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Rulings Impact Hostile Takeovers of Bankrupt Companies' Debt

By Peter S. Partee and Scott H. Bernstein

Outside Counsel

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In *In re DBSD North America Inc.*, Case No. 09-13061 (REG), the U.S. Bankruptcy Court for the Southern District of New York issued two related rulings that have important implications for the viability of hostile takeovers accomplished through purchases of a bankrupt company's distressed debt. In *DBSD North America*, Bankruptcy Judge Robert E. Gerber held that a debt purchaser's vote to reject the debtors' Chapter 11 plan should be "designated" and, thus, not counted, under §1126(e) of the Bankruptcy Code because it was cast to gain control of the bankrupt company rather than to maximize the claim holder's returns. Judge Gerber also held that the class of which the debt purchaser's claim was the sole member should be deemed to have voted to accept the plan, thereby allowing the bankrupt company to avoid the "cram down" requirements of §1129(b) of the Bankruptcy Code.

Designation of Votes Under §1126(e). Section 1126(e) of the Bankruptcy Code allows the bankruptcy court to designate the votes of "any entity whose acceptance or rejection of such plan was not in good faith, or was not solicited or procured in good faith or in accordance with the provisions of [the Bankruptcy Code]." 11 USC §1126(e).

The immediate consequence of designation of a vote under §1126(e) is that the vote is not counted in determining whether a class of claims has accepted a Chapter 11 plan. See 11 USC §1126(c). Section 1126(e) is permissive in nature and confers substantial discretion upon a bankruptcy judge in designating votes. Nevertheless, when applying §1126(e), courts recognize the importance to creditors of the ability to vote on a reorganization plan.

Although §1126(e) does not define it, courts have found bad faith when a claim holder attempts to extract or extort a personal advantage not available to other creditors in the class of creditors holding similar claims, or where a creditor acts in furtherance of a motive that is unrelated to its status as a creditor. Courts have also developed "badges" of bad faith that may justify designation, including efforts to: (1) assume control of the debtor, (2) put the debtor out of business or otherwise gain a competitive advantage, (3) destroy the debtor out of pure malice, or (4) obtain benefits available under a private agreement with a third party which depends on the debtor's failure to reorganize. It is generally not considered to be bad faith, however, for a creditor to cast a self-interested vote to maximize the recovery on its claim and to act in its economic interest as long as the interest being served is that of a creditor.

Designation of the Claim Purchaser's Vote. In *DBSD North America*, the debtors were in the business of developing integrated wireless satellite communication services. DISH Network Corporation (DISH) held no prepetition claims against the debtors and is a substantial investor in a direct competitor. Subsequent to the filing of a Chapter 11 plan, DISH purchased all of the debtors' first lien debt at par as well as less than a blocking position of DBSD's second lien

debt. The second lien debt was purchased from sellers that were not bound by an agreement obligating them to vote in favor of the reorganization plan. DISH voted all of its acquired claims against confirmation of the debtors' plan, objected to confirmation of the plan, and on the day prior to the confirmation hearing, filed a motion to terminate the debtors' exclusive period to solicit acceptances of the plan and for authority to propose a competing plan.

To avoid the cram down requirements of §1129(b), the debtors moved to designate DISH's vote of its first lien debt citing documents obtained through discovery showing DISH acquired the claims to "establish control of a strategic asset." The bankruptcy court inferred DISH's intent from internal drafts of documents prepared by junior level personnel that were never presented to senior level personnel of the company. As a result, the bankruptcy court concluded that DISH was voting its claims to gain control of the debtors rather than maximize recover and granted the motion to designate DISH's vote of its first lien claims.

Deemed Acceptance of the Plan by the Claim Purchaser's Class. Because DISH held all of the first lien debt, designating its vote left no voting claims in that class. Consensual confirmation of a plan, however, requires that each class either vote to accept the plan or be unimpaired by the plan (see 11 USC §1129(a)(8)), and neither was the case here. As a result, the Bankruptcy Court was presented with a dilemma: either deem the designated class of first lien claims to have accepted the plan—a remedy not provided for classes of impaired claims under the Bankruptcy Code—or apply the cram down requirements to DISH—the very result the debtors and the Bankruptcy Court had sought to avoid.

Deemed acceptance of a plan by a class of non-voting creditors is an issue that has divided the courts and commentators for some time. See *In re Adelphia Communications Corp.*, 368 B.R. 140, 260-63 (Bankr. SDNY 2007). Traditionally, it has been applied only to a non-voting, non-objecting creditor that was the sole member of its class. For example, in the landmark case of *In re Ruti-Sweetwater, Inc.*, 836 F.2d 1263, 1266-68 (10th Cir. 1988), the U.S. Court of Appeals for the Tenth Circuit held that a non-voting creditor's failure to take any action whatsoever to reject or object to the debtor's plan was tantamount to acceptance of the plan, and as a result, the court was not required to inquire as to whether the plan met the cram down requirements of §1129(b) with respect to that creditor.

In contrast, in *In re Westwood Plaza Apartments, Ltd.,* 192 B.R. 693, 696 (E.D. Tex. 1996), the United States District Court for the Eastern District of Texas distinguished *Ruti-Sweetwater* because the "*Ruti-Sweetwater* creditor did not appear at any hearings…while HUD, the creditor in the instant case, actively participated in the confirmation of the plan."

Judge Gerber ultimately applied *Ruti-Sweetwater,* noting it "would be incongruous to accept a different view when the failure to secure *any* votes in the class arises not from creditor apathy, but from affirmative acts of an entity whose vote deservedly was disqualified." *In re DBSD North America Inc.*, 419 B.R. 179, 207 (Bankr. SDNY 2009) (emphasis in original).

Thus, DISH's vote of its first lien claims to reject the plan were not only not counted, they were deemed to have voted to accept the plan. In addition to the application of Ruti-Sweetwater, Judge Gerber relied on the purely practical consideration that to require the debtors to meet the cram down requirements merely because there was no non-designated voting claim in the class of first lien claims would have rendered the bankruptcy court's ruling on the debtors' designation motion meaningless by reaching the same outcome that would have resulted if

DISH's vote had not been designated. Accordingly, the debtors were not required to satisfy the cram down requirements with respect to the class of first lien claims.

Soundness of the Bankruptcy Court's Ruling. The Bankruptcy Court's ruling in *DBSD North America* is open to criticism on the grounds that it engrafts a consequence of vote designation that is not found in and arguably directly contrary to the Bankruptcy Code. Section 1126(c) of the Bankruptcy Code provides quite straightforwardly that designated votes are excluded in determining whether a class of claims has voted to accept a Chapter 11 plan. It does not provide that designation of a vote permits that vote to be counted as anything, much less as an acceptance.

Reading such a remedy into the statute seems directly contrary to the Supreme Court's Bankruptcy Code jurisprudence, which requires that "when the statute's language is plain, the sole function of the courts—at least where the disposition required by the text is not absurd—is to enforce it according to its terms." *Hartford Underwriters Ins. Co. v. Union Planters Bank, N.A.*, 530 U.S. 1, 6 (2000). Perhaps Judge Gerber concluded it would have been "absurd" to apply the cram down requirements in *DBSD North America* notwithstanding the designation of DISH's vote.

Consequences of 'DBSD' for Corporate Takeovers in Bankruptcy and Distressed Debt Markets. The rationale for claims trading is that it allows an easy exit for creditors who lack the desire or financial capability to participate in a drawn-out bankruptcy proceeding. As long as there is sufficient liquidity in the market for claims, creditors may voluntarily exit the bankruptcy proceeding by selling their claims and receive fair value. Purchasers are often private equity funds that have a better understanding of the likely return, the capability to hold the claims for a longer period of time before monetizing, and/or the ability to generate a higher return because of their knowledge of the bankruptcy process.

In some cases, the ability to buy claims has allowed strategic investors to gain control of debtors. In these instances, claims trading plays the same role as a conventional takeover contest outside of bankruptcy, but the outsider buys debt instead of equity. Claim buyers will often want to advance a reorganization plan that provides for the conversion of debt into new equity in the reorganized debtor for the purpose of transforming the claims buyer into a controlling shareholder or largest shareholder. There have been a number of bankruptcy cases involving a takeover fight.

For example, in the FiberMark Chapter 11 case, Silver Point Capital, which acquired its claims after the bankruptcy filing, gained control of the company after a nasty fight with the other largest bondholders on the proposed corporate governance of the reorganized debtor. Likewise, in the Kmart reorganization, ESL Investments, acquired control of the reorganized company by investing more than $100 million in new money and purchasing approximately $2 billion in claims. In fact, Kmart's confirmed Chapter 11 reorganization plan gave ESL Investments the right to appoint four of the nine directors in the reorganized company.

The *DBSD* cases may have a chilling impact on the strategic buying of claims to acquire control of a reorganized debtor because the rulings pose the substantial risk that claim purchasers will be deprived of a voice in the reorganization proceeding in the event they are unable to reach a consensual deal with debtor's management.

The rulings also may provide debtor's management with significant leverage in bargaining with the outside party because of the attorneys' fees and costs that would result from litigating the issues raised in *DBSD*. It is also possible that, going forward, debtors may choose to avoid the uncertainty caused by vote designation by incorporating provisions into reorganization plans that stipulate:

Any class of claims that is not occupied as of the commencement of the hearing on confirmation of the plan by the holder of an allowed claim that has not been designated or a claim temporarily allowed under Bankruptcy Rule 3018 shall be deemed eliminated from the plan for the purpose of voting to accept or reject the plan and for the purpose of determining acceptance or rejection of the plan by such class pursuant to section 1129(a)(8) of the Bankruptcy Code.

As a result of the *DBSD* cases, less hostile routes of acquiring control of a debtor or its business, such as sponsoring a plan with the debtor or making a bid for the purchase of the company or its assets, are likely to become more attractive to distressed investors. The resulting retrenchment by distressed investors attempting to acquire control of a reorganized debtor by buying up claims may negatively affect the liquidity of the market for claims and drive down the price that creditors may realize for their claims against certain debtors.

Peter S. Partee *is a partner in the bankruptcy, financial restructuring and creditors' rights practice of Hunton & Williams in New York and can be reached at ppartee@hunton.com.*
Scott H. Bernstein *is a senior associate in the department and can be reached at sbernstein@hunton.com.*

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