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BANKRUPTCY UPDATE

BUT WHAT DID YOU PAY FOR IT? THE STORY OF THE AD HOC COMMITTEE, RULE 2019, AND THE *NORTHWEST* DISCOVERY DISPUTE THAT WENT AWRY

Does Federal Rule of Bankruptcy Procedure 2019(a) (Rule 2019) require members of an ad hoc creditor group to disclose when they acquired their claims and how much they paid for them? One bankruptcy court recently sent shockwaves through the distressed trading markets by answering "yes." *In re Northwest Airlines Corp.*, Case No. 05-17930, Docket # 5032 (Bankr. S.D.N.Y. Feb. 26, 2007).

The decision in the *Northwest* case (the 2019 Decision) arose out of a hostile discovery dispute between Northwest Airlines and an ad hoc group of equity holders who dubbed themselves the "Ad Hoc Committee of Equity Security Holders" (the Ad Hoc Committee). The Ad Hoc Committee's members, which included hedge funds that acquired their equity stake in Northwest during its Chapter 11 case, pooled their resources and hired a common attorney to represent the group. Along with their equity stake, the Ad Hoc Committee members held significant unsecured claims in Northwest. The Ad Hoc Committee likely put little thought into their moniker, but the inclusion of the word "committee" would come back to haunt them.

Starting in late 2006, the Ad Hoc Committee began requesting discovery of financial information from Northwest. Northwest opposed these requests as overly burdensome and sought a stay of discovery until after Northwest filed its disclosure statement on February 15, 2006. The bankruptcy court granted the stay, but the Ad Hoc Committee continued to request discovery under different rationales. Seeing this as an end-run around the bankruptcy court's orders, Northwest filed an emergency motion to sanction the Ad Hoc Committee for discovery abuses.

In its motion, and almost as an afterthought, Northwest argued that the Ad Hoc Committee's Rule 2019 disclosure was insufficient and sought an order compelling the Ad Hoc Committee to comply with Rule 2019(a)'s requirement that ***"committees"*** disclose "with reference to the time of … the organization or formation of the committee … the amounts of claims or interests owned by … the members of the committee, … the times when acquired, the amounts paid therefore, and any sales or other disposition thereof." Fed.R.Bankr.P. 2019(a)(4) (Emphasis added). The counsel for the Ad Hoc Committee's Rule 2019 disclosure had only provided the names of the Ad Hoc Committee members and, on an aggregate basis, the number of Northwest common stock shares and the value of the claims held by the members (not "the amounts paid therefore").

The Ad Hoc Committee opposed, but the bankruptcy court sided with Northwest and entered the 2019 Decision. The decision required the Ad Hoc Committee to file a Rule 2019 disclosure detailing when its members acquired their claims and the price paid for such claims. The bankruptcy court based its decision on (a) its interpretation of the historical meaning of Rule 2019, (b) the plain meaning of Rule 2019, and (c) the fact that the Ad Hoc Committee, "[b]y appearing as a 'committee' of shareholders," had "purported to speak for a group and implicitly ask the court and other parties to give their positions a degree of credibility appropriate to a unified group with large holdings."

The Ad Hoc Committee responded by filing an emergency motion to seal its Rule 2019 disclosure, which the Ad Hoc Committee proposed to make available solely to the bankruptcy court and the U.S. Trustee. The Ad Hoc Committee members explained that, as hedge funds, the amount of their claims and the price they paid for them is confidential and proprietary information, the disclosure of which would damage the members' ability to negotiate payment on or resale of their claims. Northwest, the official creditors' committee and Bloomberg News opposed the motion, arguing that sealing the disclosure would defeat the disclosure of information to the public as intended by Rule 2019.

Once again, the bankruptcy court sided with Northwest, denying the motion to seal. *In re Northwest Airlines Corp.*, Case No. 05-17930, Docket # 5220 (Bankr. S.D.N.Y. Mar. 9, 2007). In its ruling, the bankruptcy court noted that the imposition of the Rule 2019 requirements on the Ad Hoc Committee members "is not unfair because their negotiating decisions as a Committee should be based on the interest of the entire shareholders' group, not their individual financial advantage." This statement suggests that the bankruptcy court's ruling was motivated, at least in part, by a perception that the Ad Hoc Committee had fiduciary duties to the other Northwest equity holders.

The day before the bankruptcy court entered its order denying the motion to seal, three of the Ad Hoc Committee members (the Three Funds) moved for reconsideration of the 2019 Decision. Using separate counsel, the Three Funds suggested that the bankruptcy court had misinterpreted the term "committee" in Rule 2019. Based on a detailed historical review of Rule 2019, the Three Funds argued that Rule 2019 only governs "committees" that purport to represent others in a fiduciary capacity. Though the Ad Hoc Committee identified itself using the term "committee," the Three Funds argued that the Ad Hoc Committee was more accurately described as a "consortium" because it represents only its members and owes no fiduciary duties to anyone. The Three Funds concluded that the Ad Hoc Committee is not a "committee" for purposes of Rule 2019, and therefore no disclosure of the pricing information is required.

At a hearing on reconsideration held March 15, 2007, the bankruptcy court upheld its previous 2019 Decision and denied the reconsideration motion. Discretion being the better part of valor, the Ad Hoc Committee thereafter filed its Verified Amended Rule 2019(a) Statement, dated March 21, 2007, in compliance with the court's order. Notwithstanding that filing, the Ad Hoc Committee also filed appeals from the 2019 Decision and the court's decision denying the application of the Ad Hoc Committee to file its Rule 2019 Statement under seal.

Ad hoc groups of claim and equity holders have become common in large Chapter 11 cases, as like-minded parties have found it efficient to take an active role by pooling their resources. Often, the parties who take such roles purchased either some or all of their claims or equity interests in the respective debtor either shortly before or during the debtor's bankruptcy case.

The 2019 Decision is likely to be used by other debtors as a tool against ad hoc groups in future cases. Such ad hoc groups may think twice before donning the mantle of "committee," although only time and further case law will determine whether a more circumspect choice of name will preserve the proprietary rights that members of ad hoc groups appear so keen to protect.

At least one court already has entered an order at odds with the ruling in *Northwest* Airlines Corp. On April 17, 2007, Bankruptcy Judge Richard S. Schmidt of the U.S. Bankruptcy Court in Corpus Christi, Texas, ruling from the bench, denied the Debtor's motion to force an Ad Hoc Noteholders Committee to disclose what they paid for the Debtor's securities in the chapter 11 case of Scotia Pacific Company LLC. *In re Scotia Pacific Company LLC*, Case No. 07-20032-c-11, jointly administered under *In re Scotia Development LLC*, Case No. 07-20027-C-11. Judge Schmidt specifically noted that this group of hedge funds, although acting in concert, was not an official committee and so was not required to make the Rule 2019 disclosures.

Stay tuned . . ..

To view the *In re Northwest Airlines Corp.*, Case No. 05-17930, Docket # 5032 opinion, please visit www.akingump.com/docs/publication/962.pdf.

To view the *In re Northwest Airlines Corp.*, Case No. 05-17930, Docket # 5220 opinion, please visit www.akingump.com/docs/publication/963.pdf.

To view the *Northwest* transcript, please visit www.akingump.com/docs/publication/964.pdf.

To view the *In re Scotia Development LLC*, Case No. 07-20027-C-1 opinion, please visit http://www.akingump.com/docs/publication/972.pdf.

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SOLVENT CORPORATIONS CANNOT USE CHAPTER 11 TO AVOID SHAREHOLDER RIGHTS

The Delaware Chancery Court (Chancery Court) recently bolstered the rights of minority common stockholders. In *Esopus Creek Value LP v. Hauf*,[1] the Chancery Court was asked to decide whether a solvent Delaware corporation could accomplish a sale of substantially all of its assets without prior shareholder approval – requirements set forth both in section 271 of the Delaware Corporation Code and in the corporation's own certificate of incorporation – by seeking approval of the sale in a bankruptcy case. The answer was "No."

[1] 2006 WL 3499526 (Del. Ch. Nov. 29, 2006).

Metromedia International Group (Metromedia) was approached by an investor group interested in acquiring its principal asset – a majority ownership interest in the leading mobile telecommunications provider in the republic of Georgia. The proposed offer far exceeded previous unsolicited offers, and Metromedia decided to negotiate with the investor group. As negotiations progressed, Metromedia was advised that it would be impossible for the company to call a meeting of shareholders or solicit votes as required under section 271 of the Delaware Corporation Code because Metromedia was delinquent in its reporting obligations under the Securities Exchange Act of 1934. Metromedia was advised that section 14(c) of the 1934 Act bars a reporting company from calling a stockholder meeting or soliciting proxies if a company is not current on all reporting obligations. Thus, at least in the board of directors' view, compliance with state law voting requirements was not a viable option.

Undeterred by its perceived inability to comply with state law, Metromedia attempted to implement a four-step plan predicated upon a pre-negotiated Chapter 11 case. The steps were as follows: (1) execute definitive sale documentation, (2) file a voluntary petition under Chapter 11, (3) seek approval of the sale transaction under section 363 of the Bankruptcy Code, and (4) distribute the proceeds from the sale transaction pursuant to a pre-negotiated Chapter 11 plan. Needing an impaired accepting class for cram-down purposes, Metromedia negotiated with and entered into voting lock-up agreements with the primary beneficiaries of the sale transaction – holders of roughly 80 percent of Metromedia's 7.25 percent convertible preferred stock (the Preferred Stockholders). Metromedia and the Preferred Stockholders negotiated the terms of a plan of reorganization and, according to the Chancery Court, the Preferred Stockholders were able to exert their bargaining power to guarantee a highly favorable treatment for the preferred shares.

Lawsuits were brought in the Chancery Court by holders of roughly 8 percent of Metromedia's common stock shortly after the company publicly announced its execution of the lock-up agreements with the Preferred Stockholders and its letter of intent with the investor group. The common stockholders sought issuance of a preliminary injunction to prevent Metromedia from, among other things, executing definitive sale documentation absent an affirmative vote of the majority of the company's common stockholders.

Addressing an issue of first impression, the Chancery Court held that the board's decision to structure the sale transaction in bankruptcy as opposed to outside of bankruptcy was, though legally permissible, fundamentally inequitable to common stockholders. The Chancery Court held that the proposed bankruptcy process "works a profound inequity upon the company's common stockholders" due to the sound financial condition of Metromedia and the increasing value of the asset to be sold. The Chancery Court also questioned whether Metromedia's bankruptcy case would be dismissed as not being filed in "good faith," stating that it would seem to be an "abuse of the bankruptcy process for a robust and healthy company, encumbered by virtually no debt, to seek out the vast and extraordinary relief a bankruptcy court is capable of providing." While the Chancery Court recognized that the Supremacy Clause of the U.S. Constitution and federal preemption jurisprudence prevented it from issuing an order enjoining a bankruptcy filing, the Chancery Court held that it had the unquestionable power to prevent the board of directors from binding Metromedia to the sale transaction without first obtaining shareholder approval.

Structuring the sale transaction as a section 363 asset sale was equally disconcerting to the Chancery Court because it inequitably reallocated control over the corporate enterprise from common stockholders to the Preferred Stockholders. In structuring the sale transaction as it did, the Chancery Court explained that the board of directors expanded the rights of Preferred Stockholders beyond their contractual or statutory entitlements, and, as a result, relegated common stockholders to the sidelines of a process they were contractually and statutorily entitled to control. The Chancery Court dismissed the defendants' argument that the right of the common stockholders to object to the sale transaction during the bankruptcy case was an effective substitute for a shareholder vote, reasoning that the bankruptcy process is designed to protect creditor interests, not equity interests. When a debtor is insolvent, explained the Chancery Court, the failure to obtain shareholder approval of an asset sale is not inequitable because equity interest holders have no residual interest in the sales proceeds.

Finally, the Chancery Court was bothered by the board of directors' failure to seek relief from the SEC for an exemption from the rule that prohibited the company from calling a shareholder meeting in order to allow a shareholder vote in connection with the sale transaction. Compounding the Chancery Court's concern was Metromedia's stated reason for the reporting delinquency: small disagreements between the company and its auditor, the consequence of which did not greatly affect shareholder value. The Chancery Court would not countenance the board's disenfranchisement of common stockholders where the obstacle to conducting a section 271 vote appeared capable of being easily rectified through an exemptive order from the SEC.

Following oral argument on the preliminary injunction motion, Metromedia conceded its position and agreed that it would seek (i) shareholder approval of the sale transaction prior to executing definitive sale documentation and (ii) exemptive relief from the SEC to permit the company to solicit votes and to provide common stockholders with sufficient information to make an informed vote. Shortly after the opinion was issued, however, the remaining investors terminated the letter of intent, thus ending the potential sale transaction.

Esopus Creek is instructive to equity interest holders and creditors of Delaware corporations for several reasons. First, the opinion demonstrates the power and willingness of the Delaware Chancery Court to protect the statutory and contractual franchise of minority common stockholders with respect to material corporate transactions. More than 80 percent of the Preferred Stockholders and at least 44 percent of the common stockholders supported the sale transaction and implementation strategy. Second, the Chancery Court relied upon its equitable powers to prevent a transaction that it conceded was theoretically within the letter of the law. The Chancery Court was offended by the perceived advantage-taking of the Preferred Stockholders and the fact that the Preferred Stockholders had negotiated and stood to greatly benefit from a transaction they otherwise would have no influence over outside of bankruptcy. Finally, *Esopus Creek* may lead boards of directors to expend greater efforts to correct legal non-compliance issues of a technical nature that could prevent the board, by reason of a technicality, from completing a substantive transaction.

To view the *Esopus Creek Value LP v. Hauf* opinion, please visit www.akingump.com/docs/publication/961.pdf.

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TRAVELERS CASUALTY & SURETY V. PACIFIC GAS & ELECTRIC: SUPREME COURT ALLOWS ATTORNEYS' FEES INCURRED BY UNSECURED CREDITORS POST-PETITION

A recent Supreme Court opinion, *Travelers Casualty & Surety Co. of America v. Pacific Gas & Electric Co.*, 127 S.Ct. 1199 (2007), will allow creditors' claims for attorneys' fees incurred post-petition, even if the fees were incurred litigating issues "peculiar to federal bankruptcy law." In overturning the long-standing 9th Circuit rule, announced in *In re Fobian*, 951 F.2d 1149 (9th Cir. 1991), which had disallowed such claims, the Supreme Court reaffirmed the principle that a bankruptcy claim must be determined initially by reference to applicable state law, and then generally shall be allowed unless an express provision of the Bankruptcy Code requires its disallowance.

Travelers concerned several claims filed by an unsecured creditor seeking to recover attorneys' fees incurred in connection with a Chapter 11 debtor's bankruptcy case. The claims were based on the creditor's contractual rights pursuant to specific indemnity agreements executed by the debtor prepetition. Relying on the *Fobian* rule, the bankruptcy court disallowed the claims merely because they sought fees incurred post-petition litigating bankruptcy-related issues. The district court and 9th Circuit Court of Appeals affirmed.

In a unanimous opinion, the Supreme Court rejected the 9th Circuit's decision, finding that "[t]he *Fobian* rule finds no support in the Bankruptcy Code, either in § 502 or elsewhere." The Court noted that, in rejecting the claims for contractual attorneys' fees, the court of appeals did not find that the claims were unenforceable under either Section 502(b)(1), or any other provision of the Bankruptcy Code, but instead rejected the claims based solely on a rule of the court's own creation. Finding that this "absence of textural support is fatal for the *Fobian* rule," the Court reaffirmed that the courts should "generally presume that claims enforceable under state law will be allowed in bankruptcy unless they are expressly disallowed" by the Bankruptcy Code.

The Supreme Court expressly refused to decide whether, following the demise of the *Fobian* rule, other principles of bankruptcy law might provide an independent basis for disallowing a contractual claim for attorneys' fees incurred post-petition. In particular, the Court refused to address the argument that Section 506(b) requires disallowance of all unsecured claims for post-petition attorneys' fees by "explicit negation."

Following this decision, unsecured creditors with contractual rights to attorneys' fees should include such fees as part of their claims against a debtor's estate.

To view the *Travelers Casualty & Surety Co. of America* opinion, please visit www.akingump.com/docs/publication/965.pdf.

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SUBSTANTIVE CONSOLIDATION NOT QUITE DEAD IN THE THIRD CIRCUIT

REVISITING *OWENS CORNING*

The substantive consolidation of the assets and liabilities of affiliated entities has long been a tool in bankruptcy lawyers' toolkits, and is used by debtors and creditors alike. In 2005 the 3rd Circuit struck a considerable blow to substantive consolidation by issuing its critical decision, *In re Owens Corning*, 419 F.3d 195 (3d Cir. 2005). In *Owens Corning*, the 3rd Circuit denounced case law that permitted substantive consolidation without adequate proof for the need for this extraordinary remedy, and articulated a stringent standard to be satisfied before substantive consolidation may be granted. In its holding, the 3rd Circuit also stated that substantive consolidation may be used defensively to remedy harm resulting from entangled corporate affairs, but may not be used offensively to disadvantage a group of creditors or alter creditor rights. After *Owens Corning*, some bankruptcy practitioners considered substantive consolidation to be all but dead in the 3rd Circuit.

If it was dead, a recent decision from the U.S. District Court for the District of New Jersey, *In re Lisanti Foods, Inc.*,[2] appears to have resurrected substantive consolidation in the 3rd Circuit. In May 2005 the bankruptcy court in the *Lisanti Foods* Chapter 11 case confirmed a plan of reorganization that substantively consolidated three debtor entities, each a wholesale distributor of Italian specialty foods and related products. Absent precedent from the 3rd Circuit, the bankruptcy court had relied upon precedent from the D.C. Circuit[3] and from the 2nd Circuit[4] in approving substantive consolidation of the debtors' estates. Several interested parties appealed the bankruptcy court's decision in *Lisanti Foods*, claiming that one of the debtors had a lower debt-to-asset ratio than the other companies, and therefore the creditors of the former would obtain a diluted recovery by being forced to share, pro rata, in proceeds from the consolidated estate.

On August 9, 2005, the district court upheld the bankruptcy court's order,[5] and the appellants filed a notice of appeal to the 3rd Circuit. Thereafter, the parties learned of the 3rd Circuit's ruling in *Owens Corning*, and contacted the district court. In *Owens Corning* the 3rd Circuit had made clear that it preferred the more stringent test enunciated in *Augie/Restivo* over the more flexible test set forth in *Auto-Train*. After a conference with the parties, the district court invited appellants to seek relief from its August 9 order in light of the *Owens Corning* decision.

After hearing argument from the parties, and considering its opinion in light of the *Owens Corning* decision, the district court once again upheld the bankruptcy court's order. This time around, the district court considered the facts of the case under both the standard used by the *Lisanti Foods* bankruptcy court and the heightened standard set forth in *Owens Corning* and held that substantive consolidation was appropriate under both standards. In support of its holding, the district court found that there was "ample evidence" to uphold the bankruptcy court's order substantively consolidating the estates, including evidence that the debtors had the same directors and officers, conducted virtually identical business operations under similar names, performed all of their accounting functions from a centralized location, engaged in intercompany dealings without adhering to corporate formalities, and were regarded by creditors as a single entity when extending credit terms. The district court also

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[2] *Lisanti v. Lubetkin (In re Lisanti Foods, Inc.)*, 2006 U.S. Dist. LEXIS 76844 (D.N.J. Oct. 11, 2006).
[3] *In re Auto-Train Corp.*, 810 F.2d 270, 276 (D.C. Cir. 1987).
[4] *In re Augie/Restivo Baking Co., Ltd.*, 860 F.2d 515, 518-19 (2d Cir. 1991).
[5] *Lisanti v. Lubetkin (In re Lisanti Foods, Inc.)*, 329 B.R. 491 (D.N.J. 2005); rehearing denied by *Lisanti v. Lubetkin (In re Lisanti Foods, Inc.),* 2006 U.S. Dist. LEXIS 76844 (D.N.J., Oct. 11, 2006).

noted the bankruptcy court's finding that consolidation would benefit creditors by eliminating the need to determine professional fees on a case-by-case basis and the difficulties of administering the estates separately.

The *Lisanti Foods* decision suggests that substantive consolidation is not quite dead in the 3rd Circuit, notwithstanding its clearly disfavored position in the eyes of the appellate court.

To view the *In re Lisanti Foods, Inc.* opinion, please visit www.akingump.com/docs/publication/967.pdf.

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KERPS: YOU CAN'T ALWAYS GET WHAT YOU WANT

We previously reported on the impact of new Code Bankruptcy section 503(c) upon "Key Employee Retention Programs" (KERPs). The purported purpose of a KERP is to retain crucial employees who are necessary to the effective operation of the company and its successful reorganization. Section 503(c) was enacted in 2005 in an attempt to address the "glaring abuses of the bankruptcy system by the executives of giant corporations … [who] … lined their own pockets, but left thousands of employees and retirees out in the cold." See *In re Dana Corp.*, 2006 WL 3479406 at *5 (Bankr. S.D.N.Y.) (*quoting* Sen. Edward Kennedy on the Bankruptcy Bill (Mar. 1, 2005)). Its purpose was to limit the scope of KERPs and other programs providing incentives to management of the debtor as a means of inducing management to remain employed by the debtor. Section 503(c) covers three general areas: (i) section 503(c)(1) prohibits transfers made to an insider of the debtor for the purposes of retention, (ii) section 503(c)(2) prohibits severance payments to an insider of the debtor, and (iii) section 503(c)(3) prohibits transfers or obligations that are outside the ordinary course of business and not justified by the facts and circumstances of the case.[6] The introduction of section 503 has caused much hand-wringing, as entities in Chapter 11 who are looking to retain employees find themselves on unsure ground as to what is required under section 503(c) for an incentive plan to be approved. However, a set of cases in which Dana Corporation first failed, and then succeeded, in instituting an incentive plan for its executives may shed some light on this issue.

In *In re Dana Corp. et al.*, 351 B.R. 96 (Bankr. S.D.N.Y. 2006) (*Dana I*), several parties raised objections to the executive incentive compensation plan proposed by Dana Corporation. In rejecting the plan, the Court noted the following:

- The plan provided for a completion bonus that was to be paid automatically to executives upon emergence from Chapter 11. The court found this to be a poorly disguised retention bonus that merely triggered payment when the case was completed, noting that the plan "walks [like], talks [like] and is a retention bonus" in violation of section 503(c)(1). *Id.* at 102

[6] These provisions contain various exceptions not relevant to an article of this scope.

- The plan also provided for an enterprise value bonus that was supposedly tied to performance. However, the court noted that the bonus actually set targets at lower economic levels than the company was already meeting and was thus also retentive, and not incentivizing, in nature.

However, the court opined that incentivizing plans with *some* components that arguably have a retentive effect do not necessarily violate section 503(c). *Id.*

Dana tried its hand again at crafting a KERP, and this time got it right, in *In re Dana Corp,* 2006 WL 3479406 (Bankr. S.D.N.Y.) (*Dana II*). In *Dana II*, Dana filed a motion to reconsider its proposed incentive plan, this time submitting a vastly different plan. In approving the vast majority of this plan over various objections, the court noted that the completion and emergence incentive bonuses, which were virtually automatic in the *Dana I* plan, were now replaced by a long-term incentive plan (LTIP) that based its bonuses on difficult EBITDA minimum benchmarks and truly incentivized its executives to perform at a superior level. As noted by the court:

> [T]he benchmarks for the LTIP are difficult targets to reach and are clearly not "lay-ups"…achievement of the EBITDA benchmarks is uncertain, at best…In sum the LTIP is not a KERP, but is a program designed to incentivize [the executives], and may be assumed by the Debtors if it is a fair and reasonable exercise of business judgment.

Id. at *11.

Dana I made it clear that a debtor could not submit a compensation plan that simply presented a thinly veiled retention plan or maintained incentive targets which were so readily achievable that they presented no challenge for recovery of the requested bonus; for a program to be approved, the performance targets must be both legitimate and specific. *Dana I's* benchmarks were a virtual formality, with goals set so low that it was a virtual impossibility not to attain them. In contrast, the court viewed the plan in *Dana II* as a truly incentivizing plan for its executives which required the attainment of difficult performance benchmarks that ensured return of value to the enterprise and as an appropriate exercise of Dana's business judgment under section 363 of the Code.

In the end, Section 503(c) should be read not as a roadblock to KERPs so much as a road map for formulating benefit or retention plans that meet the Code requirements and encourage policies which promote the reorganization process.

To view the *In re Dana Corp. et al.* opinion, please visit www.akingump.com/docs/publication/960.pdf.

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SECURED CREDITOR'S RIGHT TO SHARE ITS PROPERTY WITH JUNIOR CREDITORS ENDURES

A secured creditor's right to share its property with some junior creditors was recently reaffirmed in the Delaware bankruptcy case of *World Health Alternatives, Inc.*[7] In *World Health*, Judge Walsh spurned the U.S. Trustee's (Trustee) attempt to extend the *Armstrong World Industries* holding to *any* settlement that calls for junior classes to be paid before higher priority classes are paid in full.

Armstrong World Industries, Inc.[8] involved a cram-down confirmation fight. In *Armstrong,* the 3rd Circuit Court of Appeals held that the absolute priority rule[9] prevented confirmation of a plan that provided for the class of equity holders to receive warrants while the senior dissenting class of unsecured creditors was not paid in full. The 3rd Circuit found that the *Armstrong* plan violated the absolute priority rule even though it used a clever device to make it appear that the warrants would not be issued directly to the equity holders. The plan provided that the warrants would first be issued to a class of personal injury claimants, which class would then automatically waive receipt of the warrants. The rejected warrants would then be issued to the equity holders. The 3rd Circuit found that the *Armstrong* plan resulted in equity holders getting paid ahead of dissenting impaired creditors and therefore violated the absolute priority rule. However, the 3rd Circuit took care to distinguish the *Armstrong* plan from other arrangements whereby senior creditors agree to give up part of their collateral for the benefit of a junior class. The 3rd Circuit noted that the cases holding that such arrangements were acceptable involved (1) cases under Chapter 7, which therefore did not trigger 11 U.S.C. § 1129(b)(2)(B), (2) cases where the senior creditor had a perfected security interest, meaning that the property was not subject to distribution under the Bankruptcy Code's priority scheme, and (3) cases where the distribution was a "carve out," a situation where a party whose claim is secured by assets in the bankruptcy estate allows a portion of its lien proceeds to be paid to others. The 3rd Circuit stated that such arrangements are acceptable, but "do not stand for the unconditional proposition that creditors are 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 …."

Perhaps in reliance on the above-quoted language from the *Armstrong* opinion, the Trustee recently sought to extend the *Armstrong* holding to deny a consensual global settlement in the *World Health Alternatives* case. The proposed *World Health* settlement, among other things, addressed the concerns of the Official Committee of Unsecured Creditors (the Committee) regarding the proposed auction and sale of substantially all of the debtors' assets by providing the Committee with a definite recovery. The Trustee was offended by the proposed settlement because it provided that the secured creditor would carve out $1,624,000 from its collateral and pay that amount to the unsecured creditors[10] while priority tax claims went unpaid. However, none of the priority creditors, nor any other party in interest, objected to the settlement. The only objection was filed by the Trustee. The *World Health* court disagreed with the Trustee's objections.

The *World Health* court noted that, under Rule 9019(a), a bankruptcy court has the authority to approve a compromise or settlement and that settlements are generally favored in bankruptcy. In addition, the court noted

[7] *In re World Health Alternatives, Inc.,* No. 06-10166 (Bankr. Del. July 7, 2006).
[8] *In re Armstrong World Industries, Inc*., 432 F.3d 407 (3d Circuit 2005).
[9] The absolute priority rule is codified in 11 U.S.C. § 1129(b)(2)(B).
[10] The $1,624,000 was to be used for distribution to the holders of allowed general unsecured claims or for use in investigating and prosecuting estate causes of action against parties other than the secured creditor.

that both the Trustee and the debtors had filed motions to convert the cases to Chapter 7. Accordingly, the *World Health* court found that Code section 1129(b)(2)(B) was not implicated because the settlement did not arise in the context of a plan of reorganization and it did not appear that a plan of reorganization would ever be filed. The *World Health* court declined to extend the statutory requirements for cram-down plan confirmation to a consensual settlement in a case that would shortly be converted to Chapter 7.

But the *World Health* court went further, pointing out that under existing precedent, even if the settlement had been proposed as a part of a Chapter 11 plan of reorganization, it would not offend the absolute priority rule. The court noted that *Armstrong* expressly distinguished cases that were factually similar to the *World Health Alternatives* case, indicating that, contrary to the Trustee's assertion, *Armstrong* did not support denial of the settlement. These other cases – specifically, *SPM Manufacturing,*[11] *MCorp,*[12] and *Genesis Health Ventures,*[13] involved transfers of property subject to a secured creditor's perfected security interest, which the 3rd Circuit had recognized as property "not subject to distribution under the Bankruptcy Code's priority scheme."[14] The *World Health* court stated that in the *World Health* case, like in *SPM Mfg.,* the 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." In addition, the *World Health* court noted that an ordinary carve-out would not violate the absolute priority rule because "the property belongs to the secured creditor – not the estate."[15]

The *World Health* opinion may leave open the door for secured creditors to maneuver creatively within the context of a liquidation and support plans that, at least on their face, permit distributions to "skip" classes.

To view the *World Health Alternatives, Inc. et al.* opinion, please visit
www.akingump.com/docs/publication/966.pdf.

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[11] *Official Committee of Unsecured Creditors v. Stern* (*In re SPM Mfg. Corp.*), 984 F.2d 1305 (1st Cir. 1993).
[12] *In re MCorp Fin., Inc.,* 160 B.R. 941 (S.D. Tex. 1993).
[13] *In re Genesis Health Ventures, Inc.,* 266 B.R. 591 (Bankr. D. Del. 2001).
[14] *World Health Alternatives* at 16 (citing Armstrong, 432 F.3d at 514).
[15] *Id.* at 17.

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