New York Law Journal

A NEW YORK LAW JOURNAL SPECIAL SECTION

An ALM Publication

Corporate Restructuring And Bankruptcy

WWW.NYLJ.COM

MONDAY, MARCH 7, 2011

Second Circuit Rejects 'Gifting' in 'DBSD' Ruling

Standing to appeal plan confirmation, bad faith voting also addressed.

BIGSTOCK

BY ALISON D. BAUER AND WILLIAM F. GRAY JR.

THE PERIL OF GIFT-GIVING, so familiar among family and friends, was recently examined in the Chapter 11 plan context by the U.S. Court of Appeals for the Second Circuit in *In re DBSD N.A. Inc.*[1] At issue was the commonly used and common law-blessed practice of "gifting," the voluntary transferring of rights or interests by a senior creditor class to a junior creditor class to facilitate confirmation of a proposed reorganization plan.

The Second Circuit reversed confirmation of a plan, holding that its gifting provisions violated the absolute priority rule, which provides that a reorganization plan is not "fair and equitable" with respect to a dissenting class of impaired creditors unless the creditors in that class are paid in full or no junior creditors or equity holders receive a distribution under the plan. In holding that the senior creditors in *DBSD* could not transfer a portion of their recoveries to shareholders over the objection of impaired unsecured creditors, the Second Circuit aligned itself with the Third Circuit.

This article also briefly discusses two other important aspects of the Second Circuit's ruling. First, adding a David and Goliath twist to its decision, the court determined that an "out-of-the-money" creditor holding a relatively small unliquidated disputed claim has standing to appeal a confirmation order supported overwhelmingly by nearly all voting senior creditors. Finally, the court analyzed the ulterior motives that warrant designating, or disqualifying, plan votes because of a lack of "good faith."

The 'DBSD' Case and the Proposed Plan

The debtor satellite communications company DBSD North America Inc. (DBSD) had sought Chapter 11 protection to buy breathing space and a fresh start to develop its mobile communications network.

At the time of filing, DBSD had purchased the requisite spectrum space and launched a communications satellite, but had not produced any serious revenues. The company was unable to service its first lien debt, consisting of a $40 million revolving credit facility, or its second lien debt, consisting of $650 million in convertible senior secured notes carrying a 7.5 percent coupon.

The Chapter 11 case served as an incubator, sustaining the company while it attempted to restructure its indebtedness. After substantial negotiations, the company proposed a reorganization plan, which deleveraged the business, thus offering a fresh start.

Under the proposed plan, the first lien creditors

ALISON D. BAUER *and* WILLIAM F. GRAY JR. *are partners in the restructuring and insolvency practice of the New York office of Torys; Mr. Gray co-chairs the firmwide restructuring and insolvency practice.*

were offered new debt obligations of longer term at the same interest rate, albeit paid in kind. The second lien creditors were to receive a majority of the new equity in reorganized DBSD, having a value estimated at between 51 percent and 73 percent of their allowed claims. General unsecured creditors were to receive approximately 0.15 percent of new equity, having a value estimated at between 4 percent and 46 percent of their unsecured claims.

The plan included a voluntary "gift" of approximately 5 percent of new equity stock and warrants to the prepetition equity holders, which gift was to come out of the recoveries of the second lien creditors. The plan was approved by 24 classes of creditors, including the gift-giving second lien creditors and then "crammed-down" on the dissenting class of general unsecured creditors, which included Sprint Corporation, the holder of a disputed litigation claim.

To confirm the plan, the bankruptcy court "designated" the vote of the first lienor class, all of whose debt had been purchased by DISH Network Corporation, effectively a competitor of DBSD, on the basis that the vote had not been in good faith. Both Sprint and DISH appealed the confirmation order.

The major issues on appeal were:

(i) whether a Chapter 11 plan may involve the gift of recoveries from a senior creditor to junior creditors and interest holders over the objection of impaired unsecured creditors despite the absolute priority rule;

(ii) whether an out-of-the money creditor with an unliquidated and disputed claim has standing to appeal confirmation of a plan; and

(iii) whether purchasing a blocking position of claims to further strategic objectives constitutes a basis for a court "designating" and, thus, not counting, a plan vote as "not in good faith."

Circuit's New Gift Return Policy

The Second Circuit upheld Sprint's appeal that DBSD's plan violated the absolute priority rule set forth in §1129(b)(2)(B) of the Bankruptcy Code.[2]

Adopting a strict constructionist view, the court held that a senior creditor could not gift recoveries to junior holders over the objection of impaired unsecured creditors, which in this case included Sprint. The plan supporters argued that Sprint was out-of-the-money and that the second lien creditors, who would be the recipients of the remainder of any distributions, were entitled to gift some of their distributions, which would no longer be property of the estate, to preexisting shareholders.

The Circuit disagreed with the bankruptcy court's conclusion that the plan did not violate the absolute priority rule under the gifting exception, as formulated by the First Circuit in *Official Unsecured Creditors Comm. v. Stern (In re SPM Mfg. Corp.)*[3] but rejected by the Third Circuit in *In re Armstrong World Industries Inc.*[4] Because Sprint would not receive value equal to the allowed amount of its claim, the plan's distribution of new equity to the junior class of prepetition shareholders violated the absolute priority rule.

The court looked at three elements of §1129(b)(2)(B): (i) whether the junior holder received "property" (ii) "under the plan," (iii) "on account of" such junior interest, easily concluding that the preexisting shareholders received property (shares and warrants) that was "property of the estate," not property of the secured creditors.

> At issue in 'DBSD' was the **commonly used** and **common law-blessed** practice of '**gifting**,' the voluntary transferring of rights or interests by a senior creditor class to a junior creditor class **to facilitate confirmation** of a proposed **reorganization plan**. The Second Circuit **reversed** confirmation of a plan, holding that its gifting provisions **violated** the **absolute priority rule**.

The Circuit rejected the argument that the recoveries were the exclusive property of the second lienors to dispose of as they wanted. Rather, the court felt the debtor had a continuing interest in the liened property that precluded unilateral disposition by the lienors. Because the secured creditors did not seek ownership of the reorganized debtor, they did not control the property. The absolute priority rule does not apply merely to "property not covered by a senior creditor's lien."

The court distinguished the First Circuit's holding in *SPM*, because that case involved a Chapter 7 debtor, to which the absolute priority rule under Chapter 11 was not applicable and the automatic stay had been lifted; therefore, the property was treated as not being part of the bankruptcy estate.

The court, primarily relying on the debtor's own words, found that the prepetition shareholders received the property "under the plan" because the distributions were provided for under the plan and the disclosure statement explained that the prepetition shareholder distributions were being paid pursuant to the plan. Furthermore, the prepetition shareholders received shares and warrants "on account of" its junior interest in the debtor regardless of whether there were other reasons to provide the equity to it.

"On account of" could be interpreted to mean "in exchange for" or "because of." Either interpretation led to the same result: The preexisting shareholders received the new shares and warrants at least partially in exchange for the old equity.

Buying cooperation and assistance from the shareholders, a factor the bankruptcy court noted, does not eliminate the fact that the shares were given on account of the preexisting interest because there is no statutory requirement that the gift be "solely" or "primarily" "on account of" the prepetition equity interest. This was not a situation in which new value was given in exchange for the equity, which even then comes under scrutiny.

In the Second Circuit's decision, a literal application of the statutory rule triumphed over the figurative and flexible common law concept of gifting. The court discussed the practical implications of the holding, such as encouraging unsecured objecting creditors to be plan "hold-outs" knowing that they have the protection of the absolute priority rule. But in the court's view, this did not outweigh the evil that may be caused by controlling shareholders who benefit in the first instance from exclusivity rights and who collude with secured creditors to the detriment of unsecured creditors if the gifting exception continued.

This decision will undoubtedly affect restructuring plans in the Southern District of New York, as it has done in Delaware. Perhaps senior creditors with post-confirmation ownership interests will give distributions to junior parties after the reorganization plan is confirmed to maximize the value of their investment since the court did not rule on gifting outside a plan. However, this approach has drawbacks in that it is unclear what disclosure would be necessary, a court might view it as against public policy, certain Bankruptcy Code securities law exemptions would be inapplicable and there are practical difficulties in binding the shareholders to a private arrangement.

The Second Circuit also noted its prior case, *In re Iridium Operating LLC*,[5] in which it held that a pre-plan settlement distribution scheme did not satisfy the absolute priority rule. Though not a strict prohibition on gifting in pre-plan settlements, this case limits the avenue for interested parties in a bankruptcy case to use pre-plan settlements to avoid the curtailment of the gifting doctrine in the Second Circuit.

Thus, gifting in the Chapter 11 plan context has been removed from the toolbox of plan sponsors and senior creditors seeking to grease the skids of the confirmation process in New York and Delaware. Bankruptcy practitioners will have to be creative in negotiating arrangements that achieve the goals of reorganization while adhering to the Second Circuit's strict reading of the absolute priority rule.

Standing to Appeal

Twenty-four creditor classes approved the proposed plan, including the second lien debt class, representing $740 million of senior secured notes. The creditor/appellant that single handedly challenged confirmation on the gifting issue was Sprint, a litigation creditor holding an unliquidated and disputed general unsecured claim allowed temporarily only for voting purposes in the amount of $2 million.

As a threshold matter, the Second Circuit dismissed a challenge to Sprint's standing to appeal, noting, "We have never demanded more to accord a creditor standing than that it has a valid and impaired claim." The court was unimpressed by the appellees' argument that Sprint had no reasonable prospect of recovery in the case. (The undisputed valuations of the debtor showed insufficient value to fully pay the allowed secured debt, let alone make any distribution to unsecured creditors.)

The Second Circuit has created a broad standing benchmark: Any creditor holding an impaired claim has standing to appeal confirmation, even if its claim is disputed, contingent, unliquidated and out-of-the-money.

In dissent, Judge Rosemary Pooler argued that a creditor with an unliquidated claim should not have standing to appeal a confirmation order in the absence of clear pecuniary loss. Much more so than the majority opinion, the dissent focused on the broad popular vote supporting the plan and the prospect of a successful reorganization.

The dissent captures the tension between the competing philosophical pillars of the Bankruptcy Code, namely, the orderly distribution of value among creditors and the imperative of providing a fresh start for debtors. The dissent seems almost offended that a single creditor holding a claim of dubious merit could thwart the consensual reorganization of a substantial business.

Good Faith Voting and Designation

DISH Network Corporation (DISH), rightly or wrongly, is cast as the villain in the case.

DISH had no prepetition claims against DBSD and is a substantial investor in a direct competitor. Shortly after DBSD's bankruptcy filing, DISH purchased at full value all of DBSD's first lien debt and a portion of its second lien debt as part of a "loan to own" strategy, hoping to take control of the plan process. DISH's attempt to derail the debtor's reorganization plan by voting against confirmation was scuttled by the bankruptcy court, which designated, or disqualified, DISH from voting because its opposition to the plan was not in good faith.

The Second Circuit upheld the bankruptcy court's designation of DISH's "no" vote under the "good faith" provisions of Code §1126(e)[6] because it was cast "not in good faith." Describing the motives that don't merit designation was easier for the court than articulating what renders motives sinister.

Merely purchasing claims in order to facilitate approval or rejection of a plan does not amount to bad faith, the court noted. "Nor will selfishness defeat a creditor's good faith…."

It is also clear that "not just any ulterior motive constitutes the sort of improper motive that will support a finding of bad faith." Yet somehow DISH threaded this needle and had its vote designated.

The key considerations were that DISH was a competitor, acquired its claims contemporaneously with the plan process, not to gain a pecuniary benefit, but rather to subvert a plan for its own strategic purposes. The court concluded that the designation was appropriate because DISH attempted to "bend the bankruptcy process" to control the company and the spectrum rights, and not "towards protecting its claim." In dicta, the court noted, however, that preexisting creditors who do not "obtain" control positions may not be subject to the same designation.

Although the court may not have eliminated the ability of creditors to purchase claims in bankruptcy and vote their claims for strategic purposes, it does lay a thick minefield around such an approach. For now, strategic claims traders should find some consolation in the court's assurance that designation should remain a rare remedy, though they should be warned that gifts may be returned.

1. __F.3d__, 2011 WL 350480 (2d Cir. Feb. 7, 2011) (Nos. 10-1175, 10-1201, 10-1352).

2. This section provides that "For the purpose of this subsection, the condition that a plan be fair and equitable with respect to a class includes the following requirements:

(B) With respect to a class of unsecured claims—

(i) the plan provides that each holder of a claim of such class receive or retain on account of such claim property of a value, as of the effective date of the plan, equal to the allowed amount of such claim; or

(ii) 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, except that in a case in which the debtor is an individual, the debtor may retain property included in the estate under section 1115, subject to the requirements of subsection (a)(14) of this section."

11 U.S.C. 1129(b)(2)(B).

3. 984 F.2d 1305, 1313-14 (1st Cir. 1993).

4. 432 F.3d 507, 514 (3d Cir. 2005).

5. 478 F.3d 452 (2d Cir. 2007).

6. 11 U.S.C. 1126(e) 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."