LENDING & RESTRUCTURING ALERT

Important Warnings Against "Gifting Plans" and Hostile Takeover Attempts in Chapter 11

The Second Circuit Court of Appeals' February 7, 2011 decision, which reversed the confirmation of a plan of reorganization for DBSD North America, Inc. ("DBSD")[1] is likely to have an impact nationwide. The ruling of this influential court, whose decisions govern all New York, Connecticut and Vermont federal district and bankruptcy courts, generally rejects two practices: (1) Distribution of property under a plan of reorganization to equity holders without fully repaying non-consenting unsecured creditors, based on the purported justification that the distribution is a "gift" of property that a senior creditor is entitled to collect; and (2) Voting of claims purchased by a competitor after a debtor has filed a plan of reorganization in order to block plan confirmation so that the competitor can take over the debtor's business.

The Gift Under DBSD's Plan is Rejected

DBSD was a development-stage company that intended to build a mobile communication network. Before its bankruptcy filing, DBSD had incurred $40 million of first lien debt and $650 million of second lien debt. After filing for bankruptcy, DBSD proposed a plan under which the second lien debt would receive nearly 95% of the equity in the reorganized company, its non-debtor parent would receive nearly 5%, while unsecured creditors would receive only .15% of such stock, representing a very small recovery on unsecured claims. Sprint Nextel Corp. ("Sprint"), an unsecured creditor holding an unliquidated litigation claim that the bankruptcy court estimated at $2 million for plan voting purposes, objected to the plan. Sprint argued that the debtor's plan violated the Bankruptcy Code's "absolute priority rule," which requires that, if a class of unsecured creditors votes against a plan, it may not be confirmed unless (i) the dissenting class receives full payment of its claims, or (ii) no class junior to this class receives any property under the plan on account of its junior claims or interests. Sprint protested that existing equity would receive a distribution under the plan even though its general unsecured creditor class had voted to reject it and was not being paid in full.

DBSD defended its plan by arguing that the distribution to existing equity was a consensual "gift" from the second-lien holders. DBSD argued that a class of secured creditors whose claims were not being paid in full, but who hold priority over general unsecured creditors, may voluntarily allocate a portion of its recovery to the equity class. DBSD contended that unsecured creditors were not harmed because they were "out-of the-money," so they were in no worse a position than if the second lien claimholder class had retained that distribution and nothing were distributed to equity under the plan.

Reversing the rulings of the bankruptcy court and the district court, the Second Circuit rejected this argument. It held that where a class of unsecured creditors votes to reject a plan, the absolute priority rule bars distribution of "any property" from a debtor's estate—including property encumbered by a secured creditor's lien—to existing equity on account of its prepetition interest. The court acknowledged that its ruling increased the leverage of unsecured creditors in plan negotiations, which it described as precisely why the Bankruptcy Code includes this rule.

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Designation of Dish's Votes

Dish Network Inc. ("Dish"), a satellite television provider, was also a competitor of DBSD. After DBSD filed its plan, Dish purchased at par all of DBSD's first lien debt, and a substantial amount of second lien debt in order to derail DBSD's plan and, according to internal Dish documents, gain control over DBSD. Agreeing with the lower courts, the Second Circuit held that Dish's votes against the plan should be designated (i.e., disregarded), because they were not cast in good faith.

The court recognized that the purchase of claims in bankruptcy in order to secure approval or rejection of a plan is not per se bad faith, and that selfishness alone does not defeat a creditor's good faith. But here, a competitor of DBSD bought a blocking position after a plan had been proposed, not to maximize its return on the debt or protect its claim, but to use its votes as levers to bend the bankruptcy process toward its strategic objective of acquiring DBSD's spectrum rights. The court did not announce a bright-line rule as to when votes should be designated. Instead, the court stated that the question of vote designation involves a fact-intensive inquiry based on the totality of the circumstances where considerable deference is afforded to bankruptcy judges. Without elaboration, it commented that on other facts, claims purchases with acquisitive or other strategic intentions may be appropriate. The court added that its ruling should deter only attempts to obtain a blocking position and thereby control the bankruptcy process to acquire a potentially strategic asset, but "left for another day" the question of designation of votes where a preexisting creditor votes with strategic intentions.

Conclusion

The court's decision appears to bar "gifting plans" in the Second Circuit. While it did not expressly prohibit every possible gifting stratagem, the thoroughness and tone of the opinion makes it appear highly unlikely that the court would be sympathetic to attempts to circumvent the "absolute priority rule" through gifts to junior debt classes. This decision does not indicate whether a gift from a serious creditor under an agreement made outside of a plan violates the absolute priority rule. The impact of the decision on disqualification of votes is less certain, but it suggests that the purchase of claims not to collect on them or protect one's position as a pre-existing creditor, but as a means for a corporate raider to influence or control a debtor's chapter 11 case, should not be permitted. Left unsettled is whether this logic applies to other creditors, such as a distressed debt fund, seeking to acquire control by purchasing "blocking" positions in classes of debt either before a troubled company files for bankruptcy or post-bankruptcy but before the debtor files a plan of reorganization. If a DBSD-type challenge to such purchases were to prove successful, it would likely have a chilling effect on the market for buying claims against debtors.

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[1] *DISH Network Corp.* v. *DBSD North America, Inc., Sprint Nextel Corp.* v. *DBSD North America, Inc.*, F.3d , 10-1201, 10-1352 (2nd Cir. February 7, 2011).