Disenfranchising Strategic Investors in Chapter 11: "Loan to Own" Acquisition Strategy May Result in Vote Designation

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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 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.

In *In re DBSD North America, Inc.*, a New York bankruptcy court ruled in December 2009 that the votes of a creditor which purchased the debtors' senior secured debt at par, after the debtors had filed a chapter 11 plan that proposed to satisfy the senior secured debt in full (by means of a modified note under an amended first-lien credit facility), should be "designated" (*i.e.*, disallowed) pursuant to section 1126(e) of the Bankruptcy Code. The creditor's acknowledged purpose in buying the debt and voting to reject the chapter 11 plan was to take control of the debtor. The bankruptcy court concluded that the creditor's conduct warranted designation of its votes, observing that:

> [w]hen an entity becomes a creditor late in the game paying . . . [100 cents] on the dollar, as here, the inference is compelling that it has done so not to maximize the return on its claim, acquired only a few weeks earlier, but to advance an "ulterior motive" condemned in the case law.

According to the court, the creditor had an "ulterior motive" in acting not to maximize its interest as a creditor, but purely as a prospective owner of the reorganized debtors. A New York district

court affirmed the ruling on March 24, 2010. The rulings have been appealed to the Second Circuit Court of Appeals and serve as a cautionary tale to prospective strategic investors pursuing a “loan to own” strategy.

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. Depending on the provisions of the plan, classes of creditors, shareholders, and other stakeholders are provided with a voice in the confirmation process through the Bankruptcy Code’s plan voting procedures. Generally, holders of allowed claims and interests have the right to vote to accept or reject a chapter 11 plan. Claimants or 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 or interest for voting purposes pending resolution of the merits of the objection. 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 dealmaking 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. Under the Bankruptcy Act, 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 stockholders 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 according to the facts and circumstances of each individual case. Court findings of bad faith, however, appear to center around certain

types of conduct; instances of bad faith identified by the courts can be grouped into three general categories:

(i) Use of obstructive tactics or holdup techniques by a creditor to extract better treatment for its claim than 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 that depends on the debtor's inability to reorganize. These factors have been identified by some courts as "badges of bad faith." Standing alone, however, 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 a fundamental entitlement, most courts consider designation to be the "exception rather than the rule" or even a "drastic remedy."

The seminal case addressing vote designation in chapter 11 is a Pennsylvania bankruptcy court's 1990 decision in *In re Allegheny International, Inc.* In that case, the court designated the votes of Japonica Partners, a hedge fund that acquired claims against a chapter 11 debtor with the "ulterior motive" of seizing control of the debtor. The court concluded that Japonica was manipulating the bankruptcy process because it was acting not to protect its interests as a creditor, but as an opportunistic investor that bought up claims 22 months into the case after the debtor had filed its chapter 11 plan and disclosure statement. Among other things, the evidence showed that Japonica purchased claims in classes with diametrically opposed interests in pending

avoidance and lender liability litigation and that the amounts and prices of claims acquired by Japonica clearly indicated it was orchestrating a scheme to block confirmation of the debtor's chapter 11 plan and propose a competing plan. The bankruptcy court in *DBSD North America* looked to *Allegheny* for guidance in assessing whether a creditor's conduct in acquiring claims to block confirmation of a plan warranted designation of its votes under section 1126(e).

DBSD North America

DBSD North America, Inc., is a development-stage enterprise formed in 2004 to develop an integrated mobile satellite and terrestrial services network to deliver wireless satellite communication services to mass-market consumers. The company and its subsidiaries (the "debtors") filed for chapter 11 protection in New York on May 15, 2009. Shortly after the debtors filed an amended chapter 11 plan, DISH Network Corporation ("DISH"), a competing satellite services provider, purchased $40 million in principal amount of the debtors' first-lien working capital facility debt. DISH thereby acquired all of the claims in Class 1 of the debtors' plan. A DISH affiliate then purchased $111 million in principal amount (less than all) of the second-lien claims classified separately under the plan, which proposed to convert the second-lien debt to equity. The second-lien claims purchase was made only after determining that the sellers were not bound by a plan support agreement. DISH paid 100 cents on the dollar for the first-lien debt.

DISH voted all of its claims against the plan. As a consequence, Class 1 would have rejected the plan. However, the debtors sought a court order designating the Class 1 votes. Bankruptcy judge Robert E. Gerber sided with the debtors, finding that:

> DISH's acquisition of First Lien Debt was not a purchase to make a profit on increased recoveries under a reorganization plan. . . [but] [r]ather . . . DISH made its investment in this chapter 11 case, and has continued to act, not as a traditional creditor seeking to maximize its return on the debt it holds, but as a strategic investor, "to establish control over this strategic asset."

Judge Gerber based his decision upon the timing of DISH's claim purchases shortly before confirmation, the inflated price DISH paid for the debt, and internal DISH documents, as well as testimony that revealed its plans to use the debt purchase as a means to "control the bankruptcy process" and "acquire control" of the company, which was a "potentially strategic asset."

According to Judge Gerber, the circumstances represented a classic case for application of *Allegheny*, as well as the ruling's identification of "efforts to assume control of the debtor" as a badge of bad faith. As Judge Gerber observed, DISH's conduct in seeking to block a plan that would have repaid its first-lien claims with a promissory note, in favor of proposing its own plan, which would have given it control of the debtors, "is indistinguishable in any legally cognizable respect from the conduct that resulted in designation in *Allegheny*, and DISH's vote must be designated for the same reasons."

Judge Gerber rejected DISH's argument that its conduct was that of a "model bankruptcy citizen" in that it had not "moved to terminate exclusivity" or "proposed a competing plan." This line of defense was belied by the fact that, on the morning of the scheduled confirmation hearing (and after the close of briefing on the designation motion), DISH filed a motion seeking court authority to terminate the debtors' exclusivity and to propose its own chapter 11 plan.

DISH appealed the ruling to the district court, which affirmed. According to district judge Lewis A. Kaplan, the bankruptcy court's finding that DISH had acted as a strategic investor to obtain control over the debtor was not clearly erroneous and was sufficient to support the court's finding of a lack of good faith for purposes of section 1126(e).

Outlook

DBSD North America does not represent the first instance that Judge Gerber has considered the standards for vote designation under section 1126(e). In his 2006 ruling in *In re Adelphia Comm. Corp.*, Judge Gerber, acknowledging 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," wrote that "[w]hile creditor tactics, activities or requests (or plan provisions that result from them) may be objectionable, the Code provides for other ways to address concerns that arise from such (such as upholding objections to confirmation) without the draconian measure of denying one's franchise to vote." Thus, Judge Gerber declined a request to designate votes in the *Adelphia* case.

In *DBSD North America*, Judge Gerber reaffirmed the legitimacy of vigorous advocacy by creditors, including extremely aggressive actions, provided that such conduct is calculated "to increase their recoveries as creditors holding long positions in debt." DISH's undoing was that it "acted to advance strategic investment interests wholly apart from maximizing recoveries on a long position in debt it holds." Given the ruling in *Adelphia*, Judge Gerber's decision to designate votes in *DBSD North America* appears to be a consequence of what he perceived to be particularly egregious facts.

As noted, DISH has appealed the district court's ruling to the Second Circuit Court of Appeals. Only a handful of chapter 11 vote-designation cases have reached the circuit courts of appeal since 1978, and the Second Circuit will have an opportunity to address the issue as a matter of first impression.

In re DBSD North America, Inc., 421 B.R. 133 (Bankr. S.D.N.Y. 2009), *aff'd*, 2010 WL 1223109 (S.D.N.Y. Mar. 24, 2010).

In re Allegheny International, Inc., 118 B.R. 282 (Bankr. W.D. Pa. 1990).

In re Adelphia Comm. Corp., 359 B.R. 54 (Bankr. S.D.N.Y. 2006).