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The Second Circuit's *Iridium* Decision: When It Comes To Preplan Settlements, "Absolute Priority" Is A Priority,  
But Not Always Absolute

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The United States Court of Appeals for the Second Circuit recently issued its opinion in **Motorola, Inc. v. Official Committee of Unsecured Creditors and JP Morgan Chase Bank, N.A. (In re Iridium Operating LLC)**. [FN1] The court "determine[d] whether a long-standing creditor protection--the Bankruptcy Code's priority scheme for reorganization plan distributions--applies to bankruptcy court approval of a settlement under [Bankruptcy] Rule 9019" [FN2] when approval is sought before a plan has been proposed. The court crafted a somewhat murky rule: "We hold that in the Chapter 11 context, whether a pre-plan settlement's distribution plan complies with the Bankruptcy Code's priority scheme will be the most important factor for a bankruptcy court to consider in approving a settlement under [Bankruptcy Rule 9019](#). In most cases it will be dispositive." [FN3]

The Second Circuit's approach accounts for the reality that sometimes the priority of a claim will not have been established when a preplan settlement is being considered by the bankruptcy court--indeed, the settlement itself may obviate the need to resolve difficult issues of claim validity and priority. However, the Second Circuit in **Iridium** gives little guidance for determining when it would be appropriate for a bankruptcy court "in its discretion," to approve a settlement that "does not comply in some minor respects with the priority rule[.]" [FN4] In that regard, the court explained that whether a proposed preplan settlement complies with the Bankruptcy Code's priority scheme will often be the "dispositive factor" when determining whether to approve a settlement, leaving open the possibility that when other factors for evaluating a settlement [FN5] "weigh heavily in favor of approving the 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 reason for approving a settlement that deviates from the priority rule." [FN6] What might justify deviation from the Code's priority scheme is unclear from the decision.

**The Settlement.** The settlement at issue in **Iridium** involved the proposed resolution of the bank lenders' (the "Lenders") asserted liens on substantially all of the debtors' assets and the claims of the estate [FN7] against the Lenders. In particular, the committee objected to the Lenders' claim to Iridium's remaining cash--roughly \$150 million. [FN8] The estate would have been "guttled," i.e., administratively insolvent, if the Lenders successfully asserted their liens. [FN9]

The committee also sought and received bankruptcy court authorization to pursue claims on behalf of the Estate against Iridium's former parent company, Motorola, for breach of contract, breach of fiduciary duty, and fraudulent conveyance. [FN10] In its action against Motorola, the committee alleged that when Motorola was Iridium's parent,

“Motorola caused Iridium to execute a series of one-sided, overreaching contracts extremely lucrative to Motorola and grossly unfair to Iridium from a financial, legal and risk allocation prospective.” [\[FN11\]](#) The committee, on behalf of the Estate, sought “billions of dollars in damages.” [\[FN12\]](#)

The estate's limited resources, however, curtailed the committee's ability to pursue the estate's claims against Motorola and the Lenders. The committee thus decided to pursue the claims against Motorola and seek a settlement with the Lenders. After approximately six months of negotiation, the committee and Lenders reached a settlement that was approved by the United States Bankruptcy Court for the Southern District of New York over the objection of Motorola, which asserted an administrative claim against the estate. [\[FN13\]](#) The district court affirmed the order of the bankruptcy court approving the settlement. [\[FN14\]](#)

The settlement was lengthy and complex, but the relevant provisions are as follows: First, upon approval of the settlement, the Lenders' liens became senior, perfected, and unavoidable and not subject to any offset or defenses, but the “liens do not enjoy those concessions... until court approval of the settlement.” [\[FN15\]](#) Second, the settlement divided the estate's remaining cash into three funds: Fund Number One split \$130 million between the Lenders and a newly created Iridium Litigation LLC (the “ILLLC”) with the Lenders receiving \$92.5 million and the ILLLC receiving \$37.5 million; Fund Number Two received \$5 million to be used for various professional fees; and Fund Number Three contained income from accounts receivable to be divided 55% to the ILLLC and the remainder to the Lenders. [\[FN16\]](#)

The ILLLC was created as a funding vehicle for the estate's litigation against Motorola. In the event of a recovery against Motorola, 37.5% of the proceeds (net professional fees and expenses) would be distributed to the Lenders, and the remaining 62.5% would go to the estate to be distributed pursuant to a future Chapter 11 plan in accordance with Bankruptcy Code priorities. [\[FN17\]](#) Any of the initial \$37.5 remaining in the ILLLC from Cash Fund Number One was to be paid directly to the ILLLC and from there to general unsecured creditors. [\[FN18\]](#)

*The Second Circuit's Discussion of “Fair and Equitable” in the Context of [Bankruptcy Rule 9019](#).* [\[FN19\]](#) After noting that [Rule 9019](#) is unique because it does not carry out or supplement a section of the Bankruptcy Code, the court explained that standards have been developed to aid courts in determining if a settlement is “fair and equitable.” [\[FN20\]](#) courts in the Second Circuit apply the following factors derived from the Supreme Court's decision in **Protective Committee for Independent Stockholders of TMT Trailer Ferry, Inc. v. Anderson**: [\[FN21\]](#)

- (1) the balance between the litigation's possibility of success and the settlement's future benefits;
- (2) the likelihood of complex and protracted litigation, “with its attendant expense, inconvenience, and delay,” including the difficulty collecting the judgment;
- (3) “the paramount interests of the creditors,” including each affected class's relative benefits “and the degree to which creditors either do not object to or affirmatively support the proposed settlement;”
- (4) whether other parties in interest support the settlement;
- (5) the “competency and experience of counsel” supporting, and “[t]he experience and knowledge of the bankruptcy court judge” reviewing, the settlement;
- (6) “the nature and breadth of releases to be obtained by officers and directors;” and,
- (7) “the extent to which the settlement is the product of arm's length bargaining.”

The requirement that a settlement be “fair and equitable” in the sense of complying with the absolute priority rule is additional *to* these factors. [\[FN22\]](#) In this connection, the Second Circuit explained in a footnote:

Courts often state that the purpose of review under the [Rule 9019](#) factors is to determine whether a settlement is “fair and equitable,” deriving this terminology, along with the factors themselves, from *TMT Trailer Ferry*. In *TMT Trailer Ferry*, however, “fair and equitable” encompassed conformity with the absolute priority rule. See *TMT Trailer Ferry*, 390 U.S. at 441, 88 S.Ct. 1157 (“[A] bankruptcy court is not to approve or confirm a plan of reorganization unless it is found to be ‘fair and equitable.’ This standard incorporates the absolute priority doctrine....”).

The “fair and equitable” analysis using the [Rule 9019](#) factors, however, does not assess whether a plan conforms to the absolute priority rule. This overlap in terminology obscures the question at issue here: whether a pre-plan settlement that is “fair and equitable” under the [Rule 9019](#) factors must also conform to the absolute priority rule. [\[FN23\]](#)

Motorola argued that the **Iridium** settlement should not have been approved because it provided for the transfer of money from the estate to the ILLLC and from the ILLLC to unsecured creditors prior to payment of its administrative claim, and accordingly was not “fair and equitable” in the sense that it violated the absolute priority rule.

The Second Circuit considered **United States v. AWECO, Inc. (In re AWECO, Inc.)**, in which the Fifth Circuit established a bright line rule that settlements must comply with the absolute priority rule. [\[FN24\]](#) The Second Circuit quotes the Fifth Circuit **AWECO** opinion with seeming approval:


As soon as a debtor files a petition for relief, fair and equitable settlement of \creditors' claims becomes a goal of the proceedings. The goal does not suddenly appear during the process of approving a plan of compromise. Moreover, if the standard had *no* application before confirmation of a reorganization plan, then bankruptcy courts would have the discretion to favor junior classes of creditors so long as the approval of the settlement came before the plan. Regardless of when the compromise is approved, looking only to the fairness of the settlement as between the debtor and the settling claimant contravenes a basic notion of fairness. An estate might be wholly depleted in settlement of junior claims-depriving senior creditors of full payment-and still be fair as between the debtor and the settling creditor. [\[FN25\]](#)

Nevertheless, the **Iridium** court rejected the Fifth Circuit's per se absolute priority rule for preplan settlements, explaining that:

[I]t is difficult to employ the rule of priorities in the approval of a settlement in a case such as this when the nature and extent of the Estate and the claims against it are not yet fully resolved. In our view, a rigid *per se* rule cannot accommodate the dynamic status of some pre-plan bankruptcy settlements. [\[FN26\]](#)

Thus, the Second Circuit concluded that compliance with the Bankruptcy Code's priority scheme “will often be the dispositive factor,” but a settlement that does not comply with the absolute priority rule “in some minor respect” could still be approved if other factors “weigh heavily” in favor of the settlement. [\[FN27\]](#) Beyond noting that the bankruptcy court “must be certain” that the parties “have not employed a settlement as a means to avoid the priority strictures of the Bankruptcy Code,” and that the deviation from the absolute priority rule would have to be “justified,” [\[FN28\]](#) the **Iridium** court ultimately gives scant, if any, guidance as to what in fact could justify such a departure.

The practical effect of the **Iridium** decision will depend on how it is applied by the bankruptcy courts, which should be guided by the Second Circuit's cautionary analysis and by the words of the Supreme Court in **TMT Trailer Ferry**: “One can easily sympathize with the desire of a court to terminate bankruptcy reorganization proceedings, for they are frequently protracted. *The need for expedition, however, is not a justification for abandoning proper standards.*” [\[FN29\]](#) Only in exceptional circumstances should courts approve preplan settlements that violate the absolute priority rule in some minor respect.

West's Key Number Digest, [Bankruptcy](#)  [3561](#)

[\[FN1\]. In re Iridium Operating LLC, 478 F.3d 452 \(2d Cir. 2007\).](#)

[\[FN2\]. In re Iridium Operating LLC, 478 F.3d at 455.](#)

[\[FN3\]. In re Iridium Operating LLC, 478 F.3d at 455.](#)

[\[FN4\]. In re Iridium Operating LLC, 478 F.3d at 465.](#)

[\[FN5\]](#). Such as:

- (1) the balance between the litigation's possibility of success and the settlement's future benefits;
- (2) the likelihood of complex and protracted litigation, “with its attendant expense, inconvenience, and delay,” including the difficulty in collecting on the judgment;
- (3) “the paramount interests of the creditors,” including each affected class's relative benefits “and the degree to which creditors either do not object to or affirmatively support the proposed settlement”;
- (4) whether other parties in interest support the settlement;
- (5) the “competency and experience of counsel” supporting, and “[t]he experience and knowledge of the bankruptcy court judge” reviewing, the settlement;
- (6) “the nature and breadth of releases to be obtained by officers and directors”; and
- (7) “the extent to which the settlement is the product of arm's length bargaining.”

[In re WorldCom, Inc.](#), 347 B.R. 123, 137 (Bankr.S.D.N.Y.2006). See also [Protective Committee for Independent Stockholders of TMT Trailer Ferry, Inc. v. Anderson](#), 390 U.S. 414, 88 S. Ct. 1157, 20 L. Ed. 2d 1 (1968) (“TMT Trailer Ferry”).

[\[FN6\]](#). [In re Iridium Operating LLC](#), 478 F.3d at 465.

[\[FN7\]](#). The creditors' committee was authorized to “commence adversarial proceedings *on behalf of the Estate* against the Lenders as to the debt ‘and any lien, pledge or security interest of Chase and/or the Lenders.’” [In re Iridium Operating LLC](#), 478 F.3d at 458 (italics in original).

[\[FN8\]](#). [In re Iridium Operating LLC](#), 478 F.3d at 457-58.

[\[FN9\]](#). [In re Iridium Operating LLC](#), 478 F.3d at 457-58.

[\[FN10\]](#). [In re Iridium Operating LLC](#), 478 F.3d at 458.

[\[FN11\]](#). [In re Iridium Operating LLC](#), 478 F.3d at 458.

[\[FN12\]](#). [In re Iridium Operating LLC](#), 478 F.3d at 458.

[\[FN13\]](#). [In re Iridium Operating LLC](#), 478 F.3d at 458-59.

[\[FN14\]](#). [In re Iridium Operating LLC](#), 478 F.3d at 460.

[\[FN15\]](#). [In re Iridium Operating LLC](#), 478 F.3d at 459.

[\[FN16\]](#). [In re Iridium Operating LLC](#), 478 F.3d at 459-60.

[\[FN17\]](#). [In re Iridium Operating LLC](#), 478 F.3d at 459-60.

[\[FN18\]](#). [In re Iridium Operating LLC](#), 478 F.3d at 459.

[\[FN19\]](#). The court addressed two issues in addition to the applicability of absolute priority in the context of [Rule 9019](#) settlements. First, the Second Circuit disposed of the Lenders' (and committee's) contention that the because of the Lenders' liens, the approximately \$130 million in Cash Fund Number One is the Lenders' property, and they can do with it what they see fit--including giving \$37.5 million of it to the ILLLC to pursue the Estate's litigation against Motorola. [In re Iridium Operating LLC](#), 478 F.3d at 461. The Second Circuit quickly disposed of this contention,

however, and rejected the Lenders' reliance on the First Circuit's opinion in [In re SPM Mfg. Corp.](#), 984 F.2d 1305, 1307, 1312 (1st Cir. 1993). In *SPM*, a Chapter 7 case, the First Circuit approved a settlement where an undersecured creditor with conclusively established and uncontested first priority liens on all of the debtor's assets "shared" some of the proceeds to which it was otherwise entitled with junior, unsecured creditors, though a priority creditor would not receive any distribution. [In re Iridium Operating LLC](#), 478 F.3d at 460-61. The Second Circuit was asked to extend *SPM* to a Chapter 11 case for the first time, but because the Iridium Lenders' liens (unlike the secured creditor's lien in *SPM*) became perfected and validated *only on approval of the settlement*, the Second Circuit did not decide whether *SPM* "could ever apply to Chapter 11 settlements." [In re Iridium Operating LLC](#), 478 F.3d at 461.

The Second Circuit also rejected Motorola's contention that the Settlement was an impermissible sub rosa plan. [In re Iridium Operating LLC](#), 478 F.3d at 466-67.

[FN20]. [TMT Trailer Ferry](#), 390 U.S. at 414, 88 S. Ct. at 1157.

[FN21]. [In re WorldCom, Inc.](#), 347 B.R. 123, 137 (Bankr.S.D.N.Y.2006); [TMT Trailer Ferry](#), 390 U.S. 414, 88 S. Ct. 1157, 20 L. Ed. 2d 1 (1968).

[FN22]. See [TMT Trailer Ferry](#), 390 U.S. at 424, 88 S. Ct. 1157 ("The requirements... that plans of reorganization be both 'fair and equitable,' apply to compromises just as to other aspects of reorganizations.").

[FN23]. [In re Iridium Operating LLC](#), 478 F.3d at 463 n.18.

[FN24]. [United States v. AWECO, Inc. \(In re AWECO, Inc.\)](#), 725 F.2d 293, 298 (5th Cir. 1984) ("a bankruptcy court abuses its discretion in approving a [pre-plan] settlement with a junior creditor unless the court concludes that priority of payment will be respected as to objecting senior creditors.").

[FN25]. [In re Iridium Operating LLC](#), 478 F.3d at 464 (quoting [AWECO](#), 725 F. 2d at 298).

[FN26]. [In re Iridium Operating LLC](#), 478 F.3d at 464.

[FN27]. [In re Iridium Operating LLC](#), 478 F.3d at 464.

[FN28]. [In re Iridium Operating LLC](#), 478 F.3d at 464-65.

[FN29]. [TMT Trailer Ferry](#), 390 U.S. at 429, 88 S. Ct. 1157 (emphasis added).

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