# A RE-EXAMINATION OF THE RULES OF PROPERTY RIGHTS AND POST-PETITION GIFTING IN BANKRUPTCY

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## INTRODUCTION

"Life is a process of continually reordering priorities."[1]

The Bankruptcy Code strictly controls what a debtor can do with its property but places few limits on what creditors with an interest in the debtor's property can do vis-à-vis one another.[2] An open question under the Code and under the case law is whether a senior creditor can use assets in which it has an interest to pay certain creditors and not others—so-called "gifting"—after a debtor has filed a bankruptcy petition.[3] Both courts and commentators are divided on whether the Code gives creditors this discretion.

On the surface, there would seem to be no objection to a senior creditor transferring its own money to whomever it chooses, as long as it is not depriving other creditors of a right to payment. But, as discussed below, allowing creditors to transfer consideration to other creditors in a manner inconsistent with payment purely under the priority scheme of the Bankruptcy Code can lead to inequitable results, even if no creditors would be paid at all absent such a transfer.

Part I of this paper illustrates the gifting problem. Part II discusses gifting in three contexts that have been addressed by courts: asset liquidation, surcharges for maintaining a secured creditor's property, and chapter 11 reorganization. Part III examines whether gifting can be accomplished through subordination agreements, an issue that has not yet been considered by the courts.[4] Part IV discusses the Supreme Court's opinion in *Czyzewski v. Jevic Holding Corp.*,[5] and its impact on the viability of gifting. Finally, Part V offers some observations that courts should consider when deciding whether to allow a senior creditor to transfer property to junior creditors in a manner that the Bankruptcy Code would prevent the debtor from doing itself.

## I. AN INTRODUCTION TO GIFTING

In contrast to general commercial litigation, which moves forward through hard-fought court battles over issues large and small,[6] the chapter 11 bankruptcy process

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[1] LAWRENCE W. FAGG, PAUSES: REFLECTIONS ON SCIENCE, SPIRITUALITY, AND THE FINE ART OF LIVING 14 (2006).

[2] One exception is the equitable doctrine of marshaling, pursuant to which a creditor with access to two funds to satisfy a debt may not defeat another creditor who may resort to only one of the funds. *See* Meyer v. United States, 375 U.S. 233, 236 (1963).

[3] As discussed further in Part IV, there is one area in which the Supreme Court has given definitive guidance. *See infra* Part IV. In *Czyzewski v. Jevic Holding Corp.*, 137 S. Ct. 973, 983 (2017), the Court held a bankruptcy court may not approve a structured dismissal of a chapter 11 case that provides for distributions that do not follow the Bankruptcy Code's ordinary priority rules without the affected creditors' consent.

[4] *See* 11 U.S.C. § 510(a) (2012).

[5] 137 S. Ct. 973 (2017).

[6] *See, e.g.*, Graves v. Mazda Motor Corp., No. CIV-08-35-F, 2008 WL 5070953, at *3 (W.D. Okla. Nov. 24, 2008) (describing the evolution of an "unwelcome trend in litigation conduct—commonly referred to as 'hardball' litigation tactics—which signaled a noticeable decline in the standards of civility to which most lawyers had adhered for as long as anyone could remember").

is designed to encourage communication and negotiation between the parties,[7] and issues large and small in sophisticated chapter 11 bankruptcies often are resolved through negotiated deals.[8] For the debtor, that process begins even before it files its petition through negotiations, for example, with lenders for use of cash collateral and/or post-petition financing,[9] or with fulcrum security holders for restructuring support agreements,[10] or with creditors generally for a pre-packaged plan of reorganization.[11] After the petition is filed, negotiations among the debtor, committees, individual creditors, and other interested parties, often are integral to the reorganization process.

The ultimate goal of the bankruptcy process is a consensual plan of reorganization under 11 U.S.C. § 1129(a), in which all stakeholders are satisfied—as much as possible given often competing positions—with the outcome.[12] But even if a plan cannot be confirmed under section 1129(a), section 1129(b) provides that a plan that satisfies all other applicable provisions of section 1129(a) may be confirmed

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[7] *See* Phoenix Premier Props. LLC v. Fed. Nat. Mortg. Ass'n, No. 2:10-BK-2837-RTB, 2012 WL 2389955, at *2 (D. Ariz. June 25, 2012) (stating different ways in which the chapter 11 bankruptcy process encourages open discussion of interests and negotiation); *see also In re* J.C. Householder Land Tr. #1, 502 B.R. 602, 606–07 (Bankr. M.D. Fla. 2013) ("The two public policies specifically underlying Chapter 11 are 'preserving going concerns and maximizing property available to satisfy creditors.' In order to promote both those policies, the bankruptcy process encourages consensual negotiation and fair bargaining.") (footnote omitted).

[8] *See* Am. United Mut. Life Ins. Co. v. City of Avon Park, 311 U.S. 138, 146 (1940) ("[T]he responsibility of the court before entering an order of confirmation to be satisfied that the plan in its practical incidence embodies a fair and equitable bargain openly arrived at and devoid of overreaching."); *In re* J.C. Householder Land Tr. #1, 502 B.R. at 606–07 ("[T]he bankruptcy process encourages consensual negotiation and fair bargaining."); *In re* Fur Creations by Varriale, Ltd., 188 B.R. 754, 758 (Bankr. S.D.N.Y. 1995) ("[C]onsensual means of plan negotiation and confirmation is among the paramount goals of chapter 11.") (quoting *In re* 500 Fifth Ave. Assocs., 148 B.R. 1010, 1017 (Bankr. S.D.N.Y. 1993), *aff'd*, No. 93 CIV. 844 (LJF), 1993 WL 316183 (S.D.N.Y. May 21, 1993)); Mark E. MacDonald, Mark E. MacDonald, Jr. & Camille R. McLeod, *Chapter 11 as a Dynamic Evolutionary Learning Process in a Market with Fuzzy Values*, *in* 1993-1994 ANNUAL SURVEY OF BANKRUPTCY LAW 1, 10–12 (1993) (referring to the following descriptions of the bankruptcy process: "'The bankruptcy process is "Let's Make a Deal,"' 'Bankruptcy involves a balancing between mutually inconsistent major principles,' 'Bankruptcy favors a little something for everyone,' or 'Bankruptcy uses vague concepts in order to encourage negotiation.'") (footnotes omitted).

[9] Although such financing is ubiquitous, a recent example is the $5.5 billion secured financing provided by a group of lenders to PG&E Corporation and Pacific Gas and Electric Company. *See* Debtors' Complaint for Declaratory Judgment and Preliminary and Permanent Injunctive Relief at 5, *In re* PG&E Corp., 603 B.R. 471 (Bankr. N.D. Cal. 2019) (19-30088).

[10] The "fulcrum security" claims are those entitled to the debtor's residual value. "If the debtor can pay back its secured debt in full, the unsecured creditors hold the residual claim on the estate. If the debtor cannot, then the junior lien-holders will usually own the fulcrum security." Sam Roberge, *Maneuvering in the Shadows of the Bankruptcy Code: How to Invest in or Take Over Bankrupt Companies Within the Limits of the Bankruptcy Code*, 30 EMORY BANKR. DEV. J. 73, 77 (2013).

[11] *See generally* Matthew W. Kavanaugh & Randye B. Soref, *Prepackaged Plans of Reorganization under Chapter 11*, BUSINESS WORKOUTS MANUAL § 19:1 (2018).

[12] *See* Harvey R. Miller & Ronit J. Berkovich, *The Implications of the Third Circuit's Armstrong Decision on Creative Corporate Restructuring: Will Strict Construction of the Absolute Priority Rule Make Chapter 11 Consensus Less Likely?*, 55 AM. U. L. REV. 1345, 1350 (2006) ("The *sine qua non* of Chapter 11 reorganization is the engagement and negotiation among parties in interest with the ultimate goal of a consensual plan of reorganization."); *In re* Columbia Gas Sys., Inc., No. 91-803, 1995 WL 404892, at *2 (Bankr. D. Del. June 16, 1995) ("[A] consensual plan of reorganization . . . should be the goal of every Chapter 11 proceeding.").

despite the rejection of the plan by a class or classes if at least one class of impaired claims consents and the plan does not unfairly discriminate and is fair and equitable.[13]

Part of the dynamic that lends itself to negotiated resolutions is that a large chapter 11 bankruptcy is often not a true zero-sum game. Thus, even if the assets of the estate are completely encumbered and are insufficient to pay the debtor's secured lenders, the lenders may still believe that it is in their interest to negotiate a plan of liquidation or reorganization rather than foreclosing on their collateral or seeking to convert the case to chapter 7.[14] This is because, among other things, confirmation of a plan of reorganization may ultimately lead to greater recovery or lessened liability for the lender than other paths.[15]

Of course, the Bankruptcy Code and the case law interpreting it provide rules that establish the boundaries for the parties' potential agreements. For example, even if a debtor needs post-petition financing to remain in business, and even if remaining in business is better for creditors as a whole, it cannot obtain that financing secured by priming super-priority liens, unless it demonstrates that the interests of its existing lienholders are adequately protected[16]—that is, that the value of the interests of existing lienholders in the debtor's assets is adequately protected from harm caused by the priming lien absent the affected lender's consent.[17] On the other side, a debtor cannot enter into a post-petition financing arrangement that solely benefits the lenders and compromises its duties to other creditors.[18]

But what limits, if any, does the Bankruptcy Code place on the ability of the debtor's creditors to give away, or "gift," their rights to estate property to other

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[13] *See* 11 U.S.C. § 1129(b)(1) (2012) ("Notwithstanding section 510(a) of this title, if all of the applicable requirements of subsection (a) of this section other than paragraph (8) are met with respect to a plan, the court, on request of the proponent of the plan, shall confirm the plan notwithstanding the requirements of such paragraph 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.").

[14] For example, in *In re Orexigen Therapeutics, Inc.*, the parties reached consensual resolution on a plan of liquidation that resulted in a distribution to unsecured creditors despite the fact that the debtor was indebted to pre-petition secured noteholders for over $165 million, and the debtor's assets were sold for $73.5 million. *See* Disclosure Statement for Debtor's Plan of Liquidation at 22–23, *In re* Orexigen Therapeutics, Inc., 596 B.R. 9 (Bankr. D. Del. 2018) (Case No. 18-10518 (KG)).

[15] While beyond the scope of this paper, there is an extensive dynamic around the granting of releases to various plan constituents. *See generally* Hon. William L. Norton Jr. & William L. Norton III, *Other plan provisions and nondebtor releases*, 6 NORTON BANKR. L. & PRAC. 3d § 109:22 (2019). Post-petition lending also often comes with significant controls on asset disposition and other critical timing.

[16] *See* 11 U.S.C. § 364(d)(1)(B).

[17] *See* Resolution Tr. Corp. v. Swedeland Dev. Grp., Inc. (*In re* Swedeland Dev. Grp., Inc.), 16 F.3d 552, 564 (3d Cir. 1994) ("In other words, the proposal should provide the pre-petition secured creditor with the same level of protection it would have had if there had not been post-petition superpriority financing."); *In re* Fontainebleau Las Vegas Holdings, LLC, 434 B.R. 716, 751–52 (S.D. Fla. 2010) (rejecting post-petition financing as there was insufficient evidence that pre-petition secured lenders' interests were adequately protected).

[18] *See In re* Crouse, 71 B.R. 544, 550–51 (Bankr. E.D. Pa. 1987) ("[W]e are unwilling to find that the terms of the Stipulations presented to us for approval in the Motions before us are either fair, or reasonable, or adequate to the Debtors or to other creditors."); *In re* Tenney Village, 104 B.R. 562, 563 (Bankr. D.N.H. 1989); *In re* Saint Mary Hospital, 86 B.R. 393, 402 (Bankr. E.D. Pa. 1988). That said, debtor's counsel frequently leaves some of the hard fighting to committee counsel.

creditors? Consider the following hypothetical: An energy company files a chapter 11 bankruptcy petition. At the time of the filing, it has approximately $500 million in debt secured by all its assets. The assets, however, are worth approximately $300 million. In addition to its secured debt, the company has approximately $41 million in unsecured debt based on pre-petition notes and over $11 million in unsecured trade debt. The secured lenders believe that they will be better off if the company is reorganized rather than liquidated but do not want to repay the unsecured loans. Can the bankruptcy court confirm a plan in which the secured lenders use their own money to repay 100% of the trade debt while repaying only a portion of the unsecured note debt?

The foregoing hypothetical calls to mind the biblical parable of the workers in the vineyard.[19] In that story, a landowner hires workers early in the morning to work in his vineyard and agrees to pay them a customary daily wage.[20] Throughout the day and into the evening, he continues to hire new workers.[21] At the end of the day, he gives them all the same daily wage, even though some of them had worked for only an hour, while others had worked a full day.[22] In response to complaints from the workers that labored all day that they should have received more, the landowner retorts, "I am not cheating you. Did you not agree with me for the usual daily wage? Take what is yours and go. What if I wish to give this last one the same as you? Am I not free to do as I wish with my own money?"[23] Like the landlord in the parable, the unsecured noteholders are out of the money and would receive nothing absent the secured creditors' agreement to give up their rights in property of the estate. The unsecured noteholders are receiving more than they bargained for. While the unsecured noteholders may gripe about the disparate treatment vis-à-vis the unsecured trade debt, can the bankruptcy court confirm a plan over their objection?

The situation described above is not a hypothetical at all. These are the facts that were presented to the Delaware Bankruptcy Court, and ultimately to the Delaware District Court, in connection with the confirmation of the reorganization plan for Nuverra Environmental Solutions, Inc. and its affiliates ("Nuverra").[24] Nuverra was in the business of providing environmental services to companies that produced oil and natural gas from shale formations.[25] As of the filing of the petitions, Nuverra had approximately $500 million in secured debt consisting of notes (the "2021 Notes"), a term loan facility (the "Term Loan Facility"), and a proposed post-petition financing

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[19] *Matthew* 20:1-16.
[20] *Matthew* 20:1-2.
[21] *Matthew* 20:3-7.
[22] *Matthew* 20:8-10.
[23] *Matthew* 20:13-15. The point of the parable is that the landowner's acts are of generosity and mercy to those who are less fortunate, such as the unemployed, and not acts of injustice.
[24] *In re* Nuverra Envtl. Sols., Inc., 590 B.R. 75 (D. Del. 2018).
[25] Declaration of Robert D. Albergotti in Support of Voluntary Petitions, First Day Motions and Applications at 3, *In re* Nuverra Envtl. Sols., Inc., 590 B.R. 75 (D. Del. 2018) (No. 17-10949-KJC).

facility (the "DIP Loan");[26] $43 million in unsecured debt (the "2018 Note Claims");[27] and approximately $11.8 million in unsecured trade debt.[28] The value of Nuverra was in the range of $270 million and $335 million, with a midpoint of approximately $302.5 million.[29]

Simultaneously with filing for bankruptcy, Nuverra filed a prepackaged plan in which it proposed to pay its trade debt, which it classified in Class A7, 100% of their claims in cash, and to pay the 2018 Note Claims, classified in Class A6, 0.9%–1.2% of their claims in cash and stock.[30] Thus, the plan placed general unsecured claims of the same priority into separate classes and provided a different recovery for each class.[31]

While similar claims cannot "be placed in different classes solely to gerrymander a class that will assent to the plan,"[32] separate classification of similar claims is permissible if the plan proponent proves that there is a legitimate reason for separate classification.[33] And if the claims are separately classified, the plan may not discriminate unfairly between these classes of similar claims; they must receive treatment in a manner consistent with the treatment given to other classes with similar legal claims.[34] Professor Bruce Markell, who is critical of the decision in *In re Nuverra Envtl. Sols., Inc.*, notes that there was no business justification for the debtor to separately classify the noteholders from the trade debt and that the plan unfairly discriminated against the noteholders.[35] We discuss this issue more extensively below.

To facilitate the restructuring and provide a recovery to holders of out-of-the-money unsecured claims, the holders of the secured claims agreed to accept a lower

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[26] Brief of Appellees Nuverra Envtl. Sols., Inc. at 6, *In re* Nuverra Envtl. Sols., Inc., 590 B.R. 75 (D. Del. 2018) (Civ. No. 17-1024-RGA) [hereinafter Nuverra Appellees Brief].

[27] Solicitation and Disclosure Statement at 103, *In re* Nuverra Envtl. Sols., Inc., 590 B.R. 75 (D. Del. 2018) (No. 17-10949-KJC) [hereinafter Disclosure Statement].

[28] Transcript of Hearing at 32:21–25, *In re* Nuverra Envtl. Sols., Inc., 590 B.R. 75 (D. Del. 2018) (No. 17-10949-KJC) [hereinafter Transcript of Hearing].

[29] Disclosure Statement, *supra* note 27, at 110.

[30] *Id.* at 10–12. The debtors later amended the plan to increase the recovery for the 2018 Note Claims to between 4% and 6% of their claims. *See* Transcript of Hearing, *supra* note 28, at 30:12–25.

[31] *In re* Nuverra Envtl. Sols., Inc., 590 B.R. 75, 79 (D. Del. 2018).

[32] *See* Boston Post Rd. Ltd. P'ship v. Fed. Deposit Ins. Corp. (*In re* Boston Post Rd. Ltd. P'ship), 21 F.3d 477, 481 (2d Cir. 1994).

[33] *See id.*; *see also* Barakat v. Life Ins. Co. of Va. (*In re* Barakat), 99 F.3d 1520, 1525 (9th Cir. 1996) ("Although noting that similar claims may be placed in different classes, the court in *Greystone* found that '[there is] one clear rule that emerges from otherwise muddled caselaw on § 1122 claims classification: thou shalt not classify similar claims differently in order to gerrymander an affirmative vote on a reorganization plan.'") (quoting Matter of Greystone III Joint Venture, 995 F.2d 1274, 1279 (5th Cir. 1991)). *See generally* Glen E. Clark, Bart B. Burnett, David E. Leta & Michael P. Richman, *Plans of Reorganization-What You Need to Know*, *Classification of Claims Pursuant to Section 1122 of the United States Bankruptcy Code*, 013003 ABI-CLE 208 (2003).

[34] *See* 11 U.S.C. § 1129(b) (2012); THOMAS J. SALERNO, CRAIG D. HANSEN, G. CHRISTOPHER MEYER, JACOB SCHUSTER & GEORGE BASHARIS, ADVANCED CHAPTER ELEVEN BANKRUPTCY PRACTICE § 11.22 (2d ed. 2019).

[35] *See* Bruce A. Markell, *The Clock Strikes Thirteen: The Blight of Horizontal Gifting*, 38 BANKR. L. LETTER at 4 (2018).

recovery on their secured claims than they were entitled to receive.[36] Specifically, the secured DIP Loan (which the bankruptcy court approved) and secured Term Loan converted to equity at a discount, receiving distributions of equity worth less than the face value of the debt converted.[37] The secured second priority 2021 Notes also converted into equity, receiving recoveries of less than 54.5% of their claims, and they voluntarily agreed to forego any distributions on account of approximately $190 million in unsecured deficiency claims relating to the 2021 Notes.[38]

The plan was supported by every class entitled to vote with the exception of Class 6, and even in that class, nearly 80% of those voting voted in favor of the plan.[39] Opposition to the plan came primarily from one creditor, David Hargreaves ("Hargreaves"), who held approximately $450,000 of the 2018 Notes.[40] Because one class of claims did not vote for the plan, Nuverra was required to seek confirmation under section 1129(b) of the Bankruptcy Code.[41] After an evidentiary hearing, the bankruptcy court overruled Hargreaves' objection and confirmed the plan,[42] holding that the secured creditors were permitted to make "gift" distributions to unsecured creditors, both trade creditors and holders of 2018 Notes alike, and to pay disparate amounts to those groups, given that all the unsecured creditors were out of the money and would not otherwise be entitled to any distribution under the Bankruptcy Code's priority scheme.[43]

The bankruptcy court's opinion was affirmed by the district court on appeal after also holding that the appeal was equitably moot.[44] Like the bankruptcy court, and like the landowner in the biblical parable, the district court perceived that Hargreaves had nothing to complain about because, but for the plan, he would have received nothing: "As Appellant and his class were not entitled to a distribution in the first place, providing a greater distribution to a different class of unsecured creditors does not alter the distribution to which Appellant is entitled."[45]

While the reasoning of both the bankruptcy court and the district court may seem straight-forward and relatively non-controversial, it is anything but. This is

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[36] Nuverra Appellees Brief, *supra* note 26, at 7.

[37] *Id.*

[38] *Id.*

[39] *See* Declaration of Christina Pullo of Prime Clerk LLC Regarding Solicitation of Votes & Tabulation of Ballots Cast on the Debtors' Prepackaged Plans of Reorganization under Chapter 11 of the Bankruptcy Code at Ex. A, *In re* Nuverra Envtl. Sols., Inc., 590 B.R. 75 (D. Del. 2018) (No. 17-10949-KJC). A class of claims has accepted a plan only if the plan has been accepted by creditors that hold more than one-half in number of allowed claims of the class and at least two-thirds in amount. *See* 11 U.S.C. § 1126(c) (2012). While the plan had the approval of well over one-half of the creditors in the class, it did not have the approval of the requisite amount of claims.

[40] Transcript of Hearing, *supra* note 28, at 76:10–12.

[41] *See* 11 U.S.C. § 1129(b).

[42] Findings of Fact, Conclusions of Law & Order Approving (I) The Adequacy of the Disclosure Statement; (II) Prepetition Solicitation Procedures; & (III) Confirmation of the Prepackaged Plan at 9, *In re* Nuverra Envtl. Sols., Inc., 590 B.R. 75 (D. Del. 2018) (No. 17-10949-KJC).

[43] Transcript of Hearing, *supra* note 28, at 8:25–9:3. The court did not resolve whether separate classification can be justified because of gifting to one group over another.

[44] *In re* Nuverra Envtl. Sols., Inc., 590 B.R. 75, 99 (D. Del. 2018).

[45] *Id.* at 91.

exemplified by the diametrically opposed opinions of two commentators. The first commentator stated, "[g]ifting is a blight on reorganizations. It is court-sanctioned graft . . . ."[46] On the other hand, the second commentator stated, "if the gift is an amount to which the gifting class is entitled (such that the objecting class is no worse off as a result of the gift), it should be permitted."[47]

## II. CONTEXTS IN WHICH GIFTING HAS ARISEN

### *A. SPM Manufacturing*

As explained in detail below, senior classes have used gifting as a tool primarily in two contexts: as a carve out from a surcharge of the secured creditor's property under section 506(c) of the Bankruptcy Code,[48] and in the context of chapter 11 liquidation or reorganization. One of the first cases to discuss the concept of gifting following the enactment of the Bankruptcy Code in 1978, however, did not address this issue in either context.

In *Official Unsecured Creditors' Committee v. Stern (In re SPM Mfg. Corp.)*,[49] the First Circuit reversed the decisions of both the bankruptcy court and the district court and upheld confirmation of a plan in which the secured creditor distributed a portion of the proceeds that it received from a sale of the debtor's assets bypassing priority unsecured tax creditors.[50] SPM Manufacturing Corporation ("SPM") was a family-owned manufacturer of photo albums.[51] When SPM filed for bankruptcy, it owed $9 million to Citizens Savings Bank ("Citizens"), which held a perfected, first priority security interest in virtually all of SPM's assets.[52] It also owed its unsecured creditors $5.5 million and owed $750,000 to the Internal Revenue Service ("I.R.S."),[53] which had a higher priority in the chapter 7 distribution scheme than the claims of general unsecured creditors.[54] The owners of SPM were personally liable for any portion of the taxes not paid to the I.R.S.[55]

SPM originally filed a chapter 11 case, and Citizens' secured claim exceeded the value of its collateral.[56] "Consequently, the [Official Unsecured Creditors'] Committee began discussions with Citizens about cooperating in the bankruptcy

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[46] Markell, *supra* note 35, at 10.
[47] Miller & Berkovich, *supra* note 12, at 1420.
[48] 11 U.S.C. § 506(c) (2012).
[49] 984 F.2d 1305 (1st Cir. 1993).
[50] *See id.* at 1318–19; 11 U.S.C. § 507(a)(2). This type of gifting is referred to as vertical gifting where an intermediate class is bypassed. It is distinct from the circumstance in *Nuverra* discussed above which involved horizontal gifting, where creditors with identical legal rights are treated differently. Each implicates different bankruptcy rules in chapter 11 – one against treating similarly situated creditors differently, 11 U.S.C. § 1129(b), and one governing priority in payment.
[51] *See In re* SPM Mfg. Corp., 984 F.2d at 1307.
[52] *Id.*
[53] *Id.*
[54] *See* 11 U.S.C. §§ 726(a), 507(a).
[55] *In re* SPM Mfg. Corp., 984 F.2d at 1307.
[56] *Id.* at 1307–08.

proceedings to maximize the value of SPM's assets and provide some return to the general, unsecured creditors."[57] The result of those discussions was an agreement pursuant to which Citizens agreed to share whatever proceeds it received as a result of the reorganization or liquidation with the Committee.[58] After it became apparent that SPM could not be successfully reorganized, the bankruptcy court granted a motion by Citizens to appoint a receiver, who sold SPM's assets for $5 million.[59] Citizens was granted relief from the automatic stay, the case was converted to chapter 7, and a trustee was appointed.[60]

Citizens thereafter filed a motion seeking delivery of the proceeds and stating that it would share those proceeds with the Committee pursuant to its pre-existing agreement.[61] The trustee and the owners of SPM—who were liable to the I.R.S. if the I.R.S.'s claim was not paid—objected to the motion, "arguing that the Agreement distributed proceeds to general, unsecured creditors ahead of the priority tax creditors in violation of the statutory scheme for distribution."[62] "Citizens and the Committee responded that the $5 million belonged to Citizens and that Citizens had a right to share its proceeds with the Committee without paying the I.R.S. or other creditors first."[63]

The bankruptcy court rejected the portion of the motion requesting approval of the agreement's sharing provision on the grounds that it was not in accordance with

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[57] *Id.* at 1308.
[58] *Id.*
[59] *Id.* at 1309 (noting the receiver's power to sell assets pursuant to 11 U.S.C. § 363(b)).
[60] *Id.*
[61] *Id.*
[62] *Id.*
[63] *Id.*

the payment priority established by sections 726(a)[64] and 507(a)[65] of the Bankruptcy Code.[66] It then entered an unusual order: it required Citizens to pay to the trustee the

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[64] 11 U.S.C. § 726(a) (2012). Section 726(a) provides:

> (a) Except as provided in section 510 of this title, property of the estate shall be distributed—
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> (1) first, in payment of claims of the kind specified in, and in the order specified in, section 507 of this title, proof of which is timely filed under section 501 of this title or tardily filed on or before the earlier of—
>
> (A) the date that is 10 days after the mailing to creditors of the summary of the trustee's final report; or
>
> (B) the date on which the trustee commences final distribution under this section;
>
> (2) second, in payment of any allowed unsecured claim, other than a claim of a kind specified in paragraph (1), (3), or (4) of this subsection, proof of which is—
>
> (A) timely filed under section 501(a) of this title;
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> (B) timely filed under section 501(b) or 501(c) of this title; or
>
> (C) tardily filed under section 501(a) of this title, if—
>
> (i) the creditor that holds such claim did not have notice or actual knowledge of the case in time for timely filing of a proof of such claim under section 501(a) of this title; and
>
> (ii) proof of such claim is filed in time to permit payment of such claim;
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> (3) third, in payment of any allowed unsecured claim proof of which is tardily filed under section 501(a) of this title, other than a claim of the kind specified in paragraph (2)(C) of this subsection;
>
> (4) fourth, in payment of any allowed claim, whether secured or unsecured, for any fine, penalty, or forfeiture, or for multiple, exemplary, or punitive damages, arising before the earlier of the order for relief or the appointment of a trustee, to the extent that such fine, penalty, forfeiture, or damages are not compensation for actual pecuniary loss suffered by the holder of such claim;
>
> (5) fifth, in payment of interest at the legal rate from the date of the filing of the petition, on any claim paid under paragraph (1), (2), (3), or (4) of this subsection; and
>
> (6) sixth, to the debtor.

[65] *Id.* § 507(a). Section 507(a) provides:

> (a) The following expenses and claims have priority in the following order:
>
> (1) First:
>
> (A) Allowed unsecured claims for domestic support obligations that, as of the date of the filing of the petition in a case under this title, are owed to or recoverable by a spouse, former spouse, or child of the debtor, or such child's parent, legal guardian, or responsible relative, without regard to whether the claim is filed by such person or is filed by a governmental unit on behalf of such person, on the condition that funds received under this paragraph by a governmental unit under this title after the date of the filing of the petition shall be applied and distributed in accordance with applicable nonbankruptcy law.
>
> (B) Subject to claims under subparagraph (A), allowed unsecured claims for domestic support obligations that, as of the date of the filing of the petition, are assigned by a spouse, former spouse, child of the debtor, or such child's parent, legal guardian, or responsible relative to a governmental unit (unless such obligation is assigned voluntarily by the spouse, former spouse, child, parent, legal guardian, or responsible relative of the child for the purpose of

collecting the debt) or are owed directly to or recoverable by a governmental unit under applicable nonbankruptcy law, on the condition that funds received under this paragraph by a governmental unit under this title after the date of the filing of the petition be applied and distributed in accordance with applicable nonbankruptcy law.

(C) If a trustee is appointed or elected under section 701, 702, 703, 1104, 1202, or 1302, the administrative expenses of the trustee allowed under paragraphs (1)(A), (2), and (6) of section 503(b) shall be paid before payment of claims under subparagraphs (A) and (B), to the extent that the trustee administers assets that are otherwise available for the payment of such claims.

(2) Second, administrative expenses allowed under section 503(b) of this title, unsecured claims of any Federal reserve bank related to loans made through programs or facilities authorized under section 13(3) of the Federal Reserve Act (12 U.S.C. 343), and any fees and charges assessed against the estate under chapter 123 of title 28.

(3) Third, unsecured claims allowed under section 502(f) of this title.

(4) Fourth, allowed unsecured claims, but only to the extent of $12,850 for each individual or corporation, as the case may be, earned within 180 days before the date of the filing of the petition or the date of the cessation of the debtor's business, whichever occurs first, for—

(A) wages, salaries, or commissions, including vacation, severance, and sick leave pay earned by an individual; or

(B) sales commissions earned by an individual or by a corporation with only 1 employee, acting as an independent contractor in the sale of goods or services for the debtor in the ordinary course of the debtor's business if, and only if, during the 12 months preceding that date, at least 75 percent of the amount that the individual or corporation earned by acting as an independent contractor in the sale of goods or services was earned from the debtor.

(5) Fifth, allowed unsecured claims for contributions to an employee benefit plan—

(A) arising from services rendered within 180 days before the date of the filing of the petition or the date of the cessation of the debtor's business, whichever occurs first; but only

(B) for each such plan, to the extent of—

(i) the number of employees covered by each such plan multiplied by $12,850; less

(ii) the aggregate amount paid to such employees under paragraph (4) of this subsection, plus the aggregate amount paid by the estate on behalf of such employees to any other employee benefit plan.

(6) Sixth, allowed unsecured claims of persons—

(A) engaged in the production or raising of grain, as defined in section 557(b) of this title, against a debtor who owns or operates a grain storage facility, as defined in section 557(b) of this title, for grain or the proceeds of grain, or

(B) engaged as a United States fisherman against a debtor who has acquired fish or fish produce from a fisherman through a sale or conversion, and who is engaged in operating a fish produce storage or processing facility—

but only to the extent of $6,325 for each such individual.

(7) Seventh, allowed unsecured claims of individuals, to the extent of $2,850 for each such individual, arising from the deposit, before the commencement of the case, of money in connection with the purchase, lease, or rental of property, or the purchase of services, for the personal, family, or household use of such individuals, that were not delivered or provided.

(8) Eighth, allowed unsecured claims of governmental units, only to the extent that such claims are for—

(A) a tax on or measured by income or gross receipts for a taxable year ending on or before the date of the filing of the petition—

(i) for which a return, if required, is last due, including extensions, after three years before the date of the filing of the petition;

(ii) assessed within 240 days before the date of the filing of the petition, exclusive of—

(I) any time during which an offer in compromise with respect to that tax was pending or in effect during that 240-day period, plus 30 days; and

(II) any time during which a stay of proceedings against collections was in effect in a prior case under this title during that 240-day period, plus 90 days; or

(iii) other than a tax of a kind specified in section 523(a)(1)(B) or 523(a)(1)(C) of this title, not assessed before, but assessable, under applicable law or by agreement, after, the commencement of the case;

(B) a property tax incurred before the commencement of the case and last payable without penalty after one year before the date of the filing of the petition;

(C) a tax required to be collected or withheld and for which the debtor is liable in whatever capacity;

(D) an employment tax on a wage, salary, or commission of a kind specified in paragraph (4) of this subsection earned from the debtor before the date of the filing of the petition, whether or not actually paid before such date, for which a return is last due, under applicable law or under any extension, after three years before the date of the filing of the petition;

(E) an excise tax on—

(i) a transaction occurring before the date of the filing of the petition for which a return, if required, is last due, under applicable law or under any extension, after three years before the date of the filing of the petition; or

(ii) if a return is not required, a transaction occurring during the three years immediately preceding the date of the filing of the petition;

(F) a customs duty arising out of the importation of merchandise—

(i) entered for consumption within one year before the date of the filing of the petition;

(ii) covered by an entry liquidated or reliquidated within one year before the date of the filing of the petition; or

(iii) entered for consumption within four years before the date of the filing of the petition but unliquidated on such date, if the Secretary of the Treasury certifies that failure to liquidate such entry was due to an investigation pending on such date into assessment of antidumping or countervailing duties or fraud, or if information needed for the proper appraisement or classification of such merchandise was not available to the appropriate customs officer before such date; or

(G) a penalty related to a claim of a kind specified in this paragraph and in compensation for actual pecuniary loss.

An otherwise applicable time period specified in this paragraph shall be suspended for any period during which a governmental unit is prohibited under applicable nonbankruptcy law from collecting a tax as a result of a request by the debtor for a hearing and an appeal of any collection action taken or proposed against the debtor, plus 90 days; plus any time during which the stay of proceedings was in effect in a prior case under this title or during which collection was precluded by the existence of 1 or more confirmed plans under this title, plus 90 days.

amount that it otherwise would have paid to the Committee's constituents.[67] The bankruptcy court entered this order notwithstanding its acknowledgement that "Citizens' allowed secured claim was $5 million."[68] Citizens and the Committee appealed, first to the district court, which affirmed, and then to the First Circuit.[69]

The First Circuit reversed.[70] It ruled that "the distribution scheme of section 726 (and, by implication, the priorities of section 507) does not come into play until all valid liens on the property are satisfied."[71] Because Citizens' allowed secured claim was $5 million, the court held that the entire $5 million belonged to Citizens, leaving nothing for any other creditors, including the I.R.S.[72]

> The Code does not govern the rights of creditors to transfer or receive non-estate property. While the debtor and the trustee are not allowed to pay nonpriority creditors ahead of priority creditors, creditors are generally free to do whatever they wish with the bankruptcy dividends they receive, including to share them with other creditors.[73]

Thus, the court directly held that after the lifting of the automatic stay and ordering the distribution to the secured creditor of the proceeds of the sale of the assets outside the context of a plan of reorganization, the proceeds were no longer property of the estate.[74]

> [O]nce the court lifted the automatic stay and ordered those proceeds distributed to Citizens in proper satisfaction of its lien, that money became the property of Citizens, not of the estate. Appellees concede that the bankruptcy court has no authority to control how Citizens disposes of the proceeds once it receives them. There is nothing in the Code forbidding Citizens to have voluntarily paid part of these

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> (9) Ninth, allowed unsecured claims based upon any commitment by the debtor to a Federal depository institutions regulatory agency (or predecessor to such agency) to maintain the capital of an insured depository institution.
> (10) Tenth, allowed claims for death or personal injury resulting from the operation of a motor vehicle or vessel if such operation was unlawful because the debtor was intoxicated from using alcohol, a drug, or another substance.

[66] *In re* SPM Mfg. Corp., 984 F.2d at 1309.
[67] *See id.* at 1310.
[68] *Id.*
[69] *Id.*
[70] *Id.* at 1306.
[71] *Id.* at 1312.
[72] *Id.*
[73] *Id.* at 1313 (citation omitted).
[74] *See id.*

> monies to some or all of the general, unsecured creditors after the bankruptcy proceedings finished.[75]

The court acknowledged that because the assets were not property of the estate, it was unclear why the trustee would be distributing them, but it gave Citizens an easy out: simply to withdraw its motion asking the trustee to distribute the proceeds and to compel the trustee to put the assets into escrow.[76] It is not clear from the decision which path Citizens ultimately took.

As we will see below, other cases addressing gifting have done so in the context of interpreting specific provisions of the Bankruptcy Code. *In re SPM Mfg. Corp.* is one of the few opinions that rests entirely on the landowner rule: that the property belonged to the secured creditor, which could spend the money however it chose.[77]

The result in *In re SPM Mfg. Corp.* is consistent with the priority of distribution under the Code. The I.R.S. was indifferent to whether it was paid by the company or its former owners. The real parties in interest in that case were the owners of SPM, who stood behind unsecured creditors,[78] and who were completely out of the money under all circumstances and sought to use the assets of the estate to relieve them of the obligation to pay the I.R.S. Therefore, the end result was that the agreement between Citizens and the Committee did not result in a change in the distribution scheme in the Code (assuming the individuals had the financial wherewithal to pay the IRS) and, perhaps, could have been upheld on that basis using the court's equitable powers,[79] rather than on the broader grounds that the proceeds were no longer property of the estate after Citizens' motion for relief from stay was granted. And, as discussed below, the proposition that the bankruptcy court has no control whatsoever over the proceeds of a sale of an undersecured creditors' collateral is hotly disputed.

### *B. Gifting Through a Surcharge*

A question that has divided courts is whether a secured creditor can voluntarily agree to transfer property to a trustee and his or her professionals in the form of a

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[75] *Id.*

[76] *Id.* at 1319.

[77] There are other examples. *See, e.g., In re* ICL Holding Co., 802 F.3d 547, 556–57 (3d Cir. 2015) (payments from secured lender group directly to unsecured creditors from trust fund paid for by group and escrowed funds for payment of debtors' wind-down expenses and professional fees did not qualify as property of the estate); *In re* Fanita Ranch, L.P., No. ADV 10-90204, 2010 WL 4955892, at *4 (Bankr. S.D. Cal. Nov. 5, 2010) (approving settlement in which secured creditor agreed to distribute $1 million pro rata to all unsecured creditors except one, with which it was in litigation); *In re* TSIC, Inc., 393 B.R. 71, 77 (Bankr. D. Del. 2008) (holding that third-party bidder for debtor's assets could pay unsecured creditors' committee's constituents a settlement amount bypassing senior claims in exchange for committee's agreement to consent to the sale); *In re* Fleming Packaging Corp., No. 03-82408, 2005 WL 2205703, at *12 (Bankr. C.D. Ill. Aug. 26, 2005) (dismissing preference and fraudulent transfer claims against insiders who, with the consent of the secured lender, received proceeds from sale of collateral that otherwise would have been subject to the lender's liens).

[78] *See* 11 U.S.C. § 726(a)(6) (2012) (placing debtors behind unsecured creditors in distribution of the estate).

[79] "The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title." *Id.* § 105(a).

surcharge to the secured creditor's property. Under section 506(c) of the Bankruptcy Code,

> The trustee may recover from property securing an allowed secured claim the reasonable, necessary costs and expenses of preserving, or disposing of, such property to the extent of any benefit to the holder of such claim, including the payment of all ad valorem property taxes with respect to the property.[80]

While no one disputes that the Court may impose such a charge, there is significant disagreement about whether the secured creditor can enter into a settlement agreement with the trustee resolving surcharge claims, pay the trustee directly, and bypass the priority of distributions in section 507 of the Code.

It is important to understand that "the trustee" referenced in section 506(c) is not disinterested in the distribution of proceeds of the estate. The trustee and the trustee's professionals have an administrative claim against the estate for fees.[81] Those claims, however, can be lower in priority than other creditors, such as those who loaned the debtor money after the bankruptcy petition was filed on a secured or super-priority basis.[82] Moreover, under section 507, which governs the distribution of assets in a chapter 7 liquidation, the claims by the trustee and his or her professional are *pari passu* with other "actual, necessary costs and expenses of preserving the estate," including employee wages and taxes.[83] If the assets of the estate are insufficient to repay the debt owed to its secured lenders, they may be insufficient to pay the administrative claims. In that case, the estate is administratively insolvent,[84] and the trustee and the trustee's professionals will have a significant incentive to make a deal with the secured lenders to recover their fees, and, as discussed below, they have great flexibility to do so if the trustee and lender do not have to prove that the funds were actually used to preserve the estate.

For their part, secured lenders also have an incentive to pay the fees of the trustee and his or her professionals to obtain their cooperation as doing so can reduce or eliminate acrimony and reduce the lenders' own fees and expenses in recovering its property.[85] Moreover, the trustee is the only party that can seek a surcharge of a

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[80] *Id.* § 506(c).

[81] *Id.* § 503(b).

[82] *See id.* § 364(c)(1) ("If the trustee is unable to obtain unsecured credit allowable under section 503(b)(1) of this title as an administrative expense, the court, after notice and a hearing, may authorize the obtaining of credit or the incurring of debt—(1) with priority over any or all administrative expenses of the kind specified in section 503(b) or 507(b) of this title.").

[83] *Id.* § 503(b).

[84] *See In re* El Paso Refinery, L.P., 257 B.R. 809, 813 n.1 (Bankr. W.D. Tex. 2000) ("'Administrative insolvency' means that an estate lacks sufficient resources even to pay for the costs of handling the estate, such as trustee's commissions, sales commissions, storage costs, attorneys' fees, and the like.").

[85] *See, e.g.*, Wrightwood Guest Ranch, LLC v. Laski (*In re* Wrightwood Guest Ranch, LLC), 896 F.3d 1109, 1111–12 (9th Cir. 2018) (finding the section 506(c) surcharge agreement between trustee and secured creditor preserved and disposed of property in a manner which benefitted creditor).

secured creditor's property under section 506(c).[86] Thus, the secured lender can limit liability under section 506(c) simply by making a deal with the trustee, and, as explained below, the seminal case permitting the debtor's lawyers to recover their fees even though other administrative claims were not paid arose in exactly this context.[87]

In *Debbie Reynolds Hotel & Casino, Inc. v. Calstar Corporation (In re Debbie Reynolds Hotel & Casino, Inc.)*,[88] the debtor operated a hotel and casino and proposed a liquidating plan that provided for the sale of substantially all of its assets for the benefit of secured creditor, Resort Funding, Inc. ("RFI").[89] One of the interested buyers was Calstar Corporation ("Calstar"), which agreed to loan the debtor $150,000 to keep the hotel open while it completed its due diligence.[90] "[The] postpetition financing was approved by the bankruptcy court on a 'superpriority' basis under 11 U.S.C. § 364(c)(1)."[91] "Calstar subsequently decided not to purchase the hotel," and it was sold at a public auction.[92] After the hotel was sold, but before final approval by the bankruptcy court, the debtor's counsel and RFI entered into an agreement allowing the debtor's counsel "to collect a $50,000 surcharge from its secured property" pursuant to section 506(c).[93] Although section 506(c) permits a surcharge only "to the extent of any benefit to the holder of" a secured claim, the bankruptcy court approved the settlement without making any determination as to whether RFI benefitted from any actions by the debtor's counsel.[94] As the Ninth Circuit acknowledged, the payment was, in essence, a bribe.[95] "RFI attempted to buy 'closure' by agreeing to a $50,000 surcharge in exchange for assurance that there would be no further challenges to collection of its secured debt."[96]

Calstar objected to the settlement payment on the grounds that it was entitled to a surcharge payment because its loan to the debtor benefitted RFI, and it also argued that because its loan to the debtor was made pursuant to section 364(c)(1), it should be repaid before the debtor's counsel.[97] The Ninth Circuit Bankruptcy Appellate Panel ("BAP") agreed with Calstar, but the Ninth Circuit "reverse[d] the BAP and [held] that the settlement agreement [was] valid and enforceable."[98] The court held that under the Supreme Court's then recent opinion in *Hartford Underwriters Ins. Co. v. Union Planters Bank, N.A.*,[99] Calstar lacked standing to seek to surcharge RFI's

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[86] *See* Hartford Underwriters Ins. Co. v. Union Planters Bank, N.A., 530 U.S. 1, 6–7 (2000).
[87] *See* Debbie Reynolds Hotel & Casino, Inc. v. Calstar Corp. (*In re* Debbie Reynolds Hotel & Casino, Inc.), 255 F.3d 1061, 1067 (9th Cir. 2001).
[88] *Id.* at 1061.
[89] *Id.* at 1063–64.
[90] *Id.* at 1064.
[91] *Id.*
[92] *Id.*
[93] *Id.*
[94] *Id.* at 1064–65.
[95] *See id.* at 1068.
[96] *Id.* at 1064–65.
[97] *Id.* at 1064.
[98] *Id.* at 1063.
[99] 530 U.S. 1, 14 (2000).

property, because that right belonged exclusively to the trustee.[100] The court further held that the surcharge was not an administrative claim but was an assessment against a secured party's collateral that does "not fall within the priority scheme of the Bankruptcy Code at all."[101] Thus, it did not have to be turned over to the chapter 7 trustee for distribution,[102] an issue the Court pretermitted in *Hartford Underwriters*.[103]

The court acknowledged the payment by RFI was not shown to be reasonable and necessary to benefit RFI's property, but was instead based on an agreement that there would be no other surcharges.[104] It reasoned, however, that after *Hartford Underwriters*, there would be no incentive for secured creditors to collude with the debtor's counsel:

> After *Hartford Underwriters*, it is unlikely that a secured creditor would be willing to enter into such an agreement. The assurances that constituted Debtor's consideration have no legal effect. RFI agreed to pay $50,000 and received nothing in return. Consequently, the underlying facts of this controversy are unlikely to repeat. There is, therefore, little concern that unsecured creditors can avoid the dictates of the Bankruptcy Code by colluding with secured creditors for the payment of a § 506 surcharge. There is no incentive for secured creditors to enter into such agreements.[105]

Subsequent courts have found the court's reasoning in *Debbie Reynolds* to be naïve. The decision in *Hartford Underwriters* likely does not decrease the incentive for the secured creditor to pay off the trustee because the trustee is the only party that can seek to surcharge the secured creditor's property and, in chapter 11, certainly has the ability, *inter alia*, to propose a favorable plan of reorganization, support a release, or initiate litigation.[106] The secured creditor can therefore "buy closure," to use the court's words, by striking a deal with the trustee, which it could not do if the Supreme Court had held that parties other than the trustee could seek to surcharge the property.

Indeed, two judges in the Ninth Circuit questioned the reasoning of *Debbie Reynolds*, but held that it compelled them to approve a similar settlement agreement between a secured creditor and estate professionals. In August 2015, an involuntary

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[100] *See In re* Debbie Reynolds Hotel & Casino, Inc., 255 F.3d at 1065–66. This overruled the Ninth Circuit's decision in *North County Jeep & Renault, Inc. v. General Electric Capital Corp.* (*In re Palomar Truck Corp.*), 951 F.2d 229 (9th Cir. 1991), which had held that other creditors could seek a surcharge if the trustee had no incentive to pursue such a claim.

[101] *In re* Debbie Reynolds Hotel & Casino, Inc., 255 F.3d at 1067.

[102] *See id.*

[103] *See* Hartford Underwriters Ins. Co. v. Union Planters Bank, N.A., 530 U.S. 1 at 12 n.4.

[104] *See In re* Debbie Reynolds Hotel & Casino, Inc., 255 F.3d at 1064.

[105] *Id.* at 1068.

[106] The Court's view appears to be that the absence of an enforceable promise, rather than currying favor, is sufficient to disincentivize the secured creditor.

bankruptcy petition was filed against Wrightwood Guest Ranch, LLC,[107] which owned an eponymous destination wedding venue in Wrightwood, California.[108] Richard Laski was appointed trustee.[109] The property was encumbered by a first deed of trust in favor of secured creditor GreenLake Real Estate Fund, LLC ("GreenLake"), which held a $9.6 million claim.[110] Laski eventually reached an agreement with GreenLake under which it would purchase the property through an affiliated entity that would submit an $8.5 million stalking-horse bid.[111] In connection with that agreement, GreenLake and the trustee entered into a settlement pursuant to which GreenLake agreed to carve out $150,000 from its proceeds to cover expenses and pay the unsecured creditors, and another $350,000 to pay Laski and his professionals as a surcharge under section 506(c).[112] No creditors other than these would receive any of the proceeds of the estate.[113]

The bankruptcy court approved the settlement.[114] Administrative claimants Reid & Hellyer ("R&H"), who represented the unsecured creditors' committee, and Walter Wilhelm Bauer ("WWB"), who represented the debtor, appealed the order approving the settlement, but their appeals were dismissed for lack of standing because the objections to the settlement that they filed in the bankruptcy court were on behalf of their clients, not the firms themselves.[115]

After the property was sold, Laski filed a motion to approve the surcharge.[116] During the hearing, the bankruptcy judge expressed concern about the holding of *Debbie Reynolds*, finding that it:

> . . . creates an opportunity for secured lenders and trustees to work out deals and call things surcharges and actually put labels on surcharges and it raises somewhat of an odor . . . It raises, though, a potential conflict that actually the Creditors' Committee has pointed out.
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> Again, not that I like it because it will lead to mischief and it's clever mischief and I can appreciate that, but it's mischief.[117]

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[107] Reid & Hellyer, APC v. Laski (*In re* Wrightwood Guest Ranch, LLC), 896 F.3d 1109, 1111 (9th Cir. 2018).

[108] *The Guest Ranch at Pacific Crest in Wrightwood*, HERE COMES THE GUIDE, https://www.herecomestheguide.com/southern-california/wedding-venues/wrightwood-guest-ranch (last visited Sept. 18, 2019).

[109] *In re* Wrightwood Guest Ranch, LLC, 896 F.3d at 1111.

[110] *Id.*; Chapter 11 Trustee and Appellee's Answering Brief at 8, *In re* Wrightwood Guest Ranch, LLC, 896 F.3d 1109 (9th Cir. 2018) (No. 18-55380).

[111] *In re* Wrightwood Guest Ranch, LLC, 896 F.3d at 1111.

[112] *Id.* at 1111–12.

[113] *Id.* at 1112.

[114] *Id.*

[115] *Id.* at 1111.

[116] *See id.* at 1111–12.

[117] Appellants' Joint Opening Brief at 4, *In re* Wrightwood Guest Ranch, LLC, 896 F.3d 1109 (9th Cir. 2018) (No. 18-55380) (citations to record omitted).

The court nevertheless approved the settlement, stating that under *Debbie Reynolds*, it was not permitted to determine whether the surcharge was warranted or appropriate.[118] The district court expressed similar disquiet for the result but affirmed for the same reason—that it was bound by *Debbie Reynolds*.[119] R&H and WWB appealed that ruling to the Ninth Circuit, but voluntarily dismissed the appeal in June 2019.[120]

In *In re Nuclear Imaging Systems, Inc.*,[121] the court reached the same conclusion as the Ninth Circuit with a more compelling justification. In *Nuclear Imaging*, the debtors initially filed bankruptcy as chapter 11, but the case was converted to chapter 7, and the debtors' assets were sold.[122] The holders of the chapter 11 administrative claims realized that the estates would have insufficient cash to make a meaningful distribution to chapter 11 administrative creditors.[123] The debtors' chapter 11 counsel entered into an agreement with the debtors' post-petition lenders, which were undersecured, to carve-out a portion of the sales proceeds as a surcharge under section 506(c) to reimburse a portion of their unpaid legal fees.[124] Another holder of a chapter 11 administrative claim, which had provided goods and services to the debtors post-petition, objected to the payment, arguing that any recovery should go into the estate for distribution pursuant to the priority scheme of the Bankruptcy Code.[125] The court rejected that contention, however, holding that the holder of a claim could contract directly with a secured creditor for payment of the claim under section 506(c).[126]

The court reasoned that if a bankruptcy trustee were required to treat recoveries for a surcharge as estate funds to be paid according to statutory priorities, other creditors who did not maintain or preserve the secured creditor's collateral would be unjustly enriched by sharing in the funds that were supposed to be directly linked to preservation of collateral.[127] Moreover, the creditor who was entitled to the surcharge

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[118] *See id.* at 3.

[119] *See In re* Wrightwood Guest Ranch, LLC, 585 B.R. at 604 ("Whatever misgivings the bankruptcy court or this Court might have about the holding in *Debbie Reynolds*, it is controlling, and the bankruptcy court correctly applied it here.").

[120] Stipulated Motion to Voluntarily Dismiss Appeal, *In re* Wrightwood Guest Ranch, LLC, 896 F.3d 1109 (9th Cir. 2018) (No. 18-55380). The court dismissed the appeal on July 9, 2019. Order Granting Voluntary Dismissal, *In re* Wrightwood Guest Ranch, LLC, 896 F.3d 1109, No. 18-55380. If a similar issue comes before the Ninth Circuit in the future, the court could reconsider *Debbie Reynolds* en banc, but a panel may also reconsider that decision if it believes that the intervening United States Supreme Court authority in *Czyzewski v. Jevic Holding Corp.*, 137 S. Ct. 973 (2017), discussed below, undermines the prior panel's decision. *See* United States v. Gay, 967 F.2d 322, 327 (9th Cir. 1992) ("[O]ne three-judge panel of this court cannot reconsider or overrule the decision of a prior panel. An exception to this rule arises when 'an intervening Supreme Court decision undermines an existing precedent of the Ninth Circuit, and both cases are closely on point.'") (citation omitted) (quoting United States v. Lancellotti, 761 F.2d 1363, 1366 (9th Cir. 1985)).

[121] 270 B.R. 365 (Bankr. E.D. Pa. 2001).

[122] *Id.* at 367–68.

[123] *Id.* at 371. If a case is converted to chapter 7, chapter 11 administrative expenses are lower in priority than chapter 7 administrative expenses. *See* 11 U.S.C. § 726(b) (2012).

[124] *In re* Nuclear Imaging Sys., Inc., 270 B.R. at 369.

[125] *Id.* at 365.

[126] *Id.* at 377–78.

[127] *Id.* at 378.

would not be repaid in full, which would be inequitable and also inhibit the trustee's ability to secure post-petition services to benefit the secured creditor's property, such as utility services.[128] Finally, the court applied the reasoning of *SPM Manufacturing*, noting that the proceeds would otherwise be payable solely to the secured creditor but for its consent, and the secured creditor was free to enter into a contract to carve out some of these proceeds.[129]

Other courts, however, have strongly disagreed with the proposition that a secured creditor, on one hand, and a debtor or trustee, on the other, can agree to use section 506(c) to bypass section 507(b). In *Ungaretti & Harris, LLP v. Steinberg (In re Resource Technology Corp.)*,[130] a case that also converted from chapter 11 to chapter 7 and was administratively insolvent, the chapter 7 trustee entered into an agreement with the debtor's chapter 11 counsel to settle an adversary proceeding brought by chapter 11 counsel seeking to recover its legal fees under section 506(c).[131] Pursuant to the settlement agreement, the law firm would be entitled to retain fees already paid and would receive an additional cash payment for a portion of the fees they claimed that they were owed.[132] The firm then would receive an allowed administrative claim for the remainder.[133] The court refused to approve the settlement, however, because it concluded that the firm could not prevail in its litigation against the estates given that (1) under *Hartford Underwriters*, the firm lacked standing to seek a surcharge of the lenders' proceeds, and (2) if there were a surcharge, "the recovery can only be recovered for the benefit of the bankruptcy estate" and not for a single creditor.[134]

The court held that any recovery by the trustee would be estate property because under section 323(a) of the Code, the trustee "is the representative of the estate,"[135] not of any individual creditor, so any recovery under section 506(c) was for the benefit of the estate.[136] The court also expressed a concern similar to that of the bankruptcy judge in *Westwood Guest Ranch*, holding that if the surcharge were paid directly to the secured creditor, the trustee would have a "major conflict of interest" because the trustee would be incentivized to make a deal with the secured creditor to get its fees paid in exchange for not seeking a surcharge for other creditors:

> In this situation, if the surcharge were payable to them, the trustee and counsel would be faced with a major conflict of interest. They would then be able to pursue—and attempt to settle for cash—a personal surcharge claim against the secured creditor to the

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[128] *See id.*
[129] *See id.* at 379–80.
[130] 356 B.R. 435 (Bankr. N.D. Ill. 2006).
[131] *Id.* at 437–38.
[132] *Id.* at 438.
[133] *Id.*
[134] *Id.* at 444–45.
[135] 11 U.S.C. § 323(a) (2012).
[136] *See In re* Res. Tech. Corp., 356 B.R. at 445.

> detriment of claims that they might pursue on behalf of other creditors or the estate, such as § 506(c) claims based on goods or services provided by others or estate claims for avoidance of liens or equitable subordination. Recovering a surcharge for another creditor or pursuing a claim on behalf of the insolvent estate has much less potential benefit for the trustee and trustee's counsel than a payment made directly to them. Thus, trustee and counsel would have a powerful incentive to agree with a secured creditor that the other (creditor and estate) claims be released in exchange for a § 506(c) surcharge paid directly to them.[137]

The court in *In re Nettel Corp.*,[138] reached the same conclusion as the court in *Resource Technology*. In *Nettel*, the chapter 7 trustee for the debtor proposed a final distribution of the proceeds left in the bankruptcy estate under which the trustee and the trustee's law firm would receive approximately 99% recovery on their claims, while the U.S. Trustee and Hartford Fire and Insurance Company ("The Hartford") would only have been paid approximately 62% of their claims.[139] The trustee argued that the amounts that he and his counsel would recover were a surcharge under section 506(c) payable only to administrative claims that benefit the secured creditor's collateral.[140] The U.S. Trustee and The Hartford argued that section 506(c) is a recovery provision for the benefit of the estate and that the distribution of those funds was governed by section 726(b).[141] The court noted the split of authority and concluded that section 506(c) was "a recovery provision created for the benefit of the estate, not any specific claimant."[142] In reaching this conclusion, the court relied not only on *Resource Technology* but also on the Fourth Circuit's decision in *Ford Motor Credit Co. v. Reynolds & Reynolds Co. (In re JKJ Chevrolet, Inc.)*,[143] which noted that costs and expenses recovered from a secured creditor under section 506(c) "become available as an unencumbered asset for distribution to the unsecured creditors."[144]

To date, the Ninth Circuit is the only Court of Appeals to decide whether money recovered by a surcharge under section 506(c) must be distributed under section 507(b) or can be paid to a creditor or group of creditors directly, so lower courts have significant ability to shape the law in this area.

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[137] *Id.* at 446.
[138] No. 00–01771, 2017 WL 5664840 (Bankr. D.C. Oct. 2, 2017).
[139] *Id.* at *1.
[140] *Id.*
[141] *Id.*
[142] *Id.* at *4.
[143] 26 F.3d 481 (4th Cir. 1994).
[144] *Id.* at 484. The holding of *JKJ Chevrolet*, which was decided before *Hartford Underwriters*, was that an administrative expense claimant lacked standing to surcharge the secured creditor's collateral.

*C. Gifting in Chapter 11*

The legality of gifting is just as murky in connection with non-consensual plan confirmation under chapter 11 as it is in liquidations, although the legal issues are different. Section 1129(b) of the Bankruptcy Code provides that a court can confirm a plan over the objection of a class that is impaired under the plan, that is, crammed down, only "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."[145] The unfair discrimination test requires equal treatment for all creditors holding claims of the same priority level, unless the difference in treatment is based on "non-bankruptcy differences in the claims (such as subordination or non-recourse status); or when the differential treatment is commensurate with tangible contributions to the reorganization effort."[146] One of the requirements of the fair and equitable test is:

> [T]hat the reorganization does not violate the absolute priority rule, which requires that "creditors of a debtor in bankruptcy reorganization receive payment of their claims in their established order of priority, and that they receive payment in full before lesser interests—such as those of equity holders—may share in the assets of the reorganized entity."[147]

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[145] 11 U.S.C. § 1129(b) (2012).

[146] Markell, *supra* note 35, at 3. Although there are many tests for unfair discrimination, a number of courts have adopted the "rebuttable presumption" test that Professor Markell proposed in his paper, *A New Perspective on Unfair Discrimination in Chapter 11*, 72 AM. BANKR. L.J. 227 (1998). *See, e.g., In re* Nuverra Envtl. Sols., Inc., 590 B.R. 75, 91–92 (D. Del. 2018); *In re* Dow Corning Corp., 244 B.R. 696, 702 (Bankr. E.D. Mich. 1999). As the court explained in *In re Tribune Media Co.*, 587 B.R. 606, 617 (D. Del. 2018),

> [A] rebuttable presumption of unfair discrimination arises when there is: (1) a dissenting class; (2) another class of the same priority; and (3) a difference in the plan's treatment of the two classes that results in either (a) a materially lower percentage recovery for the dissenting class (measured in terms of the net present value of all payments), or (b) regardless of percentage recovery, an allocation under the plan of materially greater risk to the dissenting class in connection with its proposed distribution. If there is an allegation of a materially lower percentage recovery, the presumption can be rebutted 'by showing that, outside of bankruptcy, the dissenting class would similarly receive less than the class receiving a greater recovery, or that the alleged preferred class had infused new value into the reorganization which offset its gain. A demonstration that the risk allocation was similar to the risk assumed by the parties prior to bankruptcy can rebut the presumption that a discriminatory risk allocation was unfair.

(citations omitted).

[147] *In re* W.R. Grace & Co., 475 B.R. 34, 174 (D. Del. 2012), *aff'd*, 729 F.3d 332 (3d Cir. 2013) (quoting *In re* Yasparro, 100 B.R. 91, 95 (Bankr. M.D. Fla. 1989)).

The only possible exception to the absolute priority rule is if the junior class contributes new value to the reorganization.[148]

Can plan proponents use assets of a senior creditor to pay junior creditors and thereby confirm a plan that unfairly discriminates or violates the absolute priority rule if the objecting, impaired creditors are no worse off than if the debtor's assets were liquidated in chapter 7?[149] In other words, can the gifting creditor use money to which it is entitled to fund distributions under a plan even if it is clear that the debtor could not otherwise make the distributions? Like most of the preceding cases, the outcomes in chapter 11 seem to be based on equitable principles as much as legal ones.

One of the first courts to confront the issue was the Southern District of Texas in *In re MCorp Financial Inc.*[150] MCorp Financial and its affiliates ("MCorp") were some of the many banking institutions that collapsed in the late 1980s and early 1990s after recessions in a number of markets, including Texas.[151] After the bankruptcy filing, MCorp became involved in extensive offensive and defensive litigation with the FDIC.[152] As of the confirmation hearing, the litigation had gone on for four years, and had cost the estates millions of dollars.[153]

After months of negotiations, which included mediation with the court, the debtors, the senior lenders, and the creditors' committee proposed a plan that included a $33,054,000 distribution to the FDIC, which was funded through an agreement by the senior lenders to gift a portion of their undisputed prior claim of $319,150,000 to the FDIC.[154] Junior bondholders who were at least equal in priority to the FDIC objected to the plan because it provided little or no recovery to them, and it was in their best interests to continue to litigate with the FDIC in the hope that the litigation would result in an affirmative recovery for the estates.[155] Nevertheless, the court confirmed it, not because the discrimination was fair, but based on the rationale that the senior lenders could spend their own money as they chose:

> The juniors argue that, because they are not subordinate to the FDIC, the FDIC's receiving anything before the juniors are paid in full violates the code. The court does not have to decide the priority because even if you assume the FDIC is inferior to the juniors the

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[148] *See generally* Bank of Am. Nat'l. Tr. & Sav. Ass'n v. 203 N. LaSalle St. P'ship, 526 U.S. 434 (1999) (discussing the new value exception to the absolute priority rule).

[149] A requirement for confirmation of any plan—consensual or non-consensual—is that the plan be in the best interests of creditors, meaning that objecting creditors will fare at least as well in chapter 11 as they would in chapter 7. *See* 11 U.S.C. § 1129(a)(7); *In re* Zaruba, 384 B.R. 254, 262 (Bankr. D. Alaska 2008).

[150] 160 B.R. 941 (S.D. Tex. 1993).

[151] *See* George Hane, *The Banking Crises of the 1980s and Early 1990s*, 11 FDIC BANKING REVIEW 1, 9 (1998).

[152] *See In re* MCorp Fin., Inc., 160 B.R. at 945–46.

[153] *See id.* at 945–46.

[154] *Id.* at 948.

[155] *See id.* at 949–50 (explaining the settlement would only provide the junior creditors about five percent of their claim or even nothing; therefore, litigating with the FDIC was in their best economic interests "because their amount of risk is relatively low and their gain could be huge").

> FDIC is paid by the seniors out of their higher-priority share. The seniors may share their proceeds with creditors junior to the juniors, as long as the juniors continue to receive as least as much as what they would without the sharing.[156]

The bankruptcy court for the District of Delaware reached the same conclusion as *MCorp Financial* in *In re Genesis Health Ventures, Inc. ("Genesis I")*.[157] Genesis Health Ventures and its affiliates were in the business of providing nursing and medical services from their own facilities, rather than in-home nursing care.[158] In 1999, the Federal government made significant cuts to Medicare, which at that time funded virtually all the care for individuals admitted to their centers from hospitals, and the company filed for chapter 11.[159] As of the filing date, the debtors owed over $1 billion to their senior lenders, and the loans were secured by liens on substantially all of their assets.[160] Among the debtors' creditors were 44 personal injury and wrongful death claimants who also were seeking punitive damages.[161] The debtors and the senior lenders proposed a joint plan of reorganization that separately classified the punitive damages claims from those of other unsecured creditors, and, while all other unsecured creditors received a distribution under the plan, punitive damage claimants received no distribution, unless covered by insurance.[162] It is not surprising that they objected to the plan. Nevertheless, the court confirmed the plan over their objection.[163]

The court began by noting that while bankruptcy courts have the equitable power to limit or disallow punitive damages where the claims would frustrate the debtor's reorganization, the debtors admitted that potential punitive damage awards would not interfere with the debtors' reorganization.[164] The court also acknowledged that it could not categorically disallow penalties or punitive damages if those claims held the same priority under the Bankruptcy Code as claims of other unsecured creditors.[165] The court nevertheless approved the plan because the unsecured creditors would not receive any money absent the cooperation of the senior lenders, and the senior lenders had a right to decide which claims the debtors would pay using the senior lenders' money.[166]

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[156] *Id.* at 960.
[157] 266 B.R. 591, 612 (Bankr. D. Del. 2001).
[158] *Id.* at 597.
[159] *See History*, GENESIS HEALTHCARE, https://www.genesishcc.com/about-us/company-profile/history (last visited Sept. 17, 2019).
[160] *In re* Genesis Health Ventures, Inc., 266 B.R. at 597–98.
[161] *Id.* at 600.
[162] *Id.* at 598.
[163] *See id.* at 621.
[164] *Id.* at 600.
[165] *Id.* at 601 (explaining in the absence of specific statutory direction a bankruptcy court cannot alter the priority scheme and approve a categorical disallowance of punitive damages).
[166] *See id.* at 602, 611–12.

More recently, in *In re Fansteel Foundry Corp.*,[167] the court approved a plan proposed jointly by the debtor and the unsecured creditors' committee that established a liquidating trust for the benefit of the general unsecured creditors funded by the sale of the debtor's assets to its senior secured lender, TCTM Financial ("TCTM").[168] Prior to bankruptcy, an entity known as 510 Ocean ("510") had agreed to subordinate its secured claims to those of TCTM.[169] Although the parties believed that the debtor's collateral would be sufficient to pay both creditors, ultimately, the assets were not sufficient even to repay TCTM.[170] 510, therefore, ended up with an unsecured claim but was classified separately from general unsecured creditors, who were in Class 9.[171] Under the plan, TCTM agreed to contribute $2.4 million to the liquidating trust through a creditor note, which was to be used exclusively to pay Class 9 general unsecured creditors, a class that did not include 510.[172] The disclosure statement explained that "[t]he Creditor Note is a gift from Buyer to be paid directly to the Liquidation Trust for the benefit of Class 9 creditors."[173] 510 objected to the treatment on the grounds that it was discriminatory, but the court overruled the objection and concluded that the funds were not property of the estate but were a gift:

> The Creditor Note does not result in 510's claim being improperly subordinated to the Class 9 general unsecured creditors. The funds under the Creditor Note are not estate funds and are not part of any collateral to which 510 would be entitled. Further, because these funds are a gift and are unrelated to property of the estate there is no requirement that the bankruptcy priority payment scheme to be imposed on their distribution.[174]

*Nuverra*, *MCorp Financial*, *Genesis I*, and *Fansteel Foundry* involved gifts that arguably unfairly discriminated among creditors (horizontal gifting). In *In re Armstrong World Industries*,[175] the Third Circuit Court of Appeals held that gifting had its limits and could not be used to violate the absolute priority rule (vertical gifting).[176] Armstrong World Industries ("AWI") made flooring products and was forced to file for bankruptcy protection because of asbestos litigation liabilities.[177] After extensive negotiations with its constituents, AWI proposed a plan that

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[167] No. 16-01825-als11, 2018 WL 5472928, at *8 (Bankr. S.D. Iowa Oct. 26, 2018).
[168] *See id.* at *1, *8, *11–13.
[169] *Id.* at *1.
[170] *See id.* at *2.
[171] Joint Combined Disclosure Statement and Plan of Liquidation Dated June 22, 2018 at 17–18, *In re* Fansteel Foundry Corp., No. 16-01825-als11, 2018 WL 5472928, at *1 (Bankr. S.D. Iowa Oct. 26, 2018) (No. 16-01825-als11).
[172] *Id.* at 6 (defining "Creditor Note").
[173] *Id.*
[174] *In re* Fansteel Foundry Corp., 2018 WL 5472928, at *8.
[175] 432 F.3d 507 (3d Cir. 2005).
[176] *Id.* at 514.
[177] *Id.* at 509.

separately classified unsecured trade creditors and tort claimants.[178] The plan further provided that, in addition to cash distributions, the unsecured trade creditors would receive warrants to purchase common stock in the reorganized entity.[179] If the unsecured creditors rejected the plan, however, the warrants would instead pass to the tort claims, but the plan included a mechanism through which the tort claimants, after receiving the warrants, would automatically gift them to pre-petition equity holders, who were junior in priority to both the unsecured creditors and the tort claimants.[180] The unsecured trade creditors voted to reject the plan, but the bankruptcy court confirmed it over their objection because the warrants were being gifted by a senior class (tort claimants) to the junior class of equity holders.[181] Following an appeal by the unsecured creditors' committee, the district court reversed the bankruptcy court, holding that the plan violated the absolute priority rule, and the Third Circuit affirmed.[182]

The court held that under the plain meaning of section 1129(b)(2)(B)(ii), if the plan did not pay the objecting unsecured class of creditors in full, the plan was only confirmable if "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."[183] The court held that this was consistent with Congress' intent, and that section 1129(b) "was at least designed to address 'give-up' situations where a senior class gave property to a class junior to the dissenting class."[184] It distinguished *SPM Manufacturing* on the grounds that it was a chapter 7 case that did not implicate the absolute priority rule, and that the distribution was a carve out of senior lenders' collateral that was not subject to the Bankruptcy Code's priority scheme, rather than a transfer from an unsecured creditor.[185] It distinguished *Genesis I* as also being a carve-out and *MCorp Financial* as a settlement of pre-petition litigation.[186]

Although the Third Circuit's decision has been criticized,[187] it seems difficult to defend a different outcome. The genesis of the absolute priority rule was to prevent

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[178] *Id.*
[179] *Id.*
[180] *Id.*
[181] *Id.* at 510.
[182] *Id.* at 509–11.
[183] *Id.* at 513 (quoting 11 U.S.C. § 1129(b)(2)(B)(ii) (2012) ("(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—(i) the plan provides that each holder of a claim of such class receive or retain on account of such claim property of a value, as of the effective date of the plan, equal to the allowed amount of such claim; or (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, except that in a case in which the debtor is an individual, the debtor may retain property included in the estate under section 1115, subject to the requirements of subsection (a)(14) of this section.")).
[184] *Id.*
[185] *Id.* at 514. The court described a "carve out" situation as "a situation where a party whose claim is secured by assets in the bankruptcy estate allows a portion of its lien proceeds to be paid to others." *Id.*
[186] *Id.*
[187] Miller & Berkovich, *supra* note 12, at 1421 ("The Armstrong decision essentially limits the ability of debtors and parties in interest to find ways in Chapter 11 to achieve the mutually advantageous goal of

gifting from senior secured creditors to equity.[188] And the Supreme Court has held that "[u]nder current law, no Chapter 11 reorganization plan can be confirmed over the creditors' legitimate objections . . . if it fails to comply with the absolute priority rule."[189] Moreover, as the court in *Armstrong World* pointed out, the language of section 1129(b) does not admit a contrary result.[190] That statute speaks as to what ***a plan*** must do. Regardless of the source of the funds, a plan cannot be confirmed if it violates the absolute priority rule, unless, perhaps, the junior claimholder provides new value.[191]

The Second Circuit reached the same conclusion as *Armstrong World*, holding that a plan in which secured creditors provided warrants to equity without paying unsecured creditors in full violated the absolute priority rule, notwithstanding the fact that unsecured creditors were out of the money and would have received nothing in a liquidation.[192] The court noted that there were policy arguments in favor of and in opposition to the absolute priority rule and that "the rule has attracted controversy from its early days," but held that Congress "did not create any exception for 'gifts' like the one at issue here."[193]

## III. CAN GIFTING BE ACCOMPLISHED THROUGH A SUBORDINATION AGREEMENT?

While courts have not permitted senior creditors to transfer property to a junior creditor or lienholder through a plan that violates the absolute priority rule, an interesting question is whether senior creditors can make such a transfer through a post-petition subordination agreement.

Subordination agreements are intercreditor agreements that affect the parties' rights vis-à-vis each other.[194] A subordination agreement can be used to alter priority among creditors as to their rights or claims against the debtor.[195] Payment or debt subordination "entitles the senior creditor to full satisfaction of its superior debt

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reorganization and return to the economic world simply because a party that does not suffer as a result is able to assert a technical objection as to the form of the other parties' recovery. The decision adds grist to the mill of dissidents to frustrate the objectives of Chapter 11.").

[188] *See In re* Maharaj, 681 F.3d 558, 560 (4th Cir. 2012); *In re* Arnold, 471 B.R. 578, 595 (Bankr. C.D. Cal. 2012).

[189] Norwest Bank Worthington v. Ahlers, 485 U.S. 197, 202 (1988).

[190] *See In re* Armstrong, 432 F.3d at 513.

[191] *See In re* Summers, 594 B.R. 707, 711 (Bankr. D. Colo. 2018) ("The new value exception allows courts to find that an interest holder in a Chapter 11 debtor whose plan violates the absolute priority rule may in some circumstances retain the interest because they provide 'new value' to the debtor, in the form of new capital or similar contributions.").

[192] *See* DISH Network Corp. v. DBSD N. Am., Inc. (*In re* DBSD N. Am.), 634 F.3d 79, 100–01 (2d Cir. 2011).

[193] *Id.* at 100.

[194] *See* HSBC Bank USA v. Branch (*In re* Bank of New England Corp.), 364 F.3d 355, 361 (1st Cir. 2004) ("[S]ubordination agreements typically provide that one creditor will subordinate its claim against the debtor (the putative bankrupt) in favor of the claim of another creditor.").

[195] *See id.*

before the subordinated creditor receives payment on its debt."[196] In a lien subordination agreement, a secured party agrees to subordinate its security interests to another secured party.[197]

Subordination agreements can adjust the parties' rights vis-à-vis one another immediately or upon the occurrence of a contingent future event.[198] For example, a lender may agree that if the borrower files for bankruptcy it will subordinate its claim against the borrower in favor of the claim of another creditor.[199] "This subordination alters the normal priority of the junior creditor's claim so that it becomes eligible to receive a distribution only after the claims of the senior creditor have been satisfied."[200]

Even before the Bankruptcy Code was enacted in 1978, courts almost uniformly enforced subordination agreements in bankruptcy proceedings.[201] Under current law, bankruptcy courts must enforce such agreements if they would be enforceable outside of bankruptcy.[202] Section 510(a) of the Bankruptcy Code provides that "[a] subordination agreement is enforceable in a case under [the Bankruptcy Code] to the same extent that such agreement is enforceable under the applicable nonbankruptcy law."[203] Although the phrase "applicable nonbankruptcy law" is not limited to state law and includes relevant federal law,[204] Congress has not enacted uniform laws with respect to lien priority,[205] so bankruptcy courts have looked to the relevant state law to determine the validity and interpretation of subordination agreements.[206]

The order of priority established in a subordination agreement can extend to both pre-petition and post-petition indebtedness if the agreement so provides.[207] In

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[196] *See In re* First Baldwin Bancshares, Inc., No. 13-00563, 2013 WL 5429844, at *7 (Bankr. S.D. Ala. Sept. 30, 2013).

[197] *See* Momentive Performance Materials Inc. v. BOKF, NA (*In re* MPM Silicones, L.L.C.), 874 F.3d 787, 795 n.5 (2d Cir. 2017); *In re* Holly's, Inc., 140 B.R. 643, 669 (Bankr. W.D. Mich. 1992).

[198] *See In re* Holly's, Inc., 140 B.R. at 669.

[199] *See In re* Bank of New England, 364 F.3d at 361.

[200] *Id.*

[201] *See In re* Credit Indus. Corp., 366 F.2d 402, 408 (2d Cir. 1966) (citing cases).

[202] *See In re* 203 N. LaSalle St. P'ship, 246 B.R. 325, 330 (Bankr. N.D. Ill. 2000).

[203] 11 U.S.C. § 510(a) (2012).

[204] *See* Patterson v. Shumate, 504 U.S. 753, 758 (1992) ("Nothing in § 541 suggests that the phrase 'applicable nonbankruptcy law' refers . . . exclusively to *state* law.") (emphasis in original).

[205] *See* Butner v. United States, 440 U.S. 48, 54 (1979) ("The constitutional authority of Congress to establish 'uniform Laws on the subject of Bankruptcies throughout the United States' would clearly encompass a federal statute defining the mortgagee's interest in the rents and profits earned by property in a bankrupt estate. But Congress has not chosen to exercise its power to fashion any such rule.") (footnote omitted).

[206] *See* HSBC Bank USA v. Branch (*In re* Bank of New England Corp.), 364 F.3d 355, 363 (1st Cir. 2004) ("Since the construction of private contracts is usually a matter committed to state law, the presumption is that state law will furnish the proper benchmark. That presumption is especially robust here because we can find no federal statute that might guide us in interpreting subordination agreements.") (citations omitted); Chem. Bank v. First Tr. of New York, N.A. (*In re* South East Banking Corp.), 156 F.3d 1114, 1121 (11th Cir. 1998) (certifying question of interpretation to New York state court); *In re* Plymouth House Health Care Ctr., No. 03-19135, 2005 WL 2589201, at *6 (Bankr. E.D. Pa. Mar. 15, 2005) ("Thus, non-bankruptcy law, typically state law, would govern any dispute concerning the enforceability of a subordination agreement.").

[207] *See In re* Amret, Inc., 174 B.R. 315, 319 (M.D. Ala. 1994). *See generally* 8B C.J.S. *Bankr.* § 1016 (2019).

addition, courts may enforce subordination agreements even if the parties entered into them post-petition.[208]

Current disputes in bankruptcy over subordination agreements and intercreditor agreements have focused on what rights the subordinating party has agreed to relinquish.[209] It is theoretically possible, however, for a creditor to use a post-petition subordination agreement, rather than a surcharge, for example, to gift property to another creditor in a manner that would otherwise be inconsistent with the priority scheme in the Code. This is because, as discussed below, if a debtor has multiple creditors, the laws in most states permit a senior lender to subordinate its claims to a specific creditor without losing its priority position to other creditors who are not parties to the agreement. This is often called circular priority.[210]

This rule of distribution in these so-called circular priority cases is summarized in a paper written by a well-known scholar of commercial law and one of the principal drafters of the Uniform Commercial Code, Grant Gilmore:

> To start with, *A*, *B*, and *C* have claims against debtor *X* or his property which are entitled to priority in alphabetical order: the classical example is that of first, second and third mortgages on Blackacre. *A* subordinates his claim to *C*'s. Blackacre is sold and the resulting fund is insufficient to satisfy all three claims. There is a comforting unanimity, among courts and commentators, on the proper distribution of the fund:
>
> 1. Set aside from the fund the amount of *A*'s claim.
> 2. Pay the amount so set aside to
>    a) *C*, to the amount of his claim;
>    b) *A*, to the extent of any balance remaining after C's claim is satisfied.
> 3. Pay *B* the amount of the fund remaining after *A*'s claim has been set aside.
> 4. If any balance remains in the fund after *A*'s claim has been set aside and *B*'s claim has been satisfied, distribute the balance to
>    a) *C*,
>    b) *A*,

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[208] *See* Hon. Joan N. Feeney, Hon. Michael G. Williamson, & Michael J. Stepan, Esq., *Subordination of claims—Subordination agreements*, 1 BANKRUPTCY LAW MANUAL § 6:73 (5th ed. 2019) ("[I]t is irrelevant whether the agreement was entered into prepetition or postpetition."); Case Study, *Vandelay Indus., Inc. – Case Study*, 110515 ABI-CLE 5 (2014) ("Whether entered into prepetition or postpetition, subordination agreements will be enforced by the bankruptcy court.").

[209] *See* Marc Abrams, Hon. Shelley C. Chapman, Hon. Rosemary Gambardella, Hon. James M. Peck, & Michael L. Bernstein, *Intercreditor Issues: Trends in tranche warfare, mezzanine lender issues, syndicated loans and standing for certificate-holders*, 091611 ABI-CLE 43 (2011).

[210] *See, e.g., In re* Stump, 193 B.R. 261, 265 (Bankr. N.D. Ohio 1995).

> Thus *C*, by virtue of the subordination agreement, is paid first, but only to the amount of *A*'s claim, to which *B* was in any event junior. *B* receives what he had expected to receive: the fund less *A*'s prior claim. If *A*'s claim is smaller than *C*'s, *C* will collect the balance of his claim, in his own right, only after *B* has been paid in full. *A*, the subordinator, receives nothing until *B* and *C* have been paid except to the extent that his claim, entitled to first priority, exceeds the amount of *C*'s claim which, under his agreement, is to be first paid.[211]

The main argument supporting the majority approach is that it effectuates the intent of the parties to the subordination agreement.

> That is, notwithstanding that A and C use the word "subordination," there is no logical reason or incentive for A or C to intend that A will give up its first-priority position to B and move behind C. Such a result is nonsensical because it actually disadvantages both A and C and, as noted, produces a windfall for B, who was not a party to the subordination agreement.[212]

That is, *B*, the intermediate creditor who is not a party to the subordination agreement, is neither benefitted nor harmed by the subordination agreement.

If liens have circular priority because of a subordination or intercreditor agreement, most states have adopted the priority of distribution suggested by Professor Gilmore.[213] Only a few courts have held that a senior creditor loses its priority position; that is, that if *A* subordinates its claims to *C*, *B* will move into first priority, such that the new priority of distribution would be *B*, then *C*, and then *A*.[214]

Courts have uniformly followed the property distribution priority that would occur under a subordination agreement outside of bankruptcy in property

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[211] Grant Gilmore, *Circular Priority Systems*, 71 YALE L.J. 53, 54 (1961).

[212] George A. Nation III, *Circuity of Liens Arising from Subordination Agreements: Comforting Unanimity No More*, 83 B.U. L. Rev. 591, 616 (2003) (footnotes omitted).

[213] *See, e.g.*, Wells Fargo Bank v. Neilsen, 100 Cal. Rptr. 3d 547, 556–57 (Cal. Ct. App. 2009) ("[S]ubordination agreement[s] should have no effect, negative or positive, on the intervening lienholder."); Duraflex Sales & Serv. Corp. v. W.H.E. Mech. Contractors, 110 F.3d 927 (2d Cir. 1997) (interpreting Connecticut law); ITT Diversified Credit Corp. v. First City Capital Corp., 737 S.W.2d 803, 804 (Tex. 1987) (referencing Professor Gilmore's article in determining the intermediate creditor was entitled to its expected amount, regardless of the subordination agreement to which it was not a party); Mid-Ohio Chem. Co. v. Petry, No. C-3-91-214, 1993 WL 1367439, at *7 (S.D. Ohio Dec. 30, 1993); RJB Contracting, Inc. v. Hi-G Co., No. CV 950466682S, 1995 WL 791952, at *4 (Conn. Super. Ct. Nov. 28, 1995).

[214] *See* AmSouth Bank, N.A. v. J & D Fin. Corp., 679 So. 2d 695, 698 (Ala. 1996); Ladner v. Hogue Lumber & Supply Co., 91 So. 2d 545, 547 (Miss. 1956) (finding when a first mortgagee subordinates its mortgage to a third mortgagee, the first mortgagee becomes subordinate to both second and third mortgagees); Shaddix v. Nat'l Sur. Co., 128 So. 220, 224 (Ala. 1930) ("If a first mortgagee agrees to subordinate his mortgage to one which is third in point of priority . . . it seems apparent that such first mortgagee thereby becomes subordinate to [second and third mortgagee] and occupies the third place.").

distributions in a bankruptcy case. The leading decision is the bankruptcy court's opinion in *In re Cliff's Ridge Skiing Corporation*.[215] *Cliff's Ridge* arose from a dispute over sale proceeds from a ski chairlift.[216] Three Creditors, First National Bank & Trust Company of Marquette ("First National"), Cliffs Ridge Development Co. ("Cliff's Ridge"), and First of America Bank-Marquette, N.A. ("FOA"), all claimed that they were legally entitled to the proceeds,[217] and each of their individual claims exceeded the amount of the proceeds, such that only one of them could get paid.[218]

Initially, FOA had a first priority lien, Cliff's Ridge had a second priority lien, and First National had a third priority lien.[219] Subsequently, however, FOA agreed to subordinate its security interest to First National so that First National would provide additional funding for the company.[220] Cliff's Ridge was not a party to the subordination agreement and was not aware of it at the time the parties entered into it.[221]

Ultimately, the company filed for chapter 11 bankruptcy, its assets were sold, and the proceeds were put into escrow pending a determination as to how the proceeds should be distributed.[222] Because Cliff's Ridge was not a party to the subordination agreement, FOA's lien was superior to that of Cliff's Ridge, and Cliff's Ridge's lien was superior to First National's.[223] As a consequence of the subordination agreement, however, First National's lien was superior to FOA's.[224] Applying the majority rule, the court held that the entire amount of the sales proceeds should be paid to First National.[225] The court reasoned that Cliff's Ridge's rights were not affected and that Cliff's Ridge's "initial priority should not be altered, either beneficially or adversely, as a result of a subordination agreement to which it was not a party."[226] Other bankruptcy courts have reached the same conclusion about the effect of a subordination agreement on the priority position of a creditor who is not a party to the agreement.[227]

As noted above, post-petition subordination agreements are enforced, as are pre-petition subordination agreements.[228] Does it follow then that a senior creditor can

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[215] 123 B.R. 753 (Bankr. W.D. Mich. 1991).
[216] *Id.* at 755.
[217] *Id.*
[218] *Id.* at 768.
[219] *Id.* at 756–58.
[220] *Id.* at 757–58.
[221] *Id.* at 758.
[222] *Id.* at 755.
[223] *See id.* at 765.
[224] *See id.*
[225] *See id.* at 766.
[226] *Id.* at 768.
[227] *See, e.g., In re* Kobak, 280 B.R. 164, 170 (Bankr. N.D. Ohio 2002) (granting declaratory relief in an adversary proceeding initiated to determine lien priority in chapter 11); *In re* Batterton, No. 00-80181, 2001 WL 34076431, at *3–4 (Bankr. C.D. Ill. 2001) (granting declaratory relief in an adversary proceeding initiated to determine lien priority in chapter 12). *See also* Kenneth M. Misken & J. Eric Crupi, *Complete vs. Partial Subordination: Avoiding Surprises in Circular Priorities of Claims*, AM. BANKR. INST. J., July/Aug. 2007 at 18, 62–63 (discussing subordination agreements in bankruptcy).
[228] *See* Abrams, *supra* note 209.

enter into a post-petition subordination agreement with a junior creditor, gifting rights to property, and bypassing an intermediate creditor?

The creditors in any of the gifting cases discussed above conceivably could have accomplished the same objective through a subordination agreement. For example, assume a secured creditor is in the *A* position, a junior secured or senior unsecured lender is in the *B* position, and general unsecured creditors are in the *C* position. If the secured creditor enters into a post-petition subordination agreement with the general unsecured creditors, the unsecured creditors would take first ahead of the secured lender (by virtue of the subordination agreement, up to the lesser amount of its debt or the amount owed to *A*), the secured lender (*A*) would take second (by virtue of its senior lien, up to the amount of its debt less what was paid to *C*), and the *B* creditor would take third (and possibly be out of the money). This result is consistent with the policies of the cases that have favored gifting and also would be consistent with the policy behind the majority rule in circular priority cases. The post-petition lender is not worse off, because it was out of the money anyway, the secured creditor is agreeing to subordinate its own rights to property, and there is no reason to assume that the secured lender and the general unsecured creditors intended to enter into an agreement to improve the position of the post-petition lender in the bankruptcy case.[229] But this result clearly could lead to the type of "mischief" that concerned the bankruptcy court in *Wrightwood Guest Ranch*,[230] as well as other courts that have disapproved gifting. Although we are not aware of this issue having been litigated, whether such a post-petition subordination agreement should be enforceable in a bankruptcy is a question that we discuss further in Part V.

## IV. HAS THE SUPREME COURT IMPLICITLY BARRED GIFTING?

The Supreme Court's decision in *Czyzewski v. Jevic Holding Corp.*,[231] has not been generally recognized as a "gifting" case, but the Court's opinion in that case, which strongly defended the priority scheme of the Code, may undermine the future viability of that doctrine and may prevent parties from accomplishing the same objective through a subordination agreement, at least under a non-consensual plan of reorganization.

*Jevic* arose from a failed leveraged buyout of Jevic Transportation Corporation ("Jevic") by Sun Capital Partners ("Sun"), which had acquired Jevic, in part, with funds loaned by CIT Group ("CIT"), secured by all Jevic's assets.[232] At the time Jevic filed its chapter 11 bankruptcy petition, Jevic owed $53 million to senior secured creditors Sun and CIT, and over $20 million to tax and general unsecured creditors.[233] After it filed its petition, its employees claimed that Jevic and Sun had violated both

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[229] The secured creditor might, for example, make this arrangement so that its possible post-petition operation of the debtor, following a forecasted foreclosure, is made easier through cooperative trade creditors.

[230] *See* Appellants' Joint Opening Brief, *supra* note 117.

[231] 137 S. Ct. 973 (2017).

[232] *See id.* at 980.

[233] *Id.*

state and federal Worker Adjustment and Retraining Notification (WARN) Acts by failing to give them at least sixty days' notice before their termination.[234] The bankruptcy court granted summary judgment against Jevic, leaving them a $12.4 million judgment.[235] The employees continued to litigate their claims against Sun.[236]

The bankruptcy court also authorized the general unsecured creditors' committee to sue Sun and CIT, challenging the leveraged buyout as a preference and fraudulent transfer.[237] Under the Bankruptcy Code, if the committee were to prevail in that lawsuit, "it would have been able to avoid all of CIT's and Sun's liens on Jevic's assets and to recover for the estate the value of the property transferred from Jevic to CIT and Sun to finance the buyout—potentially more than $100 million."[238] By this point, the proceeds of the estate were only $1.7 million, well short of the amount necessary to pay the secured creditors.[239] So Sun, CIT, and the creditors' committee entered into a settlement agreement pursuant to which the committee would dismiss the fraudulent-conveyance action with prejudice; CIT would pay $2 million for the committee's legal fees and administrative expenses; Sun would "assign its lien on Jevic's remaining $1.7 million to a trust, which would pay taxes and administrative expenses and distribute the remainder on a pro rata basis to the low-priority general unsecured creditors, but which would not distribute anything to" the WARN plaintiffs; and "Jevic's Chapter 11 bankruptcy would be dismissed."[240] Sun insisted on a distribution that would bypass the employees, because it did not want to fund their war chest for the litigation against Sun.[241]

The dismissal would not return the estate to the debtor, as is typically the case when the court dismisses a bankruptcy proceeding.[242] Instead, it would be a hybrid dismissal, or so-called "structured dismissal," which "'dismisses the case while, among other things, approving certain distributions to creditors, granting certain third-party releases, enjoining certain conduct by creditors, and not necessarily vacating orders or unwinding transactions undertaken during the case.'"[243]

The bankruptcy court, district court, and Third Circuit approved the settlement and the dismissal of the chapter 11, concluding that without the settlement, there

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[234] *Id.*
[235] *Id.*
[236] *See id.* at 981.
[237] *Id.* For a discussion of this cause of action, see Michael H. Strub, Jr. & Jeffrey M. Reisner, *The Expansion of the Triggering Creditor Doctrine in an Action to Avoid Fraudulent Transfers*, 24 AM. BANKR. INST. L. REV. 249, 262 (2016).
[238] Petition for a Writ of Certiorari at 10, Czyzewski v. Jevic Holding Corp., 137 S. Ct. 973 (2017) (No. 15–649); *see* 11 U.S.C. §§ 547, 548 (2012).
[239] *See Czyzewski*, 137 S. Ct. at 981.
[240] *Id.*
[241] *Id.*
[242] *See* Plumhoff v. Cent. Mortg. Co., 286 F. Supp. 3d 699, 703 n.2 (D. Md. 2017) ("[T]he dismissal of a bankruptcy case (unlike a discharge) generally "'restore[s] the status quo ante;" it is as if the bankruptcy petition had never been filed.'") (quoting *In re* Derrick, 190 B.R. 346, 350 (Bankr. W.D. Wis. 1995) (quoting *In re* Lewis & Coulter, Inc., 159 B.R. 188, 190 (Bankr. W.D. Pa. 1993))).
[243] *See Czyzewski*, 137 S. Ct. at 979 (quoting American Bankruptcy Institute Commission to Study the Reform of Chapter 11, 2012–2014 Final Report and Recommendations 270 (2014)).

would be nothing to distribute to anyone other than secured creditors, and that structured dismissals need not always respect priority.[244] In other words, unsecured creditors were better off because of the settlement, and the employees with WARN claims were no worse off because the assets would not be sufficient to provide them any distribution.

The Supreme Court reversed.[245] It first rejected the respondents' argument that the employees lacked standing because the employees would have received nothing even if the court had never approved the structured dismissal in the first place.[246] As the Court pointed out, this argument assumed that the fraudulent conveyance claims that were being compromised had no value beyond the settlement amount, and it further assumed that there would have been no settlement without violating priority rules.[247] The Court found no evidence to support those assumptions.[248]

The Court then addressed the substance of the settlement agreement and held that Congress did not intend to allow parties to bypass the payment priorities in chapter 11 through a structured settlement.[249] The Court first underscored the importance of the priority scheme to the Bankruptcy Code:

> The Code's priority system constitutes a basic underpinning of business bankruptcy law. Distributions of estate assets at the termination of a business bankruptcy normally take place through a Chapter 7 liquidation or a Chapter 11 plan, and both are governed by priority. In Chapter 7 liquidations, priority is an absolute command—lower priority creditors cannot receive anything until higher priority creditors have been paid in full. Chapter 11 plans provide somewhat more flexibility, but a priority-violating plan still cannot be confirmed over the objection of an impaired class of creditors.[250]

The Court acknowledged that in chapter 11, distributions can occur during the case that violate the priority rules, but it concluded that these distributions are approved by the courts because they have "significant Code-related objectives," such as "'first-day' wage orders that allow payment of employees' prepetition wages, 'critical vendor' orders that allow payment of essential suppliers' prepetition invoices, and 'roll-ups' that allow lenders who continue financing the debtor to be paid first on

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[244] *Id.* at 982.
[245] *Id.* at 976.
[246] *Id.* at 976.
[247] *Id.* at 983.
[248] *See id.*
[249] *See id.*
[250] *Id.* (citations omitted).

their prepetition claims."[251] The Court held that none of these Code-related objectives were accomplished through a structured settlement.[252]

The Court also acknowledged that there may be policy arguments in favor of structured dismissals that did not adhere to the Bankruptcy Code's priorities, but, echoing the concerns of some other courts in the gifting cases, held that these concerns were outweighed by other concerns:

> They include departure from the protections Congress granted particular classes of creditors. They include changes in the bargaining power of different classes of creditors even in bankruptcies that do not end in structured dismissals. They include risks of collusion, i.e., senior secured creditors and general unsecured creditors teaming up to squeeze out priority unsecured creditors. And they include making settlement more difficult to achieve.[253]

More recently, the Court held that while the Bankruptcy Code "aims to make reorganizations possible . . . it does not permit anything and everything that might advance that goal."[254]

The facts of *Jevic* are distinguishable from the facts of the gifting cases that are discussed above.[255] Principally, as the Hon. Anthony Joseph Scirica pointed out in his dissenting opinion in the Third Circuit, the settlement agreement indisputably included "property of the estate" because the fraudulent conveyance claims that the creditors were releasing were claims being brought on behalf of the estate.[256] Still,

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[251] *Id.* at 985.

[252] *See id.* at 985–86 ("We cannot find the violation of ordinary priority rules that occurred here any significant offsetting bankruptcy related justification.").

[253] *Id.* at 986–87 (citations omitted).

[254] Mission Prod. Holdings, Inc. v. Tempnology, LLC, 139 S. Ct. 1652, 1665 (2019) (holding rejection of trademark license was a breach, not rescission, and did not terminate licensee's right to use the trademark).

[255] It should be noted that the Court's opinion could have been broader and could have spoken directly to the "gifting" question, but the Court elected to decide the narrower question relating to structured dismissals. *See Czyzewski*, 137 S. Ct. at 983 ("We turn to the basic question presented: Can a bankruptcy court approve a structured dismissal that provides for distributions that do not follow ordinary priority rules without the affected creditors' consent?"). As Justice Thomas points out in his dissenting opinion, the Court initially granted certiorari to decide "[w]hether a bankruptcy court may authorize the distribution of settlement proceeds in a manner that violates the statutory priority scheme." *Id.* at 987 (Thomas, J., dissenting). After the Court granted certiorari, "petitioners recast the question presented to ask '[w]hether a Chapter 11 case may be terminated by a "structured dismissal" that distributes estate property in violation of the Bankruptcy Code's priority scheme.'" *Id.* (citation omitted). "Although both questions involve priority-skipping distributions of estate assets, the recast question is narrower—and different—than the one on which [the Court] granted certiorari." *Id.* at 987–88.

[256] *See* Jevic Holding Corp. v. CIT Group/Business Credit Inc. (*In re* Jevic Holding Corp.), 787 F.3d 173, 188–89 (3d Cir. 2015) (Scirica, J., dissenting) ("Here, the administrative and unsecured creditors received the $3.7 million as consideration for the releases from the fraudulent conveyance action, so this payment qualifies as 'proceeds' from the estate cause of action."), *rev'd and remanded sub nom*. Czyzewski v. Jevic Holding Corp., 137 S. Ct. 973 (2017).

the secured claim proceeds that Sun gifted to the trust were not "property of the estate" under *SPM Manufacturing*.[257] Moreover, the Court held that "[t]he priority system applicable to . . . distributions [under chapter 7 and chapter 11] has long been considered fundamental to the Bankruptcy Code's operation."[258] And it rejected using structured dismissals to avoid this system, noting that "[t]he importance of the priority system leads us to expect more than simple statutory silence if, and when, Congress were to intend a major departure."[259] This reasoning applies to the gifting decisions as well.

## V. OBSERVATIONS ABOUT GIFTING IN BANKRUPTCY

The law surrounding gifting is in conflict and difficult to reconcile. One could argue, as courts have, that estate assets are not really "property of the estate" if the estate's assets are insufficient to pay its secured creditors,[260] but this is problematic. The broad definition of "property of the estate" in section 541(a) of the Code includes anything of value in which the debtor has an interest.[261]

The results in most of the gifting cases seem driven as much by equity as by the language of the Bankruptcy Code. There is nothing wrong with this in theory, as courts should attempt to avoid an interpretation that would lead to inequitable or unjust results when construing a statute.[262] But "hard cases [ ] make bad law."[263] So do bad facts.[264] And broad rules that assets in the estate are not property of the estate if their value is insufficient to satisfy associated liens, or that a creditor can distribute its own property to whomever it wishes as part of the bankruptcy process, may lead to results that are inconsistent with the language of the Code. For example, if property is not property of the estate, can an undersecured creditor attach the debtor's assets? And at what point does the transformation between property of the estate and not property of the estate occur? For example, at the beginning of the debtors' bankruptcy in *Fansteel Foundry*, the court made a determination that TCTM was oversecured,[265] so the assets clearly were property of the estate at that point.

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[257] *See id.* ("The arrangement here is closer to a § 363 asset sale where the proceeds from the debtor's assets are distributed directly to certain creditors, rather than the bankruptcy estate.").

[258] *Czyzewski*, 137 S. Ct. at 984.

[259] *Id.*

[260] *See In re* ICL Holding Co., 802 F.3d 547, 556–57 (3d Cir. 2015) (holding secured lender could pay unsecured creditors and debtor's professionals in connection with a credit bid for the debtor's assets bypassing senior claim of taxing authority because funds were not property of the estate).

[261] *See In re* Minton, 348 B.R. 467, 472 (Bankr. S.D. Ohio 2006) ("Congress enacted § 541 as part of the Bankruptcy Reform Act of 1978 intending the definition of property of the estate to be construed broadly to include practically every conceivable interest a debtor may have in property as of the bankruptcy filing date.").

[262] *See* Webster v. State Bd. of Control, 242 Cal. Rptr. 685, 690 (1987) ("In construing statutes, the courts must attempt to avoid an interpretation which would lead to inequitable or unjust results.").

[263] N. Sec. Co. v. United States, 193 U.S. 197, 364 (1904) (Holmes, J., dissenting).

[264] *See* Haig v. Agee, 453 U.S. 280, 319 (1981) (Brennan, J., dissenting) ("[B]ad facts make bad law.").

[265] *In re* Fansteel Foundry Corp., No. 16-01825-als11, 2018 WL 5472928, at *8 (Bankr. S.D. Iowa Oct. 26, 2018) ("After multiple hearings a final order for use of cash collateral was approved and TCTM's claim was determined to be over-secured entitling it to augment its claim under 11 U.S.C. § 506(b).").

Moreover, under section 362(c)(1) of the Code, the automatic stay does not apply once "property is no longer property of the estate."[266] This suggests that a secured creditor like TCTM, whose claims exceed the value of the estate's assets, could foreclose on its collateral during the bankruptcy proceeding without seeking relief from the automatic stay. This is inconsistent with well-established law that a secured creditor's collateral remains property of the estate until the estate has sold it.[267] The estate "has an interest" in property secured by a lien, regardless of what additional assets it has, until the property is released.[268]

In addition, if property is not "property of the estate," the court has no power over its distribution, and creditors can benefit themselves however they see fit if non-bankruptcy law does not prohibit it. For example in *In re Goffena*,[269] the secured creditor and the trustee entered into a private agreement pursuant to which the secured creditor agreed to pay the trustee's fees out of the proceeds of the sale without notifying tax authorities that taxes were due.[270] The court invalidated that agreement on the grounds that the trustee could not benefit from a violation of his fiduciary duty to tax creditors,[271] but if those proceeds were not property of the estate, the trustee arguably would have no fiduciary duty to tax creditors concerning those proceeds. And *In re Scott Cable Communications, Inc.*,[272] the debtor and secured creditor proposed scheduling a foreclosure sale after the confirmation order to avoid paying capital gains tax.[273] The court refused to approve the plan on the ground that it violated section 1129(d) of the Bankruptcy Code,[274] but if the bankruptcy court found that it had no authority over that property, it might have reached a different conclusion.

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[266] *See* 11 U.S.C. § 362(c)(1) (2012) ("[T]he stay of an act against property of the estate under subsection (a) of this section continues until such property is no longer property of the estate.").

[267] *See In re* Salamon, 528 B.R. 171, 175 (B.A.P. 9th Cir. 2015), *aff'd*, 854 F.3d 632 (9th Cir. 2017) ("The granting of relief from stay allows a secured creditor to proceed with foreclosure proceedings but, until a sale actually occurs, the property remains property of the bankruptcy estate."); *In re* Fisher, 194 B.R. 525, 529 (Bankr. D. Kan. 1996), *aff'd*, No. 93-12224, 1996 WL 695401 (D. Kan. Nov. 27, 1996) ("The very existence of § 362(d), and the need for the procedure it sets forth to allow secured creditors to obtain their collateral, refutes any argument that liened property is no longer property of the estate and subject to the automatic stay."); *In re* Waldrop, No. 15-14689-JDL, 2016 WL 3085877, at *6 (Bankr. W.D. Okla. May 27, 2016) (holding garnished funds were subject to the automatic stay).

[268] *See* 11 U.S.C. § 506(a)(1) ("An allowed claim of a creditor secured by a lien on property in which the estate has an interest . . . is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property . . . and is an unsecured claim to the extent that the value of such creditor's interest . . . is less than the amount of such allowed claim.").

[269] 175 B.R. 386 (Bankr. D. Mont. 1994).

[270] *See id.* at 390.

[271] *See id.* at 391–92.

[272] 227 B.R. 596 (Bankr. D. Conn. 1998).

[273] *Id.* at 603.

[274] *Id.* at 604; *see* 11 U.S.C. § 1129(d) (2012) ("Notwithstanding any other provision of this section, on request of a party in interest that is a governmental unit, the court may not confirm a plan if the principal purpose of the plan is the avoidance of taxes or the avoidance of the application of section 5 of the Securities Act of 1933.").

In the case of gifting surcharges, neither line of cases is satisfactory. Section 506(c) was enacted to ensure that the trustee could recover the "necessary costs and expenses of preserving, or disposing of, such property to the extent of any benefit to the holder of such claim."[275] It should not be the case, as in *Debbie Reynolds*, that the court can approve a settlement that provides a surcharge without inquiring whether the surcharge was, in fact, a legitimate and necessary expense of preserving the secured creditor's collateral. On the other hand, it does not make sense that a creditor who did not provide such services could receive a windfall from a surcharge recovery, which could be the outcome following *Resource Technology* and *Nettel*.

The interpretation of the Bankruptcy Code that leads to the most equitable result in all contexts is to require the court to determine whether a surcharge was, in fact, incurred in connection with preserving the secured creditor's collateral. If it was, the surcharge should be approved, and it should be paid to the associated service provider. While no party other than the debtor or trustee has standing to seek a surcharge under section 506(c), every interested party has the ability to challenge a settlement agreement that proposes to pay one.[276] Moreover, if a party believes that it is entitled to a surcharge and that the trustee has ulterior motives for refusing to seek one on its behalf, that party can seek to have the trustee removed and replaced.[277] Causes for removal include situations in which the trustee is unwilling to perform the duties of a trustee, the trustee is not disinterested, or the trustee violates a fiduciary duty to the estate.[278]

Moreover, the bankruptcy court's broad discretion over settlement agreements is an additional arrow in its quiver to strike down agreements that are unfair to other creditors. Rule 9019(a) of the Federal Rules of Bankruptcy Procedure grants the bankruptcy court authority to approve settlements of legitimate disputes in bankruptcy cases.[279] In considering whether to approve a settlement, a bankruptcy court is required to review the reasonableness of the proposed settlement and make an informed judgment whether the settlement is fair and equitable and in the best interests of the estate.[280] The Bankruptcy Code prevents parties from entering into private agreements that limit the rights of the debtor or other creditors that are

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[275] 11 U.S.C. § 506(c).

[276] As a practice point, of course, administrative claimants, including law firms, should challenge the payment on their own behalf as well as on behalf of their clients if they believe that a challenge is warranted.

[277] *See* 11 U.S.C. § 324 ("The court, after notice and a hearing, may remove a trustee, other than the United States trustee, or an examiner, for cause.").

[278] *See In re* Morgan, 375 B.R. 838, 848 (B.A.P. 8th Cir. 2007) ("What constitutes sufficient cause for removal is not defined in the Bankruptcy Code, but is instead left for the courts to determine in a case-by-case basis."), *aff'd*, 573 F.3d 615 (8th Cir. 2009).

[279] *See In re* Drexel Burnham Lambert Grp., Inc., 140 B.R. 347, 349 (Bankr. S.D.N.Y. 1992).

[280] *See In re* Drexel Burnham Lambert Grp., Inc., 138 B.R. 723, 758 (Bankr. S.D.N.Y. 1992) (stating the standards approval settlement require the court to determine whether the proposed settlement is reasonable); *In re* Drexel Burnham Lambert Grp., Inc., 134 B.R. 493, 496 (Bankr. S.D.N.Y. 1991) (same).

provided by the Code.[281] If the court believes that a surcharge is really such an agreement, it should have the power to disapprove it.

In the chapter 11 context, as noted above, the holding in *Armstrong World* is likely the correct one. Section 1129(b) speaks to what a plan can do, regardless of how it does it. The absolute priority rule may be controversial, but it was created to prevent senior creditors from bypassing intermediate creditors to pay equity.[282] And if the holding in *Armstrong World* barring vertical gifting is correct, the result must be the same for horizontal gifting, because the same statute that prohibits a non-consensual plan that is not fair and equitable also prohibits a non-consensual plan that unfairly discriminates.[283] That is, a debtor should not be permitted to gerrymander a plan, violate the absolute priority rule, or unfairly discriminate among creditors of equal priority with respect to plan distributions, regardless of the source of the funds.[284] Nor should it accomplish the same outcome through a sale that effectively is a sub rosa plan of reorganization.[285]

Again, though, the solution to resolve perceived inequities from enforcing section 1129(b) can be found in other sections of the Bankruptcy Code. For example, a bankruptcy court can approve a "horizontal gifting" settlement agreement that is arguably inconsistent with the ordinary priority of distributions under a plan if there is a business justification for the agreement and it is in the best interests of

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[281] *See In re* Kidd, 458 B.R. 612, 622 (Bankr. N.D. Ga. 2011); *In re* Garris, 496 B.R. 343, 354 (Bankr. S.D.N.Y. 2013) ("[A] fee that is not enforceable under the Bankruptcy Code is not transformed, by virtue of a private agreement, into an enforceable one after a case is dismissed, even if such an agreement would be otherwise enforceable under state law.").

[282] *See In re* Armstrong World Indus., Inc., 432 F.3d 507, 513 (3d Cir. 2005) ("The absolute priority rule, as codified, ensures that 'the holder of any claim or interest that is junior to the claims of [an impaired dissenting] class will not receive or retain under the plan on account of such junior claim or interest any property.'") (alteration in original) (quoting 11 U.S.C. § 1129(b)(2)(B)(ii)).

[283] *See* 11 U.S.C. § 1129(b)(1) ("[T]he court, on request of the proponent of the plan, shall confirm the plan notwithstanding the requirements of such paragraph 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.").

[284] Another open issue is whether and to what extent a bankruptcy court can approve a pre-plan settlement agreement in a chapter 11 case that violates the absolute priority rule. *Compare* United States v. AWECO, Inc. (*In re* AWECO, Inc.), 725 F.2d 293, 298 (5th Cir. 1984) (holding bankruptcy court "abuses its discretion in approving a settlement with a junior creditor unless the court concludes that priority of payment will be respected as to objecting senior creditors") *with* Motorola, Inc. v. Official Comm. of Unsecured Creditors (*In re* Iridium Operating LLC), 478 F.3d 452, 464–65 (2d Cir. 2007) ("In the Chapter 11 context, whether a settlement's distribution plan complies with the Bankruptcy Code's priority scheme will often be the dispositive factor. However, where the remaining factors weigh heavily in favor of approving a settlement, the bankruptcy court, in its discretion, could endorse a settlement that does not comply in some minor respects 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."). This was the issue that the Supreme Court in *Jevic* declined to decide.

[285] *See* Pension Benefit Guar. Corp. v. Braniff Airways, Inc. (*In re* Braniff Airways, Inc.), 700 F.2d 935, 940 (5th Cir. 1983) ("The debtor and the Bankruptcy Court should not be able to short circuit the requirements of Chapter 11 for confirmation of a reorganization plan by establishing the terms of the plan *sub rosa* in connection with a sale of assets.").

creditors.[286] Thus, the payment required by the settlement agreement in *MCorp Financial* simply could have been approved under Bankruptcy Rule 9019 as in the best interests for creditors. Further, as discussed above, the payment in *Nuverra* could have been approved by focusing on the substance of the transaction—avoiding recovery by equity—rather than its form.

Disallowing gifting might have led to a different outcome in *Genesis I*, but in that case, the outcome that the court accomplished through applying the gifting doctrine was contrary to policy already determined by the Supreme Court. Whatever one's normative views about the payment of penalties or punitive damages under a plan, the Supreme Court already has decided that these claimants can only be excluded if the damages could interfere with a reorganization. Similarly, the court likely could not have reached the result that it did in *Fansteel Foundry* had it not allowed gifting, but the gift could only be accomplished by allowing the debtors and the creditors' committee to classify claims of general unsecured creditors separately from those of 510's unsecured deficiency claim. Courts have almost uniformly rejected plans that separately classify claims of general unsecured creditors from unsecured deficiency claims as impermissible gerrymandering.[287] Disallowing gifting simply gives those creditors the seat at the negotiating table that the Supreme Court and Courts of Appeal already held that they have.

Whether senior creditors can gift assets to a junior creditor through a post-petition subordination or intercreditor agreement is an open issue. Section 510(a) expressly authorizes subordination agreements and does not restrict this authorization to pre-petition agreements.[288] The difference between a pre-petition and post-petition subordination agreement is legally significant, however. If the subordination agreement is entered into pre-petition, the distribution of the estate's assets is consistent with the Bankruptcy Code, because "[i]n bankruptcy proceedings, state

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[286] *See In re* Glob. Vision Prod., Inc., No. 07 CV. 12628 (RDD), 2009 WL 2170253, at *6 (S.D.N.Y. July 14, 2009) ("Even if there is an allegation that the proposed action deprives a party in interest of Chapter 11 protections, the estate may take action if there is an articulated business justification for it.").

[287] *See, e.g.*, Phoenix Mut. Life Ins. Co. v. Greystone III Joint Venture (*In re* Greystone III Joint Venture), 995 F.2d 1274, 1279 (5th Cir. 1991), *cert denied*, 506 U.S. 821 (1992) (stating "thou shalt not classify similar claims differently in order to gerrymander an affirmative vote on a reorganization plan"); John Hancock Mut. Life Ins. Co. v. Route 37 Bus. Park Assocs., 987 F.2d 154, 158, 162 (3d Cir. 1993) ("The critical confirmation requirements set out in Section 1129(a)(8) . . . and Section 1129(a)(10) . . . would be seriously undermined if a debtor could gerrymander classes."); Lumber Exch. Bldg. Ltd. P'ship v. Mut. Life Ins. Co. of New York (*In re* Lumber Exch. Bldg. Ltd. P'ship), 968 F.2d 647, 650 (8th Cir. 1992) (concluding the separate classification was improper as it was "a thinly veiled attempt to manipulate the vote to assure acceptance of the plan"); Travelers Ins. Co. v. Bryson Props., XVIII (*In re* Bryson Props., XVIII), 961 F.2d 496, 502 (4th Cir. 1992) ("[I]f the classifications are designed to manipulate class voting . . . the plan cannot be confirmed."); Teamsters Nat'l Freight Indus. Negotiating Comm. v. U.S. Truck Co., Inc. (*In re* U.S. Truck Co.), 800 F.2d 581, 586 (6th Cir. 1986) ("Unless there is some requirement of keeping similar claims together, nothing would stand in the way of a debtor seeking out a few impaired creditors (or even one such creditor) who will vote for the plan and placing them in their own class."); *but see* Steelcase Inc. v. Johnston (*In re* Johnston), 21 F.3d 323, 327 (9th Cir. 1994) (special circumstances including nature of collateral and litigation justified separate classification).

[288] 11 U.S.C. § 510(a) ("A subordination agreement is enforceable in a case under this title to the same extent that such agreement is enforceable under applicable nonbankruptcy law.").

law determines interest in property and the priority of competing liens."[289] A post-petition subordination agreement changes the priority of distribution to which creditors would have been entitled under state law before the petition was filed.

In a chapter 11 case, it would seem unlikely that parties can rely on section 510(a) to avoid the specific constraints on plan distributions imposed by section 1129(b) for the reasons discussed above.[290] Moreover, there are a number of additional hurdles in chapter 11 that a plan proponent would need to overcome to use a subordination agreement to gift assets or rights to a junior creditor.[291] These issues are beyond the scope of this paper.

But in a chapter 7 liquidation, subordination agreements may fare better. While the Supreme Court has indicated that the priority scheme in chapter 7 is "fundamental,"[292] "[a]s part of its comprehensive 1978 revision of the bankruptcy laws, Congress enacted a Code provision that provides for the legal enforcement of subordination agreements in bankruptcy courts."[293]

Even if a post-petition subordination agreement that alters the chapter 7 distribution scheme may enforceable, however, it does not necessarily mean that it must be enforceable. Assuming that the debtor's property remains "property of the estate," even if the estate has insufficient assets to pay secured claims in full, the bankruptcy court may have jurisdiction over a post-petition subordination agreement because it affects the administration of the estate,[294] and perhaps the court could refuse to approve it or refuse to enforce it if the it believed that the agreement was inequitable. These are questions that remain to be tested.

## CONCLUSION

Bankruptcy courts need to have flexibility to distribute estate proceeds in a manner that is fair and equitable to all interested parties. And parties must have flexibility in negotiating a consensual plan, as this is a priority in chapter 11. But they must do so in a manner that is consistent with the policy decisions that Congress has made in enacting the Bankruptcy Code, or that already have been decided by the Supreme Court.

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[289] *In re* Glinz, 46 B.R. 266, 271 (Bankr. N.D. 1984).

[290] *See* Morton v. Mancari, 417 U.S. 535, 550–51 (1974) ("Where there is no clear intention otherwise, a specific statute will not be controlled or nullified by a general one.").

[291] For example, under section 1126(e), "the court may designate any entity whose acceptance or rejection of such plan was not in good faith, or was not solicited or procured in good faith or in accordance with the provisions of this title." 11 U.S.C. § 1126(e). *See, e.g.*, DISH Network Corp. v. DBSD N. Am., Inc. (*In re* DBSD N. Am., Inc.), 634 F.3d 79, 104 (2d Cir. 2011) (designating vote of competitor of debtor who purchased claims to block debtor's plan of reorganization to compel debtor to enter into strategic business transaction with competitor).

[292] *See* Czyzewski v. Jevic Holding Corp., 137 S. Ct. 973, 983–84 (2017).

[293] Chem. Bank v. First Tr. of New York (*In re* South East Banking Corp.), 156 F.3d 1114, 1120 (11th Cir. 1998); *see also* HSBC Bank USA v. Branch (*In re* Bank of New England Corp.), 364 F.3d 355, 362 (1st Cir. 2004) (discussing history of section 510(a)).

[294] *See* Cont'l Cas. Co. v. Carr (*In re* W.R. Grace & Co.), 900 F.3d 126, 139 (3d Cir. 2018).

In the end, though, the legality of gifting is currently uncertain, and the judicial authority is disjointed and inconsistent. It likely will remain so, unless the issue is clarified by legislation or by the Supreme Court.