Client Alert.

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DBSD: The Second Circuit Empowers Unsecured Creditors and Affirms the Risks Inherent in "Loan to Own" Strategies

By Alexandra Steinberg Barrage and Jordan Wishnew[1]

Morrison & Foerster represents ICO Global Communications Holdings Ltd. ("ICO Global"), DBSD's parent company and equity owner, in DBSD North America Inc's ("DBSD") bankruptcy proceeding.

Following the confirmation of DBSD's amended plan of reorganization on July 5, 2011, claims traders and unsecured creditors should revisit the Second Circuit's February 7, 2011 *DBSD* decision,[2] which addressed key issues on the ever-evolving "gifting" doctrine and vote designation in connection with DBSD's reorganization plan.

The Second Circuit's decision not only empowers unsecured creditors to contest "gifts" from secured creditors to junior classes if the gift violates the absolute priority rule, but also upholds the designation (or disqualification) of creditor votes tied to a strategic acquisition of a debtor's first-lien secured debt after the filing of a proposed Chapter 11 plan and disclosure statement.[3]

THE BANKRUPTCY COURT RULING

DBSD's proposed reorganization plan was intended to substantially deleverage the debtor by restructuring the first-lien debt and equitizing the second-lien and unsecured debt. Under the proposed plan, the second-lien claimants agreed to "gift" part of their distribution to the prepetition equityholders, thereby enabling ICO Global, which owned 99.8% of DBSD, to receive shares and warrants in the reorganized equity.[4]

After DBSD's original plan and disclosure statement were filed, DBSD's competitor, DISH Network Corp. ("DISH"), purchased all of the first lien debt, at par, seeking by its acquisition "to acquire control of this strategic asset."[5] DISH admitted that its acquisition of the first lien debt was done so that it could "be in a position to take advantage of [its claim] if things didn't go well in a restructuring."[6] Through an affiliate, DISH also purchased a portion of the debtors' second lien debt.

DISH ultimately rejected DBSD's plan, claiming that the plan failed to give DISH the "indubitable equivalent" of its first lien debt as required in a cramdown scenario under section 1129(b)(2)(A)(iii). DBSD subsequently asserted that DISH's rejection was not in good faith under section 1126(e). The bankruptcy court agreed, designating DISH's vote under section 1126(e) and causing DISH's wholly owned class of first lien debt to be disregarded for voting purposes. DBSD's plan was confirmed thereafter.

THE SECOND CIRCUIT RULING

After the district court affirmed the bankruptcy court's ruling, Sprint Nextel Corporation ("Sprint"), an unsecured creditor with an unliquidated claim, appealed to the Second Circuit and argued that the confirmed plan should be vacated because it improperly gave property to ICO Global without fully satisfying Sprint's senior claim, in violation of the "absolute priority

rule" in section 1129(b)(2)(B), which prevents a junior class of creditors from receiving any value under a plan if a more senior class that does not vote to accept the plan is not paid in full. Sprint asserted that the absolute priority rule had been violated because general unsecured creditors (like Sprint) had a right to receive, but did not receive, either "'full satisfaction of their claims' or at least 'an amount sufficient to obtain approval from the class.'"[7]

In addition, DISH asserted that its vote was improperly designated under section 1126(e) by the bankruptcy court, and that its class was improperly disregarded for voting purposes.

Unsecured Creditor Has Standing to Appeal Plan

Before the Second Circuit addressed Sprint's substantive objections, it first considered whether Sprint had standing to appeal the plan. Here, the court noted that "in order to have standing to appeal from a bankruptcy court ruling, an appellant must be 'a person aggrieved'—a person 'directly and adversely affected pecuniarily' by the challenged order of the bankruptcy court."[8] In other words, not only must there be an "injury in fact," but the injury must be "direct" and "financial."[9]

Because Sprint had a claim estimated at $2 million for voting purposes, but stood to receive less than that amount upon confirmation of the plan, the Second Circuit held that confirmation affected Sprint "directly" and "financially."[10] Moreover, when the Bankruptcy Code (through the absolute priority rule) requires a creditor to receive the full value of its claim before any value can be received by holders of prepetition equity, the court will find a "direct" and "financial" injury.[11]

The Second Circuit was not persuaded by a number of DBSD's arguments, including that Sprint's interest was worthless. The court noted that "none of [the court's] prior appellate standing decisions—at least none involving creditors—have turned on estimations of valuation, or on whether a creditor was in the money or out of the money. We have never demanded more to accord a creditor standing than that it has a valid and impaired claim."[12] The court was also reluctant to forbid all appeals by out-of-the-money creditors, because to do so would "disserve the protection of the parties' rights and the development of the law. We should not raise the standing bar so high, especially when it is a bar of our own creation and not one required by the language of the [Bankruptcy] Code, which 'does not contain and express restrictions on appellate standing.'"[13]

Responding to the dissent, the court also ruled that the only predicate to standing is whether a claimant—including one with an estimated, unliquidated claim—has the right to vote for the underlying plan. The underlying merits of such claim are irrelevant for purposes of standing:

> A rule that would turn a claimant's standing to appeal a bankruptcy court's ruling on the as-yet-undetermined merits of the claimant's underlying claim would unduly complicate the standing determination, and require district and circuit courts prematurely to address the merits of issues the bankruptcy court has not yet addressed . . . . The ultimate merits of that claim should not determine standing here, where [the Court of Appeals] have less ability than the bankruptcy court to decide those merits.[14]

Turning to the Merits

Court Finds Violation of Absolute Priority Rule

Here, the court's analysis was guided by the language of 11 U.S.C. § 1129(b)(2)(B)(ii), which provides that a plan is only

fair and equitable if "the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property . . . ." In determining that the bankruptcy court should not have confirmed the plan, the court noted that:

- Sprint got less than half the value of its claim;
- The plan provided that the existing shareholder receive shares and warrants "in full and final satisfaction, settlement, release, and discharge of each Existing Stockholder Interest . . . .";[15]
- The existing shareholder received "property," under the plan "on account of" its prior, junior interest; and
- The existing shareholder was not required to contribute new capital to the reorganized entity; rather, the "gift" provided to the shareholder was intended to ensure the shareholder's "continued cooperation and assistance" in the reorganized debtor.[16]

For these reasons, the court determined that the "existing shareholder 'could not have gained [its] new position but for [its] prior equity position.'"[17] Therefore, the plan violated the absolute priority rule because the existing shareholder received property under the plan on account of its prepetition equity interest.

Although the court's holding might suggest the death knell of the gifting doctrine, the court was clear to distinguish the facts before it from the First Circuit's decision in *Official, Unsecured Creditors' Comm. v. Stern (In re SPM Manufacturing Corp.)*,[18] where the court held that nothing in the Bankruptcy Code barred secured creditors from sharing their proceeds in a Chapter 7 liquidation with unsecured creditors.[19] First, *SPM* involved a Chapter 7, not Chapter 11 proceeding, which requires compliance with section 1129(b)(2)(B) in order to confirm a plan. Second, in *SPM*, the secured creditor who made the gift had previously obtained relief from the automatic stay, thereby removing the property at issue from the bankruptcy estate and vesting ownership of that property in the secured creditor.[20]

Accordingly, so long as property distributed under a plan remains part of the Chapter 11 estate, a debtor must follow the absolute priority rule. Congress "did not create any exception for 'gifts' like the one at issue" in DBSD.[21]

Vote Designation Upheld

Ordinarily, a party is entitled to vote on a plan if its claim or interest is impaired under the terms of a plan. However, section 1126(e) of the Bankruptcy Code allows a party's vote to be designated (i.e., disregarded) if that entity did not vote in good faith.

The Bankruptcy Code does not provide any specific guidance regarding what constitutes a vote as "not in good faith." As noted by the Second Circuit, "[s]ection 1126(e) comes into play when voters venture beyond mere self-interested promotion of their claims. '[Section 1126(e)] 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.'"[22]

A court's analysis under section 1126(e) typically focuses on the ulterior motives of the voting party. One of the most notable cases in the designation context is *Texas Hotel Securities Corp. v. Waco Development Co.*,[23] where the Fifth Circuit failed to designate the vote of a creditor who bought a blocking position in several classes after a plan of reorganization had been filed by a debtor. The creditor then used its position to ensure that the debtor's plan would be defeated, later enabling the creditor to submit its own plan designed to give it control over the debtor.[24] This result later prompted Congress to impose the good faith voting requirement in the Bankruptcy Code.

Drawing, in part, from *Waco* and subsequent Congressional action, the court likened the instant facts to *Waco* and affirmed the bankruptcy court's designation of DISH's vote. The court's analysis was also predicated on the language of the statute and guided by the general principle that [t]he Code measures the acceptance of a plan not creditor-by-creditor or claim-by-claim, but class-by-class. Since DISH's claim was the only claim in its class, and since that claim was designated pursuant to section 1126(e), the court was required to disregard the entire class when deciding whether to confirm a plan under section 1129(a)(8) of the Code.

Finally, the court responded to concerns that by designating DISH's vote, future creditors would be dissuaded from pursuing potential strategic transactions with Chapter 11 debtors. Here, the court stated: "our ruling today should deter only attempts to '*obtain* a blocking position' and thereby 'control the bankruptcy process for [a] potentially strategic asset'."[25] More importantly, the Second Circuit made clear that its decision did not apply to preexisting creditors (i.e., creditors whose interest in the claims predated the filing of a plan) who vote with strategic intentions.[26]

CONCLUSION

Unsecured creditors in the Second Circuit should feel empowered by *DBSD*. First, they have the standing to appeal a confirmed plan that provides them with no economic recovery so long as their claim has been estimated for voting purposes. Second, they have the ability to defeat a "gift" to a junior class that fails to provide the intermediate unsecured creditors with what is due and owing to them under the absolute priority rule.

However, *DBSD* also provides, as a sobering reminder for those in the claims trading and distressed M&A markets, that plan votes tied to the strategic acquisition of claims may ultimately be disregarded by the bankruptcy court. Although vote designation is a remedy that courts will use "sparingly," based on a fact-intensive inquiry, claims that are acquired after the filing of a proposed plan of confirmation, for the purpose of obtaining a blocking position and gaining leverage in the reorganized debtor, run a considerable risk of being deemed "not in good faith."

UNSECURED CREDITORS IN THE SECOND CIRCUIT SHOULD FEEL EMPOWERED BY *DBSD*.

In many respects, *DBSD* preserves the balance and fairness that is at the heart of the Bankruptcy Code. It reaffirms that no one party should be entitled to obtain a disproportionate advantage over others in a bankruptcy proceeding, while also reassuring unsecured creditors that their voice will be heard, regardless of the putative merits of their claim. Whether or not "gifts" made pursuant to a plan will continue after *DBSD* is a separate question. At a minimum, plan proponents will think twice, perhaps prompting more creative ways to obtain the support of junior classes.

EPILOGUE

In a twist of irony, the plan that ultimately was confirmed by the Bankruptcy Court in DBSD's bankruptcy proceeding earlier this month provided significant benefits to the parties who were on the losing side of the Second Circuit's decision. Specifically, DISH now owns DBSD's reorganized business, and ICO Global, DBSD's parent company and prepetition equity owner, received $325 million on account of its equity holdings.

IN A TWIST OF IRONY, THE PLAN THAT ULTIMATELY WAS CONFIRMED BY THE BANKRUPTCY COURT IN DBSD'S BANKRUPTCY PROCEEDING EARLIER THIS MONTH PROVIDED SIGNIFICANT BENEFITS TO THE PARTIES WHO WERE ON THE LOSING SIDE OF THE SECOND CIRCUIT'S DECISION.

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[2] Dish Network Corp. v. DBSD N. Am., Inc. (In re DBSD N. Am., Inc.), 634 F.3d 79 (2d Cir. 2011).

[3] For more detail on the Bankruptcy Court's vote designation ruling, see Norman S. Rosenbaum, et al., Riskier Times for Secured Lenders, Derivative Traders, and Distressed Debt Investors? A Synthesis of Six Significant Bankruptcy-Related Developments 7 (2010), http://www.mofo.com/files/Uploads/Images/100713Bankruptcy.pdf.

[4] 634 F.3d at 86.

[5] In re DBSD N. Am., Inc., 421 B.R. 133, 134 (Bankr. S.D.N.Y. 2009), aff'd, sub nom Dish Network Corp. v. DBSD N. Am., Inc. (In re DBSD N. Am., Inc.), No. 09-CIV-10156 (LAK), 2010 U.S. Dist. LEXIS 33253 (S.D.N.Y. Mar. 24, 2010).

[6] 634 F.3d at 87.

[7] Id. at 88.

[8] Id. at 89 (citations omitted).

[9] Id. (citations omitted)

[10] Id.

[11] Id. at 92.

[12] Id. at 90.

[13] Id. at 91 (citations omitted).

[14] Id. at 93.

[15] Id. at 95.

[16] Id. at 96.

[17] Id. (citations omitted).

[18] 984 F.2d 1305 (1st Cir. 1993).

[19] 634 F.3d at 98 (internal citation omitted).

[20] Id.

[21] Id. at 100.

[22] Id. at 102, quoting Figter Ltd. v. Teachers Ins. & Annuity Ass'n of Am. (In re Figter Ltd.), 118 F.3d 635, 638 (9th Cir. 1997).

[23] 634 F.3d at 103.

[24] Id. at 102-103; see also In re Allegheny Int'l, Inc., 118 B.R. 282, 289-90 (Bankr. W.D. Pa. 1990).

[25] 634 F.3d at 105 (emphasis added).

[26] Id. ("[O]ur opinion imposes no categorical prohibition on purchasing claims with acquisitive or other strategic intentions. On other facts, such purchases may be appropriate.").