

## **Reverse Cramdown: The Senior Creditor’s “Tip” to The Lower Classes**

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### **Introduction**

Ask any bankruptcy practitioner or law student who has taken a basic bankruptcy class who gets paid first in a bankruptcy proceeding, creditors or shareholders, and they will tell you without hesitation that creditors get paid first. Indeed, it is one of the fundamental tenets of bankruptcy law that creditors of a debtor have priority over the debtor’s equity interest holders. For purposes of chapter 11 reorganizations, this rule has been codified in 11 U.S.C. § 1129(b)(2)(B)(ii) and is generally referred to as the “absolute priority rule.”<sup>1</sup> Under the

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absolute priority rule, equity shareholders should generally not receive any property under a plan of reorganization if the debtor's assets exceed its liabilities.<sup>2</sup>

However, a number of courts have condoned a practice variously called the "reverse cramdown" (or "give back" or "give up") that allows parties supporting confirmation to circumvent the absolute priority rule. "Reverse cramdown" primarily occurs when an undersecured creditor of a chapter 11 debtor who has a lien on all of the debtor's assets collaborates with the debtor's existing equity interest holders (usually current management who drove the debtor into bankruptcy in the first place) to give the equity interest holders a piece of the reorganized debtor under the plan as an incentive for them to stay with and run the company post-confirmation while distributing little or nothing to the debtor's unsecured creditors.<sup>3</sup> Underlying the practice of reverse cramdown is the rationale that since the secured lender has a lien on all of the debtors' property and is undersecured, the secured lender can share or "give up" a portion of the enterprise value of the debtor to which it would otherwise be entitled to under the plan to whoever it wants to, including the debtor's existing equity interest holders, who, absent the secured lender's generosity, would otherwise receive nothing under the plan. Courts have applied this rationale to circumvent not only the absolute priority rule but the prohibition against "unfair discrimination" contained in 11 U.S.C. § 1129(b)(1) as well.

This article contends, however, that this rationale is flawed. Secured creditors should not be permitted to collaborate with junior creditors or equity owners to squeeze out intervening classes of creditors who are not provided for in full under a plan of reorganization. The legislative history to the 11 U.S.C. § 1129(b)(2) expressly prohibits the practice of reverse cramdown. Moreover, it was inequitable practices similar to reverse cramdown that led to the creation of the absolute priority rule in the first place.

## **Background**

### *A. Confirmation of a Plan of Reorganization Generally*

In order to fully understand the problems with the rationale underlying the practice of reverse cramdown, a general understanding of the Code's priority scheme and requirements for confirmation is necessary. Confirmation of a chapter 11 plan is generally governed by 11 U.S.C. § 1129, which provides two ways for obtaining confirmation. The first way is to satisfy all the requirements under subsection (a) of 1129, including subsection (a)(8), which requires that all

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<sup>1</sup> See *Carrieri v. Jobs.Com, Inc.*, 393 F.3d 508, 521 (5th Cir. 2004) ("One of the main purposes of Chapter 11 of the Code is demonstrated by the 'absolute priority rule' . . . that creditors' rights and claims take priority over equity interests.").

<sup>2</sup> *Justice v. Carter*, 972 F.2d 951, 954 (8th Cir. 1992) (defining absolute priority rule to bar any junior equity interest from receiving property of the debtor "until the unsecured creditors are paid in full under the reorganization plan.").

<sup>3</sup> For a good example of reverse cramdown, see David D. Farrell, *Reverse Cramdown: Another Option in the Secured Creditor's Playbook?*, 23 AM. BANKR. INST. J. 22, 63 (Sept. 2004); see also Do 'Give-ups' Violate the Absolute Priority Rule?, *Bankr. Ct. Decisions Weekly News and Comment* (October 2, 2001), at A1.

impaired classes of claims and interests accept the plan.<sup>4</sup> Confirmation under 1129(a) is considered a “consensual” confirmation since all impaired classes must accept the plan in order for the plan to be confirmed.<sup>5</sup> The second way to obtain confirmation is to satisfy the requirements of subsection (b), which allows confirmation despite the objection of an impaired class if all of the requirements of subsection (a), except subsection (8), have been met and the plan “does not discriminate unfairly” and is “fair and equitable” to the rejecting class of claims or interests.<sup>6</sup> Confirmation under 1129(b), generally referred to as the “cramdown” alternative, is sometimes required in order to confirm a plan over the objections of a dissenting class of creditors.<sup>7</sup> It is only in the context of nonconsensual plan confirmation under 1129(b) that reverse cramdown disputes arise. Indeed, it is the requirements of section 1129(b) that the practice of reverse cramdown is used to circumvent.

### 1. 1129(b)(1): Unfair Discrimination

One of the central policies of the Bankruptcy Code is equality of distribution among creditors.<sup>8</sup> Accordingly, creditors of equal rank are generally entitled to equal distributions under a plan of reorganization.<sup>9</sup> The Bankruptcy Code, however, permits a plan of reorganization to discriminate among similarly situated classes of creditors to a certain extent, as long as the discrimination is not “unfair” to a dissenting, impaired class of creditors.<sup>10</sup>

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<sup>4</sup> Bankruptcy Code section 1129 provides that a court shall confirm a plan if it meets all of the requirements set forth in § 1129(a). *See* 11 U.S.C. § 1129(a).

<sup>5</sup> *See In re Jackson*, 184 B.R. 16, 19 n. 1 (D. N.J. 1995). “Consensual” refers to whether each class of creditors or interest holders under the plan have accepted the plan. A class of creditors accepts a plan if a majority of the creditors and those holding two-thirds of the total dollar amount of the claims within that class vote to approve the plan. *See* 11 U.S.C. § 1126(c). A class equity interest holders accepts if at least two-thirds of all allowed interest holders voting accept the plan. *See* 11 U.S.C. § 1126(d).

<sup>6</sup> *See* 11 U.S.C. 1129(b); *see also In re Crosscreek Apartments, Ltd.*, 213 B.R. 521, 532 (Bankr. E.D. Tenn. 1997).

<sup>7</sup> *See Bank of Am. Nat’l Trust and Sav. Ass’n v. 203 North LaSalle St. P’ship*, 526 U.S. 434, 441 (1999). *See generally* Richard Maloy, *A Primer on Cramdown—How and Why It Works*, 16 ST. THOMAS L. REV. 1 (2003); Kenneth N. Klee, *All You Ever Wanted to Know About Cram Down Under the New Bankruptcy Code*, 53 AM. BANKR.L.J. 133 (1979). The plan proponent bears the burden of proof by a preponderance of the evidence. *In re Hoffinger Industries, Inc.*, 321 B.R. 498, 502 (Bankr. E.D. Ark. 2005); *In re Cellular Info. Sys., Inc.*, 171 B.R. 926, 937 (Bankr. S.D.N.Y. 1994).

<sup>8</sup> *See Begier v. I.R.S.*, 496 U.S. 53, 58 (1990) (“Equality of distribution among creditors is a central policy of the Bankruptcy Code.”); *Am. United Mut. Life Ins. Co. v. City of Avon Park, Florida*, 311 U.S. 138, 147 (1940).

<sup>9</sup> *See In re Combustion Eng’g, Inc.*, 391 F.3d 190, 238 (3d Cir. 2004) (“The Bankruptcy Code furthers the policy of ‘equality of distribution among creditors’ by requiring that a plan of reorganization provide similar treatment to similarly situated creditors”).

<sup>10</sup> *See, e.g., In re Weiss*, 251 B.R. 453, 464 (Bankr. E.D. Pa. 2000) (“[D]ifferent treatment is permissible if and only if the debtor is able to prove a reasonable basis for the degree of discrimination contemplated by the Plan.”); *In re Salem Suede, Inc.*, 219 B.R. 922, 933-34 (Bankr. D. Mass. 1998) (“A plan can discriminate, but not unfairly; any discrimination must be supported by a legally acceptable rationale, and the extent of the discrimination must be necessary in light of the rationale.”); *In re Stratford Assocs. Ltd. P’ship*, 145 B.R. 689, 700-01 (Bankr. D. Kan. 1992) (“While the Plan discriminates, to violate § 1129(b)(1), the discrimination must be *unfair*. Moreover, while a

The term “unfair discrimination” is not defined under the Bankruptcy Code. Therefore, courts have developed various standards to test whether or not a plan unfairly discriminates.<sup>11</sup> In determining whether a plan discriminates unfairly under these various tests, courts have primarily focused on the classification and treatment of claims and interests vis-à-vis other claims or interests.<sup>12</sup> Indeed, the prevailing view among courts is that a plan does not discriminate unfairly if there is a reasonable basis for the discrimination and the discrimination is necessary for a successful reorganization.<sup>13</sup>

## 2. 1129(b)(2)(B)(ii): Fair and Equitable

While the “unfair discrimination” requirement protects creditors against discrimination among similarly situated claims or interests, the “fair and equitable” requirement “protects each class of creditors against involuntary loss of their priority status vis-à-vis other classes of different

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debtor may separately classify creditors, that separate classification alone does not determine whether the plan discriminates unfairly.”).

<sup>11</sup> See, e.g., *In re Genesis Health Ventures, Inc.*, 266 B.R. 591, 611 (Bankr. D. Del. 2001), appeal dismissed, 280 B.R. 339 (D. Del. June 14, 2002); *In re Dow Corning Corp.*, 244 B.R. 705, 710 (Bankr. E.D. Mich. 1999); *In re Aztec Co.*, 107 B.R. 585, 590 (Bankr. M.D. Tenn. 1989). See generally G. Eric Brunstad, Jr. and Mike Sigal, *Competitive Choice Theory and the Unresolved Doctrines of Classification and Unfair Discrimination in Business Reorganizations Under the Bankruptcy Code*, 55 BUS. LAW. 1, 46-48 (Nov. 1999) (describing various tests).

<sup>12</sup> See *In re Landing Assocs., Ltd.*, 157 B.R. 791, 822 (Bankr. W.D. Tex. 1993) (“The test is not, after all, whether the plan is generally *unfair*, but whether the plan’s treatment of a particular class is unfairly *discriminatory vis-à-vis* similarly situated classes of creditors.”); *In re Greate Bay Hotel & Casino, Inc.*, 251 B.R. 213, 232 (Bankr. D.N.J. 2000) (“[T]he proscription in section 1129(b) against unfair discrimination is a ‘horizontal limit on nonconsensual confirmation . . . assuring equitable treatment among creditors who have the same level of priority.’”); *In re Sentry Operating Co. of Tex., Inc.*, 264 B.R. 850, 865 (Bankr. S.D. Tex. 2001) (unfair discrimination prohibition “protects each class of creditors against an involuntary loss of their equal distribution rights vis-à-vis other creditors of equal rank.”); see also H.R. Rep. No. 95-595, 95<sup>th</sup> Cong., 1<sup>st</sup> Sess. at 413-18 (1977); 124 Cong. Rec. H. 11, 103 (Sept. 28, 1978); S. 17, 420 (Oct. 6, 1978) (discussing cramdown).

<sup>13</sup> See *Genesis Health Ventures*, 266 B.R. at 611; *Crosscreek*, 213 B.R. at 537; *In re Buttonwood Partners, Ltd.*, 111 B.R. 57, 63 (Bankr. S.D.N.Y. 1990); *Liberty Nat’l Enters. v. Ambanc La Mesa Ltd. P’ship (In re Ambanc La Mesa Ltd. P’ship)*, 115 F.3d 650, 656 (9th Cir. 1997), cert. denied, 522 U.S. 1110 (1998); *In re 203 North LaSalle St. Ltd. P’ship*, 190 B.R. 567, 585-86 (Bankr. N.D. Ill. 1995). Several courts have adopted a modified test for unfair discrimination, which gives rise to a rebuttable presumption of unfair discrimination where 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. See *Dow Corning*, 244 B.R. at 702; *Sentry Operating Co.*, 264 B.R. at 864 (adopting the test proposed in Bruce A. Markell, *A New Perspective on Unfair Discrimination in Chapter 11*, 72 AM. BANKR. L.J. 227, 249-50 (1998)). Other courts have adopted a four part test in which the court should examine: (1) whether the discrimination has a reasonable basis; (2) whether the debtor can carry out the plan without the discrimination; (3) whether the discrimination is proposed in good faith; and (4) whether the degree of discrimination is directly related to the basis or rationale for the discrimination. *In re Aztec Co.*, 107 B.R. 585, 590 (Bankr. M.D. Tenn. 1989); *In re Apex Oil Co.*, 118 B.R. 683, 710-11 (Bankr. E.D. Mo. 1990) (citing *In re Wolff*, 22 B.R. 510, 512 (9th Cir. BAP 1982)); see also *In re Internet Navigator Inc.*, 289 B.R. 128, 132 (Bankr. N.D. Iowa 2003); *In re 11,111, Inc.*, 117 B.R. 471, 478 (Bankr. D. Minn. 1990); *In re Rochem, Ltd.*, 58 B.R. 641, 643 (Bankr. D.N.J. 1985).

rank.”<sup>14</sup> Section 1129(b) of the Bankruptcy Code provides that a plan is “fair and equitable” with respect to a dissenting class of impaired unsecured creditors if (i) no senior class is paid more than in full and (ii) no junior class will receive or retain any interest in property under the Plan.<sup>15</sup> The later requirement is known as the “absolute priority rule.”<sup>16</sup> The absolute priority rule “provides that a dissenting class of unsecured creditors must be provided for in full before any junior class can receive or retain any property [under a reorganization] plan.”<sup>17</sup>

The purpose of the absolute priority rule “is to stratify creditors and equity interests so that a cramdown . . . plan will not redistribute a dissenting creditor’s property rights to those with a junior right or interest in the debtor.”<sup>18</sup> The practical effect of the absolute priority rule is that secured creditors must be paid in full before unsecured creditors retain any interest, and unsecured creditors must be paid off before equity security holders retain any interest under a plan of reorganization.<sup>19</sup>

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<sup>14</sup> *Sentry Operating*, 264 B.R. at 865; *see also* Markell, *supra* note 10, at 228 (“unfair discrimination is best viewed as a horizontal limit on nonconsensual confirmation, in contrast to the vertical limit imposed by the requirement that a nonconsensual plan be ‘fair and equitable.’”).

<sup>15</sup> *See* 11 U.S.C. §§ 1129(b)(2)(B)(ii) and 1129(b)(2)(C)(ii). Section 1129(b)(2)(B)(ii) provides “[w]ith respect to a class of unsecured claims . . . 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.” *See* 11 U.S.C. § 1129(b)(2)(B)(ii).

<sup>16</sup> *See Bank of Am. Nat’l Trust & Sav. Ass’n v. 203 North LaSalle St. P’ship.*, 526 U.S. 434, 441-42 (1999); *In re Ambanc La Mesa, Ltd. P’ship*, 115 F.3d 650, 654 (9th Cir. 1997), *cert. denied*, 522 U.S. 1110 (1998); *In re PWS Holding Corp.*, 228 F.3d 224, 237 (3d Cir. 2000) (“This provision, [11 U.S.C. § 1129(b)(2)] is the ‘absolute priority rule.’”).

<sup>17</sup> *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 202 (1988) (alteration in original); *see also In re Haskell Dawes, Inc.*, 199 B.R. 867, 871 (Bankr. E.D. Pa. 1996); *In re Johnston*, 21 F.3d 323, 331 (9th Cir. 1994) (“before the holder of a junior claim, which, of course must include the debtor itself, can receive or retain property of the estate, a bankruptcy court must be satisfied that each unsecured senior claimant actually will receive full present payment, or its equivalent, under the plan of reorganization.”); *In re Union Fin. Servs. Group, Inc.*, 303 B.R. 390, 423 (Bankr. E.D. Mo. 2003) (“The absolute priority rule generally requires that no party in a class junior in priority may receive a distribution unless all classes senior to such party are paid in full. Therefore, equity holders of a debtor generally may not retain an interest in the reorganized entity on account of their prepetition interest in the debtor, unless all creditors and other interests above them in priority are paid in full.”); *see also* H.R.Rep. No. 95-595, at 414 (1977).

<sup>18</sup> *Phoenix Mutual Life Ins. Co. v. Greystone III Joint Venture (In re Greystone III Joint Venture)*, 995 F.2d 1274, 1282 (5th Cir. 1991), *cert. denied*, 506 U.S. 822 (1992).

<sup>19</sup> *See Wilkow v. Forbes, Inc.*, 241 F.3d 552, 554 (7th Cir. 2001); *Allen v. Geneva Steel Co. (In re Geneva Steel Co.)*, 281 F.3d 1173, 1180-81 n. 4 (10th Cir. 2002) (“The absolute priority rule requires that certain classes of claimants be paid in full before any member of a subordinate class is paid. Under this rule, unsecured creditors stand ahead of investors in the receiving line and their claims must be satisfied before any investment loss is compensated. . . . The rule reflects the different degree to which each class assumes the risk of the debtor’s insolvency.”); *In re Granite Partners, L.P.*, 208 B.R. 332, 344 (Bankr. S.D.N.Y. 1997) (“under the absolute priority rule, creditors stand ahead of the investors on the receiving line; the enterprise cannot distribute profits until it satisfies creditors’ claims.”).

B. *The Genesis of Reverse Cramdown: In re SPM Manufacturing Corp.*

Despite section 1129's prohibition against "unfair discrimination" and requirement that a plan be "fair and equitable", courts have confirmed plans that have permitted a senior class of creditors to allocate a portion of its recovery under the plan to some, but not all, junior classes. The practice of permitting senior creditors to allocate a portion of their recovery to junior creditors or equity-interest holders while excluding others originated in the First Circuit's decision *In re SPM Manufacturing Corp.*<sup>20</sup>

In *SPM Manufacturing*, the secured lender and the official committee of unsecured creditors entered into an agreement whereby the parties would act together to attempt to remove current management.<sup>21</sup> The parties agreed to divide any proceeds they received as a result of the reorganization or liquidation of the debtor.<sup>22</sup> The secured creditor was owed approximately \$9 million and had a security interest in substantially all of the debtor's assets.<sup>23</sup> The parties were successful in having a receiver appointed and the debtor's assets were sold for \$5 million.<sup>24</sup> The secured lender then successfully moved to have the stay lifted and the case converted to a chapter 7.<sup>25</sup>

The committee and the lender moved the court to enter an order requiring delivery of proceeds to the lender.<sup>26</sup> In the motion, the lender asserted that the entire proceeds of the sale were subject to its security interest and that, after paying administrative claims, a portion of the net proceeds would be distributed to committee counsel pursuant to the agreement.<sup>27</sup>

The Debtor and the management objected and argued that the agreement distributed proceeds to general unsecured creditors in violation of the statutory scheme for distribution in 11 U.S.C. §§ 724-726.<sup>28</sup> The bankruptcy court refused to approve any distribution that was not in accordance with the bankruptcy code and ordered the lender to calculate the amount that would be paid to committee counsel and pay such amount to the trustee for distribution in accordance with 11

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<sup>20</sup> 984 F.2d 1305 (1st Cir. 1993). Practices similar to reverse cramdown occurred in the equity receivership cases of the early twentieth century where secured lenders would conduct friendly foreclosures to eliminate the debtor's unsecured creditors and give the debtor's existing management long term contracts to operate the foreclosed business. See *Case v. Los Angeles Lumber Prods., Co.*, 308 U.S. 106, 109-111 (1939); *Northern Pac. Ry. Co. v. Boyd*, 228 U.S. 482, 490-93 (1913); see also Kenneth N. Klee, *Barbarians at the Trough: Riposte in Defense of the Warrant Carve-Out Proposal*, 82 CORNELL L. REV. 1466, 1481 (Sept. 1997). However, *SPM Manufacturing* has been the touchstone for the practice of reverse cramdown under the modern Bankruptcy Code.

<sup>21</sup> *SPM Mfg.*, 984 F.2d at 1308.

<sup>22</sup> *Id.* One of the motivating factors for the proceed sharing agreement was to avoid having to pay certain priority tax claims. If the priority tax claims were not paid by the debtor, its old management could be liable for the tax payment. *Id.*

<sup>23</sup> *Id.* at 1307.

<sup>24</sup> *Id.* at 1309.

<sup>25</sup> *Id.*

<sup>26</sup> *Id.*

<sup>27</sup> *Id.*

<sup>28</sup> *Id.*

U.S.C. §§ 724-726.<sup>29</sup> The committee appealed and the district court affirmed the bankruptcy court's ruling.<sup>30</sup> The committee appealed to the First Circuit Court of Appeals.<sup>31</sup>

However, the First Circuit reversed and held that the sharing agreement did not violate the Code's priority scheme. The court stated 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."<sup>32</sup> The court continued:

Because Citizens' secured claim absorbed all of SPM's assets, there was nothing left for any other creditor in this case. Ordinarily, in such circumstances, the distributional priorities of sections 726 and 507 would have been mooted. Appellees defend the outcome below on the ground that the Agreement improperly syphoned proceeds to the general, unsecured creditors "at the expense of priority creditors." However, it is hard to see how the priority creditors lost anything owed them given the fact there would have been nothing left for the priority creditors after the \$5 million was distributed to Citizens. The "syphoning" of the money to general, unsecured creditors came entirely from the \$5 million belonging to Citizens, to which no one else had any claim of right under the Bankruptcy Code.<sup>33</sup>

The debtor and the management argued that the agreement conflicts with the spirit of the Bankruptcy Code's distribution scheme under which priority creditors always get paid in full before general unsecured creditors receive anything and that Congress did not intend for unsecured creditors to circumvent this scheme by negotiating directly with secured creditors.<sup>34</sup> The court dismissed this argument as well and stated:

Appellees' theory, however, goes beyond anything appearing expressly or by implication in the Code. Section 726 and the other Code provisions governing priorities of creditors apply only to distributions of property of the estate. The Code does not govern the rights of creditors to transfer or receive nonstate 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.***

In this case, the proceeds of the sale of SPM's assets pursuant to 11 U.S.C. § 363 were property of the estate and thus the Code governed their use and distribution.

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<sup>29</sup> *Id.*

<sup>30</sup> *Id.* at 1310.

<sup>31</sup> *Id.*

<sup>32</sup> *Id.* at 1312.

<sup>33</sup> *Id.*

<sup>34</sup> *Id.* at 1313.

However, once 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 monies to some or all of the general, unsecured creditors after the bankruptcy proceedings finished.<sup>35</sup>

The Court cited cases under Massachusetts law holding that a right to receive payment is freely transferable without the consent of the debtor and stated that “the agreement did not affect estate property, i.e., the sale proceeds, but only concerned the contracting parties’ *claims* against the estate, i.e., their rights to be paid by the estate.”<sup>36</sup> The Court concluded that “we find no support in the Code banning this type of contractual assignment in all cases.”<sup>37</sup> The First Circuit vacated the bankruptcy court’s ruling and remanded the case to the bankruptcy court so that the sale proceeds could be distributed in accordance with the secured lender’s original agreement with the committee.<sup>38</sup>

## Discussion

### A. *Cases Adopting the Reverse Cramdown Rationale of SPM Manufacturing to Confirm Plans That Are Otherwise Unconfirmable Under 11 U.S.C. § 1129(b)*

Based upon the rationale articulated by the First Circuit in *SPM Manufacturing* that creditors are generally free to do whatever they wish with the bankruptcy dividends they receive, a number of courts have confirmed plans of reorganization that violate the “unfair discrimination” and “fair and equitable” requirements of 11 U.S.C. § 1129(b).

For example, in *In re MCorp Financial, Inc.*<sup>39</sup>, the court approved liquidating plans of reorganization that permitted senior bondholders to fund a settlement agreement with the Federal Deposit Insurance Corporation (“FDIC”) by reallocating a portion of their recovery to the FDIC

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<sup>35</sup> *Id.* (emphasis added) (internal citations omitted).

<sup>36</sup> *Id.*

<sup>37</sup> *Id.* at 1313-14. *See also In re Shoe Corp. of America, Inc.*, Case No. 99-55400 (Bankr. S.D. Ohio 2000) (relying on *SPM Manufacturing* and approving agreement between secured lenders and creditors committee in which secured lenders would pay the committee a portion of their cash collateral for distribution to general unsecured creditors to the exclusion of priority creditors). For a discussing of *Shoe Corp.*, see Jay R. Indyke and Brent Weisenberg, *Committee Issues: Carve Outs; Liquidations for the Benefit of Banks; Liability; Inconvenient Delaware Issues; Liquidations for the Benefit of Secured Lenders: An Unsecured Creditor’s Committee Prospective*, 041802 ABI-CLE 223 (20th Annual Spring Meeting, April 18-21, 2002).

<sup>38</sup> *Id.* at 1319.

<sup>39</sup> 160 B.R. 941 (S.D. Tex. 1993).

even though junior bondholders, who were arguably equal in rank to the FDIC in priority, were not paid in full under the plans.<sup>40</sup>

The *MCorp* bankruptcy case arose out of the collapse of the banking system in Texas during the 1980s.<sup>41</sup> After worried creditors filed involuntary petitions against MCorp., the government closed a number of the debtors' banks, which resulted in a deluge of litigation between the debtors and the FDIC.<sup>42</sup> The settlement agreement at issue between the senior bondholders and the FDIC resolved all of the claims and counterclaims among the FDIC, debtors, and related entities and was a critical element of the debtors' plans of reorganization.<sup>43</sup>

The senior bondholders supported the settlement and the contractually subordinate junior bondholders opposed the settlement on the basis that the plan discriminated unfairly and was not fair and equitable.<sup>44</sup> Specifically, the junior bondholders argued that "because [the juniors] are not subordinate to the FDIC, the FDIC's receiving anything before the juniors are paid in full violates the code."<sup>45</sup> Relying on *SPM Manufacturing*, the court dismissed this argument and stated:

The court does not have to decide the priority because even if you assume the FDIC is inferior to the juniors the 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 sharing. For instance, a secured creditor could share its proceeds with unsecured creditors whose priority came behind that of the IRS. *Cf. In re SPM Mfr. Corp.*, 984 F.2d 1305, 1312 (1st Cir. 1993). That the creditor was secured is not relevant; its was the creditor's status as prior to the IRS that allowed it to share with those under the IRS, just as the seniors' priority over the juniors allows them to fund the FDIC settlement.<sup>46</sup>

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<sup>40</sup> *MCorp.*, 160 B.R. at 960. Although the junior bondholders' notes were issued earlier than the senior bonds, the juniors' rights were expressly subordinated through the indenture by the juniors as a condition of the seniors' funding their notes. *Id.* at 946. Under the plans of reorganization, the junior bondholders were to receive approximately \$6 million on account of their approximately \$134 million claim against the debtors. *Id.* at 948-49. Moreover, the plans provided for a distribution of \$25,815,000 to the FDIC on the effective date, with an additional distribution worth a present value of \$7,239,000 during the pendency of the liquidating trusts. *Id.* at 948. In order to fund this total distribution to the FDIC of \$33,054,000, the senior bondholders limited their recovery on an undisputed prior claim of \$354 million to a distribution with a net present value of \$319,150,000. *Id.*

<sup>41</sup> *Id.* at 945. Approximately one-third of Texas banks failed in the 1980s. *Id.*

<sup>42</sup> *Id.* Specifically, the FDIC sued the debtors for approximately \$300 million and the debtors counterclaimed and filed separate suits against the FDIC for approximately \$500 million. *Id.* at 945-46.

<sup>43</sup> *Id.* at 948-49. The plan provided that the debtors would pay approximately \$45 million to the FDIC in full and final settlement of the litigation. *Id.* at 948.

<sup>44</sup> *Id.* at 959-60

<sup>45</sup> *Id.* at 960.

<sup>46</sup> *Id.*

After rejecting the objection of the junior bondholders, the court went on to confirm the plans of reorganization.<sup>47</sup> In doing so, the court effectively circumvented section 1129(b)'s prohibition against unfair discrimination. Moreover, the court suggested that it would have confirmed the plans of reorganization even if the FDIC were inferior in priority to the juniors. In other words, the court expressed its willingness to confirm a plan of reorganization that violated the absolute priority rule if the distribution to junior creditors derived from value that, absent the secured creditor's generosity, would have been given to the secured creditor.

Likewise, in *In re Genesis Health Ventures, Inc.*<sup>48</sup>, the court used the *SPM Manufacturing* rationale to confirm a plan of reorganization that allocated all of the debtor's enterprise value to the debtor's senior secured creditors and the debtor's existing management on account of their prepetition equity interests to the exclusion of unsecured creditors.<sup>49</sup> There, the debtors' joint plan of reorganization provided the debtors' officers and directors, for no additional consideration, a distribution of stock and warrants in the reorganized debtors as an incentive for continued employment despite the fact that the claims of the debtors' general unsecured creditors were not provided for in full under the plan.<sup>50</sup> In addition, the plan provided that certain general unsecured creditors would receive distributions in partial satisfaction of their claims under the plan while other classes of the same priority received nothing.<sup>51</sup>

Based upon their proposed treatment under the plan, a number of creditors and shareholders objected to the plan and argued that the plan discriminated unfairly and was not fair and equitable.<sup>52</sup> The court nevertheless confirmed the plan based on the rationale articulated in *SPM Manufacturing*.<sup>53</sup> Central to the court's finding that the plan satisfied all of the requirements of section 1129(b) was that the total enterprise value of the debtors was approximately \$1.33 billion and the outstanding indebtedness owed to the senior secured lenders was approximately \$1.46 billion.<sup>54</sup> Based upon this finding, the court concluded that "even if the [senior secured lenders] receive all of the debt and equity distributed under the debtors' plan, the claims of the [senior secured lenders] would not be satisfied in full."<sup>55</sup> Therefore, the court easily dismissed the objecting creditors unfair discrimination argument and stated:

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<sup>47</sup> *Id.* at 964.

<sup>48</sup> 266 B.R. 591 (Bankr. D. Del. 2001).

<sup>49</sup> *Genesis Health*, 266 B.R. at 616-18.

<sup>50</sup> *Id.* at 616-17.

<sup>51</sup> *Id.* at 611-12.

<sup>52</sup> *Id.*

<sup>53</sup> *Id.* at 602.

<sup>54</sup> *Id.* at 616.

<sup>55</sup> *Id.* at 602.

The disparate treatment between [the similarly situated creditors] is a permissible allocation by the secured creditors of a portion of the distribution to which they would otherwise be entitled, rather than unfair discrimination against [the punitive damage claimants who were to receive no distribution under the plan] by the proponents of the plan.<sup>56</sup>

In other words, the court held that given that the secured lenders were undersecured, the objecting unsecured creditors and interest holders had no right to complain that they were receiving less under the plan than similarly situated creditors since the value they were receiving under the plan would have otherwise gone to the secured lenders had they not agreed to share their entitlement to all of the debtors' assets.

Moreover, the court rejected the creditors' argument that the plan violated the absolute priority rule as well and stated:

The objectors are correct that the [Plan], while characterized as consideration for continued employment, borders on payments to management on account of their pre-petition equity interests, particularly in light of the generous retention package previously approved for the executives during the pendency of the case. Such an allocation might indeed be violative of the absolute priority rule, in light of the relatively small dividend proposed to be paid to unsecured creditors, and the extinguishment of equity interests otherwise. Nevertheless, as I have determined with respect to the proposed distribution to unsecured creditors, the issuance of stock and warrants to management represents an allocation of the enterprise value otherwise distributable to the [senior secured lenders], which the [senior secured lenders] have agreed to offer to the top executives as further incentive to them to remain and effectuate the debtors' reorganization. The [senior secured lenders] are free to allocate such value without violating the "fair and equitable" requirement.<sup>57</sup>

According to the court's reasoning, the absolute priority rule is not violated where the value given to old equity under a plan of reorganization comes from funds which would otherwise be distributed to a senior undersecured creditor but is instead distributed to old equity with the senior undersecured creditors consent.<sup>58</sup>

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<sup>56</sup> *Id.* at 612.

<sup>57</sup> *Id.* at 617-18.

<sup>58</sup> See also Robert J. Keach, *LaSalle, the "Market Test" and Competing Plans: Still in the Fog*, 21 AM. BANKR. INST. J. 18, 50 (January 2003) ("LaSalle is similarly not implicated where, based on the valuation of the enterprise, value otherwise distributable only to senior classes is being voluntarily allocated by such senior classes to old equity and management (who may be the same people) to provide an incentive to remain with the company. The senior classes are free to allocate their property as they wish without violating the absolute priority rule."); Barbara J. Houser, *Disclosure Statements; Confirmation and Cramdown of Chapter 11 Plans*, SHO54 ALI-ABA 337, 383 (May 2003) (citing *Genesis Health* and stating that "the absolute priority rule is not violated where the value being given to old equity comes from funds which would otherwise be distributed to a senior class but is instead distributed to old equity with the senior class's consent.").

Finally, in *In re Union Financial Services Group, Inc.*<sup>59</sup>, the court relied on *SPM Manufacturing* to approve a plan of reorganization that discriminated unfairly for purposes of section 1129(b) by providing for payment in full of the unsecured claims of certain trade vendors and utilities while unsecured noteholders only received a small equity stake in the reorganized debtor.<sup>60</sup> The debtors' plan provided that within 30 days after the plan's effective date, critical business claims, allowed utility claims, and de minimis claims were to be paid in full from cash collateral otherwise payable to the senior secured lenders.<sup>61</sup> However, the plan did not provide for payment of unsecured noteholders and other unsecured creditors in full.<sup>62</sup>

Nevertheless, the court, based upon its conclusion that the debtors' senior secured lenders were "substantially undersecured", held that the plan did not discriminate unfairly against the unsecured creditors who voted to reject the plan.<sup>63</sup> Relying on *SPM Manufacturing*, the court held that "[t]here is no unfair discrimination in a Plan provision that allows the [senior secured lenders] voluntarily to assign to unsecured creditors cash collateral proceeds that otherwise would rightfully belong to the secured creditors, particularly in the context of a reorganization where continued relations with those unsecured creditors are important to future business of the reorganized Debtors."<sup>64</sup>

#### B. *Cases Rejecting the Reverse Cramdown Rationale of SPM Manufacturing*

Surprisingly, only two courts (in reported decisions) have considered and rejected the reverse cramdown rationale of *SPM Manufacturing*.

In *In re Sentry Operating Company of Texas, Inc.*<sup>65</sup>, the issue was whether to confirm a chapter 11 plan over the objection of unsecured creditors that voted to reject the plan.<sup>66</sup> The debtors' secured lender had advanced approximately \$35 million to the debtors that was secured by a

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<sup>59</sup> 303 B.R. 390 (Bankr. E.D. Mo. 2003).

<sup>60</sup> *Union Financial*, 303 B.R. at 422-23.

<sup>61</sup> *Id.* at 421-22.

<sup>62</sup> *Id.* at 411 and 421.

<sup>63</sup> *Id.* at 420-23.

<sup>64</sup> *Id.* at 423. See also *In re Exide Technologies*, 303 B.R. 48, 77 (Bankr. D. Del. 2003) (although it accepted the rationale of *SPM Manufacturing*, the court held that plan discriminated unfairly between classes of unsecured creditors and that debtor could not rely on the rationale of *SPM Manufacturing* because debtor's enterprise value was sufficient to pay the debtor's secured lenders in full); *In re Worldcom, Inc.*, 2003 WL 23861928, 61-2 (Bankr. S.D.N.Y. Oct. 31, 2003) (using the *SPM Manufacturing* reverse cramdown rationale to conclude that the debtors' plan did not discriminate unfairly and was fair and equitable); *In re Interco, Inc.*, Ch. 11 Case Nos. 91-40442-BKC-JJB (Bankr. E.D. Mo. Order, June 29, 1992) (approving assignment of collateral by senior secured lenders).

<sup>65</sup> 264 B.R. 850 (Bankr. S.D. Tex. 2001).

<sup>66</sup> *Sentry Operating*, 264 B.R. at 862.

security interest in all of the debtors assets.<sup>67</sup> However, the secured lender was undersecured. The debtors' plan of reorganization proposed paying trade creditors in full while paying other unsecured creditors 1% of their claims.<sup>68</sup> The payments to the trade creditors (and other payments under the plan) would be subtracted from the secured lender's distribution under the plan.<sup>69</sup> Certain unsecured creditors objected to the plan and argued that the plan discriminated unfairly by proposing to pay a greater percentage distribution to trade creditors than to other unsecured creditors because both classes of creditors have equal rank under state law and equal distribution priorities under the Bankruptcy Code.<sup>70</sup>

In response, the plan proponents, relying on *In re MCorp Financial, Inc.*, argued that because the debtors' secured lender was undersecured, the objecting unsecured creditors had no right to complain since, but for the secured lender giving up part of its entitlement, they would not receive any distribution under the plan.<sup>71</sup> The court, however, characterized the secured lender's reverse cramdown argument as "a siren's song that is insufficient as a foundation for plan confirmation."<sup>72</sup> After distinguishing *MCorp Financial*, the court concluded that:

To accept [the secured lender's] argument that a secured lender can, without any reference to fairness, decide which creditors get paid and how much those creditors get paid, is to reject the historical foundation of equity receiverships and to read the § 1129(b) requirements out of the Code. If the argument were accepted with respect to § 1129(b) "unfair discrimination requirement," there is no logical reason not to apply it to the § 1129(b) "fair and equitable" requirement, or to the § 1129(a)(10) requirement that at least one class has accepted the plan. To accept that argument is simply to start down a slippery slope that does great violence to history and to positive law.<sup>73</sup>

Afterwards, court held that the plan did not meet the requirements of 11 U.S.C. § 1129(b) and denied confirmation.<sup>74</sup>

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<sup>67</sup> *Id.* at 854.

<sup>68</sup> *Id.* at 855. The debtors testified that the purpose behind paying the trade creditors in full was to increase the going concern value of the business as the debtor attempted to liquidate all of the debtors assets under the plan. *Id.* at 856.

<sup>69</sup> *Id.* at 862. Specifically, the plan provided that the debtors' secured lender would receive all of the value of the debtors, \$23 million, less approximately \$1.5 million to be used to fund other payment under the plan, approximately \$400,000 of which was allocated to unsecured trade creditors. *Id.* at 855.

<sup>70</sup> *Id.* at 859.

<sup>71</sup> *Id.* at 864.

<sup>72</sup> *Id.* at 865.

<sup>73</sup> *Id.* at 865. In determining whether the plan discriminated unfairly to the objecting unsecured creditors, the court adopted the test proposed by Bruce A. Markell, *A New Perspective on Unfair Discrimination in Chapter 11*, 72 AM. BANKR. L.J. 227, 249-50 (1998). *Id.* at 864. The court noted that "nowhere in the article does Markell suggest that a secured lender may simply purchase the assent of an unsecured class by giving up part of its claim." *Id.*

<sup>74</sup> *Id.* at 866.

The most recent decision rejecting reverse cramdown arose out of the attempted confirmation of Armstrong World Industries, Inc.'s plan of reorganization. In *In re Armstrong World Industries, Inc.*<sup>75</sup>, the Delaware District Court held that the debtors' proposed plan of reorganization violated the absolute priority rule by providing warrants to existing equity over the objections of general unsecured creditors who were not provided for in full under the plan.<sup>76</sup> Under the debtors' proposed plan, general unsecured creditors and asbestos personal injury claimants would not be paid in full and the debtors' current equity interest holders would receive warrants to purchase common stock in the reorganized debtor valued at approximately \$35-40 million.<sup>77</sup>

The key to the plan, and the arrangement that was the central issue in the case, was the asbestos personal injury claimants' consent to share a portion of their proposed distribution with equity interest holders.<sup>78</sup> If this arrangement were upheld, the debtors' existing equity interest holders would receive under the plan the warrants on account of their equity interest interests and unsecured creditors, a senior class, would receive less than full payment of their allowed claims.<sup>79</sup>

Despite the bankruptcy court's recommendation that the plan be confirmed, the District Court held that the proposed distribution of warrants to equity interest holders over the objection of the impaired unsecured creditors violated the absolute priority rule of 11 U.S.C. § 1129(b)(2)(B)(ii) and denied confirmation.<sup>80</sup> Finding no support in the legislative history to section 1129(b)(2)(B)(ii) for it, the court rejected the practice of allowing senior creditors to gift a portion of its distribution to a junior class when an intervening class of creditors was not provided for in full under a plan of reorganization:

[T]o the extent that *In re WorldCom*, *In re Genesis Health Ventures*, and *In re MCorp. Financial* read *SPM* to stand for the unconditional proposition that "[c]reditors are generally free to do whatever they wish with the bankruptcy dividends they receive, including sharing them with other creditors, so long as recoveries received under the [p]lan by other creditors are not impacted," without adherence to the strictures of 11 U.S.C. § 1129(b)(2)(B)(ii), that contention is flatly rejected here.

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<sup>75</sup> 320 B.R. 523 (D. Del. 2005).

<sup>76</sup> *Armstrong World*, 320 B.R. at 526. For an in depth analysis of *Armstrong World*, see Brian S. Herman, *Delaware Court Invalidates Use of So-called "SPM Arrangement" in Chapter 11 Plan*, 24 AM. BANKR. INST. J. 20 (May 2005).

<sup>77</sup> *Id.* at 525-26.

<sup>78</sup> *Id.* at 526. Under the plan, if unsecured creditors rejected the plan, the asbestos personal injury claimants would receive the new warrants but then automatically waive the distribution and direct the distribution to the debtors' existing equity interest holders. *Id.*

<sup>79</sup> *Id.*

<sup>80</sup> *Id.*

Bluntly put, no amount of legal creativity or counsel's incantation to general notions of equity or to any supposed policy favoring reorganizations over liquidation supports judicial rewriting of the Bankruptcy Code. Accordingly, the New Warrants distribution to the Equity Interest Holders under the Fourth Amended Reorganization Plan violates 11 U.S.C. § 1129(b)(2)(B)(ii).<sup>81</sup>

C. *The Legislative History to 11 U.S.C. § 1129(b)(2)(B)(ii) Manifests Congress's Intent to Prevent the Practice of Reverse Cramdown*

The legislative history to 11 U.S.C. § 1129(b)(2)(B)(ii) clearly indicates that Congress specifically intended to prevent the practice of reverse cramdown. For example, in the bankruptcy bill passed by the Senate prior to the enactment of the Bankruptcy Code, the Senate proposed that senior creditors be permitted to share their distribution for the benefit of stockholders under the "fair and equitable" doctrine.<sup>82</sup> Specifically, the bill contained a provision that permitted a senior creditor to "give-up" a portion of its distribution under the plan to stockholders, even if junior creditors were not satisfied in full, so long as absent the "give-up" the junior creditors received all that a "fair and equitable" plan would give them.<sup>83</sup>

Congress, however, expressly rejected this proposed provision and adopted the current language contained in section 1129(b)(2)(B)(ii) in order to prevent the practice of reverse cramdown.<sup>84</sup> Indeed, two key legislators of the Bankruptcy Code, Representative Don Edwards and Senator Dennis DeConcini, both specifically rejected the provision proposed in the Senate Report permitting reverse cramdown proposed in the Senate Report:

Contrary to the example contained in the Senate report, a senior class will not be able to give up value to a junior class over the dissent of an intervening class unless the intervening class receives the full amount, as opposed to value, of its claims or interests.<sup>85</sup>

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<sup>81</sup> *Id.* at 539-40 (citations omitted).

<sup>82</sup> *See* S. Rep. No. 95-989, at 127 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5913. The Senate Report stated:

Under paragraph (9)(A), if a class of claims or interests has not accepted the plan, the court will confirm the plan if, for the dissenting class and any class of equal rank, the negotiated plan provides in value no less than under a plan that is fair and equitable. Such review and determination are not required for any other classes that accepted the plan.

Paragraph 9(A) would permit a senior creditor to adjust his participation for the benefit of stockholders. In such a case, junior creditors, who have not been satisfied in full, may not object if, absent the "give-up", they are receiving all that a fair and equitable plan would give them.

<sup>83</sup> *Id.* The Senate Report includes an example in which a senior creditor gives up \$100,000 in value under a plan of reorganization for the benefit of stockholders even though junior debt is not provided in full under the plan. *Id.*

<sup>84</sup> The House of Representatives' version of the bankruptcy bill prevailed over the Senate's version. *See* H.R. 8200, 95th Cong., 2d Sess. (1978).

<sup>85</sup> *See* 124 Cong. Rec. H. 11089 (remarks of Rep. Edwards) (Sept. 28, 1978), *reprinted in* 1978 U.S.C.C.A.N. 6436, 6477; 124 Cong. Rec. S. 17406 (remarks of Sen. DeConcini) (Oct. 6, 1978, *reprinted in* 1978 U.S.C.C.A.N. 6505, 6546. *See also* Kenneth N Klee, *Adjusting Chapter 11: Fine Tuning the Plan Process*, 69 AM. BANKR. L.J. 551,

Moreover, when discussing 11 U.S.C. § 1129(b)(2), Representative Edwards stated:

Paragraph (2) provides guidelines for a court to determine whether a plan is fair and equitable with respect to a dissenting class. It must be emphasized that the fair and equitable requirement applies only with respect to dissenting classes. Therefore, unlike the fair and equitable rule contained in chapter X and section 77 of the Bankruptcy Act under section 1129(b)(2), senior accepting classes are permitted to give up value to junior classes *as long as no dissenting intervening class receives less than the amount of its claims in full*. If there is no dissenting intervening class and the only dissent is from a class junior to the class to which value have [sic] been given up, then the plan may still be fair and equitable with respect to the dissenting class, so long as no class senior to the dissenting class has received more than 100 percent of the amount of its claims.<sup>86</sup>

In other words, the legislative history indicates that “give ups” should not be permitted when a dissenting intervening class of creditors is not provided for in full under the plan.

The history of the absolute priority rule further undermines the practice of reverse cramdown. Practices similar to reverse cramdown often occurred in the equity receivership cases of the early twentieth century where secured lenders would conduct friendly foreclosures to eliminate the debtor’s unsecured creditors and give the debtor’s existing management long term contracts to operate the foreclosed business.<sup>87</sup> The absolute priority rule was created in response to these inequitable practices.<sup>88</sup> Therefore, the use of reverse cramdown to circumvent the absolute priority rule is particularly ironic since plan proponents are now using reverse cramdown to overcome the very rule that was designed to prevent give back practices in the first place.

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570-71 (1995) (“[A] plan should not be permitted to be crammed down where a senior class gives up value to a junior class while skipping over an intermediate or co-equal class. Although the argument can be and has been made that senior creditors should be entitled to do what they want with their property, the lessons of history should suffice to impose a per se rule that precludes senior creditors from collaborating with junior creditors or equity owners at the expense of intervening classes.”). Even the United States Supreme Court has looked to the floor statements of Representative Edwards and Senator DeConcini for evidence of Congressional intent. *See Begier v. I.R.S.*, 496 U.S. 53, 64 n. 5 (1990) (“Because of the absence of a conference and the key roles played by Representative Edwards and his counterpart floor manager Senator Deconcini, we have treated [Representative Edwards’s and Senator DeConcini’s] floor statements on the Bankruptcy Reform Act of 1978 as persuasive evidence of congressional intent.”).

<sup>86</sup> 124 Cong. Rec. 32, 407 (1978) (statement of Rep. Edwards) (emphasis added).

<sup>87</sup> *See supra* note 17; *see also Sentry Operating*, 264 B.R. at 865. The absolute priority rule was originally referred to as the “fixed principle.” *See Northern Pacific Ry. Co. v. Boyd*, 228 U.S. 482, 507 (1913).

<sup>88</sup> *Northern Pac. Ry. Co. v. Boyd*, 228 U.S. 482 (1913); *Armstrong World*, 320 B.R. at 532-34 (discussing origins of absolute priority rule); Bruce A. Markell, *Owners, Auctions and Absolute Priority in Bankruptcy Reorganizations*, 44 STAN. L. REV. 69, 74-90 (1991) (same); 7 COLLIER ON BANKRUPTCY ¶ 1129.LH[4], p. 205-221 (Lawrence P. King et al. eds., 15th ed. rev. 2005) (same) .

D. *Confirmation of Plans That Violate the Code*

The willingness of courts to confirm plans of reorganization under the reverse cramdown rationale is similar to the practice of some courts to confirm plans of reorganization that violate the Code because “all parties” support the plan whatever the plan may contain. In both cases, courts are failing to scrutinize the proposed plans to assure that the plans meet all of the requirements for confirmation. This practice has led to decisions such as *Republic Supply Co. v. Shoaf*<sup>89</sup> where plans that contain provisions inconsistent with the Code are nevertheless confirmed. *Shoaf* essentially stands for the proposition that if all parties agree to a plan at confirmation and no party in interest appeals the confirmation order, the plan is immune from collateral attack regardless of whether or not the plan complies with the Bankruptcy Code.

In *Shoaf*, the bankruptcy court confirmed a plan that contained a provision releasing a guaranty executed by Shoaf in favor of Republic Supply Co. (“Republic”).<sup>90</sup> At the confirmation hearing, Republic neither objected to this provision nor appealed the confirmation order.<sup>91</sup> Prior to confirmation, Republic had sued Shoaf on his guaranty.<sup>92</sup> After the plan was confirmed, however, Shoaf raised the defense of *res judicata*.<sup>93</sup> The district court rejected Shoaf’s defense and held that the plan provision that released the guaranty was without effect because the bankruptcy court was without authority to release a third party guarantor under 11 U.S.C. § 524(e).<sup>94</sup> On appeal, Republic contended that a provision in a plan of reorganization which provides for an action prohibited by or inconsistent with the Code is of no effect.<sup>95</sup> The Fifth Circuit disagreed, however, and stated that “[r]egardless of whether that provision is inconsistent with the bankruptcy laws or within the authority of the bankruptcy court, it is nonetheless included in the plan, which was confirmed by the bankruptcy court without objection and was not appealed.”<sup>96</sup> In other words, while it recognized the premise that the release contained in the plan was prohibited by the Code, the Court concluded that it was an issue that should have been addressed on appeal from the confirmation order, not in a collateral attack on the order. Therefore, according to *Shoaf*, if all parties in interest successfully confirm a plan that is not appealed, the fact that the plan does not comply with the Code is irrelevant since *res judicata* prevents a collateral attack on the confirmation of the plan.<sup>97</sup>

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<sup>89</sup> 815 F.2d 1046 (5th Cir. 1987).

<sup>90</sup> *Shoaf*, 815 F.2d at 1048.

<sup>91</sup> *Id.* at 1049.

<sup>92</sup> *Id.* at 1048.

<sup>93</sup> *Id.* at 1049.

<sup>94</sup> *Id.* The district court entered judgment for Republic on the guaranty in the amount of \$451,749.11, plus attorney’s fees of \$45,174.91. *Id.*

<sup>95</sup> *Id.* at 1049-50.

<sup>96</sup> *Id.* at 1050.

<sup>97</sup> See also *Anderson v. UNIPAC-NEBHELP (In re Anderson)*, 179 F.3d 1253, 1259 (10th Cir. 1999) (if a creditor fails to protect its interests by timely objecting to a plan or appealing a confirmation order, “it cannot later complain about a certain provision contained in a confirmed plan, even if such a provision is inconsistent with the Code.”);

However, the fact that there are no objections to a plan of reorganization at confirmation does not relieve a court of its duty to ensure that the plan meets the requirements for confirmation. The Code imposes an independent duty upon bankruptcy courts to determine whether a plan satisfies all of the requirements for confirmation contained in section 1129, regardless of the absence of objections to confirmation.<sup>98</sup> Therefore, although courts may be reluctant to deny confirmation *sua sponte* if all parties before the Court are supporting confirmation, courts must do so if the plan is in contravention of the Code. Likewise, even in the reverse cramdown context where an objection to confirmation has been filed, courts must ensure that the plan meets all of the requirements for nonconsensual confirmation contained in 11 U.S.C. § 1129(b).

## Conclusion

Courts that have permitted the practice of reverse cramdown have engaged in nothing less than a judicial rewriting of the Bankruptcy Code. Permitting the practice of “give ups” not only has a deleterious effect on the nonconsensual confirmation requirements of section 1129(b), it essentially reads them right out of the Code. The language of section 1129(b) is clear: a plan must be “fair and equitable” and “not discriminate unfairly” to be confirmed.<sup>99</sup> Therefore, a plan that distributes property of a debtor to a junior class of creditors or equity interest holders while intermediate classes of creditors are not provided full in full should not be confirmed. Likewise, a plan that unfairly provides a dissenting class of creditors a materially lower percentage of recovery than another similarly situated class of creditors should not be confirmed.

Not only is there no plain language in 1129(b) to the practice of reverse cramdown, the legislative history to section 1129(b) indicates that Congress anticipated the practice of reverse cramdown but then specifically rejected it. Moreover, it was practices similar to reverse cramdown that lead to the creation and eventual codification of the absolute priority rule in the first place. Permitting the practice of “give ups” and “tips” creates the perverse incentive for

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*Great Lakes Higher Educ. Corp. v. Pardee (In re Pardee)*, 193 F.3d 1083, 1086 (9th Cir. 1999); *In re Szostek*, 866 F.2d 1405, 1413-14 (3rd Cir. 1989) (absent showing of fraud, failure to apply present value provision found in Code in determining amount of creditor’s claim did not constitute grounds for vacating confirmed chapter 13 plan where creditor did not timely object to plan at confirmation); *In re Whelton*, 299 B.R. 306, 313 (Bankr. D. Vt. 2003) (“the majority of courts have held that a confirmed plan is *res judicata* as to all provisions in the underlying chapter 13 plan, even if contrary to the Bankruptcy Code.”); *Moussa v. Salisbury (In re Moussa)*, 95 B.R. 449, 451 (Bankr. N.D. Tex. 1989) (chapter 11 plan was *res judicata* precluding debtor from challenging objection to discharge). *But see Enter. Fin. Group, Inc. v. Curtis Mathes Corp.*, 187 B.R. 40, 47-8 (E.D. Tex. 1996) (holding that *Shoaf* did not apply *res judicata* effect to a retention of jurisdiction provision in plan contrary to Code but nonetheless placed in plan which was confirmed but never appealed).

<sup>98</sup> See *Williams v. Hibernia Nat’l Bank (In re Williams)*, 850 F.2d 250, 253 (5th Cir. 1988); *In re Lernout & Hauspie Speech Prods., N.V.*, 301 B.R. 651, 656 (Bankr. D. Del. 2003); *In re Shadow Bay Apartments, Ltd.*, 157 B.R. 363, 365 (Bankr. S.D. Ohio 1993).

<sup>99</sup> “[T]he first step in interpreting a statute is to determine whether the language at issue has a plain and unambiguous meaning with regard to the particular dispute in the case.” *United States v. Cooper*, 396 F.3d 308, 310 (3rd Cir. 2005) (internal quotations and citations omitted); see also *United States v. Ron Pair Enters., Inc.*, 489 U.S. 235, 241 (1989) (“where, as here, the statute’s language is plain, ‘the sole function of the courts is to enforce it according to its terms.’”).

secured creditors and old equity interest holders to collude to achieve a valuation indicating that the secured lender is undersecured in order to squeeze out other parties who may in reality be in the money. The argument that reverse cramdown would be appropriate outside of a plan of reorganization in a “side” agreement undermines one of the primary functions of bankruptcy law—to discourage “side dealing” between creditors to the detriment of other creditors.<sup>100</sup> Finally, following reverse cramdown to its logical conclusion, the nonconsensual confirmation requirements section 1129(b) would simply not apply in cases where a secured lender who has lien on all of the debtor’s property is undersecured. This simply can’t be the law.

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<sup>100</sup> See *Windsor on the River Associates, Ltd. v. Balcor Real Estate Finance, Inc. (In re Windsor on the River Associates, Ltd.)*, 7 F.3d 127, 132 (8th Cir. 1993) (stating that one of the primary functions of bankruptcy law is “to discourage ‘side dealing’ between shareholders of a corporation and some creditors to the detriment of other creditors” and that “[i]t is exactly such ‘side dealing’ that prompted the adoption of a bankruptcy code” in the first place); see also *Rowley v. Yarnell*, 22 F.3d 190, 194 (8th Cir. 1994).