

Objection to Confirmation Based on Senior Creditor Overpayment

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INTRODUCTION

Bankruptcy courts are regularly faced with concerns over fairness and equity. One of these concerns is ensuring that no claimant receives more than its allowed claim. Typically, overpayment occurs when a junior creditor is paid before a senior creditor has been paid in full. However, courts have found that the “fair and equitable” provision of section 1129(b) applies to senior creditors as well. In these cases, courts have found a plan of reorganization to violate section 1129 when such plan would cause a senior creditor to be paid a premium over its allowed claim. Under such circumstances, a plan of reorganization will not be confirmed.

Part I of this paper discusses plan confirmation under section 1129, including the requirements for a plan of reorganization, how a plan may still be confirmed over the objection of dissenting classes through the cramdown power, and the “fair and equitable” principle. Part II analyzes the legal standards some courts apply in determining whether a plan is fair and equitable, specifically when the plan has overpaid senior creditors. The memo concludes by recognizing that a plan of reorganization may be objected to when a senior creditor has been paid more than its allowed claim, and by squaring this conclusion with the basic notions of fairness and equity embodied in the bankruptcy process.

I. CONFIRMATION OF A PLAN UNDER SECTION 1129

In many bankruptcy cases, a plan for reorganization will be confirmed if all of the requirements set forth in section 1129 of the Code are satisfied and all parties have accepted the plan.¹ When one or more classes of claims have not accepted the plan, it may only be confirmed by invoking the cramdown power.² Under section 1129(b) of the Code, the plan must, among other things, be “fair and equitable” when the cramdown power is used.³ Courts and scholars have interpreted this to mean “that no creditor or interest holder be paid a ‘premium’ over the allowed amount of its claim. Once the participant receives or retains property equal to its claim, it may receive no more.”⁴

A. Requirements For Plan Confirmation Under Section 1129

In a majority of cases in which a plan is confirmed, all classes of claims and interests will accept the plan, commonly known as consensual confirmation, and therefore will only need to satisfy the general standards of confirmation,⁵ such as the requirements that the plan itself and the supporter of the plan comply with applicable provisions of chapter 11,⁶ that the plan be proposed in good faith,⁷ and that certain payments that are made under the plan or in connection with the plan be disclosed to the court and approved as being reasonable.⁸ Additionally, the statute protects the interests of dissenting members by requiring that each member receive at

¹ 11 U.S.C. 1129(a) (2006).

² *See, e.g.,* Klee, *All You Ever Wanted to Know About Cram Down Under the Bankruptcy Code*, 53 Am. Bankr.L.J. 133, 138 (1979).

³ 11 U.S.C. 1129(b)(1) 2006.

⁴ 7 COLLIER ON BANKRUPTCY ¶ 1129.03[4][a][ii] (Alan N. Resnick & Henry J. Sommer eds., 15th ed. rev. 2007)

⁵ *See* 11 U.S.C. 1129(a)(1) – (7) & (9) – (11). *See also* 11 U.S.C. §§ 1129(c) – (d).

⁶ 11 U.S.C. § 1129(a)(1) – (2)

⁷ 11 U.S.C. § 1129(a)(3)

⁸ 11 U.S.C. § 1129(a)(4)

least as much as it would have under liquidation,⁹ and by requiring that the plan be feasible, meaning the confirmation of the plan is not likely to be followed by liquidation or the need for further financial reorganization.¹⁰ If these requirements are met, a plan will be confirmed. However, if all of the requirements for a plan of confirmation have been met, except that one or more classes of claims or interests have not accepted the plan, confirmation may only occur through cramdown.

B. Confirmation of a Plan Through Cramdown

As outlined by the Supreme Court in *Bank of America National Trust and Sav. Ass'n v. 203 North LaSalle Street Partnership*, there are two conditions for a cramdown.¹¹ First, all of the requirements under section 1129(a), except the plan's acceptance by each impaired class of claims or interests under 1129(a)(8),¹² must be met. Second, the objection of an impaired creditor ("dissenting class") may be disregarded if the plan is does not unfairly discriminate and is both fair and equitable.¹³ Both the unfair discrimination and the "fair and equitable" standard are laid out in section 1129(b)(1) of the Code. If the proposed plan protects the legal rights of dissenting classes or claims in a manner consistent with the treatment of other classes whose legal rights are intertwined with those of the dissenting class, it will be said that the plan does not

⁹ 11 U.S.C. § 1129(a)(7)(A). With respect to each impaired class of claims or interests (A) each holder of a claim or interest of such class (i) has accepted the plan; or (ii) will receive or retain under the plan on account of such claim or interest property of a value, as of the effective date of the plan, that is not less than the amount that such holder would so receive or retain if the debtor were liquidated under chapter 7 of this title on such date.

¹⁰ 11 U.S.C. § 1129(a)(11)

¹¹ *Bank of America National Trust and Sav. Ass'n v. 203 North LaSalle Street Partnership*, 526 U.S. 434, 441 (1999).

¹² *Id.* (noting that "the conditions that the plan be accepted by at least one class of impaired creditors, see § 1129(a)(10), and satisfy the 'best-interest-of-creditors' test, see § 1129(a)(7)" are among the most critical).

¹³ *Id.*

unfairly discriminate dissenting classes.¹⁴ An analysis of the “fair and equitable” standard may be found below. Prior to satisfying the two cramdown conditions, the proponent of the plan must request the use of this section and subsequently has the burden of showing that both sections 1129(a) and 1129(b) have been met.¹⁵

C. The “Fair and Equitable” Standard of § 1129(b)

Once the proponent has demonstrated that the plan does not unfairly discriminate, it must show that the plan is both fair and equitable.¹⁶ One major component of the fair and equitable standard is the absolute priority rule, which essentially states that no junior creditor can be paid before a senior creditor is paid in full.¹⁷ Another way of understanding the rule is that “a plan of reorganization may not allocate any property whatsoever to any junior class on account of the members' interest or claim in a debtor unless all senior classes consent, or unless such senior classes receive property equal in value to the full amount of their allowed claims, or the debtor's reorganization value, whichever is less.”¹⁸ In most cases, this will be a non-issue because once

¹⁴ See, e.g., Klee, *All You Ever Wanted to Know About Cram Down Under the Bankruptcy Code*, 53 Am. Bankr.L.J. 133, 142 (1979).

¹⁵ See *In re MCorp Financial, Inc.*, 137 B.R. 219, 225 (Bankr. S.D. Tex. 1992). Proponents of a plan have the burden of proving by a preponderance of the evidence that all of the requirements of § 1129(a) have been met. *Home Savings Ass'n v. Woodstock Assocs. I, Inc. (In re Woodstock Assocs. I, Inc.)*, 120 B.R. 436, 453 (Bankr. N.D. Ill. 1990). Proponents' burden of proof under § 1129(b), the cramdown provision, calls for clear and convincing evidence. *In re Rusty Jones, Inc.*, 110 B.R. 362, 373 (Bankr. N.D. Ill. 1990).

¹⁶ 11 U.S.C. § 1129(b)(2) (2006).

¹⁷ *Bank of America National Trust and Sav. Ass'n v. 203 North LaSalle Street Partnership*, 526 U.S. 434, 441 (1999) (“As to a dissenting class of impaired unsecured creditors, such a plan may be found to be ‘fair and equitable’ only if the allowed value of the claim is to be paid in full, §1129(2)(B)(i), or, in the alternative, if ‘the holder of any claim or interest that is junior to the claims of such [impaired unsecured] class will not receive or retain under the plan on account of such junior claim or interest any property,’ § 1129(b)(2)(B)(ii). The latter condition is the core of what is known as the ‘absolute priority rule.’”).

¹⁸ 7 COLLIER ON BANKRUPTCY ¶ 1129.03[4][a][i] (Alan N. Resnick & Henry J. Sommer eds., 16th ed. rev. 2011)

the plan has allocated all reorganization value to all senior classes, there usually is nothing left to distribute to junior creditors.¹⁹

Courts have recognized the existence of another aspect of the absolute priority rule, noting that “a senior class cannot receive more than full compensation for its claims.”²⁰ Courts’ recognition of this “corollary” to the absolute priority rule is significant in determining whether a plan can be objected to if a senior creditor receives more than its allowed claim.²¹ Courts will deny confirmation of a plan, finding the plan is not fair and equitable if it undervalues debtors and would result in paying senior creditors more than full compensation for their allowed claims.²²

II. TREATMENT OF THE “FAIR AND EQUITABLE” STANDARD BY BANKRUPTCY COURTS

Long before the adoption of section 1129(b) of the Code, courts applied the “fair and equitable” standard by relying on case law, Chapter X, and section 77B of the Bankruptcy Act of 1898, a predecessor to the currently used Bankruptcy of 1978, commonly referred to as “the Code.” As the courts interpreted it, “fair and equitable” meant absolute priority. Thus no junior class could receive anything unless senior classes were paid in full.²³ Under the Code, the concept of the fair and equitable standard is the same. However, there is one distinction from its

¹⁹ *Id.*

²⁰ *In re Genesis Health Ventures, Inc.*, 266 B.R. 591, 612 (Bankr. D. Del 2001).

²¹ *Id.*

²² *In re Chemtura Corp.*, 439 B.R. 561, 592 (Bankr. S.D.N.Y. 2010).

²³ 6 NORTON BANKRUPTCY LAW AND PRACTICE § 113:3 (William L. Norton, Jr. ed., 3d ed. 2008)

previous incarnation.²⁴ Unlike the Chapter X absolute priority, which applied to all classes, section 1129(b) of the Code only applies to dissenting classes.²⁵

The absolute priority rule was established by the Supreme Court in *Northern P. R. Co. v. Boyd*, although at first it did not require that senior creditors be paid in full.²⁶ Some commentators have suggested that this created either an absolute priority rule or a relative priority rule, leading to splits in the lower courts and debates in law review articles.²⁷ In order to give a better understanding of the rule, the Supreme Court incorporated the absolute priority rule into the “fair and equitable” test, which had been written into section 77B of the Bankruptcy Act.²⁸ In *Case v. Los Angeles Lumber Products Co.*, the Court denied confirmation of a plan of reorganization after determining that it was not “fair and equitable.”²⁹ In addition, the Court noted that the term “fair and equitable” included the rules of law established by the Court in cases where priority was accorded to creditors over shareholders in reorganization plans.³⁰

Although the Court did not expressly state whether a plan could be objected to if a senior

²⁴ *Id.*

²⁵ *Id.*

²⁶ *Northern Pac. R. Co. v. Boyd*, 228 U.S. 482 (1913) (invalidating sale of debtor corporation when existing shareholders were allowed to participate in new corporation, while unsecured creditors receiving nothing for their claim. Court held that through their participation, shareholders received value that should have been preserved for unsecured creditors and that absolute priority rule required subordination of shareholder interests to rights of creditors).

²⁷ 6 NORTON BANKRUPTCY LAW AND PRACTICE § 113:3 (William L. Norton, Jr. ed., 3d ed. 2008)

²⁸ *Id.*

²⁹ *Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106 (1939).

³⁰ *Id.*

In equity reorganization law the term ‘fair and equitable’ included, inter alia, the rules of law enunciated by this Court in the familiar cases of *Chicago, R.I. & P. Railroad Co. v. Howard*, 7 Wall. 392, 19 L.Ed. 117; *Louisville Trust Co. v. Louisville, New Albany & Chicago Ry. Co.*, 174 U.S. 674, 19 S.Ct. 827, 43 L.Ed. 1130; *Northern Pacific Railway Co. v. Boyd*, 228 U.S. 482, 33 S.Ct. 554, 57 L.Ed. 931; *Kansas City Terminal Ry. Co. v. Central Union Trust Co.*, 271 U.S. 445, 46 S.Ct. 549, 70 L.Ed. 1028. These cases dealt with the precedence to be accorded creditors over stockholders in reorganization plans.

6 NORTON BANKRUPTCY LAW AND PRACTICE § 113:3 n.5 (William L. Norton, Jr. ed., 3d ed. 2008) quoting *Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106 (1939).

creditor was paid more than its full claim, the “fair and equitable” standard and absolute priority rule were firmly established. Eventually, ambiguity in prior bankruptcy codes and case law gave way to a legislative refinement of the term “fair and equitable” and the adoption section 1129(b) of the Code.³¹ Providing an “explicit although not exhaustive articulation of what constitutes fair and equitable,” section 1129(b) gave the courts a more intelligible indication of when a plan of reorganization would not be “fair and equitable.”³²

Recently, the United States Bankruptcy Court for the Eastern District of Pennsylvania affirmed that the absolute priority rule is violated when a secured creditor receives more than the value of its claim under a chapter 11 plan.³³ Following the expiration of the debtor’s exclusive right to propose a plan of reorganization, the Retirement Fund (“TRF”), a secured creditor, proposed its own chapter 11 plan.³⁴ After failing to gain approval from all classes of impaired creditors, it sought to cramdown its proposed plan under section 1129(b). TRF’s plan allowed TRF to obtain a parcel of property that was worth, by its own estimate, between \$5 million and \$6 million in exchange for a credit bid of \$2 million.³⁵ Further, because TRF’s secured claim was roughly \$5.2 million, TRF’s low credit bid would also give it deficiency claims against the loan guarantors.³⁶ The court determined that TRF’s plan would likely overpay TRF’s allowed claim, and therefore the plan could not be confirmed because it was not fair and equitable.³⁷

This decision is consistent with the way courts have decided previous cases involving a senior class receiving more than its allowed claim. A few years earlier, a chapter 11 debtor in *In*

³¹ 6 NORTON BANKRUPTCY LAW AND PRACTICE § 113:3 (William L. Norton, Jr. ed., 3d ed. 2008)

³² *Id.*

³³ *In re Brewery Park Associates, L.P.*, 54 BCD 192 (Bankr. E.D. Pa 2011).

³⁴ *Id.* at 4.

³⁵ *Id.* at 11.

³⁶ *Id.* at 3.

³⁷ *Id.* at 13.

re Exide Technologies sought to cramdown its plan over the objection of the official committee of unsecured creditors and others.³⁸ Here, the court took a forward-looking approach to the valuation, and determined that stock given to prepetition lenders would result in paying those lenders more than the full amount of their claim.³⁹ Recognizing that no class of claims or interests may receive more than 100% of its claim, the court found that the senior creditor’s plan undervalued the debtors, overpaid the creditors, and denied confirmation.⁴⁰

Similarly, the U.S. Bankruptcy Court for the Southern District of Texas denied confirmation of a plan when it failed to establish an upper limit to creditor distributions at the expense of rejecting stockholders.⁴¹ The court established that in applying the “fair and equitable” standard, it only needed to determine that “no senior class to the dissenting class [would] receive more than full compensation for its claims or interest and that members of the dissenting class either receive[d] full compensation for their claims or interest or no junior class receive[d] any distribution or retain[e]d any interest after confirmation of such plan.”⁴² In addition, the court expressly stated that a valuation would be required “to make sure senior classes of claims are not being provided for more than in full.”⁴³

Courts have also determined that disallowing a plan because senior creditors would receive more than their allowed claim is consistent with the legislative history of the Code.⁴⁴ Some factors in determining “fair and equitable” were omitted from the statute “to avoid statutory complexity and because they would undoubtedly be found by a court to be fundamental

³⁸ *In re Exide Technologies*, 303 B.R. 48, 61 (Bankr. D. Del 2003).

³⁹ *Id.* at 66.

⁴⁰ *Id.* at 80.

⁴¹ *In re MCorp Fin., Inc.*, 137 B.R. 219, 235 (Bankr. S.D. Tex 1992).

⁴² *Id.* citing 5 COLLIER ON BANKRUPTCY ¶ 1129.03 p. 1129-94 (15th ed. 1991).

⁴³ *Id.*

⁴⁴ *In re Future Energy Corp.*, 83 B.R. 470, 495 n.39 (Bankr. S.D. Ohio 1988).

to ‘fair and equitable’ treatment of a dissenting class.”⁴⁵ Given that its omission was intended to be one of style and not substance, as indicated by House reports and court documents, a senior class receiving more than its full claim would not be “fair and equitable.”⁴⁶

III. CONCLUSION

After thorough review of the confirmation process for a chapter 11 plan, the “fair and equitable” standard under a section 1129(b) cramdown, and how courts have treated cases where senior creditors receive more than their allowed claim, there is strong evidence that indicates confirmation of a plan will be rejected when a senior creditor would receive more than 100% of its claim. In addition, the legislative history of the Code provision indicates that although it was omitted from the statute, the intention that no senior creditor receives more than its full allowed claim was an intended result of the “fair and equitable” standard.

⁴⁵ 5 COLLIER ON BANKRUPTCY ¶ 1129.03 p. 1129-56 and 1129-60 (15th ed. 1991) *quoting* remarks of the sponsors of Pub.L.No.95-598 describing § 1129(b).

⁴⁶ *In re MCorp Fin., Inc.*, 137 B.R. at 235.

Although many of the factors interpreting “fair and equitable” are specified in paragraph (2), others, which were explicated in the description of § 1129(b) in the House report, were omitted from the House amendment “to avoid statutory complexity and because they would undoubtedly be found by a court to be fundamental to ‘fair and equitable’ treatment of a dissenting class.” For example, a dissenting class should be assured that no senior class receives more than 100 percent of the amount of its claims. While that requirement was explicitly included in the House bill, the deletion was intended to be one of style and not one of substance. The safeguards that no claim or interest receive more than 100 percent of the allowed amount of such claim or interest and that no class be discriminated against unfairly will insure that the plan is fair and equitable with respect to the dissenting class of interests.

5 COLLIER ON BANKRUPTCY ¶ 1129.03 p. 1129-56 and 1129-60 (15th ed. 1991) *quoting* remarks of the sponsors of Pub.L.No.95-598 describing § 1129(b).