SPM AND ITS PROGENY: AN EXAMINATION OF "GIFTS" TO SUBORDINATE CLASSES OF CREDITORS IN SETTLEMENT OF (ACTUAL OR THREATENED) LITIGATION

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Ted Gavin, CTP [1]
NachmanHaysBrownstein, Inc.
Wilmington, DE

When discussing the potential claims or causes of action which might vest to an Official Committee appointed in a Chapter 11 case, one must also consider the treatment of the potential spoils of war. Inasmuch as those spoils must somehow get to whatever party brought the action, be they an Official Committee of Unsecured Creditors (hereafter referred to generally as the "Committee"), another statutorily-appointed Committee, a random group of officious meddlers[2] or some other party vested with litigation rights, this often requires direction of funds from a litigation target (most often, the pre-petition secured lender) to the litigants, often in bypassing one or more intervening classes of creditors. This is both intuitive and counter-intuitive – after all, the absolute priority rule[3] dictates the order in which estate assets may be distributed, while it goes without saying (and yet, it's being said here) that a litigant rarely, if ever, sues solely for the pecuniary benefit of a senior class of creditors. The "gift" or "SPM gift" is the remedy to the structural impediment that exists in the strict adherence to the Bankruptcy Code's priority scheme.

[1] The author wishes to disclose that he had or has personal involvement in some of the cases to be discussed herein.
[2] Quoting Thomas J. Salerno, Esq; American Bankruptcy Institute Litigation Skills Symposium, 2009
[3] 11 U.S.C. §1129(b)(2)(B)

In the Beginning – the "SPM line of cases"

The constructs and general acceptance of the use of a secured creditors "gifting" to unsecured creditors some of the proceeds of the liquidation of its collateral were established through a series of decisions in what has become known as the "SPM line of cases" ("SPM"), which are, more specifically:

- Official Committee of Unsecured Creditors v. Stern (In re SPM Mfg. Corp, 984 F.2d 1305 (1st Cir. 1993);
- In re WorldCom, Inc., No. 02-13533, 2003 Bankr. LEXIS 1401, at *179 (Bankr. SDNY. Oct 31, 2003);
- In re Genesis Health ventures, Inc. 266 B.R. 591 (D. Del 2001), and;
- In re MCorp financial, Inc., 160 B.R. 941 (S.D. Tex 1993).

The decisions in these cases established that a secured lender has *"a substantive right to dispose of its property, including the right to share the proceeds subject to its lien with other classes."* [4] As such, practice has become that a Committee seeking redress reaches a proposed settlement with its target, then presents the settlement to the Court for approval pursuant to Rule 9019 [5].

In 2005, the Third Circuit ruled in *In re Armstrong World Industries* [6] that the provisions of the *Armstrong* plan violated the absolute priority rule as codified in 11 U.S.C. §1129(b) and held that the plan of reorganization that was the subject of controversy could not be confirmed. While this ruling brought into doubt the future of SPM gifts as remedies for Committee litigation, this doubt was unfounded and has been proven wrong in actual practice. While much discussion has occurred as to why

[4] In re Armstrong World Indus., Inc. 432 F. 3d 507 (3d Cir. 2005); (Armstrong, 320 B.R., at 539).
[5] Fed. R. Bankr. P. 9019, which reads, in part, "(a) On motion by the trustee and after notice and a hearing, the court may approve a compromise or settlement...(b) After a hearing on such notice as the court may direct, the court may fix a class or classes of controversies and authorize the trustee to compromise or settle controversies within such class or classes without further hearing or notice.
[6] In re Armstrong World Indus., Inc. 432 F. 3d 507 (3d Cir. 2005)

the circumstances in Armstrong are different from, and irrelevant to, the SPM cases, here we reduce the key differences to the following points:

1. SPM does not have to be and, generally, should not be, in the context of a Chapter 11 Plan - *Armstrong* was in the context of a Chapter 11 plan, where §1129 applies;
2. SPM deals with the distribution of property of the secured lender – Armstrong dealt with the distribution of property of the Debtors' estate;
3. SPM is a settlement between one or more parties that are direct parties to the controversy at hand – *Armstrong* dealt with redistribution of assets of one class to another, based on the actions of a third, uninvolved, class, and;
4. SPM is a distribution of cash in settlement of causes of action – *Armstrong* was a distribution of assets in a manner that was punitive to one class for the actions of another class.

The crux of the problem addressed in *Armstrong* was that the proposed plan provided for the distribution of warrants to Armstrong's direct/indirect parent companies and equity interest holders (Class 12) through a class of asbestos personal injury claimants (Class 7) if unsecured creditors (Class 6) rejected the plan. See Armstrong, 432 F.3d at 509. In other words, if Class 6 rejected the plan, Class 7 would get the warrants, but would immediately waive receipt of the warrants, and the warrants would issue to Class 12. See *id*. Classes 6 and 7 shared the same priority under the Bankruptcy Code, and both classes were senior in priority to Class 12. See *id*. Unsurprisingly, Class 6 voted to reject the plan. See *id*. at 510.

SPM Lives On – Post Armstrong Applications

Subsequent to the Third Circuit's decision in Armstrong, the first case in which a gift to unsecured creditors outside of the absolute priority rule was proposed was *In Re World Health Alternatives*, et al [7]. This case both continued the precedent of SPM but also further developed the basis by which settlements were appropriate and further defined exactly whom an Official Committee of Unsecured Creditors represents. The settlement, presented in the form of a Rule 9019 compromise

[7] Case No. 06-10166 (PJW); Bankr. D. Del (2006)

between the Committee, Debtor and CapitalSource (the Debtors' pre- and post-petition secured lender) provided a fixing of CapitalSource's liens and a distribution to unsecured non-priority creditors of $1.6 million, which bypassed in excess of $10 million of unsecured priority claims arrayed across the Debtor's five operating entities. As established in the two hearings held on this settlement, the only party objecting to the settlement was the United States Trustee ("UST") – none of the priority creditors objected. The basis of the UST's objection was that the settlement violated the absolute priority rule, stating:

> *"The recent ruling by the United States Court of Appeals for the Third Circuit in In re Armstrong World Industries, Inc. unequivocally stands for the general proposition that the provisions of chapter 11 of the Bankruptcy Code prohibit secured creditors from distributing the proceeds of their alleged collateral to "general" unsecured creditors at the expense of a group of priority creditors (in these cases, primarily taxing authorities). Through the Settlement, the moving parties propose an exchange similar to the proposed transfer that was rejected in Armstrong."*

Additionally, the appropriateness of the settlement was called into question, which echoes some of the concerns voiced in this panel – that in this time of abbreviated investigation periods and limited investigation resources, can *any* settlement reached this early in a case be properly determined by an informed party to be of fair value if it is ***not reasonable to expect that the determining parties are truly and fully informed***? Finally, the court considered whether the Official Committee of Unsecured Creditors owed a fiduciary obligation to the unsecured non-priority tax creditors who were being bypassed under the instant settlement.

In hearing testimony and considering the facts presented, the Court determined first that the settlement must be appropriate [8]:

> *Appropriateness of the settlement is derived by the Court: "the court does not have to be convinced that the settlement is the best possible compromise." In re Coram Healthcare Corp., 315 B.R. 321, 330 (Bankr. D. Del. 2004) (citing Nellis v. Shugrue, 165 B.R. 115, 123 (S.D.N.Y. 1994)). Rather, the court must conclude that the settlement is "within the reasonable range of litigation possibilities." In re Penn Cent. Transp. Co., 596 F.2d 1102, 1114 (3d Cir. 1979); see In re W.T. Grant Co., 699 F.2d 599, 608 (2d Cir. 1983)(stating that the responsibility of the bankruptcy judge is "not to decide the numerous questions of law and fact raised" by the objections, "but rather to canvass the issues and see whether the settlement falls*

[8] Memorandum Opinion, DI 496

> *below the lowest point in the range of reasonableness." (internal quotations and alteration omitted)).*

The court ultimately determined that the settlement was fair and appropriate and that *Armstrong* did not apply (*Id)*. In its Memorandum Opinion, the Court further clarified that the duty of the Official Committee of Unsecured Creditors was solely to unsecured non-priority creditors, and that the unsecured priority creditors were not a constituent of that committee.

This was a pyrrhic victory, however. The UST appealed the Court's ruling to the District Court and the case was converted to Chapter 7. To settle the litigation and exit the case, CapitalSource paid the settlement funds to the Debtors' estate upon conversion of the case. Subsequently, the Chapter 7 case used those funds for the administration of the estates, which have been alleged to be administratively insolvent and thus, none of the settlement proceeds will likely be available for unsecured creditors as was intended.

Making Lemonade from Lemons – Preparing for the issue of Conversion

Subsequent to *World Health* and in response to the repeated objections of the UST to these "gift" settlements, more recent settlement structures have sought to cure the deficiencies that have plagued earlier settlements post-*Armstrong* – namely, how to keep the proceeds from the reach of a subsequently appointed Chapter 7 trustee and how to prevail over objections as to the absolute priority rule issues that occasionally continue to muddy the waters as to these settlements. Two recent examples provide insightful instruction as to what may be the easiest path to resolution of these issues.

In *Avado Brands* [9], the Committee reached a settlement with the pre-petition secured lender, DDJ Capital Management, LLC ("DDJ"). DDJ was to acquirer the Debtor's assets through a credit bid in the amount of $21,050,000 and also acquired the Debtors' litigation rights for a credit bid in the amount of $2,000,000. This settlement, offered as a Rule 9019 settlement between the parties, allowed for a release of any potential Committee claims against DDJ in exchange for payment to unsecured creditors in the amount of a percentage of the recoveries realized by DDJ from its pursuit of the litigation, for which it

[9] *In re Avado Brands et al,* Case No. 07-11276 (MFW), Bankr. D. Del (2007)

purchased the rights from the Debtor. The mechanism by which the funds would transfer to the beneficiaries was a Trust, formed as a liquidating grantor trust for whom the beneficiaries of which were the holders of allowed unsecured non-priority claims against the Debtors' estates. In funding the settlement proceeds directly to the trust, DDJ provided both an amount of cash to fund the trust's administration as well as the litigation proceeds upon resolution of the litigation in a manner that bypassed the Debtors' estates. As DDJ purchased the litigation rights, the proceeds of that litigation were never property of the Debtors' estates. As the funds never passed through the Debtors' estates, and were never property of the Debtors' estates, these settlement funds would notionally be free from the reach of a Chapter 7 trustee, and irrelevant as to the application of the absolute priority rule.

In a slightly more recent case, the Committee in the *NetVersant* [10] case, the Committee reached settlement with Patriarch Partners Agency Services ("PPAS"), the Debtors' pre- and post-petition secured lender and the winning bidder for the Debtors' assets by virtue of a credit bid. The settlement provided for a cash gift to unsecured creditors, which was paid directly from PPAS to the General Unsecured Creditors Trust (the "GUC Trust") without the funds ever becoming the property of the Debtors estates. The Court's order approving the settlement agreement provided for establishment of a $50,000 reserve account under control of the GUC Trust for the purposes of funding a Chapter 7 trustee's efforts, to be paid to the Chapter 7 trustee upon request. Subsequent to the Court's approval of the settlement, the interim Chapter 7 trustee has confirmed that the funds held by the trust are not property of the Chapter 7 estate, which appears, on its face, to confirm that the revised structure embodied in the Avado Brands and NetVersant cases, among others, appears to work in upholding the intent of the settlements reached.

<u>Conclusion</u>

What, then, are the key points to remember when determining how best to take the settlement reached and ensure that it gets to the parties as intended? Here, we conclude with a few basic points to be considered in determining the optimal structure. This list is by no means exhaustive.

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[10] In re NetVersant Solutions, Inc. (now titled NVS Liquidating, Inc.) Case No. 08-12973 PJW; Bankr. D. Del (2008)

1. Be mindful of the fact that SPM settlements generally work best under a Rule 9019 settlement, whereas embodiment of such a settlement into a Plan may violate the absolute priority rule and fall squarely in the domain of *Armstrong*;
2. The settlement must be between all of the parties that will be affected and should generally avoid imposing terms on uninvolved third parties (such as was done in *Armstrong*);
3. If the settlement funds are to be used as an "investment" (i.e., to pursue causes of action that could result in additional proceeds inuring to the party bringing the action), it must be clearly determined who owns those causes of action. If and where possible, the settling party should purchase those causes of action from the Debtor's estate, and;
4. If the settlement funds "touch" the Debtor's estate on their way to the beneficiaries of the settlement, this may prove to be a fatal act at some point down the line. Those settlements which have withstood both objection and post-conversion challenge had the funds paid directly to the beneficiaries (or a Trust in their favor) directly from the settling party without the Debtor as intermediary.

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