While It May Not Yet Be Christmas, Bankruptcy Court Allows "Gifting" to Junior Creditors

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***The Issue**: May a secured creditor give a portion of its recovery to a junior creditor in exchange for the junior creditor's consent to a bankruptcy settlement or Chapter 11 plan of reorganization, or does such a '"gift" violate the bankruptcy distribution scheme?*

***The Bottom Line**: The Delaware Bankruptcy Court has applied Third Circuit precedent narrowly and allowed a "gift" from secured creditor collateral to junior creditors in the settlement context, but it remains to be seen whether such a gift may be given to equity holders or in connection with a Chapter 11 plan.*

The development, negotiation and ultimate confirmation of a plan of reorganization is critical to the Chapter 11 process. At times, this process can be hampered, if not undermined, by active challenges to plan confirmation by creditors that appear "out of the money." In order to improve the chances for confirmation in such cases, and to avoid the expense and delay entailed by a drawn-out confirmation battle, debtors and senior creditors have found ways to create peace among creditor classes. One such mechanism that has been used is the "gifting" by a senior creditor class of value they received or were to receive under a plan to a junior creditor (or equity) class in order to avoid the possibility of a contested plan confirmation hearing. But does such a gift implicate the absolute priority rule, and, if so, does it pass muster?

Settlement Agreement Approved in *In re World Health Alternatives*

On July 7, 2006, in *In re World Health Alternatives*, 2006 WL 1888558 (Bankr. D. Del. 2006), the Bankruptcy Court for the District of Delaware approved a settlement agreement among the debtors, the creditors committee and the secured lenders (both pre- and post-petition), whereby the committee withdrew its objections to a motion to sell substantially all of the debtors' business, and the secured lender agreed to carve-out from its collateral $1.625 million for the benefit of the general unsecured creditors. The "carve-out" was a "gift" made by the secured lender to the general unsecured creditors in spite of the fact that it would enable the unsecured creditors to receive payment before priority creditors were paid in full. The only party that objected to this settlement was the Office of the United States Trustee, which argued, among other things, that the settlement was prohibited by the recent Third Circuit's decision in *In re Armstrong World Indus.*, Inc., 432 F.3d 507

(3d Cir. 2005). Noticeably absent was any objection from any priority creditor. The bankruptcy court ultimately disagreed with the US Trustee's argument and approved the settlement agreement.

In so holding, the bankruptcy court distinguished the facts in *Armstrong* from the facts before it in *World Health Alternatives*. First, it noted that the "absolute priority rule," which provides, in general terms, that a junior class can only receive a distribution if the classes senior to it are paid in full, is only implicated in the context of a plan of reorganization. Thus, the bankruptcy court concluded that, unlike in *Armstrong*—where, under a proposed plan, an unsecured creditor class would automatically transfer warrants it was to receive to the holders of equity interests—the "gifting" that occurred in *World Health Alternatives* arose in the context of a settlement agreement, where the absolute priority rule does not apply. Second, the court noted that the case involved the distribution to a junior class from a "carve out" of property that fully secured the creditor's perfected security interest, and thus was not subject to distribution, even under a plan, according to the Bankruptcy Code's priority scheme. Accordingly, the court determined that the secured lender had a right to dispose of the property subject to its liens. The bankruptcy court concluded that the case more closely resembled *In re SPM Manufacturing Corp.,* 984 F.2d 1305 (1st Cir. 1993), where the First Circuit approved in a Chapter 7 context a similar "gifting" agreement between a secured lender and the creditors' committee, than it did *Armstrong*.

Future of "Gifts" to Junior Creditor Classes Still Uncertain

Despite the recent decision in *World Health Alternatives*, it is unclear how far courts will go in permitting the "gifting" structure. Will "gifting" of proceeds payable on account of the secured claim only be allowed by a fully secured lender to a junior creditor class if there is no prospect for a plan, or will gifting be allowed as long as it is done outside the context of a plan of reorganization? While the bankruptcy court in *World Health Alternatives* stated, *in dicta*, that even if the absolute priority rule applied, an ordinary carve out would not offend the rule, it is by no means clear from the *Armstrong* opinion that the Third Circuit would go so far. Also, the court in *World Health Alternatives* made several references to the fact that "consideration" for the "gift"—the withdrawal by the committee of its objection to the sale—could not be undone, as the sale had already been consummated. It is certainly possible that the issue would have been decided differently had the withdrawal of the objection been conditioned upon the approval of the settlement prior to the completion of the sale.

The case law also appears more permissive when the "gift" is from a secured lender to an unsecured creditor, and courts may be more stringent where the "gifting" is from an unsecured creditor to an equity holder (indeed, it is by no means clear that the *World Health Alternatives* decision would apply to a "gift" from an unsecured party to a junior party in the context of a settlement agreement). Thus, the issue of whether "gifting" to junior classes is allowed is still not free from doubt, and—if structured incorrectly—creditors may find coal in their stockings rather than presents under their tree.

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