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A Vote for *Allegheny*: *DBSD North America*

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Feature

In a recently published decision, *In re DBSD North America Inc.*, 421 B.R. 133 (Bankr. S.D.N.Y. 2009), Hon. **Robert E. Gerber** of the U.S. Bankruptcy Court for the Southern District of New York "designated," or disqualified, the vote to reject the debtors' proposed plan of reorganization that was cast by the sole holder of the debtors' pre-petition first-lien debt. The court ordered this extreme remedy pursuant to the debtors' request after determining that the claimholder had voted as a "strategic investor" rather than as a "traditional creditor."

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Although the Bankruptcy Code explicitly grants bankruptcy courts the power to designate claimholders' votes, courts rarely exercise this power. This may be because, as Judge Gerber once noted in a decision denying a designation request, "[t]he ability to vote on a reorganization plan is one of the most sacred entitlements that a creditor has in a chapter 11 case."[2]

In certain instances, however, bankruptcy courts have been willing to take this extraordinary step, and the *DBSD* decision can be read as a reaffirmation and application of those past cases. Indeed, in his ruling, Judge Gerber relied heavily on a 20-year-old bankruptcy court decision from the Western District of Pennsylvania, *In re Allegheny Int'l Inc.*, 118 B.R. 282 (Bankr. W.D. Pa. 1990).

As it becomes increasingly common for would-be acquirers to purchase claims against distressed targets as a way of seeking to channel, block and/or control restructurings, the *DBSD* decision may also prove a harbinger of an increased willingness on the part of bankruptcy courts to explore claims purchasers' motivations when they vote on plans of reorganization. In that case, it will be more important than ever for strategic investors and their advisors to understand and heed the lessons of *Allegheny* and its progeny.

The Crux of Vote Designation: Lack of Good Faith

Pursuant to § 1126(e) of the Bankruptcy Code, on the request of a party in interest, a bankruptcy court may designate the vote of any entity whose acceptance or rejection of a plan of reorganization was not in good faith.[3] Accordingly, decisions on whether or not to designate votes turn on whether the votes in question were cast in "good faith."

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Good faith is not defined in the Code; it is instead left to courts to define on a case-by-case basis. Over time, the focus by most courts has been on the claimholder's motivation in casting its vote. The case law makes clear that a creditor is "expected to cast his vote in accordance with his perception of his own self-interest."[4] The question asked by most courts is whether the vote is cast in pursuit of an interest other than the creditor's interest as a creditor. When that is the case, the creditor opens itself to having its vote designated as having not been cast in good faith.

Modern Vote Designation: The *Allegheny* Doctrine

A good starting point for a discussion of modern vote designation is the oft-cited *Allegheny* decision. In that case, a competing plan proponent, Japonica Partners LP, purchased an amount of claims sufficient to block confirmation of the debtor's proposed plan. Japonica voted the claims in favor of its competing plan, which would give it ownership of the debtor.[5] The debtor moved to designate Japonica's votes.

The bankruptcy court designated Japonica's votes, holding that it had purchased its claims and voted them in bad faith. The bankruptcy court focused on the facts that Japonica had purchased just enough claims to block the debtor's

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2 *In re Adelphia Commcn's Corp.*, 359 B.R. 54, 56-57 (Bankr. S.D.N.Y. 2006).

3 Section 1126(e) also provides for vote designation where a vote was not solicited or procured in good faith or in accordance with the provisions of the Bankruptcy Code.

4 *Insinger Machine Co. v. Fed. Support Co. (In re Fed. Support Co.)*, 859 F.2d 17, 19 (4th Cir. 1988).

5 118 B.R. at 289.

plan and had purchased its claims at close to par value.[6] The bankruptcy court also noted that Japonica was not a pre-petition creditor of the debtor.[7] Rather, it purchased its claims only after the debtor's proposed plan had been filed. Moreover, Japonica had a longstanding interest in the debtor, but only proposed its competing plan on the last day of the hearing on the debtor's disclosure statement.[8] According to the *Allegheny* court, these facts established that Japonica acted with an ulterior motive to take over and control the debtor, rather than acting merely to further its own economic interests as a creditor.[9]

Development of the Allegheny *Doctrine: Decisions Granting Motions to Designate Votes*

Since *Allegheny*, there have been relatively few reported decisions designating votes. Those that have granted the remedy have looked to whether a claimholder, through its vote, was pursuing an ulterior motive—an interest other than its interest as a creditor—as an indication that the vote was not cast in good faith. As various courts have noted, examples of such ulterior motives often include a desire to:

> (1) assume control of the debtor, (2) put the debtor out of business or otherwise gain a competitive advantage, (3) destroy the debtor out of pure malice or (4) obtain benefits available under a private agreement with a third party which depends on the debtor's failure to reorganize.[10]

At least one, and usually more, of the following indicators of ulterior motive have been present in cases where courts have designated a claimholder's vote: (1) the claimholder was not a pre-existing creditor of the debtor; (2) the claimholder purchased the claims at issue after a plan was proposed; (3) the claimholder purchased its claims on highly unfavorable economic terms; (4) the claimholder is a competitor of the debtor; and (5) there are competing plans of reorganization before the court.

For example, in *In re Applegate Property Ltd.,* 133 B.R. 827 (W.D. Tex. 1991), a Texas bankruptcy court designated the votes of an affiliate of the debtor that had purchased a majority of the debtor's unsecured claims and voted them against a competing plan that contemplated the debtor's liquidation.[11] The court reasoned that the affiliate's purchase and vote of its claims were in bad faith because they were in aid of an interest—avoiding liquidation of the debtor—other than that of a creditor.[12] A number of the *Allegheny* factors were present: (1) the affiliate was not a pre-existing creditor, (2) it purchased its claims after a plan had been proposed; and (3) it paid par for its claims, notwithstanding the fact that the affiliate's favored plan would pay only four cents on the dollar on account of the purchased claims. Based on these facts, the court could find no reason for the affiliate's purchase other than a desire to block acceptance of the competing plan.[13]

Similarly, in *In re Holly Knoll Partnership,* 167 B.R. 381 (Bankr. E.D. Pa. 1994), the bankruptcy court held that a claimholder's purchase and vote of its claim was in bad faith and would have been disqualified had it not already been disregarded as the vote of an insider.[14] Although considered in *dicta*, the *Holly Knoll* court's reasoning on this point is in line with *Allegheny*. A co-proponent of the debtor's proposed plan purchased a claim against the debtor after learning that confirmation of the debtor's plan hinged on the vote of that claim.[15] Notably, under the proposed plan, the co-proponent would become the new general partner of the debtor and receive a 10 percent interest in the debtor, in addition to other fees.[16] As in *Allegheny* and *Applegate*, the co-proponent was not a pre-existing creditor of the debtor.[17] These factors indicated to the court that the claimholder "was not acting to protect or maximize its rights as a creditor but, rather, was acting to preserve financial advantages it would receive if the plan was confirmed."[18] According to the bankruptcy court, this ulterior motive constituted bad faith.[19]

Decisions Denying Motions to Designate Votes

More prevalent are decisions that decline to designate votes. A review of these decisions establishes that courts will decline to designate votes where it is feasible that the relevant claimholder is attempting to maximize its individual recovery as a creditor. Where such "ordinary recovery maximization strategies" are present, courts are more reluctant to inquire into a creditor's motives behind the purchase and vote of its claims.[20]

For instance, in *Adelphia*, a group of claimholders held claims against several debtor entities. The claimholders voted against one of the debtor's plans because any recovery under the plan would have decreased the claimholders' recovery under the other debtors' plans. Although describing the creditors' conduct as "overly aggressive" and "overreaching,"[21] the bankruptcy court declined to disqualify the creditors' votes because they did not appear to be trying to harm the debtor or its business with their votes.[22]

Even where a creditor votes purchased claims to block confirmation of a plan, designation will not likely be a risk so long as the creditor appears to be voting in its economic interest as a claimholder. In *In re Marin Town Center,* 142 B.R. 374 (N.D. Cal. 1992), the district court reversed the bankruptcy court's designation of a creditor's claims. The creditor had purchased certain claims against the debtor that gave it the right to foreclose on the debtor's property if the debtor failed to refinance the property.[23] The creditor voted its claims against the debtor's plan, thereby blocking confirmation and the debtor's ability to refinance.[24] In designating the creditor's votes, the bankruptcy court relied on *Allegheny* and held that the claimholder voted in bad faith because it voted its claim as a potential purchaser of the property rather than as a creditor.[25] However, on appeal, the district court reversed, holding that a "vote cannot be said to have been cast in bad faith simply because it was voted for the purpose of blocking confirmation of a reorganization plan."[26] The district court distinguished *Marin* from *Allegheny*, noting that, unlike in *Allegheny*, the creditor in *Marin* had purchased a sufficient blocking position before a plan of reorganization was proposed and did not itself propose a competing plan.[27] Thus, rather than voting with the ulterior

6 *Id.* at 289.
7 *Id.* at 289-90.
8 *Id.* at 289.
9 *Id.* at 289-90. In addition to its reliance on pre-Code cases, the *Allegheny* court relied on a case decided under the Bankruptcy Code, *In re MacLeod Co.*, 63 B.R. 654 (Bankr. S.D. Ohio 1986), where vote designation was also found appropriate.
10 *DBSD*, 421 B.R. at 138 (*citing In re Dune Deck Owners Corp.*, 175 B.R. 839, 844-45 (Bankr. S.D.N.Y. 1995) (internal citations omitted)).
11 133 B.R. at 828.
12 *Id.* at 834.
13 *Id.* at 832.
14 *Id.* at 835.
15 167 B.R. at 388.
16 *Id.*
17 *Id.* at 384.
18 *Id.* at 388.
19 *Id.* at 389.
20 *Id.*
21 *Adelphia*, 359 B.R. at 64.
22 *Id.* at 62.
23 142 B.R. at 377.
24 *Id.*
25 *Id.* (internal citations and quotations omitted.)
26 Id.
27 *Id.* at 379-80.

motive to confirm a competing plan, the creditor in *Marin* was more apparently voting as a creditor.[28]

The DBSD *Decision*

Judge Gerber's decision designating votes in *DBSD* represents the most recent application of the *Allegheny* doctrine. DBSD North America Inc. (collectively with its subsidiaries, "DBSD") is a satellite telecommunications company.[29] On May 15, 2009, DBSD filed for chapter 11 relief, and on July 24, 2009, it filed an amended plan of reorganization and disclosure statement. Under the plan, DBSD proposed to replace its first-lien debt with an amended first-lien facility. Two weeks later, DISH Network Corp. purchased all of DBSD's first-lien debt, approximately $40 million, at par. In addition, through an affiliate, DISH purchased all of DBSD's second-lien debt that was not subject to a plan support agreement—approximately $111 million. The second-lien debt represented a fulcrum security that the plan proposed to convert to equity.[30] Notably, DISH is a significant investor in TerreStar Corp., a direct competitor of DBSD.[31]

DISH voted all of its claims to reject the debtor's plan.[32] In response, DBSD moved to designate DISH's votes of its first-lien claims. Then, on the eve of confirmation, DISH filed a motion to terminate the debtors' exclusivity, seeking to file its own plan.[33] At the confirmation hearing, Judge Gerber granted DBSD's motion and designated DISH's votes, finding that DISH, through the purchase and vote of its claims, acted as a "strategic investor seeking to establish control" over DBSD and not as a "traditional creditor, seeking to maximize its return on the debt it holds."[34]

At the outset, Judge Gerber discussed the case law surrounding § 1126(e) and then turned to *Allegheny*, opining that the instant case was "a classic case for application of the *Allegheny* doctrine."[35] First, Judge Gerber pointed to the fact that DISH paid par value for its claims. Indeed, DISH admitted that it overpaid for its claims.[36] As in *Allegheny*, Judge Gerber noted, this created the inference that DISH was acting with an ulterior motive rather than a creditor's interest in gaining financially through plan distribution.[37]

Second, as in *Allegheny*, DISH purchased its claims late in the case—after a plan was proposed and the disclosure statement was approved. Thus, DISH knew that it had no interest in the expected return on its claims. Moreover, DISH had acquired just enough claims to constitute a blocking position and no more. In fact, in addition to purchasing all of the debtor's first-lien claims, DISH purchased only those second-lien claims that were able to be voted against the plan, even though it would have received the same recovery on the second-lien claims that were bound to support the plan.[38]

Third and finally, as in *Allegheny*, there was uncontroverted evidence presented that DISH acquired its claims with the purpose of obtaining control of DBSD's business. DISH was interested in obtaining DBSD as a strategic asset. Further, documents produced to the court evidenced DISH's admitted intent to "control the bankruptcy process."[39] DISH even attempted to propose a competing plan at the eleventh hour.[40]

According to the *DBSD* court, these facts created an inference that DISH was advancing its "strategic investment interests wholly apart from maximizing recoveries" on its claims.[41] While a typical creditor votes with an eye toward financial recovery through distribution under the plan, DISH's votes were cast pursuant to its interest in controlling DBSD. This, Judge Gerber held, was an ulterior motive that warranted vote disqualification.[42] If DISH wished to obtain control of DBSD, Judge Gerber suggested that it should have proposed a competing plan as an outsider or made a bid to buy DBSD or its assets, rather than becoming a "voluntary claimant."[43]

Notably, on March 24, 2010, the U.S. District Court for the Southern District of New York affirmed *DBSD*.[44] The district court noted that there was "an abundance of evidence" supporting Judge Gerber's finding that DISH acted as a strategic investor, rather than a traditional creditor.[45] Further, the district court held that such a finding is sufficient to establish a "lack of 'good faith'" within the meaning of § 1126(e).[46] DISH has appealed this decision to the U.S. Court of Appeals for the Second Circuit.

Conclusion

DBSD is in line with *Allegheny* and its progeny. The case contained almost all of the factors that courts generally look to in determining whether a creditor purchased and voted its claims in "bad faith." However, it remains to be seen whether this recent application of *Allegheny* is any indication of an increase in the willingness of certain courts to examine the motives behind a claimholder's purchase and vote of its claims.

DBSD certainly reaffirms that where ulterior motives behind a creditor's actions are clearly and obviously behind a claims purchaser's vote, as evidenced, for example, by the timing and economics of its purchase transactions, the creditor's vote risks being designated. At the other end of the spectrum, the typical loan-to-own case, where a strategic investor purchases a fulcrum security and seeks to maximize its value, would appear to present very little risk of vote designation. However, predicting the outcome in a situation somewhere between the two extremes is more problematic. For example, where a claims purchaser pays a high price for its claims and may not be focused completely on maximizing the value of its purchased claims, a court will face the difficult task of determining the creditor's motives. As it becomes increasingly commonplace for strategic investors and other parties to buy claims and use them in a variety of ways in a bankruptcy case, it may become more difficult to predict the result of application of the *Allegheny* doctrine. ■

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28 *Id.* at 380.
29 421 B.R. at 134.
30 *Id.* at 135.
31 *Id.* at 135-36.
32 *Id.* at 136.
33 *Id.* at 137.
34 *Id.*
35 *Id.* at 139.
36 *Id.* at 141.
37 *Id.* at 139.
38 *Id.* at 140.
39 *Id.* at 141.
40 *Id.* at 137.
41 *Id.*
42 *Id.* at 143.
43 *Id.* at 139-40.
44 *Sprint Nextel Corp. v. DBSD North America Inc. (In re DBSD North America Inc.)*, 2010 U.S. Dist. LEXIS 33253 (S.D.N.Y. March 24, 2010).
45 *Id.* at *8.
46 *Id.* at *10. The district court also affirmed Judge Gerber's remedy for the designation, which was to regard DISH's class of claims as an accepting class. *Id.* at *9-10.