Do Death Trap Provisions Breathe Life into a Chapter 11 Reorganization Plan?

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By Amanda K. Bloch

In modern day Chapter 11 bankruptcy proceedings, pre-petition secured creditors often provide debtor-in-possession financing, and these lenders consequently become the controlling entity in the bankruptcy. Several new practices have developed as a result of this financing scheme which permit the pre-petition lenders to increase their status in the bankruptcy (e.g. roll-ups, the new value exception). One such practice is the inclusion of a “death trap” provision in a reorganization plan. These provisions stipulate that an impaired class, usually an equity class in an insolvent corporation, will receive a distribution under the plan in return for an affirmative vote, but no distribution if the class votes against the plan. While these devices may promote negotiations in a reorganization and help a debtor avoid a costly and time-consuming cram down hearing, courts that apply a strict interpretation of the Bankruptcy Code may find death trap provisions extremely problematic. In particular, death trap provisions may make it impossible for an impaired class to vote in an adequately informed manner, and these provisions may additionally violate the unfair discrimination prohibition and fair and equitable requirements of a cram down hearing. While there is surprisingly little litigation regarding death trap provisions, the courts to address the issue are split over whether they violate the Bankruptcy Code. This paper analyzes and evaluates death trap provisions, including both a legal analysis of the issue and a discussion of the policy implications that permitting or prohibiting death traps could have on corporate reorganizations.

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Introduction

Chapter 11 reorganizations have changed considerably since the Bankruptcy Code was enacted in 1978. In particular, senior creditors frequently provide DIP financing to insolvent corporations, and they consequently become the controlling entity in its reorganization. This system has produced new practices that may conflict with the provisions of the Bankruptcy Code. For example, there are many disputes over whether the new value exception, the “gifting” doctrine, and roll-ups should be permitted in bankruptcy. Each of these practices allows plan proponents, who are often pre-petition creditors and post-petition lenders, to further their plan and their status in the reorganization.

One such controversial practice that may arise in a reorganization plan is a “death trap” provision. A death trap is a stipulation that provides a class with a reward for voting in favor of a plan, such as warrants for the newly formed company, but with no such distribution if it votes against a plan. These devices may promote negotiations in a reorganization, but they may be problematic as well. While there is surprisingly little litigation regarding death trap provisions, the courts to address the issue are split over whether they violate the Bankruptcy Code.

This paper provides an analysis of death trap provisions in Chapter 11 reorganization plans. Part I puts forth an overview of the formulation and confirmation of a reorganization plan. Part II presents the split in authority regarding whether death traps defy the boundaries of the Bankruptcy Code. Part III then analyzes and evaluates death trap provisions, including both a legal analysis of the issue and a discussion of the policy implications that permitting or prohibiting death traps could have on corporate reorganizations.

I. Creating and Confirming a Reorganization Plan

The Bankruptcy Code provides specific procedures governing the formulation and confirmation of a Chapter 11 reorganization plan. Unlike Chapter 7 liquidation proceedings, the purpose of a Chapter 11 filing is to restructure the company and replace old claims and interests with new ones. When a corporation files a Chapter 11 bankruptcy, the directors and officers remain in place and they are collectively the debtor-in-possession. The debtor-in-possession has the exclusive right to propose a reorganization plan within a specified time period after filing, and if the plan is not submitted or confirmed within the time period, other parties in interest may file a plan.

Section 1123 of the Code stipulates the mandatory contents of a reorganization plan. First, a plan must divide the claims of creditors and the interests of equity holders into various classes. The Code instructs that only substantially similar claims may be classified together, and courts have disagreed on whether this provision requires similar legal claims to be classified together or simply prohibits different legal claims from being

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1 11 U.S.C. § 1104. Hereafter, all statutory citations are to the Bankruptcy Code, codified in Title 11 of the United States Code, unless otherwise noted.
2 § 1121
3 § 1222(a)
classified together. Regardless of the interpretation that a court follows, there is “one clear rule” that has emerged from the jurisprudence on classification: “thou shalt not classify similar claims differently in order to gerrymander an affirmative vote on a reorganization plan.” All claims or interests in a class must be treated the same unless the class consents to unfavorable treatment. If a class is unimpaired in the reorganization plan, it is deemed to have accepted the plan. If a class is impaired under the plan, however, it is entitled to vote on the plan, and § 1126(g) provides that if a class receives nothing under the plan it is deemed to have rejected the plan. Equity holders in an insolvent corporation will therefore usually be deemed to have rejected the plan.

After the proponents draft a plan, they must formulate a disclosure statement that will inform parties in interest about the plan. The court must hold a disclosure hearing to ensure that the disclosure statement contains accurate information, and the Code requires that the statement adequately informs classes about the plan before the proponents may solicit votes. If a court approves the statement in a disclosure hearing, the proponents may solicit votes and the impaired classes vote on the plan.

Section 1129 puts forth several requirements that must be satisfied in order for a court to confirm a plan. Of relevance to this paper are §§ 1129(a)(8) and (a)(10). Together, these provisions set the stage for cram down hearings. They provide that if there are any impaired classes, the plan may only be confirmed if at least one impaired class votes in favor of the plan. If the plan proponents are able to garner support from at least one impaired class, they may request a cram down hearing, which invokes the requirements § 1129(b). This provision specifies that the court may approve a plan over a dissenting class, but only if the plan (1) does not unfairly discriminate against that dissenting class and (2) is fair and equitable. The first requirement, the prohibition against unfair discrimination, is a horizontal inquiry that requires a plan to treat classes with similar legal claims or interests equally. The fair and equitable requirement, which embraces the absolute priority rule, is a vertical inquiry that mandates a plan to pay a class in full before any class junior to it receives a distribution (unless the senior class consents). A cram down hearing requires a valuation of the corporation, and it is a very expensive and time-consuming enterprise.

II. Split in the Courts

A. Courts that prohibit death trap provisions

There is a split in the courts regarding whether death trap provisions satisfy the requirements of §1129. In In re Mcorp Financial Inc, a Texas bankruptcy court denied confirmation in a cram down hearing because the reorganization plan unfairly
discriminated against an impaired class and because the plan was not fair and equitable. The Chapter 11 plan in MCorp included a provision, the death trap provision, that authorized a possible payout to equity holders (Classes 15, 16, and 17) if Class 15 voted in favor of the plan, but no payout to any of these classes if Class 15 voted against the plan. Class 15 voted against the plan, and the debtor subsequently requested a cram down hearing.

The court found the reorganization plan problematic for several reasons. First, due to the uncertainty stemming from the death trap provision, the plan was not fair and equitable in its treatment of equity holders. The plan failed to impose an upper limit on the amount of recovery granted to the debtor’s junior creditors (who are senior to the equity holders). One of the assets allocated to the junior creditors, which was also the asset that Classes 15, 16, and 17 would receive if Class 15 voted in favor of the plan, was an uncertain amount of damages from a pending lawsuit. This therefore left open the possibility that, if the recovery was for a large amount like expected, the juniors could receive more than 100% of the allowed amount of their claim. This arrangement therefore violated the absolute priority rule.

The court interpreted the fair and equitable requirement, which it referred to as a “modified version” of the absolute priority rule, by stating that a plan “must provide that an impaired non-accepting class of creditors be paid in full with respect to their claims, or that no interest junior to that class receive any distributions under the plan with respect to the junior claimants’ prepetition claims or interest.” It looked to House reports to determine the scope of the fair and equitable requirement, and it noted that Congress intended for dissenting classes to be sure no senior class receives more than 100% of the amount of its claims. Therefore, in order to confirm a plan, the court recognized that a class of creditors could not be paid more than in full if there is an impaired class of equity holders. Since the plan in question allocated an uncertain amount of damages to the junior creditors, which could very well end up being more than 100% if Class 15 voted against the plan, the court denied confirmation.

Additionally, the court held that the death trap provision unfairly discriminated against the equity holders; however, it did not apply the typical unfair discrimination test. Usually, when a court determines whether a plan unfairly discriminates against a class, it looks to whether classes of the same legal rights are treated similarly. Here, however, the court cited In re Allegheny Int’l, Inc, a Pennsylvania bankruptcy case, and

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11 Id. at 236.
12 Id.
13 Id. at 224–25.
14 Id. at 234–35.
15 Id.
16 Id. at 235.
17 Id.
18 Id. at 234–35.
19 Id.
20 Id. at 235.
21 Id.
22 Id.
23 Id. at 236.
24 See Part III.B.1.
noted that “[t]here is no authority in the Bankruptcy Code for discriminating against classes who vote against a plan of reorganization.” Therefore, the court refused to confirm the plan not because classes with the same legal rights were treated differently, but because a class was discriminated against based on its vote against the reorganization plan.

B. Courts that permit death trap provisions

The bankruptcy court for the Southern District of New York has put forth two decisions confirming reorganization plans that include death trap provisions. In In re Drexel Burnham Lambert Group Inc., the court confirmed a plan that provided warrants to any accepting class of equity holders (Classes 7, 8 and 9). Classes 7 and 9 voted in favor of the plan, and were thus entitled to warrants, but Class 8 voted against the plan and received no distribution. The plan proponents then requested a cram down hearing, and the court held the plan did not unfairly discriminate against the dissenting class of equity holders.

First, the court held that the plan satisfied the unfair discrimination requirement because the differences attributable to the various classes of equity holders treat each of the classes in an “identical non-discriminatory manner.” In other words, the plan does not discriminate against classes with the same legal interests. Viewing this plan from a different perspective than the MCorp and Allegheny courts, the Drexel court noted that the dissenting class voluntarily elected to receive nothing under the plan. The plan itself, however, provided equal treatments between the classes. Class 8 thus elected to be treated differently—they were not compelled to do so—and they were therefore not unfairly discriminated against.

Additionally, the Drexel court addressed the concerns put forth in MCorp and Allegheny regarding whether the death trap provision exceeded the Bankruptcy Code’s authority by discriminating against a dissenting class. The court first differentiated those cases on a factual basis, stating that here the only class affected by a negative vote is the dissenting class and not any junior classes. The court then went further and noted that it had “no conceptual problem with senior interests offering to junior interests an

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26 MCorp, 137 B.R. at 236. In Allegheny, the court rejected a death trap provision stipulating that if any class of equity holders voted against the plan, neither that class nor any class junior to it would receive a distribution. Allegheny, 118 B.R. at 304 n. 15. The court found the provision discriminatory and in violation of the absolute priority rule. Id.
27 MCorp, 137 B.R. at 236.
29 Id. at 717.
30 Id. at 715.
31 Id. at 717.
32 Id. at 715.
33 Id. at 716 (“If either class accepts the Plan, its members will receive warrants in amounts proportionate to the size of their holdings of common stock equivalents under the [] Charter.”).
34 Id.
35 Id.
36 Id.
37 Id.
inducement to consent to the Plan and waive whatever rights they have.”

Instead of focusing on the fact that there is no authority in the Code to permit discrimination against dissenting classes, the court noted that there is no provision in the Code prohibiting such discrimination. It acknowledged that § 1129(a)(3) permits the confirmation of a plan if it is in good faith and not forbidden by any law.

In In re Adelphia Communications Corp., the court similarly confirmed a plan that included a death trap provision allocating value to assenting classes of equity holders. However, unlike the cases thus far discussed, there was no cram down hearing in Adelphia, since all 30 classes approved the plan. The court therefore did not delve into the legal issues surrounding the fair and equitable or unfair discrimination provisions of § 1129. However, the Equity Committee objected to the plan, claiming it violated the absolute priority rule because a dissenting class should be entitled to the proceeds from litigation that are in excess of the senior class’s distribution amount. The court rejected their argument, noting that the equity holders here are fully out of the money unless the litigation damages reach an incredibly high amount (which is very unlikely). The court instead focused on the fact that the plan provides equity holders with more than they are legally entitled in order to induce them to vote in favor. Like Drexel, the court found that this “carrot and stick” approach does not violate any specific provision of the Code.

A Delaware bankruptcy court has agreed with Drexel rather than MCorp and approved a plan with a death trap provision at a disclosure hearing. In In re Zenith Electronics Corp., the court permitted the provision because “if the class accepts, the Plan proponent is saved the expense and uncertainty of a cramdown fight. This is in keeping with the Bankruptcy Code's overall policy of fostering consensual plans of reorganization and does not violate the fair and equitable requirement of section 1129(b).” Therefore, courts are split within the Third Circuit regarding whether death trap provisions exceed the authority of the Bankruptcy Code.

III. Analysis

A. Death Trap Provisions at the Disclosure Hearing

In order to solicit votes for a reorganization plan, the proponents must submit a disclosure statement to the court and the court must approve it at the disclosure hearing. Bankruptcy courts may only approve a statement if it provides the parties with “adequate

38 Id. at 717.
39 Id.
40 Id.
41 368 B.R. 140 (Bankr. S.D.N.Y. 2007).
42 Id. at 275–76.
43 Id. at 258.
44 Id. at 274.
45 Id. at 275.
46 Id. at 275–76.
47 Id.
49 Id. at 105.
information” so they may make an informed vote on the proposed reorganization plan. The Code defines “adequate information” as:

information of a kind, and in sufficient detail, as far as is reasonably practicable in light of the nature and history of the debtor and the condition of the debtor’s books and records, that would enable a hypothetical reasonable investor typical of holders of claims or interests of the relevant class to make an informed judgment about the plan.50

Although there is very little case law regarding whether a court should approve a death trap provision at the disclosure hearing, these types of provisions could be problematic for several reasons.

First, a plan containing a death trap provision may not provide voting classes with adequate information because the plan may change depending on a class’s vote. For example, in a plan like Drexel there are multiple classes of equity holders in an insolvent corporation and a death trap provision that prevents a class from receiving a distribution if they vote against the plan. Based on this provision alone, the equity classes are likely voting with adequate information. Each class knows its potential distribution based on its vote, and it is aware at the time of its vote whether or not it will receive that distribution.

Alternatively, if the provision stipulates that if any of the classes vote against the plan none of the classes receive a distribution, the analysis may change. Since the classes will typically vote simultaneously, they will be unaware of their status at the time of their vote. This is similar to the plan that was rejected in MCorp, and the court acknowledged this concern during the cram down hearing: “Classes 16 and 17 not only lost any possible distributions, but also the right to vote effectively, since they could not know until after [Class 15] had cast its vote (due on the same date as that of all other claimants) what their own status was.”51 Therefore, while the MCorp court reviewed this question during the cram down hearing in its analysis of § 1129(b), the court implied that Classes 16 and 17 lacked adequate information to make an informed vote on the plan.

However, a significant counterargument to MCorp’s position is that it is irrelevant whether Classes 16 and 17 were able to vote “effectively” or in an adequately informed manner. Each class is aware that if it votes against the plan, neither that class nor any of the other classes of equity will receive a distribution. Each class also knows that if it votes in favor of the plan, it still may not receive a distribution, because another class may vote against it. If the corporation is insolvent, the equity holders are not entitled to a distribution anyway—the death trap provision merely provides the equity with a possible distribution in order to confirm the plan. Therefore, one could argue that it should not matter whether any of these classes are “adequately informed” at this point because they will lose nothing by not having the information.

If there is an impaired class of creditors voting on the plan, though, the analysis significantly changes. In order to provide a potential distribution to equity holders of an insolvent corporation, the distribution must take value away from another source. If there is an impaired class of creditors voting on this plan, they will not be fully informed as to whether that value will be distributed to the equity holders, because they vote at the same

50 § 1125(a)(1)
51 MCorp, 137 B.R. at 236.
time as the equity classes. Therefore, a court taking MCorp’s approach on these provisions may be particularly reluctant to approve a plan at the disclosure hearing if there is a dissenting class of creditors and a death trap provision that will potentially allocate a distribution to equity holders based on their vote.

A second issue that may arise regarding death trap provisions at the disclosure hearing is that courts may refuse to approve a reorganization plan where, on its face, it is unconfirmable. Although courts typically will not determine whether a plan unfairly discriminates against an impaired class or is not fair and equitable at this stage in the process, where it is clear to a court that the plan may not later be confirmed, the court may simply prevent the plan from progressing any further. For example, in In re Stoneridge Apts 52, the court held that where a plan clearly classified the creditors in an impermissible fashion, it would not approve the disclosure statement. 53 The court in In re El Comandante Mgmt Co, LLC 54 went further and stated that courts may reject a plan at the disclosure hearing when it is so fatally flawed that confirmation would not be possible. 55 It put forth relevant factors for courts to consider, including classification of claims and whether the plan unfairly discriminates against a class. 56 As the court noted, “it is within this court’s discretion to address these issues prior to the confirmation of the plan.” 57 Therefore, while courts typically do not delve into the § 1129(b) factors before a cram down hearing, courts may refuse to approve a plan where it is obviously defective and would not be confirmable at a later stage. This may particularly matter to a court confronting a death trap provision if that court is strongly averse to any maneuvering around the fair and equitable requirement and the prohibition against unfair discrimination, as discussed in Part II.B.

B. Death Trap Provisions at the Cram Down Hearing

Section 1129(b)(1) of the Code provides:

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. 58

While § 1129(b)(2) provides guidance as to the meaning of “fair and equitable,” the Code fails to define what it means to “discriminate unfairly.” It is important to recognize that both requirements are a term of art, and courts have put forth numerous opinions interpreting and defining the proper scope of these requirements. However, the courts are far from settled as to the appropriate meaning or application of either. For this reason,

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53 Id. at 796.
55 Id. at 415.
56 Id.
57 Id.
58 § 1129(b)(1).
determining whether a death trap provision satisfies or violates these requirements poses numerous problems.

1. Unfair Discrimination

The prohibition on unfair discrimination requires a horizontal inquiry into whether a plan treats classes containing the same legal claims equally. The statute merely states that plans should not discriminate unfairly, and courts have interpreted the meaning and scope of the requirement by relying on its history.\(^{59}\)

There are two different arguments that parties may make regarding whether a death trap provision violates the prohibition on unfair discrimination. First, a party may argue that the plan violates the boundaries of the Bankruptcy Code by discriminating against a class who rejects the plan. This is the main argument relied on in the courts who reject death trap provisions.\(^{60}\) However, there is a difference between the word “discrimination” and the term “unfair discrimination” in the context of § 1129, and this distinction significantly impacts how a court should evaluate this argument. Second, a party may argue that the plan unfairly discriminates against a class who rejects the plan because it may leave that class with unequal interests compared to another class holding similar legal claims or interests. While this argument requires a straightforward application of the unfair discrimination prong tests to the facts at hand, courts may differ sharply in their holdings. Overall, the first argument requires a broad analysis of the Code and its limits while the second argument requires a narrower interpretation of § 1129(b)(1).

- **Does discriminating against a class based on its vote exceed the Code’s authority?**

  In **MCorp** and **Allegheny**, the courts refused to approve a death trap provision in a reorganization plan because it discriminated against an impaired class who rejected the plan. Neither court applied the unfair discrimination jurisprudence, instead focusing on the fact that this type of discrimination exceeds the authority granted to plan proponents under the Code.\(^{61}\) While the courts did not explicitly identify any provision of the Code that was violated, they put forth their analyses in the purview of their discussions on whether the plan violated the cram down provisions of § 1129(b), thus implying that discriminating against a class based on its vote may equate to the type of discrimination that §1129(b)(1) proscribes. However, there is a fundamental distinction between this type of discrimination and “unfair discrimination” as it applies to the Code.

  “Unfair discrimination” under § 1129(b)(1) represents the doctrine that classes with equal claims should be treated similarly, or receive equal distributions. The concept of prohibiting discrimination because it is beyond the authority of the Code, on the other hand, as applied by the courts in **MCorp** and **Allegheny**, uses the term “discrimination”


\(^{60}\) See **MCorp**; **Allegheny**.

\(^{61}\) See Part II.A.
according to its plain meaning. The two uses of the word discrimination are distinct—one being its dictionary definition and the other being a term of art used to describe a situation prohibited by the Code. The ability of a court to prevent a plan from unfairly discriminating against an impaired class under § 1129(b)(1) should not be confused with its ability to prevent a plan from discriminating against a class based on its vote.

Moreover, the court’s reliance on a “lack of authority” under the Code to invalidate a death trap provision faces a fatal flaw: the Butner principle. In Butner v United States, the Supreme Court held that state property law determines property rights in the assets of a bankruptcy estate. The doctrine from Butner subsequently expanded to represent the principle that in the absence of a specific bankruptcy provision to the contrary, bankruptcy takes nonbankruptcy rights and laws as it finds them. Therefore, in a bankruptcy proceeding, if one party seeks an outcome that differs from the one a court would hold outside of bankruptcy, the court will require that party to identify a specific bankruptcy rule requiring that conclusion.

Accordingly, as the court in Drexel observed, it is irrelevant that the Bankruptcy Code does not specifically authorize plan proponents to discriminate against a class based on its vote. So long as neither the Code nor state law explicitly prohibit the practice, parties should remain within the limits of their rights in bankruptcy to include discriminatory provisions without necessarily violating the Code or its prohibition against unfair discrimination.

b. Do death trap provisions violate the prohibition on unfair discrimination?

Whether a provision violates the Code by unfairly discriminating against an impaired class requires a different type of inquiry. There are two main tests that courts apply to determine whether a plan unfairly discriminates against a dissenting class. The majority approach to unfair discrimination is a four-factor balancing test set forth by the court in In re Aztec Co., which allows some discrimination as long as it is fair. In particular, the Aztec test advises courts to consider: “(1) whether the discrimination is supported by a reasonable basis; (2) whether the debtor can confirm and consummate a plan without the discrimination; (3) whether the discrimination is proposed in good faith; and (4) the treatment of the classes discriminated against.”

A minority of courts follow a more conservative approach to § 1129(b)(1) that shifts the burden and typically bars discrimination regardless of whether it is fair or reasonable. The court in In re Dow Corning Corp. laid out a test to apply in cram down hearings to determine whether a plan unfairly discriminates against a dissenting class:

63 Id. at 55.
64 Douglas G. Baird, Elements of Bankruptcy 5 (Foundation Press 2006).
65 Id. at 6.
68 See Liberty National Enterprises v. Ambanc La Mesa Ltd. Partnership (In re Ambanc La Mesa Ltd. Partnership), 115 F.3d 650, 656 (9th Cir. 1997).
69 In re Dow Corning Corp., 244 B.R. 705 (Bankr. E.D. Mich. 1999);
a rebuttable presumption that a plan is unfairly discriminatory will arise 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.\footnote{1}

The \textit{Aztec} court criticized this “mechanical” approach to § 1129(b)(1) because, unlike the \textit{Aztec} court’s four-factor balancing test, the \textit{Dow Corning} test proscribes all discrimination, not simply \textit{unfair} discrimination.\footnote{2} However, courts in favor of the \textit{Dow Corning} approach counter that it is merely a rebuttable presumption in favor of the impaired class.

Often, death trap provisions apply to classes of equity holders, and, depending on the provision, it may leave one class with a distribution and the other without. A reorganization plan may therefore pose a significant problem in the § 1129(b)(1) analysis if a class claims it is unfairly discriminated against due to a death trap provision and it is able to identify a class of similar claims that is treated more favorably as a result of its vote. However, a court’s interpretation of a death trap provision will probably depend on its jurisdiction. The provision will be most problematic if it is being litigated in a jurisdiction that follows the \textit{Dow Corning} line of cases. This is because \textit{Dow Corning} places a high burden of proof on the plan proponents to justify a discriminatory provision, whereas the \textit{Aztec} test provides proponents with greater deference and ability to defend their use of the provision. Therefore, in courts following \textit{Dow Corning}, any provision that leaves one class of interests with an inferior distribution to an equal class of interests may find it exceptionally difficult to convince a court that the plan does not violate the prohibition on unfair discrimination.

Courts following \textit{Aztec}, though, will look to the reasonableness and advantages of the plan, thereby providing a significant advantage for plan proponents of a death trap provision. First, when the court is determining whether the discrimination is supported by a reasonable basis, the proponents may be able to identify strong reasons for including the provision. For example, they can allege that including this type of a provision in the plan is the only way to move forward with negotiations and thus facilitate a successful reorganization, and this argument will be particularly persuasive if the other classes are in favor of the plan. Additionally, one of the factors to consider is the treatment of the classes discriminated against. In this inquiry, the court may take serious note of the fact that the class otherwise would not be entitled to a distribution, that it deliberately chose to reject the distribution, thus creating the discriminatory result (as the court noted in \textit{Drexel}), and last, that the dissenting class caused a cram down hearing which may be a form of renegotiation, like a hold-out. However, if the dissenting class is a junior class of creditors, the analysis changes and proponents may have far more difficulty rationalizing the discrimination and defending the treatment of the dissenting class.

\footnote{1} Id. at 710.  
\footnote{2} \textit{Aztec}, 107 B.R. at 588–89.
2. Fair and Equitable

The fair and equitable requirement in a cram down hearing is a vertical inquiry that requires senior creditors to be paid in full before junior creditors are entitled to a distribution. Section 1129(b)(2) codifies the absolute priority rule from the era of equity receiverships, but includes its own gloss on the rule. During the era of equity receiverships, each creditor enjoyed rights under the absolute priority rule. The Supreme Court first recognized the rule in Northern Pacific Railroad v Boyd, where it held that a plan was not permitted to completely freeze-out an intervening creditor. The Court then forged a link between the term “fair and equitable” and the absolute priority rule in Case v Los Angeles Lumber Products. In Case, the Court recognized that allowing old equity holders to participate in the restructured company caused problems because it allowed old shareholders to hold up other investors. It held that the fair and equitable standard afforded each creditor its full right of priority in the new firm, thus cutting back sharply on a shareholder’s ability to participate in the reorganization of an insolvent firm over a creditor’s objection.

The Code codified the Case Court’s interpretation of the absolute priority rule in § 1129(b)(2), but it now only applies to a dissenting class. The section includes specific requirements for secured claims, unsecured claims, and equity interests, but the basic point of the statute is that, in a cram down hearing, either the claimants in the senior class must get paid in full or junior classes may not receive any distribution. As discussed in detail below, courts are in wide disagreement over the limits of the absolute priority rule.

Few courts have questioned whether death trap provisions violate the fair and equitable requirement in § 1129(b)(2), but from a doctrinal standpoint, it seems as though the provisions may be problematic. In plans with a death trap provision, a junior class may get a distribution even though a class above it is not paid in full. In these situations, the death trap may act like a form of the “gifting” doctrine, which is a hotly contested issue with a clear split of authority. Like unfair discrimination, the jurisdiction in which a death trap provision is challenged may have a significant impact on whether the plan may be confirmed over a dissenting class. Whether a court is likely to respond to this argument will probably be intertwined with its view on the gifting doctrine split.

Many times, insolvent corporations filing for Chapter 11 bankruptcy may want to distribute equity in the restructured corporation to equity holders in the old corporation. However, the Bankruptcy Code explicitly prevents shareholders from retaining a stake in the business “on account of” their old interests if senior classes have not been paid in

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73 Baird at 273.
74 228 U.S. 482 (1913).
75 Id.
76 308 U.S. 106 (1939).
77 Id.
78 Id.
79 Baird at 273.
80 Compare Official Unsecured Creditors Committee v. Stern (In re SPM Manufacturing Co.), 984 F.2d 1305 (1st Cir. 1993) (approving a plan that gifted a portion of the distribution to a junior class), with In re Armstrong World Industries, Inc., 432 F.3d 507 (3d Cir. 2005) (holding that gifting violates the absolute priority scheme of the Code).
full. As a consequence, plan proponents have become more strategic in their plans, and often build into the plan a provision that allows one class to “gift” a portion of their proceedings to the old class of equity holders. This so-called gifting doctrine is a controversial practice with some courts allowing it and others holding that it violates the absolute priority rule or the unfair discrimination prohibition. The two leading cases on the issue are Official Unsecured Creditors Committee v Stern (In re SPM Manufacturing Co.)\textsuperscript{82} and In re Armstrong World Industries, Inc.\textsuperscript{83}.

In SPM, the First Circuit upheld the gifting doctrine as an acceptable form of negotiation under the Code. In SPM, a secured lender entered into a sharing agreement with unsecured creditors to share in the proceeds that would result from the debtor’s reorganization.\textsuperscript{84} The reorganization did not work, and the business was eventually converted to a Chapter 7 case and liquidated.\textsuperscript{85} The court first held that an order compelling the secured lender to pay the trustee the money required under the agreement is beyond its equitable powers.\textsuperscript{86} However, it did state that the creditors are free to contract as they would like with the dividends they receive, and this includes giving it to other classes that would not be entitled to the distributions under the Code.\textsuperscript{87} It was critical to the court’s reasoning that once the proceeds were distributed to the secured creditors, the proceeds were no longer property of the estate.\textsuperscript{88}

Recently, the Third Circuit split from SPM and its progeny when it held that the gifting doctrine exceeds the boundaries of the Bankruptcy Code. In Armstrong, the reorganization plan created 11 classes of claims and one class of equity interests.\textsuperscript{89} A provision in the plan provided that Class 7 must consent to share a portion of its proceeds with the equity holders.\textsuperscript{90} If Class 6, the unsecured creditors, rejected the plan, Class 7 would receive new warrants but would automatically waive the distribution, causing the equity interest holders to secure the warrants.\textsuperscript{91} The result of this provision was that these equity holders received property (new warrants) on account of their equity interests, although a senior class (Class 6) did not have fully satisfied claims.\textsuperscript{92} The district court rejected the plan, holding that the distribution of new warrants over the unsecured creditors violated the fair and equitable requirement of § 1129, and the Third Circuit affirmed.\textsuperscript{93} The courts distinguished Armstrong from SPM, though,
claiming that **SPM** differed because it was a chapter 7 case, where the absolute priority rule does not apply, and because the **SPM** plan was similar to an ordinary carveout whereby it was permitted to share its proceeds with other classes. The district court, however, additionally noted that it believed the **SPM** line of cases was wrongly decided. Although it recognized there may be strong policy reasons to permit these schemes, it held that “no amount of legal creativity . . . supports judicial rewriting of the Bankruptcy Code.” The Third Circuit agreed with the lower court, and additionally put forth policy reasons for proscribing gifting provisions. It stated that these types of provisions encourage parties to sidestep the “carefully crafted strictures” of the Code and that they undermine Congress’s objective of providing unsecured creditors with bargaining power in the reorganization process.

These cases provide guidance as to whether courts are likely to uphold or deny death trap provisions. The gifting doctrine and death trap provisions are similar in many ways, and it seems fairly likely that courts may therefore apply similar analyses. This may be particularly helpful to parties attempting to include a death trap provision in their plan because there is little litigation regarding death traps, but far more litigation on gifting. First, death trap provisions and gifting provisions are similar because they provide a junior class with a distribution where that class otherwise would be entitled to less or nothing at all. Also, in both scenarios, due to legal maneuvering, a middle class (often the unsecured creditors) may end up being frozen out. As the **Armstrong** court noted, this faces the risk of violating the absolute priority rule. Last, both types of provisions are included in a plan in order to promote negotiations and keep lower classes (usually equity holders) involved in the process and satisfied.

There are, however, significant differences between death trap and gifting provisions that prevent the **Armstrong**/**SPM** split from being a perfect analogy. First, there is a difference in the underlying scheme that differentiates the two types of provisions. Where a death trap provision is present, the distribution to the lower class is lost if that party votes against it, thus incentivizing that class to affirm the plan. Gifting provisions contain no such requirement. Second, and more importantly, there is a difference in form—though perhaps not substance—between the two provisions. While death trap provisions provide a distribution to a class, that distribution is not “gifted” from a more senior class. In other words, the distribution is not initially granted to a more senior class and then allocated to the junior class through a separate contract; it is directly provided to the junior class through the plan based on its vote. This may matter to a court because the courts that approve gifting provisions view the distribution to the junior class as no longer part of estate property. Last, as the **Armstrong** court noted, junior parties receive a distribution on account of their old interests when they are gifted a distribution. In death trap provisions, however, classes receive a distribution on account of their vote. While the former is explicitly prohibited by the Code, the latter is not mentioned.

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94 Id. at 514.
95 In re **Armstrong World Industries**, Inc., 320 B.R. 523 (D. Del. 2005), aff’d In re **Armstrong World Industries**, Inc., 432 F.3d 507 (3d Cir. 2005), (rejecting the contention that creditors are generally free to do whatever they would like with their dividends without adherence to the requirements of § 1129(b)(2)).
96 Id. at 540.
97 **Armstrong**, 432 F.3d at 515–16.
98 Id.
C. Policy Implications

Death trap provisions may play a pivotal role in a Chapter 11 reorganization. It may be the only way for a plan proponent to obtain the support of an impaired class, thereby either leading to a confirmation (if no classes dissent) or a cram down hearing. However, as discussed above, these provisions have the potential to defy the boundaries of the Bankruptcy Code, and courts may therefore prohibit them. Regardless of a court’s view on the legal limits of death trap provisions, there are strong policy implications on both sides of the issue.

There are numerous justifications for prohibiting death trap provisions. First, these provisions may act as a creative solution for inducing an unwilling class to vote in favor of a reorganization plan, like a form of constrained choice. They thus incorporate the same types of problems that led courts to forbid gerrymandering in classification. The “one clear rule” prohibiting gerrymandering when classifying claims is meant to prevent an abuse of the system—gerrymandering would allow plan proponents to contravene the provisions of the Code by cleverly forming classes to ensure that at least one impaired class votes affirmatively. The Eighth Circuit warned against this practice because “[t]here is potential for abuse when the debtor has the power to classify creditors in a manner to assure that at least one class of impaired creditors will vote for the plan, thereby making it eligible for the cram down provisions.”

Courts recognize that doing so would nullify Congress’ intention in passing the provisions governing classification, voting, and confirmation, and thus should not be permitted.

Death trap provisions may similarly disrupt Congress’ intentions by inducing a class to vote in favor of a plan in order to confirm the plan or at least request a cram down hearing. Under certain circumstances, this may be especially problematic. For instance, even if a plan violates congressional mandates—such as the absolute priority scheme or the prohibition on unfair discrimination—a class may be deterred from asserting its rights because of its potential distribution. But, if that class’s distribution is based on both its and another class’s vote (like the plan in Allegheny) and another class dissents, the first class is in a sticky situation. Since it voted in favor of the plan, the court may not consider that class in its inquiry into the § 1129(b) factors, which only apply to a dissenting class. A court in the SDNY, where death trap provisions have been permitted, offered his unenthusiastic view on death trap provisions:

[A] culture has developed in large chapter 11 cases in which many consider it acceptable, and indeed expected, to use the litigation process as a means to assert or follow through on threats, and to seek various kinds of relief, to secure ‘leverage’ in efforts to increase recoveries. I don’t like it. . . . [but] they boil down to activities that, while distasteful and heavy handed, are sufficiently within what the law permits.

99 Hanson v. First Bank of South Dakota, N.A., 828 F.2d 1310, 1313 (8th Cir. 1987).
100 See Boston Post Rd. Ltd. v. Federal Deposit Ins. Corp. (In re Boston Post Rd.), 21 F.3d 477, 483 (2d Cir. 1994).
Additionally, permitting death trap provisions provides even more control to DIP financers, consequently lessening the already-reduced power that junior creditors have in bankruptcies. 102 When the Code was first enacted, the unsecured creditors were the influential class in a reorganization. This was based on the idea that secured creditors already had a property interest that could not be interfered with, and they therefore did not have a major stake in a reorganization—they had nothing to gain and nothing to lose. Today, however, senior secured creditors often provide DIP financing, and this “grants the lender virtually complete control over the reorganization process.” 103 Several contemporary practices have emerged which illustrate the clout of these parties who play the role of both secured creditors and DIP lenders. For example, roll-ups and cross-collateralization clauses demonstrate the ability of these lenders to increase their positions in bankruptcy over those of the junior creditors. Permitting the financers to include death trap provisions in order to confirm a reorganization plan may only further their positions while weakening those of the unsecured creditors—it is not clear courts should encourage this cycle to continue.

Last, there may be several negative consequences that could flow from courts routinely permitting plan proponents to include a death trap provision. It may be a slippery slope whereby courts’ continuous infringement on the absolute priority rule effectively lowers the protection that it provides to classes of creditors. It could also lead to significant hostility if one class’s vote prevents another class from receiving a distribution. Or, it could lead to collusion, where classes may come together and agree to refuse the distribution in order to prevent a cram down hearing and negotiate for greater stakes in the restructured company.

There are, however, strong rationales for permitting death trap provisions. First and foremost, these provisions are included in reorganization plans because they promote negotiation among the parties. Judges and academics both recognize the practical difficulties involved in reorganizing an insolvent corporation, and often “[f]lexibility and creativity on the part of the professionals and the courts . . . become imperative and necessary to affect the reorganization . . . and deal fairly with the parties in interest.” 104 The consequence of preventing proponents from including these provisions, which may be the only way to pass a plan of reorganization, may be to prevent the various interests involved in a reorganization from reaching a consensus, thus leading to a failed Chapter 11. These repercussions have been recognized in relation to prohibitions on “gifting” in bankruptcy 105, and they apply with equal force to prohibitions on death trap provisions.

Additionally, these provisions may be viewed as a quid pro quo that benefits all parties involved. Proponents most likely would include a death trap provision in the reorganization plan to encourage classes to vote in favor of the plan, thereby avoiding a cram down hearing. These hearings are extremely expensive procedures that require a

102 See Baird at 246–48.
103 Id. at 246 (“Debtor-in-possession financing . . . is so central to bankruptcy cases that senior lenders have been able to use it to exert substantial control over the dynamics of large reorganizations.”).
105 See id. at 1349.
 valuation of the company and lengthen the bankruptcy proceeding. Proponents may offer death trap provisions to classes who are not otherwise entitled to any distribution to incentivize them against causing a cram down hearing. If the classes vote in favor of the plan, they receive value where they are not entitled to it; if they vote against the plan, they do not get that extra distribution because they caused the corporation to endure the expense and duration of a cram down hearing. As opposed to being an inequitable practice, these plans could therefore be viewed as not only equitable but advantageous for the impaired parties involved in the bankruptcy.

Conclusion

Through its discussion, this paper has demonstrated that there are strong legal and policy arguments on both sides of the death trap issue. While courts that apply broad interpretations of the Code and provide parties with greater autonomy in the process are more likely to approve death trap provisions, a strict interpretation of the Bankruptcy Code indicates that the provisions may be problematic at several stages in the process. Additionally, although there are compelling reasons to forbid these types of plans, the concept of using this “carrot and stick” approach to promote negotiation and avoid expensive cram down hearings are strong justifications for allowing death traps. Overall, regardless of whether a court permits or prohibits death trap provisions, any determination of the issue requires a thorough analysis of the Bankruptcy Code and a keen awareness of the consequences that the court’s decision may have on future Chapter 11 reorganizations.

106 See Baird at 251.