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A Broader Perspective

Alert

Bankruptcy, Restructuring and Creditors' Rights Client Service Group

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THE SECOND CIRCUIT REJECTS "GIFTING" STRATEGY BY A SENIOR SECURED CREDITOR CLASS AND SENDS A WARNING TO STRATEGIC CLAIM TRADERS

In *Dish Network Corp. v. DBSD N. Am., Inc. (In re DBSD N. Am., Inc.)*, --- F.3d ----, 2011 WL 350480, (2d Cir. Feb. 7, 2011), the Second Circuit issued a ruling that sends two very important messages to parties involved in chapter 11 restructurings. First, the Second Circuit enforced the absolute priority rule in favor of an unsecured creditor who opposed a debtor's plan that was premised on a "gifting" strategy, where a secured creditor left value behind for the benefit of the equity holders even though unsecured creditors were not paid in full. Second, and perhaps more importantly, the Second Circuit ruled that a competitor of the debtor that bought a large claim was properly denied the right to vote on the claim because it did so for an improper "ulterior motive."

The Absolute Priority Rule "Trumps" The Strategy Of Gifting Value To A Debtor's Equity Holders

In *DBSD*, Sprint Nextel Corporation *("Sprint")* held a general unsecured, unliquidated litigation claim temporarily allowed in the amount of $2 million against debtor DBSD North America, Inc. *("DBSD")*. DBSD's plan provided that the second lien secured creditor class, which was composed of $740 million in convertible senior notes, would receive the bulk of the shares in the reorganized debtor valued at 51% to 73% of their original claims. Unsecured creditors, including Sprint, received shares valued at 4% to 46% of their original claims. DBSD's old shareholders received shares and warrants in the reorganized debtor pursuant to a "gift" from the second lien secured creditor class.

Sprint objected to the gift to old equity and argued it was an improper end run around the absolute priority rule of 11 U.S.C. § 1129(b)(2)(B). The Bankruptcy Court for the Southern District of New York confirmed the plan over Sprint's objection and the Federal District Court affirmed on appeal. The Second Circuit, however, held that voluntary gifting to a junior class when an intermediary class does not receive full value on their claims is a violation of the absolute priority rule.

The Second Circuit based its ruling on case law going back almost 100 years which recognized the "fixed principle" that creditors are entitled to be paid before shareholders can retain shares for any purpose whatsoever, and the Court's belief that a weakened absolute priority rule could allow for "serious mischief" between senior creditors and existing shareholders. The Second Circuit did not adopt a *per se* rule barring the gifting strategy. But the Court sent a clear message that using a gifting strategy when equity provides *no new value* will be a non-starter — at least in the Second Circuit.

Depending On Motives, Claim Traders Are At Risk Of Losing Their Voting Rights On Purchased Claims

Claim traders generally think they are free to purchase claims of a debtor and vote them in any way to their strategic advantage. The *DBSD* decision, however, sends a strong warning message to claim traders to proceed with caution when buying claims to block confirmation of a chapter 11 plan.

Under section 1126(e) of the Bankruptcy Code, a bankruptcy court may essentially disregard the vote of a creditor who is found to have cast its vote "not in good faith." That is precisely what happened in *DBSD*, where the Second Circuit designated the vote cast by DISH Network Corporation *("DISH")*.

DISH was an indirect competitor of DBSD. DISH bought a $40 million first lien position and a portion of the second lien debt, although not enough to control the second lien debt class. The Second Circuit reiterated the general rule that merely purchasing claims in bankruptcy "for the purpose of securing the approval or rejection of a plan does not of itself amount to 'bad faith.'" Nor is it improper to buy a claim to obtain standing to file a competing plan. *Id.* at *17.

However, the Second Circuit ruled that DISH, as an indirect competitor of DBSD, had purchased the claims after the plan had been proposed not to maximize its return on the acquired claims, but for the purpose of leveraging a strategic transaction with DBSD. The Second Circuit ruled that these "ulterior motives" of DISH were improper and triggered the designation of its plan vote under § 1126(e). Hence, the Second Circuit affirmed the trial court's decision to disregard DISH's vote of its $40 million senior secured claim that would have rejected DBSD's plan.

Adding insult to injury, the Second Circuit's ruling left DISH powerless to oppose DBSD's plan treatment of its $40 million claim. Under the plan, this claim was given a four year maturity with no principal payments in the interim. DISH would receive interest on its claim at 12.5%, but the interest was "paid in kind" by being added to the principal balance — so-called PIK interest.

The Second Circuit softened the blow of its ruling by noting this result would not necessarily apply to situations where a "*preexisting* creditor votes with strategic intentions" and that it did not amount to "[a] categorical prohibition on purchasing claims with acquisitive or other strategic intentions . . . ." *Id.* at *20. There is no doubt, however, that the *DBSD* decision leaves parties who buy distressed claims for strategic purposes with a number of issues that need to be given very serious consideration before executing on such buying strategies — especially if the buyer is a competitor of the target company.

To discuss this issue further, please speak to your Bryan Cave contact, or to:

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