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3rd Cir. Decision Casts Doubt on Gifts to Individual Class Members

By Andrew K. Glenn, Shai Schmidt, Rich Ramirez and Naznen Rahman

Whether senior creditors may transfer, or "gift," a portion of their recoveries to junior stakeholders to obtain their support in the plan confirmation process has been subject to much dispute and controversy. Some commentators have denounced gifting as "state-sanctioned bribery" that should never be allowed. *See* Bruce A. Markell, *The Clock Strikes Thirteen: The Blight of Horizontal Gifting*, 38 No. 12 Bankr. L. Letter NL 1 (2018). Courts, however, have taken a more nuanced approach that examines whether the gift is "vertical" or "horizontal." Vertical

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Post-Confirmation, Pre-Effective Date Claim Subject to Bar Date

By Christopher Patalinghug

A claim for employment discrimination arose after a debtor won confirmation of its Chapter 11 bankruptcy exit plan but before the plan was declared effective. The claimant, however, failed to file a proof of claim within the deadline set by the bankruptcy court for filing administrative expense claims. (He did file a lawsuit in district court.) Is the claim subject to the Bankruptcy Code's discharge provisions?

"To our knowledge, no federal appellate court has directly addressed this issue," the Hon. Thomas L. Ambro of the United States Court of Appeals for the Third Circuit said.

The debtor, Westinghouse Electric Company LLC, argued that the age

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gifting involves the transfer of value from a senior creditor to a junior class of stakeholders while skipping an intermediate class. Both the Second and Third Circuits have prohibited this form of gifting, finding that it violates the absolute priority rule pursuant to Section 1129(b) of the Bankruptcy Code, under which a plan is "fair and equitable" with respect to an impaired, dissenting class of unsecured claims only if (1) it pays the class's claims in full, or (2) it does not allow holders of any junior claims or interests to receive or retain any property under the plan on account of such claims or interests. See *DISH Network Corp. v. DBSD N. Am., Inc. (In re DBSD N. Am., Inc.)*, 634 F.3d 79 (2d Cir. 2011); *In re Armstrong World Indus., Inc.*, 432 F.3d 507 (3d Cir. 2005).

Whether senior creditors may transfer, or "gift," a portion of their recoveries to junior stakeholders to obtain their support in the plan confirmation process has been subject to much dispute and controversy.

Horizontal gifting, where a senior creditor transfers value to a class of junior stakeholders while a separate class of *equal* priority receives less (or nothing at all), has generally been viewed with less suspicion. A recent example is the *Nuverra* case, where secured creditors were to give up part of their plan recoveries as a "gift" to two classes of unsecured creditors: one consisting of trade claims and the other of funded debt. *See Hargreaves v. Nuverra Envtl. Sols., Inc. (In re Nuverra Envtl. Sols., Inc.)*, 590 B.R. 75, 79-81 (D. Del. 2018). The trade class, however, was to receive a 100% recovery while the funded debt class would receive only a 4-6% recovery. *Id*. The Delaware bankruptcy court confirmed the plan, and the district court affirmed, holding that because the gift at issue was not vertical — *i.e.*, it did not involve "class skipping" — it did not implicate the absolute priority rule as the Third Circuit held in *Armstrong*. *Id*. at 94-95. The relevant question was whether the disparate treatment of trade claims and funded debt constituted "unfair discrimination" between the classes in violation of Section 1129(b), under which a plan may be crammed down on a dissenting impaired class (here, the funded debt) only if it "does not discriminate unfairly" with respect to that class. *Id*. at 89-93. There was no unfair discrimination, the court held, because Nuverra's unsecured creditors were "entitled to nothing under the Bankruptcy Court's priority scheme, and an increased distribution to [the trade class did] not diminish the distribution" to the holders of funded debt. *Id*. at 91. The Third Circuit affirmed the district court's order on equitable mootness grounds without opining on the permissibility of horizontal gifting. *See In re Nuverra Envtl. Sols., Inc.*, 834 F. App'x 729 (3d Cir. 2021).

Should Gifts to Individual Members of a Class Be Allowed If They Do Not "Discriminate Unfairly"?

The upshot of *Nuverra* is that while horizontal gifting may be discriminatory, it is permissible where the discrimination between the classes is not "unfair." Horizontal gifting may therefore be allowed, for instance, where the aggrieved class would have done no better absent the gift. This raises the question of whether a senior creditor may transfer value to a subset of a junior class while refusing to extend the gift to other members *of the same class*. If permitted, senior creditors may utilize gifts to individual junior stakeholders to settle their plan objections or ensure that the plan is accepted by their class over the dissent of the other class members (Section 1126 of the Bankruptcy Code requires acceptance by two-thirds in amount and more than one-half in number of the allowed claims in the class). One could argue that, just like

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in the case of horizontal gifting, gifts to individual stakeholders within a class do not implicate the absolute priority rule and should therefore be prohibited only if they are unfair.

The Delaware district court recently embraced this approach in *Exide*, where the plan created an environmental remediation trust ("ERT") funded by certain creditors under a settlement, which allocated less money to the California Department of Toxic Substances Control ("DTSC") than other agencies in the same class. *See Cal. Dep't of Toxic Substances Control v. Exide Holdings, Inc. (In re Exide Holdings, Inc.)*, Case No. 20-1402, 2021 WL 3145612, at *2, 15-16 (D. Del. July 26, 2021). The DTSC argued that the plan violated Section 1123(a)(4) of the Bankruptcy Code, under which a plan must "provide the same treatment for each claim or interest of a particular class, unless the holder of a particular claim or interest agrees to a less favorable treatment of such particular claim or interest." *Id.* at *15. The district court rejected this argument, reasoning that "the $10 million payments transferred to the ERTs were not the Debtors' property" (rather, they were settlement payments made by the consenting creditors), and that "[n]othing in the Bankruptcy Code requires a third party to make settlement payments or provide substantial contributions to similarly situated creditors in equal or prorated amounts." *Id.* The district court further held that even though DTSC's allocation under the ERT was different than the allocations given to other agencies, it "was fair and not discriminatory" because it was based on a reasonable method that considered various relevant factors. *Id.* at *16.

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Similarly, in *In re Journal Register Co.*, 407 B.R. 520 (Bankr. S.D.N.Y. 2009), the court approved a gift, funded by secured lenders, that was extended to unsecured trade creditors but not to other unsecured creditors in the same class. *Id.* at 533. The court reasoned that the secured lenders were granting the gift out of their own property — not the estate's. *Id.* at 532-533. Moreover, even though the plan at issue facilitated the gift, the provisions of the plan relating to it, including the appointment of an administrator to make plan distributions, were "immaterial and do not cause it to be an inappropriate distribution 'under the Plan.'" *Id.* at 533. The equal treatment requirement under Section 1123(a)(4), which restricts only unequal distributions made under a plan, was therefore inapplicable. *Id.* The court added that even "if the Court excised the gift provision from the Plan, the recoveries of the 'disfavored' Class 4 creditors would not be increased." *Id.*

Exide and *Journal Register* focused on (1) the fairness of the disparate treatment of different stakeholders within a class, and (2) whether the gift at issue was paid out of estate resources or property of the gifting creditors. This reasoning is not without challenges. *First*, unlike the "unfair discrimination" standard under Section 1129(b), which is applicable to the treatment

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of an entire class in a cram-down situation, Section 1123(a)(4) does not appear to allow discrimination — whether "fair" or "unfair" — among members of a class. This provision plainly requires that the "same treatment" be provided to every member of the class. *Second*, focusing on whether the gift is paid out of estate or third-party property may allow plan proponents to manipulate the rules to their advantage. For example, instead of increasing plan distributions to individual stakeholders but not others in the same class (which is generally prohibited under Section 1123(a)(4)), a debtor could simply agree to increase distributions to senior creditors, who would in turn agree to "gift" their enhanced recoveries to those same individual stakeholders. These two scenarios appear to be identical in substance and, as such, should not be treated differently.

Overlooked Lessons from *Nuverra*

As mentioned, the Third Circuit dismissed as equitably moot an appeal brought by a member of the dissenting class in *Nuverra*. See 834 F. App'x at 736. At issue was whether the appeal was equitably moot notwithstanding the fact that the only relief sought by the appellant was an individual payout of $450,000 (i.e., the 100% recovery that the trade class had received), which independently would not have "fatally scramble[d] the plan." *Id.* at 733. The Third Circuit held that the size of the requested individual payout was irrelevant because, under Section 1123(a)(4), "one creditor [cannot receive] more than the other creditors in the same class." *Id.* at 734. The only remedy appellant could have legally pursued was "relief for the [entire] class of creditors unfairly discriminated against," which would have fatally scrambled the plan and was thus equitably moot. *Id.* at 735. Highlighting the importance of the equal treatment requirement under Section 1123(a)(4), the Third Circuit further noted that the appellant would not have been successful in arguing to the bankruptcy court that the appropriate remedy to address his plan objection was for the plan "to pay only him and no one else in his class." *Id.* Nor did it matter, the Third Circuit held, whether the appellant requested an individualized payout to be funded by the debtors or the secured creditors themselves, because "an individualized payout is not permitted in any event." *Id.* at 733 n.5.

While the court declined to opine on the permissibility of horizontal gifting, its decision casts significant doubt on the legality of gifts to individual class members in the Third Circuit. As demonstrated by the Delaware district court's more recent *Exide* decision, which allowed disparate treatment of class members because their recoveries were not funded by the debtor, market participants may have overlooked the significance of the Third Circuit's *Nuverra* decision beyond the issue of equitable mootness. Moving forward, other jurisdictions — including the Southern District of New York (where *Journal Register* was decided) — may prove to be better options for debtors and senior creditors seeking to implement gifts to individual junior stakeholders as part of a Chapter 11 plan. ¤

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