims—remains part of the estate. *See DBSD N. Am., Inc.*, 634 F.3d at 98 (citing United States v. Whiting Pools, Inc., 462 U.S. 198, 203-04 (1983)). Thus, creditors are not free to gift away property of the estate. *See id.*; *see also In re* Sentry Operating Co. of Tex., 264 B.R. 850, 865-66 (Bankr. S.D. Tex. 2001) (enumerating the "equitable tools" of bankruptcy, including "that all other creditors are held at bay under an automatic stay while the plan is formulated and implemented").

170. *See DBSD N. Am., Inc.*, 634 F.3d at 98.

171. *See id.* at 100.

opportunity for "self-enrichment" in a Chapter 11 reorganization.[172] Using the facts in *DBSD* to support this assertion, the court noted that under the proposed plan, the existing shareholder stood to gain "approximately $28.5 million worth of equity," while the unsecured creditors received $850,000 to be shared among them.[173] In addition, the court noted that the legislative history to the absolute priority rule indicated that Congress never intended to create an exception for the type of gift at issue in *DBSD*.[174]

V. IS GIFTING STILL A VALID TOOL IN THE FIFTH CIRCUIT?

Several scholars have concluded that the Second Circuit's *DBSD* opinion will effectively bar, or at least severely limit, gifting plans in other circuits in the future.[175] But, is *DBSD* really the end of the story for gifting plans in the Fifth Circuit? And, how will the Fifth Circuit deal with such plans in the future?

A. Gift Giver Beware: What the Fifth Circuit Says About Gifting

The Fifth Circuit has never explicitly addressed the issue of gifting in the context of the absolute priority rule, but the Fifth Circuit indirectly considered the issue in *AWECO*.[176] And, a bankruptcy court in the Fifth Circuit recently

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172. *Id.* (quoting Leah M. Eisenberg, *Gifting and Asset Reallocation in Chapter 11 Proceedings: A Synthesized Approach*, 29 AM. BANKR. INST. J. 50, 50 (Sept. 2010)).

173. *Id.*

174. *Id.* at 100-01 (citing H.R. REP. NO. 95-595, at 416 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6372)).

175. *See* Doyle, *supra* note 112, at 38 (positing that the *DBSD* and *Armstrong* opinions will constrain corporate reorganizations and severely limit gifting plans); Jeanfreau, *supra* note 54, at 333 (stating "it is clear that gifting plans are a dead letter in the Second Circuit"). *But see* Brubaker, *supra* note 7. In his article, Brubaker stated that although "one might be tempted to declare inter-class give-ups dead (or at least mortally wounded)" after the *DBSD* opinion, such a conclusion "would clearly be premature and would vastly underestimate the resourcefulness of the Chapter 11 bar." *Id.* Brubaker's prediction seems accurate, given the Seventh Circuit's recent holding in *Holly Marine Towing*. *See In re* Holly Marine Towing, Inc., 669 F.3d 796, 802 (7th Cir. 2012). In *Holly Marine Towing*, the debtor filed for Chapter 11 bankruptcy but later converted the case to a Chapter 7 bankruptcy. *See id.* at 799. Affirming the bankruptcy and district courts, the Seventh Circuit approved a settlement plan between the debtor's two principals and the bankruptcy estate over the objection of one of the estate's creditors. *See id.* The creditor argued that the settlement violated the Code's distribution scheme, but the Seventh Circuit found that because the funds the principals received did not belong to the estate, "the priority scheme simply [did] not apply." *Id.* at 801. Such reasoning is akin to the explanation the courts in cases like *SPM*, *MCorp Financial*, and *Genesis Health* used in approving gift plans. *See* Official, Unsecured Creditors' Comm. v. Stern (*In re* SPM Mfg. Corp.), 984 F.2d 1305, 1312-15 (1st Cir. 1993); *In re* MCorp Fin., Inc., 160 B.R. 941, 960 (S.D. Tex. 1993); *In re* Genesis Health Ventures, Inc., 266 B.R. 591, 616-18 (Bankr. D. Del. 2001). Although the full impact of the court's decision is unknown at this time because it is too recent, the *Holly Marine Towing* holding certainly indicates that gifting may still be a possibility in the Seventh Circuit, despite the *DBSD* holding. *See In re Holly Marine Towing*, 669 F.3d at 796; *DBSD N. Am., Inc.*, 634 F.3d at 95. The gifting debate, therefore, will continue. *See In re Holly Marine Towing*, 669 F.3d at 801-02.

176. *See* United States v. AWECO, Inc. (*In re* AWECO, Inc.), 725 F.2d 293, 298 (5th Cir. 1984).

addressed the issue in *OCA*.[177] The holdings in these two cases—*AWECO* and *OCA*—give important insight into how the Fifth Circuit might decide a gifting case.[178]

1. AWECO

In *AWECO*, the Fifth Circuit indirectly addressed the gifting issue.[179] The debtor, AWECO, and one of its creditors, United American Car Co. (United), were embroiled in a lawsuit over two contracts.[180] But during the bankruptcy, the parties reached a settlement to the lawsuit, and AWECO agreed to transfer "to United of some $5.3 million worth of cash and property."[181] The property AWECO proposed to transfer, however, was secured by a judgment lien to which another creditor—Sutton Investments (Sutton)—alleged it had a claim.[182] The Internal Revenue Service (IRS), also a creditor of the debtor, further alleged that the plan transferred assets that were secured by one of its tax claims.[183] Thus, the settlement transferred property to an unsecured creditor, United, but the secured creditors—Sutton and the IRS—were not paid in full.[184]

Upon the debtor's filing of notice in bankruptcy court of the intended settlement, several creditors, including Sutton and the IRS, filed objections.[185]

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177. *See In re* OCA, Inc., 357 B.R. 72, 86-88 (Bankr. E.D. La. 2006).

178. *See* discussion *infra* Part V.A.1-2.

179. *See AWECO, Inc.*, 725 F.2d at 298. The plan at issue in *AWECO* was a settlement plan, *not* a plan of reorganization; therefore, the absolute priority rule did not apply. *See id.* at 291; 11 U.S.C. § 1129(b)(2)(B)(ii) (2006). In fact, the court never referenced the absolute priority rule or § 1129(b) in its opinion. *See AWECO, Inc.*, 725 F.2d at 297-98. Nevertheless, the case is useful in determining how the Fifth Circuit might decide a gifting case because the case focuses on the fair and equitable standard—the same standard that is embodied in the absolute priority rule. *See id.* at 298; *infra* notes 188-92 and accompanying text.

180. *AWECO, Inc.*, 725 F.2d at 295.

181. *Id.* at 295-96. A debtor may settle adversary proceedings or release outstanding claims in a separate proceeding or within a plan of reorganization, and the bankruptcy court is authorized to approve or deny the settlement. *See* 11 U.S.C. § 1123(b)(3)(A) (2006); FED. R. BANKR. P. 9019(a). Bankruptcy courts typically favor settlements because they prevent costly litigation and promote one of the goals of bankruptcy policy—maximizing the debtor's finite assets to realize the greatest distribution for creditors. *See* Deutsch & Daucher, *supra* note 53, at 54 (citing Protective Comm. for Indep. Stockholders of TMT Trailer Ferry, Inc. v. Anderson, 390 U.S. 414, 434 (1968)).

182. *See AWECO, Inc.*, 725 F.2d at 295-96.

183. *Id.*

184. *Id.*

185. *Id.* at 296. Sutton later withdrew its objection to the settlement because the bankruptcy court "granted Sutton a replacement lien" on various assets that were not already secured by a lien. *Id.* at 296 n.5. When a creditor has a lien on assets in the bankruptcy estate, the bankruptcy trustee, or debtor in possession in the case of a Chapter 11 reorganization, is required to adequately protect the assets. *See* 11 U.S.C. § 361 (2006). Failure to do so is grounds for relief from the automatic stay. *See* 11 U.S.C. § 362(d)(1) (2006). One way in which the trustee can offer adequate protection is to provide a replacement lien to the extent that the automatic stay or use of the property "results in a decrease in the value of such entity's [creditor's] interest in such property." *Id.* § 361(2). Thus, the court's granting of a replacement lien dispelled Sutton's concern that its lien was displaced by the settlement because the assets were protected by the lien. *See AWECO, Inc.*, 725 F.2d at 296 n.5. And as a result, the IRS ultimately was the only creditor to appeal to the Fifth Circuit. *Id.* at 297.

The bankruptcy court approved the settlement and the district court affirmed.[186] But on appeal, the Fifth Circuit vacated the district court's order and remanded the case to the bankruptcy court.[187] Citing *Protective Committee v. Anderson* for support, the Fifth Circuit noted that in deciding whether to confirm a pre-plan settlement, a court must determine whether the plan is fair and equitable.[188] "Fair and equitable," the court explained, means "senior interests are entitled to full priority over junior ones."[189] In using this language, the court essentially applied the same absolute priority standard in § 1129(b), or rather the principle the rule embraces, to pre-plan settlements.[190] Indeed, fair and equitable settlement of creditors' claims is always one of the goals of bankruptcy.[191] Therefore, even though the plan at issue involved a pre-plan settlement rather than a plan of reorganization, the Fifth Circuit effectively extended the absolute priority rule to pre-plan settlements.[192]

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186. *See AWECO, Inc.*, 725 F.2d at 297. Although bankruptcy courts generally favor settlements, neither the Code nor the Bankruptcy Rules provide "guidance [to bankruptcy courts] as to what standard to apply when judging whether a settlement should be approved." Deutsch & Daucher, *supra* note 53, at 54. Through case law, however, courts have developed several standards by which to evaluate a settlement plan, including whether the settlement is fair and equitable and "in the best interests of the estate." *In re* Mirant Corp., 348 B.R. 725, 738 (Bankr. N.D. Tex. 2006). Although the requirements for a settlement plan are different than the requirements for a plan of reorganization, the fair and equitable standard is very similar for each. *See id.* at 739-40 (explaining the four-prong test courts use to determine whether a settlement plan is fair and equitable and in the best interests of the estate); *infra* notes 189-90 and accompanying text.

187. *See AWECO, Inc.*, 725 F.2d at 300.

188. *Id.* at 298 (citing Protective Comm. for Indep. Stockholders of TMT Trailer Ferry, Inc. v. Anderson, 390 U.S. 414, 424 (1968)).

189. *Id.* (quoting SEC v. Am. Trailer Rentals Co., 379 U.S. 594, 611 (1965)).

190. *Compare id.* (holding a pre-plan settlement that distributed assets to the unsecured creditor over the objection of the secured creditor and without paying the secured creditor in full is not fair and equitable), *with* 11 U.S.C. § 1129(b)(2)(B)(ii) (2006) ("[T]he condition that a plan be fair and equitable with respect to a class [of unsecured claims] includes . . . the holder of any claim or interest that is *junior* to the claims of such class[es] *will not receive or retain* under the plan on account of such junior claim or interest *any property* . . . ." (emphasis added)). *See generally* Robin E. Phelan et al., *Fine. No Gifts for Anyone. Are You Happy Now?*, TEX. BAR CLE ADVANCED BUS. BANKR. COURSE ch. 3.2, at 7 (Sept. 2011) ("Thus, under the holding in *AWECO*, the absolute priority rule, or at least the concept embodied in the absolute priority rule, that senior interests are entitled to priority over junior interests, is applicable beyond the context of a cramdown plan of reorganization."). Even in the context of a settlement plan (which is outside the reach of the absolute priority rule), the Fifth Circuit was concerned with distribution and priority of payment—a key principle behind bankruptcy and the absolute priority rule. *See AWECO, Inc.*, 725 F.2d at 298; *see also* Official Comm. of Unsecured Creditors v. Cajun Elec. Power Coop., Inc. (*In re* Cajun Elec. Power Coop., Inc.), 119 F.3d 349, 355 (5th Cir. 1997) (stressing the importance of respecting distribution rules in the Code within the context of settlement plans).

191. *See AWECO, Inc.*, 725 F.2d at 298.

192. *See id.*; *see also* Iridium Operating LLC v. Official Comm. of Unsecured Creditors (*In re* Iridium Operating LLC), 478 F.3d 452, 464 (2d Cir. 2007) (explaining that in *AWECO*, the Fifth Circuit held that the absolute priority rule applies to pre-plan settlements). The Fifth Circuit was careful to explain, though, that it was "[making] a limited extension of the fair and equitable standard," holding as follows: "a bankruptcy court abuses its discretion in approving a settlement with a junior creditor unless the court concludes that priority of payment will be respected as to objecting senior creditors." *AWECO, Inc.*, 725 F.2d at 298. In other words, courts need only apply the fair and equitable standard when evaluating pre-plan settlements if there are dissenting senior creditors. *See id.*

The principle expressed in *AWECO*—respecting priority of payment among senior and junior creditors—is precisely the concept the bankruptcy court in *OCA* focused on when it rejected the debtors' plan.[193] Although the bankruptcy court in *OCA* never cited *AWECO*, the court was similarly concerned with respecting the priority of payment.[194]

2. OCA

In *OCA*, the debtors filed a Chapter 11 petition, and the debtors, Unsecured Creditors' Committee, secured lender, and Official Equity Committee filed a plan of reorganization.[195] One of the shareholders, Mr. Bart Palmisano, Sr.—who was also a general unsecured creditor of the debtors—objected to the plan, arguing that the plan impermissibly allowed the secured creditor to gift a portion of its proceeds to the equity holders without first paying the general unsecured creditors in full.[196] The bankruptcy court agreed with Mr. Palmisano and denied confirmation of the plan.[197]

In reaching its holding, the bankruptcy court discussed and distinguished several gifting cases.[198] First, it distinguished *SPM*, explaining, just as the courts in *Armstrong* and *DBSD* did, that the absolute priority rule did not apply in *SPM* because it was a Chapter 7 case.[199] Furthermore, the estate in *SPM* was liquidated; thus, "the sharing did not occur until after the distribution of estate property, having no effect on the bankruptcy distributions to other creditors."[200] Next, the court distinguished the facts in *MCorp*, explaining that the settlement in *MCorp* put an end to the "hotly contested litigation that had endured for over four years" between the debtor and creditors.[201] In contrast, the settlement in *OCA* was not the result of extensive litigation, but rather a scheme by the plan

193. *See In re* OCA, Inc., 357 B.R. 72, 92 (Bankr. E.D. La. 2006).

194. *See infra* Part V.A.2.

195. *In re OCA*, 357 B.R. at 75 & n.3.

196. *Id.* at 83-84. Specifically, the plan provided that the secured creditor would give "up to 15% of the new common stock that it [was] entitled to receive under the plan in favor of the equity holders in exchange for their agreeing not to raise objections to the plan." *Id.* at 84. Mr. Palmisano was entitled to vote in the general unsecured creditors' class and the equity holders' class, and he voted against the plan in both classes. *Id.* at 75. He argued that the plan violated § 1129(b)(2)(B)(ii) because his unsecured claim was not paid in full, yet the plan provided for a distribution to the equity holders. *See id.* at 84. Mr. Palmisano likely stood to gain more on his unsecured claim than he would have on the gift to the equity holders, which is why he objected to the plan. *See id.*

197. *Id.* at 93.

198. *See id.* at 84-89.

199. *See id.* at 85; *see also* DISH Network Corp. v. DBSD N. Am., Inc. (*In re* DBSD N. Am., Inc.), 634 F.3d 79, 98 (2d Cir. 2011) (citing Official, Unsecured Creditors' Comm. v. Stern (*In re* SPM Mfg. Corp.), 984 F.2d 1305, 1309 (1st Cir. 1993)) ("*In re SPM* involved Chapter 7, not Chapter 11, and thus involved a liquidation of the debtor, not a reorganization."); *In re* Armstrong World Indus., Inc., 432 F.3d 507, 514 (3d Cir. 2005) ("*SPM* involved a distribution under Chapter 7, which did not trigger 11 U.S.C. § 1129(b)(2)(B)(ii) . . . .").

200. *In re OCA*, 357 B.R. at 85.

201. *Id.*; *see In re* MCorp Fin., Inc., 160 B.R. 941, 948 (S.D. Tex. 1993).

proponents intended to buy the vote of the equity holders.[202] Such a plan, the court reasoned, was "not similar enough to the facts in *MCorp* . . . to circumvent the absolute priority rule."[203] Finally, the court distinguished *Genesis Health*, in part because the case "relie[d] heavily on *SPM* and *MCorp*"—two cases the *OCA* court concluded were inapplicable and unsupportive of the plan at issue.[204]

Ultimately, the court concluded that the proposed plan violated the absolute priority rule because it provided for distribution to the equity holders without paying the unsecured creditors—a class senior to the equity holders—in full.[205] It found the reasoning in cases like *Armstrong*, which held that the absolute priority rule prohibited plans that permitted distribution from senior secured creditors to equity holders without paying general unsecured creditors in full, persuasive.[206]

Although the holdings in *OCA* and *AWECO* are not directly on point, the holdings are premised on a common principle—senior creditors should be paid before junior creditors—and the holdings provide valuable insight into how the Fifth Circuit might evaluate a gifting provision.[207] The cases are therefore useful in determining whether gift plans are a viable option in the Fifth Circuit.[208]

B. Analyzing What the OCA *and* AWECO *Cases Mean for Gift Plans in the Fifth Circuit*

Given the holdings in *OCA* and *AWECO*, practitioners in the Fifth Circuit should be cautious in using gift plans.[209] The courts in each case stressed the importance of respecting the priority of payment among senior and junior creditors.[210] And in each case, the courts struck down plans that violated this priority by making distributions to junior creditors at the expense of more senior claims.[211] It was not the type of plan (a settlement or reorganization

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202. *See In re OCA*, 357 B.R. at 85.

203. *Id.*

204. *Id.* at 86; *see In re* Genesis Health Ventures, Inc., 266 B.R. 591, 612 (Bankr. D. Del. 2001) (citing *SPM Mfg.*, 984 F.2d 1305); *In re MCorp Fin.*, 160 B.R. at 960.

205. *See In re OCA*, 357 B.R. at 92.

206. *See id.* at 87-88.

207. *See* United States v. AWECO, Inc. (*In re* AWECO, Inc.), 725 F.2d 293, 298 (5th Cir. 1984) ("As soon as a debtor files a petition for relief, fair and equitable settlement of creditors' claims becomes a goal of the proceedings. The goal does not suddenly appear during the process of approving a plan of compromise."); *In re OCA*, 357 B.R. at 87, 92 ("[T]he court finds it troublesome when the creditor purports to share with other creditors or equity, over the objection of an intermediate class, through the mechanism of a plan in a Chapter 11 that this court is called upon to confirm.").

208. *See* discussion *infra* Part V.B.

209. *See* discussion *supra* Part V.A.

210. *See AWECO, Inc.*, 725 F.2d at 298; *In re OCA,* 357 B.R. at 92.

211. *See AWECO, Inc.*, 725 F.2d at 298; *In re OCA*, 357 B.R. at 92. That the provision in *AWECO* did not involve a plan of reorganization or the absolute priority rule does not detract from the significant implications of the case. *See generally* Iridium Operating LLC v. Official Comm. of Unsecured Creditors (*In*

plan) nor was it the governing authority (case law or the Code) that determined the outcome of *AWECO* and *OCA* but, rather, each court's concern with fairness and equity.[212] Simply put, secured creditors should be paid in full before unsecured creditors or equity holders receive a distribution, and the courts in *OCA* and *AWECO* were unwilling to allow deviation from this basic principle.[213] Consequently, practitioners that include gifting provisions run the risk of a bankruptcy court—and on appeal, a district court or the Fifth Circuit—denying plan confirmation because of the inherent inequity of gift plans.[214]

Furthermore, given the long history of the absolute priority rule, the Fifth Circuit would likely be hesitant to approve a gifting provision not only from an equitable standpoint but also from one based on precedent.[215] Long before Congress codified the absolute priority rule, courts rejected gifting-type plans.[216] To be sure, the Supreme Court rejected gifting-type plans because the Court found they were "void in equity."[217] Thereafter, the Court developed the absolute priority rule as a means of preventing gift plans that skipped over intermediate creditors.[218] The present rule, codified in § 1129(b)(2)(B)(ii), embraces what courts have long held: "[T]he holder of any claim or interest that is junior to the claims of such class [unsecured claims] will not receive or retain under the plan . . . any property . . . ."[219]

Moreover, while not controlling, the *DBSD* holding would certainly be a factor in the Fifth Circuit's consideration of a gifting provision in a Chapter 11 plan because *DBSD* was decided by a fellow circuit court.[220] Although other courts have held that gift plans do not violate the absolute priority rule, the Second Circuit held gift plans simply did not respect the Code's priority of

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re Iridium Operating LLC), 478 F.3d 452, 464 (2d Cir. 2007) (citing *AWECO* for the proposition "that the absolute priority rule should also apply to pre-plan settlements").

212. *See AWECO, Inc.*, 725 F.2d at 298; *In re OCA*, 357 B.R. at 86-88; *see also supra* notes 21-24 and accompanying text (discussing the hierarchy of distribution under state law and the Code). The Supreme Court has also recognized the importance of respecting fairness and equity in evaluating gifting-type provisions, both under the fixed principle and more recently under the absolute priority rule. *See, e.g.*, Bank of Am. Nat'l Trust & Sav. Ass'n v. 203 N. LaSalle St. P'ship, 526 U.S. 434, 444 (1999) (explaining "fairness and equity required that 'the creditors . . . be paid before the stockholders could retain [equity interests] for any purpose whatever'" (alteration and omission in original) (quoting N. Pac. Ry. Co. v. Boyd, 228 U.S. 482, 508 (1913))); Chi., Rock Island & Pac. R.R. v. Howard, 74 U.S. (7 Wall.) 392, 409-10 (1868) (commenting that "the rule is well settled that stockholders are not entitled to any share of the capital stock nor to any dividend of the profits until all the debts of the corporation are paid").

213. *See AWECO, Inc.*, 725 F.2d at 300; *In re OCA*, 357 B.R. at 86-88. Indeed, this principle is the foundation of the absolute priority rule. *See supra* Part II.E.

214. *See supra* notes 210-13 and accompanying text.

215. *See infra* notes 216-23 and accompanying text.

216. *See* discussion *supra* Part II.E.

217. *Boyd*, 228 U.S. at 502.

218. *See id.* at 505-07; *see also* DISH Network Corp. v. DBSD N. Am., Inc. (*In re* DBSD N. Am., Inc.), 634 F.3d 79, 86, 99 (2d Cir. 2011) ("Those cases [*Boyd* and others] dealt with facts much like the facts of this one . . . . And it was on the basis of those facts that the Supreme Court developed the absolute priority rule, with the aim of stopping the very sort of transaction that the appellees propose here.").

219. 11 U.S.C. § 1129(b)(2)(B)(ii) (2006).

220. *See DBSD N. Am., Inc.*, 634 F.3d at 95; discussion *supra* Part IV.

payment, and this holding is similar to the Fifth Circuit's holding in *AWECO*.[221] Thus, the Fifth Circuit would likely find *DBSD*'s reasoning is more in line with its previous precedent and more persuasive than cases such as *SPM* and *Genesis Health*.[222]

Thus, Fifth Circuit practitioners who include a gifting provision in a Chapter 11 plan of reorganization should expect such a provision to be subject to intense scrutiny, particularly if the provision allows the secured creditor to give up a portion of its distribution in favor of equity or an existing shareholder.[223] But, if bankruptcy practitioners in the Fifth Circuit may no longer use gifting provisions as a tool of reorganization, what options do they have?[224]

VI. POTENTIAL ALTERNATIVES TO GIFTING

Including a gifting plan is really just a means to an end for bankruptcy practitioners; the ultimate goal is to get a plan of reorganization confirmed and achieve a successfully reorganized corporate debtor.[225] Gifting plans are not the only means by which practitioners can achieve this goal.[226]

A. The New Value Exception

In addition to the gifting doctrine, the new value exception, or new value corollary, is another potential workaround to the absolute priority rule.[227] Practitioners argue, and many courts have agreed, that the phrase "on account of such junior claim" in § 1129(b)(2)(B)(ii) indicates that Congress intended an exception to the absolute priority rule.[228] The exception, practitioners argue,

221. *See DBSD N. Am., Inc.*, 634 F.3d at 94; United States v. AWECO, Inc. (*In re* AWECO, Inc.), 725 F.2d 293, 298 (5th Cir. 1984).

222. *See* discussion *supra* Parts III.A, IV.

223. *See supra* notes 209-22 and accompanying text.

224. *See* discussion *infra* Part VI.

225. *See supra* notes 19-20 and accompanying text.

226. *See* discussion *infra* Part VI.A-B.

227. *See* Miller & Berkovich, *supra* note 7, at 1376. Similar to the gifting doctrine, bankruptcy practitioners developed the new value exception as a means of avoiding the absolute priority rule's requirement that senior creditors be paid in full before junior creditors are paid, but the exception does not appear in the Code itself. *See id.*

228. *See, e.g.*, Bonner Mall P'ship v. U.S. Bancorp Mortg. Co. (*In re* Bonner Mall P'ship), 2 F.3d 899, 908, 918 (9th Cir. 1993) (emphasis omitted) (quoting 11 U.S.C. § 1129(b)(2)(B)(ii) (2006)) (explaining that "the new value exception is fully consistent with the structure and underlying policies of Chapter 11"); Beal Bank, S.S.B. v. Way Apartments, D.T. (*In re* Way Apartments, D.T.), 201 B.R. 444, 455-56 (Bankr. N.D. Tex. 1996) (holding that the general partners' contribution of new value to the reorganized entity in exchange for an equity interest did not violate the absolute priority and "is allowed under the new value exception"). *But see, e.g.*, Coltex Loop Cent. Three Partners, L.P. v. BT/SAP Pool C Assocs., L.P. (*In re* Coltex Loop Cent. Three Partners, L.P.), 138 F.3d 39, 46 (2d Cir. 1998) (rejecting the new value exception); Travelers Ins. Co. v. Bryson Props., XVIII (*In re* Bryson Props., XVIII), 961 F.2d 496, 504 (4th Cir. 1992) (holding that the equity holders' exclusive right to contribute new value constituted "property" and thus violated § 1129(b)(2)(B)(ii)). The Fifth Circuit initially rejected the new value exception in *Greystone III*, holding that

permits old equity holders to retain an interest in the reorganized debtor—despite § 1129(b)'s prohibition against such an arrangement—as long as the old equity holders contribute new value (i.e., new capital) to the reorganized entity.[229] In effect, the absolute priority rule does not apply because the equity holders are not receiving an interest in the reorganized entity on account of their previous ownership in the entity but on account of their contribution of new value to the reorganized entity.[230] Although the Supreme Court has never expressly decided whether § 1129(b) contains a new value exception, it may be a viable tool for bankruptcy practitioners hoping to encourage approval of a reorganization plan.[231]

For plan proponents hoping to obtain plan confirmation, providing equity holders with a share in the reorganized entity in exchange for new value may be a useful option.[232] Under a new value plan, senior creditors may provide equity holders with the option to buy stock in the reorganized debtor in exchange for the equity holders' contribution of new value.[233] Theoretically, the equity holders' contribution of new value benefits the debtor attempting reorganization by infusing new capital into the entity, which benefits all of the debtor's creditors.[234] In turn, the equity holders' contribution of new value avoids application of the absolute priority rule, and the bankruptcy court may confirm and cramdown the reorganization plan, assuming the plan meets the

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"[n]either in the Code's language, nor in the context of a previous, different reorganization law, nor in legislative history, nor in policy is there room for a 'new value exception' to the absolute priority rule now defined by § 1129(b)(2)(B)." Phx. Mut. Life Ins. Co. v. Greystone III Joint Venture (*In re* Greystone III Joint Venture), 995 F.2d 1274, 1284 (5th Cir. 1991), *modified on reh'g*, 995 F.2d 1284 (1992). But, that section of the opinion (section IV) was later "withdrawn and deleted." *Id.*

229. *See* Miller & Berkovich, *supra* note 7, at 1376. The plan might seem to violate the absolute priority rule because it permits a distribution to equity holders without first paying general unsecured creditors in full. *See id.* at 1376-77. But, the new value exception excuses such an impermissible distribution because of equity's contribution of new capital. *See id.*

230. *See id.* at 1376.

231. *See* Bank of Am. Nat'l Trust & Sav. Ass'n v. 203 N. LaSalle St. P'ship, 526 U.S. 434, 443, 449, 458 (1999); *see also* Miller & Berkovich, *supra* note 7, at 1376-82 (giving a detailed explanation of the origins of the new value exception and the implications of the *LaSalle* case). *LaSalle* is the most recent Supreme Court opinion to consider the new value issue. *See LaSalle*, 526 U.S. at 443. In *LaSalle*, the Court specifically stated: "We do not decide whether the statute [§ 1129(b)(2)(B)(ii)] includes a new value corollary or exception . . . ." *Id.* But, the Court did acknowledge that "the absolute priority rule now on the books as subsection (b)(2)(B)(ii) may carry a new value corollary," and it did not foreclose the possible validity of a new value plan if the plan proponents subjected the plan to market forces. *Id.* at 449, 458 (holding that a new value plan that is not subjected to market forces does not meet the requirements of § 1129(b)(2)(B)(ii)). The debate over whether such an exception exists is outside the scope of this Comment; therefore, this argument presumes that § 1129(b)(2)(B)(ii) contains a new value exception. *See* § 1129(b)(2)(B)(ii).

232. *See infra* notes 234-36 and accompanying text.

233. *See, e.g.*, *LaSalle*, 526 U.S. at 442.

234. *See* Bonner Mall P'ship v. U.S. Bancorp Mortg. Co. (*In re* Bonner Mall P'ship), 2 F.3d 899, 915 (9th Cir. 1993) (noting that the new value exception is based on the practical recognition that the debtor may not be able to obtain new money without such an exception).

other requirements in § 1129(b).[235] The benefits of a new value provision are therefore twofold—it provides the reorganized debtor with new capital and it makes confirmation of a reorganization plan more likely.[236]

Of course, including a provision that falls under the new value corollary does have its drawbacks.[237] For a court to approve a new value plan, the offered value must be the following: (1) new, (2) substantial and upfront, (3) paid in money or money's worth, (4) necessary to the reorganization, and (5) reasonably equivalent to the value the equity holders received.[238] In addition, the Supreme Court held in the *LaSalle* case that the plan proponents must submit the plan to market forces to avoid invalidity under § 1129(b)(2)(B)(ii).[239]

For certain plans, meeting these requirements might prove difficult.[240] For example, the equity holders may not be able to come up with sufficient new capital.[241] Specifically, "new capital" refers to money from an outside source rather than from the debtor.[242] Moreover, the proponent must show that the new value is actually necessary to the reorganization and not just a collusive scheme between the equity holders and the plan proponents.[243] Therefore, plan proponents and practitioners must ensure that the equity holders have an independent interest in the reorganized entity.[244] Finally, the plan proponent must meet *all* of the requirements for the court to approve the plan, which may prove challenging for some proponents.[245]

Furthermore, because the Supreme Court has not definitively decided whether § 1129(b) contains a new value exception, including a new value provision may lead to additional litigation.[246] Indeed, parties that oppose the plan might be more willing to challenge the plan given the Court's failure to resolve the circuit split regarding the exception and its failure to define what the market test requires.[247] Then again, including a provision that requires the junior creditors or interest holders to contribute new value may not be the only

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235. *See* § 1129(b); *see also* Tabb, *supra* note 20, at 846-47 (explaining that one of the reasons the absolute priority rule is frequently violated is because "[c]reditor interests have no effective means of making these equity nuisances go away, except to pay them off").

236. *See supra* notes 234-35 and accompanying text.

237. *See infra* notes 238-47 and accompanying text.

238. *See Bonner Mall*, 2 F.3d at 908.

239. *See* Bank of Am. Nat'l Trust & Sav. Ass'n v. 203 N. LaSalle St. P'ship, 526 U.S. 434, 458 (1999).

240. *See infra* notes 241-47 and accompanying text.

241. *See* Bruce A. Markell, LaSalle *and the Little Guy: Some Initial Musings on the Ultimate Impact of* Bank of America, NT & SA v. 203 North LaSalle Street Partnership, 16 BANKR. DEV. J. 345, 356 (2000).

242. *See In re* Rocha, 179 B.R. 305, 307-08 (Bankr. M.D. Fla. 1995).

243. *See Bonner Mall*, 2 F.3d at 911.

244. *See id.*

245. *See* Bank of Am. Nat'l Trust & Sav. Ass'n v. 203 N. LaSalle St. P'ship, 526 U.S. 434, 458 (1999); *Bonner Mall*, 2 F.3d at 908.

246. *See LaSalle*, 526 U.S. at 443.

247. *See id.* at 443, 445-55; Miller & Berkovich, *supra* note 7, at 1381-82.

option for practitioners hoping to obtain confirmation of a reorganization plan.[248]

B. Pre-Bankruptcy Planning

Given the uncertainty of using gifting plans as a tool of reorganization, bankruptcy practitioners are well-advised to continue engaging in careful pre-bankruptcy negotiations.[249] Planning and negotiating with creditors before filing bankruptcy gives debtors who are faced with financial distress leverage they might not otherwise have once they file bankruptcy.[250] Pre-bankruptcy workouts—more specifically, the resolution or settlement of creditors' claims prior to the debtor filing bankruptcy—may include "the execution of forbearance agreements, composition agreements, exchange offers, assignments for the benefit of creditors, and receiverships," as well as many other arrangements.[251]

The negotiation of such arrangements prior to bankruptcy is beneficial to the debtor, and oftentimes the creditor, for several reasons.[252] First, engaging in pre-bankruptcy planning allows corporate debtors time to truly plan proactively.[253] Instead of being forced to file bankruptcy as a last resort, timely

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248. *See* discussion *infra* Part VI.B.

249. *See* DRAKE & STRICKLAND, *supra* note 5, at 31 (explaining that most businesses explore a variety of other options to resolve their financial troubles before they opt to file a Chapter 11 petition); Tabb, *supra* note 20, at 804-05 ("When a company gets into financial difficulties, the first thought is not, 'let's auction off the assets'; rather, the first thought is, 'let's make a deal.'").

250. *See* Mark A. Castillo, *Liquidating Chapter 11s: New Developments and Strategies*, *in* TRENDS IN COMMERCIAL BANKRUPTCY FILINGS 25, 32 (Aspatore 2010), *available at* 2010 WL 3650161.

251. Hon. Erithe A. Smith, *Pre-Bankruptcy Workout Negotiations*, 2 A.B.A. SEC. BUS. L. ESOURCE, No. 3, at 2 (2003), http://apps.americanbar.org/buslaw/blt/archive (follow "Volume 2" hyperlink under "eSource"; then follow "August 2003 – Number 3" hyperlink); *see also* DRAKE & STRICKLAND, *supra* note 5, at 32-43 (suggesting additional options such as enlisting the help of a third-party investor or agreeing to a merger with a financially sound entity, to consider before filing for Chapter 11 relief). In fact, pre-bankruptcy negotiations may even lead, in some cases, to a "prepackaged" or "prenegotiated" plan of reorganization. Smith, *supra*; *see also* Robert K. Rasmussen & Randall S. Thomas, *Timing Matters: Promoting Forum Shopping by Insolvent Corporations*, 94 NW. U. L. REV. 1357, 1374-75 (2000) (explaining that prepackaged bankruptcies are a "hybrid" between formal bankruptcy reorganizations and informal workouts outside of bankruptcy). With a prepackaged bankruptcy, "[t]he relevant classes of creditor[s] agree on a plan of reorganization before the filing and appear before the bankruptcy judge with a plan in hand." BAIRD, *supra* note 26, at 234. While prepackaged plans may reduce the time and cost associated with a typical Chapter 11 proceeding, the plan must still comply with the requirements of a Chapter 11 confirmation. *See* 11 U.S.C. § 1129 (2006); DRAKE & STRICKLAND, *supra* 5, at 709. For that reason, this Comment's discussion of pre-bankruptcy workouts does not include prepackaged bankruptcies. *See infra* notes 252-59 and accompanying text.

252. *See infra* notes 253-56 and accompanying text; *see also* Tabb, *supra* note 20, at 804 (noting that about half of the reorganizations negotiated are done through out-of-court agreements).

253. Castillo, *supra* note 250, at 32. Needless to say, the debtor must approach bankruptcy counsel earlier rather than later to reap the full benefits of pre-bankruptcy planning. *See id.* at 32-33; DRAKE & STRICKLAND, *supra* note 5, at 57. After all, counsel is left with few options if the debtor "spends its last dime attempting to avoid a bankruptcy" but ultimately files bankruptcy anyway "as a last ditch effort." Castillo, *supra* note 250, at 32. AMR's recent bankruptcy provides an excellent example of a corporation that did not wait until the brink of financial disaster. *See* Marie Beaudette & Joseph Checkler, *American Airlines—Learning from Its Rivals' Mistakes*, WALL ST. J. DEAL J. BLOG (Nov. 30, 2011, 10:20 AM),

and careful pre-bankruptcy negotiation can help the debtor save more of its diminishing resources by preventing costly and lengthy litigation.[254] Second, negotiating outside of bankruptcy is significantly less expensive for both debtors and creditors than formally negotiating inside Chapter 11.[255] Finally, and most importantly, negotiating with creditors prior to filing bankruptcy provides the debtor with some predictability as to the treatment of creditors' claims, thereby reducing the necessity for tools such as gift plans to entice creditors to vote for the plan because the creditors' claims have already been settled.[256]

But, how does pre-bankruptcy planning help solve the problem of practitioners' inability to use gifting provisions in Chapter 11 reorganization plans? Quite simply, it may eliminate the need to use a gifting provision in the first instance.[257] Pre-bankruptcy workouts allow the debtor to negotiate and modify or settle its obligations with its creditors outside the confines of the Code.[258] Hence, by the time the debtor files bankruptcy (sometimes, the pre-petition workout completely eliminates the debtor's need to file bankruptcy), the debtor has hopefully negotiated with most of its major creditors, eliminating the need to include an enticement such as a gift to vote in favor of the plan.[259]

Pre-bankruptcy planning is certainly not without its drawbacks, though.[260] Unlike in bankruptcy, a pre-petition workout is only binding upon creditors that are a party to the agreement.[261] Thus, creditors that choose not to consent to the agreement are not bound and may still pursue state court remedies such as initiating foreclosure or pursuing a judgment lien.[262] Similarly, a rogue creditor may prematurely disrupt pre-petition negotiations by filing an involuntary

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http://blogs.wsj.com/deals/2011/11/30/american-airlines-learning-from-its-rivals-mistakes. Although AMR began negotiations with labor unions and its creditors before filing, it chose to file for Chapter 11 bankruptcy protection while it still had cash resources available—$4 billion to be exact. *See id.*

254. *See* Castillo, *supra* note 250, at 32. *But see* Jason J. DeJonker, *Strategy and Legal Issues in Chapter 11 Cases, Single Asset Real Estate Matters, and Bankruptcy Litigation*, *in* CHAPTER 11 BANKRUPTCY AND RESTRUCTURING STRATEGIES (2012 ed. Aspatore 2011), *available at* 2011 WL 6471013, at *16 (noting that a "willingness to try a case can create favorable settlement leverage" and can help in "maximizing recoveries or limiting settlement payments" for both debtors and creditors).

255. *See* Rasmussen & Thomas, *supra* note 251, at 1374-75; *see also* Rafael Efrat, *The Case for Limited Enforceability of a Pre-Petition Waiver of the Automatic Stay*, 32 SAN DIEGO L. REV. 1133, 1146-49 (1995) (highlighting the drawbacks of reorganization under the Code, including the significant cost).

256. *See generally In re* Colonial Ford, Inc., 24 B.R. 1014, 1017 (Bankr. E.D. Utah 1982) (discussing the benefits of pre-bankruptcy workouts); *see also* Tex. Commerce Bank, N.A. v. Licht (*In re* Pengo Indus., Inc.), 962 F.2d 543, 549 (5th Cir. 1992) (noting that bankruptcy policy "strongly favors" pre-bankruptcy workouts and citing *Colonial Ford* for support).

257. *See infra* notes 258-59 and accompanying text.

258. *See In re Colonial Ford*, 24 B.R. at 1016-17.

259. *See id.*; Smith, *supra* note 251. In *Colonial Ford*, the bankruptcy court pointed out that "the Code, in several specific respects, contemplates that workouts will be a prelude to, yet consummated in, bankruptcy." *In re Colonial Ford*, 24 B.R. at 1017.

260. *See infra* notes 261-63 and accompanying text.

261. *See In re Colonial Ford*, 24 B.R. at 1015; Tabb, *supra* note 20, at 805.

262. *See In re Colonial Ford*, 24 B.R. at 1015; Tabb, *supra* note 20, at 805.

petition of bankruptcy.[263] Finally, pre-petition workouts may do little for a business that already has minimal resources and is teetering on the verge of financial ruin.[264]

Although these options are certainly not exclusive, they do provide practitioners with two practical alternatives to a gift plan.[265] For a struggling business whose goal is to return to economic health, practical options may be a welcome relief.[266]

VII. WRAPPING UP THE GIFTING ISSUE

The road to a successful reorganization is not an easy one.[267] Bankruptcy practitioners must develop a reorganization plan that not only pleases all of the debtor's creditors—of which there may be many—but also leads to a rehabilitated business.[268] Yet, whatever creative means practitioners use to achieve reorganization, they are ultimately bound by the confines of the Code.[269] And gifting plans, no matter how tempting they may be for Fifth Circuit practitioners, do not fit within the Code according to the holdings in *AWECO*, *OCA*, and *DBSD*.[270]

To be sure, respecting the priority of payment conjures up basic notions of fairness and equality that are central to bankruptcy law.[271] In effect, opinions such as *DBSD* and *AWECO* simply echo the sentiment the Supreme Court expressed over one hundred years ago in the times of railroad barons and equity receiverships: senior creditors should be paid before junior creditors.[272] It is

263. *See In re Colonial Ford*, 24 B.R. at 1017-18. An involuntary petition, as the term implies, is filed by the debtor's creditors instead of the debtor and forces the debtor into bankruptcy. *See* 11 U.S.C. § 303 (2006). In *Colonial Ford*, the court noted that there is a potential solution to a creditor's filing of an involuntary petition in § 305—a bankruptcy court's power to suspend or dismiss proceedings. *See In re Colonial Ford*, 24 B.R. at 1017-18. Significantly, the bankruptcy court's decision to do so is non-reviewable. *See id.* § 305(c) (2006). But, as the court itself concedes, § 305 "should be invoked sparingly" due to the severity of such a remedy. *In re Colonial Ford*, 24 B.R. at 1023.

264. *See In re Colonial Ford*, 24 B.R. at 1015.

265. *See generally* Brubaker, *supra* note 7 (citing Ralph Brubaker, *The* Chrysler *and* GM *Sales: § 363 Plans of Reorganization?*, 29 No. 9 BANKR. L. LETTER 1 (2011)) (discussing the possibility of structuring an inter-class gift as a "'sale' transaction rather than using a traditional plan structure," like the parties did in the General Motors and Chrysler reorganizations); Jeanfreau, *supra* note 54, at 333-34 (suggesting a "conditional plan" as a way for senior creditors to share their proceeds with junior creditors). *But see* Miller & Berkovich, *supra* note 7, at 1419-26 (arguing that "there are very good policy reasons" to continue allowing gift plans and that "to the extent [gift plans are] blunted by blind adherence to strict construction of the statute, a legislative remedy should be obtained").

266. *See generally* H.R. REP. NO. 95-595, at 220 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6179 (finding that the goal of Chapter 11 is to "restructure a business's finances").

267. *See supra* Part II.

268. *See supra* Part II.

269. *See supra* Part II.A-D.

270. *See* discussion *supra* Part V.

271. *See* discussion *supra* Part II.A, E.

272. *See* discussion *supra* Part V.B.

this principle practitioners should always keep in mind when formulating reorganization plans for their clients.[273]

But while the future of using gifting plans to encourage plan confirmation in the Fifth Circuit is arguably bleak, practitioners are not left without options.[274] Preemptive and careful pre-bankruptcy planning, or a new value plan once the debtor files for bankruptcy, offer two viable options for Fifth Circuit practitioners.[275] Each alternative may be a useful option for practitioners, depending upon when the debtor seeks counsel.[276] And of course, knowing how a particular court or circuit may decide the gifting issue leaves practitioners with another, simpler option: file the bankruptcy petition in a different circuit.[277]

In the end, the debate over the validity of gifting plans will continue until the Supreme Court decides the issue or Congress amends the Bankruptcy Code. But in the meantime, consumers will continue to enjoy their cream-filled treats and travel by plane across the country, thanks to the talented practitioners that help make Chapter 11 reorganizations a success.

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273. *See supra* Parts V.B, VI.
274. *See supra* Part VI.
275. *See supra* Part VI.
276. *See supra* Part VI.
277. *See supra* note 175 and accompanying text.