

Second Circuit Rejects Gifting Exception to Absolute Priority Rule and Affirms Vote Designation for Claims Acquired in Bad Faith

The United States Court of Appeals for the Second Circuit (the "Second Circuit") on February 7, 2011 issued an opinion rejecting the often used gifting doctrine in the context of a plan of reorganization on the one hand, while affirming vote designation for claims not purchased in good faith on the other. *In re DBSD N. Am., Inc.*, __ F.3d __, 2011 WL 350480 (2d Cir. Feb. 7, 2011). The decision will have significant implications on the ability of parties seeking to gift portions of their recovery to junior classes as a way to accelerate an efficient and non-adversarial chapter 11 case. The decision will also force investors to think twice before acquiring claims for strategic purposes. The following is a summary overview of the decision.

The DBSD Plan and the Sprint and DISH Objections

DBSD proposed a plan of reorganization which (i) provided first lien debt holders with new loans and interest to be paid-in-kind over four years, (ii) granted the bulk of shares in the reorganized entity to second lien debt holders, (iii) granted holders of general unsecured claims shares estimated to be worth 4% to 46% of their original claims, and (iv) provided for the "gifting" of shares and warrants in the reorganized entity by the second lien lenders to ICO Global, the existing shareholder.

Sprint Nextel Corporation ("Sprint") objected to the plan arguing, among other things, that the plan violated the absolute priority rule by providing a substantial recovery to the existing shareholder, whose interest was junior to Sprint's class of general unsecured claims. Under the absolute priority rule, a plan may not provide for distribution of property to holders of junior claims or interests on account of those claims or interests,

unless all classes of senior claims either receive full value of their claims or otherwise consent. DISH Network Corporation ("DISH")—who acquired all of the first lien debt at par, and \$111 million of the second lien debt, because it wanted to control the bankruptcy process—also objected to the plan on the grounds that (i) it was not feasible, and (ii) did not give DISH the indubitable equivalent of its first lien debt. In response to DISH's objection, DBSD sought the designation of DISH's rejection of the plan as not being in good faith.

In concluding that the DBSD plan did not violate the absolute priority rule, the Bankruptcy Court (Judge Gerber) held that (i) ICO Global's receipt of shares and warrants was a "gift" from the second lien debt holders, who were themselves not receiving the full value of their claims, and (ii) the gifting was permitted because it came from secured creditors, was based upon understandable reasons, there were no ulterior motives and Sprint would not have received any additional recovery

had the gift not been made. In determining to designate DISH's vote and to disregard DISH's wholly-owned class of first lien debt, the Bankruptcy Court held that as a competitor to DBSD, DISH had voted on the plan to establish control over a strategic asset, not as a traditional creditor seeking to maximize its return. Indeed, the Bankruptcy Court concluded that DISH's own actions (purchasing all of the first lien debt at par without making any determination whether it made financial sense to do so, and acquiring the debt after the DBSD plan was filed) and internal documents made it clear that its purpose was as a strategic investor, intending to promote its own interests in acquiring control over DBSD's assets, rather than in maximizing recovery to all creditors. The Bankruptcy Court also concluded that the plan was feasible and provided DISH with the indubitable equivalent of its claim. After designating DISH's vote, disregarding the class of first lien debt for plan acceptance purposes, and overruling all objections, the Bankruptcy Court confirmed the plan. The District Court affirmed.

The Second Circuit Rejects the Gifting Exception to the Absolute Priority Rule

Sprint's appeal to the Second Circuit focused on the narrow issue of whether the plan violated the absolute priority rule by improperly providing distribution to ICO Global without satisfying Sprint's senior claim in full. In response, DBSD argued that the second lien debt holders were free to gift a portion of their recovery with ICO Global under the gifting doctrine—citing the 1993 First Circuit case of *In re SPM Manufacturing Corp.*—because the second lien debt holders were entitled to the full residual value of DBSD. The Second Circuit concluded that the issue of whether the Bankruptcy Court erred in confirming the plan turned on whether ICO Global received or retained any property, under the plan, and on account of its junior interest, and ultimately found that (i) “any property” included the shares and warrants received by ICO Global, (ii) ICO Global received such property “under the plan” and (iii) ICO Global received its recovery “on account of its junior interest” (noting, among other things, that ICO Global did not contribute additional capital to the reorganized entity). The Second Circuit also found the *SPM* case to be irrelevant because (i) it involved a chapter 7 (which does not include the absolute priority rule), and (ii) the secured creditor in *SPM* obtained relief from the automatic stay such that the property in question was beneficially owned by the secured creditor alone, and was not property of the estate. The Second Circuit

further explained that the Supreme Court developed the absolute priority rule to limit the same type of transaction proposed in DBSD, where undersecured creditors of an over-leveraged corporation “gift” shares to prior shareholders while intermediate lenders receive less than the value of their claims.

While the Second Circuit did recognize the policy arguments against enforcing the absolute priority rule in a “gifting” context—*i.e.*, that gifting could facilitate an efficient and non-adversarial proceeding, and tips to out of the money equity sponsors are common to ensure a consensual process, it also noted the “substantial” policy arguments in favor of strictly adhering to the rule—*i.e.*, it curbs self-enrichment opportunities for shareholders to control the reorganization process at the expense of intermediate and more senior creditors. Finally, the Second Circuit noted that while Congress was aware of the benefits and disadvantages of the rule, it did not create any exception for gifts. Accordingly, the Second Circuit held that the Bankruptcy Court erred in confirming DBSD's plan.

The Second Circuit Affirms Vote Designation for Claims Acquired in Bad Faith

DISH appealed on the grounds that, among other things, the Bankruptcy Court should not have (i) designated its vote as not cast in good faith and (ii) disregarded the entire class that DISH's claim comprised (as DISH was the sole creditor in that class). Under section 1126 of the Bankruptcy Code, a court is empowered to disregard the votes of any entity whose acceptance or rejection of a plan was not in good faith. The Second Circuit recognized that (i) courts should employ designation sparingly, and (ii) selfishness alone will not defeat a creditor's good faith, but courts could designate the vote of a party who voted with an “ulterior motive.” The Second Circuit cited several examples of the kinds of ulterior motives that have resulted in vote designation, including where (i) a party bought a blocking position in several classes after the debtor proposed a reorganization plan and then sought to defeat the plan while promoting its own plan to seize control over the debtor, (ii) a competitor bought claims to obstruct the debtor's reorganization thereby furthering the interests of their own business, and (iii) an affiliate of a debtor acquired claims to prevent confirmation of a competing plan. In concluding that the Bankruptcy Court permissibly designated DISH's vote, the Second Circuit found that DISH, an indirect competitor of DBSD and part owner of a direct competitor,

acquired a blocking position after a plan had been proposed with the intent not to maximize its return but to enter a strategic transaction with DBSD. Finally, the Second Circuit also affirmed the Bankruptcy Court's decision to disregard DISH's entire class for the purposes of determining plan acceptance because the Bankruptcy Code measures plan acceptance on a class by class basis, not creditor by creditor, or claim by claim. Because DISH's class effectively contained zero claims, common sense mandated that the entire class be disregarded as well.

Conclusion

The Second Circuit's decision will have far reaching implications across the chapter 11 landscape. Companies seeking to formulate a restructuring plan premised on the gifting exception to the absolute priority rule will now need to think twice before filing in the Second Circuit and, regardless of where they file, will need to take into account the DBSD decision when seeking creative mechanisms to accelerate an efficient and non-

adversarial chapter 11 proceeding. An example of such a mechanism could be an agreement entered into pre-confirmation by senior creditors to convey value to creditors or equity holders in junior classes *outside* of the plan context. The Second Circuit's analysis turned on whether ICO Global received property "under the plan" and the Court, in fact, did not address the propriety of "gifting" outside of a plan. Accordingly, "gifting" outside of a plan may achieve the same objectives as "gifting" within a plan, without running afoul of the absolute priority rule. Of course, any parties seeking to avail themselves of that possible solution to DBSD would be well advised to fully disclose their agreement to the court administering the related plan.

The Second Circuit also limited its decision regarding vote designation to parties that vote after obtaining blocking positions, leaving for another day the situation in which a preexisting creditor votes with strategic intentions. As a result, investors will now need to pause before acquiring debt solely with the intent to obtain a blocking position.

Practice group contacts

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