Disenfranchising Creditors in Chapter 11: In Search of the Meaning of "Bad Faith" under Section 1126(e)

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The ability of a creditor whose claim is "impaired" to vote on a chapter 11 plan is one of the most important rights conferred on creditors under the Bankruptcy Code. The voting process is an indispensable aspect of safeguards built into the statute designed to ensure that any plan ultimately confirmed by the bankruptcy court meets with the approval of requisite majorities of a debtor's creditors and shareholders and satisfies certain minimum standards of fairness. Under certain circumstances, however, a creditor can be stripped of its right to vote on a plan as a consequence of its conduct during the course of a chapter 11 case. A ruling recently handed down by the bankruptcy court presiding over the bankruptcy cases of Adelphia Communications Corporation and its affiliates carefully examines the concept of creditor disenfranchisement in chapter 11. In *In re Adelphia Comm. Corp.*, the court refused to disqualify under section 1126(e) of the Bankruptcy Code the votes of three separate groups of creditors that voted to support the debtors' chapter 11 plan. "Designation," or disqualification, of their votes was unwarranted, the court held, because (i) the creditors' alleged conduct in seeking to benefit their economic interests, though it may have been overly aggressive, did not justify the "draconian" remedy of disenfranchisement; and (ii) the inherent conflict of interest arising from a creditor holding claims against multiple debtors, or claims against a single debtor in different classes, does not in and of itself represent an ulterior motive or "bad faith" warranting designation of a vote.

Chapter 11 Plan Voting Procedures

The preferred culmination of the chapter 11 process is confirmation of a chapter 11 plan specifying how the claims and interests of all stakeholders in the bankruptcy case are to be treated going forward. Creditors, shareholders and other stakeholders have a voice in the confirmation process through the Bankruptcy Code's plan voting procedures. Holders of allowed claims and interests have the right to vote to accept or reject a chapter 11 plan. Claimants or equity interest holders whose claims or interests are not "impaired," however, are deemed conclusively to accept the plan, and stakeholders who receive nothing under a plan are deemed to reject it. Any holder of a claim or interest to which an objection has been filed does not have the right to vote the portion of the claim or interest objected to, unless it obtains an order temporarily allowing the claim for voting purposes pending resolution of the merits of the objection. Most unliquidated or contingent claims may be estimated for purposes of voting on a plan.

Voting rights can have a significant impact on the ultimate fate of a chapter 11 plan. If a creditor holds a significant bloc of claims in a single class under a plan, it may be able to prevent confirmation of the plan, or force the plan proponent to comply with the Bankruptcy Code's "cramdown" requirements to achieve confirmation. Creditors holding a blocking position or having sufficient influence to create one through deal-making with other creditors commonly use the resulting leverage to maximize their recoveries under the plan, sometimes at the expense of creditors who lack the same negotiating power. In some cases, the accumulation of claims and voting power can even be an effective means to gain control of a company in chapter 11.

Disqualification of Votes

The drafters of the Bankruptcy Code recognized that the chapter 11 voting process can sometimes be abused by the unscrupulous. Section 1126(e) of the Bankruptcy Code provides:

> On request of a party in interest, and after notice and a hearing, the court may designate 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 this title.

"Designation" of a vote means that the vote is disqualified or disallowed. Section 1126(e) expands the disqualification procedures that existed under chapter X of the former Bankruptcy Act. Previously, a bankruptcy court was authorized to disqualify claims or stock for the purpose of determining the requisite majorities for acceptance of a plan if the holders of those claims or interests did not accept or reject the plan in good faith. The provision's purpose was to prevent speculators who had acquired claims or stock at depressed prices from exercising unfair veto power over the debtor's reorganization, and to keep creditors and stock holders from securing advantages by refusing to vote in favor of a plan unless they received preferential treatment.

Section 1126(e) is broader than its predecessor under the Bankruptcy Act — it authorizes the court to disallow votes that are not cast, procured or solicited in good faith, or in accordance with the provisions of the Bankruptcy Code. The bankruptcy court has broad discretion in determining whether to "designate" a vote. The statute does not explain what kind of conduct amounts to bad faith, which is necessarily a flexible concept that has been left to the courts to define based upon the facts and circumstances of each individual case. Instances of bad faith identified by the courts can be grouped into three general categories:

(i) use of obstructive tactics or hold-up techniques by a creditor to extract better treatment for its claim than that given to the claims of similarly situated creditors in the same class;

(ii) casting a vote for the ulterior purpose of securing some advantage to which the creditor would not otherwise be entitled; and

(iii) casting a vote motivated by something other than protection of a creditor's own self-interest.

Votes, for example, have been deemed to be tainted if designed to assume control of the debtor, put the debtor out of business or otherwise gain a competitive advantage, destroy the debtor out of pure malice, or obtain benefits available under a private side agreement with a third party which depends on the debtor's inability to reorganize. These factors have been identified by some courts as "badges of bad faith." Standing alone, a creditor's "selfish motive" for casting its vote is not a basis for disqualification under section 1126(e). Given the practical ramifications of barring an impaired creditor from exercising such a fundamental entitlement, most court consider designation to be the "exception rather than the rule" or even a "drastic remedy." As such, the party seeking designation of a vote bears a heavy burden of proof.

The analysis becomes more complicated in large chapter 11 cases involving affiliated debtors. The existence of inter-company debts, an extensive body of creditors asserting multiple claims of varying priorities against one debtor or claims against more than one debtor based upon inter-company guarantees, and inter-creditor or subordination agreements makes determining a creditor's motives in voting no simple matter.

Lawmakers attempted to address the potential problems arising from one of these eventualities — a creditor holding claims against the same debtor classified in competing classes — when

enacting the Bankruptcy Code in 1978. The House version of the bill that later became the Bankruptcy Code originally contained a provision that would have expressly authorized the court to designate the vote of an "entity that has, with respect to such class, a conflict of interest that is of such a nature as would justify exclusion of such entity's claim or interest" from the computation involved in determining whether a class has accepted or rejected a chapter 11 plan. The provision, however, did not appear in the Senate version of the draft legislation and never made its way into the statute. At the time, a leading sponsor of the legislation, Senator Dennis DeConcini, expressed the view that Congress deemed the provision unnecessary because a bankruptcy court's broad equitable powers under section 105(a) of the Bankruptcy Code give the court the power to disqualify a creditor from voting its claims on the basis of conflict of interest.

A challenge to the bona fides of creditor votes in favor of a plan based upon conduct amounting to overreaching and conflicts of interest confronted the bankruptcy court in *Adelphia*.

Adelphia Communications

Adelphia Communications Corporation, once the nation's fifth largest cable services company with 5.7 million subscribers in over 31 states, filed for chapter 11 protection in June of 2002. On July 31, 2006, the bankruptcy court approved the sale of the bulk of Adelphia's assets to Time Warner NY Cable and Comcast Corporation for $17.6 billion. The court confirmed a joint chapter 11 plan for Adelphia and its affiliated debtors on January 5, 2007 that distributes the companies' remaining $15 billion in assets. The confirmation order, however, was stayed on January 24, 2007 pending the resolution of an appeal to the district court, which initially required the appellants to post a $1.3 billion bond as a prerequisite to the issuance of a stay. By order

dated February 12, 2007, the district court vacated its stay of the order confirming Adelphia's plan. The plan went effective on the following day.

The fitful progress of Adelphia's chapter 11 cases, which involved over 230 subsidiaries, multiple tranches of secured and unsecured debt, a host of complicated inter-company relationships and multiple ad hoc creditors' committees or groups, was accentuated by rancorous disputes between certain groups of major creditors. The antagonists involved were predominantly investors in distressed debt, many of whom held claims in more than one of the numerous classes of unsecured claims treated under Adelphia's chapter 11 plan.

Among them were a group consisting of certain holders of Adelphia's senior notes (the "ACC Bondholders Group"). The ACC Bondholders Group objected to confirmation of the plan and appealed the confirmation order. It also sought a court order designating the votes cast in favor of the plan by three separate groups of creditors who held both senior notes and notes issued by an indirect subsidiary of Adelphia, Arahova Communications Corp. (collectively referred to as the "Targeted Creditors").

A central feature of Adelphia's chapter 11 plan is a settlement of inter-company disputes. The settling parties include Adelphia's creditors' committee, several unofficial committees comprised of Adelphia and Arahova creditors, the Targeted Creditors and various individual creditors. As part of the settlement, the plan contains releases, exculpation and fee reimbursements for committee members and individual creditors, including senior noteholders, who signed onto the settlement and agreed to support the plan. These benefits are denied to creditors who chose not

to support the settlement and the plan. The Targeted Creditors voted all of their claims in support of the plan. The ACC Bondholders Group vehemently opposed both the plan and the underlying settlement.

According to the ACC Bondholders Group, the Targeted Creditors filed numerous motions during the chapter 11 case seeking to thwart judicial determination of inter-debtor issues as part of a "scorched earth litigation strategy" that if successful, would have been devastating to creditor recoveries, in an effort to extract a greater distribution under Adelphia's plan. The Targeted Creditors, the ACC Bondholders Group alleged, also engaged in tactics, such as thinly-veiled threats of litigation and onerous discovery requests, designed to strong-arm dissenting creditors into accepting the settlement and voting in favor of the plan. Taken as a whole, the ACC Bondholders Group maintained, this conduct warranted designation of the Targeted Creditors' votes under section 1126(e).

The Bankruptcy Court's Ruling

The bankruptcy court denied the motion. In prefacing its discussion, the court explained that "[t]he ability to vote on a reorganization plan is one of the most sacred entitlements that a creditor has in a chapter 11 case." This right should not be denied, the court emphasized, "except for highly egregious conduct."

Addressing allegations by the ACC Bondholders Group that the Targeted Creditors had obtained special consideration under the plan in the form of releases, exculpation and fee reimbursement, the court held that although such matters might support an objection to confirmation, they "are not matters of the type that warrant disqualification of the Targeted Creditors' votes." Even

accepting as true the allegations that the Targeted Creditors were overly aggressive and overreaching in acting to benefit their economic interests in securing confirmation, the court explained, complaints concerning their conduct are properly addressed as part of the plan confirmation process. According to the court, whether or not the provisions in the plan favorable to the Targeted Creditors would pass muster under the Bankruptcy Code's confirmation requirements, they are "all variants of measures to advance one's interests in maximizing recoveries under a reorganization plan, which have consistently been held to be acceptable exercises of creditor power."

Next, the court turned to the allegations that the Targeted Creditors' votes in favor of the plan were driven by an ulterior motive — namely, the desire to maximize their recovery in another class, of another debtor (Arahova), under Adelphia's joint chapter 11 plan. None of the conduct alleged to have been engaged in by the Targeted Creditors, the bankruptcy court reasoned, falls within the broad categories of actionable abuse that has led courts in the past to designate votes. Objectionable motives under section 1126(e), the court emphasized, have not historically included the motive "to maximize an economic recovery, or to hedge, by owning bonds of multiple debtors in a single multi-debtor chapter 11 case, or . . . to hold bonds in different, antagonistic, classes of a particular debtor in a single chapter 11 case."

Inherent conflicts of interest between creditor classes, the court explained, exist in most chapter 11 cases, whether within a single debtor or across multiple debtors, competing for maximized shares of a limited pot of assets. Even so, the court concluded, holding or acquiring claims of different debtors in the same chapter 11 case is not the sort of ulterior motive or "bad faith" that

has previously been held to justify vote designation. It accordingly ruled that "a creditor's ownership of claims in several debtor entities does not, by itself, amount to bad faith under section 1126(e), and does not afford a sufficient basis on which to qualify votes of creditors who have voted to accept the plan."

Two additional considerations, the court emphasized, suggest that this approach is the correct one. First, the court explained, "the law has long upheld creditors' efforts to maximize their individual recoveries in their self interest as creditors under a plan." Although subject to the "ulterior interest exception," ordinary recovery maximization strategies cannot be said to exclude holding long positions in bonds of various debtors.

Finally, the bankruptcy court examined the "conflict of interest" subsection that was ultimately excluded from section 1126 as originally enacted in 1978. Congress' decision to omit the clause and the "marked reluctance" of courts to interpret section 105(a) expansively to give courts powers that are not expressly delineated elsewhere in the Bankruptcy Code led the bankruptcy court to resolve that disqualifying votes under the circumstances before it "would be too much of a jump."

Outlook

Under the *Adelphia* court's formulation of the "bad faith" standard in section 1126(e), a wide range of creditor conduct would appear to be permissible, as long as it serves the goal of maximizing recovery and/or can be remedied through less "draconian" means than disenfranchising the offending creditor. Whether or not this approach is the right one, the message it conveys is likely to make the chapter 11 process more contentious in some cases. A

chapter 11 plan is almost always a product of negotiation and cooperation among stakeholders who work together to achieve a mutually satisfactory solution regarding the future of the debtor and the treatment of its obligations and ownership interests. The message borne by *Adelphia* is that most kinds of overreaching or overly-aggressive creditor conduct designed to extract greater value, concessions or benefits under a plan may be objectionable, but are not sanctionable under section 1126(e). Given the reality that "distressed" investors involved in chapter 11 cases are more likely than most creditors to play hard ball at the plan negotiating table, *Adelphia* may actually encourage the sort of intractable conduct that the court found to be objectionable and unproductive, yet outside the scope of section 1126(e).

Nonetheless, the bankruptcy court's analysis of the conflict of interest issue is consistent with the commercial realities of large chapter 11 cases and the relevant language and legislative history of the Bankruptcy Code. Large chapter 11 cases commonly involve several debtors, multiple layers of debt and stock, complicated inter-company relationships and creditors asserting claims of varying priorities against a single debtor or claims against more than one debtor. Equating inherent conflicts of interest arising from this practical reality with "bad faith" for purposes of vote designation could result in the wholesale disenfranchisement of the very creditors who have the greatest stake in ensuring that a chapter 11 case culminates successfully with a confirmed plan.

In re Adelphia Comm. Corp., 2006 WL 3609959 (Bankr. S.D.N.Y. Dec. 11, 2006).

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