THE GIFT THAT GIVES TOO MUCH: INVALIDATING A GIFTING EXCEPTION TO THE ABSOLUTE PRIORITY RULE

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In Chapter 11 reorganizations, there is a norm that all senior claimants must be paid in full before a junior claimant may be paid anything. This norm is known as the absolute priority rule, and is codified in the Bankruptcy Code as § 1129(b)(2)(B)(ii). Despite being denounced repeatedly by pre-Code common law and expressly legislated out of the Bankruptcy Code in the last century, there is a practice of senior creditors bypassing intermediate creditors in favor of lower ranked ones by "gifting" part of their distribution under the plan. Some view this practice as legitimate as a gifting exception to the absolute priority rule.

This Note argues that the practice of "gifting"—when it violates the absolute priority rule—violates the express statutory language of the Code, and circumvents the legislated priority distribution. In doing so, gifting defeats all of the fairness and orderliness that justify a uniform federal bankruptcy law to begin with.

I. INTRODUCTION

Imagine a case in which a court allowed a senior creditor in a Chapter 11 reorganization to take nearly $100 million dollars that *should* have been paid to an intermediate creditor and use it to *buy* the cooperation of the debtor company's shareholders—all in violation of clear statutory law and over 100 years of Supreme Court precedent. It sounds absurd, and yet, that is exactly what the Bankruptcy Court of the Southern District of New York did in *In re DBSD North America, Inc.*, in 2010.[1] The Second Circuit reversed the bankruptcy court's ruling in *In re DBSD* and re-asserted the authority of the absolute priority rule in Chapter 11 plans,[2] but the case remains a clear example of why a gifting exception to the rule has no proper place in bankruptcy law.

* J.D. 2013 University of Illinois College of Law. M.S. 2008 Erikson Institute. B.A. 2006 University of Chicago. Many thanks to the editors and members of the *University of Illinois Law Review* especially Michael Newton and James Liu for their thoughtful comments and edits. I am especially grateful to Professor Charles Tabb, who not only introduced me to this topic, but also served as an invaluable teacher, mentor, and champion these past three years.

1. *In re* DBSD N. Am., Inc., 419 B.R. 179, 210–211 (Bankr. S.D.N.Y. 2009) *aff'd in part*, *rev'd in part*, 627 F.3d 496 (2d Cir. 2010); *see infra* Part II.B.2.a.

2. *See In re* DBSD N. Am., Inc., 634 F.3d 79, 85 (2d Cir. 2011).

The fundamental rationale of modern bankruptcy law is that it provides a collective procedure allowing the creditor body *as a whole* to realize the most just and efficient outcome in the distribution of an insolvent debtor's scarce assets.[3] The bankruptcy proceeding provides an opportunity for all parties—creditors and debtor alike—to take a court-imposed break from the fast-paced state law collections world and settle their financial affairs in an orderly, efficient, and *fair* manner.[4] We may wonder whether the distributive priorities in bankruptcy are truly "fair"—after all, they typically leave some creditors with a payout and some creditors with nothing. But the key to analyzing how bankruptcy law is applied is to remember that Congress has decided, as a policy matter, that the Bankruptcy Code ("Code") structure *is* what is fair and, most importantly, that the creditors involved have conducted their business upon this expectation. Furthermore, the bankruptcy priority structure tracks the state law priority rights, or "place in line," that creditors bargained and paid for.[5]

The practice of "gifting"—when it violates the absolute priority rule—circumvents the expected, legislated priority distribution structure in bankruptcy by bypassing intermediate creditors in favor of lower ranked ones.[6] In doing so, gifting circumvents all of the fairness and orderliness that justify a uniform federal bankruptcy law to begin with.[7] But despite being denounced repeatedly by pre-Code common law and expressly legislated out of the Bankruptcy Code in the last century, the practice of gifting continues in Chapter 11 reorganizations.[8] Scholars have argued persuasively that there may be legitimate policy rationales for permitting gifting in some circumstances.[9] Courts, meanwhile, have perhaps conclusively closed the door on interclass gifting within Chapter 11 plan confirmations,[10] but likely have left large openings for other ways of effectuating gifts outside the plan context.[11] The state of gifting is thus

3. CHARLES JORDAN TABB, THE LAW OF BANKRUPTCY 4 (2d ed. 2009).

4. *Id*. at 4–6.

5. *Id*. at 2–3. For example, secured creditors maintain priority over unsecured creditors in bankruptcy law, just as in state law, and are paid the value of their collateral. *Id*.

6. Ralph Brubaker, *Taking Chapter 11's Distribution Rules Seriously: "Inter-Class Gifting is Dead! Long Live Inter-Class Gifting!,"* BANKR. L. LETTER, April 2011, at 1, 1–2.

7. *See* TABB, *supra* note 3, at 4.

8. Brubaker, *supra* note 6, at 1.

9. *See* Douglas G. Baird & Thomas H. Jackson, *Bargaining After the Fall and the Contours of the Absolute Priority Rule*, 55 U. CHI. L. REV. 738, 788–789 (1988); 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, 1426 (2006).

10. Stephen J. Lubben, *Ruling Appears to End Chapter 11 'Gift' Plans*, NEW YORK TIMES DEALBOOK (Feb. 8, 2011, 1:45 PM), http://dealbook.nytimes.com/2011/02/08/ruling-appears-to-end-to-chapter-11-gift-plans/.

11. *See* Brubaker, *supra* note 6, at 2; David R. Doyle, *Gift Plans in Doubt After* DBSD North America, AM. BANKR. INST. J., May 2011, at 38, 64.

wholly unclear, which is precisely the problem. The current state of alternative routes around the absolute priority rule and exceptions to the rule in the plan context—while certainly providing ample work for bankruptcy attorneys—fails to provide creditors the orderly, predictable process that justified creation of a uniform bankruptcy code.

This Note looks at the confused state of the absolute priority rule today and analyzes three potential approaches to the gifting practices and absolute priority rule enforcement in Chapter 11 reorganizations. Part II addresses the history of the absolute priority rule and the Chapter 11 gifting doctrine. It introduces the current state of the law both in and out of the formal Chapter 11 plan context. Next, Part III presents three potential approaches to clarifying the current legal uncertainty surrounding gifting doctrine, and analyzes the legal and policy arguments for and against each of these options. Finally, Part IV recommends a solution that reflects the most critical of the policy concerns about gifting and calls for a strict, exception-less approach to the absolute priority rule.

II. BACKGROUND

This section lays out the background information essential to understanding the legal and policy arguments for and against a gifting exception to the absolute priority rule. Part A discusses the process of confirming a Chapter 11 plan, including the role of the absolute priority rule in a cram-down plan situation. Next, Part B describes the practice of interclass gifting and elucidates the historic line of associated case law from 1868 to 2011. Finally, Part C introduces alternative strategies for gifting outside of the plan context, particularly in pre-plan settlement agreements and § 363 sales.

A. Confirming a Chapter 11 Plan

To understand the concept of interclass gifting both within and outside of a Chapter 11 bankruptcy plan, one must first understand the details of the Chapter 11 plan confirmation process.[12] The theory behind having a Chapter 11 reorganization option at all—instead of simply liquidating the debtor's assets—is that all parties involved could be better off by reorganizing a business and capturing the positive *current* income the businesses produces.[13] At the heart of the Chapter 11 process is classification of the claims against the estate.[14] Each claim or interest is

12. The options for corporate bankruptcy relief are Chapter 7 and Chapter 11. TABB, *supra* note 3, at 92, 97. Chapter 7 plans liquidate and distribute the debtor's current assets, while Chapter 11 reorganization plans restructure the company's finances and allow it to continue operating. H.R. REP NO. 95-595, at 220 (1977); TABB, *supra* note 3, at 1039.

13. TABB, *supra* note 3, at 1039–40. This is also referred to as capturing the company's "going-concern value." *Id*. at 1039.

14. *Id*. at 1106.

placed in a particular class of other "substantially similar" claims or interests[15]—similarity being based on the claimholder's "relative priority in payment."[16] Under this scheme, secured claims, unsecured claims, and equity interests will always be dissimilar and will be placed in different classes.[17] Within these types of claims and interests there may be additional class distinctions. For example, some types of unsecured claims are entitled to different levels of priority; different types of equity holdings may be classified separately.[18] This classification process significantly bears on the rest of the reorganization: under the final Chapter 11 plan, all members of a specific class must receive equal treatment unless a particular claim holder "agrees to a less favorable treatment."[19]

Confirmation of a Chapter 11 plan depends in part on voting by these classes of "substantially similar" claims or interests.[20] Classes which are not impaired under the plan are "*conclusively* presumed to have accepted the plan" and do not have a vote; only member classes that are impaired under the plan may vote on the plan.[21]

Chapter 11 plans can be confirmed either as a consensual plan or a cram-down plan.[22] Consensual plans must follow the basic list of confirmation requirements set out in Code § 1129(a), including the requirement in § 1129(a)(8) that each class has either accepted the plan or is not impaired under the plan.[23] Cram-down plans, though, allow confirmation based on all of the § 1129(a) requirements *except* § 1129(a)(8) if at least

15. 11 U.S.C. § 1122(a) (2006).

16. TABB, *supra* note 3, at 1108.

17. *Id*. These claims are dissimilar because, by definition, they have different relative priority rights to payment. Secured claims are paid out of collateral, unsecured claims are paid out of residual estate assets, and equity interests only receive value after all claims have been paid in full. *Id*.

18. *Id*. For example, preferred and common stock holdings may be placed in separate classes despite both being similar equity interests. *See id*. at 1108–09. This kind of "gerrymandering" of claim classification can sometimes be used to a plan proponent's benefit. *Id*. at 1109–10. For example, the plan proponent may seek to separate a dissenting creditor from other similar unsecured creditors to satisfy the requirement of § 1129(a)(10) that at least one impaired class votes in favor of the proposed plan. *Id*. at 1109. The extent to which this practice is allowed under the Code is hotly contested by parties. *Id*. at 1110.

19. 11 U.S.C. § 1123(a)(4); TABB, *supra* note 3, at 1104.

20. 11 U.S.C. §§ 1122(a), 1126(c)–(d); TABB, *supra* note 3, at 1124. "The ultimate goal of a chapter 11 case is to confirm a plan of reorganization. . . . If a plan is confirmed, the terms of the plan will serve as the blueprint for the debtor's financial obligations from that point forward. Upon confirmation, all prior claims and interests against the debtor are replaced by the provisions of the plan." TABB, *supra* note 3, at 1098 (citing 11 U.S.C. § 1141).

21. TABB, *supra* note 3, at 1124.

22. 11 U.S.C. § 1129(a), (b). As the name suggests, cram-down plans are not consensual. TABB, *supra* note 3, at 1159. Unlike a consensual plan, a cram-down plan requires only one impaired creditor class to approve the plan (in addition, of course, to the other requirements of § 1129(b)(2)(A)). *Id.; see infra* note 24 and accompanying text.

23. 11 U.S.C. § 1129(a); TABB, *supra* note 3, at 1150–51. A class of claims or interests is "impaired" under the proposed plan unless the plan "leaves unaltered the legal, equitable, and contractual rights to which such claim or interest entitles the holder of such claim or interest" or, under special deacceleration conditions found in § 1124(2) if the debtor is in default and the creditor has demanded accelerated payment. 11 U.S.C. § 1124; TABB, *supra* note 3, at 1114–15.

one impaired creditor class approves the plan—but only if "the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan."[24] This special requirement for cram down of a plan is known as the *absolute priority rule*, and it applies to all classes from the dissenting class down.[25]

In the gifting context, the key requirement of the absolute priority rule is that the plan "is fair and equitable."[26] For dissenting classes of unsecured claims, § 1129(b)(2)(B)(ii) sets out the standard for a "fair and equitable" plan: either the dissenting class must be paid in full or,

> the holder of any claim or interest that is junior to the claims of such class *will not receive or retain under the plan on account of such junior claim or interest any property*, except that in a case in which the debtor is an individual, the debtor may retain property included in the estate under section 1115, subject to the requirements of subsection (a)(14) of this section.[27]

The legislative history describes this standard even more clearly by explaining that, "[t]he dissenting class must be paid in full before any junior class may share under the plan."[28] This requirement has plagued Chapter 11 reorganization efforts for years as practitioners persist in attempting to use methods that violate the absolute priority rule to gain support for a proposed plan.[29] Despite the apparent statutory prohibition, various forms of interclass gifting practices have emerged in the last several decades.[30]

B. Interclass Gifting

Interclass gifting[31] is a practice employed in cram down plans whereby one class "gifts" or "shares" part of the distribution it expects to receive under the Chapter 11 plan to another class.[32] Gifting is typically used by senior creditors to gain some kind of cooperation from the junior recipient class (often the debtor's original shareholders), in the form of support during the confirmation process, support for the reorganized debtor after confirmation, or both.[33] In fact, at times the senior creditors

24. 11 U.S.C. § 1129(b).
25. TABB, *supra* note 3, at 1151.
26. 11 U.S.C. § 1129(b)(2).
27. 11 U.S.C. § 1129(b)(2)(B)(ii) (emphasis added).
28. H.R. REP. NO. 95-595, at 413 (1977). As noted above, the legislative history confirms that this section, "codifies the absolute priority rule from the dissenting class on down." *Id*.
29. Brubaker, *supra* note 6, at 1–2.
30. *Id*.
31. Inter-class gifting is also known as a "give up," "carve out," or the "gifting doctrine." *See id*. at 1; Lubben, *supra* note 10.
32. Brubaker, *supra* note 6, at 1; Lubben, *supra* note 10.
33. Ann Marie Uetz & John A. Simon, *"Gift" Arrangements in Chapter 11: A Viable Tool?*, MICH. B.J., July 2008, at 35, 36; Lee Jason Goldberg, *No Gift for You! The Second Circuit's DBSD*

may also be the original shareholders of the debtor corporation, thereby "buying" their own cooperation with such a gift.[34] Or, creditors may "cut-in" senior managers of the company by making a gift to equity holders—not explicitly because of their status as equity holders, but rather to buy their continued expertise needed to run the reorganized company.[35] A secured creditor may also use gifting (either as part of the plan or in a pre-plan settlement) as a strategy to avoid litigation brought by junior creditors attacking its security interest in estate property.[36] The practice of interclass gifting comes into conflict with the absolute priority rule in the situation in which a senior creditor gifts part of its expected distribution to a junior class, bypassing an intermediate class in the process.[37] Courts and practitioners have struggled over the years with whether there is or should be an exception to the absolute priority rule for gifting that would otherwise violate the rule.[38]

1. The State of "Gifting" pre-DBSD

The idea of a gifting doctrine is not new, and neither are courts' efforts to stop it.[39] While the 1978 Bankruptcy Code ("1978 Code") codified the absolute priority rule in § 1129(b)(2)(B)(2), the doctrine is rooted in a long history of Supreme Court case law which clearly maintains that the "fair and equitable" requirement in cram-down cases does not allow for interclass gifting.[40] Starting with *Railway Co. v. Howard* in 1868 and including *Louisville Trust Co. v. Louisville, New Albany & Chicago Railway Co.; and Northern Pacific Railway Co. v. Boyd*, each case in this line of Supreme Court decisions expressly foreclosed the possibility of a gifting exception to the absolute priority requirement.[41] Many of the arguments put forth unsuccessfully by gifting parties in these cases are precisely the same arguments practitioners use today, more than 100 years later, to advocate for a gifting exception.[42] The Court again outlined this line of cases in the 1939 case, *Case v. Los Angeles Lumber Products Co.*, using language that gave the absolute priority rule its name, and conclusively holding that the doctrine was "firmly embedded" in the "fair and

Decision Rejects Gifting Under Chapter 11 Plans, WEIL BANKRUPTCY BLOG (Feb. 17, 2011), http://business-finance-restructuring.weil.com/chapter-11-plans/no-gift-for-you-the-second-circuits-dbsd-decision-rejects-gifting-under-chapter-11-plans/.

34. Goldberg, *supra* note 33.

35. EDWARD I. ALTMAN, CORPORATE FINANCIAL DISTRESS AND BANKRUPTCY: A COMPLETE GUIDE TO PREDICTING & AVOIDING DISTRESS AND PROFITING FROM BANKRUPTCY 87 (2d ed. 1993).

36. Leah M. Eisenberg, *Gifting and Asset Reallocation in Chapter 11 Proceedings: A Synthesized Approach*, AM. BANKR. INST. J., Sept. 2010, at 50, 50.

37. Brubaker, *supra* note 6, at 4–5; Lubben, *supra* note 10.

38. *See infra* Part II.B.2.

39. Brubaker, *supra* note 6, at 1.

40. *Id*. at 7.

41. *Id*.

42. *Id*. at 1.

equitable" statutory requirement.[43] These cases remain important precisely because § 1129(b)(2)(B)(ii) was intended to codify the common law, pre-Code practice in this area.[44] As the Court has repeated many times, it will not "read the Bankruptcy Code to erode past bankruptcy practice absent a clear indication that Congress intended such a departure."[45]

But despite this great effort of courts and Congress to do away with interclass gifting, the practice remains common. As Professor Ralph Brubaker writes,

> [f]or a time, not too long ago, it seemed to be a widely held view in the Chapter 11 bar that 'give ups' . . . were perfectly appropriate, entirely unproblematic, and essentially an exception to the absolute priority rule and other distribution strictures such as the prohibition against "unfair discrimination."[46]

What happened after the 1978 codification of the absolute priority rule to make lawyers think interclass gifting was once again a viable option in a Chapter 11 plan? Gifting's "modern reincarnation" came about in 1993 after a First Circuit opinion in the Chapter 7 context. In *SPM Manufacturing Corp. v. Stern*,[47] the secured creditor, Citizens Savings Bank ("Citizens"), was entitled to receive the entire profit of SPM's Chapter 7 liquidation sale.[48] Citizens had made an agreement to distribute a portion of these sale proceeds to SPM's unsecured creditors ahead of the IRS's priority tax claim.[49] The bankruptcy court ruled that the trustee could not distribute the sale proceeds in this manner, but the First Circuit reversed.[50] The First Circuit reasoned that, "creditors are generally free to do whatever they wish with the bankruptcy dividends they receive, including to share them with other creditors."[51] Thus, Citizens was able to skip a priority creditor and distribute sale proceeds to a lower ranked, unsecured creditor.[52] Because this was a Chapter 7 liquidation,

43. Case v. L.A. Lumber Prods. Co., 308 U.S. 106, 118–19 (1939) (citing Chicago R.I. & P. R.R. v. Howard, 74 U.S. 392 (1868) and N. Pac. Ry. Co. v. Boyd, 228 U.S. 482 (1913), in establishing what Justice Douglas referred to as the "rule of full or absolute priority").

44. Brubaker, *supra* note 6, at 7; Doyle, *supra* note 11, at 38–39.

45. Pa. Dep't of Pub. Welfare v. Davenport, 495 U.S. 552, 563 (1990); *see also* Hamilton v. Lanning, 130 S. Ct. 2464, 2467 (2010) (looking to bankruptcy practice pre-2005 to interpret changes to the Code introduced by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005).

46. Brubaker, *supra* note 6, at 1.

47. *Id.; see In re* SPM Mfg. Corp., 984 F.2d 1305 (1st Cir. 1993).

48. *In re SPM Mfg. Corp*., 984 F.2d at 1312. The sale amounted to $5 million; Citizens' secured claim was for all of SPM's assets. *Id*.

49. *Id*. at 1310.

50. *Id*. at 1318.

51. *Id*. at 1313.

52. *Id*. at 1318–19.

the court was not confined by the strict § 1129 requirements for Chapter 11 plans.[53]

This reasoning was subsequently extended from *SPM*'s Chapter 7 context to many Chapter 11 plans to resurrect a gifting doctrine "exception" to the absolute priority rule.[54] In fact, the bankruptcy court in *DBSD* used the *SPM* property rights argument in a Chapter 11 case to allow gifting in violation of the absolute priority rule.[55] As discussed in the next section, the Second Circuit later overturned the *DBSD* bankruptcy court decision and effectively upended the "gifting doctrine."[56] According to the bankruptcy court in *DBSD*,

> [p]rovisions of the Bankruptcy Code governing priority of creditors apply only to distributions of property of the estate . . . . [I]f the creditor class is entitled to property from the estate—as particularly is the case when a class of secured creditors holds a perfected security interest in the property—it may generally do whatever it wishes with such property, including transferring it to other holders of claims or interests—at least so long as the property clearly belongs to the senior creditor gift-giving class.[57]

The Second Circuit, however, distinguished *SPM* and took exception to the Bankruptcy Court's assertion that property in which a secured creditor holds a perfected security interest is *not* "property of the estate."[58]

In 2005, the Third Circuit took a significant stance against the gifting doctrine with its decision in *In re Armstrong World Industries, Inc.*[59] The proposed reorganization plan in this case included a gift of equity from one of the unsecured claimant classes to the old equity interest holders, bypassing the general unsecured class.[60] Both the district court and the Third Circuit determined that this plan violated the absolute priority rule of § 1129(b)(2)(B)(ii), but also went one step further in definitively declaring that there was *not* a gifting exception to the absolute priority rule.[61] In the words of the Third Circuit,

> [w]e adopt the District Court's reading of [*SPM*], and agree that [it] do[es] not stand for the unconditional proposition that creditors are

53. *See* 11 U.S.C. § 1129 (2006). The requirements in this section apply exclusively to Chapter 11 cases. *Id*.

54. Brubaker, *supra* note 6, at 2.

55. *In re* DBSD N. Am., Inc., 419 B.R. 179, 210–211 (Bankr. S.D.N.Y. 2009) *aff'd in part*, *rev'd in part*, 627 F.3d 496 (2d Cir. 2010).

56. *Id*. ("The Gifting Doctrine permits creditors, if they wish, to 'gift' part of the distributions to which they'd otherwise be entitled to junior classes or interests, even if that gift results in unequal distributions to classes that would otherwise be *pari passu*, or if the gift makes distributions to a class when a more senior class has not been paid in full. Its rationale was explained in *SPM*, the case from which the doctrine first evolved.").

57. *Id*. (quoting *In re SPM Mfg. Corp*., 984 F.2d at 1313) (internal quotations omitted).

58. *See infra* Part II.B.2.

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

60. *Id*. at 509–10.

61. *Id*. at 517.

> generally free to do whatever they wish with the bankruptcy proceeds they receive. Creditors must also be guided by the statutory prohibitions of the absolute priority rule, as codified in 11 U.S.C. § 1129(b)(2)(B).[62]

Importantly, though, *Armstrong* dealt with a gift by an *unsecured* creditor.[63] Even under the *SPM* reasoning, unsecured creditors are certainly less entitled than secured creditors to claim unconditional property rights to a potential bankruptcy distribution while the property is still in the bankruptcy estate.[64] Thus, despite the court "flatly reject[ing]" a gifting exception in this particular case, many Chapter 11 attorneys and scholars argued that *Armstrong* still left the door open for gifts by secured creditors.[65]

At the time, the Second Circuit had also left open the possibility of secured creditor gifting—at least in the pre-plan settlement context—noting in *In re Iridium Operating LLC* that "we need not decide if *SPM* could ever apply to Chapter 11 settlements, because it is clear that the Lenders did not actually have a perfected interest in the cash on hand."[66] Four years later, though, the Second Circuit was finally forced to decide this issue within the plan context in *DBSD*.[67]

2. Second Circuit Decision in In re DBSD North America

DBSD concerned the reorganization of a development-phase hybrid satellite and land-based wireless service company.[68] The three relevant claims against the debtor consisted of a fully-secured first lien of approximately $51 million; an under-secured second lien of approximately $752 million; and an unliquidated, unsecured claim arising from a lawsuit by Sprint against a DBSD subsidiary.[69] DBSD's proposed reorganization plan included distributions of (1) shares of the reorganized debtor to unsecured creditors, including Sprint, which would amount to between four percent and forty-sixty percent of these creditors' claims, and (2) shares and warrants in the reorganized debtor to the *existing* shareholder (consisting almost entirely of ICO Global, the parent company of DBSD).[70]

62. *Id*. at 514.
63. *Id*. at 509.
64. 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. 319, 330 (2011).
65. *In re* Armstrong World Indus., Inc., 320 B.R. 523, 540 (D. Del. 2005) *aff'd*, 432 F.3d 507 (3d Cir. 2005); *see, e.g*., Brubaker, *supra* note 6, at 3; Debra A. Dandeneau, *Wrapping Up Gifting: Some Additional Thoughts (and Even More Questions) on* DBSD, 128 BANKING L.J. 521, 524 (2011).
66. *In re* Iridium Operating LLC, 478 F.3d 452, 461 (2d Cir. 2007).
67. *In re* DBSD N. Am., Inc., 634 F.3d 79 (2d Cir. 2011).
68. *In re* DBSD N. Am., Inc., 419 B.R. 179, 185–86 (Bankr. S.D.N.Y. 2009) *aff'd in part*, *rev'd in part*, 627 F.3d 496 (2d Cir. 2010).
69. *Id*. at 186; *In re DBSD N. Am*., *Inc*., 634 F.3d at 86.
70. *In re DBSD N. Am., Inc*., 634 F.3d at 86.

Sprint objected, arguing that the plan violated the absolute priority rule because it gave equity to a junior class (the existing shareholder) without first paying Sprint, a senior class, the full value of its claim.[71] As mentioned earlier, the bankruptcy court confirmed the plan over Sprint's objections based on the "gifting exception" rationale of *SPM*.[72] The Second Circuit reversed.[73]

The Second Circuit started its analysis with the plain language of § 1129(b)(2)(B)(ii).[74] Because Sprint made up a dissenting class and was not paid in full on its claim, the absolute priority rule of § 1129(b)(2)(B)(ii) mandated that the plan could only be confirmed if no interest junior to Sprint "receive[d] or retain[ed] under the plan on account of such junior claim or interest any property."[75] The court had no trouble finding that under the proposed plan, the existing shareholder received property both "under the plan" and "on account of" its junior interest.[76] The court particularly rejected the plan proponents' argument that the property was not gifted "on account of" the shareholders' junior interest, but rather "on account of" their cooperation and support for the reorganized company.[77] As the court noted, the statutory text does not require that the property is received *only* "on account of" its interest; instead, *partially* "on account of" is sufficient.[78] There was no question this was satisfied in *DBSD*, as the plan included a provision that the gift would fully and finally satisfy the shareholder's claim.[79]

In addition to its analysis of the statutory language, the court offered several other reasons for ruling against a gifting exception. First, the court looked to precedent regarding the "new value exception" in two important cases, *Bank of America National Trust & Savings Ass'n v. 203 North LaSalle Street Partnership* and *Northwest Bank Worthington v. Ahlers*.[80] The new value exception to the absolute priority rule would allow senior creditors to give value to a junior creditor (often equity holders) in exchange for some contribution by the junior creditor of "new value"—i.e., not "on account of such junior claim of interest."[81] But in both *203 North LaSalle* and *Ahlers*, the Supreme Court refused to allow a junior equity class to bypass the absolute priority rule by giving "new

71. *Id*. at 93–94.
72. *In re DBSD N. Am., Inc*., 419 B.R. at 210–211; *see supra* notes 35–36 and accompanying text.
73. *In re DBSD N. Am., Inc*., 634 F.3d at 108.
74. *Id*. at 95.
75. *Id.* (quoting 11 U.S.C. § 1129(b)(2)(B)(ii) (2006)).
76. *Id.* at 96–97.
77. *Id*. at 96; Brubaker, *supra* note 6, at 5–6.
78. *In re DBSD N. Am., Inc*., 634 F.3d at 96; Brubaker, *supra* note 6, at 6.
79. *In re DBSD N. Am., Inc*., 634 F.3d at 96–97; Brubaker, *supra* note 6, at 6.
80. *In re DBSD N. Am. Inc.*, 634 F.3d at 98–97.
81. GRANT W. NEWTON, CORPORATE BANKRUPTCY: TOOLS, STRATEGIES, AND ALTERNATIVES 227–28 (2003). See the statutory language in 11 U.S.C. § 1129(b)(2)(B)(ii), providing that a junior class cannot receive under the plan "on account of such junior claim or interest."

value" to the debtor in exchange for interest in the reorganized company.[82] The court in *DBSD* notes that, based on the precedent of *203 North LaSalle* and *Ahlers*, it is difficult to see why the Court would "allow old owners to receive new ownership *without* contributing any new value," as is the case with the gifting exception, when it did not even allow a gift of new ownership in *exchange* for new value.[83]

Second, the *DBSD* court distinguished this case from *SPM*.[84] *SPM* involved a Chapter 7 liquidation which is not bound by the absolute priority rule of § 1129(b)(2)(B)(ii).[85] Additionally, the property at issue in *SPM* was part of the secured creditor's liquidation proceeds and was no longer property of the estate—and thus not under control of the Bankruptcy Code—whereas the property in *DBSD* was part of the bankruptcy estate at all times.[86] In the court's words, "[i]n a very real sense, the property [in *SPM*] belonged to the secured creditor alone, and the secured creditor could do what it pleased with it."[87] But the property in *DBSD* "has never belonged to the secured creditors outright."[88]

Third, the court invoked the historical line of case law discussed above, including the birth of the court-made absolute priority rule to stop the practice of gifting and the rule's subsequent codification.[89] The court balked at the idea of going against this pre-Code line of law and refused to "conclude that Congress abrogated the more-than-a-century-old core of the absolute priority rule by passing a statute whose language explicitly adopts it."[90]

Finally, the court recognized substantial policy arguments both for and against strict enforcement of the absolute priority rule.[91] The main rationale the court noted for allowing a gifting exception to the absolute priority rule is that it can help with an efficient, collaborative, and con-

82. Bank of Am. Nat'l Trust & Sav. Ass'n v. 203 N. LaSalle St. P'ship, 526 U.S. 434, 443 (1999); Nw. Bank Worthington v. Ahlers, 485 U.S. 197, 203 n.3 (1988); *In re DBSD N. Am., Inc.*, 634 F.3d at 97; TABB, *supra* note 3, at 1152–53; Doyle, *supra* note 11, at 38.

83. *In re DBSD N. Am., Inc.*, 634 F.3d at 97 (emphasis added).

84. *Id.* at 98 ("We distinguish this case from *In re SPM* on several grounds.").

85. *Id.* ("The first and most important distinction is that *In re SPM* involved Chapter 7, not Chapter 11, and thus involved a liquidation of the debtor, not a reorganization. Chapter 7 does not include the rigid absolute priority rule of § 1129(b)(2)(B)(ii)." (citations omitted)).

86. *Id.*; s*ee also* Doyle, *supra* note 11, at 39 (agreeing with the court in *In re DBSD, Inc.*, that "the proceeds from the liquidation in *SPM* were no longer property of the estate").

87. *In re DBSD N. Am., Inc.*, 634 F.3d at 98.

88. *Id.*

89. *Id.* at 98 ("Even if the text of § 1129(b)(2)(B) left any room for the appellees' view of the case, we would hesitate to accept it in light of the Supreme Court's long history of rejecting such views. That history begins at least as early as 1868, in *Howard*, 74 U.C. 392."); *see supra* notes 39–45 and accompanying text.

90. *In re DBSD N. Am., Inc.*, 634 F.3d at 99.

91. *Id.* at 100 ("Gifting may be a 'powerful tool in accelerating an efficient and non-adversarial . . . [c]hapter 11 proceeding, and no doubt the parties intended the gift to have such an effect here." (citation omitted)).

sensual plan proceeding.[92] In the same vein, not allowing gifting can "encourage hold-out behavior by objecting creditors . . . even though the transfer has no direct effect on the value to be received by the objecting creditors."[93] The rationale *for* the rule is that with shareholders in substantial control of the debtor company during the Chapter 11 process, gifting creates ample opportunity for "serious mischief between senior creditors and existing shareholders."[94] But above all, as the court finally noted, policy considerations do not trump plain statutory language.[95] Congress made a considered decision with knowledge of all material arguments when it codified the absolute priority rule, and it clearly thought the policy reasons against gifting outweighed those reasons to allow it.[96]

In the end, the Second Circuit very clearly held that § 1129(b)(2)(B)(ii) does not have a gifting exception.[97] This decision is particularly important because, as discussed previously, earlier case law had possibly left the door open for court-approved gifting by *secured* creditors.[98] Prior to *DBSD*, commentators following the *SPM* rationale argued that the absolute priority rule did not apply to secured creditors who held an actual property interest in the debtors' assets.[99] Secured creditors have a "property interest," they argued, that is not dependent on the bankruptcy plan, while unsecured creditors have no such guaranteed interest independent of possible proceeds of the bankruptcy estate.[100] After *DBSD*, then, the Second Circuit closed the door on a gifting exception to secured and unsecured creditors alike.

a. Valuation: An Added Concern

Notably, asset valuation has considerable implications for plan proponents' common argument that a gifting scheme will not actually *harm* intermediate creditors, who will not receive anything under the plan anyway.[101] Valuing an existing company is simultaneously nearly impossible to do accurately and at the heart of some of the most forceful arguments against gifting.[102] The classic characterization of enterprise valuation as "an estimate compounded by a guess" was particularly appropriate in the

92. *Id*.
93. *Id*. (citing Miller & Berkovich, *supra* note 9, at 1349).
94. *Id*.
95. *Id*. ("Whatever the policy merits of the absolute priority rule, however, Congress was well aware of both its benefits and disadvantages when it codified the rule in the Bankruptcy Code.").
96. *Id*.
97. *Id*. at 101; Brubaker, *supra* note 6, at 4.
98. *See supra* notes 63–65 and accompanying text.
99. Hugo Arias, Comment, *Skipping Classes: When Does "Gifting" Among Creditors Violate the Priority Guidelines of the Bankruptcy Code?*, 52 S. TEX. L. REV. 251, 267–68 (2010).
100. *Id*.
101. Brubaker, *supra* note 6, at 10.
102. *See infra* notes 182–83, 239–41 and accompanying text.

case of DBSD, a company that, still in its development phase, was not expected to generate any revenue for years.[103] Nonetheless, a key rationale of the bankruptcy court in *DBSD* for allowing the gifting parties (the second lien debt holders) to bypass the absolute priority rule was their status as *under*secured creditors.[104] In other words, based on the valuation of assets in the case, the court determined that the second-lien debt holders would be entitled to the entire value of the debtor party that remained after the first-lien debt holders were paid—nothing would be left for any junior creditors.[105]

The bankruptcy court's justification for allowing gifting, then, included the reasoning that "the gifting here does not injure any junior creditor. In fact, the only class that receives less than its entitlement is the one agreeing to provide the gift."[106] But the determination that the junior creditors would not have received a payout under the plan was based on the highly speculative judicial valuation of the corporation. The initial plan was based on "an enterprise valuation of $492 to $692 million" but, as the case turned out, the company actually sold for more than $1.4 billion.[107] Because the Second Circuit rejected the proposed "gift" plan, Sprint will now receive 100% of its claim and the existing shareholder (ICO Global) will receive almost $325 million—about $257.5 million more than it would have received as a "gift" under the rejected plan.[108]

As one commentator suggests, "[w]hen the DBSD reorganization plan lost, almost everyone won."[109] But the even bigger take-away from the outcome of this particular case is the proposition that even a "certain" interest, or lack of interest, in property of the estate is still subject to the notoriously *uncertain* practice of judicial valuation.[110] Confirmation of the initial proposed plan in this case would not only have violated the distribution structure of Chapter 11, but also drastically overpaid the second-lien holders and underpaid the unsecured creditors and shareholders.[111]

103. Brubaker, *supra* note 6, at 10 (quoting Professor Coogen, H.R. REP. NO. 95-959, at 225).

104. *In re* DBSD N. Am., Inc., 419 B.R. 179, 214 (Bankr. S.D.N.Y. 2009) *aff'd in part*, *rev'd in part*, 627 F.3d 496 (2d Cir. 2010) ("It is also the case that the gifting here does not injure any junior creditor.").

105. *In re* DBSD N. Am., Inc., 634 F.3d 79, 94 (2d Cir. 2011).

106. *In re DBSD N. Am., Inc.*, 419 B.R. at 214.

107. Christopher W. Frost, *Update: When the DBSD Reorganization Plan Lost, Almost Everyone Won*, BANKR. L. LETTER, Oct. 2011, at 6, 7. This turn of events allowed Professor Brubaker a nice "told you so" moment. *Id.* (citing Brubaker, *supra* note 6, at 10 ("If ever there were a case in which enterprise valuation was . . . 'an estimate compounded by a guess,' it is *DBSD*—a development-phase company generating no revenues that, indeed, was not anticipated to generate any revenues for at least several years after plan confirmation.)).

108. *Id*.

109. *Id*. at 6.

110. Brubaker, *supra* note 6, at 10–11.

111. Frost, *supra* note 107, at 8.

b. Impact of Venue

DBSD and *Armstrong* were decided by the Second and Third Circuits, but these cases are integral for all Chapter 11 reorganizations. For one, the Southern District of New York (in the Second Circuit) and the District of Delaware (in the Third Circuit) are the primary venues for large corporate Chapter 11 cases.[112] Accordingly, courts in these two primary venues are now governed by precedent denying a gifting exception to the absolute priority rule.[113] As one New York Times contributor noted, between the Second and Third Circuits' stances, the only option left for large Chapter 11 corporate reorganizations to try to effectuate a gifting scheme *within* the bankruptcy plan is to try their case in an "untested jurisdiction."[114] To that point, there is also evidence that other bankruptcy courts are modeling their procedures after the Delaware Bankruptcy Court.[115] Practically speaking, then, Second and Third Circuit precedent significantly impacts Chapter 11 practice across the nation.

C. Gifting: Alternative Strategies

These cases are not, however, the end of the story. Even if *DBSD* forecloses the possibility of a gifting exception to the absolute priority rule within the plan context, there may be other ways to effectuate a "gift" from a senior creditor to a junior creditor outside the confines of a strictly enforced § 1129(b)(2)(B)(ii). Interested parties may have strong incentives to test these alternative gifting strategies in court, and scholars and commentators seem sure that Chapter 11 attorneys will do their best to exploit any means possible to keep interclass gifting alive.[116]

1. Voluntary Agreements

One possibility is a voluntary plan support agreement—where two parties agree to transfer property outside the context of the plan.[117] The *DBSD* court seemed to leave this option open, noting that it "need not

112. Lubben, *supra* note 10.

113. Doyle, *supra* note 11, at 64; Lubben, *supra* note 10.

114. Lubben, *supra* note 10.

115. Harvey R. Miller, *Chapter 11 Reorganization Cases and the Delaware Myth*, 55 VAND. L. REV. 1987, 2017 (2002).

116. *See, e.g.*, Brubaker, *supra* note 6, at 2 ("Indeed, after *DBSD* one might be tempted to declare inter-class give-ups dead . . . . That, however, would clearly be premature and would vastly underestimate the resourcefulness of the Chapter 11 bar . . . . The Chapter 11 bar is most adept at exploiting potential porousness in Chapter 11's distributional norms, and means for evading *DBSD* are readily available."); Ralph Brubaker & Charles Jordan Tabb, *Bankruptcy Reorganizations and the Troubling Legacy of* Chrysler *and* GM, 2010 U. ILL. L. REV. 1375, 1406–07; Dandeneau, *supra* note 65, at 529–30.

117. Goldberg, *supra* note 33.

decide" the issue because it did not apply under the present facts.[118] But out-of-court agreements have serious downsides, most notably on the disclosure and enforceability fronts.[119] A fiduciary party to the bankruptcy plan might be obligated to disclose even a non-plan agreement to the court.[120] Additionally, it is less than certain whether a court would feel comfortable enforcing the terms of an agreement that it was not allowed to confirm under a Chapter 11 plan.[121]

If the parties feel confident in a non-enforceable agreement, these issues may not be a problem—but of course, dissenting senior creditor class members cannot then be compelled to contribute to the gift.[122] In fact, the second lien debt holders in *DBSD* did not all vote in favor of the proposed gifting plan and this type of situation could quite often disable the viability of an unenforceable, voluntary agreement.[123]

2. Legally Binding Agreements

A more promising option for debtors is to find a way to obtain binding court approval of an interclass "gift" outside of the plan confirmation process.[124] Possibilities include a pre-plan settlement agreement approved by the bankruptcy court or an interclass "gift" structured as a § 363 sale.[125] Whether the absolute priority rule and other plan requirements apply to these outside-of-plan reorganizations, or to what extent they might apply, is virtually unknown.[126]

a. Pre-plan Settlements

Pre-plan settlements are subject to court approval under Bankruptcy Rule 9019,[127] but do not necessarily fall under the requirements of the absolute priority rule.[128] These settlements seek to resolve controversies among the parties to the bankruptcy as to claims to the estate outside of the plan confirmation process.[129] Facing concerns that Rule 9019 does not always protect the interests of impaired creditors or those not party to the settlement agreement, however, the Fifth Circuit in 1984 held that

118. *In re DBSD N. Am., Inc.*, 634 F.3d 79, 95 (2d Cir. 2011); Brubaker, *supra* note 6, at 12.
119. Brubaker, *supra* note 6, at 12.
120. *Id.*
121. *Id.*
122. *Id.*
123. *Id.* at 12–13.
124. *Id.* at 13; *see In re* DBSD N. Am., Inc., 34 F.3d 79, 95.
125. Brubaker, *supra* note 6, at 13.
126. *Id.*
127. *In re* Iridium Operating LLC, 478 F.3d 452, 455 (2d Cir. 2007).
128. *Id.* at 463; Christopher W. Frost, *Settlements, Absolute Priority, and Another Look at Inter-Class Give-Ups*, BANKR. L. LETTER, June 2007, at 1, 2.
129. *See* Frost, *supra* note 128, at 1.

conformation to the distribution structure of the absolute priority rule is a per se requirement of pre-plan settlements.[130]

In 2006, the Bankruptcy Court for the District of Delaware in *In re World Health Alternatives* held that the absolute priority rule does *not* apply to a pre-plan settlement agreement.[131] The court found that, as in *SPM*, the absolute priority rule was not implicated here because the gifted property belonged to the gifting creditor and was not part of the assets of the estate.[132] This assertion by the court, however, misses a key issue: "Until the settlement was approved . . . the Lenders' liens were contested and the money held by the Lenders was an asset of the estate."[133] In other words, it was the settlement itself that created an undisputed, perfected lien belonging to the creditors and not the estate.[134] Before the settlement was in effect, the contested liens were, in fact, assets of the estate.[135] The Second Circuit focused on this issue one year later, in a case with very similar facts to those in *World Health Alternatives*.[136]

The Second Circuit in *In re Iridium Operating LLC*,[137] took a stricter approach to the absolute priority rule in the pre-plan settlement context—how strict, though, is yet to be seen.[138] The court in *Iridium* suggested that the rule does apply in this context, but that the Fifth Circuit's per se approach required adherence to the absolute priority rule was too "rigid."[139] The Court agreed with the Fifth Circuit's rationale that it should protect *all* parties to the bankruptcy, not just the parties to the settlement agreement,[140] and it admitted that its own resolution had the downside of increasing the risk of improper collusion between parties to a settlement.[141] Nonetheless, while maintaining that the bankruptcy distribution scheme "must be the most important factor for the bankruptcy court to consider when determining whether a settlement is 'fair and eq-

130. *In re Iridium Operating LLC*, 478 F.3d at 463 (citing United States v. AWECO, Inc. (*In re* AWECO, Inc.), 725 F.2d 293 (5th Cir. 1984)).

131. *In re* World Health Alts., Inc., 344 B.R. 291, 298 (Bankr. D. Del. 2006) ("Section 1129(b)(2)(B) and the absolute priority rule . . . are not implicated here because the settlement does not arise in the context of a plan of reorganization."); Frost, *supra* note 128, at 3.

132. *In re World Health Alts., Inc*., 344 B.R. at 298; Frost, *supra* note 128, at 3–4.

133. *In re Iridium Operating LLC*, 478 F.3d at 461; Frost, *supra* note 128, at 4.

134. Frost, *supra* note 128, at 4.

135. *Id*.

136. *See In re Iridium Operating LLC*, 478 F.3d 452.

137. *Id*. at 464–65.

138. Fan B. He, *Another Hole in the Absolute Priority Rule—the Second Circuit Opens the Door for Carve-Outs in Preplan Settlements*, 17 NORTON J. BANKR. L. & PRAC. 453, 464 (2008).

139. *In re Iridium Operating LLC*, 478 F.3d at 464.

140. *Id*.

141. *Id*. ("Rejection of a *per se* rule has an unfortunate side effect, however: a heightened risk that the parties to a settlement may engage in improper collusion."). The court suggested that this problem could be resolved by being "certain that parties to a settlement have not employed a settlement as a means to avoid the priority strictures of the Bankruptcy Code." *Id*. Ferreting out improper collusion in this context, however, is not an easy task, and may not be possible at all. *See infra* notes 224–228 and accompanying text.

uitable' under Rule 9019," the court concluded that, "where the remaining factors weigh heavily in favor of approving a settlement, the bankruptcy court, in its discretion, could endorse a settlement that does not comply in some minor respects with the priority rule."[142] What particular factors the Second Circuit thinks may justify non-compliance with the rule, and how "minor" that deviation must be remain unclear.[143] The court remanded for an explanation of the reasoning in not adhering to the absolute priority rule.[144] Thus, while the Second Circuit did not adopt the Fifth Circuit's per se rule and left a small opening for pre-plan settlements that deviate from the priority structure, the opening may indeed be narrow: the absolute priority rule remained a crucial aspect of both of these decisions.

Even when settlements do not directly address the priority scheme of the forthcoming bankruptcy plan, settlements that resolve disputed claims to estate assets "necessarily affect[] bankruptcy distributions" by affecting the parties' priority rights.[145] This is an important policy consideration when thinking about if or how strictly the typical priority schemes of bankruptcy should apply to pre-plan settlement agreements.

Importantly, "[t]here is more opportunity [for gifting] in the pre-plan context than in the plan, so parties will undoubtedly test the limits of how much they may deviate from the absolute priority rule in pre-plan settlements and private agreements entered into in contemplation of a plan."[146] Certainly, this seems to be the trend in the past few years of Chapter 11 practice.[147] Given any possibility of a gifting allowance, parties can be expected to fight to turn even the smallest deviation or exception into a wide-open hole in the absolute priority rule.[148]

b. Gifts as § 363 Sales

Another potential method of providing equity to junior classes while skipping over intermediate claims is the § 363 sale.[149] Both Chrysler and GM recently took advantage of this practice by structuring their Chapter 11 reorganizations as "sales" rather than traditional plans.[150] This strategy potentially allows parties a significant loophole to circum-

142. *Id*. at 464–65.

143. Frost, *supra* note 128, at 3; He, *supra* note 138, at 466–67.

144. *In re Iridium Operating LLC*, 478 F.3d at 466–67; Frost, *supra* note 128, at 3.

145. Frost, *supra* note 128, at 6.

146. Thomas E. Patterson, *You Can't Give It Away: Gifts, Carveouts, Settlements, and Other Incursions Into Absolute Priority*, ALI-ABA COURSE OF STUDY 548 (April 28–29, 2011), *available at* http://files.all-cle.org/thumbs/datastorage/skoobesruoc/pdf/CS029_chapter_11_thumb.pdf.

147. Frost, *supra* note 128, at 1.

148. *See* Brubaker, *supra* note 6, at 1.

149. *Id*. at 13; *see* 11 U.S.C. § 363 (2006) (allowing the trustee to sell property of the estate outside of the ordinary course of business).

150. Brubaker, *supra* note 6, at 13.

vent the priority protections provided by the Chapter 11 plan confirmation rules.[151] There is nothing particularly problematic about the increasingly common practice of reorganization via a § 363 sale—the problem is in "determining whether the supposed 'sale' is in fact not just a sale, but instead 'is in reality a "reorganization" masquerading in "sale" clothing.'"[152] If the proposed sale will actually effectuate a reorganization, it should have to conform to the Chapter 11 plan confirmation rules and priority scheme just like every other plan.[153]

As a detailed look at the Chrysler and GM sales brings to light, the serious *sub rosa* plan concerns brought to the Second Circuit in *Indiana State Police Pension Trust v. Chrysler, LLC* have real implications for the practical future of the absolute priority rule, and the Second Circuit did not meaningfully address priority scheme concerns under § 363 sales.[154] The Supreme Court vacated the Second Circuit's *Chrysler* opinion without issuing its own opinion on the issue.[155] So, while *Chrysler* is not binding precedent regarding the extent to which § 363 sales are governed by the absolute priority rule, it still has the potential to influence future cases.[156]

In the end,

> given the realities of modern-day Chapter 11 practice, resolving that very issue is the central challenge confronting reorganization courts today, and at stake is nothing less than preserving (or abandoning) the very core and essence of bankruptcy reorganization law. There is no way to consistently and coherently enforce Chapter 11's distributional rules and norms unless and until the courts have a clear sense of what is and is not a sub rosa plan of reorganization that is subject to Chapter 11's distributional rules.[157]

Much of the scholarly work on gifting focuses on how to work *around* the absolute priority rule, but says very little about whether the potential availability of these workarounds is good for the state of Chapter 11 law.[158] What policy considerations are in play when thinking about whether and how Chapter 11 distributional rules *should* come into play in *sub rosa* plans? Is there a principled, well-reasoned way to apply such rules? The next Part discusses these concerns in the context of three potential options for the future of gifting.

151. Brubaker & Tabb, *supra* note 116, at 1378.
152. *Id*. (quoting TABB, *supra* note 3, at 459).
153. *Id*. at 1379.
154. *Id*. at 1410.
155. *Id*. at 1408.
156. *Id*. at 1410 ("The formal effect of the Second Circuit decision is now as if it has never been issued; but of course, the Second Circuit opinion did issue, and its approach likely will nonetheless (and unfortunately) remain influential in the brave new world of '§ 363 reorganizations.'").
157. Brubaker, *supra* note 6, at 13.
158. *See, e.g.*, Dandeneau, *supra* note 65, at 524; Doyle, *supra* note 11, at 65; He, *supra* note 138, at 454; Patterson, *supra* note 146, at 551–52.

III. ANALYSIS

Even before *DBSD*, bankruptcy attorneys voiced the opinion that, "if taken too literally, the absolute priority rule impedes the creativity and flexibility needed in bankruptcy negotiations."[159] Indeed, some argued that the Third Circuit "squelched the creative efforts to facilitate Chapter 11 plan confirmations by its textually oriented decision in *In re Armstrong World Industries, Inc.*"[160] This Part examines the policy arguments for and against three potential approaches to the absolute priority rule: first, a loose interpretation of the rule with ample room for a gifting exception both in and out of the formal plan context; second, a strictly enforced absolute priority rule in the formal plan context, but with room for gifting strategies in the pre-plan or sale contexts; and finally, a strictly enforced absolute priority rule with no gifting exception in any Chapter 11 context.

A. Reinstating a Gifting Doctrine

The first potential approach to the absolute priority rule, and one advocated by many Chapter 11 attorneys, is to reinstate a gifting exception which allows gifting in both formal and informal plan arrangements.[161] This approach faces some obvious and significant legal hurdles,[162] but the historic persistence of parties in their attempts to find a place for gifting in the Chapter 11 context suggests that there are still some compelling policy arguments for allowing gifting.[163]

1. Legal Challenges: Statutory and Case Law Precedent

From the perspective of textual statutory interpretation, a gifting exception to the absolute priority rule is hard to justify.[164] When the text of a statute is unambiguous—as multiple courts have determined to be true with § 1129(b)(2)(B)(ii)—the plain language of the statute is the beginning and end of the interpretive endeavor.[165] Even several of the staunchest proponents of a gifting exception admit that "[t]he best, and

159. Arias, *supra* note 99, at 260.

160. Miller & Berkovich, *supra* note 9, at 1349.

161. He, *supra* note 138, at 477; Miller & Berkovich, *supra* note 9, at 1426.

162. *See infra* Part III.A.1.

163. *See* Brubaker, *supra* note 6, at 1.

164. *See* Jeanfreau, *supra* note 64, at 331 ("[I]t is difficult to criticize the Second Circuit's decision [in *In re DBSD, Inc.*] as a matter of textual interpretation.").

165. *In re* DBSD N. Am., Inc., 634 F.3d 79, 97 (2d Cir. 2011); *In re* Armstrong World Indus., Inc., 432 F.3d 507, 512–13 (3d Cir. 2005); Jon Travis Powers, *Strong Arming Chapter 11: The (In)validity of "Gifting" in Corporate Reorganization from* SPM *to* DBSD, 2011 NORTON ANN. SURV. BANKR. L. 259, 261–62 ("When legislative text is plain and unambiguous, the statute at issue must be applied according to its terms, as in such cases the 'first canon is also the last: 'judicial inquiry is complete.'" (citations omitted)).

perhaps the only, argument [against gifting] is that the Bankruptcy Code is unambiguous . . . ."[166]

In accordance with a strict approach to statutory interpretation, when the text is clear it is not necessary to look to legislative history for Congressional intent: "[W]hen the text of a statute is clear, that is the end of the matter."[167] But the legislative history in this case explicitly supports a plain language reading of § 1129(b)(2)(B)(ii):

> Not only did the House of Representatives report on the draft bankruptcy bill note that the "absolute priority rule was designed to prevent a senior class from giving up consideration to a junior class unless every intermediate class consents, is paid in full, or is unimpaired," but the Senate Report on its version of the draft bill contemplated a version of the absolute priority rule which would have contained language explicitly permitting senior creditors to make gifts of their distributions to junior creditors so long as intermediate creditors were not harmed in the process.[168]

Obviously, the language permitting gifting was not included in the final statute.[169] As the Third Circuit in *Armstrong* emphasized, allowing a gifting exception to the absolute priority rule of § 1129 (b)(2)(B)(ii) would "impermissibly sidestep the carefully crafted strictures of the Bankruptcy Code, and would undermine Congress's intention to give unsecured creditors bargaining power in this context."[170] This is as clear as statutory interpretation gets—both the plain language of the statute and the legislative history lead to the conclusion that Congress definitively did *not* intend to allow a gifting exception to the absolute priority rule.

2. Policy Support

Congress, of course, is always free to change the Code. The question then becomes, should it? The policy arguments in favor of a gifting exception focus on two lines of reasoning: (1) a property rights theory and (2) efficiency considerations.

At the forefront is the "property rights" theory—the argument that the proposed gift is the property of the senior creditor, and the creditor has the inherent right to dispose of its property as a gift if it wishes.[171] The common claim in these situations is framed as an issue of standing:

166. Miller & Berkovich, *supra* note 9, at 1425.

167. Antonin Scalia, *Common-Law Courts in a Civil-Law System: The Role of United States Federal Courts in Interpreting the Constitution and Laws, in* A Matter of Interpretation: Federal Courts and the Law 3, 16 (Amy Gutmann ed., 1997); *see also* Powers, *supra* note 165, at 261–62 (citing case law supporting the proposition that when statutory text is clear, the interpretive analysis is complete).

168. Jeanfreau, *supra* note 64, at 332–33 (quoting *In re DBSD N. Am., Inc.*, 634 F.3d at 100).

169. 11 U.S.C. § 1129(b)(2)(B)(ii) (2006).

170. *In re Armstrong World Indus., Inc.*, 432 F.3d at 514–15; *see also* Miller & Berkovich, *supra* note 9, at 1416 (discussing the *Armstrong* court's assertions).

171. *In re* DBSD N. Am., Inc., 419 B.R. 179, 211 (Bankr. S.D.N.Y. 2009) *aff'd in part*, *rev'd in part*, 627 F.3d 496 (2d Cir. 2010).

junior creditors have no grounds to object to the gift distribution because there is no possibility that any unsecured creditor will receive anything in the distribution.[172] The gifted property would never have gone to the complaining party.[173] In fact, some even argue that gifting distributions are not actually "exceptions" to the absolute priority rule, but "merely distributions outside of the scope of those provisions."[174] Based on the idea that a creditor is gifting its own *property*, which is somehow apart from the distribution scheme of Chapter 11, the argument is that inter-class gifts do not actually implicate the absolute priority rule.[175]

This argument is especially strong where the gifting party is a secured creditor with a lien on the entire residual value of the estate,[176] and some courts accept the proposition that secured creditors' collateral is not property of the estate.[177] The Third Circuit in *Armstrong* did not accept this proposition, however, and it was certainly correct on this point: secured creditor collateral *is* property of the estate.[178] The entire procedure of seeking relief from the automatic stay would be unnecessary if it were otherwise.[179] Although the secured creditor in *SPM* already had relief from the automatic stay,[180] in *DBSD* and other Chapter 11 cases, gifted property is very much still property of the estate, and as such is subject to the stay.[181] Furthermore, the "property rights" argument rests heavily on an accurate judicial valuation of the debtor company's assets because, of course, it is impossible to know if there would be any value left over for unsecured creditors without knowing how much the company is worth.[182] As the end results in *DBSD* point out most saliently, judi-

172. *See id*. at 210; Jeanfreau, *supra* note 64, at 329. *But c.f.* Powers, *supra* note 165, at 303 ("[T]hese creditors should not be permitted to gift to lower classes, as their property interests remain in question until distribution of the estate assets.").

173. Jeanfreau, *supra* note 64, at 329 ("In such circumstances, one might consider that none of the classes junior to the secured creditors would get anything without a gift from the secured creditors and so conclude that an intermediate creditor has no grounds to complain if the secured creditors make a gift to someone else.").

174. Miller & Berkovich, *supra* note 9, at 1425.

175. *Id*.

176. Jeanfreau, *supra* note 64, at 329.

177. *In re* Armstrong World Indus., Inc., 432 F.3d 507, 514 (3d Cir. 2005); Miller & Berkovich, *supra* note 9, at 1417 & n.418.

178. United States v. Whiting Pools, 462 U.S. 198, 203–204 (1983) ("Al-though Congress might have safeguarded the interests of secured creditors outright by excluding from the estate any property subject to a secured interest, it chose instead to include such property in the estate and to provide secured creditors with 'adequate protection' for their interests."); *In re* DBSD N. Am., Inc., 634 F.3d 79, 98 (2d Cir. 2011); Jeanfreau, *supra* note 64, at 331.

179. Jeanfreau, *supra* note 64, at 331.

180. *In re DBSD N. Am., Inc.,* 634 F.3d at 98; *In re* SPM Mfg. Corp. v. Stern, 984 F.2d 1305, 1309 (1st Cir. 1993); Jeanfreau, *supra* note 64, at 331.

181. *In re DBSD N. Am., Inc*., 634 F.3d at 98.

182. *See supra* Part II.B.2.a.

cial valuations can be drastically incorrect, and relying on them in this situation could lead to dire consequences for creditors.[183]

On the other hand, scholars seem to agree that taking gifting off the table makes it more difficult to resolve Chapter 11 cases.[184] Gifting can encourage junior creditor classes to go along with a plan, thereby expediting the confirmation process.[185] At the extreme end, some consider strict adherence to the absolute priority rule to give intermediate creditors *too much* bargaining power, allowing them to extract "hold up value" (i.e. a payout for themselves) from senior creditors and delay the process for everyone involved.[186] But the entire structure of Chapter 11 plan confirmation is premised on giving creditor classes significant bargaining power: plans *without* the support of each class must either leave each class unimpaired, or abide by the rules prohibiting unfair discrimination and requiring fair and equitable treatment, including the absolute priority rule.[187] The power these commentators argue against is exactly the amount of bargaining power Congress intended to give unsecured creditors.[188] The Chapter 11 plan confirmation structure is *supposed to* give creditor classes the ability to block a plan they are uncomfortable with.[189] This is not a "hold up" or an aberration of some sort—it is essential to the rights and power that Chapter 11 affords to creditors.[190] The bargaining structure these gifting proponents are really seeking is the structure that was in place before the absolute priority rule was introduced to reorganizations—starting with the nineteenth-century line of cases including *Howard* and its formal codification in the 1978 Bankruptcy Code.[191]

In addition to concerns about maintaining statutory bargaining power, it is somewhat disingenuous to claim that gifting collateral or other property of the estate is the only option creditors have for efficiently confirming a Chapter 11 plan. There are certainly other ways for creditors to "buy" the cooperation of inferior creditor classes, if that becomes necessary. For one, parties are always free to voluntarily hand over their

183. *See supra* Part II.B.2.a.

184. *See, e.g.*, He, *supra* note 138, at 477 (addressing this concern in the context of preplan settlement agreements, which are discussed further *infra* Part III.B.2.); Jeanfreau, *supra* note 64, at 335 ("It can be convincingly argued that by making gifting plans difficult if not impossible to confirm, the Second and Third Circuits have made the work of restructuring professionals more difficult and made contentious, acrimonious, and prolonged Chapter 11 cases more likely."); Miller & Berkovich, *supra* note 9, at 1425–26.

185. *In re DBSD N. Am., Inc.*, 634 F.3d at 100.

186. Miller & Berkovich, *supra* note 9, at 1422–23 ("This gives [the intermediate creditor class] *too much leverage* to extract value from others and delay emergence." (emphasis added)).

187. 11 U.S.C. § 1129 (2006).

188. *See* H.R. REP. NO. 95-595, at 413 (1977); Miller & Berkovich, *supra* note 9, at 1422–23.

189. Brubaker, *supra* note 6, at 11.

190. *See id.*

191. Brubaker & Tabb, *supra* note 116, at 1379; Brubaker, *supra* note 6, at 11.

bankruptcy distributions *after* the plan has been confirmed.[192] Voluntary agreements probably are not legally binding,[193] but there is little incentive to shortchange shareholders if a creditor is seeking their ongoing cooperation after reorganization. For that matter, creditors are also free to gift money or property unrelated to the bankruptcy that definitely *is* theirs right now.[194] Or, parties could use gifts to induce dissenting intermediate creditors to accept a proposed plan, thereby avoiding the cram-down situation and the absolute priority rule altogether.[195] Most importantly, though, it is simply absurd to think parties should be able to "gift" property that is not only presently property of the estate, but also might not end up being *their* property to give away.[196]

Thus, this policy argument repeatedly comes back to a desire for unhampered "creativity" and "innovative . . . solutions" in the reorganization effort.[197] This, frankly, seems like a thinly-veiled plea to keep reorganization attorneys in business—a criteria which should have no place in a serious policy discussion.[198]

B. Strict Plan, Loose Alternatives

The second potential approach to the absolute priority rule is to apply the rule strictly within the plan context, but allow gifting in out-of-plan situations such as pre-plan settlements and § 363 sales. As discussed, there is strong legal support for applying the rule strictly within the plan.[199] The legal justification for applying the rule outside the plan context, however, is less clear, and courts have come out differently in these situations.[200] Nonetheless, there are also significant policy argu-

192. *See supra* Part II.C.1.

193. *See supra* Part II.C.1.

194. In fact, the Supreme Court made this point in one of the early restructuring cases in an emphatic rejection of gifting doctrine. *See* Louisville Trust Co. v. Louisville, New Albany & Chi. Ry. Co., 174 U.S. 674, 688 (1899) ("It is one thing for a [mortgage] bondholder who has acquired absolute title by foreclosure to mortgaged property to thereafter give of his interest to others, and an entirely different thing whether such [mortgage] bondholder . . . to secure a waiver of all objections on the part of the stockholder and consummate speedily the foreclosure, may proffer to him an interest in the property after the foreclosure. The former may be beyond the power of the courts to inquire into or condemn. The latter is something which on the face of it deserves the condemnation of every court, and should never be aided by any decree or order thereof. It involves an offer, a temptation, . . . the purchase price therof to be paid, not by the mortgagee, but in fact by the unsecured creditor."); *see* Brubaker & Tabb, *supra* note 116, at 1403.

195. Jeanfreau, *supra* note 64, at 325.

196. *See supra* Part II.B.2.a.

197. Miller & Berkovich, *supra* note 9, at 1425–26.

198. *See id*. ("In those extremely complicated cases, innovative creative solutions should be applauded. It is in such situations that bankruptcy professionals add value. The value added should be recognized by the courts and evaluated in perspective of the policies and objectives of Chapter 11.").

199. *See supra* Part III.A.1.

200. *See infra* Part III.B.1.

ments against allowing gifting in out-of-plan contexts to the extent that it affects any creditor's priority distribution status.[201]

1. Legal Challenges: The Current State of Law

The current state of the law on gifting *outside* the plan context is murky—not because the absolute priority rule is unclear, but because courts are divided on when the rule applies.[202] On its face, the absolute priority rule is found in § 1129, which only applies to plan confirmation.[203] But because settlements can substantially affect distribution priority, some courts and scholars argue that the absolute priority rule applies just as much in settlements as in plans.[204] As discussed above, courts have not been consistent on this front: the Fifth Circuit considers the absolute priority rule a per se requirement for pre-plan settlements; the bankruptcy court for the District of Delaware does not apply the rule at all in this context; and the Second Circuit applies the rule but allows "minor" deviations when other factors weigh heavily towards approving a settlement.[205] Certainly, the most promising legal options for parties attempting a gifting strategy outside the plan context are still pre-plan settle-settlements and § 363 sales.

2. Policy Considerations

The policy arguments against strictly applying the absolute priority rule in the plan context also apply to those potential gifting methods outside the plan context.[206] For example, one commentator argues that strict adherence to the absolute priority rule in the context of pre-plan settlements could impede "parties' ability to reach a[n] efficient and equitable settlement" by removing the flexibility, restricting parties' leveraging options, and altering their bargaining power.[207] Even proponents of the rule in the pre-plan context suggest that applying the absolute priority rule at every point of compromise throughout the reorganization process could constrain the process beyond what is ideal.[208] In general, pre-plan settle-

201. *See infra* Part III.C.2.

202. *Compare In re* Iridium Operating LLC, 478 F.3d 452, 455 (2d Cir. 2007) (applying the absolute priority rule but allowing deviations in some circumstances), *and* United States v. AWECO, Inc. (*In re* AWECO, Inc.), 725 F.2d 293, 298 (5th Cir. 1984) (requiring conformation of pre-plan settlements to the absolute priority rule), *with In re* World Health Alts., Inc., 344 B.R. 291, 298 (Bankr. D. Del. 2006) (holding that pre-plan settlements are not bound by the absolute priority rule).

203. 11 U.S.C. § 1129 (2006); Frost, *supra* note 128, at 6.

204. Protective Comm. for Indep. Stockholders of TMT Trailer Ferry, Inc. v. Anderson, 390 U.S. 414, 424 (1968); *In re AWECO, Inc.*, 725 F.2d at 298; Frost, *supra* note 128, at 6.

205. *See supra* Part II.C.2.a.

206. *See supra* Part III.A.2.

207. He, *supra* note 138, at 477.

208. Frost, *supra* note 128, at 6.

ments can contribute to an "efficient administration of the bankruptcy estate."[209]

To what extent should courts feel bound to consider the absolute priority rule outside the plan context? One argument is that "the better-reasoned view is that the rule should apply to settlements just as it applies to the plan itself."[210] This is because most pre-plan settlements somehow affect priority status.[211] Settlements may resolve a disputed claim, fix the amount of a secured creditor's claim, or resolve conflicts about what is estate property, for example, all of which will impact the ultimate reorganization distribution.[212] As the Fifth Circuit noted, the goal of resolving creditors' claims in a "fair and equitable" manner begins the moment the debtor files for relief.[213] Under this overarching goal, a court is not free to favor junior creditor classes over senior classes in a pre-plan settlement any more than it is within the plan context.[214] In line with Supreme Court precedent dating back to the 1968 decision in *TMT Trailer Ferry*, therefore, all pre-plan settlement agreements should receive a higher level of judicial scrutiny than a compromise between litigants would ordinarily receive outside of bankruptcy.[215] Finally, courts should hold all settlements that allocate proceeds among the parties involved to the absolute priority rule and should prohibit gifting in the context of a pre-plan settlement if it violates the rule.[216]

C. Strict Enforcement—No Exceptions

The final option is to enforce the absolute priority rule strictly both in and out of the plan context, whenever parties' distribution priority may be affected. As previously discussed, there is strong textual support for this option.[217] Important policy concerns including valuation issues, preventing collusion, and maintaining proper priority and bargaining power also urge strict enforcement of the rule in all contexts.[218]

209. *In re* Iridium Operating LLC, 478 F.3d 452, 455 (2d Cir. 2007).
210. Frost, *supra* note 128, at 6.
211. *Id*.
212. *Id*.
213. *Id*. (citing United States v. AWECO, Inc. (*In re* AWECO, Inc.), 725 F.2d 293, 298 (5th Cir. 1984)).
214. *See id*.
215. Protective Comm. for Indep. Stockholders of TMT Trailer Ferry, Inc. v. Anderson, 390 U.S. 414, 424 (1968); Frost, *supra* note 128, at 6, 8.
216. Frost, *supra* note 128, at 8.
217. *See supra* Part III.A.1.
218. *See infra* Part III.C.2.

1. Legal Challenges: Solidifying the Law

The legal ground for strictly applying the absolute priority rule within the plan context is solidly based in the plain language of § 1129(b)(2)(B)(ii), relevant legislative history, and historical precedent.[219] Accordingly, the Second Circuit in *DBSD*, "recognized the policy merits in favor of limiting the hold-out rights of out-of-the-money junior creditors, [but] it found that argument foreclosed by the history and precedent behind the absolute priority rule."[220] But the legal grounds for strictly applying the rule in out-of-plan contexts are less clear.[221] There is, however, strong support for the argument that a pre-plan settlement or § 363 sale, which effectuates a gift to a junior creditor bypassing an intermediate class should be subject to the absolute priority rule, because each practice has the potential to alter the priority distribution scheme.[222] Additionally, plainly allowing gifting outside the plan context leads to somewhat of a statutory absurdity: it is hard to believe that Congress and the courts are wed to the idea of strict enforcement of the absolute priority rule in the plan context—as evidenced by § 1129(b)(2)(B)(ii) and years of case law—but would nonetheless allow parties to bypass the rule by effecting distributions that violate the priority structure in other contexts.[223]

2. Policy Considerations

One significant policy benefit of a per se, strictly enforced absolute priority rule is that it prevents courts from having to try to snuff out improper collusion between senior creditors and equity holders.[224] Indeed, it is "virtually impossible to penetrate the real reasons for the 'gift' to old equity."[225] Chapter 11 may allow shareholders a convenient opportunity to gain what would essentially be a "kickback" at the expense of intermediate creditors.[226] Others suggest that courts are most concerned with the situation in which equity holders use their position as managers of the company to get a payout from the secured creditors over the intermediate creditors—so that the improper collusion concern is at its height when equity holders, rather than unsecured creditors, are the gift recipi-

219. *See supra* Part III.A.1.

220. Patterson, *supra* note 146, at 547.

221. *See supra* Part III.B.1.

222. Brubaker & Tabb, *supra* note 116, at 1406–07; Frost, *supra* note 128, at 6.

223. *Compare* discussion *supra* Parts II.B.1, III.A.1 (elucidating the strong statutory and historic common law support for strict enforcement of the absolute priority rule in the plan context), *with* discussion *supra* Part II.C.2 (describing the courts' conflicted holdings as to the enforcement of the absolute priority rule in out-of-plan contexts such as pre-plan settlements and § 363 sales).

224. *In re* DBSD N. Am., Inc., 634 F.3d 79, 100 (2d Cir. 2011); Brubaker, *supra* note 6, at 12; Patterson, *supra* note 146, at 545.

225. Brubaker, *supra* note 6, at 12.

226. *In re DBSD N. Am., Inc.*, 634 F.3d at 100.

ents.[227] In the end, the *only* certain way to prevent improper collusion is to hold all plans strictly to the absolute priority rule.[228]

Furthermore, the Bankruptcy Court for the Southern District of Texas had an interesting take on the "fair and equitable" rule.[229] There are significant advantages to the Chapter 11 process over state law resolution, it argued, but these advantages come with costs.[230] The "price" of using these "powerful equitable tools" when a class of creditors is impaired is "negotiation to win over the acceptance of an impaired class and treatment of all nonaccepting classes fairly, equitably, and without unfair discrimination."[231] Thus, a party that enjoys the procedural benefits of Chapter 11 must also pay the costs that are certainly not required under state law procedures; the absolute priority rule is one of those costs.[232]

One of the strongest policy arguments favoring a strict application of the absolute priority rule in all contexts is that "the doctrine has the potential to be an exception which swallows the . . . rule."[233] An "exception" by definition must only allow a practice in limited circumstances. Accordingly, the bankruptcy court in *DBSD* and Second Circuit in *Iridium* tried to place limits on a possible gifting "exception" by suggesting that gifts should only be allowed under certain circumstances—for example, when the gift is from secured creditors, when there are "good business reasons" for the gift, or when the gift does not have inappropriate ends.[234] These limits, of course, have no basis in the Bankruptcy Code and are essentially made up by courts.[235] But additionally, placing limits on gifting violates the gifting doctrine's basic property rights reasoning.[236]

227. Patterson, *supra* note 146, at 551–52.

228. Brubaker, *supra* note 6, at 12.

229. *In re* Sentry Operating Co. of Tex., Inc., 264 B.R. 850, 865–66 (Bankr. S.D. Tex. 2001); *see also Inter-Class Give-Ups in a Chapter 11 Plan of Reorganization: Remembering the Origins of the Absolute Priority Rule*, BANKR. L. LETTER, JUNE 2005, at 1, 10 (discussing the *Sentry* court's observations on this subject).

230. *In re Sentry Operating Co. of Tex., Inc.*, 264 B.R. at 866. Some advantages to federal bankruptcy proceedings include the automatic stay; preservation of going-concern value; and leaving the debtor in possession and control of the business. *Id*.

231. *Id*.

232. *Id*.

233. Jeanfreau, *supra* note 64, at 325.

234. *In re* DBSD N. Am., Inc., 419 B.R. 179, 211–12 (Bankr. S.D.N.Y. 2009) *aff'd in part*, *rev'd in part*, 627 F.3d 496 (2d Cir. 2010); *In re* Iridium Operating LLC, 478 F.3d 452, 464–65 (2d Cir. 2007).

235. *See* Jeanfreau, *supra* note 64, at 325 ("Although some courts have attempted to discern such limits by suggesting, for example, that only a gift which left the intermediate creditors no worse off than they would have been had the gift not been made and which was supported by legitimate business reasons would be permissible, or that gifts may not be made from improper motivations [such as] tax avoidance, such limitations do not seem to have any basis in either the Bankruptcy Code or the language of *SPM*. Without some anchor for such limitations in either the Bankruptcy Code or a higher court ruling, where one court chooses to impose a limitation on the sort of gifts which could be made, another court could impose no limitations at all." (internal citations omitted)).

236. *Id*.

If a court's justification for allowing gifting is based in property rights—that creditors should be "free to do whatever they wish" with their bankruptcy distribution[237]—then any limits placed on the practice *also* violate the creditor's property rights. Following this rationale, "it is not clear why there should be *any* restrictions on gifting beyond, perhaps, requirements that gifts not be made in bad faith or in violation of some other law."[238] Having any gifting exception, then, leads to a conundrum: without limitations, the exception has the potential to consume the absolute priority rule to an unacceptable degree; with limitations, the exception is a non-sensical, unprincipled approach to statutory interpretation.

The valuation issues addressed in Part II.B.2.a also play a role here. Erroneous value estimates can alter the entire spectrum of the proposed "gift" by potentially allowing a senior creditor to gift property that *should actually belong to the intermediate creditor* to a lower class because of an overvaluation of the senior creditor's entitled distribution.[239] This makes the "property rights" argument particularly hard to swallow, considering the highly uncertain practice of judicial valuation, because the senior creditor's actual right to property cannot be certain until after plan confirmation.[240] Accordingly, some suggest that courts should use "heightened scrutiny" and take special care to ensure that gift plans are not subsequently invalidated when the actual reorganization value is determined.[241] One hopes, however naively, that courts already use the highest level of scrutiny possible when valuing debtors' assets. Given the inherent uncertainty in the practice of valuation, it is hard to see how even "heightened scrutiny" would lead to valuations accurate enough to predict plan distributions with certainty.

Perhaps as a resignation to the fact that courts may continue to plague reorganization cases with a "blind adherence to strict construction of [§ 1129]," there could be a "legislative remedy."[242] Certainly, the Code could use some clarity in this area, particularly in defining to what extent the absolute priority rule applies to pre-plan settlements or to gifts effec-

237. *In re* SPM Mfg. Corp. v. Stern, 984 F.2d 1305, 1313 (1st Cir. 1993); *In re DBSD N. Am., Inc.*, 419 B.R. at 211.

238. Jeanfreau, *supra* note 64, at 325.

239. *See* Brubaker, *supra* note 6, at 10–11; Powers, *supra* note 165, at 301–02.

240. *See* Brubaker, *supra* note 6, at 10–11; Powers, *supra* note 165, at 301–02. Powers gives another example of the misallocation of funds that can result from gifting in an environment of inherent valuation uncertainties. Powers, *supra* note 165, at 302. The proposed plan in *In re Exide technologies* was based on an undervaluation of the debtor enterprise by $550 million, and would have resulted in a "gift" to unsecured creditors of funds to which the secured creditor (the gifting party) was not even entitled. *Id*.

241. Powers, *supra* note 165, at 303 ("As such disputes cannot be conclusively resolved until the actual reorganization value has been realized, in many instances post[-]confirmation, 'gift' plans in such circumstances should receive *heightened scrutiny* in order to prevent subsequent invalidation. . . . [C]are should be taken to not authorize a 'gift' agreement that will subsequently violate the absolute priority rule.").

242. Miller & Berkovich, *supra* note 9, at 1426.

tuated as § 363 sales. If Congress makes a policy determination that the current distribution of bargaining power in Chapter 11 should be altered, and that the risks of undervaluation and collusion are outweighed by the potential benefits of faster reorganization resolutions, so be it. But as long as parties conduct their business in the shadow and with the expectation of the absolute priority rule as it stands, courts should adhere to the rule whenever distribution priority is involved.

Thus, there is legal justification for applying the absolute priority rule strictly in all contexts that affect parties' distribution priority rights, even if courts do not agree on the extent to which the rule applies outside the plan context.[243] Additionally, a number of strong policy arguments urge for a strict approach to the rule.[244] Among concerns including undervaluation, collusion, and an overbroad exception, is the very real possibility that allowing gifting in contravention of the absolute priority rule deprives creditors of their full distribution and bargaining rights under Chapter 11.

IV. RECOMMENDATION

A strict approach to the absolute priority rule and against a gifting exception is the best way to resolve ambiguity and close loopholes in the current gifting law. This recommendation puts aside for the time being the potential solution of legislative reform.[245] Of course, changing the underlying Bankruptcy Code could make issues of priority status clearer, especially in out-of-plan contexts. Altering the priority rights of parties in bankruptcy, however, would mean a fundamental shift in bargaining power that seems drastic and unlikely. Unlike the Tax Code, Congress does not often update the Bankruptcy Code, and a major overhaul was just recently completed.[246] This recommendation addresses both the legal and policy justifications for a strict application of the absolute priority rule. It focuses on the overriding issues which preclude allowing any room for gifting despite its potential benefits in some circumstances.

Three main considerations show that applying a strict absolute priority rule both in- and out-of-plan context is the correct approach: (1) statutory interpretation; (2) valuation issues; and (3) policy considerations including avoiding collusion, requiring parties to "pay" for the benefits of Chapter 11, and maintaining the bargaining power of intermediate creditors.[247]

243. *See supra* Part III.C.1.

244. *See supra* Part III.C.2.

245. *See supra* Part III.C.2.; Miller & Berkovich, *supra* note 9, at 1426.

246. TABB, *supra* note 3, at 52. Before 2005, the most recent serious reform of the Bankruptcy Code was in 1978; previous reform was some forty years earlier. *Id*. at 45–46.

247. This typically will mean maintaining bargaining power for unsecured creditors.

First, it is clear from the text of § 1129(b)(2)(B)(ii), the historical line of case law preceding the 1978 Code, and relevant legislative history that Congress did not intend to allow a gifting exception to the rule within the plan context.[248] Any such exception, no matter how conducive to a more efficient reorganization, would necessarily lead to either arbitrary, court-made limits or to an exception so large that the rule is meaningless.[249] This holds true for gifting outside the plan context as well: although the absolute priority rule statutorily applies only to Chapter 11 *plans*, courts should not allow parties to circumvent the rule by effectuating settlements or sales that alter parties' distributional priority rights.[250]

Second, as the previous Part discussed, valuation issues play an appreciable role in gift plans. Given the questionable certainty with which even the most scrutinizing court can measure the going-concern value of a company before a reorganization plan is in place, basing any kind of gifting allowance on a judicial valuation is unwise and unfair to junior creditors.[251] Despite arguments to the contrary, even secured creditor collateral is property of the estate during the course of the reorganization unless the creditor has received relief from the automatic stay.[252] Not only is the property rights argument absurd in light of this fact, but it is also a contravention of the automatic stay process to allow a secured or otherwise senior creditor to "gift" based on the speculative valuation of its eventual distribution payout.

The figures from the eventual *DBSD* distribution show the reality of the concern that senior creditors will be able to confirm a plan by "gifting" property that did not even belong to them in violation of the absolute priority rule.[253] Had the secured party's gifting proposal been accepted by the Second Circuit in *DBSD*, the intermediate creditor would have been completely out of the money, even though under the confirmed plan Sprint was eventually paid one hundred percent of its claim.[254] The potential consequences of allowing gifting in violation of the absolute priority rule in a situation with judicial under-valuation of the going-concern value of the company are obviously serious—and seriously disruptive of creditors' rights in bankruptcy.[255] Thus, the particular valuation issues involved in a Chapter 11 case make a gifting exception to the absolute priority rule untenable and detrimental to the system as a whole.

248. *See supra* Part II.B.
249. *See* Jeanfreau, *supra* note 64, at 325; *supra* notes 233–238 and accompanying text.
250. *See supra* Part III.B.
251. *See supra* Part II.B.2.a; notes 239–241 and accompanying text.
252. *See supra* notes 176–83 and accompanying text.
253. *See* Frost, *supra* note 107, at 7; *supra* Part II.B.2.a.
254. *See* Frost, *supra* note 107, at 7; *supra* Part II.B.2.a.
255. *See supra* Part II.B.2.a.

Finally, a strict approach to the rule promotes the policy goals of (1) preventing improper collusion, (2) requiring parties to "pay" for the benefits of Chapter 11, and (3) maintaining bargaining power for intermediate (usually unsecured) creditors. Particularly in the Chapter 11 context, where it is nearly impossible to determine the true reason for a gift to junior creditors, improper collusion is an unavoidable result of allowing gifting plans that violate the absolute priority rule.[256] And while there may not always be serious policy objections to compensating equity holders for their cooperation in a reorganization plan, there should be serious objections when those equity holders are the very same managers who filed for bankruptcy.[257] Furthermore, the structure of Chapter 11 comes with particular costs and benefits to the parties involved: the automatic stay, protection from the state law race to the courthouse, preserving a debtor's going-concern value, and allowing a debtor to remain in control of the business are all significant benefits, while the absolute priority rule can be costly. Decoupling these costs and benefits alters the incentive and power structure Congress created.[258] It is true that allowing gifting could speed up plan confirmation by giving senior creditors more bargaining power and allowing junior creditors to "sell" their votes for distribution value.[259] But *speed* was not all Congress had in mind when it adopted the Code.[260] Courts should protect the bargaining power and distribution structure Congress created by enforcing the absolute priority rule whenever parties' distribution rights are implicated.

The costs of a gifting exception to the absolute priority rule vastly outweigh any potential benefits. The only way to ensure that creditors' bargained-for priority rights are protected from collusive or otherwise detrimental action is to strictly ban all gifting that conflicts with the absolute priority rule. This includes strictly enforcing absolute priority even in out-of-plan contexts, as gifting in those situations can affect creditor priority rights just as much as gifting within the plan context. The Second and Third Circuits recently addressed the gifting problem, especially in in-the-plan contexts, but loopholes abound. Thus, courts must work to prevent the costs of a gifting exception by closing these loopholes, and holding all Chapter 11 plans strictly to the absolute priority rule, in both in- and out-of-plan contexts.

256. Brubaker, *supra* note 6, at 12.

257. *See supra* notes 33–36 and accompanying text.

258. *See In re* Armstrong World Indus., Inc., 432 F.3d 507, 514 (3d Cir. 2005) (allowing gifting "would undermine Congress's intention to give unsecured creditors bargaining power in this context"); *supra* notes 170, 186–191 and accompanying text.

259. *See supra* Part III.A.2.

260. The Second Circuit made this very point in its decision in *In re DBSD N. Am., Inc*. *See In re* DBSD N. Am., Inc., 634 F.3d 79, 100 (2d Cir. 2011); H.R. REP. NO. 95-595, at 413 (1977); *supra* notes 28, 168 and accompanying text.

V. CONCLUSION

For over one hundred years, the Supreme Court has tried to hold cram down reorganization plans to the absolute priority rule; in 1978 Congress codified this rule for Chapter 11 plans. Yet, gifting continues. Just as the Court found so many years ago, a gifting exception to the absolute priority rule has the potential to significantly interfere with creditors' bargained-for priority status and distribution rights in the bankruptcy proceeding. In addition, gifting opens the door for virtually undetectable collusion among management, shareholders, and others. The only way to ensure parties' rights will be protected—from improper collusion, valuation uncertainty, and loss of bargained-for priority status—is to hold all plans, settlements, and sales to the absolute priority rule without exception.