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Second Circuit Upholds the Designation of Claim Purchaser's Vote on DBSD Plan

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The authors review a recent decision that, they suggest, should serve as a warning for parties looking to gain a strategic advantage over competitors in bankruptcy.

The U.S. Court of Appeals for the Second Circuit recently issued its opinion in the DBSD N.A., Inc., bankruptcy case addressing several bankruptcy issues that have received widespread reporting, including the validity of the "gifting" doctrine and the standing of an "out of the money" creditor to object to confirmation of a Chapter 11 plan. A lesser publicized issue addressed in the decision, but one that should signal a warning to claim purchasers of bankrupt companies, was the designation of a vote of DISH Network Inc. on DBSD's plan under Section 1126(e) of the Bankruptcy Code.[1]

CASE BACKGROUND

DBSD was founded in 2004 to develop a network for mobile communications based on satellite and land-based transmission. In its first

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five years, the company launched a satellite and obtained "spectrum" licenses. The company never reached critical mass, however, and remained a non-operating development company until its bankruptcy filing. DBSD issued debt in order to finance its development. Without any revenue, the company could not service its debt and filed a Chapter 11 petition with the United States Bankruptcy Court for the Southern District of New York in May 2009.

DBSD listed approximately $40 million of secured first lien debt and $650 million of secured second lien debt on its schedules. The largest general unsecured claim was asserted by Sprint Nextel Corporation, in the amount of $211 million, resulting from litigation commenced prior to the bankruptcy filing.

DBSD filed a Chapter 11 plan that proposed to provide first lien debt holder with new secured notes in an equal amount and to convert second lien debt into equity in the reorganized company. The bankruptcy court valued the new equity that the second lien debt holders would receive at between 51 percent and 73 percent of their original claims. Notwithstanding that second lien debt holders would receive less than full payment of their claims, the plan "gifted" 0.19 percent of the new equity to general unsecured creditors, and equity would receive 4.99 percent of the new shares.

Shortly after the filing of DBSD's plan, DISH Network Corporation purchased all of DBSD's first lien debt at full value, subject to an agreement by the sellers to file objections to the plan that DISH could adopt, and a substantial portion of the second lien debt that was not subject to a plan support agreement. DISH had an eye toward DBSD's spectrum rights. In addition to providing satellite television service, DISH also has a substantial stake in TerreStar Corporation, a direct competitor of DBSD. DISH was not a prepetition creditor of DBSD. During this period, DISH simultaneously pursued a strategic transaction with DBSD.

THE BANKRUPTCY COURT'S DECISION

DISH voted against the plan and adopted a number of objections to plan confirmation. For example, DISH argued that the plan failed

to provide DISH the "indubitable equivalent" of the first lien debt that DISH recently acquired. In response, DBSD moved the bankruptcy court to designate the vote of DISH and confirm the plan over its objections. The bankruptcy court sided with DBSD and disregarded DISH's vote pursuant to Section 1126(e) of the Bankruptcy Code. Interestingly, the bankruptcy court also disregarded the entire class of first lien debt holders for the purpose of satisfying Section 1129(a)(8), which requires that every creditor class either accept the plan or the debtor must satisfy the "cram-down" standards set forth in Section 1129(b). The bankruptcy court justified this unusual ruling by finding that DISH acted in "bad faith" in voting against the plan and objecting to confirmation.[2]

THE DISTRICT COURT AND SECOND CIRCUIT AFFIRM

DISH appealed to the district court, which affirmed, and then to the Second Circuit, which also affirmed. In affirming the bankruptcy court's decision, the Second Circuit surveyed cases addressing Section 1126(e), which permits a bankruptcy court to designate a vote on a plan that was not made in "good faith."[3] The Bankruptcy Code does not define "good faith." In its analysis, the Second Circuit noted that the decision to designate a vote is left to the discretion of the bankruptcy court.

For example, the Second Circuit cited to the case of *Texas Hotel Securities Corp. v. Waco Development Co*.,[4] a pre-Bankruptcy Code case and progenitor of the good faith exception. In *Waco Development*, Conrad Hilton purchased sufficient claims against a debtor to obtain a "blocking" position to confirmation of the debtor's plan, which proposed to transfer a lease previously held by Hilton's company. By purchasing and voting the claims, Hilton intended to regain control of the operation of a hotel on the debtor's property. Although the district court refused to allow Hilton's conduct by invalidating his vote, the Fifth Circuit reversed.[5] Two years after *Waco*, Congress enacted the good faith requirement as part of the Chandler Act of 1938.[6]

The Second Circuit reasoned that Congress intended to prohibit conduct similar to Hilton's in enacting Section 1126(e). The court noted that designation is an exceptional remedy. The mere purchasing of claims for the purpose of voting against a plan alone is not sufficient to justify vote designation. Rather, designation is reserved to proscribe voting with an "ulterior motive" or with "an interest other than an interest as a creditor" (i.e. maximizing return).[7] As the Second Circuit noted, not every ulterior motive is one of bad faith. For example, trade creditors often vote not only in consideration of the treatment of their claims, but potentially on the prospect of having a trading partner emerge.[8]

In the case of DISH, the bankruptcy court was convinced that DISH's ulterior motive crossed the line, and warranted designation. First, DISH was a competitor of DBSD, albeit an indirect one, but part owner of a direct competitor. The Second Circuit noted that parties that purchase bankruptcy claims of competitors will be subject to circumspection. Second, the details of DISH's purchase of the first lien debt indicated a motive other than maximization of value. DISH purchased the entire class of first lien debt *after* the plan was filed and at *par*. DISH also purchased the second lien debt only from creditors that had not entered into a plan support agreement with DBSD. Third, the smoking gun came from internal communications and documents at DISH that indicated it observed a "strategic opportunity" to exercise control over the bankruptcy process of a "potentially strategic asset."[9] To compound matters, directly contrary to DISH's argument that it had not sought to terminate DBSD's exclusivity, on the eve of the plan confirmation, DISH reversed course and filed a motion to terminate DBSD's exclusivity (and filed a competing plan that was later withdrawn).

The Second Circuit held that DISH's behavior warranted the designation of its vote, and found that the facts mirrored Hilton's conduct in *Waco*. In each case, a purchaser of claims sought to control the bankruptcy process of a competitor for reasons other than to maximize the value of the claims.[10]

The Second Circuit not only affirmed the bankruptcy court's decision to disregard DISH's vote for calculating whether that class of creditors had accepted the plan, but also the bankruptcy court's decision to ignore the class of claims in which DISH was the sole member for purposes of Section 1129(a)(8) as well. Since the class of claims in which DISH was the sole member was ignored, DBSD did not have to establish that the plan was in the best interest of creditors for DISH's class for the plan to be confirmed, otherwise known as "cram down." In the case of DISH, because it purchased all the claims in the class of first lien debt holders, there were no other creditors in that class available to vote for the plan. Accordingly, unless the bankruptcy court also designated DISH's vote with respect to Section 1129(a)(8), the ruling would not have been effective. While the Second Circuit affirmed the bankruptcy court's decision, it specifically noted that its ruling should not impact whether the same result would be appropriate for other tests imposed by Section 1129(a) for confirmation of a plan.[11]

CONCLUSION

The *DBSD* decision should serve as a warning for parties looking to gain a strategic advantage over competitors in bankruptcy. If one thing is clear, the purchasing of bankruptcy claims in order to torpedo a competitor's plan would qualify as an "ulterior motive" justifying the designation of such purchaser's vote.

However, the broader impact of the decision remains less clear. For example, parties routinely employ a "loan to own" strategy whereby debt is acquired *pre-bankruptcy* in order to ultimately gain control of the debtor by swapping the debt for equity in the reorganized debtor. Perhaps acknowledging the narrow scope of the decision, and in response to concerns expressed by the Loan Syndications and Trading Association, as *amicus curiae*, the Second Circuit reserved the issue of whether its holding would apply to a *pre-existing* creditor. The court underlined the fact-intensive nature of a decision to designate votes and rejected any categorical prohibition on purchasing claims with strategic intentions.[12] At a minimum, the decision serves as

a reminder of the pitfalls of purchasing claims with an eye toward obtaining a blocking position or exercising any other strategic advantage where the motive involves more than simply the maximization of the claim.

NOTES

[1] *In re DBSD N.A, Inc.*, 634 F.3d 79 (2d Cir. 2011).
[2] 634 F.3d at 87-88.
[3] *DBSD*, 634 F.3d at 102-05.
[4] 87 F.2d 395 (5th Cir. 1936).
[5] *Waco Development*, 87 F.2d at 400.
[6] *See* Pub L. No. 75-575, § 203, 52 Stat. 840, 894.
[7] *DBSD*, 634 F.2d at 104.
[8] *Id.*
[9] *DBSD*, 421 B.R. at 136.
[10] *DBSD*, 634 F.2d at 104.
[11] *Id.* at 106.
[12] *Id.* at 105.