KEY POINTS

- US Courts may exclude votes exercised in bad faith.
- Commercial motivation, in itself, does not necessarily constitute bad faith.
- Majority votes are recognised by English Courts as a necessary commercial tool.

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Trading places: distressed debt trading in the US and UK restructuring markets

Unsurprisingly, it has been the biggest bankruptcy in US filing history, Lehman Brothers, which has dominated the US debt trading charts over the last four years. Just recently it has been overtaken by claims traded in MF Global, which since its collapse in October 2011 has generated over $4.2bn of trades. Reported cases, however, are not as prevalent as the trading itself.

Philip Hertz, Rick Antonoff, Mark Pesso, Tim Bennett and Leah Edelboim look at how Courts in the US and the UK have scrutinised the actions of secondary market purchasers which disrupt restructurings in various ways for the purpose of extracting value or gaining a strategic advantage.

In the US, those who trade in distressed debt are alive to the fact that Courts may scrutinise the trading of claims in which parties seek to extract value by disrupting or delaying a Chapter 11 reorganisation. Purchasing the debt of a distressed company can yield myriad advantages for the acquirer; the most significant advantage is the ability to obtain a controlling position in the reorganised debtor. This very rationale for purchasing claims may, however, also be a basis for a Court to "designate", ie, not count, the vote of a claim purchaser on a Chapter 11 plan. A party risks designation when it moves beyond the realm of maximising the recovery on its claim, and votes according to a wholly different, collateral purpose. Whilst in the UK cases challenging the right to vote in the context of a restructuring have thus far been rare, similar issues could arise.

In this article we focus on a recent decision delivered by the US Bankruptcy Court in the Eastern District of North Carolina, which sheds further light on the development in the US of the law related to vote "designation" after the significant "Dish Network" decision. We then go on to look at two English cases, the first of which considers the ability of secondary investors to cram down a minority in a restructuring, and the second looks at how an investor may seek to use rescue proceedings as part of a strategic play for its own benefit.

BAD FAITH

The seminal US case where a Court scrutinised the motives behind a secondary market claims purchase is *Dish Network Corp v DBSD North America, Inc (In re DBSD N. Am. Inc.)*, 421 B.R. 133 (Bankr. S.D.N.Y. 2009), aff'd 634 F.3d 79 (2d Cir. 2010). Dish, an indirect competitor of, and a significant investor in a direct competitor of, DBSD, purchased all of the first lien debt of debtor DBSD, at par, shortly after DBSD filed its Chapter 11 plan. After Dish subsequently voted to reject the plan, DBSD sought to have Dish's vote designated, or disregarded, as a result of its conduct in connection with the purchase of its claims and its subsequent behaviour in the bankruptcy proceeding.

CHAPTER 11 VOTING

Before a Chapter 11 plan of reorganisation may be confirmed, each impaired class must either accept the plan or be found to be afforded fair and equitable treatment under the plan (11 U.S.C. § 1129(a)(8), (b)). A class of claims is deemed to accept the plan if such plan has been accepted by creditors that hold at least two-thirds in amount and more than one-half in number of the allowed claims in such class (11 U.S.C. § 1126(c)).

Section 1126(e) of the Bankruptcy Code allows the Court to designate – meaning not to count – the vote of any creditor whose vote was not cast or procured in "good faith." (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.*")

It should be noted that the votes of insiders are not counted when determining whether an impaired class has accepted a plan of reorganisation as a means of protecting the interest of other creditors (in UK insolvency proceedings similar safeguards apply, so that the votes of connected parties are not taken into account for such purposes).

The Court of Appeals for the Second Circuit affirmed the Bankruptcy Court's decision that Dish had acted in bad faith, and in designating Dish's vote accordingly. The Bankruptcy Court found that Dish acted in bad faith because it "*acted to advance strategic investment interests wholly apart from maximising recoveries on a long position in debt it [held].*" In affirming the Bankruptcy Court's decision, the Court of Appeals explained that Dish "*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 maximise its return on the debt but to enter a strategic transaction with [the debtor]*" and "*to use status as a creditor to provide advantages over proposing a plan as an outsider, or making a traditional bid for the company or its assets.*"

AGGRESSIVE ACTION TO MAXIMISE RETURNS DOES NOT AMOUNT TO BAD FAITH

In a more recent case, Lichtin/Wade *(In re Lichtin/Wade, LLC)*, Ch. 11 Case No. 12-00845-8-RDD, Doc. No. 353, slip op. (E.D.N.C., Dec. 17, 2012), the debtor, Lichtin/Wade LLC, owned and leased space in two office buildings and owned additional vacant land approved for the construction of three additional office buildings located in Raleigh, North Carolina. After the debtor filed for Chapter 11, ERGS II, LLC, an

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affiliate of Archon Group, L.P., a global investment management purchased all of the secured debt from the original lender (the Notes). ERGS also purchased two of the four claims in a separate, unsecured class. ERGS voted all its claims to reject the debtor's Chapter 11 plan.

Ultimately, the debtor sought to have all votes cast by ERGS designated and took the position that ERGS was not acting as a creditor in the case but as a strategic party acting "*for its own ulterior motive of obtaining control of the debtor's business operations*." According to the debtor, throughout the course of the case, ERGS had acted with an eye toward obtaining control of the debtor's properties; such conduct, the debtor argued, warranted the "extraordinary remedy"of designating ERGS's votes.

Based on the evidence adduced at trial, the Court found that, at all times, ERGS acted as a creditor seeking to maximise its investment and advance its own economic interests, "*rather than for the purpose of advancing a strategic competitive interest against the debtor*." To this end, the Court was persuaded by the argument that, had "*ERGS's only goal been to own the debtor's real property, it would have been easier and less costly for ERGS to simply have filed a motion to lift the stay and seek foreclosure*." Instead, ERGS spent significant sums throughout the case, including preparing a competing Chapter 11 plan and disclosure statement. With respect to any competitive motive, the Court found that the businesses were not comparable and it was unlikely that the debtor was posing any direct or indirect competition to ERGS, a much larger entity.

The Court found that the actions of ERGS were motivated "*primarily [by its desire] to improve its plan treatment rather than to take complete control of the Debtor's business*." ERGS purchased the Notes because it saw an opportunity for a good investment, and the Court found it significant that ERGS had undertaken an extensive underwriting process prior to purchasing the debt. In addition, unlike Dish, who purchased all of the first lien debt at par in *DBSD*, the Court found it notable that ERGS purchased the unsecured claims at less than par value to protect its economic interests. While it was likely that ERGS purchased these claims to allow it to control certain classes, this was an effort to maximise its return and not indicative of a lack of good faith or an attempt to obtain ultimate control of the debtor's business. Accordingly, the Court found that, at all times, ERGS acted as a creditor, albeit an aggressive one, protecting its economic interests.

MAJORITY RULES

From a UK perspective, whilst there is an active secondary debt market, jurisprudence on the topic of creditor voting and activism by secondary market purchasers is scarce. One of the most notable cases, *Redwood Master Fund Limited and Others v TD Bank Europe Limited and Others* [2006] 1BCLC 149, provides an interesting contrast with the US cases previously discussed. It is of interest because, whilst it shows an activist approach on the part of the distressed investors, the challenge originates from the position of being part of a minority (not sufficient enough to block a majority vote) and a subsequent complaint that the majority had acted in a way that discriminated against the minority, and, in doing so, breached a duty to act in a *bona fide* manner for the benefit of the lender body as a whole.

In the *Redwood* case, a group of investors acquired interests in a Dutch telecommunications group through the secondary market. These lenders purchased interests in two separate facilities provided to the Dutch group (Facilities A and B). As part of a restructuring proposal, the lenders sought a waiver to various terms of the facilities, the effect of which was to use draw downs from Facility A to prepay Facility B. As a result, eighteen out of forty-six lenders were unaffected (as they had exposures in the same proportions in each facility); fourteen were net receivers and fourteen were net payers. Seven of those net payers only had exposure to the A facility; of the remaining seven net payers, four consented to the waiver. The group of lenders that had acquired their interests in the secondary market fell into the net payers category. They brought a challenge that the waiver letter discriminated against them. In particular, they argued that the majority lenders who had voted in favour of the waiver (60% in number and 81.7% in value, which, in accordance with the terms of the facility, bound all lenders to the waiver including the secondary debt market participants) had breached their duty to act in the *bona fide* interests of all lenders.

The Court found, on the facts of the case, that the group of lenders who had acquired their interests in the secondary market failed to establish any evidence that the actions of the majority lenders had been motivated by any considerations of bad faith. In addition, and perhaps most importantly, the Court was not prepared to imply into the voting powers in the facility agreement a term that the power to waive and amend the facility could only be validly exercised for the benefit of the lenders as a whole. The Court explained that to do so would effectively paralyse the nature of majority voting powers altogether. In this respect, the case is distinguishable from earlier English authorities on majority voting provisions which dealt with resolutions in respect of members of a single class with like interests. The *Redwood* case held that the different treatment of the different lenders was not by the design of the majority lenders, but a consequence of the proposal implemented by the debtor to achieve an overall reduction in its exposure.

The *Redwood* case has recently been referred to in *Assénagon Asset Management SA v Irish Bank Resolution Corp Ltd (formerly Anglo Irish Bank Corp Ltd)* [2012] EWHC 2090 (Ch), a case in which the Court questioned the legitimacy of coercive "exit consents" – a technique used by an Irish bank to enforce losses on subordinated bondholders – under English Law. Whilst the Court recognised that a discriminatory effect on its own is not sufficient to undermine the majority voting provisions, the judge suggested that there may be particular contexts in which it is appropriate to imply terms (ie, a duty to act in the interests of the group as a whole) into arrangements which confer powers on a majority to bind a minority.

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In the *Assénagon* case, consideration was given to whether a majority vote made by bondholders in relation to an exchange offer as part of a restructuring was an abuse of power. The Court held that the "exit consent" technique used to persuade holders of a bond issue to accept an exchange of their bonds for different bonds on different – and less favourable – terms, constituted an oppression of a minority. The terms of the exchange essentially disenfranchised bondholders who did not vote in favour, whilst offering participating bondholders consent fees and a higher return. In this respect, the majority voting power was exercised for the purpose of conferring special collateral benefit on the majority with a view to damaging the minority. The Court held that it was unlawful for the majority to exercise its power in a way that was oppressive or unfair to the minority. An appeal had been lodged in the *Assénagon* case but has since been discontinued, so the particulars of that case, have not been considered at an appellate level. However, in a conjoined appeal *Azevedo and Another v Importação, Exportação e Indústria de Oléos Ltda and Others [2013] EWCA Civ 364*, the English Court of Appeal has reaffirmed the principle that the majority voting power must be exercised in a *bona fide* manner for the purposes of benefiting the best interests of the bondholders as a whole. In the *Azevedo* case the consent payments were not considered to be coercive or oppressive in relation to the non-consenting bondholders.

There are similarities between the *Assénagon* case and *Beck v Manufacturers Hanover Trust Co, 632 NYS 2d 520 (1st Dept 1995)*, a New York State Court decision that dealt with a sale of collateral by a trustee on the instructions of majority bondholders. In that case, the bond indenture contained an express provision that the bondholder trustee should act in accordance with the instructions of 75% of bondholders. The Government of Mexico held approximately 95% of the bonds and instructed the trustee to realise the collateral securing the bonds. The Government of Mexico had bought the bonds in an auction, where it had been the only bidder and, consequently, had paid the upset price. The Court held that the trustee had fiduciary responsibilities more wide ranging than those contemplated in the indenture and, thus, could not rely solely on instructions from a majority holder.

Whilst the factual matrices in the *Redwood* and *Assénagon* cases are very different from the US cases, they both illustrate how strategic plays by secondary market purchasers to either block restructurings if they hold sufficient votes, or seek to use the fact that they are in the minority to mount a challenge to a restructuring that works against their commercial interests, may themselves be the subject of the Court's scrutiny.

STRATEGIC PLAYS

The other English case worthy of mention is one from a few years ago: *Highberry Ltd v Colt Telecom Group plc* [2002] EWHC 2815 (Ch). It is very much a case of the time, when secondary market debt investors were perceived as potential activist litigants, and the fact that they were seeking to gain strategic advantage was frowned upon by the English Court as being "not quite cricket".

In that case, distressed debt investors, having purchased £75m of bonds issued by Colt at a significant discount, sought to place Colt into a formal insolvency process. The investors, described as a "vulture fund", specialised in taking short positions in shares and acquiring debt securities at a discount. Whilst the investors were not owed anything on the bonds, they sought a formal insolvency process on the basis that Colt was likely to become insolvent at some point (3–7 years in the future) as part of its strategy to make a speculative profit on its notes (by forcing a transfer of value from its shareholders to bondholders). At the time of the application, Colt was a FTSE mid-250 member, with a market capitalisation in excess of £550m and its latest balance sheet showed net assets of £977m. The distressed debt investor relied on a dramatic fall in its share price, operating losses, and negative cashflows as a basis for its claim that Colt was likely to become insolvent in the future. The key objective of the proposed administration was to achieve a "restructure"which would transfer the value in the company from the shareholders to the bondholders, either by debt to equity conversion or a payment of cash, or both.

On the facts of this case, the Court held, amongst other things, that Colt was not insolvent or likely to become insolvent, and the case lacked any substance, save that it was recognised that the distressed investors' case was self serving and for its own benefit, rather than to rescue a company in need of restructuring.

TRADING PLACES

Courts on both sides of the Atlantic appear to distinguish between a strategic party, with its motive to take control of the debtor, and a "typical creditor" protecting its claim, and seeking to maximise return. Distressed debt investors should be mindful of these decisions. In the context of the US, distressed debt traders should bear in mind that debtors may attempt to use the extraordinary remedy of vote designation, and that the Courts, in such an instance, will delve into a transaction to ascertain the relationships between the parties and their respective strategic motives and positions. In the UK, the challenges so far have come from the other creditor constituents, where oppression of the minority and acting for a collateral purpose in bad faith will be frowned upon. In the UK, whilst thus far there has been comparatively less jurisprudence, we have nonetheless seen a willingness of the Court to recognise the distinction between creditors who are acting in bad faith with an ulterior motive, and those that are legitimately protecting their commercial interests.

Debt trading will no doubt continue to be a significant element of future restructurings for some time to come, both in the UK and US. Motives for purchasing distressed debt will be as varied as the nature of these debts themselves; purchasers must be alive to the fact that, whilst the Court accepts that economic interests must be protected, voting in less than a *bona fide* way will not escape the Court's scrutiny. ■