SECOND CIRCUIT UPHOLDS DESIGNATION OF VOTES OF INVESTOR SEEKING TO ACQUIRE CONTROL AND PROHIBITS "GIFTING" IN PLAN OF REORGANIZATION

February 16, 2011

To Our Clients and Friends:

On February 7, 2011, the Court of Appeals for the Second Circuit issued its opinion in *In re DBSD North America, Inc.* (1) affirming the Bankruptcy Court's designation of votes of an investor, DISH Network Corporation ("DISH"), that purchased the senior secured debt of the debtor, DBSD North America, Inc. ("DBSD"), in furtherance of an "ulterior strategic motive" and (2) reversing the Bankruptcy Court's dismissal of a creditor's objection that the "gifting" in the proposed plan of reorganization violated the absolute priority rule.

Both aspects of the decision are of substantial importance. The Second Circuit's holding with respect to vote designation could cause investors to act more cautiously when acquiring claims in furtherance of a restructuring or distressed acquisition. The determination that non-consensual "gifting" violates the absolute priority rule aligns the Second Circuit (including the popular Southern District of New York bankruptcy venue) with the Third Circuit (which includes the popular Delaware bankruptcy venue) and may make it more difficult for debtors and senior creditors to win the support of junior creditors in the negotiation of plans of reorganization.

BACKGROUND

As described in more detail in our prior Client Update, the United States Bankruptcy Court for the Southern District of New York "designated", or disqualified, DISH's vote to reject DBSD's proposed plan of reorganization.[1] The court determined that DISH had not acted in good faith when, after DBSD had proposed a plan which would have satisfied the first lien debt through the issuance of a modified promissory note, DISH purchased all of DBSD's first lien debt at par and voted to reject the plan.

The plan also included a "gift" from the impaired second lien holders to the equity holders, which Sprint Nextel Corporation ("Sprint"), an unsecured creditor, objected to as a violation of the "absolute priority rule" codified in Section 1129(b)(2)(B) of the Bankruptcy Code.

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[1] *For more background on In re DBSD North America, Inc., please see our Client Update of March 1, 2010, entitled Bankruptcy Court Designates Votes of Investor Seeking to Acquire Control of the Debtor, available at* http://www.debevoise.com/files/Publication/88790379-6502-4149-b10c-128b1fe7a467/Presentation/PublicationAttachment/77d34e0d-a562-4243-860d-1bf8d3879e7b/BankruptcyCourtDesignatesVotesOfInvestorSeekingToAcquireControlOfTheDebtor.pdf.

Under the terms of the plan, the impaired second lien holders were to receive the majority of the stock in the reorganized entity, with approximately 0.15% of the stock allocated to unsecured creditors and approximately 5% of the stock and warrants allocated to the existing equity holders.

Both DISH and Sprint appealed to the Second Circuit after the Bankruptcy Court confirmed the plan of reorganization over their objections and the District Court affirmed the Bankruptcy Court rulings.[2]

VOTE DESIGNATION

As set forth in more detail in our prior Client Alert, Section 1126(e) of the Bankruptcy Code permits a court to designate any claimant's acceptance or rejection of a plan if such acceptance or rejection was not in good faith. In this case, the lower courts determined that DISH's rejection was in bad faith as DISH was pursuing an "ulterior strategic motive"—the acquisition of DBSD. The Second Circuit upheld the lower court rulings.

The Second Circuit, after reviewing relevant case law and evidence of Congressional intent, determined that DISH's behavior fit into "the general constellation" formed by *Allegheny Int'l Inc.,* 118 B.R. 282, 289-290 (Bankr. W.D. Pa. 1990) (party bought blocking positions to be able to promote its own plan), *In re MacLeod Co.*, 63 B.R. 654, 655-656 (Bankr. S.D. Ohio 1986) (parties affiliated with a competitor bought claims to obstruct plan and further their own business interests), and *In re Applegate Prop. Ltd.*, 133 B.R. 827, 833-35 (Bankr. W.D. Tex. 1991) (affiliate of debtor purchased claims to prevent confirmation of competing plan), and therefore the Bankruptcy Court permissibly designated DISH's vote. A driving factor in the court's decision appears to be that DISH was more interested in directing the proceedings toward a desired result rather than maximizing the return on its claims. The Second Circuit determined that DISH purchased the claims so that it could "bend the bankruptcy process toward its own strategic objective …, not toward protecting its claim." The Court also found that there was no clear error in the lower court's factual findings (many of which were supported by DISH's own internal communications).

The Second Circuit noted that "[m]erely purchasing claims in bankruptcy for the purpose of securing the approval or rejection of a plan does not itself amount to bad faith … [n]or will selfishness alone defeat a creditor's good faith" and that Section 1126(e) is implicated only

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[2] *The full decisions are as follows: In re DBSD North America, Inc., 419 B.R. 179 (Bankr. S.D.N.Y. 2009), available at http://www.nysb.uscourts.gov/opinions/reg/180446_479_opinion.pdf; In re DBSD North America, Inc., 421 B.R. 133 (Bankr. S.D.N.Y. 2009); In re DBSD North America, Inc., 2010 WL 1223109 (S.D.N.Y. 2010); In re DBSD North America, Inc., __ F.3d __, 2011 WL 350480 (2d Cir. 2011), available at http://www.ca2.uscourts.gov/decisions/isysquery/50b54c6d-ab89-4c46-9669-ebd6ed990f6b/1/doc/10-1175%20Complete_opn.pdf.*

when parties move beyond the selfish promotion of their claims and vote based on a different purpose. In addition, the Second Circuit specifically noted that the decision only addresses attempts to "*obtain* a blocking position" and that it leaves open the issue of whether a *preexisting* creditor can vote with strategic intentions.

Given the highly fact specific nature of this decision, it is difficult to predict what effect the decision will have on loan-to-own strategies and the risks associated with possible vote designation. However, it is clear that this decision opens the door to the possibility of more litigation (both threatened and actual) in this area.

GIFTING AND THE ABSOLUTE PRIORITY RULE

In a "gifting" plan, a class of senior creditors that is not receiving the full value of its claims permits the debtor to provide a portion of such class's recovery to a class of junior creditors or interest holders by passing an intervening non-consenting class. In *DBSD North America, Inc.,* Sprint argued that the "gifting" plan violated the absolute priority rule set forth in Section 1129(b)(2)(B) by providing shares and warrants to equity holders while Sprint (an unsecured creditor senior to the equity holders) did not receive full value and rejected the plan. In approving the DBSD plan of reorganization, the Bankruptcy Court determined that the secured second lien debt holders were undersecured and therefore entitled to the full residual value of the debtor. As such, the second lien debt could provide a "gift" to subordinate classes if the second lien debt so desired. The Bankruptcy Court determined that such gifting was permissible when the gift "comes from secured creditors, there is no doubt as to their secured creditor status, where there are understandable reasons for the gift, … and where the complaining creditor would get no more if the gift had not been made."[3] Courts have approved "gifting" plans in the past based on these or similar criteria based on the decision of the Court of Appeals for the First Circuit in *In re SPM Manufacturing Corp.,* 984 F.2d 1305 (1st Cir. 1993).

In *In re SPM Manufacturing*, a secured creditor and the general unsecured creditors in SPM's Chapter 11 bankruptcy agreed to seek liquidation of the debtor and to share the proceeds of the liquidation. The Bankruptcy Court granted relief from the automatic stay and the case was converted to a Chapter 7 liquidation. However, once converted, the Bankruptcy Court did not allow the unsecured creditors to receive their agreed share and instead ordered it be provided to an intervening class of creditors. The First Circuit reversed the Bankruptcy Court, holding that nothing in the Bankruptcy Code prohibited secured creditors from sharing their proceeds in a Chapter 7 liquidation with unsecured creditors at the expense of an intervening creditor who would otherwise take priority over the unsecured creditors. The Second Circuit distinguished *In re SPM* on numerous grounds, the most important being that

[3] *In re DBSD North America, Inc., 419 B.R. at 212 (Bankr. S.D.N.Y. 2009)*

In re SPM was a Chapter 7 liquidation and Chapter 7 does not include the absolute priority rule set forth in Section 1129(b)(2)(B).

Section 1129(b) provides that if a dissenting class of senior claim holders does not receive the full value of their claims under a plan of reorganization, then no holder of a junior claim or interest may receive any property under the plan on account of such junior claim or interest. The Second Circuit, in a strict reading of Section 1129(b), determined that the dissenting senior claim holder was not receiving full value for its claim (pursuant to the plan the estimated recoveries for the class was less than 50%) and that the existing equity holders were receiving "property" "under the plan" "on account of" such equity holders' existing interest, and therefore the plan of reorganization was not "fair and equitable" to the dissenting senior claim holders and could not be confirmed.

The Court determined that the shares and warrants being issued were property of the bankruptcy estate and not property of the senior secured creditors, who chose not to receive the specified property and therefore had no ownership rights to the property – such ownership rights remained with the estate. The Court specifically noted that the absolute priority rule covers "any property" and not "any property not covered by a secured creditor's lien." The Court also determined that the property was being received "under the plan," as the disclosure statement specifically provided that the existing equity holders would be receiving shares and warrants pursuant to the plan. Lastly, the Court determined that the shares and warrants were being received "on account of" the existing equity interest and not due to other consideration provided by the existing equity holder.

The Court acknowledged that strict enforcement of the absolute priority rule may encourage dissenting creditors to hold out and thereby complicate plan negotiations. The Court concluded, however, that the codification of the absolute priority rule in Section 1129(b)(2) reflected a Congressional judgment that protecting creditors from collusion between senior secured creditors and existing controlling shareholders outweighed the hold-out risk. The decision does not reach the question of whether senior creditors may "gift" outside the context of a plan. The Second Circuit's decision will likely effect the structuring and negotiation of plans of reorganization in cases filed in the Southern District of New York.

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