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On the Edge

Delaware Court Invalidates Use of So-called "SPM Arrangement" in Chapter 11 Plan

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In an important recent decision, U.S. District Judge Robreno, sitting by designation in Delaware,[2] denied confirmation of Armstrong World Industries Inc.'s reorganization plan.[3] Specifically, Judge Robreno found that the plan violated bankruptcy's "absolute priority" rule, as codified in §1129(b)(2)(B)(ii) of the Code, by seeking to effect a distribution of warrants to existing equity through a waiver of the right to receive such warrants by a class of asbestos personal injury claimants—a so-called "SPM arrangement"[4]—notwithstanding that another class of general unsecured creditors voted against the plan and stood to receive only approximately $0.60 on the dollar.[5] The decision's significance extends beyond *Armstrong* because it rejects the use under a cramdown plan of a commonly employed technique to leak value down to junior classes where none might otherwise exist.

Armstrong's Chapter 11 Plan

Armstrong's plan classified creditors into 11 separate creditor classes and included a single class of equity interest-holders. Of importance to Judge Robreno's decision were the distributions to three of those classes—Class 6 (general unsecured creditors), Class 7 (asbestos personal injury claimants) and Class 12 (equity interest-holders). Under Armstrong's plan, general unsecured creditors in Class 6 and asbestos personal injury claimants in Class 7 would not be paid in full, while equity interest-holders would receive warrants in the reorganized debtor valued at approximately $35-$40 million.[6]


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A critical component of the plan was the asbestos personal injury claimants' consent to share through the plan a portion of their proposed distribution with equity interest-holders. Specifically, pursuant to the plan, if Class 6 (general unsecured creditors) voted against the plan (which it did), then the warrants to be distributed directly to equity interest-holders would be distributed to holders of allowed asbestos personal injury claims who, in turn, would automatically waive receipt of the distribution, directing it instead to the equity interest-holders. If allowed, this reallocation of distributions under the plan would have resulted in holders of equity interests receiving warrants on account of their equity interests despite a senior class of general unsecured creditors receiving less than full payment of its allowed claims. "It is the lawfulness of this arrangement that forms the central issue in the case."[7]

In re SPM Manufacturing Corp.

The practice of senior creditors forfeiting a portion of their distributions in favor of junior creditors or equity interest-holders is rooted in the First Circuit's decision in *In re SPM Mfg. Corp.*, the case *Armstrong* primarily relied upon. At issue in *SPM* was the validity of an agreement between the debtor's secured lender and the creditors' committee under which the former agreed to share a portion of its distribution with general unsecured creditors, despite the debtor's inability to pay intervening priority tax creditors in full. The secured lender held a lien on substantially all of the debtor's assets, but the obligations secured by the lien exceeded the value of the debtor's assets; as a result, absent the sharing arrangement, unsecured creditors stood to recover little if anything on account of their claims. By agreeing to share a portion of its recovery with unsecured creditors, the secured lender sought to obtain the committee's cooperation throughout the remainder of the case.[8]

Subsequent to the secured lender and the committee's entry into the sharing arrangement, the debtor's assets were sold for $5 million, or $4 million less than the secured creditor's claim. Almost immediately after the sale, the debtor's case was converted to chapter 7 and the secured lender and the committee jointly moved for entry of an order authorizing that the sale proceeds be distributed to them in accordance with their sharing arrangement. The debtor and its principal objected on the ground that the sharing arrangement violated the Code's distribution requirements by permitting a distribution to general unsecured creditors ahead of priority tax creditors. The secured lender and the committee responded that the sale proceeds belonged to the secured creditor, and the secured creditor had the right to share them with general unsecured creditors without first having to satisfy priority claims.[9]

The bankruptcy court agreed with the debtor and ordered that the money that otherwise would have gone to the general unsecured creditors under the sharing arrangement (net of certain expenses) should

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2 Hon. Eduardo C. Robreno, a judge in the U.S. District Court for the Eastern District of Pennsylvania, was designated by the Third Circuit Court of Appeals to sit on the District Court for the District of Delaware in the *Armstrong* case. Because Armstrong's reorganization plan required the issuance of a §524(g) channeling injunction, the bankruptcy court's proposed findings of fact and conclusions of law and proposed confirmation order were reviewed by Judge Robreno pursuant to Bankruptcy Rule 9033.

3 *In re Armstrong World Indus. Inc.*, 320 B.R. 523 (D. Del. 2005). Armstrong has appealed Judge Robreno's order denying confirmation to the Third Circuit Court of Appeals.

4 *SPM* is a reference to the First Circuit's decision in *Official Unsecured Creditors' Comm. v. Stern (In re SPM Mfg. Corp.)*, 984 F.2d 1305 (1st Cir. 1993), in which a senior secured lender was permitted to surrender a portion of its distribution from the debtor's estate to general unsecured creditors notwithstanding that priority creditors were not paid in full.

5 *Armstrong*, 320 B.R. at 526.

6 *Id.* at 525-26.

7 *Id.* at 526.

8 *Id.* at 1308.

9 *Id.* at 1309.

instead be paid to the chapter 7 trustee for distribution to creditors, including holders of priority tax claims, in accordance with the Code's priority scheme. On appeal, the district court determined that the bankruptcy court appropriately exercised its equitable powers by reforming the sharing arrangement to comply with the Code's chapter 7 distribution priorities.[10]

However, the First Circuit Court of Appeals reversed, holding that the sharing arrangement did not violate the Code's priority scheme. The court observed correctly that priority creditors were not entitled to receive a distribution given that the entire $5 million rightfully belonged to the secured lender. Importantly, for purposes of upholding the arrangement, the siphoning of a portion of the $5 million to general unsecured creditors was to occur *after* distribution of the funds to the secured lenders, having no effect whatever on the distributions of *estate* property to other creditors.[11] The First Circuit went on to note that §726 and the other Code provisions governing payment priorities apply only to distributions of estate property and are not implicated by agreements to transfer estate property once it has passed into the hands of the debtor's creditors. At that point, the court observed, "creditors are generally free to do whatever they wish with the bankruptcy dividends they receive, including to share them with other creditors."[12]

The Holding in *Armstrong*

Unlike the sharing arrangement the First Circuit upheld in *SPM,* the arrangement proposed by Armstrong required a distribution of *estate* property—*i.e.,* warrants—*under the plan* to a junior class of interest-holders ahead of a senior creditor class that was not being paid in full and voted to reject the plan. Such an arrangement, though not uncommon in chapter 11 plans, implicates the Code's "absolute priority" rule and, according to Judge Robreno, absent consent, must comply with §1129(b)(2)(B)(ii) to pass muster.[13]

Section 1129(b)(2)(B)(ii) provides, in pertinent part, that:

> (b) ...the court...shall confirm the plan...if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan.
>
> > (2) For the purpose of this subsection, the condition that a plan be fair and equitable with respect to a class includes the following requirements...
> >
> > (B) With respect to a class of unsecured claims...
> >
> > (ii) the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property.

11 U.S.C. §1129(b)(2)(B)(ii). This provision is referred to colloquially as the "absolute priority" rule.

Construing §1129(b)(2)(B)(ii) to give it its plain meaning, Judge Robreno determined that "a plan is not 'fair and equitable' if a class of creditors [*sic*] that is junior to the class of unsecured creditors receives debtor's property because of its ownership interest in the debtor while the allowed claims of the class of unsecured creditors have not been paid in full."[14] Applying these plain requirements to the situation before him, Judge Robreno found that it was clear that (1) the interests held by the debtor's equity interest-holders were junior to the claims of the debtor's general unsecured creditors; (2) *under the plan,* the interest-holders would receive *property of the debtor—i.e.,* warrants—on account of their interests in the debtor; and (3) the unsecured creditors' allowed claims would not be paid in full. Under these circumstances, Judge Robreno found that Armstrong's plan violated §1129(b)(2) (B)(ii) of the Code because it was not "fair and equitable" to the debtor's general unsecured creditors.[15]

Judge Robreno found further support for his conclusion that the plan was not "fair and equitable" in the Code's legislative history. Specifically, Judge Robreno noted that Sens. Edwards and DeConcini—key legislators of the Code—rejected a proposal contained in the Senate Report that would have permitted a senior creditor to alter its distribution for the benefit of stockholders under the "fair and equitable" standard. "'[A] senior class will not be able to give up value to a junior class over the dissent of an intervening class unless the intervening class receives the full amount, as opposed to value, of its claims or interests.'"[16]

Finally, Judge Robreno distinguished *SPM* and the cases Armstrong relied upon to support its distribution of warrants to interest-holders. Most notably, Judge Robreno found *SPM* inapposite because, unlike in *Armstrong,* the arrangement in *SPM* altered the parties' distributions only *after* the estate property had already been distributed. Judge Robreno further distinguished *SPM* in the following two respects:

- *SPM* involved distributions under chapter 7 where §1129(b)(2)(B)(ii) does not apply, and
- The property distributed in *SPM* was not subject to chapter 7's priority scheme—*see* 11 U.S.C. §726—which is not implicated until all valid secured claims are first satisfied (in *SPM,* the secured lender was undersecured).[17]

The other cases upon which *Armstrong* relied—*In re WorldCom Inc.,* No. 02-13533, 2003 Bankr. LEXIS 1401 (Bankr. S.D.N.Y. Oct. 31, 2003); *In re Genesis Health Ventures Inc.,* 266 B.R. 591 (Bankr. D. Del. 2001); and *In re MCorp. Fin. Inc.,* 160 B.R. 941 (S.D. Tex. 1993)—were determined to be factually inapposite.[18] Alternatively, Judge Robreno concluded that to the extent these other cases read *SPM* unconditionally to mean that "'[c]reditors are generally free to do whatever they wish with the bankruptcy dividends they receive, including sharing them with other creditors, so long as recoveries received under the [p]lan by other creditors are not impacted,'...without adherence to the strictures of 11 U.S.C. §1129(b)(2)(B)(ii), that contention is flatly rejected here."[19]

The Future of *SPM* Arrangements

Judge Robreno's *Armstrong* decision does not spell an end to the use of "*SPM* arrangements" under a plan. To the contrary, a senior creditor class can still siphon value to a junior class under a plan where an intervening or co-equal class(es) is not being paid in full if such intervening or co-equal class(es) consents. Absent such consent, however, parties should consider implementing the "*SPM* arrangement" outside of a plan, to the extent practicable. ■

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10 *Id.* at 1309-10.
11 *Id.* at 1312.
12 *Id.* at 1313 (internal citations omitted).
13 *Id.* at 526.
14 *Armstrong,* 320 B.R. at 536.
15 *Id.*
16 *Id., citing* 124 Cong. Rec. S. 34007 (Oct. 5, 1978) (remarks of Sen. DeConcini); 124 Cong. Rec. H. 32408 (Sept. 28, 1978) (remarks of Rep. Edwards). Though *Armstrong* did not involve a senior class siphoning value to a junior class over the objection of an *intervening* class, Judge Robreno nonetheless invoked this prohibition found in the legislative history to prevent the *co-equal* class of asbestos personal-injury claimants from giving up value to a junior class of interest-holders over the objection of the *co-equal* class of general unsecured creditors.
17 *Id.* at 538-39.
18 *Id.* at 539.
19 *Id.* at 540 (internal citations omitted).