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Bucking The Trend With Rule 9019 Settlements

Law360, New York (September 17, 2012, 12:59 PM ET) -- In the normal course, prepetition unsecured creditors are not entitled to receive payments on their claim until the effective date of a plan — i.e. at the same time that all other prepetition unsecured creditors receive payment. Sometimes, however, under the guise of Bankruptcy Code Sections 363 and 105, debtors enter into Rule 9019 settlements with prepetition unsecured creditors that pay such creditors in cash (or other form of currency) upon approval of the settlement, instead of the effectiveness of the plan.

The "justifications" for such settlements are usually among the following: (a) the creditor is receiving less of a recovery on its claim than is projected for unsecured creditors in the case, (b) early payment is a requirement for the creditor to agree to the settlement, (c) no unsecured creditor is harmed by the settlement, and/or (d) no one objects.

In the last 12 months, in the Chapter 11 cases of TerreStar Networks (TSN) (Case No. 10-15446) and TerreStar Corporation (TSC) (Case No. 11-10612) in the Southern District of New York, three of these types of settlements have been proposed: two have been approved, and one has been rejected. It is important for all unsecured creditors to understand the reasons behind these decisions, as approval for Rule 9019 settlements with these types of provisions will certainly continue to be sought in the future.

Most recently, on Aug. 23, the Bankruptcy Court approved a settlement under Rule 9019 among TSC, Elektrobit Inc. and a group of certain holders of preferred shares and bridge loan debt of TSC. Pursuant to the settlement, Elektrobit agreed to resolve its asserted pre-petition claim of $27.8 million, various objections to TSC's plan of reorganization, and its motion to designate the votes of the Bridge Lenders, for a one-time cash payment of $13.5 million (i.e. a 49 percent recovery on its asserted claim), in cash, payable upon entry of the order approving the settlement.

Under the plan of reorganization, as an unsecured creditor of a solvent debtor (TSC), Elektrobit would have been entitled to receive payment in full, in the form of a three-year second lien secured note, that will pay interest at a rate of 10.5 percent, in kind. A hearing on confirmation of the plan is scheduled for early October.

Van Vlissengen, a trade creditor with an asserted claim of $1.6 million, was the only creditor that objected to the settlement; specifically, it asserted that (a) the settlement didn't meet the standards of

Rule 9019; (b) the settlement was inappropriate because the TSC debtors effectively "bought off" the only creditor in the case with the resources to object to the plan, and (c) the settlement improperly required a cash payment to an unsecured creditor on account of its pre-petition claim upon entry of the order approving the settlement, instead of upon the effectiveness of any plan; i.e. the settlement "favored" Elektrobit at the expense of Van Vlissengen.

After hearing argument and reading the parties' various papers, the Bankruptcy Court granted the motion to approve the settlement. Judge Sean Lane relied on the decision of the Second Circuit (Judge Richard Wesley) in Motorola,Inc. v. Official Committee of Unsecured Creditors (In re Iridium Operating LLC), 478 F.3d 452 (2d Cir. 2007), in which the Second Circuit reasoned that the most important factor in determining whether a settlement is "fair and equitable" is whether the settlement complies with the absolute priority rule.

In the instant case, because there was no argument made by Van Vlissengen that the notes that unsecured creditors are contemplated to receive under the plan would pay them less than a 49 cent recovery, the Bankruptcy Court determined that there was no violation of the absolute priority rule under the proposed settlement. The court also found that the settlement met all of the other requirements under Rule 9019, and therefore approved the settlement.

The reasoning behind the decision is interesting when juxtaposed with two other decisions in the TSN Chapter 11 cases regarding settlements which contained components requiring paying unsecured creditors cash upon approval of the settlement, and outside of a plan.

First, in December 2011, Judge Lane approved a global settlement in the TSN case among (among others) the debtors, an ad hoc group of their senior secured noteholders, certain of their unsecured noteholders, the Official Committee of Creditors, EchoStar Corporation and Sprint, which paved the way for the mechanic for distributions of sale proceeds to be made under a TSN Chapter 11 plan.

Importantly, the settlement contained a provision which required Sprint to receive approximately $20 million on its $104 million asserted claim upon Bankruptcy Court approval of the settlement — which would occur a number of months prior to confirmation of the plan. In light of the mountain of litigation being settled by the global settlement, the fact that no party objected to the settlement (and the creditors' committee affirmatively supported the settlement), and the fact that the settlement went hand in hand with a sister settlement in the DBSD Chapter 11 bankruptcy case, the court approved the settlement, paving the way to confirmation of the plan.

Second, in January 2012, Judge Lane did not approve a potential settlement between TSN and Hain Capital, a trade creditor, because part of the settlement required payment of attorney fees immediately upon entry of the order approving the settlement. The proposed settlement would have compromised an approximately $33.5 million asserted unsecured claim for a $3.5 million allowed unsecured claim against TSN, but would also have required the debtors to reimburse Hain for its fees (including counsel fees), up to an amount not to exceed $25,000, of which $10,000 would be paid upon entry of the order approving the settlement and the remaining $15,000 would be distributed on the plan effective date.

Although no party objected to the settlement, Judge Lane stated that he didn't believe that the payment of attorney fees upon entry of the order was critical to the settlement, and asked TSN and Hain to see if they could work something out and change the settlement. After a short recess, the parties agreed to remove this portion of the settlement (and instead, Hain would receive the full $25,000 in fees upon the effective date), and the Judge thereafter approved the settlement without the offensive provision.

In his remarks, Judge Lane noted that payments to creditors outside of a plan generally needed to meet the test for the "Doctrine of Necessity" and cited to two cases, In re C.A.F Bindery Inc., 199 B.R. 828 (Bankr. S.D.N.Y. 1996) and In re Rosenberg, No. 09-46326, (Bankr. E.D.N.Y. Feb. 5, 2010) that stand for the general propositions that (a) parties seeking court approval for settlements that contain payments outside of a plan need to present evidence that such payments are necessary for the reorganization, and (b) courts are loathe to simply approve settlements that require the court to violate the Bankruptcy Code under the guise of Section 105 of the Bankruptcy Code without ample justification.

It is difficult to draw general conclusions from these three settlement decisions, because each settlement had very dissimilar fact patterns (and therefore the decisions rested on different principles). In the TSC-Elektrobit Settlement, (a) the TSC debtors are solvent estates, (b) Elektrobit agreed to take a recovery of one-half of its asserted claim, and (c) the lone objector put on no evidence that unsecured creditors receiving notes under the plan would fare worse, under absolute priority principles, than Elektrobit.

In the TSN-Sprint Settlement, (a) Sprint's various litigations threatened to hold up the entire case (and any distributions to unsecured creditors), and deplete an already "melting ice cube", (b) the settlement was tied to a sister settlement in the DBSD bankruptcy case, and (c) no party objected, and instead, every active party in the case supported the settlement.

In the TSN-Hain Settlement, (a) there was no evidence that the payment outside of a plan was necessary to the reorganization, (b) the court simply didn't believe that such a provision was necessary for the overall settlement (and the court was right), and (c) the court relied on the Doctrine of Necessity in disapproving the settlement.

Nevertheless, the following principles seem to emerge from these decisions that creditors should look for on a going-forward basis when evaluating any settlements that propose to pay unsecured creditors on account of their claim outside of the plan context:

1. Showing that a settlement doesn't violate absolute priority principles — and therefore is fair and equitable to all other unsecured creditors — is of paramount importance;
2. It is most helpful — although not necessarily dispositive — to ensure that all other unsecured creditors (and indeed, all other active parties in the case, including the creditors' committee) support the settlement; and
3. Showing that the settlement payment outside of the plan context is "necessary for the reorganization" is helpful to getting the cash payment approved, and providing as much evidence as possible of this fact is probably as important (if not more) than simply stating that the creditor will not approve of the settlement absent such a payment.

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