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Bankruptcy & Restructuring ALERT

December 2010 www.ssd.com

Second Circuit Designation Ruling Serves Wake-Up Call to Strategic Bankruptcy Investors

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Introduction

A recently decided case may send shivers down the spines of equity investors employing a loan-to-own strategy. In what should be a significant wake-up call to strategic bankruptcy investors, the Second Circuit Court of Appeals recently upheld the District Court's affirmation of the Bankruptcy Court's decision that claims purchased by an investor for strategic purposes – i.e., to control the votes of a class or blocking confirmation of a plan, and not to share in a potentially higher distribution – were subject to disqualification. *DISH Network Corp v. DBSD North America, Inc. (In re DBSD North Am., Inc.)*, 2010 U.S. App. LEXIS 24861 (2d Cir. Dec. 6, 2010). This is likely to have a chilling effect on strategic investors, many of which use the purchase of claims as a means of acquiring control of a target debtor. As noted below, however, strategic investors need not look for jobs elsewhere; with proper advance planning, plan-based acquisition efforts may still be viable, even in the Second Circuit.

The Debtors

DBSD North America, Inc. (DBSD) was a start-up company seeking to develop a satellite communications system with both space and earth-based components.

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As part of its initial financing efforts, DBSD borrowed capital under two financing facilities: (i) a US$40 million first lien working capital facility, initially at a 12.5 percent annual interest rate, secured by (a) substantially all of DBSD's assets (the First Lien Debt) and (b) a pledge of 100 percent of the equity of the Debtors; and (ii) a second lien facility in the approximate amount of US$810 million (the Second Lien Debt).

The Bankruptcy Case

On May 19, 2009 (the Petition Date), DBSD and its subsidiaries (the Debtors) filed for relief under Chapter 11 of the Bankruptcy Code. Prior to the Petition Date, certain holders of the Second Lien Debt entered into a support agreement (the Support Agreement) with the Debtors, pursuant to which, among other things, the Debtors agreed to proceed with a plan of reorganization (the Plan) that would exchange Second Lien Debt for approximately 95 percent of new common stock in the reorganized Debtors, with 5 percent of the new stock going to the existing shareholders. On July 24, 2009, the Debtors filed their Plan and their Disclosure Statement. The proposed Plan provided for, among other things, an exit financing facility of US$57 million, secured, in part, by a junior lien on the Debtors' assets, and backstopped by certain holders of the Second Lien Debt.

With respect to the First Lien Debt, the Debtors proposed a cramdown, whereby First Lien Debt claims would be satisfied with a modified promissory note under an amended credit facility (the Amended Facility), having principal equal to the allowed amount of the First Lien Debt, a four year maturity date and payment in kind (PIK) interest at 12.5 percent per annum. Significantly, the lien on the Debtors' equity would be cancelled. Two weeks after the Debtors filed the Disclosure Statement, DISH Network Corporation (DISH), a competitor of the Debtors, purchased all of the First Lien Debt at par. In addition, an affiliate of DISH purchased approximately US$111 million of the Second Lien Debt from those holders who were not bound by the Support Agreement with the Debtors. Its stated goal was to ultimately obtain control of DBSD.

DISH voted all of its claims, including the entire class of First Lien Debt, to reject the Debtors' Plan. In response, the Debtors filed a motion to designate DISH's vote of its First Lien Debt to reject the Plan (its Second Lien Debt rejection was insufficient to carry that class, which voted in favor of the Plan). As a preliminary matter, the Bankruptcy Court found that DISH did not purchase its

First and Second Lien Debt in order to make a profit on the possibility of increased recoveries, but rather as a "strategic" investor to acquire control of the Debtors. This finding was made easier by DISH's own documents, which were rife with statements such as "we have an opportunity to obtain a blocking vote," "we can control the bankruptcy process for this potentially strategic asset" and "we want to acquire the remaining [Second Lien Debt] in an attempt to convert to equity and acquire control of the Debtors." *See In re DBSD North America, Inc.*, 421 B.R. 133 (Bankr. S.D.N.Y. 2009).

Designating Claims Under the Bankruptcy Code

The Bankruptcy Code provides that certain votes can be "designated" – i.e., not counted for plan voting purposes. These votes can be either to accept or to reject a plan when such acceptance or rejection "was not in good faith, or was not solicited or procured in good faith or in accordance with the provisions of this title." 11 U.S.C. §1126(e); *see also Century Glove, Inc. v. First American Bank of New York*, 860 F.2d 94, 97 (3d Cir. 1988) (noting that §1126(e) "grants the bankruptcy court discretion to sanction any conduct that taints the voting process, whether it violates a specific provision or is in 'bad faith'"). The Bankruptcy Code does not define "good faith," but in the context of vote designations, other bankruptcy courts have found that its counterpart, "bad faith," can be found "where a claim holder attempts to extract or extort a personal advantage not available to other creditors in the class, or where a creditor acts in furtherance of an ulterior motive, unrelated to its claim or its interests as a creditor." 421 B.R. at 138.

The Bankruptcy Court observed that several badges of bad faith have been developed by other courts in connection with designation. They include efforts to (i) assume control of the debtor; (ii) put the debtor out of business; (iii) destroy the debtor out of pure malice; or (iv) obtain benefits available under a private agreement with a third party that depends on the debtor's failure to reorganize. *See id.* (citing *In re Dune Deck Owners Corp.*, 175 B.R. 839, 844-45 (Bankr. S.D.N.Y. 1995) and *In re Adelphia Communications Corp.*, 359 B.R. 54, 61 (Bankr. S.D.N.Y. 2006)).

With respect to the first element, efforts to "assume control," the Bankruptcy Court looked to the seminal case on this factor, *In re Allegheny Int'l, Inc.*, 118 B.R. 282 (Bankr. W.D. Pa. 1990), in which a third-party plan proponent, Japonica Partners (Japonica), bought up claims against the debtor at increasing prices including par after the debtor had filed its plan. In designating Japonica's vote against the debtor's plan, the court found that it was not the fact that Japonica had purchased claims, but the manner in which it had done so. First, because Japonica purchased the bulk of its claim after the disclosure statement was approved, it knew what it was getting into when it made those purchases − it was a voluntary claimant − and if Japonica was not happy with the proposed distribution, it had the option of not becoming a creditor or could have proposed a plan without buying any claims. 421 B.R. at 139 (citing *Allegheny*, 118 B.R. at 289). Second, Japonica bought claims at all different prices, so creditors in the same class were receiving differing treatment. The *Allegheny* court found that Japonica's intent was obviously to take over and control the debtor, a purpose "fundamentally different" from the normal desire of creditors to maximize the recovery on their claims. "[V]otes must be designated when the court determines that the creditor has cast his vote with an 'ulterior motive' aimed at gaining some advantage to which he would not otherwise be entitled in his position." *Id.* The *Allegheny* court ruled that the purpose to take over the debtor was such an "ulterior motive," warranting vote designation. *Id.* (citing *Allegheny*, 118 B.R. at 290). What appeared to bother the Court in *Allegheny*, however, was that certain creditors got significantly less from Japonica than they would have in the reorganization. By contrast, DISH paid all creditors out at par.

In the instant case, the Bankruptcy Court determined that DISH bought its claims for a high price (at par) and, like Japonica, extremely late in the case (after the Disclosure Statement and Plan were filed). Further, testimony was elicited that DISH was willing to and did overpay for its claims, an action the Court felt was for purposes other than increasing its recovery. DISH, on the other hand, argued that it had been a "model bankruptcy citizen." In fact, it had not acted in secret, but had acknowledged in open court at the hearing on the Disclosure Statement that it had a strategic interest in acquiring the Debtor. Further, it had not attempted to interfere with the Support Agreement or moved to terminate exclusivity, had not proposed a competing plan and had not taken advantage of creditors, but had paid them at par. Each of these factors had previously been considered in the industry as hallmarks of having clean hands. The Bankruptcy Court was not swayed by these arguments, particularly in light of the fact that several days after the Disclosure Statement hearing, DISH did indeed file a motion to terminate exclusivity and propose a competing plan. *Id.* at 141. It probably did not help DISH that it came late to the game as a spoiler of an otherwise confirmable plan, announced it was doing so for its own benefit to acquire the company and replaced existing lenders' counsel with its own counsel who promptly ran up significant fees chargeable against the estate.

The Bankruptcy Court held that DISH's actions in the instant case were "indistinguishable" from Japonica's actions in *Allegheny;* the documents evidenced a clear strategic purpose. Therefore, just as in *Allegheny*, the votes of the First Lien Debt held by DISH must also be designated. *Id.* at 143. The District Court affirmed the Bankruptcy Court's decision, finding that there was no convincing case that the Bankruptcy Court's decision was "clearly erroneous," particularly in light of the abundance of evidence as to DISH's behavior. 2010 U.S. Dist. LEXIS 33253 (S.D.N.Y. March 24, 2010). And on December 6, 2010, the Second Circuit affirmed, as well.

Conclusion

The Court's ruling came as a shock to both the bankruptcy and private equity worlds where pursuing a loan-to-own strategy is commonplace. As always in bankruptcy, the specific facts of the case were outcome determinative, and one should not presume that the purchase of claims for strategic reasons will always lead to designation of the buyer's votes. Nonetheless, there are clearly some lessons one can glean from *DBSD.* The following safeguards are helpful in avoiding designation:

1. Bear in mind that all nonprivileged writings are likely to be discoverable, so take care in describing strategic goals in internal memoranda, emails and the like. To the extent communications can properly be labeled "Attorney-Client Privileged Communication," they should be, but expect the Court to see through unnecessary use of such designation.
2. Many investment strategies have a fallback position, and if so, this should be emphasized in all internal communications. It hurt DISH that its announced goal was to take over the company. Had its internal memoranda read: "We can either make a profit trading in the claims or possibly acquire control for a reasonable investment," the ruling might not have been so harsh.
3. Enter the fray as early as possible. Buying the claims after the plan was filed and then acting as a spoiler of what the Court perceived as an otherwise confirmable plan clearly hurt DISH.
4. DISH was hurt by buying its claims at par, since it demonstrably could not make money as a mere creditor. On the other hand, Japonica was

criticized for paying creditors less than they would have received under the plan and treating similarly situated creditors differently. Careful attention to the pricing of claims buying activities will be important in the future.

5. Other alternatives should be thoroughly explored with counsel, such as a competing plan that provides more for creditors or challenging the propriety of a cramdown or indubitable equivalent.
6. Careful attention should be paid to the amount of claims purchased. DISH may have been better off not being the sole owner of the First Lien Claims and having other parties vote no or be injured by the designation.
7. Courts have long been wary of the unregulated market in trading claims. Clearly, when one embarks on a claims trading strategy, the advice of experienced counsel will be key as courts decide whether *DBSD* is merely a blip or a preview of things to come.

If you have any questions concerning the Second Circuit's designation ruling or related matters, please contact your principal Squire Sanders lawyer or one of the lawyers listed in this Alert.