LJN LAW JOURNAL NEWSLETTERS

The Bankruptcy Strategist®

An incisivemedia publication

Volume 26, Number 10 • August 2009

The Life and Times of the Non-Absolute Priority Rule

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What better way to strike fear into the hearts and minds of attorneys than to style a particular rule as "absolute?" A linchpin of bankruptcy law, the absolute priority rule is supposed to provide some measure of order and certainty in the otherwise uncertain, if not sometimes chaotic, world of Chapter 11. It does this by ensuring that the hiearchy of priorities remains absolute. And if you read very closely between the lines of § 1129 of the Bankruptcy Code, you might be able to discern the challenge to us all that the drafters of that particular section embedded therein: "Let's see you get around this rule." But bankruptcy practitioners know that the mere inclusion of the word "absolute" in the rule's name does not make it so. And indeed, it is not so. It appears that the priority rule is far from absolute after all.

What Is the Absolute Priority Rule and Where Did It Come From?

Simply put, the absolute priority rule provides that no junior class should receive any distribution unless and until senior classes are paid in full. Seems pretty straightforward. Indeed, it is a concept that is so fundamental, and so rooted in common sense, that one needs to question the necessity for a rule in the first place, let alone one that purports to be absolute. The origins of the absolute priority rule can be traced as far back as the Bankruptcy Act of 1898 and the fundamental proposition that the treatment afforded to creditors under a plan of reorganization be "fair and equitable." The absolute priority rule was first articulated and applied by the United States Supreme Court in *Northern Pac. R. Co. v. Boyd*, 228 U.S. 482 (1913). In that case, Boyd, a general unsecured creditor of the Northern Pacific Railroad, was not given any stake in the reorganized Northern Pacific Railway, but the Railroad's shareholders, who were lower in priority than Boyd, were given an equity interest in the reorganized company. Sound familiar? While the trial court overruled the objection interposed by the unsecured creditors — who argued that the proposed plan was the result of collusion by and between the Railroad's bondholders and shareholders to specifically exclude the unsecured creditors from receiving any equity in the new company — the Supreme Court ultimately affirmed a decree that subjected the property of the reorganized Railway to Boyd's judgment against the Railroad.

Fast-forward 65 years to the enactment of the current Bankruptcy Code in 1978, and § 1129 therein, which provides, among other things, that: 1) in order to "cram down" a plan on a dissenting impaired class of creditors, the treatment afforded to such dissenting creditors under the proposed plan must be "fair and equitable"; and 2) a plan that pays a junior claim or interest before all senior claims or interests are paid in full is not fair and equitable to those senior claims or interests. The Supreme Court, in *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197 (1988), has since confirmed that the absolute priority rule extended into the "fair and equitable" requirement found in § 1129. But even absolute rules were meant to be broken, and, not surprisingly, courts have carved out exceptions that technically compromise the dictates of absolute priority but where the result does not really violate the distributional principles that undergird absolute priority.

The 'New Value' Exception

One important exception to the absolute priority rule is where a prepetition claim or interest holder contributes new value as part of the plan of reorganization. The origins of this so-called new value exception can also be traced back to the Bankruptcy Act of 1898, and the exception was referenced in dicta in *Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106 (1939), suggesting that absolute priority is not violated when new money or money's worth is contributed by equity. Although some lower courts have continued to apply the new value exception to post-Code cases, the Circuit Courts appear to be split as to whether the exception actually survived the enactment of the Bankruptcy Code in 1978. The Second and Fourth Circuits have held that the exclusive right to purchase an equity interest in the reorganized debtor is property, and that any subsequent distribution to equity would therefore be on account of equity's prior interest. In contrast, the Seventh and Ninth Circuits have held that the "on account of" language of § 1129(b)

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(2) of the Bankruptcy Code should be interpreted as permitting the continued existence of the new value corollary to the absolute priority rule, because the contribution of new value was not subjected to a market test.

The most recent Supreme Court case on the new value exception is *Bank of Am. Nat'l Trust & Sav. Ass'n v. 203 N. LaSalle St. P'ship*, 526 U.S. 434 (1999), and it represents the third time this issue has made it to the Supreme Court and the third time that the Court refused to rule on it explicitly. In that case, an under-secured creditor objected, on the basis of its deficiency claim, to old shareholder's receipt of new equity, for which shareholders contributed new capital. The Court held that because there was no outside opportunity to bid — *i.e.*, no "market test" — the new equity was illegitimate because of, and thus on account of, the old equity. *LaSalle* makes challenging new value jurisprudence because the Court: 1) found only that the new value corollary would not apply to the facts of the case; and 2) did not determine whether or not the new value exception actually survived the codification of the Bankruptcy Code. In fact, the *LaSalle* Court explicitly called into question the continuing validity of the new value exception under the Code. The real problem with the new value exception is that determining whether distributions to equity are on account of its post- — as opposed to its pre- — petition entitlements, is not always easy to do. Subjecting the new value exception to a market test allays some of those concerns but often old equity is the only, or the most feasible, source for new capital.

In the Wake of *LaSalle*

Courts considering the application of the new value exception in the wake of *LaSalle* have sought to limit the *LaSalle* holding to violations of the absolute priority rule. In other words, the absolute priority rule, as articulated in § 1129(b)(2)(B)(ii), is simply not applicable, and therefore not violated, if all creditor classes voted in favor of a particular plan. For example, the Delaware Bankruptcy Court, in *In re Zenith Electronics Corp.*, 241 B.R. 92 (Bankr. D.Del. 1999), found that *LaSalle* did not apply to the plan submitted by the debtor in that case because the plan was approved by all creditor classes and therefore the absolute priority rule simply did not apply. Similarly, the bankruptcy court in the Southern District of Florida, in *In re New Midlands Plaza Associates*, 247 B.R. 877 (Bankr. S.D. Fla. 2000), found that since *LaSalle* dealt with a violation of the absolute priority rule, the *LaSalle* holding would not be applicable in a situation where the rule would not otherwise apply and is not violated.

The 'Gifting' Exception

Another important exception deals with the concept of "gifting," where a senior class carves out a portion of its due and gives that carve-out to a junior class, passing over an intermediate class in the process. Although arguably a violation of the absolute priority rule, some courts have held that the senior class holder can do as it likes with its distribution including giving some to a junior class. While this makes sense — since the middle claim/interest holder was not entitled to any of those proceeds in the first place — this practice, as one would imagine, is not entirely uncontroversial.

The bankruptcy court ultimately approved the sale of substantially all of the debtors' assets over the objections of all parties.

The lead case on gifting is the First Circuit case of *In re SPM Mfg. Corp.*, 984 F.2d 1305 (1st Cir. 1993). In that case, a creditor with a security interest in virtually all of the debtor's property entered into a private agreement that compelled it to make distributions upon liquidation to a specified group of unsecured creditors, passing over higher priority tax claims in the process. In spite of the agreement, the bankruptcy court ordered distribution to take place in accordance with bankruptcy priorities. The First Circuit, however, reversed, holding that "creditors are generally free to do whatever they wish with the bankruptcy dividends they receive, including to share them with other creditors." In *In re Genesis Health Ventures, Inc.*, 266 B.R. 591 (Bankr. D.Del. 2001), the Delaware Bankruptcy Court affirmed a plan that made distributions to the general unsecured creditors while punitive damage claims would only be paid to the extent covered by insurance. The bankruptcy court in that case opined that the punitive damage class could not complain that it was not receiving anything because the senior creditors were entitled to receive all equity and debt distributions under the plan. The same result was reached in *In re MCorp Fin., Inc.*, 160 B.R. 941 (S.D. Tex. 1993).

After considering the *SPM* and *MCorp-Genesis* line of cases, the Third Circuit, in *In re Armstrong World Indus.*, 432 F.3d 507 (3d Cir. 2005), determined that a class of unsecured creditors was not permitted, in the context of a contested plan, to gift a portion of its recovery for the benefit of a junior class where an objecting class of unsecured creditors was not otherwise getting paid in full, without violating the absolute priority rule.

To be clear, however, the *Armstrong* court did not deal with a situation where a class of secured creditors determined to gift a portion of its recovery to a junior class without violating the absolute priority rule. In point of fact, the *Armstrong* decision actually seems to support the proposition that a secured creditor's rights in its collateral may provide the basis for gifting, especially in a situation where such gifting was: 1) consented to by the affected creditor classes; and 2) contained within a settlement agreement approved pursuant to Bankruptcy Rule 9019 outside the context of a contested plan scenario. Indeed, just one year after *Armstrong* was decided, the Delaware Bankruptcy Court, in *In re World Health*

Alternatives, Inc., et al., 344 B.R. 291 (Bankr. D. Del. 2006), held that the *Armstrong* decision does not prohibit secured creditors from carving out a portion of their collateral for the benefit of a junior class, even if an intervening creditor class will not receive payment in full under a plan.

In *Motorola, Inc. v. Official Comm. of Unsecured Creditors* (*In re Iridium Operating, LLC*), 478 F.3d 452 (2d Cir. 2007), the official creditors' committee and a group of secured lenders formulated a global settlement agreement which provided for, among other things: 1) the distribution of estate cash to the secured lender group and to a litigation trust created for the purpose of commencing various claims and causes of action against Motorola; 2) the distribution of any proceeds recovered from the actions against Motorola to the lenders, administrative claimants and the estate; and 3) the distribution of excess cash in the litigation trust to Iridium's general unsecured creditors, notwithstanding the fact that various senior claims, including secured and/or administrative priority claims, may not have been paid in full. Motorola objected to the proposed settlement on the grounds that it violated the absolute priority rule. The bankruptcy court approved the settlement agreement over Motorola's objection, and the district court affirmed on appeal. The Second Circuit ultimately vacated the order approving the settlement agreement and remanded the case back to the bankruptcy court to provide an explanation as to why: 1) any excess cash in the litigation trust needed to be distributed to junior creditors; and 2) it approved a settlement agreement which violated the absolute priority rule.

The Chrysler Sale

Which brings us to the Chrysler sale. Secured creditors — some of whom were chastised by President Obama as constituting "a small group of speculators" who were holding out for a "taxpayer-funded bailout" — who should have been first in the priority line, were sent to the back of the line, while the United Auto Workers, holders of general unsecured claims, received 55% of the new company, Fiat received 20% of the new company, and the United States and Canadian Governments received the rest. The arguments advanced in support of the Chrysler sale were as follows: This is an asset sale to a third party allowed under § 363 of the Code, the debtors are getting fair value, and any benefits New Chrysler confers to junior creditors or interest holders has nothing to do with the debtors, as these benefits do not come from the debtors' estates. In response, first lien lenders, including various Indiana state funds, argued that the sale represented a blatant violation of the absolute priority rule in that, among other things: 1) their unsecured deficiency claims would not be paid while the debtors' unsecured trade debt would get paid in full; and 2) their senior claims would be impaired while other junior lien holders and unsecured creditors, such as VEBA and the UAW, would receive equity in New Chrysler. In addition, various non-TARP lenders, citing *In re Braniff Airways, Inc.*, 700 F.2d 935 (5th Cir. 1983), argued that the proposed sale constituted an illegal *sub rosa* plan of reorganization that essentially redistributed value from senior to junior creditor classes.

The bankruptcy court ultimately approved the sale of substantially all of the debtors' assets over the objections of all parties. In doing so, the court disagreed that the sale violated the absolute priority rule and held, among other things, that: 1) rather than allocating any sale proceeds away from the first lien lenders, the lenders' security interests attached to the sale proceeds; and 2) New Chrysler had the absolute right to negotiate deals with non-debtor parties even though as a result, certain junior class creditors would receive better treatment than certain senior class creditors. The Second Circuit affirmed the bankruptcy court's opinion and the Supreme Court allowed the sale to proceed.

Conclusion

The Supreme Court stated in *NLRB v. Bildisco & Bildisco*, 465 U.S. 513 (1984), that "the fundamental purpose of reorganization is to prevent the debtor from going into liquidation, with an attendant loss of jobs and possible misuse of economic resources." If this principle truly is paramount, as the Chrysler debtors argued in support of the sale of their assets, then can there ever be a bankruptcy rule that is absolute? Indeed, the absolute priority rule itself is an oxymoron. Consider the irony that various "first-day" motions, including payments for critical vendors or the rollover of a senior lender's prepetition debt into a postpetition DIP facility, have become commonplace and are routinely granted with little, if any, of the fanfare that has surrounded the Chrysler deal, yet don't those motions violate at least the spirit of the absolute priority rule as well? Perhaps it is the blatant disregard in the Chrysler case for well-established bankruptcy principles that has shocked us all because if at the end of the day, there are no rules, then there can be no organized legal system. If only the folks who coined the phrase the "absolute priority rule" would have underlined the word absolute. That would have made all the difference.

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