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BANKRUPTCY LAW

Another Blow to Asbestos Bankruptcies

Third Circuit finds asbestos plan violates the Absolute Priority Rule

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In another setback for asbestos bankruptcy cases, the U.S. Court of Appeals for the Third Circuit denied the confirmation of a Chapter 11 bankruptcy plan which sought to distribute stock warrants to the old equity holders over the objection of an impaired class of unsecured creditors. In re Armstrong World Indus., Inc., 432 F.3d 507 (3rd Cir. 2005). The ruling affirmed the decision of United States District Court for the District of Delaware.

In *Armstrong*, the debtor attempted to skirt the "Absolute Priority Rule" by having the warrants go first to a class of unsecured creditors and then to the equity holder (by means of an automatic waiver), in an effort to fall within the parameters of previously approved distribution schemes. The Third Circuit distinguished the other distribution schemes in a strict reading of the judicially created Absolute Priority Rule.

The Absolute Priority Rule

Under the Bankruptcy Code, creditors are paid pursuant to a priority scheme which generally prohibits lower priority creditors from being paid unless senior creditors are paid in full. In many Chapter 11 cases, a battle arises when equity holders (the lowest priority) receive property while unsecured creditors are paid a small portion of their claims. If an impaired class of unsecured creditors objects to the confirmation of a Chapter 11 plan, the bankruptcy court may confirm the plan if the court finds that the plan is "fair and equitable" to the objecting class of unsecured creditors, a determination which requires the application of the judicially created Absolute Priority Rule. The Absolute Priority Rule provides that a plan is "fair and equitable" to objecting unsecured creditors so long as it does not offer a junior claimant or interest holder any property on account of such junior claim or interest before each unsecured claimant (from the rejecting class) receives full satisfaction of its claim. 11 U.S.C. § 1129(b)(2)(B).

Armstrong's Proposed Plan

Armstrong proposed a Chapter 11 plan of reorganization with 11 separate classes of creditors and equity interests. Of particular relevance are Class 6 (unsecured creditors), Class 7 (present and future asbestos claimants), and Class 12 (common stockholder). The sole claimant in Class 12 was the debtor's parent company which held all of the debtor's common stock. Under the plan, Class 6 and Class 7 were given the same priority, but received different treatment. Class 6 creditors were to receive a distribution of approximately 59.5 percent of their claims, while Class 7 creditors were to be paid approximately 20 percent of their claims from a trust created from a contribution of approximately $1.8 billion. The debtor created the trust for the Class 7 creditors to obtain a channeling injunction under Bankruptcy Code Section 524(g) (a typical asbestos plan provision). The Class 12 equity holder would receive warrants to purchase new shares of stock in the reorganized debtor (worth $35-$40 million) in a creative distribution scheme.

Under the plan, the warrants were to be paid to Class 12, subject to certain restrictions. If Class 6 rejected the plan (meaning the Absolute Priority Rule would apply), the Class 7 creditors would receive the warrants. However, the plan further provided that the Class 7 creditors automatically waive their right to receive the warrants which, by default, would be issued to the Class 12 equity holder. The Class 6 creditors voted to reject the plan and the warrants were earmarked for the Class 12 claimant.

Denial of Confirmation

The committee of unsecured creditors objected to the confirmation of the debtor's plan on the grounds that it violated the Absolute Priority Rule. The creditors argued that since the Class 6 creditors were not being paid in full, the junior

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equity holder could not receive any property (including warrants) under the Chapter 11 bankruptcy plan.

The debtor advanced three notable arguments in response to the objections. First, the debtor argued that the Absolute Priority Rule applies only when the objecting class of creditors is an intermediate class that is getting short-changed by the sharing with the lower class (i.e., squeezed out). The debtor relied upon floor statements made by key legislators of the Bankruptcy Code to support this novel argument. The Third Circuit adopted a plain reading of Bankruptcy Code Section 1129(b)(2)(B)(ii) which, on its face, does not require the objecting class to be an intervening class. Although the squeezing out of intervening classes was one of the evils being remedied by the Bankruptcy Code, such a narrow reading of the statute was not supported by the legislative history. The Third Circuit concluded that the Absolute Priority Rule is not limited to intermediate classes which are being leapfrogged by the distribution scheme — it applies to all classes, including classes with equal priority (i.e. Classes 6 and 7 in this case).

Second, the debtor claimed that the distribution to the Class 12 equity holder was not on account of the Class 12 claimant's prepetition equity interest. Rather, the warrants were issued in consideration for settlement of the Class 12 claimant's inter-company claims (valued at $12 million). The court rejected this argument on several grounds, including the debtor's failure to explain the discrepancy in the value of the warrants ($35-40 million) and the value exchanged to obtain the warrants (release of claims worth $12 million). Since the Class 12 claimant received more than it was giving up, the additional value must have been paid on account of its prepetition equity interest. Why else would equity receive the warrants? The debtor also argued that the issuance of the warrants was "on account" of the Class 7 personal injury claims since the warrants were being issued to the Class 7 claimants before proceeding to Class 12. This argument was also rejected.

Third, the debtor argued that creditors are free to do whatever they wish with the bankruptcy dividends they are entitled to receive, including giving a portion of their dividends to a junior class of creditors without violating the Absolute Priority Rule. The debtor relied upon three cases which approved similar distribution schemes. *In re SPM Mfg. Corp*, 984 F.2d 1305 (1st Cir. 1993); *In re Genesis Healthcare*, 266 B.R. 591 (D. Del. 2001); and *In re MCorp Fin., Inc*., 160 B.R. 941 (S.D. Tex. 1993). The District Court and Third Circuit distinguished the three cases in an analysis that bears questioning.

In the opinion of the District Court and Third Circuit, the most distinguishable fact common to the *SPM* and *Genesis* cases was that secured creditors were sharing their distributions. In both cases, the secured creditor agreed to a "carve out" of their secured claims to the extent of the distribution of the equity holders. Although not fully explained (at least as to this author's satisfaction), it appears that a secured creditor can share a portion of it secured claim with equity holders even if the distribution is "on account" of the equity holder's prepetition interest. The Third Circuit also noted that *SPM* involved a Chapter 7 case which is not governed by the fair and equitable requirement under Bankruptcy Code Section 1129(b) (Chapter 7 has its own distribution rules).

The *MCorp* case was more on point to the extent that the sharing of the distribution was done by unsecured creditors. It provided support for the debtor's argument that the status of the senior class (secured versus unsecured) was not relevant. In *MCorp*, unsecured senior bondholders agreed to distribute $33 million to the Federal Deposit Insurance Corporation to settle prebankruptcy litigation between the FDIC and debtor. The Third Circuit distinguished *MCorp* on the fact that distribution to the FDIC was being made to settle prebankruptcy litigation, not on account of the FDIC's prebankruptcy claim.

Distribution sharing as a means of circumventing the Absolute Priority Rule is not without limits, at least not in the Third Circuit. The automatic transfer of the warrants to the Class 12 claimant gave the appearance that the entire scheme was simply a way of laundering the distribution before it went to the Class 12 claimant in an effort to undermine Congress' intention of providing unsecured creditors with negotiating leverage. The Third Circuit's strict reading of the Absolute Priority Rule may make it more difficult to confirm plans that depend on creditor-to-creditor contributions without the consent of the junior class, a result which has some support from a strict reading of the Bankruptcy Code. However, from a policy point of view, the narrow reading of the Absolute Priority Rule appears to restrict the ability of senior creditors to give up certain property rights and receive less money to get a plan approved by the court. ■