February 9, 2011

Second Circuit Bars "Gifting" Plans and Upholds Designation of Competitor's Votes as "Not In Good Faith"

In a February 7, 2011 decision, *DISH Network Corp*. v. *DBSD North America, Inc.*, *Sprint Nextel Corp*. v. *DBSD North America, Inc*.,[1] the Second Circuit Court of Appeals held that "gifting" plans violate the absolute priority rule and that a competitor's vote was appropriately designated for being "not in good faith" when its motive was to attempt to obtain a blocking position and control the bankruptcy.[2]

Background

ICO Global Communications ("ICO Global") founded DBSD North America, Inc. and its subsidiaries ("DBSD") in 2004 to develop a mobile communication network that combined satellites and land-based transmission. In May 2009, after accumulating a large amount of debt and with its network still only in the development stage, DBSD (but not its parent ICO Global) voluntarily filed for chapter 11 relief. Key claims against DBSD included (i) a credit facility with a first-priority security interest in substantially all of DBSD's assets ("First Lien Debt"); (ii) senior secured notes with a second-priority security interest in substantially all of DBSD's assets ("Second Lien Debt"); and (iii) an unliquidated unsecured claim by Sprint Nextel Corp. ("Sprint") based on a lawsuit against a DBSD subsidiary.

Under DBSD's plan of reorganization, holders of First Lien Debt would receive new obligations with a four-year maturity at the same interest rate, but with PIK interest, while holders of Second Lien Debt would receive the bulk of the equity in reorganized DBSD, worth between 51% and 73% of their claims. Unsecured creditors, including Sprint, would receive equity in the reorganized DBSD worth between 4% and 46% of their claims. Finally, ICO Global would receive shares and warrants in the reorganized DBSD, value that would go to Second Lien Debt holders but for their agreement otherwise.

Sprint objected to the plan, arguing that it violated section 1129(b)(2)(B) of the Bankruptcy Code, commonly known as the "absolute priority rule," because ICO Global, an interest holder junior to Sprint, would receive shares and warrants while Sprint did not receive the full value

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1 *DISH Network Corp.* v. *DBSD North America, Inc., Sprint Nextel Corp.* v. *DBSD North America, Inc.*, Case Nos. 10-1175, 10-1201, 10-1352 (2nd Cir. February 7, 2011).

2 Before ruling on the "gifting" plan and vote designation issues, the Court of Appeal held (with one dissenting vote) that Sprint, an out-of-the-money creditor holding an unliquidated claim, nonetheless had standing to appeal. It noted in particular that the plan's violation of the absolute priority rule directly and financially harmed Sprint.

of its claim. Because the unsecured creditor class, which included Sprint, had voted against the plan, such class had to be "crammed down." The Bankruptcy Court found, and District Court affirmed, that ICO Global's receipt of shares and warrants was a "gift" from the Second Lien Debt holders, but a permissible one that did not violate the absolute priority rule.

Separately, shortly after DBSD filed its disclosure statement, DISH Network Corp. ("DISH"), a competitor of DBSD and formerly not a creditor, purchased all of the First Lien Debt at par and a minority, non-blocking position in the Second Lien Debt. DISH voted against DBSD's plan, proposed to enter into a strategic transaction with DBSD, and requested permission to file a competing plan. DBSD moved to designate DISH's vote as "not in good faith" under section 1126(e) of the Bankruptcy Code.[3] Both the Bankruptcy Court and the District Court agreed that vote designation was appropriate.

Sprint's Appeal: "Gifting" Plans and the Absolute Priority Rule

After an extensive review of the absolute priority rule's origins and development, the Second Circuit reversed confirmation of the plan. The absolute priority rule requires that, absent the consent of all impaired classes of unsecured claimants, a confirmable plan must ensure either (i) that the dissenting class receives the full value of its claim, or (ii) that no classes junior to such class receive any property under the plan on account of their junior claims or interests. DBSD argued that the Second Lien Debt holders' "gifting" of the shares and warrants to DBSD's shareholder, ICO Global, involved a transfer of value that rightfully belonged to the Second Lien Debt holders as undersecured creditors, and thus Sprint had no reason to complain. The Court disagreed and held that the absolute priority rule applies to "any property" including property covered by a secured creditor's lien; the "gift" to ICO Global on account of its shareholder interest came out of the DBSD estate, not from the Second Lien Debt holders, and thus the "gifting" violated the absolute priority rule. While the Court of Appeals did not foreclose the possibility of "gifting" outside of a plan, it held that the absolute priority rule bans all "gifting" under a plan.

DISH's Appeal: Vote Designation

The Second Circuit also affirmed the designation of DISH's vote. Generally, courts use the remedy of vote designation sparingly. Only when a creditor does not act in "good faith;" that is, when the creditor uses its vote to obtain a benefit to which the creditor is not otherwise entitled and is voting with an "ulterior motive" should the creditor's vote be designated. Here the record supported the finding that DISH's "ulterior motives" manifested a lack of "good faith" mandating designation. DISH had purchased its claims to control the bankruptcy process to acquire DBSD's spectrum rights--a benefit to which it was not otherwise entitled as a creditor--not towards protecting or maximizing the value of its claim. The Court found evidence of DISH's lack of "good faith" in (i) its position as a competitor of DBSD; (ii) its willingness to overpay for the claims that it had bought; (iii) its attempt to propose a competing plan; and (iv) its internal communications, which described a desire to "to obtain a blocking position" and "control the bankruptcy process for this potentially strategic asset."

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[3] Section 1126(e) of the Bankruptcy Code states: "On request of a party in interest, and after notice and a hearing, 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."

The Court specified that its holding only applies to attempts to obtain a blocking position and to control a competitor's bankruptcy case; it excluded from its ruling the actions of preexisting creditors voting with strategic intentions. The Court also emphasized that vote designation involves a fact-intensive inquiry, and on other facts conduct by claims purchasers for acquisitive or other strategic purposes may be appropriate.

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This memorandum is not intended to provide legal advice with respect to any particular situation and no legal or business decision should be based solely on its content. Questions concerning issues addressed in this memorandum should be addressed to any of the following:

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