AMERICAN BANKRUPTCY INSTITUTE
JOURNAL
The Essential Resource for Today's Busy Insolvency Professional

Turnaround Topics

By Lisa Laukitis, Edward P. Mahaney-Walter and Daniel C. Kennedy[1]

Equality of Treatment vs. Equality of Result

Lisa Laukitis
Skadden, Arps, Slate, Meagher & Flom LLP
New York

Edward P. Mahaney-Walter
Skadden, Arps, Slate, Meagher & Flom LLP
New York

Daniel C. Kennedy
Skadden, Arps, Slate, Meagher & Flom LLP
New York

In a market-based economy, investments go to those who value them the most — leading to an efficient allocation of capital. However, chapter 11 reorganization plans often follow a one-size-fits-all approach to treatment of creditors' claims, with the same treatment offered to all those in the same class. This is due to an interpretation of the requirements of the Bankruptcy Code that similarly situated creditors must receive the same treatment.

However, more flexibility in providing treatment options to creditors could benefit companies and creditors alike. If an overleveraged company is emerging from bankruptcy by discharging its old debt, and issuing new debt and equity, some creditors might prefer to receive equity, whereas some creditors in the same class may prefer to receive debt, or may even prefer to receive cash at a significant discount. Thus, bankruptcy plans can — and should — be drafted more creatively to create optionality and encourage stakeholders to choose the option that works best for their individual situation and risk tolerance.

The Statutory Framework

When the plan proponent designs a reorganization plan, it must classify claims and interests. Sections 1122 and 1123 of the Bankruptcy Code discuss classification and treatment of such claims and interests. Section 1122(a) begins the analysis by requiring that a plan may place a claim or interest in a particular class only if such claim or interest is substantially similar to the other claims or interests of such class. Even if well intentioned, an attempt to split up identical creditors so as to provide different treatments might not be permissible. For example, if certain bondholders within a particular bond issuance wanted to own go-forward equity, while others wanted to be cashed out at a discount, it might be improper classification for the plan proponent to place them in separate classes.[2]

Section 1123 goes further and discusses the mandatory and permissible contents of a reorganization plan. In particular, § 1123(a)(1)-(3) provides that a plan shall designate classes of claims and interests, specify any that are not impaired, and specify the treatment of any that are impaired. Section 1123(a)(4) further requires that the plan provide the same treatment for each claim or interest of a particular class, unless the holder agrees to a less favorable treatment.

"Less Favorable Treatment"

Based on the language of § 1123(a)(4), one way that a plan could create optionality is by allowing claimants to opt into less favorable treatment. However, such an approach has obvious problems, including that most parties would not volunteer to receive less favorable treatment. However, what a party might perceive as less favorable treatment might differ based on individual circumstances. Ultimately, arguments for and against optionality in reorganization plans on the basis of § 1123(a)(4) are a red herring. As explained in further detail, giving the same right to all class members to elect different treatments is what constitutes giving them the same treatment.

1 This article is the work of its authors, and the statements made herein are not necessarily those of their firm or any one or more of its clients.

2 Although substantially dissimilar claims may not be classified together, courts disagree about the extent to which substantially similar claims may be classified separately. The more similar the claims are (*e.g.*, within one bond issuance, versus across two bond issuances with different characteristics) and the less "reasonable" or "justified" the separate classifications appear, the more likely it is that a court will consider the classification problematic.

A Sample Reorganization Plan

A plan where one option is objectively less favorable than another might lead all claimants to select the more favorable option. This result can be avoided by (1) giving higher estimated recoveries to riskier options, and (2) capping the amount of claims that can elect each option. For example, imagine a reorganization plan that could permit bondholders to allocate the treatment of their claims among the following options:

1. A bondholder may elect to receive cash in exchange for its claims. For every dollar of old bonds, the bondholder will receive 60 cents in cash on the emergence date, which is subject to a cap. If claimants elect this treatment holding claims in excess of the cap, then the claimants will receive cash *pro rata* up to the cap, and receive option number three for the remainder of their claims. The cap is important because it protects the debtor from a scenario where most claimants elect to receive cash, depleting the reorganized debtor's cash reserves.
2. A bondholder may elect to receive new bonds in exchange for her claims. For every dollar of old bonds, the bondholder will receive 65 cents in face value of new bonds. The new bonds will have a longer maturity, and a different interest rate, than the old bonds. This option is also subject to a cap, so as to protect the debtor from most claimants electing to receive new bonds, straining the balance sheet of the reorganized debtor with debt.
3. A bondholder may elect to receive stock in the reorganized debtor. For every dollar of old bonds that elects this option, the bondholder will receive a *pro rata* share in the reorganized debtor. The estimated recovery would be 70 percent, assuming that bondholders elected options number one and two up to the cap.[3]

Lisa Laukitis is a partner, and Edward Mahaney-Walter and Daniel Kennedy are associates, in the Corporate Restructuring Practice of Skadden, Arps, Slate, Meagher & Flom LLP in New York.

The benefit of such a plan is that it provides optionality to claimants. First, some claimants are able and inclined to receive equity, due to their flexible investment mandates and risk tolerances, and can elect accordingly. Second, some claimants are risk-averse or cannot hold equity securities, and can elect to receive the less-speculative options: cash or new bonds.

Because the plan is structured with the equity having the highest expected recovery in the long term, claimants are encouraged to select the third option, resulting in a more deleveraged company. However, it might still be valuable from the perspective of some claimants to have the flexibility to receive something other than new equity, even if the alternatives have lower expected recoveries in the long term.

Also, different investors will make their own assumptions and projections about the future operations and finances of the reorganized debtor, and will form different estimates of the future expected recoveries from the securities being offered. For example, those valuing the reorganized debtor the most would be more likely to elect to receive equity.

Equality of Treatment

Is such a plan permissible? The answer is "yes." Courts interpret "equality of treatment" under § 1123(a)(4) as meaning "equality of opportunity," not "equality of result." This is a standard that focuses on procedural equality rather than outcome-based equality. Claimants do not all have to elect the same treatment. Rather, the plan proponent has to give them all the same options for treatment.

The classic example of this "procedural equality" has arisen in asbestos and other mass tort bankruptcies. In such cases, a claimant could be offered either settlement — immediate payout on a claim at a discount to face value — or an alternative such as preserving its claims for future litigation. In other words, the plan can contain "optionality," where the claimant can either grant a release and receive an immediate recovery, or not grant a release and not receive an immediate recovery.

For example, in *In re Dow Corning Corp.*, the court held that claimants could either accept a lower settlement or hold out for a potentially higher recovery from litigation.[4] Similarly, in *In re W.R. Grace & Co.*, the question arose as to whether the plan's personal-injury trust's distribution procedures could result in disparate treatment within a class. The court concluded that what mattered was not recovery amounts, but "equal opportunity to recover on their claims."[5]

A similar situation arose in *In re Washington Mutual Inc.* In this case, the court held that a claimant could agree to provide a release in exchange for a distribution — that is, to settle rather than to litigate. What was required was that "each claimant within a class have the same opportunity to receive equal treatment."[6]

In re Central Medical Center Inc. presents a particularly interesting case where a court viewed a reorganization plan from the perspective of procedural equality and did not find discriminatory inequality of outcomes. The plan contemplated a "lottery" under which, going forward, a portion of

---

3 The exact value of the new equity would depend on the amounts of cash and new bonds distributed, if below the cap. A disclosure statement could concisely describe the enterprise valuation assumptions used to calculate a range of recoveries based on the reorganized debtor's cash and debt levels.

4 255 B.R. 445, 497-98 (E.D. Mich. 2000), *aff'd in part and remanded in part on other grounds*, 280 F.3d 648 (6th Cir. 2002).

5 729 F.3d 311, 326-27 (3d Cir. 2013). In the *W.R. Grace* case, the court below had interpreted § 1123(a)(4) more strictly. 475 B.R. 34, 120-21 (D. Del. 2012), *aff'd*, 729 F.3d 311 (holding that equal treatment means that all class members must (1) be subject to the same process, (2) receive the same percentage and (3) give up the same consideration). But, as the quote cited at the beginning of this footnote indicates, the Third Circuit did not follow it in that regard. *Accord Ad Hoc Committee of Personal Injury Asbestos Claimants v. Dana Corp. (In re Dana Corp.)*, 412 B.R. 53, 61-62 (S.D.N.Y. 2008); *King v. Dalkon Shield Claimants Trust (In re A.H. Robins Co.)*, 219 B.R. 161, 175-76 (E.D. Va. 1998); *see also In re Joint E. & S. Dist. Asbestos Litig.*, 982 F.2d 721, 749 (2d Cir. 1992), *as modified*, 993 F.2d 7 (2d Cir. 1993) ("Whether the Settlement permissibly classifies according to seriousness of injury or impermissibly denies health claimant creditors the 'same treatment' need not be resolved.").

6 442 B.R. 314, 355-56 (Bankr. D. Del. 2011).

bonds would be selected randomly for redemption annually. As interest rates on the bonds rose over time, this plan resulted in not only different cash flows but different interest rates.[7]

Claims vs. Claimants and Rights Offerings

One particular way that disputes arise over whether a plan provides for "equal treatment of claims" is when the reorganizing debtor has secured new money financing (*e.g.*, via a rights offering or backstop agreement). If some (but not all) bondholders participate and receive value on account of that participation, other bondholders may object pursuant to § 1123(a)(4). In that situation, courts generally will overrule the objection, explaining that § 1123(a)(4) requires "equal treatment of claims," not "equal treatment of claimants." In other words, the additional value is not a recovery on pre-petition bonds, but consideration for the new investment.[8]

Conclusion

As a general principle, as courts evaluate plan confirmations, they consider "equality of distribution among creditors" to be a central policy of the Bankruptcy Code, and they consider "the bankruptcy scheme as an integrated whole."[9] However, when evaluating plan constructs that provide optionality to creditors, courts focus not on equality of outcome, but on "equal opportunity to recover on their claims."[10]

This result should not be surprising. While certain Code provisions are intended to further the fundamental policy of equality among creditors,[11] when there is good reason, bankruptcy courts will allow payments to critical vendors and other parties pursuant to "first-day orders" and the doctrine of necessity, or will allow pre-petition debt to be rolled up into a debtor-in-possession financing arrangement. Moreover, courts follow both the letter and the spirit of the law by reading § 1123(a)(4) to permit differences in results among creditors, so long as creditors are given "equal treatment" in the form of a homogeneous menu of options from which to choose.

The fundamental economic fact is that different investors have different risk tolerances, and willingness to hold different types of securities, and expectations about future performance govern the capital markets, including the post-emergence trading in the securities of a reorganized debtor. Practitioners should follow § 1123(a)(4) by being creative and flexible in the plan process, by giving investors what they want, and by optimizing the capital structure of the reorganized debtor. Plans with optionality work well, are within the letter and spirit of the Bankruptcy Code, and should be used more often. **abi**

Reprinted with permission from the ABI Journal, Vol. XL, No. 1, January 2021.

The American Bankruptcy Institute is a multi-disciplinary, nonpartisan organization devoted to bankruptcy issues. ABI has more than 12,000 members, representing all facets of the insolvency field. For more information, visit abi.org.

---

7 122 B.R. 568, 574-75 (Bankr. E.D. Mo. 1990).

8 *See, e.g., In re Peabody Energy Corp.*, 933 F.3d 918, 924-28 (8th Cir. 2019) (finding that right to participate in private placement was not "treatment for" participating creditors' claims, but rather consideration for commitments to support plan and backstop financing); *In re TCI 2 Holdings LLC*, 428 B.R. 117, 133 (Bankr. D.N.J. 2010) (no disparate treatment just because only certain noteholders were permitted to participate in backstop of rights offering); *In re CHC Grp. Ltd.*, Case No. 16-31854 (BJH), ECF No. 1794 at 20-25 (Bankr. N.D. Tex. March 3, 2017) (finding that backstop agreement was not problematic, finding that "premium" to be received by certain noteholders was not distribution on pre-petition debt, and finding no discrimination under § 1123(a)(4)). *See also In re Breitburn Energy Partners LP*, 582 B.R. 321, 357-58 (Bankr. S.D.N.Y. 2018) (Bernstein, C.J.) (finding equality of opportunity and therefore equality of treatment, where all members of class had opportunity to subscribe to rights offering, but not all class members in fact subscribed). In *Breitburn Energy*, Hon. **Stuart M. Bernstein** distinguished his earlier opinion in *Quigley. See In re Quigley Co.*, 377 B.R. 110, 116-19 (Bankr. S.D.N.Y. 2007) (Bernstein, C.J.) ("Equality of treatment has two aspects. Absent consent to accept less favorable treatment, all members of the class must receive equal value. In addition, each member of the class must pay the same consideration for its distribution."). In *Pacific Drilling*, the court approved a backstop, but explained that "financing terms ... must be reasonable, and they cannot just be a disguised means of giving bigger creditors a preferential recovery." *In re Pacific Drilling S.A.*, Case No. 17-13193 (MEW), ECF No. 631 at 5 (Bankr. S.D.N.Y. Oct. 1, 2018) ("The Bankruptcy Code does not permit the unequal treatment of creditors in the same class."). *See also, generally*, 7 *Collier on Bankruptcy* ¶ 1123.01[4][b] & nn.21-22 (citing *In re Heron, Burchette, Ruckert & Rothwell*, 148 B.R. 660, 672 (Bankr. D.D.C. 1992) (distinguishing between treatment of claims regarding plan recoveries, and treatment of claimants or potential claimants regarding releases and injunction)); *In re Acequia Inc.*, 787 F.2d 1352, 1362-63 (9th Cir. 1986) (rejected contention that having one old shareholder participate in go-forward management and another shareholder not participate violated § 1123(a)(4), reasoning that positions as directors and officers of debtor are separate from positions as equity security-holders); *Ahuja v. LightSquared Inc.*, 644 Fed. App'x 24, 29-30 (2d Cir. 2016). *But see In re Adelphia Commc'ns Corp.*, 361 B.R. 337, 362-64 (S.D.N.Y. 2007) (semantic distinction between claim and claimant should not apply).

9 *In re Combustion Eng'g Inc.*, 391 F.3d 190, 239, 241 (3d Cir. 2004).

10 *In re W.R. Grace & Co.*, 729 F.3d 311, 326-27 (3d Cir. 2013).

11 *See, e.g.*, 11 U.S.C. §§ 547 (preferences) and 548 (fraudulent transfers), and other provisions in chapter 5 regarding avoidance actions.