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Beyond *Dish Network*: Further Developments in Designating the Votes of Claims Purchased in Bankruptcy

The decision of the United States Court of Appeals for Second Circuit in *Dish Network Corp. v. DBSD North America, Inc.* (*In re DBSD North America, Inc.*) ("DBSD")[1] put those who trade in distressed debt on notice that courts may scrutinize claims trades in which parties seek to extract value by disrupting or delaying a Chapter 11 reorganization. Purchasing the debt of a distressed company can yield myriad advantages for the acquirer in the Chapter 11 process; the most significant advantage is the ability to obtain a controlling position in the reorganized debtor. After DBSD, this very rationale for purchasing claims may also be a basis for a court to "designate" – *i.e*. not count – the vote of a claim purchaser on a Chapter 11 plan.[2] A party risks designation when it moves beyond maximizing the recovery on its claim and votes based on a wholly different purpose.[3] To this end, two recent decisions delivered by the Bankruptcy Court in the Eastern District of North Carolina in the same bankruptcy case with two different outcomes shed further light on the development of the law related to vote designation.

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[1] 634 F.3d 79 (2d Cir. 2010).

[2] Before a Chapter 11 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. 11 U.S.C. § 1129(a)(8), (b). A class of claims is deemed to accept the 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. 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." 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.").

[3] *In re DBSD N. Am., Inc.*, 634 F.3d at 104.

Dish Network Corp. v. DBSD North America, Inc.

DBSD concerned the actions of Dish Network Corp. ("Dish"), an indirect competitor of, and a significant investor in a direct competitor of, DBSD. Shortly after DBSD filed its Chapter 11 plan and disclosure statement, Dish purchased all of the first lien debt of DBSD, at par. When 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 behavior in the bankruptcy proceeding.

The Court of Appeals for the Second Circuit affirmed the Bankruptcy Court's decision that Dish acted in bad faith and, accordingly, designating Dish's vote. The Bankruptcy Court found that Dish acted in bad faith because it "acted to advance strategic investment interests wholly apart from maximizing recoveries on a long position in debt it [held]."[4] 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 maximize 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."[5]

The Lichtin/Wade Case: Motion of the Debtor to Designate the Votes of ERGS

In a case decided after *DBSD*, the Debtor, Lichtin/Wade LLC (the "Debtor"), 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. ERGS II, LLC ("ERGS") is an affiliate of Archon Group, L.P., a global investment management firm founded by Goldman Sachs. Archon acquires, develops, manages and finances a variety of real estate investments, including mortgage loans secured by real estate.[6] After the Debtor filed for Chapter 11, ERGS 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 plan.

The record of the case indicates a contentious relationship between the Debtor and ERGS. 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."[7] 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.

Following an evidentiary hearing, the Court issued a decision in which it refused to designate the votes of ERGS, holding that the Debtor failed to carry its "heavy" burden of demonstrating that ERGS's vote to reject the plan was not in good faith.[8] Based on the evidence adduced at trial, the Court found that, at all times, ERGS acted as a creditor seeking to maximize its investment and advancing its own economic interests, "rather than for the purpose of advancing a strategic competitive interest against the Debtor."[9] To this end, the Court found convincing testimony that had "ERGS's only goal been to own the Debtor's real property,

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[4] *In re DBSD N. Am. Inc.,* 421 B.R. 133, 142 (Bankr. S.D.N.Y. 2009).
[5] *In re DBSD N. Am., Inc.*, 634 F.3d at 104 (internal quotation marks omitted).
[6] http://www.archongroup.com.
[7] *In re Lichtin/Wade, LLC*, Ch. 11 Case No. 12-00845-8-RDD, Doc. No. 353, slip op. at 4 (E.D.N.C., Dec. 17, 2012).
[8] *Id*. at 9.
[9] *Id*. at 11.

it would have been easier and less costly for ERGS to simply have filed a motion to lift stay and seek foreclosure."[10] Instead, ERGS spent significant sums throughout the case, including preparing a competing Chapter 11 plan and disclosure statement. With respect to any competitive motivation, 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."[11] 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, which 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 maximize its return and not indicative of a lack of good faith or an attempt to obtain 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.

Motion of ERGS to Designate the Votes of Aviation Management Group, Inc.

The second designation motion in the case was filed by ERGS and it was based on very different actions by another claimholder. ERGS sought to designate another claimholder's vote on the basis that this vote was not procured in good faith and that the claimholder was an insider of the Debtor. Insiders are excluded in determining whether an impaired class has accepted a plan of reorganization as a means of protecting the interests of other creditors.[12] Whether an entity is an insider of the Debtor is a question of fact that courts examine on a case-by-case basis.[13] A court's determination of insider status focuses on two factors: "(1) the closeness of the relationship between the parties; and (2) whether the transaction in question was at arm's length."[14]

Aviation Management Group ("AMG") purchased its claims one day prior to the ballot due date. AMG then filed a proof of claim.[15] When the Debtor filed its Second Amended Plan (the "Plan"), these claims were placed in their own class. Under the Plan, this class was impaired and therefore entitled to vote to accept or reject the Plan.

In its designation motion, ERGS contended that AMG purchased its claims in bad faith at the direction of the principal of the Debtor in order to create an artificially impaired class entitled to vote on the Plan and thereby obtain confirmation over ERGS's objection. AMG is a provider of services for the operation of private aircraft. The president of AMG and the principal of the Debtor had a professional and personal relationship spanning 14 years.

Based on the evidence adduced at trial, the Court found that AMG was an insider of the Debtor. Prior to purchasing its claims, AMG had never purchased a claim in a bankruptcy. The principal of the Debtor had called the president of AMG to ask whether he would be willing to purchase the claims, so that AMG could cast a vote in favor of the plan.[16] There was no due diligence; the claims were purchased without reviewing any documents, leases or bankruptcy filings. The president of AMG even testified that he was not aware of the claims' treatment under the Chapter 11 plan. Most significantly, it was not disputed that AMG

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[10] *Id*.
[11] *Id*. at 15.
[12] *In re Lichtin/Wade, LLC*, Ch. 11 Case No. 12-00845-8-RDD, Doc. No. 355, slip op. at 4 (E.D.N.C., Dec. 18, 2012), citing *In re Gilbert*, 104 BR 206, 210 (Bankr. W.D.Mo. 1989).
[13] *Id*. (citing *In re Broumas*, Nos. 97-1183 & 97-1182, 1998 WL 77842, at *7 (4th Cir. 1998)).
[14] *Id*. at 5 (citing *Angell v. First Eastern, LLC* (*In re Caremerica, Inc*.), Ap. No. 08-00157-9-JRL, at 8).
[15] The decision does not address why the claims bar date was after the plan voting deadline. In fact, AMG filed its claims after the bar date although the decision does not indicate whether ERGS challenged the claim on that basis.
[16] *In re Lichtin/Wade, LLC*, Ch. 11 Case No. 12-00845-8-RDD, Doc. No. 355, slip op. at 7 (E.D.N.C., Dec. 18, 2012).

purchased the claims solely based on the personal relationship between the two men; there was no business justification. Rather, the Debtor was one of AMG's top clients, and the principal of the Debtor was a friend. Accordingly, the Court found that AMG's relationship with the Debtor was "sufficiently close and personal so as not to rise to an arm's length business transaction with the Debtor"[17] and, consequently, designated AMG's votes.

Conclusion / Lessons from Licthin/Wade

In *DBSD*, the Court distinguished between a strategic party, with its motive to take control of the Debtor and a "typical creditor" protecting its claim. In *DBSD* and the decisions preceding it, courts had focused on aggressive acts by claim holders that disrupt the Chapter 11 process in order to obtain a strategic advantage. To this end, after *DBSD*, parties were cautioned not to overreach. The *DBSD* Court also expressed the view that as long as a creditor's strategies truly have an eye toward improving the recovery on its claim, those strategies will not justify designating the creditor's votes despite a litigious or particularly aggressive strategy.

The *Lichtin/Wade* Court's decision in the case of ERGS was in line with *DBSD*. It is not disputed that ERGS was aggressive and litigious. Despite these actions, the evidence demonstrated that its motives in purchasing claims were in furtherance of its recovery on its claim; there was no ulterior strategic motive.

Conversely, the Court's decision to designate the votes of AMG should give parties pause. The case of AMG shows the extent to which a Court may look into a transaction and the facts and circumstances under which the claims were bought and sold. Claims traders should be mindful that these decisions could signal an increasing trend, whereby a debtor will attempt to use the extraordinary remedy of vote designation and courts will delve into a transaction to ascertain the relationships between the parties and their respective strategic motives and positions.

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[17] *Id*. at 8.