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US CORNER

Sprint Nextel Corp. v DBSD North America Inc.: The Second Circuit Rejects Plan's Use of the Gifting Exception to the Absolute Priority Rule and Upholds Designation of Strategic Investor's Votes

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Introduction

One of the cornerstones of the United States Bankruptcy Code is equality of distribution to similarly situated creditors. This objective leads to negotiation, creative settlements and free enterprise among interested parties with the goal of maximising value to creditors within the Bankruptcy Code's framework. To further this purpose, bankruptcy courts are courts of equity enjoying significant flexibility to promote consensual resolutions among competing interests. As a result, despite often contentious gamesmanship among various factions, parties frequently reach compromises enabling debtors to reorganise and emerge quickly from bankruptcy. And often when a debtor and all of its creditor constituencies agree to support a consensual plan, a bankruptcy court will defer to the business judgment of the debtor and the willingness of the debtor's claim and interest holders to cooperate.

But as capital structures have become more complex and the market for trading claims has become more robust across such capital structures, it has become increasingly more challenging to consensually resolve the various layers and divergent interests in a manner that satisfies all interested parties and complies with the Bankruptcy Code's statutory requirements for plan confirmation. In these circumstances, debtors are often left with no choice but to garner support from, and create a strategy with, some parties and fight it out with the rest. In this regard, the bankruptcy of DBSD North America, Incorporated, and its various subsidiaries ('DBSD') has many elements present in the post-economic meltdown bankruptcy era: a debtor with a valuable asset, a plan supported by certain parties, a sidedeal between two classes, a game-changing debt trade attracting other interested parties and forcing initial bids significantly higher.

DBSD's fate is a common story. Taking advantage of a strong lending market, it significantly leveraged its assets. In early 2008, DBSD borrowed USD 40 million under a revolving credit facility (the 'First Lien Debt') and USD 650 million in 7.5% convertible senior secured notes (the 'Second Lien Debt'). Then, in addition to this substantial leverage, an unfavourable decision by the Federal Communications Commission ('FCC') in the litigation between DBSD and Sprint Nextel Corporation ('Sprint') regarding a 2004 arrangement with the FCC to clear a spectrum band threatened DBSD with a possible USD 300 million – 1.9 million judgment. Like many others, DBSD was unable to sustain its debt level long enough to become operational. Coupled with the Sprint litigation, bankruptcy became inevitable.

Shortly before the bankruptcy in an attempt to maximise the chance of an organised and consensual proceeding, DBSD negotiated with and entered a plan support agreement with some, but not all, of its key constituents. The plan support agreement obligated the parties thereto, DBSD, a majority of the holders of the Second Lien Debt and ICO, to support a plan that would replace the First Lien Debt with a new credit agreement and distribute the equity of the reorganised DBSD to claimants under the Plan. The holders of the Second Lien Debt would receive approximately 95% of the new equity, the general unsecured creditors would receive approximately 0.15% and DBSD's existing shareholders would receive approximately 4.99%. Importantly, the holders of the Second Lien Debt that executed the plan support agreement agreed to give part of their recovery to equity under a seemingly well-established doctrine and practice of gifting. This doctrine presents an exception around the absolute priority rule, which requires that all creditors be paid in full before equity holders receive anything. The doctrine would be applicable under this Plan as the Second Lien Debt and the general unsecured creditors would not be paid in full, but equity would receive a large portion of the reorganised DBSD.

Meanwhile, once news of DBSD's restructuring plans became public, because of its valuable satellite system,

Notes

1 We thank Raniero D'Aversa, Jr., co-chair of Orrick, Herrington & Sutcliffe LLP's Restructuring Group, for his invaluable guidance, assistance and advice.

DBSD attracted strategic and financial investors, including indirect competitor DISH Network Corporation ('DISH'), a provider of satellite television interested in DBSD's satellite system as a way to expand its own spectrum capability. In an apparent attempt to influence DBSD's reorganisation to further this goal, DISH purchased all of the First Lien Debt and a portion of the Second Lien Debt. DISH objected to DBSD's plan and then took several actions to influence the reorganisation. Although this can (and did) create a more difficult process for DBSD and the ultimate downfall of its original plan for reorganisation, as discussed below, DISH's actions ultimately lead to increased returns for the estate. In fact, although vilified throughout the proceedings, it was DISH's prolonged interest in DBSD that increased market participant interest leading to the most value for DBSD's stakeholders.

Despite its attempts to avoid a contested proceeding, DBSD's fate was left for the courts to decide how to address a plan objection by Sprint and DISH's strategic positioning. As will be described in more detail below, the Bankruptcy Court and the appellate courts considered: (i) can the Bankruptcy Court confirm a plan that violates the absolute priority rule by providing a distribution to equity before all creditors are paid in full (i.e., can DBSD satisfy only a fraction of Sprint's claim but give a windfall to equity holders?); and (ii) can the Bankruptcy Court designate (disqualify) DISH's vote on the Plan because it failed to prove it voted in good faith (i.e., should DISH's position on DBSD's Plan even be considered if its primary goal was to gain control of DBSD's spectrum)?

Amid this factual and legal landscape, in addition to resolving the legal issues at bar, the most interesting theme emerging from the DBSD case is how the Bankruptcy Court and the appellate court balanced the importance of negotiated resolutions with the protections afforded to the estate and its constituents under the Bankruptcy Code. The Second Circuit Court of Appeals took a big step in finding that parties cannot craft agreements outside of the fundamental statutory protections given to creditors; namely, the solemnity of the absolute priority rule, which provides that each senior class of claims or interests must be paid in full before any junior class can receive distributions (effectively, secured creditors are paid in full before unsecured creditors, and all creditors are fully satisfied before equity holders receive anything). As will become apparent in this article, although the appellate court made clear that it encourages bankruptcy courts to promote a free market and innovative solutions, it will not allow participants in the process (including a bankruptcy court) to disregard the protections afforded to debtors, creditors and other interest holders under the Bankruptcy Code.

Facts and relevant law

DBSD is a developmental stage enterprise formed to design and develop an integrated mobile system and terrestrial services network to deliver wireless satellite communications services to mass-market consumers. Ahead of other satellite communications operators, DBSD successfully launched a satellite and obtained necessary spectrum licenses from the Federal Communications Commission (the 'FCC'). For these endeavours, DBSD had access to the First Lien Debt (USD 40 million) and the Second Lien Debt (USD 740 million). However, in early 2009 when the credit markets froze, DBSD was unable to obtain sufficient additional financing to become operational. Contemporaneously, an unfavourable ruling by the FCC in the litigation between DBSD and Sprint regarding the reimbursement of amounts related to the relocation of certain radio frequencies to a more efficient spectrum signalled a potential multi-hundred million dollar judgment against a DBSD subsidiary. Unable to progress under the burden of these liabilities, in May of 2009, DBSD filed for bankruptcy in the United States Bankruptcy Court for the Southern District of New York (the 'Bankruptcy Court').

The Plan

Similar to other recent large bankruptcy cases such as the Tronox and Almatis bankruptcies, prior to filing its Chapter 11 plan of reorganisation (the 'Plan'), DBSD entered into a plan support agreement with its non-debtor parent and sole shareholder, ICO Global Communications (Holdings) Limited ('ICO') and the Second Lien Debt holders (the 'Support Agreement') with the goal of building consensus among these key constituents and facilitating a peaceful plan process. As set forth in the Support Agreement, DBSD sought approval of the Plan which set DBSD's reorganised value at USD 572 million and provided for: (i) First Lien Debt holders to receive new notes secured by liens under an amended credit facility; (ii) Second Lien Debt holders to receive approximately 95% of the new equity of the reorganised debtor, which has an approximate value of USD 542 million; (iii) unsecured creditors to receive 0.15% of the new equity, which has an approximate value of USD 850,000; and (iv) ICO to receive 4.99% of the new equity , which has an approximate value of USD 28.5 million. The distribution to existing shareholders is referred throughout this article and the case as the 'gift', as equity holders are generally not entitled to distributions if all creditors are not repaid in full. The envisioned Plan would provide a recovery of approximately 51-73% on the Second Lien Debt, 4-46% on the claims to the general unsecured creditors and equity valued at USD 28.5 million to existing equity (e.g. ICO). The Support Agreement bound signatories to vote in favour of the Plan and restricted them from

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trading their claims unless the purchasers agreed to be bound by the Support Agreement. The Support Agreement did not restrict the holders of the Second Lien Debt, DISH, Sprint or any other parties that did not sign the Support Agreement.

In order to confirm a plan of reorganisation, in addition to satisfying the statutory requirements of the Bankruptcy Code as to the terms of the plan (such as the absolute priority rule), a certain number of the debtor's creditors holding a certain amount of the claims must approve the plan. The Bankruptcy Code provides that for a bankruptcy court to confirm a plan of reorganisation each impaired class must vote in favour of the plan.[2] For a class to accept a plan, at least two-thirds in amount of claims in each class and one-half in number of creditors from each class must vote to accept the plan.[3] Because the Support Agreement bound 57% of the holders of Second Lien Debt and ICO, it guaranteed DBSD had support for its Plan from the majority of Second Lien Debt holders and ICO. But because the Support Agreement did not bind holders of the First Lien Debt or the remaining holders of Second Lien Debt, DBSD knew it might be faced with dissenters and forced to seek confirmation of the Plan over the dissenting creditors' objections. As described in detail below, the Plan failed to meet the requirements of Section 1129(a)(8) because not all impaired classes accepted the Plan. Specifically, the class of First Lien Debt and the class containing Sprint's claim rejected the Plan.

Section 1129(b)(1) allows a Bankruptcy Court to confirm a plan over a class's rejection if one impaired class votes to accept the plan and such plan does not 'discriminate unfairly' and is 'fair and equitable' with respect to each impaired class that has not accepted the plan.[4] A plan will generally be deemed 'fair and equitable' if it complies with the absolute priority rule; this Plan did not. But to overcome the rejections of its Plan, DBSD had no choice but to rely on these cram-down provisions. DBSD thus had to address the fact that the Plan violated the absolute priority rule contained in the cram-down provisions by characterising the 4.99% of the equity in the new DBSD to be distributed to ICO as a gift from the holders of the Second Lien Debt to the shareholders rather than a distribution. In the bankruptcy context, a gift is when one creditor allocates a portion of its recovery to a party with a junior position in the absolute priority hierarchy, thereby providing such junior party a recovery greater than it is otherwise entitled to under the Bankruptcy Code. Gifts, if approved by the bankruptcy court or structured outside of estate and the purview of the bankruptcy court, can be an effective way to satisfy aggrieved parties and obtain cooperation for a smoother proceeding. Here, the equity distribution to ICO ensured ICO would not dispute the USD 572 million valuation, avoiding a costly and drawn-out valuation battle.

The votes and objections to the Plan

DBSD filed the Plan and then several events occurred giving rise to the controversy appealed to the Second Circuit. DISH purchased (at par) all of the First Lien Debt and a portion of the Second Lien Debt, and the holders of which did not sign the Support Agreement and thus were not required to support the Plan. DISH, voting on behalf of all of the First Lien Debt and a portion of the Second Lien Debt, rejected the Plan. DISH also proposed alternative transactions to the Plan. Sprint, voting on behalf of its unsecured claim, also rejected the Plan.

DBSD then moved to designate DISH's vote under Section 1126 of the Bankruptcy Code. Section 1126 allows the Bankruptcy Court to effectively disqualify a creditor's vote if it finds the vote was not cast in good faith. DBSD argued the Bankruptcy Court should designate DISH's claim because DISH's actions demonstrated it did not reject the Plan to support its best interests as a creditor, but did so only to promote its own strategic business agenda. DBSD argued this was evidenced by the fact DISH purchased fully matured debt at par with full knowledge of the terms of the Plan. Also, DISH is neither a financial institution with a business interest in being DBSD's lender, as would have been the case under the Plan, nor is it a company engaged in the trading of distressed company claims. In other words, DISH's actions were not those of a financial arbiter trying to purchase a claim for 90% and receive 100% in new notes under the plan or those of a typical lender intending to hold the new notes and receive interest until their maturity; DISH was trying to make a deal. As seen by the alternative transactions DISH has proposed, DISH was attempting to cause a transaction with DBSD that would not only benefit DISH, but would also increase the returns to DBSD creditors. Notwithstanding the potential value DISH's interest brought to DBSD's bankruptcy, in line with Section 1126 of the Bankruptcy Code, the Bankruptcy Court correctly found that DISH purchased the First Lien Debt to prevent the Plan's approval by objecting to and voting against the Plan. The Bankruptcy Court

Notes

2 11 U.S.C. §1129(a)(8)(2010).
3 11 U.S.C. §1126(c)(2010).
4 11 U.S.C. §1129(b)(1) (2010).
5 Debtors' Supplemental Brief at 3, *In re DBSD N. Am., Inc.*, No. 09-13061 (REG) (Bankr. S.D.N.Y. Oct. 2, 2009).

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characterised DISH's actions as a move to hijack the bankruptcy process and gain a competitive industry edge warranting designation.

Sprint objected to the Plan arguing, among other things, that the Plan violated the Bankruptcy Code's absolute priority rule by distributing value to equity holders prior to repaying unsecured creditors in full.[6]

The Bankruptcy Court's decision

On 23 November 2009, the Bankruptcy Court confirmed the Plan (the 'Confirmation Order') over Sprint's objection. DBSD and the Second Lien Debt holders argued the Plan could distribute the new equity to existing shareholders because the Second Lien Debt holders had a lien on all of DBSD's assets and would not receive value sufficient to be repaid in full. Nonetheless, the holders agreed to give or gift a portion of the distribution it was otherwise entitled to, to the existing shareholders. The Bankruptcy Court agreed with DBSD and overruled Sprint's objection. Specifically, the Bankruptcy Court found the gifting doctrine an accepted exception to the absolute priority rule permitting such result where: (i) there is no dispute as to the gifting classes' secured status; (ii) there are understandable reasons for the gift; (iii) there are no ulterior motives or improper ends; and (iv) the complaining creditor would get no more if the gift had not been made.[7]

The Bankruptcy Court next found the vote for the class of the First Lien Debt (held by DISH) should be disregarded for the purpose of determining whether DBSD's Plan garnered the necessary acceptances because it had designated DISH's vote prior to the confirmation hearing.[8] The Bankruptcy Court stated: '[t]o hold, even though the sole class occupant DISH was disqualified from rejecting, that Class 1 *effectively rejected anyway*, because there was nobody left to accept, would make my designation ruling meaningless'.[9]

The appeal

Both Sprint and DISH appealed the Bankruptcy Court's decision to confirm the Plan and DISH appealed the designation of its vote. Appeals from bankruptcy court decisions are first heard by the federal district court, in this case, the District Court for the Southern District of New York (the 'District Court'). Sprint argued the Bankruptcy Court reached the incorrect decision when confirming the Plan because the Plan violated the absolute priority rule and therefore, the Bankruptcy Code prohibited confirmation. DISH argued the Bankruptcy Court committed a reversible error by designating its votes. DISH and Sprint did not sway the District Court; the District Court affirmed the Bankruptcy Court's decision to confirm the Plan. Sprint and DISH then appealed to the next court of appeal for bankruptcy courts, the circuit court (and in this case, the Second Circuit Court of Appeal (the 'Court')).

The decision

Gifting and the Absolute Priority Rule

On 7 February 2011, the Court issued its opinion (the 'Opinion') reversing the Bankruptcy Court's confirmation of the Plan, in agreement with Sprint's position. In doing so, the Court's decision effectively unwound the business deal set forth in the Support Agreement. The Court did not uphold the deal reached to gift USD 28.5 million worth of equity in reorganised DBSD to ICO while Second Lien Debt and general unsecured creditors remained unpaid under the guise of the gifting doctrine because it did not think the business deal should trump the sanctity of the absolute priority rule. It stated, '[t]he absolute priority rule was designed to prevent a senior class from giving up consideration to a junior class unless every intermediate class consents, is paid in full, or is unimpaired'.[10]

The Court considered the facts, the Bankruptcy Code, policy and existing caselaw in its decision on Sprint's appeal. It highlighted the Bankruptcy Code's legislative history which does not indicate a gift exception. The Court also spent considerable time distinguishing the USD 28.5 million provided to ICO under the DBSD Plan from 'gifts' approved in other cases. Specifically, the Court compared it to the facts in the *In re SPM Mfg Corp.* ('SPM') case in which the First Circuit approved a gifting arrangement. In SPM, the prepetition lender held a perfected first-priority security interest in all of SPM's assets that were worth less than the total amount of debt. Realising that SPM could not be successfully reorganised, SPM, the creditors' committee and the secured lender agreed to liquidate SPM's assets. From the liquidation proceeds, the prepetition lender agreed to give unsecured creditors a portion of the liquidation proceeds ahead of the IRS's tax claim. In approving this settlement, the First Circuit reasoned

Notes

6 See 11 U.S.C. §§ 1129(b)(2)(B)(ii) and (C)(ii)(2010).
7 Bench Decision on Confirmation at 51, *In re DBSD N. Am., Inc.*, No. 09-13061 (REG) (Bankr. S.D.N.Y. Oct. 26, 2009).
8 Bench Decision at 39.
9 Bench Decision at 41.
10 Op. at 37, *DISH Network Corp. v DBSD N. Am., Inc.* (In re DBSD N. Am., Inc.), Nos. 10-1175, 10-1201, 10-1352 (2d Cir. Feb. 7, 2011).

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that because the unsecured creditors did not receive the distribution from the debtor, but received their gift from the lenders, the absolute priority rule was not violated (i.e., it was property of the lenders, not the estate, and thus the lenders could direct the payment of the proceeds).[11]

The DBSD Court found distinguishing facts in DBSD's Plan that dictated a contrary ruling. First, the SPM distribution occurred under a Chapter 7 liquidation, which does not include the same stringent absolute priority rule as a Chapter 11 plan. Also relevant, the DBSD Plan was subject to even higher scrutiny because an impaired class rejected the Plan and, therefore, DBSD had to satisfy the cram-down provisions. Chapter 7 proceedings, such as the one in SPM, simply liquidate the assets and distribute the proceeds. The proceeds from assets encumbered by liens will be distributed to the holders of such liens and the proceeds from unencumbered assets will be distributed to unsecured creditors in the order prescribed by the Bankruptcy Code; in all cases creditors will be paid before equity. This is all done by the Chapter 7 trustee with the approval of the bankruptcy court – there is no plan that is subject to approval by its creditors. Second, in SPM the senior lender provided the gift to the junior class after the estate distributed the liquidation proceeds. In DBSD, the relevant distribution (i.e., stock and warrants) came from the debtors and was part of the estate – it was not the property of the holders of the Second Lien Debt and thus not theirs to give.

In its Opinion, the Court also focused on the magnitude of the equity gift to ICO – an estimated USD 28.5 million of equity value in the reorganised DBSD – and the fact that ICO made no monetary contribution to the Plan. In stark contrast, unsecured creditors, would only receive USD 850,000.00 worth of equity. Op. at 36. The Plan's statement that ICO provided value in exchange for its equity gift by its 'continued cooperation and assistance' did not convince the Court that ICO deserved such a recovery. The Court rejected the notion that 'continued cooperation and assistance' constituted sufficient value to fall within the 'new value' line of cases that allow distributions to existing equity holders ahead of creditors in very limited circumstances. The Court strongly suggested that only a capital contribution may have sufficed to justify the distribution to equity under these facts.[12]

In its decision, the Court acknowledged the role of senior creditors gifting part of its recovery to junior stakeholders in fostering a non-adversarial Chapter 11 proceeding. The Court recognised the value in encouraging debtors and their constituents to negotiate and reach consensus, but ultimately, in this case, it refused to let the business agreement among a limited number of DBSD's constituents infringe upon the rights provided to others under the Bankruptcy Code. The Court reasoned, that although gifting may accelerate an efficient and foster a non-adversarial Chapter 11 proceeding, 'a weakened absolute priority rule could allow for serious mischief between senior creditors and existing shareholders'.[13]

Notwithstanding the Court's veto of the Plan's equity gift to ICO, the Court clearly limited its opinion to the circumstances before it, and did not issue a blanket decision banning all gifts in all circumstances. So long as a gift does not run afoul of the absolute priority rule, the Opinion does not appear to extend to the typical situation where gift type settlements often occur – namely when a senior secured creditor that will not be paid in full nevertheless agrees to contribute a portion of its distribution to general unsecured creditors. In such situations, the senior secured creditor essentially buys the creditors' committee's cooperation throughout the bankruptcy process, which occurs often in connection with debtor-in-possession financing or a plan. The Opinion, however, cannot be disregarded by creditors attempting to garner support for plans by giving certain claim or interest holders more than they may otherwise have been entitled to receive. In transactions where a creditor agrees to make a gift to prepetition equity, however, this Opinion signifies courts' hesitation and reluctance in allowing equity to receive any value before repayment in full of creditors. The DBSD Opinion will become another obstacle against out-of-the-money equity holders.

To the extent parties, whether among creditors or between creditors and equity holders, continue to try and use gifts as a means of compromise, gifts will have to be carefully structured with the absolute priority rule and this DBSD decision in mind. Although it would seem an easy solution to reach side-deals and implement them outside of a bankruptcy court's reach, this comes with its own set of complications. For example, if a creditor gifts stock, warrants or options outside of a plan, such assets often have restrictions, and distribution of such will be governed by the Securities Exchange Act without the benefit of the exceptions provided in the Bankruptcy Code. Similarly, if the asset is not a distribution on account of a claim but rather a gift from one creditor to another, such a transaction may create tax consequences for the recipient. In the end, structuring gifts outside of the Bankruptcy Court will likely be too complicated or inefficient to be a meaningful solution to the DBSD solution. As is intended and was upheld by

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11 *In re SPM Mfg. Corp.*, 984 F.2d 1305, 1312-14 (1st Cir. 1993).
12 Op. at 28.
13 Op. at 35-36.

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the Court, transactions relating to distributing assets of a Chapter 11 debtor cannot escape the Bankruptcy Code in structuring their settlements.

Vote designation

Although the Court reversed the Confirmation Order because it violated the absolute priority rule, the Court upheld the Bankruptcy Court's decision to designate DISH's claims under Section 1126(e) and disregard the entire class of First Lien Debt for plan approval purposes. It found the Bankruptcy Court properly followed Section 1126, which allows a bankruptcy court to disregard or designate the votes of 'any entity whose acceptance or rejection of such plan was not in good faith' and to not consider designated votes for purposes of plan acceptance.[14] The Court recognised that whether a vote is in 'good faith' is an amorphous concept not defined in the Bankruptcy Code and, as such, is determined on a case-by-case basis. The Court recognised designation of votes has been used (and should be used) sparingly and only after a thorough review of the facts.[15]

In issuing its decision, the Court focused on the purpose of the Bankruptcy Code's designation provisions. In the Court's words, the drafters of Section 1126(e) intended to designate votes of '[parties] not attempting to protect their own proper interests, but who were, instead, attempting to obtain some benefit to which they were not entitled'.[16] According to the Court, it should designate votes if it finds the creditor has an ulterior motive or an interest other than that of a creditor.[17]

The Opinion clearly recognised that there is a balancing act between allowing parties to protect their own self interest and finding facts warranting designation – the Court was quick to note that not all ulterior motives warrant designation.[18] The Court noted an investor purchasing claims to secure the outcome of a plan or a vendor voting to ensure continued business with the reorganised debtor both may have ulterior motives, but that fact alone will not necessarily establish ground for designation.[19]

In this case, however, the Court found the facts supported a basis to designate DISH's votes. One of the issues on which the Court focused was DISH's role as a strategic investor and indirect competitor of DBSD who could use DBSD's satellite system to further its own business not its interests as a creditor. After the Plan was proposed, DISH bought all the First Lien Debt. The testimony and documentary evidence revealed that DISH had significant interest in DBSD's assets. Based on the evidence, the Court found 'DISH purchased the claims as votes it could use as levers to bend the bankruptcy process toward its own strategic objective of acquiring DBSD's spectrum rights, not towards protecting its claim'.[20] The Court was convinced, by the evidence presented to the Bankruptcy Court, that DISH's intent was to 'obtain a blocking position' and 'control the bankruptcy process for this potentially strategic asset' not to protect its interests as a creditor.[21]

The Opinion focused on the fact that '[c]ourts have been especially wary of the good faith of parties who purchase claims against their competitors'.[22] In this case, DISH did not breach any contract, the Bankruptcy Code or any Bankruptcy Court order when it purchased loans unrestricted by the Support Agreement. And the purchase of the First Lien Debt at par alone does not mean a purchaser has an ulterior motive.[23] But, by DISH's own admission, it wanted to purchase DBSD's spectrum – it was not interested in becoming a long-term lender to DBSD as the Plan provided for the holders of First Lien Debt. These facts led the Court to find DISH acted with an ulterior motive, highlighting a trend among courts post-*Lehman* to scrutinise the actions of investors and the propriety of debt trades, especially where business competitors are involved in the mix.[24]

Notes

14 See 11 U.S.C. §1126(c) and (e) (2011).
15 *In re Adelphia Commc'ns Corp.*, 359 B.R. 54, 61 (Bankr. S.D.N.Y. 2006).
16 Op. at 40.
17 Op. at 40.
18 See *In re Figter*, 118 F.3d 635, 639 (9th Cir. 1997).
19 *In re P-R Holding Corp.*, 147 F.2d 895, 897 (2d Cir. 1945); op. at 40.
20 Op. at 44.
21 Op. at 45-46.
22 Op. at 45.
23 Op. at 45.
24 Although outside of the bankruptcy context, the District Court for the Southern District of New York (and then the Second Circuit) enjoined J.P. Morgan Securities Inc. (collectively, 'JPMorgan') from selling its debt to an indirect competitor of the borrower finding that by doing so JP Morgan violated the covenant of good faith and fair dealing (the 'Empresas Case'). *Empresas Cablevision, S.A.B. DE C.V. v JPMorgan Chase Bank, N.A.*, No. 09 civ 9972 20(JSR), 2010 WL 318232 (S.D.N.Y. Jan. 28, 2010). The facts were as follows. JPMorgan loaned Cablevisión, a Mexican telecommunications operator, USD 225 million pursuant to a credit agreement. In mid-2009, JPMorgan reached an agreement to sell a substantial portion of the loans to Banco Inbursa, a bank controlled by Carlos Slim Helú. Slim also has a controlling interest in Telmex, a Mexican conglomerate that owns more than 80% of the telephone landlines in Mexico and is Cablevisión's primary competitor. Because the Credit Agreement restricted assignments without Cablevisión's prior consent, JPMorgan sought Cablevisión's approval. Cablevisión did not consent to the assignment because of the relationship between Banco Inbursa and Telmex. Unable to execute a direct sale, JPMorgan arranged

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Notwithstanding the Court's upholding the Bankruptcy Court's designation ruling, the Opinion recognised the value a strategic investor, such as DISH, could bring to the bankruptcy process. By making clear its ruling was specific to the facts – a strategic investor purchasing an entire class of claims, shortly before the solicitation deadline and then voting against, and objecting to, the Plan; the Court acknowledged that bankruptcy courts should encourage strategic transactions as they often help maximise value for the creditors. The Court went on to state its Opinion should 'deter only attempts to 'obtain a blocking position' and thereby 'control the bankruptcy process for a potentially strategic asset'. In fact, the Opinion is sufficiently narrow to leave open whether a prepetition or preplan filing creditor can cast its votes with strategic intentions – suggesting that where strategic investors are involved timing and structure may really be everything.[25]

Although the DBSD decision has caused concern through the debt trading community, it should not frighten financial institutions trading claims for profit. The lesson learned from the decision is a claimholder can vote with the purpose of maximising its return on its claims and protecting its interests as a creditor of the debtor, but should not overreach in an effort to create business opportunity for itself beyond the scope of the claim. Thus, investors who obtain debt to obtain control of a debtor's assets will have to act cautiously. If the assets are not being offered for sale, purchasing claims as a means to influence the process may still be a worthwhile endeavour, but such investors should be wary of the DBSD decision when formulating their approach.

Postscript

On 1 February 2011, after the Court issued its decision designating DISH's vote but prior to issuing the Opinion, DISH and the Debtors executed an agreement (the 'Investment Agreement') under which DISH would acquire the Debtors through the funding of an alternate plan (the 'Alternate Plan'). Under this Alternate Plan, DISH was to provide approximately USD 1 billion of value in exchange for 100% of the equity of the reorganised debtors. The First Lien and Second Lien Debt were to be paid in full plus accrued interest, and the unsecured creditors were to receive a cash recovery of approximately USD 39 million.[26] Moreover, as DBSD indicated it was on the brink of insolvency, DISH agreed to provide USD 87.5 million debtor-in-possession facility providing DBSD sufficient funds to complete the transactions contemplated by the Investment Agreement.

This Alternate Plan's distribution scheme complied with the absolute priority rule so Sprint's Plan objection was mooted, but on 4 February 2011 Sprint objected to the Investment Agreement on different grounds, arguing that the Alternate Plan undervalued DBSD's assets and the Investment Agreement would chill bidding by other potential investors. Because such objection is completely factual in nature it would have been significantly more burdensome to prove. Moreover, rather than chill bidding, the Investment Agreements actually encouraged more bidding. Specifically, on 10 March 2011 two funds holding Second Lien Debt offered DBSD a competing transaction that would combine DBSD with TerreStar Networks, another bankrupt satellite provider in which such creditors have a significant interest. This offer proposed a USD 1.14 billion investment in the Debtors and a USD 87.5 million DIP facility but contained more conditions that the Alternate Plan including being subject to, among other things, (i) completion of additional due diligence and (ii) securing sufficient financing.

As DBSD indicated it was on the brink of administrative insolvency, this additional due diligence would be an undue burden, so DBSD went back to DISH to improve the terms of the Alternate Plan and the Investment Agreement. As a result of this offer, DISH improved the terms of the Investment Agreement and Alternative Plan. Finally, if the Alternate Plan is approved by the Bankruptcy Court, DISH will take control of DBSD pursuant to a plan that will provide more than USD 1.4 billion to DBSD's estate, an amount sufficient to repay DBSD's creditors in full and include a USD 325 payment to ICO.

As seen by all of these subsequent events, it is clear DISH did purchase the First Lien Debt as a strategic move to obtain control of DBSD and its assets and DBSD knew that, so it moved to designate DISH's claim as a defense to avoid a takeover. But most importantly, although the Court denied DISH's appeal and upheld the claim designation, it recognised the value an 'ulterior

Notes

to sell a participation interest in the loans; the sale of a participation interest was permitted by the Credit Agreement and did not require any approvals. Cablevisión opposed the participation and sought to (and succeeded in) enjoining JPMorgan's participation arguing that it would cause irreparable harm to its business because its major competitor would gain access to its confidential and competitively sensitive information. Moreover, to the extent the participation was elevated to an assignment, Slim and Telmex would have a competitive advantage and the potential ability to exert control over Cablevisión's business. Similar to the DBSD case, Cablevisión convinced the court that JPMorgan did not act in good faith arguing JPMorgan deliberately subverted its right to approve assignments and in doing so, breached the covenant of good faith and fair dealing by deliberately 'undercut[ing]' the assignment provisions. *Empresas* at *6. Both the Empresas decision and the Opinion, although limited in scope, may provide additional ammunition to borrowers and debtors negotiating with strategic investors.

25 Op. at 46.

26 See Debtors' Motion Approving The Investment Agreement at 7, *In re DBSD N. Am., Inc.*, No. 09-13061 (REG) (Bankr. S.D.N.Y. Feb. 1, 2011).

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motive' could bring to a Chapter 11 reorganisation. Like so many contested bankruptcy proceedings, DISH and DBSD ultimately resolved their dispute through the Investment Agreement and the Alternate Plan, which, was approved on 15 March 2011, resulting in tremendous value to the DBSD estate well in excess of DBSD's original plan. So, in the end, maybe the greatest irony, after years of disagreement between DBSD and DISH, and the Court designating DISH's vote, DISH rescued DBSD's valuable assets from potential liquidation and created massive returns for all of DBSD's constituents.

Conclusion

There are several observations worth noting in the DBSD case. First, the Court's Opinion was correct in all regards. Second, despite the years of litigation, DBSD and DISH reached a resolution whereby DISH may finalise the business transaction it set out to accomplish when purchasing the First Lien Debt. Third, although the various courts' rulings determined DISH did not act in good faith and therefore, its vote should be designated, it is DISH that is the hero in this saga – it will provide desperately needed financial support to DBSD, rescue DBSD from potential liquidation, repay creditors in full and provide a significant return for equity. DISH's relentless pursuit of DBSD stirred competition from two holders of the Second Lien Debt that launched their own campaign to effect a transaction with DBSD. If approved, that transaction would have ultimately benefited TerreStar Networks, an entity in which such creditors have a significant interest. Ultimately, DISH prevailed, but not before this competition forced DISH to increase its bid by almost USD 400 million. The clear winners here though are DBSD's creditors and ICO, who, because of DISH, will receive significantly greater returns than the original Plan, achieving a bankruptcy's ultimate goal of maximising the value of the bankruptcy estate.

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