# VOTE DESIGNATION IN THE AFTERMATH OF *DBSD*

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Purchase of a distressed company's debt can give a potential acquirer of that company a significant advantage in any restructuring process. Before a bankruptcy filing, owning debt can provide a profit opportunity, as well as leverage to require a company to sell assets, raise equity or offer to exchange debt for equity. Owning debt can also provide an inside track if a distressed company decides to enter a prepackaged or pre-negotiated bankruptcy. During the bankruptcy process itself, a debtholder has myriad advantages, including the right to be heard in court as well as, for a secured creditor, the ability to credit bid in an auction.[1] Moreover, the purchase of sufficient amounts of claims also gives a holder the ability to influence or even control the confirmation of a bankruptcy plan.

There are, however, certain risks involved in purchasing claims both before and after a bankruptcy filing. Among these is the possibility that a claimant's votes will be designated (*i.e.*, disregarded) as a result of its conduct in connection with the purchase of its claims and its subsequent behavior in the bankruptcy proceeding. Surprisingly, a recent decision of the United States Court of Appeals for the Second Circuit, *DISH Network Corp. v. DBSD North America, Inc. (In re DBSD North America, Inc.)*,[2] has suggested that the very rationale underlying most potential acquirers' purchase of claims—*i.e.*, obtaining a controlling position in the reorganized debtor—might be a basis for depriving a claim purchaser of its right to have its vote on a chapter 11 plan counted. If so interpreted, *DBSD* may substantially curtail the main benefit that a potential acquirer hoped to derive from purchasing its target's debt. This article presents an overview of the law relating to vote designation and considers the impact of *DBSD* on future purchases of distressed debt by potential acquirers.

## I. Vote Designation: Section 1126(e) and What Constitutes "Bad Faith"

Before a plan of reorganization may be confirmed, each impaired class must either accept the plan or be found to be afforded fair and equitable treatment under the plan.[3] A class of claims is deemed to accept a plan if a majority in number of the voting claimholders in such class holding claims accounting for at least two-thirds of the total amount of all claims in such class accept the plan.[4] Section 1126(e) of the Bankruptcy Code, however, allows the court to "designate"—*i.e.*, not count—the vote of any creditor whose vote is not cast or procured in "good faith."[5] Any claimant therefore may face an allegation that its vote on a plan was not in good faith and ought to be set aside.

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[1] Recently, courts have been split as to whether secured creditors have the right to credit-bid in auctions conducted under plans of reorganization. *Compare River Road Hotel Partners, LLC v. Amalgamated Bank*, 2011 WL 2547615 (7th Cir. June 28, 2011) (Bankruptcy Code does not permit debtor to conduct a sale pursuant to a plan without allowing secured creditor to credit bid), *with In re Philadelphia Newspapers, LLC*, 599 F.3d 298 (3d Cir. 2010) (under certain circumstances, Bankruptcy Code permits debtor to conduct a sale pursuant to a plan without allowing secured creditor to credit bid).

[2] 634 F.3d 79 (2d Cir. 2011).

[3] 11 U.S.C. § 1129(a)(8), (b).

[4] 11 U.S.C. § 1126(c).

[5] *See* 11 U.S.C. § 1126(e) ("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 Bankruptcy Code contains no definition of "good faith" or "bad faith," leaving it to the courts to develop an appropriate analytical framework.[6] In so doing, they have established a few general principles.

### A. Self-Interest Is Not Bad Faith

First, it is well established that a creditor is entitled to pursue its self-interest as a creditor, *i.e*., to increase or protect recovery on its claims, without being subject to vote designation. As the United States Court of Appeals for the Ninth Circuit has held:

> [W]e do not condemn mere enlightened self interest, even if it appears selfish to those who do not benefit from it. . . . [I]f [a creditor] act[s] out of enlightened self interest, it is not to be condemned simply because it frustrate[s] [a debtor's] desires. That is true, even if [the creditor] purchased [its] claims for the very purpose of blocking confirmation of [the debtor's] proposed plan.[7]

Thus, a creditor is under no obligation "to approach reorganization plan votes with a high degree of altruism and with the desire to help the debtor and their fellow creditors."[8]

### B. Use of Obstructive Tactics to Obtain Disproportionate Recovery Constitutes Bad Faith

"Bad faith" has been found to encompass a creditor's use of "obstructive" tactics to gain an improper advantage beyond what the Bankruptcy Code would otherwise allot to such creditor. The United States Supreme Court, for example, has stated that the analogous good faith requirement imposed under the former Bankruptcy Act was intended "to prevent creditors from participating who by the use of obstructive tactics and hold-up techniques exact for themselves undue advantages," particularly receipt by such creditors of "more than the ratable equivalent of their proportionate part of the bankrupt assets."[9] Accordingly, a creditor acts in bad faith where

[6] *See DBSD N. Am., Inc.*, 634 F.3d at 101.

[7] *Figter Ltd. v. Teachers Ins. & Ann. Ass'n of Am. (In re Figter Ltd.)*, 118 F.3d 635, 639 (9th Cir. 1997) (citations omitted); *see also In re Gilbert*, 104 B.R. 206, 217 (Bankr. W.D. Mo. 1989) ("As long as a creditor acts to preserve what he reasonably perceives as his fair share of the debtor's estate, bad faith will not be attributed to his purchase of claims to control a class vote."); *In re Pine Hill Collieries Co.*, 46 F. Supp. 669, 671 (E.D. Pa. 1942) ("If a selfish motive were sufficient to condemn re-organization policies of interested parties, very few, if any, would pass muster.").

[8] *Figter*, 118 F.3d at 639.

[9] *See Young v. Higbee Co.*, 324 U.S. 204, 213 & n.10 (1945) (internal quotation marks omitted); *see also id.* at 213 n.10 ("Bad faith [is] to be attributed to claimants who opposed a plan for a time until they were 'bought off'; those who 'refused to vote in favor of a plan unless . . . given some particular preferential advantage.'") (second alteration in original) (internal quotation marks omitted).

it "attempts to extract or extort a personal advantage not available to other creditors in its class."[10]

### C. Bad Faith Includes Action Driven by an "Ulterior Motive"

A creditor also acts in bad faith when it acts with an "ulterior motive."[11] Recognized ulterior motives include "pure malice,"[12] impeding the assertion of a cause of action against the creditor in question,[13] injuring the debtor's business to the benefit of such creditor's competing business[14] and obtaining benefits "under a private agreement with a third party which depends on the debtor's failure to reorganize."[15] Such ulterior motives align with "badges of bad faith" that other courts have used to analyze a creditor's actions.[16] Alternatively, where a

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[10] *In re Dune Deck Owners Corp.*, 175 B.R. 839, 844 (Bankr. S.D.N.Y. 1995); *see also In re Landing Assocs., Ltd.*, 157 B.R. 791, 808 (Bankr. W.D. Tex. 1993) (distinguishing "holding out for better plan treatment," which does not constitute bad faith, from seeking an "improper gain," which does).

[11] *See, e.g., Figter*, 118 F.3d at 639; *255 Park Plaza Assocs. Ltd. P'ship v. Conn. Gen. Life Ins. Co. (In re 255 Park Plaza Assocs. Ltd. P'ship)*, 100 F.3d 1214, 1219 (6th Cir. 1996); *Insinger Mach. Co. v. Fed. Support Co. (In re Fed. Support Co.)*, 859 F.2d 17, 19 (4th Cir. 1988); *see also In re P-R Holding Corp.*, 147 F.2d 895, 897 (2d Cir. 1945) ("When [a creditor's] purchase [of a claim] is in aid of an interest other than an interest of a creditor, such purchases may amount of 'bad faith' under [the former] Bankruptcy Act.").

[12] *Figter*, 118 F.3d at 639 (quoting *Pine Hill Collieries*, 46 F. Supp. at 671).

[13] *Cf. In re Keyworth*, 47 B.R. 966, 971-72 (D. Colo. 1985) (denying standing to a creditor to object to certain aspects of a debtor's pursuit of a cause of action against such creditor on the equitable ground that the creditor had acted in bad faith by purchasing its claim for the sole purpose of interfering with the assertion of the cause of action); *In re Kuhns*, 101 B.R. 243, 247 (Bankr. D. Mont. 1989) (rejecting settlement of claims asserted by a debtor against a party who had purchased offsetting claims against the debtor, which were also to be settled, with funds provided by the debtor's wife). *But see Fed. Support Co.*, 859 F.2d at 19-20 (finding no evidence of bad faith where a creditor that was also the defendant in a cause of action asserted by the debtor voted to reject a proposed plan of reorganization); *In re Lehigh Valley Prof'l Sports Clubs, Inc.*, 2001 WL 1188246, at *6 (Bankr. E.D. Pa. 2001) ("The fact that [the creditor] voted against a plan because its centerpiece was a suit against it without more is not a basis to find bad faith. A creditor is expected to act in its own self interest."); *In re A.D.W., Inc.*, 90 B.R. 645, 651 (Bankr. D.N.J. 1988) ("The existence of the district court litigation involving [the creditor], the debtor and the debtor's principals does not constitute grounds to designate the vote of [the creditor] as not in good faith. The plan, if approved[,] would leave the pending litigation undisturbed.").

[14] *See In re MacLeod Co.*, 63 B.R. 654, 655-56 (Bankr. S.D. Ohio 1986) (concluding that certain creditors' votes should be designated as the "rejection of debtor's plan by the named individuals was not in good faith, but rather was for the ulterior purpose of destroying or injuring debtor in its business so that the interests of the competing business with which the named individuals were associated, could be furthered").

[15] *Dune Deck Owners*, 175 B.R. at 845.

[16] *In re Adelphia Commc'ns Corp.*, 359 B.R. 54, 61 (Bankr. S.D.N.Y. 2006) (noting that "badges of the requisite bad faith include creditor votes designed to (1) assume control of the debtor, (2) put the debtor out of business or otherwise gain a competitive advantage, (3) destroy the debtor out of pure malice or (4) obtain benefits available under a private agreement with a third party that depends on the debtor's failure to reorganize" (internal quotation marks omitted)).

creditor can draw a connection between its conduct in a case and its self-interest *as a creditor*, it is unlikely that its votes will be designated.[17]

A mere conflict of interest resulting from a creditor's holding of claims "of multiple debtors in a single multi-debtor chapter 11 case, or . . . in different, antagonistic, classes of a particular debtor in a single chapter 11 case" generally does not necessarily amount to such an ulterior motive.[18] For instance, in *In re Adelphia Communications Corp.*, it was argued that votes by certain creditors in favor of the plan should be designated because they were driven by an ulterior motive—to maximize their recovery in another class.[19] The court found no cognizable claim of bad faith: the creditor's motive was "to maximize an economic recovery, or to hedge, by owning bonds of multiple debtors in a single multi-debtor Chapter 11 case."[20]

### D. Good Faith Inquiry Requires Close Examination of All Relevant Circumstances

Beyond these basic principles, courts have generally eschewed clear rules in favor of a case-by-case approach.[21] The good faith inquiry is necessarily fact intensive and guided by the totality of relevant circumstances.

## II. Purchasing Claims to Obtain a Blocking Position and Acquire Control

### A. *In re Alleghany International, Inc.*

In a well-known case, *In re Allegheny International, Inc.*, Japonica Partners, an investor, bought certain of the debtor's subordinated notes after the debtor had proposed a plan of reorganization.[22] After proposing its own plan, Japonica proceeded to purchase a blocking position in a class of unsecured claims as well as a class of secured bank debt, in some instances

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[17] *See Three Flint Hill Ltd. P'ship v. Prudential Ins. Co. (In re Three Flint Hill Ltd. P'ship)*, 213 B.R. 292, 301 (D. Md. 1997) (creditor did not act in bad faith by buying claims in order to block a plan of reorganization and force the debtor to liquidate; creditor's desire to buy the debtor's property was consistent with a desire to "maximize the amount recovered from the defaulted loan"); *In re Marin Town Ctr.*, 142 B.R. 374, 379 (N.D. Cal. 1992) (vote cast in good faith where creditor rejected plan in furtherance of view that liquidation would provide a greater return on creditor's claim); *see also In re Landing Assocs., Ltd.*, 157 B.R. 791, 809 (Bankr. W.D. Tex. 1993) (declining to find bad faith where creditor's rejection of a plan was driven by incentives provided by agreement distinct from, but substantially related to, such creditor's interest as a creditor).

[18] *Adelphia Commc'ns*, 359 B.R. at 63-65. *But see Dune Deck Owners*, 175 B.R. at 845 & n.13 (suggesting that such a conflict might justify designation under certain circumstances).

[19] *See Adelphia*, 359 B.R. at 63.

[20] *Id.*; *see also In re Pleasant Hill Partners, L.P.*, 163 B.R. 388, 395 (Bankr. N.D. Ga. 1994) (purchasing claims to control the vote in one class for the benefit of another is not an ulterior motive evidencing bad faith).

[21] *See Figter*, 118 F.3d at 639 ("[T]he concept of good faith is a fluid one, and no single factor can be said to inexorably demand an ultimate result, nor must a single set of factors be considered. It is always necessary to keep in mind the difference between a creditor's self interest as a creditor and a motive which is ulterior to the purpose of protecting a creditor's interest.").

[22] 118 B.R. 282 (Bankr. W.D. Pa. 1990).

at highly inflated prices. The bankruptcy court concluded that Japonica had accumulated its claims in bad faith, noting the following facts:

- Japonica's stated purpose was to take control of the debtor;

- Japonica amassed its position late in the debtor's bankruptcy process and only after a disclosure statement filed by the debtor had been approved and Japonica had proposed a competing chapter 11 plan;

- Japonica purchased claims at highly inflated values solely to acquire a blocking position in certain classes;

- in its capacity as a plan proponent, Japonica was a fiduciary of the debtor and had received substantial nonpublic information; and

- Japonica acquired large positions in classes that had directly conflicting interests in pending litigation.[23]

In the course of so ruling, the *Allegheny* court worried that "[i]f a plan proponent, such as Japonica, can purchase a blocking position, the votes of the other creditors and interest holders are rendered meaningless," and stated that a party such as "Japonica, who chose to become a creditor, should not have veto control over the reorganization process."[24]

It is therefore clear that the *Allegheny* court was troubled by Japonica's acquisition of a blocking position for the purpose of ensuring that it obtained control of the debtor. At the same time, however, the decision establishes that the court considered Japonica a "bad actor" that had exploited its position as a plan proponent and fiduciary.[25] As a result, it is not certain whether the court considered Japonica's purchase of claims for the purpose of taking control of the debtor to be a sufficient basis, in and of itself, for designating Japonica's votes.

### B. Blocking Positions Generally

In the aftermath of *Allegheny*, numerous courts held that the purchase of claims to obtain a blocking position in connection with a plan of reorganization, absent some other evidence of an ulterior motive, does not amount to bad faith warranting the designation of votes.[26] For example, in *Figter*, the United States Court of Appeals for the Ninth Circuit

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[23] *See id.* at 289-90, 295-99; *see generally* Scott K. Charles, *Trading Claims in Chapter 11 Cases: Legal Issues Confronting the Postpetition Investor*, 1991 ANN. SURV. AM. L. 261, 303-04 (1991).

[24] *Allegheny*, 118 B.R. at 290.

[25] *See id.* at 295-99 (indicating that (1) Japonica's purchase of claims while also a plan proponent amounted to an "end run around the bankruptcy process," (2) while engaging in such purchases, Japonica was in possession of inside information and subject to the duties of a fiduciary and (3) "Japonica ha[d] engaged in a pervasive pattern of bad faith designed to control the debtor and manipulate the bankruptcy process" (internal quotation marks omitted)).

[26] *See, e.g.*, *Figter*, 118 F.3d at 638-39; *255 Park Plaza Assocs.*, 100 F.3d at 1219; *Three Flint Hill Ltd. P'ship*, 213 B.R. at 301; *In re Waterville Valley Town Square Assocs., Ltd. P'ship*, 208 B.R. 90, 95-96 (Bankr. D.N.H. 1997). *But see In re Applegate Prop., Ltd.*, 133 B.R. 827, 836 (Bankr. W.D. Tex. 1991) ("Sanctioning claims acquisition

examined the conduct of an unimpaired secured creditor which opposed the debtor's proposed plan and acquired a blocking position by purchasing a majority of unsecured claims (the sole impaired class) against the debtor.[27] The debtor sought to have the secured creditor's votes designated under section 1126(e). The Ninth Circuit, however, affirmed the bankruptcy court's denial of the debtor's motion, noting that the secured creditor opposed the debtor's plan for reasons directly related to the plan's treatment of its secured claim, was not a proponent of an alternative plan at the time it acquired claims and had offered to purchase all of the debtor's unsecured claims.[28] Moreover, the court expressly stated that "'[a]s long as a creditor acts to preserve what he reasonably perceives as his fair share of the debtor's estate, bad faith will not be attributed to his purchase of claims to control a class vote.'"[29]

Certain of these decisions even permitted the creditor at issue to use its blocking position to ensure that an alternative plan proposed by such creditor would be confirmed.[30] In *Three Flint Hill Limited Partnership*, a secured creditor acquired the vast majority of the debtor's unsecured claims and proposed an alternative plan of reorganization. The bankruptcy court confirmed the secured creditor's plan after the relevant classes (the class containing only the claim of the secured creditor and the class containing the claims of unsecured creditors) voted to reject the debtor's plan and confirm the secured creditor's claim.[31] The court also denied the debtor's request that the secured creditor's votes be designated, noting that the secured creditor had not acted in bad faith as it was "quite possible" that the secured creditor believed that the course of action set forth in its alternative plan "was the most effective way to maximize the amount recovered" in respect of its secured claim.[32]

### C. *In re DBSD North America, Inc.*

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for purposes of blocking an opponent's plan would . . . ignite a scramble for votes conducted almost entirely outside the Code's carefully developed structure . . . leaving creditors to select not the best plan but the best deal they might be able to individually negotiate."). Certain courts, however, remained skeptical about an outsider's purchase of claims to facilitate its gaining control of the debtor. *See, e.g., Waterville Valley Town Square Assocs.*, 208 B.R. at 95 ("A problem arises when a creditor purchases claims in a manner that advances a *noncreditor* interest, *e.g.*, to gain control of the debtor's operations."); *In re Holly Knoll P'ship*, 167 B.R. 381, 389 (Bankr. E.D. Pa. 1994) (creditor's purchase of claims was in bad faith because motivated by desire to become general partner of debtor); *Landing Assocs.*, 157 B.R. at 807-08 ("[W]hen the voting process is being used as a device with which to accomplish some ulterior purpose, out of keeping with the purpose of the reorganization process itself, and only incidentally related to the creditor's status *qua* creditor, section 1126(e) is rightly invoked. Thus, voting to block a plan in order to acquire the company ones' self justifiably results in disqualification . . . .").

[27] *See Figter*, 118 F.3d at 637.

[28] *See id.* at 640.

[29] *Id.* at 639 (quoting *In re Gilbert*, 104 B.R. 206, 217 (Bankr. W.D. Mo. 1989)).

[30] *See Three Flint Hill Ltd. P'ship*, 213 B.R. at 301.

[31] *See id.* at 295-97.

[32] *Id.* at 301.

Thus, until recently, the *Allegheny* decision stood as something of an outlier. In *DISH Network Corp. v. DBSD North America, Inc. (In re DBSD North America, Inc.)*,[33] however, the United States Court of Appeals for the Second Circuit affirmed lower court rulings which had relied principally on *Allegheny* in holding that acquiring claims "to establish control over [a] strategic asset" constituted bad faith.[34] *DBSD* concerned the actions of DISH Network, a satellite television provider and a competitor of the debtors. After the debtors filed their plan and disclosure statement, DISH purchased all of the first lien debt of the debtors at par. DISH then opposed DBSD's chapter 11 plan, and separately offered to enter into a strategic transaction with DBSD.[35] The bankruptcy court, as affirmed by the district court, designated DISH's vote rejecting the debtor's plan as "not in good faith," and the Court of Appeals both affirmed this ruling and further held that the designation of the vote of the sole entity in the class of first lien creditors eliminated the need for the plan to provide fair and equitable treatment of that class.[36]

In affirming the bankruptcy court's decision that DISH acted in bad faith, the Court of Appeals reasoned that DISH was a competitor of DBSD that had "bought a blocking position in (and in fact the entirety of) a class of claims, after a plan had been proposed, with the intention not to maximize its return on the debt"[37] but to "vot[e] against any plan that did not give it a strategic interest in the reorganized company."[38] The Court, reviewing factual findings for "clear error," was particularly troubled by the timing of the purchases, which were made after the debtor's filing of a plan, and the evidence that DISH's purpose was to thwart any plan that did not meet its acquisition goal, reflected in internal DISH communications stating that its purpose was "'to obtain a blocking position' and 'control the bankruptcy process for this potentially strategic asset.'"[39]

This ruling represents a possible game changer for distressed M&A. Contrary to the general willingness of most courts since *Allegheny* to allow creditors to accumulate and make use of blocking positions, the *DBSD* court appeared to view such action with substantial suspicion. Moreover, unlike *Allegheny*, the decision in *DBSD* does not appear to rest, even in part, on the court's perception that the creditor at issue was a fiduciary acting in derogation of its duties. Rather, its attempt to use a blocking position to obtain control of the debtor was alone sufficient to justify designation of the creditor's votes. Finally, the court's conclusion that designation of a creditor's votes eliminates the need to satisfy cramdown requirements with

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[33] 634 F.3d 79 (2d Cir. 2011).

[34] *In re DBSD N. Am., Inc.*, 421 B.R. 133, 137 (Bankr. S.D.N.Y. 2009).

[35] *See DBSD N. Am., Inc.*, 634 F.3d at 87.

[36] *See id.* at 88, 101-06.

[37] *Id.* at 104. Notably, under the proposed plan, the recovery for first lien lenders like DISH would not have consisted of payment in full in cash, but rather participation in a new secured credit facility.

[38] *Id.* at 104.

[39] *Id.* at 104-05.

respect to any class consisting solely of claims held by such creditor potentially exposes purchasers of claims to risks beyond mere loss of a potential acquisition.[40]

At the same time, however, it is not clear that the reasoning articulated in *DBSD North America* will become commonplace. The Second Circuit affirmed that vote designation is a fact-specific remedy to be employed "sparingly," declined to decide whether a "preexisting" creditor would be similarly at risk of designation, rested its decision, at least in part, on lower court findings of extremely late and disruptive conduct on the part of DISH, and expressly emphasized that its decision "imposes no categorical prohibition on purchasing claims with acquisitive or other strategic intentions."[41] Whether courts will apply *DBSD* in a case where a claim is purchased at less than par remains an open question. Another, perhaps the most, intriguing question is whether courts will apply *DBSD*'s vote designation holding to an acquirer that is not a strategic competitor, but rather an investor that owns all or part of a competitor. The limits of the principles articulated in *DBSD* are not at all clear. Indeed, as no court has yet addressed *DBSD* in the context of claims purchases for purposes of obtaining control, it remains to be seen whether the approach articulated therein will be limited to the particular facts at issue.[42] Given the limiting language of that decision, however, it appears likely that its reasoning will be relied upon where the potential acquirer is unable to reach consensual agreement with the debtors and other parties in interest and, instead, undertakes disruptive action intended to force the debtor to adhere against its will to the acquirer's demands.

## III. Conclusion

Following *DBSD North America*, the reality is that aggressive acts by a controlling stakeholder, when they are not clearly tied to the stakeholder's interests as a creditor, create risk that the stakeholder's votes will be designated under section 1126(e) of the Bankruptcy Code. That risk is at its height when a would-be acquirer of a debtor has an adversarial relationship with the debtor or, to a lesser extent, its official committees, leading to confrontational behavior that may be deemed disruptive by a court. On the other hand, when a potential acquirer works cooperatively with a debtor and its official committees as a sponsor for a plan to be proposed by the debtor, the risk of designation can be reduced or eliminated.

[40] *Id.* at 105-07. Other than its reliance on the bankruptcy court below, the Second Circuit did not cite any precedent for this aspect of its holding.

[41] *Id.* at 104-05.

[42] One court has briefly addressed *DBSD* in the vote designation context, but did not explore the question whether the purchase of claims for the purpose of facilitating a takeover of the debtor amounted to bad faith. *See In re GSC, Inc.*, 453 B.R. 132, 158-62 (Bankr. S.D.N.Y. 2011) (suggesting that designation of the votes of a creditor that stands to reap disproportionate benefit from rejection of a plan is unlikely where such creditor can articulate valid alternative reasons for rejection of such plan).