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Absolute Priority Rule Absolutism? How Strict Interpretation of the Bankruptcy Code's Cramdown Provisions Nearly Caused Hawker Beechcraft's Plan Confirmation to Skid Along the Runway

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By nearly any measure, the chapter 11 cases of Hawker Beechcraft and its affiliates (the debtors) were a significant success. The cases began as a standalone reorganization predicated upon a restructuring support agreement (RSA) among the debtors' senior lenders and noteholders, which soon thereafter gained the support of the official creditors' committee. The cases then switched over to a sale process, and when that bogged down the debtors, the lenders and the committee seamlessly restarted the standalone reorganization based on the RSA.

The debtors' plan of reorganization provided for the cancellation of all existing equity of the corporate parent, Hawker Beechcraft, Inc. ("HB Parent"), and the issuance of equity in a new holding company to creditors, with 89 percent going to the senior lenders and the remaining 11 percent going to noteholders and other unsecured creditors. The plan contemplated that the Hawker Beechcraft corporate structure would otherwise remain the same, leaving existing intercompany interests unimpaired.[1]

The debtors went into the plan confirmation hearing with almost no major objections and without any substantial litigation having taken place along the way, a remarkable achievement for chapter 11 cases of the debtors' size and complexity. It therefore surprised nearly everyone in the courtroom when Judge Stuart Bernstein of the U.S. Bankruptcy Court for the Southern District of New York raised an objection of his own based on the alleged failure of one debtor to satisfy the cramdown requirements of § 1129(b) of the Bankruptcy Code.

The plan required the approval of creditors of each of the separate debtors. When the votes were tabulated, however, the unsecured creditors of one debtor, Hawker Beechcraft Corp. (HBC), had voted to reject the plan. This in and of itself did not give rise to substantial concern, as the debtors believed that they would be able to readily confirm the plan over the HBC creditors' rejection under the cramdown provisions of § 1129(b).[2] With respect to unsecured creditors who are not paid in full, "fair and equitable" requires adherence to the "absolute priority rule," which in turn means that

> the holder of any claim or interest that is junior to the claims of the [rejecting] class will not *receive or retain* under the plan *on account of* such junior claim or interest *any property*...[3]

Since all of the existing equity of HB Parent, HBC's indirect corporate parent, was being cancelled and new equity was being issued to creditors, the debtors believed that they complied fully with § 1129(b). Judge Bernstein, however, in a very strict reading of the absolute priority rule, stated that while he would confirm the plan for all of the other debtors, he could not do so for HBC because of the provisions that

left the Hawker Beechcraft corporate structure intact In other words, Judge Bernstein saw a violation of the absolute priority rule with respect to HBC's creditors because the equity of HBC itself was not being cancelled, and viewed that as an impermissible retention of "property" by the direct parent of HBC (itself a subsidiary of HB Parent) "under the plan on account of [a] junior claim or interest…."

An animated colloquy followed in which debtors' counsel contended that both the HBC equity had no value and was remaining in place solely to maintain the Hawker Beechcraft corporate structure for the benefit of the new equity holders, and that the cancellation of HB Parent's stock satisfied the dictates of § 1129(b) and the absolute priority rule. Judge Bernstein eventually agreed to allow the debtors to brief the issue and to make technical changes to the plan.

As it turned out, applicable precedent was not difficult to find. A few years earlier, in *In re Ion Media Networks Inc.*, 419 B.R. 585 (Bankr. S.D.N.Y 2009), Judge James Peck rejected a challenge to plan confirmation based on the same issue. Judge Peck expressly held that only the treatment of the equity of the ultimate corporate parent should be considered for purposes of determining whether the absolute priority rule has been satisfied:

> This technical preservation of equity is a means to preserve the corporate structure that *does not have any economic substance* and that does not enable any junior creditor or interest holder to retain or recover *any value* under the Plan. The Plan's retention of intercompany equity interests for holding company purposes constitutes a device utilized to allow the Debtors to maintain their organizational structure and avoid the unnecessary cost of having to reconstitute that structure.[4]

After reviewing the debtors' submission with its citation to *Ion Media* and the proposed changes to the plan, Judge Bernstein the following day confirmed the plan for all of the debtors, including HBC.

Judge Bernstein's initial reading of § 1129(b) can be justified as a "plain language" reading of the statute, but, as with other recent instances of "plain language" interpretations of the Bankruptcy Code, it contravenes widely accepted views regarding the purpose and intent of the absolute priority rule and the Bankruptcy Code's cramdown provisions.[5] The HBC equity left in place under the plan had no economic substance, and Judge Bernstein correctly reconsidered his position that the plan violated the absolute priority rule with respect to HBC's unsecured creditors.

[1] Kelley Drye & Warren LLP represented a major Hawker Beechcraft creditor.

[2] This section provides that a plan may be confirmed notwithstanding the rejection of one or more classes of creditors (*i.e.*, "crammed down") so long as, among other things, it is "fair and equitable."

[3] 11 U.S.C. § 1129(b)(2)(B)(ii) (emphasis added).

[4] *Id.* at 601 (emphasis added).

[5] *See, e.g.*, *Radlax Gateway Hotel LLC v. Amalgamated Bank*, 132 S. Ct. 2065 (2012) (court rejected argument based on "plain language" of § 1129(b) that a secured creditor could be denied the right to credit-bid in connection with a sale of its collateral under a plan of reorganization).

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