In Re Armstrong World Industries: In Denying Confirmation, Third Circuit Re-Affirms Commonly Used Chapter 11 Tools

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On December 29, 2005, the United States Court of Appeals for the Third Circuit rendered its decision in *In re Armstrong World Industries, Inc.* The issue considered by the Court of Appeals involved the appeal by Armstrong World Industries ("*AWI*") of the decision of the United States District Court for the District of Delaware denying confirmation of AWI's plan of reorganization (the "*Plan*"). The District Court had concluded that the Plan could not be confirmed because it violated the absolute priority rule and no equitable exception to the absolute priority rule applied.

While the Third Circuit affirmed the District Court's denial of confirmation based upon a relatively straightforward application of the Bankruptcy Code mandated absolute priority rule, it reinforced two tools often utilized by parties to confirm chapter 11 plans: (i) the ability of a secured creditor to "gift" distributions to a junior class to obtain such party's consent to a chapter 11 plan; and (ii) the distribution to a junior class in consideration of the settlement of claims between the parties. In addition, while expressing the need for compelling circumstances, the Third Circuit acknowledged the authority of a court to review the equities of a case when considering a flexible application of the absolute priority rule.

A. Facts

Under the Plan, AWI's creditors were divided into eleven classes and AWI's equity interest holders were placed into a twelfth class. Relevant to the appeal were Class 6, a class of unsecured creditors; Class 7, a class of present and future asbestos-related personal injury claimants; and Class 12, the class of equity interest holders who own AWI's common stock. Classes 6 and 7 held equal priority, and had interests senior to those of Class 12. All three classes were impaired.

The Plan provided that AWI would place a portion of its assets into a trust for Class 7 and Class 7's members would be entitled to an initial payment percentage from the trust of 20% of their allowed claims. Meanwhile, Class 6 would recover a portion (approx. 59.5%) of its claims. The Plan also proposed to issue new warrants to purchase AWI's new common stock to Class 12. If Class 6 rejected the Plan, then the Plan provided that Class 7 would receive the warrants. However, the Plan also provided that Class 7 would automatically waive receipt of the warrants, which would then be issued to Class 12.

Class 6 rejected the Plan. Since an impaired class objected to the Plan, the Plan could only be "crammed down" if it was "fair and equitable" to the objecting class. Pursuant to the "absolute priority rule" of section 1129(b) of the Bankruptcy Code, a plan is fair and equitable with respect to an impaired, dissenting class of unsecured claims if it (1) pays the class's claims in full, or (2) does not allow holders of any junior claims or interests to receive or retain any property under the plan "on account of" such claims or interests.

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The United States Bankruptcy Court recommended confirmation of the Plan to the District Court, finding that the absolute priority rule had not been violated. The District Court refused to confirm the Plan, holding that (1) the issuance of warrants to the equity interest holders violated the absolute priority rule, and (2) no equitable exception to the absolute priority rule applied.

B.Congressional Intent And The Plain Meaning Of The Absolute Priority Rule

In its appeal, AWI first argued that the Court of Appeals should apply a flexible interpretation of the absolute priority rule based on Congressional intent. Specifically, AWI argued that Congress designed the absolute priority rule to prevent the "squeezing out" of intermediate unsecured creditors. Class 6 was not an intermediate class (as it was equal to Class 7) and was not being squeezed out by Class 7's transfer of warrants to Class 12. Therefore, AWI argued, the absolute priority rule did not apply.

The Court of Appeals noted that the legislative history does show that section 1129(b) was at least designed to address situations where a senior class gave property to a class junior to the dissenting class. However, the Court of Appeals further noted that other statements in the legislative history of section 1129(b) appear to apply the statute more broadly (i.e., to non-intervening classes). As such, the Court of Appeals determined that the legislative history supports the notion that an impaired class may object to a co-equal class's distribution of property to a junior class.

Furthermore, the Court of Appeals determined that the plain language of the absolute priority rule makes it clear that a plan cannot give property to junior claimants "on account of" such claim or interest over the objection of a senior class that is impaired. Applying the plain meaning of the statute to the facts at hand, the statute would be violated because the Plan would give property to Class 12, which had interests junior to those of Class 6.

C. *MCorp-Genesis Line of Cases* Distinguished, but not Overturned

AWI further argued that Class 7 may distribute the property it will receive under the Plan to Class 12 without violating the absolute priority rule, relying on a line of cases that involved creditors who were permitted to distribute their proceeds from the bankruptcy estate to other claimants without offending the absolute priority rule (the "*MCorp-Genesis Line of Cases*").

The Court of Appeals held that the *MCorp-Genesis Line of Cases* was distinguishable from the facts at hand and that the reasoning set forth therein remained intact. For instance, *In re Genesis Health Ventures, Inc.,* 266 B.R. 591 (D. Del. 2001) and *In re SPM Mfg. Corp*., 984 F.2d 1305 (1st Cir. 1993) both involved a "carve out," a situation where a party whose claim is properly perfected and secured by assets in the bankruptcy estate allows a portion of its lien proceeds to be paid to others. To the contrary, in *Armstrong,* Class 7 was not a secured class, and the proposed distribution was not a "carve out."

The Court of Appeals noted further that the structure of the Plan clearly conveyed that the transfer between Class 7 and Class 12 was devised to ensure that Class 12 received the warrants, with or without Class 6's consent. The distribution of the warrants was only made to Class 7 if Class 6 rejected the Plan. In turn, Class 7 automatically waived the warrants in favor of Class 12, without any means for dissenting members of Class 7 to protest. The Court of Appeals concluded that allowing this particular type of transfer would undermine the Bankruptcy Code. Through the absolute priority rule, Congress intended to give intermediate creditors a great deal of bargaining power in negotiating with senior or secured lenders who wish to have a plan that gives value to equity. Allowing this type of transfer, the Court reasoned, would take such bargaining power away from Class 6.

D. Transfer Of The Warrants "On Account Of" Class 12's Equity Interests

The absolute priority rule provides that a plan is fair and equitable if it does not allow holders of any junior claims or interests to receive or retain any property under the plan "on account of" such claims or interests. AWI argued that the warrants would not be distributed to Class 12 "on account of" its members' equity interests, but rather would be given as consideration for settlement of its members' intercompany claims.

In making this argument, AWI relied on *In re PWS Holding Corp*., 228 F.3d 224 (3d Cir. 2000). In *PWS*, the debtors released their legal claims against various parties to facilitate their reorganization, including an avoidance claim that would have allowed them to avoid certain aspects of a previous recapitalization. *Id.* at 232-35. The appellants in *PWS* argued that releasing the avoidance claim resulted in a prohibited transfer of value to equity interest holders who had participated in the recapitalization. The Court of Appeals held that "without direct evidence of causation, releasing potential claims against junior equity does not violate the absolute priority rule in the particular circumstance [where] the claims are of only marginal viability and could be costly for the reorganized entity to pursue." *Id.* at 242.

The Court of Appeals distinguished *PWS* from the *Armstrong* facts. The warrants had an estimated value of $35 to $40 million, while the intercompany claims held by the members of Class 12 were only valued at approximately $12 million, resulting in a substantial benefit for Class 12. AWI gave no adequate explanation for the difference in value, leading the Court of Appeals no alternative but to conclude that Class 12 would receive the warrants "on account of" their status as equity interest holders.

F. Equitable Considerations

Citing *In re Penn Central Transportation Co*., 596 F.2d 1127 (3d Cir. 1979), AWI argued that the Court of Appeals should apply equitable considerations to allow an exception to the absolute priority rule. To prevent a railroad crisis and to address the difficulties of the *Penn Central* reorganization, Congress passed the Regional Rail Reorganization Act of 1972, which directed that major portions of Penn Central's rail assets be conveyed to Conrail, a new company formed under the Act to continue operation of some of the routes served by Penn Central. *Id*. at 1134. In *Penn Central*, the Court of Appeals held that "[o]ur construction and application of precedents such as the absolute priority rule must necessarily take account of the unique facts of this Plan and proceed in an environment pervaded more by relativity than by absolutes." *Id*. at 1142.

AWI analogized *Penn Central* to its own case, arguing that the facts were unique and warranted a more equitable and flexible application of the absolute priority rule. The Court of Appeals disagreed, finding that AWI's bankruptcy due to asbestos liabilities simply did not involve the kind of exigent circumstances present in *Penn Central*. In so holding, the Court of Appeals did not determine that exceptions to the absolute priority rule do not exist, but rather found that no such exceptions applied to AWI's Plan.

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