

Reverse Cramdown in the Brave New  
*Post-Armstrong World*

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## Introduction

The basic purpose of chapter 11 of United States Bankruptcy Code<sup>1</sup> is to provide the debtor an opportunity to rehabilitate through a confirmed plan of reorganization.<sup>2</sup> The Bankruptcy Code provides the debtor considerable flexibility in operating its business, including the ability to assume or reject leases and contracts, obtain financing and sell assets during the bankruptcy case. The Bankruptcy Code, however, contains limitations on how the debtor may emerge from bankruptcy through confirmation of a chapter 11 plan. Without limitation, and as set forth in more detail below, Section 1129 of the Bankruptcy Code contains an extensive list of requirements that must be met in order to confirm a plan. With a consensual confirmation, all classes of creditors and investors accept the plan or are not impaired.<sup>3</sup> In a “cramdown” confirmation, one or more impaired classes are impaired and have rejected or are deemed to reject the plan, and the debtor may obtain confirmation only if the plan is determined to be fair and equitable and does not discriminate unfairly.<sup>4</sup>

As pointed out in a recent article in the *American Bankruptcy Institute Journal*<sup>5</sup>, the success of a plan of reorganization often depends on how effective the plan proponent has been in reaching compromises with various constituencies. Debtors’ counsel must be proactive and creative to reach consensus among secured creditors, unsecured creditors, and equity holders. However, the increasing complexity and contentiousness of large chapter 11 cases has made it extremely difficult to build consensus among competing stakeholders. For example, the prevalence of debt and claims trading before and during large chapter 11 cases undermines the ability of a debtor to negotiate with stakeholders and obtain consent. Moreover, under the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the “Act”), debtors potentially now have less time to propose and obtain confirmation of a plan, less time to make critical decisions on the assumption or rejection of leases, and less ability to provide management and other key personnel incentives to stay with the debtor through the bankruptcy and confirmation process. The Act’s addition of Section 503(b)(9) also has increased the risk that some chapter 11 cases will be administratively insolvent upon the filing of the petition.

Perhaps as a result of the foregoing factors, a growing trend in recent years has been for debtors to use chapter 11 of the Bankruptcy Code as a mechanism for an orderly liquidation instead of a true rehabilitation. Debtors may liquidate pursuant to a chapter 11 plan of liquidation, through one or more major asset sales pursuant to Section 363 of the Bankruptcy Code, or a combination of the two processes.<sup>6</sup> It has become increasingly common for debtors to use the bankruptcy court as an auction house to provide the buyer with the protections of Section 363 of the Bankruptcy Code and the convenience of Section 365 of the Bankruptcy Code,

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<sup>1</sup> 11 U.S.C. §§ 101-1532.

<sup>2</sup> *In re Indian Palms Associates, Ltd.*, 61 F.3d 197, 208 (3<sup>rd</sup> Cir. 1995).

<sup>3</sup> 11 U.S.C. § 1129(a).

<sup>4</sup> 11 U.S.C. § 1129(b)(1).

<sup>5</sup> See David D. Farrell, *Reverse Cramdown: Another Option in the Secured Creditor's Playbook?*, 23 Am. Bankr. Inst. J. No. 7, Sept. 2004.

<sup>6</sup> *In re Ionosphere Clubs, Inc.*, 184 B.R. 648, 654 (S.D.N.Y. 1995).

provided that the debtor can demonstrate a business justification for such a sale outside of a chapter 11 plan.<sup>7</sup>

To achieve a true reorganization, therefore, debtor's counsel needs every tool he or she can find to formulate and obtain confirmation of a workable chapter 11 plan. One technique utilized by debtors in recent years involves the agreement of secured lenders or other senior creditors to "gift" a portion of their distribution down to a class of creditors or interest holders that would not otherwise be able to receive or retain property under Section 1129(b)(2)(B)(ii) of the Bankruptcy Code. This technique, sometimes referred to as "reverse cramdown," finds its modern origins in *Official Committee of Unsecured Creditors v. Stern (In re SPM Manufacturing, Inc.)*,<sup>8</sup> in which the United States Court of Appeals for the First Circuit set forth the concept that creditors generally are free to do whatever they wish with the bankruptcy distributions they receive, including to share their distributions with other creditors.<sup>9</sup> As outlined below, several cases cited *SPM* for the proposition that a debtor could obtain confirmation of a nonconsensual plan that provided for the sharing of plan distributions. However, the United States Court of Appeals for the Third Circuit, in *In re Armstrong World Industries, Inc.*,<sup>10</sup> recently held that such sharing arrangements, when implemented through a plan of reorganization, may not always be consistent with the requirements of the Bankruptcy Code.<sup>11</sup> Because of the unique facts in *Armstrong World*, however, debtors may still be able to utilize the reverse cramdown technique with respect to secured creditors or in a pre-bankruptcy lock-up agreement.

This paper outlines Bankruptcy Code provisions relevant to the reverse cramdown issue, surveys the major cases addressing the reverse cramdown procedure, and offers some potential solutions to the apparent blow *Armstrong World* dealt to the reverse cramdown technique.

### **Requirements for Plan Confirmation and the Absolute Priority Rule**

For a plan of reorganization to be confirmed, it must meet all the applicable requirements of Section 1129(a) or (b) of the Bankruptcy Code. The proponent of a plan has the burden of proving by a preponderance of evidence that all the requirements of Section 1129(a) have been satisfied.<sup>12</sup> If the proponent meets all the requirements of Section 1129(a) except Section 1129(a)(8), the proponent may seek confirmation under the provisions of Section 1129(b). To the extent Section 1129(b) applies, the proponent must prove the elements of subsection (b) by clear and convincing evidence.<sup>13</sup>

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<sup>7</sup> Standards for sales of substantially all assets outside of a plan were considered by the court in *In re Lionel*, 722 F.2d 1063, 1071 (2d Cir. 1985).

<sup>8</sup> 984 F.2d 1305 (1<sup>st</sup> Cir. 1993).

<sup>9</sup> 984 F.2d at 1313.

<sup>10</sup> 432 F.3d 507.

<sup>11</sup> 432 F.3d at 514.

<sup>12</sup> See *In re MCorp Financial, Inc.*, 137 B.R. 219 (Bankr. S.D. Tex. 1992).

<sup>13</sup> *Id.*

A. Section 1129(a) (Consensual Confirmation).

Section 1129(a) enumerates thirteen requirements for confirmation of a plan in business chapter 11 cases.<sup>14</sup> A court is required to confirm a plan if and only if all of the requirements are satisfied.<sup>15</sup> Satisfaction of all applicable sections of 1129(a) is mandatory and may not be waived by consent. Even if every class has accepted the plan, the plan may not be confirmed if it fails to meet the requirements of Section 1129(a).<sup>16</sup>

Section 1129(a)(1) provides that the plan must comply “with the applicable provisions of this title.” Although the plan must not violate any provisions of the Bankruptcy Code, subsection (a)(1) refers primarily to Bankruptcy Code Sections 1122 and 1123 regarding classification of claims. Section 1129(a)(2) provides that the proponent of the plan must comply “with the applicable provisions of this title.” The primary focus of subsection (a)(2) is to ensure that the debtor proposing a plan has complied with the requirements of Bankruptcy Code Section 1125 with respect to the solicitation of acceptances of the plan.

Section 1129(a)(3) requires that “[t]he plan has been proposed in good faith and not by any means forbidden by law.” The good faith test means that the plan was proposed with honesty and good intentions and with the basis for expecting that reorganization can be effected. The good faith required to confirm a plan is different than the good faith that must be established as a prerequisite to the filing of a chapter 11 petition. The court should look at the plan and the totality of the circumstances and determine whether a plan will fairly achieve a result consistent with the Bankruptcy Code. A plan is considered proposed in good faith if there is a reasonable likelihood that the plan will achieve a result consistent with the standards prescribed under the Code.

Section 1129(a)(4) provides that payments to be made under the plan for services or for costs and expenses in connection with the case or the plan must be subject to court approval as being reasonable.

Section 1129(a)(5) requires disclosure of the identity of directors, officers and insiders to be employed by the reorganized debtor. The court must determine that such employment is consistent with the interest of creditors and equity security holders and with public policies. Compensation payable to insiders to be employed by the reorganized debtor must be disclosed.

Section 1129(a)(6) deals with rate changes and provides that the plan cannot be approved unless any governmental regulatory commission with jurisdiction over the rates of the debtor has approved any rate change provided for in the plan.

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<sup>14</sup> Under the Act, individual chapter 11 debtors have two additional requirements related to domestic support obligations and commitment of disposable income to the funding of the plan.

<sup>15</sup> *In re Johns-Mansville Corp.*, 68 B.R. 618, 629 (Bankr. S.D. N.Y. 1986), *aff'd*, 78 B.R. 407 (S.D. N.Y. 1987), 843 F.2d 636 (2d Cir. 1988).

<sup>16</sup> *In re Texaco, Inc.*, 84 B.R. 893 (Bankr. S.D. N.Y. 1988).

The dissenting members of an impaired accepting class are protected by the best interest test in Section 1129(a)(7) of the Bankruptcy Code. This section provides that each member of an impaired class must either (i) accept the plan or (ii) receive or retain under the plan on account of its claim or interest property of a value, as of the effective date of the plan, that is not less than the amount it would receive or retain if the debtor were liquidated under the provisions of chapter 7 of the Bankruptcy Code. This section protects dissenting *members* of an *accepting class* by requiring each member to receive under the plan at least as much as it would receive in liquidation. In contrast, the cramdown provisions of Section 1129(b) are designed to protect dissenting *classes*. Generally, Section (a)(7) requires a hypothetical liquidation analysis to determine how much unsecured creditors would receive in a liquidation under chapter 7. If dissenting unsecured creditors will not receive under the plan as much as they would have received in a chapter 7 liquidation, the plan cannot be confirmed. Obviously, this section often requires valuation testimony and is one of the most difficult aspects of obtaining confirmation in a chapter 11 case.

Section 1129(a)(8) provides that each class of claims or interests must either (i) accept the plan, or (ii) not be impaired under the plan. Impairment is defined in Section 1124. Generally, any change or modification of a creditor's right constitutes impairment. Under Section 1129(a)(8), if all classes consent to the plan (and any dissenting individual class members are treated in accordance with subsection (a)(7)), the plan may be confirmed without regard to whether the plan is fair or equitable to all classes. If an impaired class votes to reject the plan, the plan still may be confirmed under the cramdown provisions of Section 1129(b). A plan may be confirmed under Section 1129(b) only if it is fair and equitable and does not discriminate unfairly between impaired classes that have voted to reject the plan, as discussed below. However, Section 1129(a)(8) permits confirmation of a plan without resort to the fair and equitable test if all classes accept the plan.

Section 1129(a)(9) deals with the treatment of priority claims and provides generally that priority claims must be paid in full at confirmation, except for certain tax claims of the kinds specified in Section 507(a)(8) of the Bankruptcy Code. These tax claims may be paid over period of time ending not later than five years after the date of the order for relief. Note that Section 1129(a)(9) does not require monthly payments or quarterly payments. It merely requires deferred cash payments, over a period not to extend beyond five years from the date of the order for relief, of a value, as of the effective date of the plan, equal to the allowed amount of the claim.

Section 1129(a)(10) states that if a class of claims is impaired under the plan, at least one class of claims that is impaired under the plan must accept the plan, without including any acceptances of the plan by an insider. Obtaining the acceptance of an impaired class often is difficult and may turn on how the plan classifies claims. Section 1122(a) of the Bankruptcy Code provides that a claim may be placed in a particular class pursuant to a plan only if the claim is substantially similar to the other claims in a class. Some courts adhere to the rule that classification of claims should focus exclusively on the underlying legal nature of the claim. These courts require substantially similar claims to be classified together for reorganization purposes.

Section 1129(a)(11) provides that a plan can be confirmed only if confirmation of the plan is not likely to be followed by the liquidation or the need for further financial reorganization of the debtor or any successor to the debtor under the plan, unless such liquidation or reorganization is proposed in the plan. Feasibility means there is a reasonable prospect of success and the plan is workable.<sup>17</sup> In determining feasibility, courts should consider such elements as adequacy of the capital structure of the proposed reorganized debtor, earning power of the business, economic conditions, management, working capital, the length of the plan's payout term, and the reasonableness of the projections of the proponent. A proponent, however, is not required to guarantee the ultimate success of its plan. Instead, a proponent generally is required to show that there is a reasonable likelihood of success and that the projected performance is more likely to occur than not.<sup>18</sup> A proponent may be able to satisfy Section 1129(a)(11) by providing for an orderly liquidation of assets in the plan in the event the debtor is unable to make the payments set forth in the plan. Feasibility hearings are fact intensive and the outcome often depends on the testimony of expert witnesses.

Section 1129(a)(12) requires the payment of bankruptcy fees and costs required under Section 1930 of Title 28. Section 1129(a)(13) requires that the plan provide for the continuation of all retiree benefits (as defined in Section 1114) for the duration of the period the debtor has obligated itself to provide such benefits. Section 1114 provides, *inter alia*, that if modification of retiree benefits payments is required for a successful reorganization, the debtor may do so only with the approval of the appropriate representatives of the retirees or upon approval of the bankruptcy court. Prior to seeking court approval, however, the debtor must conduct good faith negotiations in an attempt to reach an agreement with the authorized representative.

*B. Section 1129(b) (Cramdown Confirmation).*

If all the requirements of Section 1129(a) have been met, other than paragraph 8 (all classes that are impaired have accepted), the court, on request of the proponent of the plan, shall confirm the plan if the plan does not discriminate unfairly and is fair and equitable with respect to each class that is impaired under, and has not accepted, the plan. Note that, unlike the best interest test of Section 1129(a)(7) that protects the rights of each member of a class, Section 1129(b) protects the rights of dissenting classes as a whole.<sup>19</sup>

Under Section 1129(b)(1), the plan must not discriminate unfairly.<sup>20</sup> This requirement compliments the fair and equitable test (see below). A plan does not discriminate unfairly with respect to a dissenting class if the plan protects the legal rights of such class in a manner consistent with the treatment of other classes whose legal rights are inter-related with the rights of the dissenting class. For example, a plan would discriminate unfairly if, absent any contractual or equitable subordination, an unsecured creditor in one class receives 20% while an unsecured creditor in another class receives 30%. Plans that provide for elective treatment (for example, paying more to creditors who elect to surrender certain rights than to creditors retaining such rights) do not discriminate unfairly if the election is available to all creditors in such class.

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<sup>17</sup> *In re Johns-Mansville*, 68 B.R. 618 (Bankr. S.D. N.Y. 1986).

<sup>18</sup> *In re New Hampshire Electric Co-op, Inc.*, 138 B.R. 668 (Bankr. D. N.H. 1992).

<sup>19</sup> *Kane v. Johns-Mansville Corp.*, 843 F.2d 636 (2d Cir. 1988).

<sup>20</sup> 11 U.S.C. § 1129(b)(1).

## 1. Secured Creditors

Under Section 1129(b)(2), the plan must provide fair and equitable treatment to all creditors. A plan is fair and equitable with respect to a secured creditor if at least one of the following three requirements are met:

### a. Retain Liens and Receive Payments.

A plan may provide that the secured creditor retain the liens securing its claim to the extent of the allowed amount of the claim and receives on account of the claim deferred cash payments totaling at least (A) the allowed amount of the claim, and (B) as of the effective date of the plan, the value of the creditor's interest in the estate's interest in the collateral. This method of cramdown requires a valuation under Section 506(a) of the Bankruptcy Code. Under Section 506(a), the secured creditor is secured only to the extent of the value of the collateral and is unsecured for the balance of its debt. For example, if a creditor with a claim of \$10.0 million has a mortgage on an apartment complex with an appraised value of \$6.0 million, the creditor is secured to the extent of \$6.0 million and unsecured for \$4.0 million. Under Section 1129(b), the proponent of the plan may satisfy the cramdown requirements by paying the secured creditor \$6.0 million in deferred cash payments over a period of time, but with interest so that the present value of the stream of payments is equal to at least \$6.0 million. To effectuate a cramdown using deferred cash payments, the proponent must apply an appropriate interest rate to guarantee that the present day value of such stream of payments is not less than the amount of the secured claim.

Courts disagree on the appropriate interest rate under 1129(b). Courts historically have applied the contract rate, the market rate, and the coerced loan rate. Under *Till v. SCS Credit Corporation*,<sup>21</sup> the United States Supreme Court applied, in the chapter 13 context, a “formula approach,” which consisted of taking the prime rate and adding points to account for the risk factor associated with dealing with a debtor in bankruptcy.<sup>22</sup> However, it is unclear whether *Till* is directly applicable in chapter 11.<sup>23</sup> In any event, the present value of the stream of payments must be at least equal to the value of the secured claim. The determination of the appropriate interest rate is often the most significant factor in determining feasibility under a plan. For instance, a debtor may be able to pay 8% interest per annum but not 10 ½% per annum. The cash flow of the debtor will often limit the feasible interest rate. However, a limitation on the rate the debtor is able to pay should not dictate which interest rate is appropriate in satisfying the cramdown requirements under this section.

### b. Sale of Collateral.

A plan may provide for the sale, subject to Section 363(k), of the creditor's collateral free and clear of the creditors, provided that (A) such liens to attach to the proceeds of the sale, and (B) the lien on the sales are treated as required by clause (i) or (iii) of 1129(b)(2). A secured creditor may be crammed down if the plan provides for the sale of such secured creditor's

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<sup>21</sup> 541 U.S. 465 (2004).

<sup>22</sup> 541 U.S. 479-80.

<sup>23</sup> See *In re American Home Patient, Inc.*, 420 F.3d 559, 568 (6<sup>th</sup> Cir. 2005).

collateral, subject to the right of the secured creditor to credit bid, free and clear of such liens, with such liens to attach to the proceeds of such sale. In other words, a plan may provide for the sale of the collateral with the proceeds payable to the secured creditor. If the secured creditor does not agree to the sale, the secured creditor may protect itself by bidding at such sale and receiving a credit against its debt. Note that a non-recourse creditor loses its unsecured deficiency claim (and the right to vote such deficiency claim) under Section 1111(b) if the collateral is sold under Section 363 or under a plan.

c. Indubitable Equivalent.

Finally, a secured creditor may be crammed down if the plan provides that the creditor will realize the “indubitable equivalent” of its secured claim. The term “indubitable equivalent” is not defined in the Bankruptcy Code. The concept of indubitable equivalence permits the rights of a secured creditor to be modified by a plan if the rights the creditor receives under the plan are exactly identical to the rights it had immediately prior to the confirmation. Many cases have provided that “dirt for debt” provides the indubitable equivalent.<sup>24</sup> Most courts are very strict in interpretation of this provision and the burden is on the proponent to prove that any modification provides the secured creditor with the realization of the indubitable equivalent.

2. Unsecured Creditors

A plan may be confirmed over the objection of a class of unsecured creditors if the plan provides that each unsecured creditor will receive or retain on account of such claim property of a value, as of the effective date of the plan, equal to the allowed amount of such claim, or the holder of any claim or interest that is junior to the claims of such class will not receive or retain any property under the plan on account of such junior claim or interest.<sup>25</sup>

A plan that provides for payment in full to unsecured creditors may be confirmed over the objection of an unsecured class as long as the proponent can prove that the proposed payment or property to be transferred has a value, as of the effective date of the plan, equal to the full allowed amount of such claim. This does not mean that the unsecured creditor must be paid cash in full. Rather, the proposed stream of payments or transfer of property under the plan must have a value equal to the full allowed amount of such claims. In order to comply with this section, a valuation of the property or assets to be transferred to the class of unsecured creditors is required. The proponent must prove that the value of the property to be transferred to the unsecured creditors has a value equal to the allowed amount of such claim. Thus, a promissory note with an appropriate interest rate which proposes to pay the unsecured creditors in full should satisfy the provisions of this subsection.

Unfortunately, very few financially-distressed debtors are able to propose a feasible plan that pays unsecured creditors in full. Therefore, the majority of plans contain provisions to pay unsecured creditors little, if anything, under the reorganization. Nevertheless, such a plan may be confirmed if it satisfies all the requirements of Section 1129(a) (except (a)(8)) and the holder

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<sup>24</sup> *In re Sandy Ridge*, 881 F.2d 1346 (5th Cir. 1989).

<sup>25</sup> 11 U.S.C. § 1129(b)(2)(B).

of any claim or interest that is junior to the claims will not receive or retain under the plan on account of such claim or interest any property. This is known as the “absolute priority rule.” The absolute priority is set forth in Section 1129(b)(2)(B)(ii).

The absolute priority rule provides a dissenting class with an absolute right to veto a plan of reorganization if the plan proposes less than full payment to an unsecured class and allows any junior creditor or interest holder to receive or retain any property under the plan. The absolute priority rule expressly forbids a junior creditor or interest holder to receive any property, irrespective of value, on account of such claim or interest unless unsecured secured creditors are paid in full. Thus, a plan that simply proposes a 20% dividend to unsecured creditors and allows shareholders to retain ownership of the stock cannot be confirmed over the objection of a dissenting class because it violates the absolute priority rule. A plan that violates the absolute priority rule per se is not “fair and equitable.” It is immaterial that the property retained by a junior creditor or interest holder is of no value.<sup>26</sup>

Many courts have held that the absolute priority rule is subject to an exception derived from the Supreme Court holding in *Case v. Los Angeles Lumber Products, Inc.*<sup>27</sup> The exception, known as the “new value exception” provides that even if senior classes are not paid in full, a junior interest holder or creditor may receive or retain property under the plan if he makes a substantial and necessary contribution of new equity to the debtor. *Los Angeles Lumber* provides that a shareholder may participate in the reorganization so long as the shareholder makes a contribution “in money or money's worth” that is essential to the debtor's reorganization efforts and is reasonably equivalent to the value of the distributions received. This exception, therefore, permits confirmation of a plan that provides for distributions to junior interest holders or creditors even though unsecured claims are not being paid in full.<sup>28</sup>

In *Bank of America Nat'l Trust and Savings Ass'n v. 203 North LaSalle Street Partnership*,<sup>29</sup> the Supreme Court determined that it must be shown that old equity holders did not acquire new equity at a price that failed to provide the greatest possible addition to the bankruptcy estate as a result of their prior position as equity holders. The Supreme Court especially was concerned that the old equity holders' prior position did not in any way permit them to obtain an ownership interest for less than someone else would have paid. In order to satisfy this requirement, the Court recommended the use of competing bids or competing plans or other market mechanisms. In other words, new value plans which provide old equity holders with opportunities free from competition and without benefit of market valuation fall within the prohibition of §1129(b)(2)(B)(ii).

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<sup>26</sup> *In re Bryson Properties, XVIII*, 961 F.2d 496 (4th Cir. 1992), cert. denied, 113 S.Ct. 191 (1992).

<sup>27</sup> 308 U.S. 106, (1939).

<sup>28</sup> See *In re U.S. Truck Company*, 800 F.2d 581; *In re Bonner Mall Partnership*, 2 F.3d 899; *In re Bryson Properties*, 961 F.2d 496 (4th Cir. 1992). The contribution may not be “sweat equity.” See *Norwest Bank v. Ahlers*, 485 U.S. 197 (1988).

<sup>29</sup> 526 U.S. 434 (1999).

## **Reverse Cramdown as an Additional Exception to the Absolute Priority Rule**

Another way that debtors have attempted to tackle the absolute priority rule is through the concept of reverse cramdown, which, as stated above, finds its modern origins in the *SPM* case. *SPM* involved a Chapter 11 debtor whose creditors consisted of: (1) Citizens Savings Bank, owed approximately \$9 million, secured by perfected security interests in substantially all of SPM's assets; (2) the IRS, owed priority withholding taxes of approximately \$750,000; and (3) general unsecured creditors, owed approximately \$5.5 million. Citizens and the committee worked together to remove SPM's management. Citizens and the committee agreed that Citizens would share with the unsecured creditors any proceeds they received as a result of the reorganization or liquidation of SPM. Ultimately, SPM's assets were sold for \$5 million and the case was converted to a Chapter 7 liquidation.

The bankruptcy judge ruled that the distribution of the sales proceeds in accordance with the sharing agreement violated the priority scheme of the Bankruptcy Code.<sup>30</sup> The bankruptcy judge ordered Citizens to pay the amount it had agreed to share with the unsecured creditors to the trustee to administer the proceeds in accordance with the Bankruptcy Code provisions concerning priority for tax claims.<sup>31</sup>

The First Circuit reversed. The First Circuit found that Citizens held a valid lien securing a \$9 million debt on all of the SPM assets, which were sold for \$5 million and noted that the bankruptcy court allowed Citizens' secured claim in that amount. The First Circuit reasoned that absent the order, the entire \$5 million belonged to Citizens in satisfaction of its lien, leaving nothing for the estate to distribute to the other creditors, including the I.R.S. The First Circuit held that ordinarily, in such circumstances, the distributional priorities of sections 726 and 507 would have been mooted.<sup>32</sup> The First Circuit stated that it was "hard to see how the priority creditors lost anything owed them given the fact there would have been nothing left for the priority creditors after the \$5 million was distributed to Citizens." The First Circuit concluded that "creditors are generally free to do whatever they wish with the bankruptcy dividends they receive, including to share them with other creditors," and "the bankruptcy court has no authority to control how Citizens disposes of the proceeds once it receives them."<sup>33</sup>

## **Chapter 11 Cases Applying the *SPM* Reasoning**

*SPM* was not a Chapter 11 plan confirmation case. Nonetheless, several courts relied on *SPM* to allow reallocation of a secured creditors' collateral to stockholders or other junior stakeholders notwithstanding payment of less than the full value of the claims of creditors in intermediate classes.

In *In re MCorp Financial, Inc.*,<sup>34</sup> the United States District Court for the Southern District of Texas confirmed liquidating chapter 11 plans that provided for distributions of a

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<sup>30</sup> 984 F.2d at 1309.

<sup>31</sup> 984 F.2d at 1310.

<sup>32</sup> 984 F.2d at 1312.

<sup>33</sup> 984 F.2d at 1313.

<sup>34</sup> 160 B.R. 941 (S.D. Tex. 1993).

portion of the senior bondholders' potential recoveries to the FDIC in settlement of complex litigation. In *MCorp*, the debtors owed approximately \$354 million to senior bondholders and approximately \$134 million to junior bondholders. The debtors were involved in multiple lawsuits with the FDIC in which the FDIC originally claimed damages against the debtors in excess of \$800 million. Filed claims against the debtors totaled approximately \$4.0 billion. The debtors' liquidating plans, which were supported by all voting classes except the junior bondholders, provided for payment of approximately 9% of the FDIC's asserted claims. Under the settlement, as incorporated into the plan, the payment to the FDIC was to be funded by the senior bondholders' distribution from estate assets. Junior bondholders were to receive distributions equal to approximately 5% of their claims. The junior bondholders argued that the settlement, as incorporated into the debtors' plans, violated the absolute priority rule. Without limitation, the junior bondholders asserted that the plan could not be confirmed because the FDIC's claim was junior to their claim, and the FDIC was to receive a distribution before the junior bondholders received payment in full.

The court confirmed the plan over the junior bondholders' objection, holding that it was unnecessary to consider priority issues.<sup>35</sup> The court held that even if one were to assume that the FDIC's claim was inferior to the claims of the junior bondholders, the FDIC was being paid by the senior bondholders out of their clearly higher-priority share of estate proceeds.<sup>36</sup> The court stated that the senior bondholders could share their proceeds with creditors junior to the junior bondholders, as long as the junior bondholders continued to receive at least as much as they would have without the sharing.<sup>37</sup> Citing *SPM*, the court held that the senior bondholders' priority status over the junior bondholders allowed the senior bondholders to allocate their distributions as they wished.<sup>38</sup>

In *In re Genesis Health Ventures*,<sup>39</sup> the United States Bankruptcy Court for the District of Delaware confirmed a chapter 11 plan that provided for distributions of new common stock to existing management that certain objecting parties argued was violative of the absolute priority rule.<sup>40</sup> In *Genesis Health Ventures*, the debtors' secured lenders were owed approximately \$1.6 billion, and the indebtedness was secured by liens on essentially all of the debtors' assets. The debtors' plan provided that the secured lenders would receive cash, new notes, new preferred stock and new common stock in the reorganized company. General unsecured creditors and senior subordinated debt were to receive new common stock. Finally, management would receive new common stock and options to purchase additional stock. The debtor characterized the distributions to management as consideration for continued employment. However, the objecting parties contended, and the court agreed, that the distributions "border[ed] on payments to management on account of their pre-petition equity interests."<sup>41</sup>

The court noted that, absent the facts of this particular case, the allocation of stock and options to management might violate the absolute priority rule, given the relatively small

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<sup>35</sup> 160 B.R. at 960.

<sup>36</sup> *Id.*

<sup>37</sup> *Id.*

<sup>38</sup> *MCorp*, 160 B.R. at 960.

<sup>39</sup> 266 B.R. 591.

<sup>40</sup> 266 B.R. at 620-21.

<sup>41</sup> *Id.* at 617.

dividend proposed to be paid to unsecured creditors, and the extinguishment of equity interests otherwise.<sup>42</sup> The court held, however, that the issuance of stock and warrants to management represented an allocation of enterprise value otherwise distributable to the secured lenders, which the secured lenders agreed to offer to management as an incentive to remain and effectuate the debtors' reorganization.<sup>43</sup> The court concluded, therefore, that because the secured lenders were free to allocate such enterprise value without violating the "fair and equitable" requirement of the Bankruptcy Code, the plan was due to be confirmed.<sup>44</sup>

### **Armstrong World**

In the *Armstrong* bankruptcy case, as summarized in the *Armstrong* district court opinion,<sup>45</sup> the debtors negotiated a plan of reorganization with the official committees, and the future asbestos claimants' representative. The reorganization plan provided, in pertinent part, that Armstrong World Industries, Inc. ("AWI") would distribute \$1.8 billion in value to a trust established pursuant to §524(g) of the Code to satisfy claims of all present and future asbestos creditors (Class 7). General unsecured creditors (Class 6), represented by the unsecured creditors' committee, would receive approximately 59.5 percent of the value of their claims. Class 12, consisting of Armstrong Worldwide Inc. ("AWWD"), AWI's parent, would receive \$35-40 million in warrants to purchase equity in reorganized AWI. However, in the event that the unsecured creditors in Class 6 rejected the plan, those warrants would be distributed to the asbestos claimants in Class 7, who would automatically waive receipt, and the warrants would be issued to AWWD, the existing Class 12 holder of the equity interests.

After the bankruptcy court had established a voting deadline for the plan, the creditors' committee withdrew their support for the plan. Then, when the class of general unsecured creditors failed to accept the plan by the requisite majorities specified in Code § 1126(c), the creditors' committee objected to confirmation of the plan, arguing that the plan did not satisfy Section 1129(b) of the Bankruptcy Code. The creditors' committee argued that the plan violated the absolute priority rule because the plan proposed to distribute warrants to purchase common stock in the reorganized debtor to the junior class of equity interest holders, in apparent violation of Section 1129(b)(2)(B)(ii).

The debtor argued that the court could nonetheless confirm its plan of reorganization. Citing *SPM*, the debtor argued that "notwithstanding the text of Section 1129(b)(2)(B)(ii), the Asbestos P[ersonal injury] Claimants may share their proposed distribution with the Equity Holders without violating the absolute priority rule."<sup>46</sup> Without limitation, the debtor asserted that under the plan the debtor would rely upon an *SPM* distribution-sharing argument for confirmation. Without limitation, in the event of a rejection by the class of general unsecured creditors, warrants would be issued to asbestos personal injury claimants, who were deemed to have waived their right to the warrants that were to be issued to equity holders.<sup>47</sup> The debtor

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<sup>42</sup> *Id.*

<sup>43</sup> *Id.* at 617-18.

<sup>44</sup> *Id.* at 618.

<sup>45</sup> *In re Armstrong World Industries, Inc.*, 320 B.R. 523 (D. Del. 2005).

<sup>46</sup> *Armstrong World*, 320 B.R. at 537.

<sup>47</sup> 320 B.R. at 526 & n.8.

asserted that such an arrangement in chapter 11 was consistent with the holdings in *MCorp* and *Genesis Health Ventures*. The bankruptcy court approved the plan as proposed.

The district court, however, rejected the notion that a distribution-sharing exception to the absolute priority rule existed. The district court held that “to the extent that *In re WorldCom*, *In re Genesis Health Ventures*, and *In re MCorp Financial* read *SPM* to stand for the unconditional proposition that ‘[c]reditors are generally free to do whatever they wish with the bankruptcy dividends they receive, including sharing them with other creditors, so long as recoveries received under the [p]lan by other creditors are not impacted,’ without adherence to the strictures of 11 U.S.C. § 1129(b)(2)(B)(ii), that contention is flatly rejected here.”<sup>48</sup>

The district court, applying what it described as the plain meaning of section 1129 of the Bankruptcy Code, held that the plan violated the absolute priority rule because it permitted a distribution to a junior class of creditors over the objection of a senior impaired and non-accepting class.<sup>49</sup> The district court held that the legislative history of section 1129 restricted the ability of unsecured creditors to bypass a dissenting intervening class and hand over their distributions to a junior class.<sup>50</sup> The district court rejected the “‘unconditional proposition’ that creditors are generally free to do whatever they wish with the bankruptcy dividends they receive, including sharing them with other creditors.”<sup>51</sup>

On appeal, AWI raised two issues with respect to the applicability to the plan of 11 U.S.C. § 1129(b)(2)(B): (1) whether the issuance of warrants to AWWD violated the absolute priority rule; and (2) whether an equitable exception to the absolute priority rule applied in the circumstances of the AWI asbestos bankruptcy case. The United States Court of Appeals for the Third Circuit affirmed the district court.<sup>52</sup> The Court of Appeal rejected AWI’s contention that §1129(b)(2)(B) of the Bankruptcy Code was intended by Congress to protect only “intermediate” classes of unsecured creditors. The Court of Appeals held that the plain language of that section precluded the distribution of warrants to AWWD over the objection of the unsecured creditors in Class 6, reasoning that “the plan would give property to Class 12, which has claims junior to those of Class 6.”<sup>53</sup>

Adopting the district court’s reasoning, the Court of Appeals distinguished those cases cited by AWI for the proposition that a creditor class can transfer some of its recovery to a junior class without violating § 1129(b) of the Code finding that those cases did not “stand for the unconditional proposition that creditors are generally free to do whatever they wish with the bankruptcy proceeds they receive.”<sup>54</sup> Noting that the structure of the plan ensured that Class 12 received the warrants regardless of whether Class 6 consented, the court held that “[a]llowing this particular type of transfer would encourage parties to impermissibly sidestep the carefully

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<sup>48</sup> 320 B.R. at 539-40.

<sup>49</sup> *Id.* at 536.

<sup>50</sup> *Id.* at 536-37.

<sup>51</sup> *Id.* at 540.

<sup>52</sup> *In re Armstrong World Industries, Inc.*, 432 F.3d 507, 518 (3<sup>rd</sup> Cir. 2005).

<sup>53</sup> 432 F.3d at 513.

<sup>54</sup> *Id.* at 514.

crafted structures of the Bankruptcy Code and would undermine Congress' intention to give unsecured creditors bargaining power in this context.”<sup>55</sup>

The Court of Appeals then addressed AWI's argument that Class 12 was receiving the warrants in settlement of AWD's intercompany claims, and not “on account of” its equity interests, the latter of which would violate §1129(b)(2)(B)(ii). Although acknowledging “that there are some cases in which property can transfer to junior interests not ‘on account of’ those interests but for other reasons,” the Court of Appeals found that the AWI plan was not one of those cases.<sup>56</sup> The Court of Appeals noted that under the plan, AWD would get warrants worth \$35-40 million, among other considerations, in exchange (according to AWI's argument) for the release of a \$12 million intercompany claim. Because the debtor did not adequately explain why there was such a substantial difference in value, the Court of Appeals concluded that the warrants would be received on account of AWD's status as equity-holder in violation of the absolute priority rule.<sup>57</sup>

The Court of Appeals rejected AWI's argument that an equitable exception to the absolute priority rule should be applied under *In re Penn Central Transportation Co.*,<sup>58</sup> in which the Third Circuit held, in the context of resolving what was then “the most complex set of interrelated and conflicting claims ever addressed under... the Bankruptcy Act,” that the absolute priority rule “must necessarily take account of the unique facts of this plan and proceed in an environment pervaded more by relativity than by absolutes.”<sup>59</sup> The Court of Appeals, however, held that a “bankruptcy due to asbestos liabilities simply does not involve the kind of exigent circumstances” required to cast aside the absolute priority rule.<sup>60</sup>

Finally, the Court of Appeals held that the unsecured creditors' committee was not estopped from objecting to the plan in anticipation of the possible enactment of the FAIR Act.<sup>61</sup> The Court of Appeals held that the committee was free to file an objection at any time prior to the objection deadline, notwithstanding that it was premised, in part, upon the possible passage of FAIR. The Court of Appeals concluded that the unsecured creditors' committee's objection also was based on an alleged violation of the absolute priority rule, which outweighed any concern that the objection was based “on speculation that legislation will be passed.”<sup>62</sup>

### **The Effect of *Armstrong* on Reverse Cramdown – What Options are Left?**

Obviously, the *Armstrong* decision represents a potential obstacle to formulating and confirming a plan of reorganization in certain circumstances. However, the district court in *Armstrong* affirmatively distinguished a number of scenarios which it considered inapposite, including *SPM*.<sup>63</sup> The district court held that *SPM* was inapposite because *SPM* involved the

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<sup>55</sup> *Id.* at 514-15.

<sup>56</sup> *Id.* at 515.

<sup>57</sup> *Id.*

<sup>58</sup> 596 F.2d 1127, 1142 (3<sup>rd</sup> Cir. 1979).

<sup>59</sup> 596 F.2d at 1142.

<sup>60</sup> 432 F.3d at 517.

<sup>61</sup> *Id.* at 518.

<sup>62</sup> *Id.*

<sup>63</sup> 320 B.R. at 538.

agreement by a secured creditor, rather than unsecured creditors, to share distribution with a junior class and because the arrangement was consummated outside of a chapter 11 plan.<sup>64</sup> The district court stated that the arrangement in *SPM* could be construed as a “carve-out” pursuant to which a party secured by all or some of the assets of the estate agrees to allow some portion of its lien proceeds to be paid to others. This distinction is important for plan proponents, as it suggests that one of the primary reasons for the district court’s denial of confirmation was the fact that the plan dealt with “sharing” between an unsecured class and equity holders. The implication is that the court might have permitted a carve-out of a secured creditor’s collateral that otherwise would not have been available for distribution to unsecured creditors or equity holders. The district court’s reasoning is consistent with the Bankruptcy Code itself, as different standards apply to secured creditors and unsecured creditors under the fair and equitable test in Section 1129(b).<sup>65</sup>

The district court in *Armstrong* distinguished *Genesis Health Ventures* in a similar manner, holding that *Genesis Health Ventures* involved a voluntary carve-out of from a secured creditor’s liens.<sup>66</sup> The district court distinguished *MCorp* on grounds that *MCorp* involved a settlement of pre-petition litigation.<sup>67</sup> The analysis in *Armstrong*, therefore, leaves open the possibility for a reverse cramdown plan in which a **secured** creditor agrees to a carve-out for equity or lower priority unsecured creditors, as well as the possibility of obtaining a settlement of competing claims and interests pursuant to Bankruptcy Rule 9019 outside of a chapter 11 plan.

Moreover, Section 1125(g) of the Bankruptcy Code expressly permits pre-petition solicitation of plan support so long as such solicitation complies with applicable non-bankruptcy law. One by-product of *Armstrong*, therefore, may be that plan proponents will engage in a more comprehensive pre-petition effort to reach consensus among stakeholders, including a debtor’s major unsecured creditors, to avoid the implications of Section 1129(b) altogether. A pre-bankruptcy plan support agreement among secured creditors, major unsecured creditors, and equity holders could be assumed by the debtor, after notice and hearing, in the early stages of the case. In cases where the debtors’ assets are fully encumbered, reasonable unsecured creditors, if fully and properly educated on the effect of a chapter 7 liquidation on their claims, might be persuaded to commit to the plan early.

### Conclusion

Because, the *Armstrong* case seems to distinguish secured creditor plan carve-outs from unsecured creditor sharing agreements, debtors still should have some flexibility in crafting a chapter 11 plan that provides for distributions of fully encumbered assets among unsecured creditors and equity holders. If anything, the *Armstrong* case, coupled with the outer limits on exclusivity under the Act, underscores the importance of intensive pre-bankruptcy planning and negotiations with the major players in the debtor’s potential case.

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<sup>64</sup> *Id.* at 538-39.

<sup>65</sup> See pages 7-9, *supra*.

<sup>66</sup> 320 B.R. at 539.

<sup>67</sup> *Id.*