LJN LAW JOURNAL NEWSLETTERS

The Bankruptcy Strategist®

An ALM Publication

Volume 28, Number 4 • February 2011

Second Circuit Affirms Designation of Secured Lenders' Vote and Effective Cram Down

Warning to Vultures

By Michael L. Cook and Joseph E. Bain

The U.S. Court of Appeals for the Second Circuit, on Dec. 6, 2010, summarily affirmed a bankruptcy court's designation of a secured lender's vote on a reorganization plan in a two-page order, effectively enabling the debtor to cram down the lender's claim. *In re DBSD North America, Inc.*, __ F.3d__, 2010 WL 4925878 (2d Cir. Dec. 6, 2010) (*held*, lower courts did not err in designating secured lender's vote, but "plan violated the absolute priority rule" in its treatment of a separate unsecured creditor). As a result, the secured lender that bought all of the debtor's senior first lien secured debt at par will be paid only interest over a period of four years before its loan matures. S*ee In re DBSD North America, Inc.*, 419 B.R. 179, 207-08 (Bankr. S.D.N.Y. 2009) (confirming debtors' proposed plan). According to the Second Circuit, an "opinion" explaining its reasoning "will follow in due course."

The *DBSD* ruling is important to would-be acquirers of Chapter 11 debtors. As shown below, a lender's so-called "loan to own" strategy may still be valid, but acquirers cannot overreach. Consistent with other decisions discussed below, *DBSD* means that a competitor's manipulating the reorganization process to block a reorganization or to destroy the debtor's business will not work.

Facts

The would-be acquirer in *DBSD*, a competing network ("Network"), purchased the entire first-lien debt plus a significant portion of the second-lien debt, "a fulcrum security that the Plan proposed to convert to equity," in an attempt to take over the debtor and "acquire control of this strategic asset," explained the bankruptcy court. 421 B.R. 133, 134-35 (Bankr. S.D.N.Y. 2009). Indeed, the bankruptcy court relied on explicit admissions in Network's internal documents:

- "We believe there is a strategic opportunity *to obtain a blocking position* in the 2nd Priority Convertible Notes and control the bankruptcy process for this potentially strategic asset." *Id.* at 136, 140-41 (emphasis in original).
- "We are seeking board approval for up to [$200M] to acquire the remaining convertible bonds outstanding and *establish control of this strategic asset*." *Id.* at 136, 141 (emphasis in original).
- "The [debtor] is attempting to negotiate a proposal to equitize Bondholders in return for 95% of a restructured [DBSD] … . We believe there is a strategic opportunity to obtain the remaining convertible bonds outstanding *in an attempt to convert to equity and acquire control of* [*DBSD*]." *Id.* at 136 (emphasis in original).

Network's "strategic" conduct impressed the bankruptcy court because it was "a direct competitor of the Debtor." *Id.* at 135. In short, Network intended to buy up debt, get a blocking position and "control the process" to ensure its ultimate "strategic" goal of devouring one of its competitors.

The price, type and amount paid for claims, plus other indicia of manipulative intent, were key facts in *DBSD*. *Id.* at 139-42. For example, the high price Network paid for the DBSD debt showed its intention to control the reorganization process improperly. Network was willing to purchase the debt at par — "paying the price for which most other creditors could only hope" — because it was making a strategic acquisition of a competitor. *Id.* at 135. Network's "acquisition of First Lien Debt was not a purchase to make a profit on increased recoveries under a reorganization plan. Rather, the [Bankruptcy] Court found that [Network, as a competitor,] made its investments in the Debtors' First Lien and Second Lien Debts as a strategic investor." *Id.* at 136.

Vote Designation

Bankruptcy Code ("Code") Section 1126(e) provides that when a party moves to designate (*i.e.*, disqualify) a creditor's vote on a reorganization plan, "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." *See Figter Ltd. v. Teachers Ins. & Annuity Assoc. of American* (*In re Figter Ltd.*), 118 F.3d 635, 638 (9th Cir. 1997) ("In this context, 'designate' means disqualify from voting."). Vote designation "is often used to monitor the conduct of creditors who seek to gain an untoward advantage over others in the bankruptcy process." *In re Combustion Eng'g, Inc.*, 391 F.3d 190, 247 n.68 (3d Cir. 2004). "Bad faith" — *i.e.*, the absence of the requisite good faith — may be found when a creditor acts in furtherance of an ulterior motive unrelated to its claim or its interests as a creditor. *In re P-R Holding Corp.*, 147 F.2d 895, 897 (2d Cir. 1945) ("The mere fact that a purchase of creditors' interest is for the purpose of securing the approval or rejection of a plan does not of itself amount to 'bad faith.' When that purchase

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is an aid of an interest other than an interest of a creditor, such purchases may amount to 'bad faith'… ."; *held*, purchaser of claims barred from voting); *In re Dune Deck Owners Corp.*, 175 B.R. 839, 845 (Bankr. S.D.N.Y. 1995) ("[W]here the record contains evidence that the creditor has voted without regard to the treatment of its claim, but instead, to achieve some benefit or goal inconsistent with interests of the estate and its creditors, the Court must inquire into those motives in order to preserve the integrity of the Chapter 11 process."). Similarly, bad faith applies "to claimants who opposed the plan for a time until they were 'bought off'" as well as "those who refused to vote in favor of a plan unless … given some particular preferential advantage." *Young v. Higbee Co.*, 324 U.S. 204, 211 n.10 (1945).

Examples of Bad Faith

DBSD simply confirmed that a purported creditor's vote to block a reorganization plan in order to acquire a corporate competitor for one's self may also justifiably result in disqualification of the creditor's vote. 421 B.R. at 139 (citing 7 Collier, Bankruptcy ¶ 1126.06[2], at 1126-18 (16th ed. 2010)); *see also* Richard Lieb, Vultures Beware: Risks of Purchasing Claims Against a Chapter 11 Debtor, 48 *Bus. Lawyer* 915, 929 (1993) (" … 'good faith' [under § 1126(e)] does not exist if the claims purchaser intends to block any and all plans … other than one with which the purchaser is satisfied.").

Rejecting a reorganization plan in order to destroy the debtor and further a competing business interest has always constituted bad faith. *In re MacLeod Co.*, 63 B.R. 654, 656 (Bankr. S.D. Ohio 1986) (designating votes of debtor's former employees who had started a competing business; their votes were "not in good faith, but rather … for the ulterior purpose of destroying or injuring debtor in its business so that the interests of the competing business … could be furthered."). Accepting a plan in order to secure financial rewards apart from an entity's interests as a creditor is also bad faith. *In re Holly Knoll P'ship*, 167 B.R. 381, 388-89 (Bankr. E.D. Pa. 1994) (designating vote because creditor "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 and it became Debtor's general partner and collected the proposed management and construction fees."); *see also In re Allegheny Int'l, Inc.*, 118 B.R. 282, 296-99 (Bankr. W.D. Pa. 1990) (finding acquirer's access to inside information and attempts to control debtors rendered it an insider).

Good Faith Self-Interest

The Ninth Circuit has held, however, that the sole secured creditor of a single-asset real estate debtor did not act in bad faith when it purchased and voted a majority of unsecured claims (21 of 34) in order to defeat the debtor's proposed reorganization plan. *Figter Ltd. v. Teachers Ins. & Annuity Assoc. of American* (*In re Figter Ltd.*), 118 F.3d 635 (9th Cir. 1997). According to the court, the creditor acted to preserve what it reasonably perceived to be its fair share of the debtor's estate, and had no ulterior motive. Thus, bad faith should not be attributed to the purchase of claims in order to control a class vote.

The secured creditor in *Figter* had abandoned its competing plan before buying the claims. The bankruptcy court found that the creditor was not the proponent of a competing plan, but a lender, when it tried to purchase the claims, and had not tried to buy a small number of claims to block the debtor's plan. Instead, it offered to buy all claims of the class, and acted to protect its interest as a major creditor.

According to the Ninth Circuit, when a person tries "to secure some untoward advantage over other creditors for some ulterior motive," that constitutes "bad faith." 118 F.3d at 639. Still, creditors do not have to vote on a plan "with a high degree of altruism and with the desire to help the debtor and other creditors." *Id.* A selfish motive by itself is not enough. On the other hand, "pure malice, 'strikes' and blackmail," and the intent to "destroy" the debtor's business by a competitor would plainly constitute bad faith. *Id.* (citing *In re Pine Hill Collieries Co.*, 46 F. Supp. 669, 671 (E.D. Pa. 1942)). "[E]nlightened self-interest," however, cannot be condemned even if it frustrated the debtor's desires. It is not bad faith when a creditor has acquired additional claims for the purpose of protecting its own existing claim by blocking the debtor's plan. *Id.*

Fact-Intensive Analysis

The bankruptcy court carefully explained its reasoning in *DBSD*:

> [Network's] actions in this case, and its documents, demonstrate that [it] did not purchase and vote its claims in order to gain financially by way of a distribution in this case. Rather, as [Network's] actions and documents make clear, its purpose was as a strategic investor — and, it may fairly be inferred, to *use status as a creditor to provide advantages over proposing a plan as an outsider, or making a traditional bid for the company or its assets.*
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> 421 B.R. at 139-40 (emphasis added).

The court relied in its analysis on such cases as *Allegheny*:

> The purpose [of the plan confirmation process] is to increase the pool of value for all creditors and shareholders. Here, [one creditor] clearly attempts to deprive creditors of the control premium by a manipulation of the reorganization process through the strategic purchase of claims.
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> *Allegheny*, 118 B.R. at 300.

A creditor's intent is key to determining whether designation of its vote is appropriate. *DBSD*, 421 B.R. at 141-42. "The particular claims that [a creditor] purchased, and the manner in which they were purchased, can be used to determine their intent." *Allegheny*, 118 B.R. at 289; *see also Am. United Mut. Life Ins. Co. v. City of Avon Park*, 311 U.S. 138, 145-46 (1940) ("The court is not merely a ministerial register of the vote of the several classes of security holders. The responsibility of the court entails scrutiny of the circumstances surrounding such acceptances, the special or ulterior motive which may have induced them, the time of acquiring the claims so voting, the amount paid therefor, and the like. Only after such investigation can the court exercise the informed, independent judgment which is an essential prerequisite for confirmation of a plan. And that is true whether the assents to the plan had been obtained prior to the filing of the [bankruptcy] petition or subsequent thereto.").

Conclusion

The bankruptcy court's *DBSD* decision has been called "controversial" by some lawyers. Peter S. Partee & Scott H. Bernstein, *Rulings Impact Hostile Takeovers of Bankruptcy Companies' Debt*, *N.Y.L.J.*, June 4, 2010, at 4 (col. 1). But applying the documented facts in light of established precedent confirms the *DBSD* decision's validity. Neither the bankruptcy court nor the Second Circuit broke new ground here. In the end, hard specific facts drove the result.

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