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Strategic Claim Purchasers Beware, Motive Counts

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Although the recent decision of the United States Court of Appeals for the Second Circuit in *In re DBSD North America, Inc.*[1] struck a major blow to "gifting" plans in chapter 11, perhaps the more notable aspect of the Court's decision is its affirmance of the Bankruptcy Court's designation of plan votes of a party who had purchased claims with the intent of acquiring control over a strategic asset of the debtors.[2] The Court's holding is significant to strategic acquirers of distressed debt and should be considered in evaluating the risks associated with any distressed debt investment.

Background

DBSD North America, Inc. ("DBSD") was founded in 2004 to develop an integrated mobile satellite and terrestrial service network to deliver wireless communications services to mass-market consumers. To that end, DBSD successfully launched a satellite and obtained certain spectrum licensing from the Federal Communications Commission. By May 2009, however, DBSD was unable to generate revenue to offset mounting debt of more than US$800 million, and thus it filed a voluntary petition for bankruptcy in the United States Bankruptcy Court for the Southern District of New York (the "Bankruptcy Court"). DBSD's debt at the time of filing consisted primarily of a US$40 million revolving credit facility that was secured by first-priority liens on substantially all of DBSD's assets, and US$740 million owed with respect to senior secured notes that were secured by second-priority liens on substantially all of DBSD's assets.

In June 2009, DBSD filed an amended plan of reorganization. The plan provided that holders of the first-lien debt would receive new obligations with a four-year maturity and the same 12.5 percent interest rate that was in place prepetition; interest, however, would be payable in kind. The plan also provided that (i) holders of the senior secured notes were to receive the bulk of the shares of the reorganized company (a recovery valued at approximately 51 percent to 73 percent of the claims); (ii) unsecured creditors would receive shares of the

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1 *In re DBSD N. Am., Inc.*, ___ F.3d ____, No. 10-1175, 2011 WL 350480 (2d Cir. Feb. 7, 2011).

2 This article does not address the Court's holding regarding "gifting" chapter 11 plans, with respect to which the Court reversed the Bankruptcy Court and concluded that the absolute priority rule under section 1129(b) of the Bankruptcy Code does not permit junior interest holders to receive any property under a plan on account of such interests if senior creditors are not paid in full, regardless of whether such property received by the junior interest holders can be deemed "gifted" by another more senior class of creditors.

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reorganized company (a recovery valued at approximately 4 percent to 46 percent of the claims); and (iii) existing equity would receive shares and warrants in the reorganized company.

Approximately two months after the petition date and two weeks after DBSD filed its plan, DISH Network Corporation ("DISH"), which has a number of its own satellites and also owns a significant stake in a direct competitor of DBSD, purchased all of DBSD's first-lien debt at face value of US$40 million. DISH's apparent motivation in purchasing the debt was to enter into a transaction with DBSD to acquire its spectrum rights.

DISH voted all of its claims to reject the plan and, separately, proposed to enter into a strategic transaction with DBSD, including a request to propose its own competing plan of reorganization. In response, DBSD filed a motion seeking to designate (and, in effect, disregard) the votes of DISH under section 1126(e) of the Bankruptcy Code.

The Bankruptcy Court granted DBSD's motion to designate DISH's plan votes, disregarded such votes and confirmed the plan over DISH's objection.[3] DISH appealed, arguing, among other things, that the Bankruptcy Court should not have designated its votes as "not in good faith" under section 1126(e) of the Bankruptcy Code. The United States District Court for the Southern District of New York affirmed the Bankruptcy Court[4] and DISH appealed further to the Second Circuit.

The Court's Decision

The Court began its analysis of the designation issue by first noting that although section 1126(e) of the Bankruptcy Code allows a court to designate the plan votes of "any entity whose acceptance or rejection of [the] plan was not in good faith,"[5] the Bankruptcy Code fails to provide any guidance regarding what constitutes a bad faith vote to accept or reject a plan. Thus, the Court continued, determining whether a party satisfies the "good faith" test under section 1126(e) of the Bankruptcy Code is a task wholly delegated to the courts.

The Court then acknowledged that, as a general principal, designation of votes on bad faith grounds under section 1126(e) of the Bankruptcy Code should be utilized sparingly as the exception, not the rule. The Court then opined that "'[t]he section was intended to apply to those who were not attempting to protect their own proper interests, but who were, instead, attempting to obtain some benefit to which they were not entitled.'"[6] Thus, the Court concluded that a bankruptcy court may properly designate the votes of a party who votes (i) "'in the hope that someone would pay them more than the ratable equivalent of their proportionate part of the bankruptcy assets,'"[7] or (ii) "with an 'ulterior motive,'… that is, with 'an interest other than an interest as a creditor.'"[8]

Discussing the concept of "ulterior motive," the Court explained that not all ulterior motives would support a finding of bad faith under section 1126(e) of the Bankruptcy Code because the formulation of such a rule might lead to the designation of all but a few votes in any given bankruptcy proceeding; "[a]fter all, most creditors have interests beyond their claim against a particular debtor, and those other interests will inevitably affect how they vote the claim."[9] In determining the appropriate relationship between "ulterior motive" and a finding of bad faith under section 1126(e) of the Bankruptcy Code, the Court looked to the apparent origin of the "good faith" rule, the 1936 case of *Texas Hotel Securities Corp. v. Waco Development Co.*,[10] and then cited several modern examples where bankruptcy courts have designated the votes based on a finding of an "ulterior motive." Specifically, *Waco* involved a party that purchased claims of the debtor to block a plan of reorganization that proposed to give a lease on the debtor's property, which the claim purchaser wanted for itself. The modern cases cited by the Court included scenarios where (i) a party acquired a blocking position in multiple creditor classes and then promoted its plan of reorganization that would have given it control over the reorganized debtor company,[11] (ii) parties affiliated with a competitor purchased claims to impede the debtor's reorganization and further their own business interests,[12] and (iii) a party affiliated with the debtor purchased claims to prevent confirmation of a rival reorganization plan.[13]

3 *See In re DBSD N. Am., Inc.*, 421 B.R. 133 (Bankr. S.D.N.Y. 2009).

4 *See In re DBSD N. Am., Inc.*, No. 09 Civ. 10156(LAK), 2010 WL 1223109 (S.D.N.Y. Mar. 24, 2010).

5 *In re DBSD N. Am., Inc.*, 2011 WL 350480, at *17 (quoting 11 USC. § 1126(e)).

6 *Id.* (quoting *In re Figter Ltd.*, 118 F.3d 635, 638 (9th Cir. 1997)).

7 *Id.* (quoting *Young v. Higbee Co.*, 324 U.S. 204, 211 (1945)).

8 *Id.* (quoting Revision of the Bankruptcy Act: Hearing on H.R. 6439 Before the House Comm. on the Judiciary, 75th Cong. 180 (1937) (statement of SEC Commissioner William O. Douglas) and *In re P-R Holding Corp.*, 147 F.2d 895, 897 (2d Cir. 1945)).

9 *Id.* at *18.

10 87 F.2d 395 (5th Cir. 1936).

11 *See In re Allegheny Int'l, Inc.*, 118 B.R. 282 (Bankr. W.D. Pa. 1990).

12 *See In re MacLeod Co.*, 63 B.R. 654 (Bankr. S.D. Ohio 1986).

13 *See In re Applegate Prop., Ltd.*, 133 B.R. 827 (Bankr. W.D. Tex. 1991).

The Court expressly declined to opine on the correctness of the decisions it cited, but found that the actions of DISH, as an indirect competitor of DBSD and part-owner of a direct competitor of DBSD, fit within the "constellation they form" and, in particular, echo the facts of "the *Waco* case that motivated Congress to impose the good faith requirement in the first place."[14] The Court determined that DISH, like the purchaser in *Waco*, "was less interested in maximizing the return on its claim than in diverting the progress of the proceedings to achieve an outside benefit."[15]

The Court concluded that the facts of the case supported the Bankruptcy Court's finding of bad faith, including DISH's own internal communication that expressed a desire to obtain a blocking position in a class of claims with the intent to enter into a strategic transaction with DBSD and the fact that DBSD purchased its claims at par. Thus, the Court held that the Bankruptcy Court had permissibly designated DISH's plan votes.

Conclusion

Although it is too soon to determine the effect the Court's decision may have on bankruptcy proceedings as a whole, it is clear that acquirers of distressed debt must consider in any transaction that their motives in purchasing the debt may be relevant in determining whether their votes on a plan will be considered, especially in the Second Circuit. Some comfort is provided, however, in the fact that the Court went out of its way to recognize that the "good faith" determination under section 1129(e) of the Bankruptcy Code is a fact-intensive inquiry, and that designation should be used sparingly as the exception, not the rule. This leaves open the possibility that bankruptcy courts may be willing to distinguish the Court's holding under any number of fact scenarios.

14 *In re DBSD N. Am., Inc.*, 2011 WL 350480, at *19.

15 *Id.*

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