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Second Circuit Disapproves "Gifting" Plan and Designates Strategic Investor's Vote as Lacking Good Faith

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On February 7, 2011, the Court of Appeals for the Second Circuit issued a highly significant opinion in two consolidated appeals from the order of the United States District Court for the Southern District of New York affirming the bankruptcy court's confirmation of a chapter 11 plan of reorganization for DBSD North America and its subsidiaries (DBSD). The opinion, which can viewed here , was delivered in furtherance of the court's summary order of December 6, 2010 that (1) the "gifting" feature of DBSD's plan violated the absolute priority rule and therefore could not be confirmed, and reversing the district and bankruptcy courts, and (2) the bankruptcy court did not err in "designating" the vote of a creditor as not having been cast in good faith. The Second Circuit's opinion has already sent shock waves through the restructuring community and presents a major setback to a commonly accepted chapter 11 restructuring technique.

The "Gifting" Plan Violated the Absolute Priority Rule

It is not uncommon for a senior class of creditors to agree to a chapter 11 reorganization plan providing that some portion of the recovery that would otherwise accrue to the senior class be shared with a junior class

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(or classes) in the capital structure – a junior class of creditors and/or shareholders – even though an intermediate class of creditors would receive less than a full recovery under the plan. Sometimes referred to as "gifting" or a "tip" to the junior class, this consensual departure from the recognized distribution priority "stack" whereby senior creditors rank above junior creditors, who themselves rank above equity holders, is typically done for a very pragmatic reason – to get the deal done, and to get it done sooner rather than later. In many cases, absent a deal, the junior debt or equity class may be able to significantly delay, or even block, the debtor's emergence from chapter 11, typically by waging, or threatening to wage, a long and expensive battle over the value of the reorganized debtor, or raising other objections to plan confirmation. The gift may also be motivated by the senior creditors' desire to obtain a release, provided by the plan, of claims against them. A primary argument supporting such an agreement to permit the junior class a recovery over the protest of the intermediate class is straightforward and seemingly compelling. The seniors (supported by the plan proponents and other parties favoring the plan) argue to the effect that, "the debtor's value is insufficient to pay us in full, so we are free to share what would otherwise be our recovery as we see fit." The Second Circuit saw it differently.

DBSD developed a mobile communications network using satellites and land-based transmission towers. The large amount of debt that DBSD accumulated during the developmental period led it to seek chapter 11 relief. DBSD's plan de-leveraged its balance sheet. The first lien debt holders, all of whose claims had been bought by DISH Network (DISH), a competitor of DBSD, shortly after the plan was announced, were to be satisfied under an amended credit facility having the same non-default interest rate as their prepetition obligations. The second lien debt holders, owed US$740 million, would receive approximately 95% of the new equity of the reorganized debtor, for an estimated recovery of between 51% and 73%. Unsecured creditors would receive 0.15% of the new stock, for estimated 4% to 46% recovery. Sprint Nextel Corporation (Sprint) held an unsecured claim. DBSD's existing equity holders would receive new stock and warrants – a generous tip relative to the unsecureds' recovery, given that it amounted to 4.99% of the equity.

After the bankruptcy court confirmed the plan over the rejecting votes of Sprint's unsecured creditor class and DISH's first lien debt class (i.e., crammed down the plan), and the district court affirmed the bankruptcy court's ruling, the appeal landed in the Second Circuit.

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That court, in a 2-1 decision, held that the gifting feature of DBSD's plan precluded confirmation of the plan under the cram-down provisions of chapter 11. (The third member of the three-judge panel did not address the merits of Sprint's gifting challenge. Characterizing Sprint as an "out-of-the-money" unsecured creditor with an unliquidated claim, this judge believed that Sprint did not have standing to appeal from the order confirming the plan and dissented from the portion of the opinion granting appellate standing to Sprint.)

The core of the Second Circuit's ruling is its strict reading of the language of section 1129(b)(2)(B) of the Bankruptcy Code, which sets forth a form of the so-called "absolute priority rule" (a principle developed in Supreme Court decisions that creditors are entitled to be paid before equity holders can retain their stock) and requires that in order for a plan to be "fair and equitable" and confirmable over the vote of a dissenting class of unsecured creditors, the plan must *either* provide for full payment of the unsecured claims *or* provide that no class (of claims or equity interests) junior to the dissenting unsecured class "receive or retain under the plan on account of" the junior claims or equity interests "any property." The court had little difficulty determining that the plan did not comply with this cram-down requirement. First, there was no dispute that Sprint's unsecured class would receive less than 100 cents on the dollar under the plan. Next, the existing shareholders would clearly receive "property" in the form of new stock and warrants. That property would also be received by the shareholders "under the plan"; the disclosure statement for the plan stated clearly that shareholders would receive the stock and warrants under the plan and in satisfaction of their existing stockholder interests. Finally, the shareholders would receive the stock and warrants "on account of" their old equity interests (and not, for example, on account of an investment of new value in the reorganized entity, a possible exception or corollary to the absolute priority rule). The Second Circuit rejected DBSD's argument that the gifting doctrine permitted the second lien debt holders, as secured creditors, to gift a portion of "their" recovery as they wished. The court found no support for this position in the language of the Bankruptcy Code, and distinguished on several grounds a First Circuit decision often cited in support of the gifting doctrine, *In re SPM Manufacturing Corp.,* 984 F.2d 1305 (1st Cir. 1993), including that it was a chapter 7 case and thus did not implicate the "rigid absolute priority rule of § 1129(b)(2)(B)."

Noting that the language of section 1129(b)(2)(B) was dispositive, the Second Circuit nevertheless found

further support for its holding in Supreme Court precedent, as far back as an 1868 railroad reorganization case, rejecting the view that secured creditors may freely gift "their" recoveries to junior creditors or interests.

Finally, in the face of the policy argument that gifting promotes efficient, consensual resolutions of chapter 11 cases, the Second Circuit offered policy arguments in favor of the absolute priority rule – the potential for self-enrichment by shareholders who control the debtor and for mischievous behavior between senior creditors and shareholders.

Conclusion

While the Second Circuit rather forcefully rejected the gifting element of DBSD's plan, it cannot be said that the decision necessarily eliminates gifting in all forms and in all chapter 11 cases. But it is clear, at least in the Second Circuit, that a gift will almost certainly need to be effected within the confines of the language of section 1129(b)(2)(B). Thus, for example, the Second Circuit expressly did not decide whether a gift may comply with the Bankruptcy Code by taking place not "under the plan," but rather "outside of the plan." Creative restructuring attorneys no doubt will analyze whether this issue left open by the court provides an opportunity for a gifting transaction that does not run afoul of the absolute priority rule. In addition, to the extent that the gift can be shown to be "on account of" something other than the junior claim or interest – a release of claims against the gifting class, for example – it may possibly pass muster. Moreover, it is possible that in an extraordinary case, a gift may be approved as part of a settlement approved by the bankruptcy court under Bankruptcy Rule 9019 and, if so approved, incorporated into a plan. In the settlement context, the absolute priority rule does not apply directly, but an earlier Second Circuit decision, *In re Iridium Operating LLC,* 478 F.3d 452 (2d Cir. 2007), makes clear that whether the distribution under the settlement complies with the absolute priority rule will often be the "dispositive" factor in the bankruptcy court's consideration of the settlement; that a "minor" departure from the rule might be permissible; but that the court must be "certain" that the parties have not used the settlement to circumvent the rule. Finally, *DBSD,* together with other recent decisions, as well as the expense of restructuring in chapter 11, should further motivate troubled companies and their advisors to fully explore whether a successful restructuring can be consummated outside of the chapter 11 process.

Postscript on Designation of DISH's Vote

Shortly after the Second Circuit's December 2010 order, we issued an alert offering our thoughts on the bankruptcy court's designation of DISH's vote to reject the plan as lacking good faith and the district court's and Second Circuit's affirmance of that ruling. That alert can be found here. With the Second Circuit's analysis now fully set out in its opinion, we think our concluding discussion of lessons to be taken away from the ruling remains applicable. However, we again caution that "good faith" is particularly factual in nature, so that a strategic investor's consideration of any purchase of claims that could later be implicated in a vote designation dispute must be carefully analyzed in light of the particular facts and circumstances.