CLEARY GOTTLIEB Alert Memo

NEW YORK FEBRUARY 9, 2011

www.clearygottlieb.com

In re DBSD North America, Inc.: Second Circuit rules that gifting doctrine violates the absolute priority rule

On February 7, 2011, in In re DBSD North America, Inc. ("DBSD"),[1] the United States Court of Appeals for the Second Circuit held it was error for the bankruptcy court to confirm a Chapter 11 plan that provided for a "gift" from the debtor's undersecured second-lien noteholders to the debtor's existing equityholder.[2] The Second Circuit found that the gifting provision contained in the plan violated section 1129(b)(2)(B) of the Bankruptcy Code, because the existing equityholder was to receive a distribution under the plan on account of its equity interests, even though a dissenting senior class of unsecured creditors was not receiving payment in full of its allowed claims.

I. In re DBSD North America, Inc.

In DBSD, the debtor, a telecommunications company, proposed a Chapter 11 plan that, among other things, provided that: (i) the noteholders (the debtor's largest creditors with claims of approximately $740 million) would receive in satisfaction of their claims shares issued by the reorganized debtor (estimated to be worth approximately 51% to 73% of the noteholders' allowed claims); (ii) the debtor's general unsecured creditors, which included Sprint Nextel Corp., would receive shares in the reorganized debtor (estimated to be worth approximately 4% to 46% of the general unsecured creditors' allowed claims and which represented just 0.15% of the equity in the reorganized debtor); and (iii) the existing equityholder would receive shares in the reorganized debtor (representing 4.99% of the equity in the reorganized debtor) and warrants to purchase additional shares. The class of general unsecured claims to which Sprint belonged rejected the plan. Sprint objected to the debtor's plan, arguing, among other things, that the plan violated the "absolute priority rule" set forth in section 1129(b)(2)(B) of the Bankruptcy Code.[3] The U.S. Bankruptcy Court for

---

1 No. 10-1175, 2011 WL 350480 (2d Cir. Feb. 7, 2011).

2 In its opinion, the Second Circuit also addressed whether it was appropriate for the bankruptcy court to designate the vote on the plan of a creditor that was a competitor of the debtor as not being exercised in good faith. This alert memorandum does not address that portion of the Second Circuit's opinion.

3 Section 1129(b)(2)(B) of the Bankruptcy Code partially codifies the common law doctrine known as the absolute priority rule. In its purest form, the common law absolute priority rule required that if a creditor's claim was not satisfied in full, an equityholder could not receive or retain any property in a debtor's reorganization. Section 1129(b)(2)(B) of the Bankruptcy Code provides that if an impaired

the Southern District of New York confirmed the debtor's plan and overruled Sprint's objection. The bankruptcy court reasoned that the existing equityholder's receipt of stock and warrants under the plan did not run afoul of the absolute priority rule, because the distribution was a gift from the noteholders who were undersecured and, absent the gift, Sprint and other creditors in Sprint's class would not receive any greater distribution from the debtor's estate than they were already receiving under the plan. Sprint appealed. The district court affirmed the bankruptcy court.

"Gifts" Under a Plan from Undersecured Creditors to Equityholders Violate the Absolute Priority Rule Where a Senior Class of Creditors Rejects the Plan and Does Not Receive Full Payment on its Claims

The Second Circuit began its discussion of gifting by reviewing the history behind the absolute priority rule. The Court noted that the absolute priority rule was promulgated by the Supreme Court in 1913 in response to the practice of senior creditors and existing equityholders cooperating to control the reorganization of the debtor, which often resulted in existing equityholders receiving or retaining some stake in the reorganized entity and junior creditors receiving nothing.

Next, the Second Circuit examined the plain language of section 1129(b)(2)(B) and found that such section was implicated by the gifting provision in the plan. First, the existing equityholder received property (i.e., stock and warrants) "under the plan," because the gift from the noteholders to the existing equityholder was contained in the plan. Accordingly, the Second Circuit noted that it need not decide whether the Bankruptcy Code would permit the existing equityholder and the noteholders to agree to transfer shares outside of the plan. Second, the plan expressly provided that the existing equityholder was receiving stock and warrants in the reorganized debtor "on account of" its junior interests in the debtor. The bankruptcy court had explained that the gift from the noteholders was being made to assure the existing equityholder's cooperation with respect to the plan. The Court responded that cooperation was only useful because of the existing equityholder's status as an equityholder in the debtor.[4] Examining prior Supreme Court precedent, the Second Circuit found that the absolute priority rule must be read strictly and that the Supreme Court

---

class of unsecured claims does not vote to accept a plan, (i) the plan must provide each holder of a claim in such class with property of a value, as of the effective date of the plan, equal to the allowed amount of such holder's claim or (ii) the holder of a 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.

[4] The Second Circuit noted in a footnote that not all distributions to a junior class are necessarily "on account of" junior claims or interests. For example, the Second Circuit noted that the Supreme Court has left open the possibility that old equity could argue that it is providing new value to the reorganized entity. The Second Circuit expressly declined to address the viability of a "new value" exception to the absolute priority rule, given that the debtor's shareholder was not contributing additional capital.

"has never suggested any exception [to the absolute priority rule] that would cover a case like this one."

The Second Circuit then turned to the argument that the noteholders, as undersecured creditors, were free to share a portion of their distribution under the plan with the existing equityholder. This argument relied in large part on a decision of the U.S. Court of Appeals for the First Circuit, In re SPM Manufacturing Corp. ("SPM"),[5] which held that an undersecured creditor could gift a portion of its collateral to a junior creditor over the objection of a senior creditor. In addition to finding that such an argument is not consistent with the plain language of section 1129(b)(2)(B), the Second Circuit also found SPM to be distinguishable from DBSD. First, SPM was a Chapter 7 liquidation case, and Chapter 7 "does not include the rigid absolute priority rule of §1129(b)(2)(B)." Second, the distribution scheme of Chapter 7 does not come into play until all valid liens are satisfied. Third, in SPM, the secured creditor had obtained relief from the automatic stay such that its collateral could no longer be considered property of the debtor's estate.

Finally, the Second Circuit addressed the policy arguments with respect to the gifting doctrine. The Second Circuit recognized that gifts from undersecured creditors to existing equityholders have become commonplace as a means of fostering consensual Chapter 11 plans. However, the Second Circuit noted countervailing policy considerations, including that shareholders retain substantial control over the Chapter 11 process such that there is "significant opportunity for self-enrichment at the expense of creditors" and also the potential for "serious mischief between senior creditors and existing shareholders."

II. Implications of In re DBSD

The DBSD decision represents a clear rejection by the Second Circuit of the gifting doctrine, at least where (i) there is a dissenting senior class of claims not receiving full payment on its allowed claims, (ii) the gift is reflected in the terms of the plan (as opposed to being implemented outside of the plan) and (iii) the recipient of the gift is receiving such gift "on account of" its status as an equityholder or junior creditor (as opposed to being provided on account of new value).

The Second Circuit's decision left open several possibilities, suggesting that gifting may still be available in certain circumstances:

- First, the absolute priority rule does not apply when the senior classes accept the plan. To encourage class acceptance and a consensual resolution, some recent Chapter 11 plans provide gifts to junior classes and non-gifting senior classes only if those classes accept the plan.

[5] 984 F.2d 1305 (1st Cir. 1993).

- Second, it may be possible to accomplish a gift to equity outside of the terms of a Chapter 11 plan. However, structuring a gift outside of the terms of a plan (e.g., through individual agreements, perhaps obtained in connection with a Chapter 11 solicitation process) would pose its own unique challenges. For example, would courts require the "gifting" creditors to actually receive the distribution before making the gift to junior classes? Securities law issues could arise in the absence of reliance on the section 1145 securities law exemption. Another challenge would be obtaining the agreement of a sufficient threshold of creditors outside of a plan process, which could be impractical and costly. Presumably, any such agreements would need to be disclosed to the bankruptcy court. Further, there is no assurance that a court would find such a private agreement to be permissible.

- Third, the Second Circuit acknowledged (without deciding the issue) that a gift to equity from an undersecured creditor may be permissible notwithstanding the rejection of a plan by a senior creditor class so long as the equityholder has provided "new value" to the reorganized entity. Given that the Supreme Court has reserved judgment on the existence of the "new value exception," this approach is subject to uncertainty.

Finally, it is worth noting that the Second Circuit's decision in DBSD brings the Second Circuit's jurisprudence on gifting more in line with the gifting jurisprudence from the United States Court of Appeals for the Third Circuit (which includes Delaware).[6]

Please feel free to contact any of your regular contacts at the firm or any of our partners and counsel listed under Bankruptcy and Restructuring in the "Practices" section of our website (http://www.clearygottlieb.com) if you have any questions.

CLEARY GOTTLIEB STEEN & HAMILTON LLP

[6] In re Armstrong World Industries, Inc., 432 F.3d 507 (3d Cir. 2005) (holding that a gift from a class of unsecured creditors to the debtor's equityholders violated the absolute priority rule where a co-equal class of unsecured creditors did not accept the plan and was not paid in full).

CLEARY GOTTLIEB

Office Locations

NEW YORK
One Liberty Plaza
New York, NY 10006-1470
1 212 225 2000
1 212 225 3999 Fax

WASHINGTON
2000 Pennsylvania Avenue, NW
Washington, DC 20006-1801
1 202 974 1500
1 202 974 1999 Fax

PARIS
12, rue de Tilsitt
75008 Paris, France
33 1 40 74 68 00
33 1 40 74 68 88 Fax

BRUSSELS
Rue de la Loi 57
1040 Brussels, Belgium
32 2 287 2000
32 2 231 1661 Fax

LONDON
City Place House
55 Basinghall Street
London EC2V 5EH, England
44 20 7614 2200
44 20 7600 1698 Fax

MOSCOW
Cleary Gottlieb Steen & Hamilton LLP
CGS&H Limited Liability Company
Paveletskaya Square 2/3
Moscow, Russia 115054
7 495 660 8500
7 495 660 8505 Fax

FRANKFURT
Main Tower
Neue Mainzer Strasse 52
60311 Frankfurt am Main, Germany
49 69 97103 0
49 69 97103 199 Fax

COLOGNE
Theodor-Heuss-Ring 9
50668 Cologne, Germany
49 221 80040 0
49 221 80040 199 Fax

ROME
Piazza di Spagna 15
00187 Rome, Italy
39 06 69 52 21
39 06 69 20 06 65 Fax

MILAN
Via San Paolo 7
20121 Milan, Italy
39 02 72 60 81
39 02 86 98 44 40 Fax

HONG KONG
Bank of China Tower
One Garden Road
Hong Kong
852 2521 4122
852 2845 9026 Fax

BEIJING
Twin Towers – West
12 B Jianguomen Wai Da Jie
Chaoyang District
Beijing 100022, China
86 10 5920 1000
86 10 5879 3902 Fax