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What exactly does the term "Fair and Equitable" mean?

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In a plan of reorganization, the Bankruptcy Code outlines a priority scheme that must be strictly adhered to. 11 U.S.C. § 1129. According to the Code, "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). When faced with the question of extending the codified priority rule to settlement approvals, the Fifth Circuit in *United States v. AWECO Inc. (In re AWECO, Inc.),* 725 F.2d 293 (5th Cir. 1984) held that the rule applied to all settlements, even those made prior to a plan of reorganization. *Id.* at 298. More recently, the Second Circuit in *Motorola Inc. v. Official Comm. of Unsecured Creditors (In re Iridium Operating LLC),* 478 F.3d 452 (2d Cir. 2007) was faced with the same issue but choose not to adopt the *AWECO* rule. *Id.* at 455. ("This case requires us to determine whether . . . Bankruptcy Code's priority scheme for reorganization plan distributions—applies to bankruptcy court approval of a settlement under Rule 9019."). The Second Circuit Court of Appeals held that although a pre-plan settlement's distribution plan's compliance with the Bankruptcy Code's priority scheme is the most important factor to consider in approving a settlement under Bankruptcy Rule 9019, it was not necessarily dispositive. *Id.* at 464.

Rule 9019 requires that all settlements be approved by a court; however, the Bankruptcy Code does not provide guidelines for how to determine whether a settlement should be approved. Fed. Rules Bankr. Proc. 9019. This problem was addressed by the Supreme Court in *TMT*

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Trailer Ferry, Inc., v. Anderson, 390 U.S. 414, 424 (1967). In that case the Court adopted the statutory language "fair and equitable" from the Bankruptcy Act §§ 174, 221(2), which dealt with plans of reorganization. *Id.* at 424 ("The requirements of [ ], that plans of reorganization be both 'fair and equitable,' apply to compromises just as to other aspects of reorganizations.") (citations omitted). Although the language was adopted from the Bankruptcy Act, which has been replaced by the Bankruptcy Code 11 U.S.C. § 1129, "its principles have been broadly held applicable to settlements under the Bankruptcy Code." 2 NORTON BANKR. L. & PRAC. 2d § 41:10 (2007). In *TMT Trailer Ferry,* the Court lists several factors courts should look to in determining whether a settlement is "fair and equitable." 390 U.S. at 424. Specifically the court held that "the judge should form an educated estimate of the complexity, expense, and likely duration of such litigation, the possible difficulties of collecting on any judgment which might be obtained, and all other factors relevant to a full and fair assessment of the wisdom of the proposed compromise." *Id.*

Under the Code in order to be "fair and equitable," a plan of reorganization must adhere to the priority scheme. 11 U.S.C. § 1129. The Supreme Court has failed to directly address the issue of whether settlements must adhere to the priority scheme. *See TMT Trailer Ferry,* 390 U.S. 414. The only guidance the Court has provided is that settlements must be "fair and equitable" and judges should weigh all relevant factors in determining this. *See id.* at 424*; See also* 10 COLLIER ON BANKRUPTCY, ¶9019.02 at 9019-4 (Alan N. Resnick et al. Eds., 15th ed. Rev. 2006) (interpreting Supreme Court in *TMT Trailer Ferry* as requiring courts to take into account all relevant factors to determine whether compromise is "fair and equitable"). It is widely agreed upon that the priority scheme is relevant to the analysis of fair and equitable, however, there is a split in the circuits as to how the priority scheme should be applied. *See Iridium,* 478 F.3d 452;

AWECO, 725 F.2d 293; *Olson v. Anderson (In re Anderson)*, 377 B.R. 865, 870 n. 3 (6th Cir. B.A.P. 2007). The next section will compare the Fifth Circuit's holding in *AWECO,* 725 F.2d 293 with the Second Circuit's holding in *Iridium,* 478 F.3d 452.

The *AWECO* Rule

The first court to address the issue of how to apply the priority scheme to pre-plan settlements was the Fifth Circuit Court of Appeals in *AWECO.* 725 F.2d 293. *AWECO* involved three parties: AWECO, Inc., United American Car Co. ("United") and the United States. *Id.* at 295. AWECO was a debtor who was primarily engaged in the oil and gas business. *Id.* AWECO filed Chapter 11 in 1981 and a few months later filed a plan of reorganization which was never submitted to the creditors or the court. *Id.* United was a creditor who held an unsecured, unliquidated claim for $27 million. *Id.* After extensive litigation AWECO and United came to terms and settled for $5.8 Million. *Id.* In November of 1981, AWECO filed a notice with the bankruptcy court of its intention to settle. *Id.* at 296. Some of the secured creditors filed objections to the proposed settlement. *Id.* They argued that the settlement was unfair. *Id.* Ultimately the bankruptcy court issued a written order that the settlement was "'fair and equitable'" and "'in the best interests of the [d]ebtor, its estate, and its creditors.'" *Id.* at 297. The secured creditors sought a rehearing and the judge agreed to hear more testimony. *Id.* However, after hearing more testimony the judge denied a stay and approved the settlement. *Id.*

Following that bankruptcy court's decision, two of the creditors, the government and the Department of Energy appealed to the district court. *Id.* They argued the approved settlement was unfair to the secured creditors. *Id.* The district court rejected this argument, and affirmed the bankruptcy court on the basis that the lower court judge had taken into account extensive

testimony and decided that this settlement would provide the debtor its only chance at reorganization. *Id.*

Following the district court's decision, the IRS, one of AWECO's secured creditors, appealed to the Fifth Circuit Court of Appeals asserting "that the bankruptcy court abused its discretion in approving the settlement of the unsecured, unliquidated claim." *Id.* The government claimed that the "principles of fairness and equity fell victim to the perceived need for speed in approving the settlement." *Id.* In response to those claims, the Fifth Circuit Court of Appeals noted that when approving compromises, the decision lies with the discretion of the judge and an appellate court will only reverse when that discretion has been abused. *Id.* The court went on to hold that compromises must be "fair and equitable" when they make up part of a plan of reorganization. *Id.* at 298. In order to be "fair and equitable" the court stated that a settlement must follow the priority scheme and if a court approves a settlement as part of a plan of reorganization that violates the priority scheme, it has abused its discretion. *Id.*

However, the court recognized that the settlement between United and AWECO was approved prior to, and separate from, a plan of reorganization. Therefore, the court had to decide whether a settlement proposed for approval prior to a plan of reorganization should be subject to the absolute priority rule. *Id.*

United argued that the "fair and equitable" standard should not extend to such settlements because an extension would "frustrate the new Bankruptcy Code's policy of 'less rigid and formalized procedures.'" *Id.* It argued that applying the "fair and equitable" standard would preclude all settlements prior to a plan of reorganization. *Id.*

The court decided the issue was narrower; the only question was whether a senior creditor could validly object to a settlement based on the fact that the settlement would keep him from

being paid in full. *Id.* The court held the "fair and equitable" doctrine should be extended to settlements created prior to a plan of reorganization and rejected United's argument that all plans would thus be precluded. *Id.* (noting "if the standard had *no* application before confirmation of a reorganization plan, then bankruptcy courts would have the discretion to favor junior classes of creditors so long as the approval of the settlement came before the plan."). Therefore, if a court approved *any* settlement in violation of the priority scheme, it abused its discretion and must be reversed. *Id*. The next section will discuss how the *AWECO* holding has been interpreted throughout the different circuits.

Subsequent History of *AWECO*

First Circuit

Citing *AWECO,* a court within the First Circuit held that the standard set out by the Code for plans of reorganization applied equally to settlements even when the settlement was seeking approval prior to a plan. *In re Public Serv. Co.*, 114 B.R. 820, 826 (Bankr. D. N.H. 1990). Another First Circuit court in a less clear interpretation rejected a settlement where it was unable to determine whether or not the priority scheme may be altered by the terms of the settlement. *In re Libreria Alma Mater, Inc.*, 123 B.R. 698 (Bankr. D. P.R. 1991). Although the court cited *AWECO* in its opinion, it did so only to show the standard of review was abuse of discretion. *Id.* at 699 n. 3. However, the court cited the section of the Code requiring plans of reorganization to adhere to the priority scheme in deciding whether to approve the settlement. *Id.* at 700. Ultimately the court did not approve the settlement because it did not have enough facts to analyze whether the settlement was in the "best interest of all creditors." *Id.* It is unclear whether or not the court was going to adopt the per se rule set out in *AWECO* or whether the court, with enough facts, could have found an adequate reason to allow the priority scheme to be altered. *Id.*

Third Circuit

A Third Circuit Bankruptcy Court cited *AWECO* stating that a settlement must be "fair and equitable." *Walsh v. Hefren-Tillotson, Inc., (In re Devon Capital Mgmt.),* 261 B.R. 619, 623 (Bankr. W.D. Pa. 2001). Immediately following the citation of *AWECO* the court stated, "[e]ven if a settlement is fair and equitable to the parties to the settlement, approval is not appropriate if the rights of others who are not parties to the settlement will be unduly prejudiced." *Id.* This seems to support the holding in *AWECO* that approval shall not be granted where secured creditors interests may be unduly prejudiced. *AWECO,* 725 F.2d at 298. Another Third Circuit Bankruptcy case came out to a similar conclusion. In *In re Medical Asset Management, Inc.,* 249 B.R. 659, 663 (Bankr. W.D. Pa. 2000) the court stated, "[F]airness and equity require in [approving a settlement], for instance, that the rights of a senior creditor may not be adversely affected by a settlement agreement between a debtor and a junior creditor."

Seventh Circuit

Perhaps the Seventh Circuit Court of Appeals had the most interesting interpretation of *AWECO* in *In re American Reserve Corp.,* 841 F.2d 159, 162 (7th Cir. 1987). In that case the court cited *AWECO* for the definition of what "fair and equitable" means in regards to the priority scheme. *Id.* ("'Fair and equitable' is a term of art that means that 'senior interests are entitled to full priority to junior ones'" (*In re American Reserve Corp.,* 841 F.2d 159, 162 (quoting *AWECO*, 725 F.2d at 298)). However, the court then stated that whether the priority scheme is followed should merely be a factor courts should consider in determining whether a settlement is in the estate's best interest. *American*, 841 F.2d at 162. This analysis is almost identical to that of *Iridium,* which was not decided for another twenty years, however, *Iridium*

fails to cite *American* anywhere in its holding. *Iridium*, 478 F.3d 452. The next section will discuss the Second Circuit's interpretation of *TMT Trailer Ferry*, and *AWECO*.

The *Iridium* Rule

Recently, in *Iridium,* the Second Circuit Court of Appeals held that although a pre-plan settlement's distribution plan's compliance with the bankruptcy code's priority scheme is the most important factor to consider in approving a settlement under Bankruptcy Rule 9019, it is not necessarily dispositive. *Id.* at 464 ("[W]hether a particular settlement's distribution scheme complies with the Code's priority scheme must be the most important factor for the bankruptcy court to consider when determining whether a settlement is fair and equitable under Rule 9019."). Although the court noted both the importance of compliance with the priority scheme and that non-compliance is often dispositive, it rejected the per se rule of *AWECO*. *Id.* at 464.

Facts and Procedural Background

Iridium Operating LLC ("Iridium") was in Chapter 11 proceedings. *Id*. at 456. JPMorgan Chase Bank and other lenders ("Lenders") asserted liens over much of what was left of Iridium. *Id.* The Official Committee of Unsecured Creditors ("Committee") contested those liens, including the Lenders' claim to Iridium's remaining cash held in accounts at Chase. *Id.* The Committee also sought claims against Motorola Inc. ("Motorola"), who was Iridium's former parent company. *Id.* There was a settlement between the Lenders and the Committee, which included setting up a litigation vehicle for the Committee to sue Motorola and placing some of the funds in the possession of a newly created entity, the Iridium Litigation LLC ("ILLLC"). *Id.* at 459. Motorola objected to the settlement on the grounds that it took a portion of estate property and distributed it to lower priority creditors (ILLLC) before any payments were made to it. *Id.* The settlement was approved at the bankruptcy court and that decision was affirmed at the

district court. *In re Iridium Operating LLC,* 2005 WL 756900 (S.D.N.Y. Apr 04, 2005). Motorola then appealed to the Second Circuit Court of Appeals. *Iridium,* 478 F.3d at 460.

Second Circuit Court of Appeals

On appeal, Motorola argued that the settlement should not have been approved by the lower court because it provided for the transfer of money from the estate to a newly-created entity, and from the entity to the unsecured creditors after litigation in a separate suit with the company. *Id.* at 462. Motorola claimed that "a settlement can never be fair and equitable if junior creditors' claims are satisfied before those of more senior creditors." *Id.* Motorola based this claim on the "fair and equitable" standard set out in the Bankruptcy Code. 11 U.S.C. § 1129. Agreeing with Motorola that the code's "fair and equitable" language applies to settlements, the court quoted the Supreme Court in *TMT Trailer Ferry*, "'[t]he requirements . . . that plans of reorganization be both "fair and equitable," apply to compromises just as to other aspects of reorganizations.'" *Iridium*, 478 F.3d at 463 (quoting *TMT Trailer Ferry*, 390 U.S. at 424).

The court did not agree, however, that the fair and equitable language meant that the priority scheme must be followed. *Iridium,* 478 F.3d at 464. Instead the court held that compliance with the priority scheme is the most important factor a court should consider in approving a settlement. *Id.* When a settlement impairs the rule of priorities it must show specific and credible grounds to justify that deviation and the court must "carefully articulate its reasons" for approval of the agreement. *Id.* at 465 ("[B]ankruptcy court . . . could endorse a settlement that does not comply . . . with the priority rule if the parties to the settlement justify, and the reviewing court clearly articulates the reasons for approving, a settlement that deviates from the priority rule."). Therefore, because the lower court did not carefully articulate its reasons for approval of the agreement the court remanded the case to the bankruptcy court for an assessment

of the justification for an impairment of the code's priority scheme. *Id.* at 467. The next section will discuss how courts have interpreted the holding in *Iridium*. *Id.*

Subsequent History

The decision in *Iridium* has been widely cited across the country in different circuits. For example, a Fourth Circuit bankruptcy court cited *Iridium* to support it's holding that the priority scheme does not need to be followed in all cases involving approval of settlements. *In re Tackley Mill, LLC*, 386 B.R. 611, 615 (Bankr. N.D. W. Va. 2008); *See also In re AB&C Group Inc.*, 2008 Bankr. LEXIS 1940, *30–31 (Bankr. N.D. W. Va. July 2, 2008) (acknowledging holding in *Iridium* and *Tackley,* however, finding no need to apply holdings to its particular fact pattern). Similarly, the Sixth Circuit Bankruptcy Appellate Panel cited *Iridium* in deciding the "fair and equitable" language by the Court in *TMT Trailer Ferry* did not require that a settlement comply with the priority scheme. *Anderson,* 377 B.R. at 870 n. 3. Furthermore, in adopting *Iridium* it held that whether the priority scheme is followed is a crucial factor in approving a settlement. *Id.* Lastly, the D.C. Circuit District Court included "the interest of creditors" as one of the factors to consider in approving a settlement. *Advantage Healthplan, Inc. v. Potter,* 391 B.R. 521, 554 (D.C. Cir. 2008). Although it did not explicitly mention the priority scheme the court cited the decision in *Iridium* regarding "the interest of creditors" factor. *Id.*

Conclusion

Iridium is important because it takes a different approach to pre-plan settlement then the Fifth Circuit did in *AWECO.* 725 F.2d 293. In *AWECO*, the court held that the Code's absolute priority rule applied to all pre-plan settlements under Rule 9019. *Id.* at 298. The court in *Iridium* noted that the Fifth Circuit was correct in its view that there could be problems if the priority scheme was not considered when approving settlements, but thought that the *per se* application

of it was to rigid. *Iridium*, 478 F.3d at 464 ("The Fifth Circuit accurately captures the potential problem a pre-plan settlement can present for the rule of priority, but, in our view, employs to rigid a test. . . . A rigid per se rule cannot accommodate the dynamic status of some pre-plan bankruptcy settlements.").

It is important to note, because the Second Circuit in *Iridium* adopted a less rigid rule, it gives judges discretion to allow settlements that do not follow the priority scheme of 11 U.S.C §1129(b)(2)(B)(ii). *Iridium,* 478 F.3d at 464. The court explained that this creates a heightened risk of collusion between parties to a settlement. *Id.* (noting rejecting the per se rule in *AWECO* creates heightened risk parties to a settlement may engage in improper collusion). However, this risk may not be as great as one might think. Giving judges discretion may be the best policy because a judge's decision can be appealed for review, whereas a per se rule would leave no room for discretion or review. *Id.* at 461 n. 13 ("[B]ankruptcy court's articulation of Rule 9019's standard for evaluation a settlements is a legal issue subject to de novo review."). Furthermore, if the risk of collusion still exists, even with the opportunity for appeal, there may be benefits that outweigh it. The Second Circuit's discretionary test may promote settlements and increase judicial efficiency. *See Will v. Northwestern Univ. (In re Nutraquest, Inc.)*, 434 F.3d 639, 644 (noting that settlements are favored but courts must be careful in approving them). If the settlement must follow the strict priority scheme than there is less incentive to try to settle. *Iridium*, 478 F.3d at 464. As the Second Circuit noted, a *per se* rule might make it impossible to settle disputes early in a case when the priority of claims is still uncertain. *Id.* There is a clear a split among the circuits that is ripe for resolution by the Supreme Court.