" 'Motorola': Absolute Priority Rule, FRBP 9019 Settlements"

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In the recent case of *Motorola, Inc. v. Official Committee of Unsecured Creditors*, the U.S. Court of Appeals for the Second Circuit addressed and sought to clarify a bankruptcy court's duties when exercising its discretion pursuant to Rule 9019 of the Federal Rules of Bankruptcy Procedure (FRBP) (Rule 9019) to approve a settlement that binds all creditors, shareholders and other parties in interest.[1]

Standard of 'TMT Trailer Ferry'

Although Rule 9019 does not enumerate any particular standards a court must follow in approving the propriety of a settlement, courts routinely borrow, with minor variation, the standard articulated by the Supreme Court in *TMT Trailer Ferry*,[2] wherein the Court held that an "informed and independent judgment as to whether a proposed compromise is fair and equitable" requires that:

the bankruptcy judge has apprised himself of all facts necessary for an intelligent and objective opinion of the probabilities of ultimate success should the compromised claim be litigated. Further, the judge should form an educated estimate of the complexity, expense, and likely duration of such litigation, the possible difficulties of collecting on any judgment which might be obtained, and all other factors relevant to a full and fair assessment of the wisdom of the proposed compromise. Basic to this process in every instance, of course, is the need to compare the terms of the compromise with the likely rewards of litigation.[3]

Debtors have used the power and authority of Rule 9019 in numerous ways including the settlement of adversary proceedings, claim objections and disputes concerning the priority and classifications of claims.[4] In a number of prominent bankruptcy cases, Rule 9019 settlements were used to form the basis of a plan prior to the plan confirmation process.[5] For the most part, objections to settlements that bind creditors to a type of classification, claim or plan have been largely unsuccessful.

Most notably, in *Drexel, Adelphia* and *WorldCom*, the bankruptcy court in each case approved settlements over objecting creditors' concerns that the proposed settlements were in effect a sub rosa plan meant to bind parties in interest to a type of plan, classification scheme or claim. [6] For example, in *Adelphia*, the debtors moved the court for an order approving three related agreements which taken together formed a four-way settlement between the debtors and the U.S. Department of Justice, the Securities and Exchange Commission and members of John Rigas' (Adelphia's founder) family. The Creditors' Committee, the Ad Hoc Committee of Senior Preferred Shareholders and others argued, among other things, that the settlement violated the absolute priority rule. In *Adelphia* (as in *Drexel*) the estate's assets were effectively partitioned in the settlement between the estate and government's claims asserted on behalf of injured investors.

In *Adelphia*, the objecting parties argued that §510(b) of the Bankruptcy Code would result in the subordination of investor-SEC claims to creditors' claims on the theory that a shareholder who shares in profits and losses should not attain a higher priority status vis-à-vis creditors who were seeking return of principal plus interest.[7] Both the Bankruptcy Court and the District Court denied the objections to the settlement, noting that since the government had the right to indict Adelphia, thus putting Adelphia effectively out of business, it was in the best interest of the estate and its creditors to approve the settlement despite any technical violations of the absolute priority rule.[8]

On appeal, the Second Circuit did not address the absolute priority rule, instead, surprisingly, finding that the case was moot following the implementation of the settlement by the parties.[9] Accordingly, violations of the priority and classification schemes of the Bankruptcy Code did not appear to be a fundamental consideration in the court's Rule 9019 approval standard.

The 'Motorola' Case

Recently, however, the Second Circuit seems to have had second thoughts on whether to include adherence to the absolute priority rule as a prong of the Rule 9019 settlement standard. In the bankruptcy case of *Iridium Operating LLC*, Motorola Inc. claimed that its potential administrative claim against the debtor was effectively subordinated to claims of unsecured creditors in contravention of the absolute priority rule of the Bankruptcy Code and therefore should not be approved.[10]

The Official Committee of Unsecured Creditors ("Committee") in *Iridium* challenged the validity of liens asserted by certain lenders (Lenders) purporting to include all of Iridium's property including its cash and various causes of action. The *Iridium* court had authorized the committee to commence an adversary proceeding against the lenders on behalf of Iridium's estate. The committee was also authorized by the court to pursue causes of action including breach of contract, breach of fiduciary duty, as well as avoidance actions against Motorola, Iridium's former corporate parent.

However, due to insufficient resources to fight these two wars simultaneously, the committee negotiated a settlement with the lenders whereby the lenders' liens were recognized as valid and the estate's cash was divided between the lenders and the estate, with a portion of the estate's cash being directed to a litigation fund (fund) which was created to pursue litigation against Motorola. The fund was nearly entirely for the benefit of Iridium's unsecured creditors and any recoveries from the litigation against Motorola would be distributed, in part to the lenders, with the bulk going to the estate to be distributed pursuant to a future plan.[11] The bankruptcy court approved the settlement over Motorola's objection and the district court affirmed.

On appeal to the Second Circuit, Motorola did not attack the settlement on the grounds that it did not satisfy the factors set forth in *TMT Trailer Ferry* and its progeny, but that a settlement cannot be fair and equitable where, as here, there is the potential for the claims of junior creditors to be satisfied before more senior claimants.[12]

Citing precedent from the U.S. Court of Appeals for the Fifth Circuit in *United States v. AWECO, Inc.*,[13] the Second Circuit held that "whether a settlement's distribution plan complies with the Bankruptcy Code's priority scheme will often be the dispositive factor [in approving the settlement]."[14]

The Second Circuit did not, however, hold that a pre-plan settlement must always follow the absolute priority rule, noting that such a per se rule, as employed by the Fifth Circuit in *AWECO*, does not "accommodate the dynamic status of some pre-plan bankruptcy settlements."[15]

Flexibility Called Necessary

The Second Circuit pointed to the uncertainties that existed in *Iridium* as a prime example as to why flexibility in this rule is necessary: Motorola's administrative claim was not yet established, litigation costs and remaining balance in the fund were "at best estimates" and claims against Motorola would not likely be resolved for years.[16]

In that uncertain environment, requiring a pre-plan settlement to strictly adhere to the absolute priority rule may be impossible and unnecessarily preclude a settlement that may truly be in the best interests of the estate.

Instead, "where the remaining [Rule 9019] factors weigh heavily in favor of approving a settlement, the bankruptcy court, *in its discretion*, could endorse a settlement that does not comply in some minor respects with the priority rule *if the parties to the settlement justify, and the reviewing court clearly articulates the reasons for approving, a settlement that deviates from the priority rule.*"[17] Because the record below did not contain an articulation of the reasons to violate the absolute priority rule, the Second Circuit remanded the matter for further findings.

Conclusion

It is not clear that the Second Circuit's directive that settlement proponents must justify, and courts must articulate a reason for, deviating from the priority scheme is a new standard or that it will ultimately have had any impact on the *Iridium* case, or would have had an impact on prior decisions for that matter. In *Adelphia*, for example, the bankruptcy court's reasoning that, despite its technical violation of the absolute priority scheme, failure to approve the settlement would sink the company and its creditors may be that carefully articulated reason that the Second Circuit was looking for in *Motorola.*

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Endnotes:

1. See *Motorola, Inc. v. Official Cmte. of Unsecured Creditors (In re Iridium Operating LLC),* 478 F3d 452 (2d Cir. 2007).

2. *Protective Comm. for Indep. Stockholders of TMT Trailer Ferry, Inc. v. Anderson*, 390 US 414 (1968).

3. Id. at 424-25.

4. See, e.g., *Prin Corp. v. Altman (In re Altman),* 265 B.R. 652 (Bankr. D. Conn. 2001); *In re Bennett Funding Group, Inc.,* 1999 Bankr. LEXIS 1860 (Bankr. N.D.N.Y. April 9, 1999).

5. See, e.g., *In re Adelphia Communications Corp*., 327 B.R. 175 (Bankr. S.D.N.Y. 2005), affirmed by *Ad Hoc Adelphia Trade Claims Committee v. Adelphia Communications Corp*., 337 B.R. 475 (S.D.N.Y. 2006); *In re WorldCom Inc*., Case No. 02-13533 Docket #8125 (Bankr. S.D.N.Y. Aug. 6, 2003); see also *In re Drexel Burnham Lambert Group, Inc*., 995 F.2d 1138 (2d Cir. 1993); *Lambert Brussels Assocs. Ltd. Partnership v. The Drexel Burnham Lambert Group, Inc. (In re Drexel Burnham Lambert Group, Inc.),* 140 B.R. 347 (S.D.N.Y. 1992); *In re Drexel Burnham Lambert Group, Inc.,* 138 B.R. 723 (Bankr. S.D.N.Y. 1992).

6. See, e.g., *Pension Benefit Guaranty Corp. v. Braniff Airways, Inc.* (*In re Braniff Airways, Inc.*)*,* 700 F.2d 935 (5th Cir. 1983).

7. See 11 USCA §510(b) (West 2007); *Adelphia,* 327 B.R. at 168; see also *In re Enron Corp.,* 341 B.R. 141 (Bankr. S.D.N.Y. 2006); John J. Slain and Homer Kripke, "The Interface Between Securities Regulation and Bankruptcy - Allocating the Risk of Illegal Securities Issuance Between Securityholders and the Issuer's Creditors," 48 N.Y.U.L. Rev. 261 (1973); see also H.R. Rep. No. 95-595, at 194-96 (1977) (noting Congress' adoption of the *Slain/Kripke* position and the rejection of that espoused by the SEC).

8. *Adelphia*, 327 B.R. at 168-70 (discussing these objections and noting as part of the court's reasoning that the equity holders and defrauded noteholders would be sharing in a fund created and owned by the government, and not assets of the estate under a plan).

9. *Ad Hoc Adelphia Trade Claims Cmte v. Adelphia Comm. Corp.,* 2006 WL3826700 (2d Cir. Dec. 26, 2006).

10. *Motorola, Inc. v. Official Committee of Unsecured Creditors (In re Iridium Operating LLC),* 478 F3d 452 (2d Cir. 2007).

11. *Motorola*, 478 F3d at 459

12. Id. at 462.

13. *United States v. AWECO, Inc. (In re AWECO, Inc.),* 725 F2d 293 (5th Cir. 1984); see also *Motorola*, 478 F3d at 464 (interpreting *AWECO* as requiring strict compliance with absolute priority rule in 9019 settlements in the U.S. Court of Appeals for the Fifth Circuit).

14. *Motorola,* 478 F3d at 464.

15. Id.

16. Id.

17. Id. at 464-65 (emphasis added).