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Maneuvering in the Shadows of the Bankruptcy Code: How to Invest in or Take Over Bankrupt Companies within the Limits of the Bankruptcy Code

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MANEUVERING IN THE SHADOWS OF THE BANKRUPTCY CODE: HOW TO INVEST IN OR TAKE OVER BANKRUPT COMPANIES WITHIN THE LIMITS OF THE BANKRUPTCY CODE

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ABSTRACT

Profiting off of bankrupt companies? Sounds impossible. It is not—and this Article explains how to do it. When a company declares bankruptcy, all levels of its capital structure are for sale. Investors have two alternatives: (1) purchase these "claims" against the company at a discount, and turn them into profitable investments once the company exits bankruptcy; or (2) take over the bankrupt entity, in a bankruptcy version of a hostile takeover.

There is risk: the Bankruptcy Code empowers judges to punish investors whose purchase or vote of a claim was "not in good faith." But the Bankruptcy Code provides little statutory guidance on when to punish claims purchasers. In that absence, many bankruptcy judges have used the legislative history of the bad faith statutes as evidence of Congress's skepticism of bankruptcy investments and takeovers. This Article disagrees with that approach. After examining the legislative history surrounding the framing of the current and former bad faith statutes, this Article argues that the same history pointed to by judges does not show Congressional disapproval of these types of investments. Moreover, the thrust of recent amendments to the Bankruptcy Code potentially shows that Congress approves of bankruptcy investments. Accordingly, this Article provides a practical and theoretical roadmap to demonstrate the good faith of an investor's action in the face of judicial scrutiny.

"A slowdown in large corporate [c]hapter 11 filings in 2012 didn't stop distressed investors, who bought and sold more than $41 billion worth of bankruptcy claims last year."—DOW JONES DAILY BANKRUPTCY REVIEW, January 28, 2013.

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INTRODUCTION

To most investors, bankruptcy is bad news. To certain investors, however, bankruptcy spells opportunity. Specifically, bankruptcy represents an opportunity to invest in bankrupt companies' distressed debt. In addition, although they do not happen very frequently under state corporate law, hostile takeovers frequently occur in bankruptcy.[1] This Article explores the legal theory and practice of claims trading under chapter 11 of the Bankruptcy Code ("Code")—the mechanism by which investors invest in or take over bankrupt companies.

Broadly speaking, bankruptcy claims investors fall into two categories. In the first, investors purchase discounted claims in the hopes that their eventual payout will be higher than the purchase price ("Passive Investors"). In the second, investors purchase claims with the hope of executing a strategic transaction, such as a merger ("Strategic Investors"). Where appropriate, this Article flags areas of law where courts' treatment of Passive Investors differs from treatment of Strategic Investors. Accordingly, readers can focus on the sections most applicable to their cases, clients or business.

Claims trading is a $41 billion dollar per year industry.[2] By way of comparison, the claims trading industry is larger than the market capitalizations of approximately 80% of all S&P 500 companies.[3] This Article aims to explain this large and important industry, as well as to provide guidance for both courts that regulate it and investors that intend to make money within it.

In a claims trading market, investors purchase claims against the debtor from the debtor's creditors, usually—but not always—at a discount.[4] Then, investors attempt to profit from the debtor's bankruptcy by doing nothing, tweaking the debtor's plan of reorganization, or proposing their own plan.[5]

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[1] *See Distressed Mergers and Acquisitions*, WACHTELL, LIPTON, ROSEN & KATZ 131 (2013), *available at* http://www.wlrk.com/webdocs/wlrknew/AttorneyPubs/WLRK.22377.13.pdf.

[2] Jacqueline Palank, *Investors Traded $41 Billion in Bankruptcy Claims in 2012*, DOW JONES DAILY BANKR. REV., Jan. 28, 2013.

[3] Tyler Durden, *Twitter Now Has A Larger Market Capitalization Than 80% Of All S&P 500 Companies*, ZEROHEDGE (Dec. 26, 2013), http://www.zerohedge.com/news/2013-12-26/twitter-now-has-larger-market-capitalization-80-all-sp-500-companies.

[4] *Distressed Mergers and Acquisitions*, *supra* note 1, at 19.

[5] *See id.* at 150.

Once the debtor emerges from bankruptcy, the investor is hopefully left with a return on the debt or an equity stake in the reorganized debtor.[6]

That is the upside. Here is the downside: there is a risk that a bankruptcy court will designate (disqualify) the investor's vote in the bankruptcy process because of the Code's prohibition against bad faith when voting claims.[7] The law surrounding when an investment or takeover constitutes bad faith is unsettled.[8] Some bankruptcy courts have held that investments in, and hostile takeovers of, bankrupt companies can constitute bad faith.[9] Bankruptcy judges have looked at the legislative history surrounding the framing of the bad faith statutes to argue that Congress intended to block bankruptcy hostile takeovers.[10]

This Article examines the specific legislative history of the current and predecessor bad faith statutes to argue that the history does not, in fact, support a broad ban on takeovers. For example, examination of one of the bad faith statutes reveals that some bankruptcy courts quote a Congressional *witness's* testimony as a definitive statement of what *Congress* intended to accomplish by passing the bad faith statute.[11] This Article argues that the legislative history gives reason to be skeptical of courts' analysis and provides a practical means for guiding them to a different result.

In addition to relying on legislative history, bankruptcy courts criticize takeovers by citing general principles derived from the Code.[12] This Article argues, however, that many principles from the modern Code support a robust claims trading system, including hostile takeovers. Given the bankruptcy courts' thin justifications, this Article provides a starting point to push back on their disapproval of investments and hostile acquisitions through chapter 11 claims trading. Finally, moving from theory to practice, this Article concludes by offering several strategies for future claims purchasers to minimize the risk of vote designation and maximize the return on their investment.

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6 *Id.*

7 *See* 11 U.S.C. § 1126(e) (2012).

8 *See* DISH Network Corp. v. DBSD N. Am., Inc. (*In re* DBSD N. Am., Inc.), 634 F.3d 79, 104 (2d Cir. 2010).

9 *Distressed Mergers and Acquisitions*, *supra* note 1, at 195–96.

10 *See infra* Part III.A.

11 *See, e.g.*, Young v. Higbee Co., 324 U.S. 204, 211 (1945); *In re* Allegheny Int'l, Inc., 118 B.R. 282, 288 (Bankr. W.D. Pa. 1990).

12 *See infra* Part III.B.

I. BANKRUPTCY CODE BACKGROUND

Before delving into the nuts and bolts of claims trading, it is important to review the key parts of bankruptcy law relevant to acquiring and voting a claim in a chapter 11 restructuring. Specifically, these elements of bankruptcy law relate to plan confirmation, rejection, and challenging an outsider's acquisition of voting claims. These provisions provide the rules of the game for investing in or taking over a debtor, and they are discussed with an eye towards gaining an advantage in the plan proposal and confirmation process.

A. Chapter 11 Plan of Reorganization

Once a company declares bankruptcy under chapter 11, the debtor's existing management becomes the "debtor in possession" ("DIP").[13] The company's creditors may then file a proof of claim with the bankruptcy court where the debtor filed.[14] A claim, among other things, details how much money the creditor is owed.[15] That claim is the creditor's ticket to participate in the bankruptcy process, entitling the creditor to receive cash, assets, or equity of the postbankruptcy entity as well as to vote on the plan of reorganization.[16] The plan, and one's position within it, is extremely important, because the plan not only determines the value creditors receive on their claims, but ultimately the allocation of control over the entity that emerges from the bankruptcy process.[17]

The debtor has the exclusive right to propose a plan of reorganization for the first 120 days after filing the chapter 11 petition.[18] If the debtor files a plan within the 120-day period, creditors may not file competing plans until 180 days have elapsed.[19] Thus, the debtor has 180 days to solicit votes exclusively, provided that it files within the first 120 days. Based on these rules, the debtor has the advantage of putting its plan on the table first, increasing the chances that it will be confirmed. Investors purchasing claims of an entity that has already declared bankruptcy must remember that the debtor has this first-mover advantage.

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13 *See* 11 U.S.C. §§ 1107–1108 (2012).
14 *Id.* § 501(a).
15 *Id.* § 502(a)–(b).
16 *Id.* §§ 501–503.
17 *See Distressed Mergers and Acquisitions*, *supra* note 1, at 150.
18 11 U.S.C. § 1121(b).
19 *Id.* § 1121(c)(3).

B. The Road to Plan Confirmation

The debtor's plan must first divide creditor claims into classes.[20] Creditors' claims in the same class must be substantially similar to the other claims within the class.[21] For example, a debtor cannot classify secured claims with shareholders' claims. This is because different claims will have different interests and incentives that affect how the creditor will vote during the plan confirmation process. Often, a debtor's chapter 11 plan will classify certain claims as entitled to the debtor's residual value—the "fulcrum security."[22] Owners of the fulcrum security will hold equity in the reorganized debtor.[23] Which creditor class translates into the fulcrum security depends on the value of the debtor's collateral and assets.[24] If the debtor can pay back its secured debt in full, the unsecured creditors hold the residual claim on the estate.[25] If the debtor cannot, then the junior lien-holders will usually own the fulcrum security.[26]

Once the creditors are divided into their respective classes, certain classes then vote on whether to accept or reject the plan.[27] Only classes which are "impaired" by the plan—that is, classes whose rights have been negatively affected in some way—may vote.[28] Unimpaired classes are deemed to have accepted the plan,[29] while fully impaired classes are deemed to have rejected the plan.[30] Because the plan confirmation process only cares about impaired claims, purchasers will try to buy up these important votes.[31]

C. Plan Confirmation

The easiest route to plan confirmation occurs when all creditor classes vote in favor of the plan. Individual debt classes are deemed to have voted in favor

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20 *Distressed Mergers and Acquisitions*, *supra* note 1, at 105–06.

21 11 U.S.C. § 1122(a).

22 *Distressed Mergers and Acquisitions*, *supra* note 1, at 151.

23 In some chapter 11 cases, the fulcrum security can change, either through a valuation dispute or through plan amendments. *Id.* To the extent that this risk exists, claims purchasers would be wise to purchase multiple classes of potential fulcrum securities. *Id.* Otherwise, the purchaser may find itself crammed down or holding unwanted debt in a reorganized debtor. *Id.*

24 *Id.*

25 *Id.*

26 *Id.*

27 *See* 11 U.S.C. §§ 1126(f), 1129(a)(8) (2012).

28 *Id.* § 1129(a)(8).

29 *Id.* § 1126(f).

30 *Id.* § 1126(g).

31 *Id.* § 1129(a)(8).

of a plan if at least two-thirds of the amount of the claims, and over one-half of the number of claims, have voted in the affirmative.[32] For example, if a class consists of five trade creditors, each holding one claim worth $100, then at least four creditors (totaling $400 out of the $500 that the class claims are worth) must vote for confirmation for the class to vote in favor of the plan.[33]

If an impaired class votes to reject the plan, the plan is ordinarily vetoed.[34] However, the proponent may seek “cramdown”—confirmation of the plan over the objection of the dissenting class—if at least one impaired class votes in favor of the plan.[35] As an investor or acquirer, for purposes of claims trading, it is important to keep in mind the cramdown power, which negates a creditor’s veto power over the debtor’s plan.[36] To the extent that proposing a particular plan of reorganization is crucial to one’s investment strategy, the prospect of cramdown can be a threat.

To achieve cramdown, the proponent must show, among other requirements, that: (1) the plan is “fair and equitable;” (2) the plan does not unfairly discriminate against the dissenting class; and (3) the dissenting class will receive the amount that it would have received following a chapter 7 liquidation.[37]

First, the requirements of “fair and equitable” depend on the status of the creditor. For secured creditors, the plan must allow the creditor to do one of the following: (1) retain his or her lien and provide the creditor with cash payments equal to at least the present value of the collateral; (2) allow the creditor’s lien to attach to the proceeds of a § 363 sale (discussed below); or (3) provide the secured creditor with the “indubitable equivalent” of his or her claim.[38] With regard to unsecured creditors, the plan must provide property with a present value equal to the full allowed claim amount, or no junior creditor can receive anything under the plan.[39]

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32 *Id.* § 1126(c).

33 There are other requirements for class confirmation. While important, they are not specifically relevant to claims trading.

34 *See generally* 11 U.S.C. § 1129(a).

35 *Id.* § 1129(a)(10).

36 *Distressed Mergers and Acquisitions*, *supra* note 1, at 112.

37 11 U.S.C. § 1129(a)(7)(A)(ii), (b)(1).

38 *Id.* § 1129(b)(2)(A)(i)–(iii).

39 *Id.* § 1129(b)(2)(B)(i)–(ii).

Second, the plan must not unfairly discriminate against the dissenting class.[40] As discussed above, unfair discrimination can occur when similarly-situated creditors are not treated equally.[41] For example, a plan proponent is generally not allowed to split trade creditors into different classes, and pay one less than the other.[42] Third, the dissenting class member must receive at least what he or she would have received on the claim in a hypothetical chapter 7 liquidation.[43] Overall, the cramdown power contains a number of substantive protections for dissenting creditor classes, but an investor must always be on guard for the possibility of being crammed-down.

D. Section 363 Sales

A plan of confirmation with a fulcrum security is not the only way to transfer ownership of a bankrupt company. Specifically, § 363(b)(1) ("363 sale") allows the DIP, after notice and a hearing, to sell the entire estate or certain assets.[44] The typical 363 sale of a debtor's assets proceeds as follows: the debtor must convince the judge that there is a "good business reason" for the sale and then provide notice to the other creditors. Although not required by § 363(b), a public auction usually follows.[45] In a public auction, existing creditors or outside investors may place a bid.[46] This difference distinguishes 363 sales from chapter 11 plans, where one must be a creditor to participate.

A 363 sale offers several advantages over the chapter 11 process. For example, the debtor can quickly sell a business that is rapidly declining in value. Furthermore, if a business's operating expenses exceed revenues, a lengthy chapter 11 proceeding may do more harm than good.[47] As a result, investors looking to acquire companies out of chapter 11 should remember that a 363 sale is an alternative avenue to acquisition.

E. Recap

For purposes of bankruptcy investing, it is important to remember that there are two ways for a debtor to successfully exit bankruptcy—a plan or a

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40 *Id.* § 1129(b)(1).
41 *Distressed Mergers and Acquisitions*, *supra* note 1, at 113.
42 *Id.* (citing *In re* Dow Corning Corp., 244 B.R. 705, 710 (Bankr. E.D. Mich. 1999)).
43 11 U.S.C. § 1129(a)(7)(A)(ii).
44 *Id.* § 363(b); *Distressed Mergers and Acquisitions*, *supra* note 1, at 48–49.
45 *Distressed Mergers and Acquisitions*, *supra* note 1, at 55.
46 *Id.* at 78.
47 *Id.* at 52.

363 sale. If one is merely a Passive Investor purchasing undervalued claims, one may be indifferent as to whether the bankruptcy ends through a plan or a sale—as long as either is value-maximizing. However, if one intends to acquire the debtor, one's strategy must change according to how the debtor intends to exit bankruptcy. This Article highlights these issues where appropriate.

II. SYNTHESIZING CLAIMS TRADING AND § 1126(E) BAD FAITH CASE LAW

This Part lays out the statutory basis under which a court will analyze a claims trading case, as well as the relevant tests that courts have developed to guide their inquiry. This Part also highlights the recent seminal claims trading cases.

A. Showdown with the Debtor in Possession

A typical situation involving a bankruptcy investor squaring off with the DIP looks like this: after the company files for bankruptcy, a rival company enters the picture by purchasing a class of secured debt from an existing creditor. Specifically, the rival has purchased a blocking position in that class (one-half of the number of claims in that class or over one-third of that class's debt).[48] The DIP wants to confirm its plan but cannot because not all classes have voted in favor. Suppose then that the DIP cannot cram down the plan because the plan does not satisfy the cramdown requirements. Therefore, the DIP and the rival company are at an impasse. To break the impasse, the DIP will seek to designate or disregard the rival's bankruptcy vote.

B. Statutory Backdrop

A debtor seeking to confirm its plan against a claims purchaser's negative vote will ask the court to designate that creditor's vote.[49] A creditor may also seek to designate a fellow creditor.[50] The court will analyze the aggrieved party's request under § 1126(e) of the Code, which allows the court to "designate any entity whose acceptance or rejection of [the] plan was not in good faith, or was not solicited or procured in good faith or in accordance with the provisions of [the Code]."[51] Accordingly, vote designation will turn on the

48 *Id.* at 152.
49 11 U.S.C. § 1126(e).
50 *See, e.g.*, *In re* Allegheny Int'l, Inc., 118 B.R. 282, 285 (Bankr. W.D. Pa. 1990).
51 11 U.S.C. § 1126(e).

"good faith" of the claims purchaser,[52] or whether the purchaser violated some other provision of the Code. If the purchaser votes or solicits claims in bad faith, the bankruptcy judge will designate those votes. However, the Code does not define "good faith," leaving judges little guidance in vote designation cases.[53]

C. Selfishness Versus the Ulterior Motive Test

Due to the lack of statutory guidance, bankruptcy courts have developed case law tests for bad faith.[54] Courts have held that acting as a selfish creditor is permissible.[55] Conversely, many bankruptcy courts have declared that a creditor may be acting in bad faith when voting "with an ulterior motive" ("Ulterior Motive Test"), meaning "with an interest other than an interest as a creditor."[56] Courts will usually analyze a bankruptcy investor's actions by characterizing them as selfish or ulterior.[57] Consequently, the relevant question becomes: what does it mean to act with an interest of a creditor (selfishly), as opposed to acting with an interest *other than* that of a creditor (with ulterior motive)?

1. Selfishness Is Permissible

Courts consistently hold that acting as a selfish creditor is acceptable under the Code.[58] Accordingly, a potential purchaser of bankruptcy claims will want to know what "selfish" means. While courts have struggled to define the term, the Second Circuit in *In re DBSD*, analyzing the Ninth Circuit's decision in *In re Figter*, provided a working definition, noting that "[§ 1126(e)] was intended to apply to those who were not attempting to protect their own proper interests,

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[52] At least one bankruptcy court has ruled that bad faith of the claim *seller* flows through to the buyer. The district court reversed, however, holding that bad faith is personal. *See* Enron Corp. v. Ave. Special Situations Fund II, LP (*In re* Enron Corp.), 333 B.R. 205, 233 (Bankr. S.D.N.Y. 2005), *vacated sub nom.* Enron Corp. v. Springfield Assocs. (*In re* Enron Corp.), 379 B.R. 425, 439 (S.D.N.Y. 2007); *see also Distressed Mergers and Acquisitions, supra* note 1, at 158–60.

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

[54] *See id.* at 138.

[55] *Id.* at 139.

[56] *See, e.g.*, DISH Network Corp. v. DBSD N. Am., Inc. (*In re* DBSD N. Am., Inc.), 634 F.3d 79, 102 (2d Cir. 2010); Figter Ltd. v. Teachers Ins. & Annuity Ass'n of Am. (*In re* Figter Ltd.), 118 F.3d 635, 639 (9th Cir. 1997) ("If a person seeks to secure some untoward advantage over other creditors for some *ulterior motive*, that will indicate bad faith.") (emphasis added); *In re* Charles St. African Methodist Episcopal Church, 480 B.R. 66, 69 (Bankr. E.D. Mass. 2012).

[57] *In re* Pine Hill Collieries Co., 46 F. Supp. 669, 671 (E.D. Pa. 1942) ("If the emphasis be placed on 'ulterior' rather than 'selfish' this seems to be as practical a test as could be found.").

[58] *In re DBSD*, 421 B.R. at 139.

but who were, instead, attempting to obtain some benefit to which they were not entitled."[59] This definition is circular, however, as it begs the question of what constitutes a "proper" interest. The *Pine Hill* court echoed the *DBSD* definition of selfishness, pointing out that creditors will permissibly act in their own interests in a bankruptcy plan.[60]

Courts usually deem a creditor's interest "proper," and hence in good faith, when the creditor acts to protect a prepetition debt.[61] For example, the creditor may purchase more claims after the debtor files, but as long as those additional claims protect the creditor's existing position, the court is not likely to designate its vote. *Pine Hill* is illustrative. In that case, the court refused to designate the vote of a prepetition creditor who purchased the second mortgage in order to block the debtor's plan of reorganization.[62] Reasoning that the creditor was acting with permissible selfishness, the court cited the creditor's ongoing "very substantial stake in this enterprise" and that the creditor's motive was "the protection of its already large investment in the Debtor."[63]

Other cases follow this pattern. In *In re Deluca*, an undersecured creditor purchased unsecured claims and voted against the debtor's plan.[64] Specifically, the debtor's plan would have made the purchaser "an involuntary lender to the debtor for the next seven years."[65] By opposing the plan, the court declared, the creditor was simply "enforc[ing] its legitimate contractual rights with respect to a loan that has matured."[66] Accordingly, the court permitted the creditor's postpetition maneuvering.[67] A similar situation occurred in *In re Waterville Valley Town Square Associates*, where the court allowed an undersecured creditor to block confirmation of the debtor's plan after purchasing unsecured claims.[68] Overall, bankruptcy courts generally permit

59 *DISH Network*, 634 F.3d at 102 (quoting *In re Figter*, 118 F.3d at 638).

60 *In re Pine Hill*, 46 F. Supp. at 671 ("If a selfish motive were sufficient to condemn reorganization policies of interested parties, very few, if any would pass muster.").

61 *See, e.g.*, *id.* at 672.

62 *See, e.g.*, *id.* at 671–72.

63 *See, e.g.*, *id.* at 672.

64 Principal Mut. Life Ins. Co. v. Lakeside Assocs., L.P. (*In re* DeLuca), 194 B.R. 797, 800, 804 (Bankr. E.D. Va. 1996).

65 *Id.* at 805.

66 *Id.*

67 *Id.* at 804.

68 *In re* Waterville Valley Town Square Assocs., 208 B.R. 90, 95 (Bankr. D.N.H. 1997).

prepetition creditors, acting to protect their existing claims, to purchase postpetition claims and vote them against the debtor's plan.[69]

2. *Ulterior Motives Generally Not Permissible*

By and large, bankruptcy courts frown on investors whose actions evidence an ulterior, as opposed to purely selfish, motive.[70] As was the case with defining selfish, determining the contours of the Ulterior Motive Test challenges courts. Bad faith can be determined when the creditor attempts to "extort a personal advantage" not available to other creditors in the class, or when the creditor acts to procure some collateral or competitive advantage that does not relate to its claim.[71] In addition, attempting to fill this definitional void, courts have articulated "several badges of bad faith which may justify disqualification."[72] Under the badge analysis, a claims purchaser may not "(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) collaborate with a third party to obstruct the debtor's reorganization.[73] In articulating these badges, the court in *In re Dune Deck Owners Corp.* specifically stated that these actions "may justify disqualification."[74] The court did not say that the badges will always result in designation. Vote designation is not automatic, and will therefore turn on the individual facts of each case.[75]

It is also important to note that not every ulterior motive will justify disqualification. The recent case, *In re Charles Street African Methodist Episcopal Church*, declared that "not every ulterior motive is deemed bad faith."[76] In addition, the court in *DBSD*, before designating the creditor's vote, stated that "not just any ulterior motive constitutes the sort of improper motive that will support a finding of bad faith."[77] By not making a sweeping statement that all ulterior motives are impermissible, the *DBSD* court realized that most

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69 *See e.g.*, *In re* DBSD N. Am., Inc., 421 B.R. 133, 138 (Bankr. S.D.N.Y. 2009); *In re* Pine Hill Collieries Co., 46 F. Supp. 669, 671 (E.D. Pa. 1942).

70 *See, e.g.*, *In re DBSD*, 421 B.R. at 138; *In re* Adelphia Commc'ns Corp., 359 B.R. 54, 61 (Bankr. S.D.N.Y. 2006).

71 *In re* Dune Deck Owners Corp., 175 B.R. 839, 844 (Bankr. S.D.N.Y. 1995).

72 *Id.*

73 *Id.* at 844–45 (citations omitted).

74 *Id.* at 844.

75 *See* DISH Network Corp. v. DBSD N. Am., Inc. (*In re* DBSD N. Am., Inc.), 634 F.3d 79, 105 (2d Cir. 2010) ("Whether a vote has been properly designated is a fact-intensive question that must be based on the totality of the circumstances.").

76 *In re* Charles St. African Methodist Episcopal Church, 480 B.R. 66, 69 (Bankr. D. Mass. 2012).

77 *DISH Network*, 634 F.3d at 102.

creditors do have multiple interests affecting how they will vote.[78] For example, the court pointed out that trade creditors with an expectation of continued business with the debtor have the ulterior motive of avoiding a liquidation.[79] Similarly, if interest rates began to spike, a fully secured creditor could favor a liquidation to facilitate investment elsewhere at a higher rate of return.[80]

D. Applications of the Ulterior Motive Test

Given the fact-intensive nature of the bad faith inquiry, examining how courts have applied § 1126(e) to previous fact scenarios will be crucial to arguing any current designation case. Although each case presents different facts, several recurring themes emerge: courts will focus on (1) the identity and motive of the purchaser; (2) when the purchaser proposes the competing plan; (3) the substance of the competing plan; and (4) other actions of the purchaser during the proceeding. Each of these themes will be discussed below.

1. Identity and Motive of the Claims Purchaser

As discussed *supra*, a critical first distinction is whether the claims purchaser held prepetition claims, or whether the purchaser was a latecomer to the bankruptcy process.[81] If the investor was not a prepetition creditor, the level of judicial scrutiny potentially increases.

Here is a juncture where courts' treatment of Passive Investors differs from that of Strategic Investors. Specifically, newcomer creditors who solely hold claims as passive investments run very little risk of vote designation. For example, a purchaser may acquire a claim for a fraction of its par (face) value, hoping that the claim will receive a higher distribution under the chapter 11 plan, but not otherwise act within the bankruptcy. The bankruptcy court in *DBSD* implied that this practice does not constitute bad faith:

> DISH's purpose, of course, was not that of a typical creditor—either a victim of financial distress left holding the bag when a debtor fails, or *even an investor in distressed debt* seeking to profit from the

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78 *Id.*

79 *Id.* (citing John Hancock Mut. Life Ins. Co. v. Route 37 Bus. Park Assocs., 987 F.2d 154, 161–62 (3d Cir. 1993).

80 *Id.* ("We do not purport to decide here the propriety of either of these motives, but they at least demonstrate that allowing the disqualification of votes on account of *any* ulterior motive could have far-reaching consequences and might leave few votes upheld.").

81 *See supra* Part II.C.1.

> spread between its purchase price for the distressed debt and its ultimate distributions under a plan.[82]

If the postpetition creditor buys claims at par, however, the court is likely to conclude that the purchaser has other, perhaps ulterior, motives.[83] This is because if the creditor buys at the maximum upside value, then surely it is seeking something else. In *DBSD*, DISH Network, a direct and indirect competitor of the debtor, purchased blocking positions after the debtor filed its bankruptcy petition.[84] DISH purchased debtor's first lien debt at par, "*paying* the price for which most creditors could only hope."[85] Similarly, Japonica, the interloping creditor in *In re Allegheny Int'l Inc.*, initially purchased debtor's public subordinated debentures (debt instruments) at roughly 27% of face value, but significantly increased its willingness to pay when it sought blocking positions in other classes of debt.[86] In contrast to DISH, Japonica was a complete stranger with no business connections to the debtor.[87]

If the purchaser is not a prepetition creditor or long-position debt investor,[88] then odds are that the purchaser intends to acquire the debtor. Recall that attempting to assume control of the debtor can be, according to the courts, a badge of bad faith.[89] In designating Japonica's votes, the court noted that "[it] is hard pressed to characterize Japonica's actions as merely furthering their own economic interests."[90] Similarly, the *DBSD* court noted that DISH sought to acquire the debtor because of its valuable spectrum licenses.[91] To sum up: preexisting creditors, acting to protect their position as creditors, run a lower risk of vote designation than newcomer creditors with motives other than maximizing return on a discounted claim.

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82 *DISH Network*, 634 F.3d at 140 (emphasis added); *see also In re* Lichtin/Wade, L.L.C., No. 12-00845-8, 2012 Bankr. LEXIS 5785, at *20 (Bankr. E.D.N.C. Dec. 17, 2012) ("Based on the totality of the circumstances, the [c]ourt finds that ERGS purchased claims for the purpose of maximizing its investment and advancing its own economic interest rather than for the purpose of advancing a strategic competitive interest against the Debtor.").

83 *See, e.g.*, *In re* DBSD N. Am., Inc., 421 B.R. 133, 139–40 (Bankr. S.D.N.Y. 2009) (citing *In re* Allegheny Int'l, Inc., 118 B.R. 282, 289–90 (Bankr. W.D. Pa. 1990)).

84 *In re DBSD*, 421 B.R. at 134–35.

85 *Id.* at 135.

86 *In re Allegheny Int'l*, 118 B.R. at 286–87.

87 *Id.* at 286.

88 An investor who takes a long position seeks to profit as the security appreciates in price.

89 *See supra* Part II.C.2.

90 *In re Allegheny Int'l*, 118 B.R. at 290.

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

2. *When Purchaser Proposes the Competing Plan*

At least one court has found that blocking a debtor's plan, but not proposing a competing plan, can be done in good faith.[92] *Waterville Valley* distinguished its purchaser's actions from the *Allegheny* purchaser, Japonica, because Japonica "purchased claims in order to block confirmation of the debtor's plan *and to promote confirmation of their own plan*."[93] The court did not detail its reasoning, except for explaining that a "plan proponent should be prohibited from purchasing claims because of the inconsistency between the payments made in the purchases and the payments proposed under the plan."[94] But this rationale seems to conflict with other courts' willingness to allow long position *debt investors* to purchase claims and then profit from the spread upon distribution.

If the purchaser does propose a competing plan, the court will scrutinize the date of proposal. Competing plans proposed immediately before the time to confirm the debtor's plan can show bad faith, because the debtor has less time to counter the competing plan. For example, in *Allegheny*, Japonica "filed its plan of reorganization at the eleventh hour."[95] Similarly, the *DBSD* purchaser, DISH, sought to terminate exclusivity and propose a competing plan on the morning before the debtor's confirmation hearing.[96] Proposing a plan when the debtor's exclusivity period has expired is within the letter of the Code,[97] but perhaps courts object to a creditor's effort to game the system by waiting until the last minute.

3. *Substance of Purchaser's Competing Plan*

If the creditor seeks to propose its own plan of reorganization, the court will inspect that plan for signs of bad faith.[98] One such sign is pressure on other creditors and lower value to other creditors. In *Allegheny*, for example, Japonica's competing plan offered "the cash equivalent of $6.42 per share,

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[92] *See, e.g.*, *In re DBSD*, 421 B.R. at 139–40; *In re Allegheny Int'l*, 118 B.R. at 289–90.

[93] *In re* Waterville Valley Town Square Assocs., 208 B.R. 90, 95 (Bankr. D.N.H. 1997).

[94] *Id.* (quoting JAMES F. QUEENAN, JR. ET AL., CHAPTER 11 THEORY AND PRACTICE § 30.25 (1994)).

[95] *In re Allegheny Int'l*, 118 B.R. at 289.

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

[97] 11 U.S.C. § 1121(c)(2)–(3) (2012) (stating, in relevant part, that any party in interest may file a plan if the debtor has not filed a plan that has been accepted within 180 days upon filing for bankruptcy or if the debtor failed to failed to file a plan before 120 days after filing).

[98] *See generally*, *In re Allegheny Int'l*, 118 B.R. at 296–98; *In re DBSD*, 421 B.R. at 140–43.

with holdbacks."[99] By contrast, the debtor's plan offered stock valued at $7.00 per share.[100] Furthermore, after purchasing a class of claims at 66% of par, Japonica amended its plan to pay that class 94.86% of the prepetition value.[101] This maneuver offended the court, because Japonica did not bring third party financing into the pool of assets in exchange for this almost 29% increase.[102] Instead, the increase would come out of the debtor's existing assets.[103] In *DBSD*, DISH never got the chance to file its own plan because the court designated its blocking votes, but DISH did submit a confidential proposal to the debtor, proposing a "major transaction," presumably a merger or acquisition.[104]

In a similar vein, courts are more likely to find a purchaser's plan in bad faith if other creditors object.[105] As the most extreme example, the other creditors in *Allegheny* sued Japonica, seeking, among other things, equitable subordination of Japonica's purchased claims.[106] Likewise, all of the impaired creditors in *DBSD*, with a single exception, voted in favor of the debtor's plan.[107] But for DISH's veto, the debtors only needed to convince one creditor group or cram the plan down over the objection of that creditor group.[108] By contrast, the *DeLuca* purchaser offered to purchase the unsecured creditors' claims for 100% of par—the same amount of repayment proposed under the debtor's plan.[109]

4. *Other Purchaser Actions Showing Lack of Good Faith*

Because the bad faith inquiry turns on such specific facts, all facts relating to the claims purchaser's conduct are potentially relevant. Hence, a prospective claims purchaser should remember that a court may later put every action under the judicial microscope to ascertain his or her motive, and whether it is

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[99] Certain amounts of the $6.42 would be "held back" by the creditor until the reorganized entity obtained financial goals. *See, e.g.*, *In re Allegheny Int'l*, 118 B.R. at 286.

[100] *Id.*

[101] *Id.*

[102] *Id.* at 297 ("Japonica intends to use the debtor's existing cash, assets, and debt to fund this modification.").

[103] *See id.* ("This is *chutzpah* with a vengeance. It is also bad faith.").

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

[105] *E.g.*, *id.* at 136–37; *In re Allegheny Int'l*, 118 B.R. at 285.

[106] *In re Allegheny Int'l*, 118 B.R. at 285.

[107] *In re DBSD*, 421 B.R. at 136–37.

[108] *See id.*

[109] Principal Mut. Life Ins. Co. v. Lakeside Assocs., L.P. (*In re* DeLuca), 194 B.R. 797, 800, 805 (Bankr. E.D. Va. 1996).

"ulterior." For example, in *Allegheny*, Japonica, without the court's permission, launched a public tender offer for certain claims before the court approved its disclosure statement.[110] Not only did the tender offer violate the Code's strict rules about when and how creditors can be paid, but it also forced creditors to choose between an immediate sum of cash and an undetermined sum at a later date.[111] Although tender offers outside of the bankruptcy context can provide incentives and coercive mechanisms, the *Allegheny* court declared that tender offers were an impermissible circumvention of the Code.[112] Creditors could not competently evaluate the difference between the two offers because the plan with respect to that class had not been confirmed yet.[113] The court also found that Japonica delayed plan confirmation, which reduced the value of the other claims, prompting those creditors to sell.[114]

With regard to *DBSD*, the bankruptcy court took issue with several of DISH's statements, which were later contradicted by DISH's actions.[115] Specifically, the court found that DISH understated its acquisitive intentions by claiming that it was a "model bankruptcy citizen" and that it "ha[d] not moved to terminate exclusivity, and it ha[d] not proposed a competing plan."[116] A few days later, however, on the morning of the debtor's scheduled confirmation hearing, DISH ambushed the debtor by moving to terminate exclusivity and proposing a competing plan.[117] Furthermore, discovery uncovered past-dated memos that showed DISH's longstanding strategic interest in the debtor.[118] Presumably, DISH's eleventh hour tactics, in the face of its long-held desire to acquire the debtor, showed an ulterior motive, and hence, bad faith.[119]

III. JUSTIFICATIONS FOR THE "ULTERIOR MOTIVE" TEST

Given the lack of statutory guidance, bankruptcy courts derived the Ulterior Motive Test from two principal sources: (1) the legislative context surrounding the previous statute to § 1126(e); and (2) general principles drawn from the

110 *In re Allegheny Int'l*, 118 B.R. at 295.
111 *Id.* at 295–96.
112 *Id.* at 296.
113 *Id.*
114 *Id.* at 299–300.
115 *In re* DBSD N. Am., Inc., 421 B.R. 133, 141–42 (Bankr. S.D.N.Y. 2009).
116 *Id.*
117 *Id.*
118 *Id.* at 136.
119 *Id.* at 143.

Code. This Part explains both approaches that courts have used to flesh out the Ulterior Motive Test.

A. Legislative Context of Bad Faith Statutes

Congress passed the first modern "good faith" statute for business reorganizations as § 203 of the Bankruptcy Act of 1938.[120] The language in § 203 is nearly identical to the current language in § 1126(e) of the Code:

> If the acceptance or failure to accept a plan by the holder of any claim or stock is not in good faith, in light of or irrespective of the time of the acquisition thereof, the judge may, after hearing upon notice, direct that such claim or stock be disqualified for the purpose of determining the requisite majority for the acceptance of a plan.[121]

Because of the extreme similarity between these two sections, courts look to the legislative context of § 203 for guidance in modern-day § 1126(e) hearings.[122] For example, *Allegheny* devoted several pages to reviewing the history of § 203 before designating Japonica's vote.[123]

Specifically, Congress passed § 203 in response to *Texas Hotel Securities Corp. v. Waco Development Co.*[124] In *Texas Hotel*, Waco Development Company ("Waco") executed a sale-leaseback transaction with Conrad Hilton's Texas Hotel Securities Corporation ("THSC").[125] As the lessee, THSC made several improvements to the hotel, but then defaulted on the lease payments.[126] Acting pursuant to Texas state law, Waco canceled the lease and captured the value of the improvements.[127] Shortly thereafter, Waco sought to reorganize under the Bankruptcy Act.[128] In the bankruptcy proceeding, a vengeful THSC acquired claims "for the avowed purpose of controlling the

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120 Bankruptcy Act of 1938 (Chandler Act) ch. 575, § 203, 52 Stat. 840, 894 (repealed 1978) (amending the Bankruptcy Act of 1898, 30 Stat. 544 (repealed 1978)).

121 *Compare id.* (granting judge the authority to disqualify stock or claim when acceptance or failure to accept a plan by the holder of a claim is not in good faith), *with* 11 U.S.C. § 1126(e) (2012) (granting judge the authority to designate any entity whose acceptance or rejection of plan is not in good faith).

122 *E.g.*, *In re DBSD*, 421 B.R. at 137–38; *In re* Allegheny Int'l, Inc., 118 B.R. 282, 287–88 (Bankr. W.D. Pa. 1990).

123 *In re Allegheny Int'l*, 118 B.R. at 287–89.

124 Young v. Higbee Co., 324 U.S. 204, 211 n.10 (1945) (citing Tex. Hotel Sec. Corp. v. Waco Dev. Co., 87 F.2d 395 (5th Cir. 1936)); *Revision of the Bankruptcy Act: Hearing on H.R. 6439 Before the H. Comm. on the Judiciary*, 75th Cong. 180–82 (1937) [hereinafter *Hearing*].

125 *Texas Hotel*, 87 F.2d at 398.

126 *Id.* at 399.

127 *Id.*

128 *Id.*

plan of reorganization so that THSC could ostensibly recover losses associated with the cancellation and forfeiture and regain management of the hotel."[129] Accordingly, THSC voted its claims against the debtor's plan.[130]

Although there were not any good faith statutes on the books, the bankruptcy judge threw out THSC's vote.[131] The Fifth Circuit reversed, declaring that "[a] debtor corporation, whether insolvent or merely unable to meet its debts as they mature, is not guaranteed by [the predecessor of chapter 11] a right to a reorganization."[132] In other words, the Fifth Circuit could find no section of the Bankruptcy Act forbidding THSC's obstruction of Waco's reorganization.[133]

In response to *Texas Hotel*, Congress enacted § 203.[134] As evidence of § 203's connection to *Texas Hotel*, courts point to House of Representatives hearings on the Revision of the Bankruptcy Act.[135] Specifically, *Young v. Higbee* stated that § 203's "purpose was to prevent creditors from participating who by use of obstructive tactics and hold-up techniques exact for themselves undue advantages from the other stockholders who are cooperating."[136] In *Texas Hotel*, the obstructive creditor was THSC, who refused to assent to the plan that leased the hotel to another entity.[137] Instead, THSC wanted the hotel for itself.[138] According to the *Allegheny* court, § 203 stands for the proposition that a creditor may not acquire a blocking position to facilitate its acquisition of the debtor's assets.[139]

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129 *In re* Allegheny Int'l, Inc., 118 B.R. 282, 288 (Bankr. W.D. Pa. 1990) (discussing *Texas Hotel*, 87 F.2d at 399).

130 *Texas Hotel*, 87 F.2d at 399.

131 *Id.* at 397.

132 *Id.* at 399.

133 *Id.* ("Section 77B does not prohibit such transfer, nor put transferred claims in a peculiar class.").

134 *See, e.g.*, Young v. Higbee Co., 324 U.S. 204, 211 n.10 (1945) ("To this end they adopted the 'good faith' provision of § 203."); *In re Allegheny Int'l*, 118 B.R. at 288 ("[I]t is clear that section 203 of the Bankruptcy Act was enacted, inter alia, in response to *Texas Hotel* . . . .").

135 *E.g.*, DISH Network Corp. v. DBSD N. Am., Inc. (*In re* DBSD N. Am., Inc.), 634 F.3d 79, 101 (2d Cir. 2010); *In re Allegheny Int'l*, 118 B.R. at 288.

136 *Higbee*, 324 U.S. at 211 n.10 (quoting *Hearing*, *supra* note 124, at 180–82.).

137 *Texas Hotel*, 87 F.2d at 397.

138 *Supra* note 129 and accompanying text.

139 *In re Allegheny Int'l*, 118 B.R. at 289 ("Japonica, like Hilton in the *Waco* case, bought a blocking position after the debtor proposed its plan of reorganization.").

B. Using General Bankruptcy Code Principles to Flesh Out Bad Faith

In addition to the statutory context surrounding §§ 203 and 1126(e), bankruptcy courts have looked to the Code as a whole to distill principles about acceptable behavior.[140] Admittedly, looking to "bankruptcy principles" can be vague, general, and subject to much disagreement. However, given the lack of statutory and case law guidance, a practitioner must be prepared to address these arguments.

The *Allegheny* court began its analysis with the first principles of bankruptcy, eventually arriving at the conclusion that Japonica's voting to block the debtor's plan constituted bad faith.[141] The purpose of bankruptcy law, according to Chief Judge Cosetti, is "to offer an opportunity to maximize results for all creditors and interest holders."[142] Maximizing results for all creditors requires a collective and compulsory solution on all creditors.[143] Applying those maxims to the *Allegheny* facts, Chief Judge Cosetti reasoned that Japonica sought a control profit, which would not be shared by other creditors.[144]

In addition, Chief Judge Cosetti opined that the purpose of chapter 11 was to allow "creditors and interest holders [to] vote for or against a plan of reorganization, after adequate disclosure, if such vote is in their best economic interests."[145] Accordingly, allowing an interloping creditor to obstruct that process renders the votes of other creditors meaningless.[146] Chief Judge Cosetti made sure to specify that "Japonica, *who chose to become a creditor*, should not have veto control over the reorganization process."[147] By emphasizing that Japonica was not a preexisting creditor, the *Allegheny* court preempted the counterargument that *any* creditor can obstruct the reorganization process as long as the dollar amount and numerosity requirements are met. Therefore, the *Allegheny* court seems to read the Code as entitling preexisting creditors to vote on a plan without interference from postpetition creditors.

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[140] *See, e.g.*, 11 U.S.C. § 1126(e) (2012) ("[T]he court may designate any entity whose acceptance or rejection of such plan was not . . . in accordance with the provisions of this title."); *In re Allegheny Int'l*, 118 B.R. at 290.

[141] *In re Allegheny Int'l*, 118 B.R. at 290, 299.

[142] *Id.* at 299.

[143] *Id.* (citing THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 10–13 (1986)).

[144] *Id.* at 300 ("Here, Japonica clearly attempts to deprive creditors of the control premium by a manipulation of the reorganization process through the strategic purchase of claims.").

[145] *Id.* at 290.

[146] *Id.*

[147] *Id.* (emphasis added).

C. Summary

A debtor seeking to designate a claim purchaser's vote will have to show bad faith on the part of that creditor. Despite the lack of statutory guidance from the Code, courts have developed the Ulterior Motive Test, which subsumes the following badges of bad faith: (1) trying to assume control of the debtor; (2) putting the debtor out of business or gaining a competitive advantage; (3) destroying the debtor; or (4) collaborating with a third party to obstruct the debtor's reorganization. Courts justify designating these as impermissible actions by pointing to the context surrounding the adoption of § 203 of the Bankruptcy Act, passed in response to a business competitor dispute that spilled over into the bankruptcy process. Some bankruptcy courts also draw on general bankruptcy principles of preserving creditors' abilities to vote and share in the common pool of assets. Next, this Article examines the justifications to see if the Ulterior Motive Test is in fact grounded in the Code and bankruptcy law in general.

IV. EXAMINING THE JUSTIFICATIONS FOR THE ULTERIOR MOTIVE TEST

The previous Part explained courts' justifications for the Ulterior Motive Test. This Part pushes back on those justifications. Specifically, Section A argues that the legislative history does not support a broad ban on hostile takeovers and Section B argues that the general principles behind the Code do in fact support claims trading.

A. Legislative History Justifications for Badges of Bad Faith

As explained above, bankruptcy courts have looked to the legislative history of § 203 to shed light on § 1126(e).[148] Specifically, the House of Representatives held hearings in 1937 on the subject of revisions to the Bankruptcy Act.[149] One of these revisions added § 203 in 1938.[150] The House called William O. Douglas, then Commissioner of the Securities and Exchange Commission ("SEC"), to testify about the addition of § 203.[151] Because

[148] *See supra* Part III.A.

[149] *See Hearing*, *supra* note 124.

[150] *See* Bankruptcy Act of 1938 (Chandler Act) ch. 575, § 203, 52 Stat. 840, 894 (repealed 1978) (amending Bankruptcy Act of 1898, 30 Stat. 544 (repealed 1978)); Alfred N. Heuston, *Corporate Reorganizations Under the Chandler Act*, 38 COLUM. L. REV. 1199, 1219 n.104 (1938).

[151] *Hearing*, *supra* note 124, at 180–82 (statement of William O. Douglas, Comm'r, SEC).

modern courts draw from this 1937 testimony, it is important to review precisely what Commissioner Douglas said:

> We envisage that "good faith" clause to enable the courts to affirm a plan over the opposition of a minority attempting to block adoption of a plan merely for selfish purposes. The *Waco case*, reported in 87 Federal (2d) 395, was such a situation . . . where a minority group of security holders refused to vote in favor of the plan *unless that group* [*was*] *given some particular preferential treatment, such as the management of the company*. That is, there were ulterior reasons for their actions. According to the lower court, they said: "For a price you can have our vote." That is the type of situation this is designed to meet.[152]

In the above excerpt, Commissioner Douglas links "preferential treatment" with "management of the company." In other words, Commissioner Douglas seems to be arguing that demanding control of a company through bankruptcy is necessarily demanding preferential treatment.[153]

However, his comments must be placed in context with his prior testimony: "[S]tockholders or creditors . . . can very frequently by the use of obstructive tactics and of hold-up techniques exact for themselves undue advantages from other stockholders."[154] Thus, Commissioner Douglas considered a hostile acquisition to be in bad faith if it disadvantages other stakeholders of the debtor. But this is not necessarily true. A hostile acquirer generally proposes a competing plan of reorganization, which could provide more value to the creditors than the debtor's plan. But the other creditors will never be able to tell if the court designates the purchaser's votes before allowing competing plans, as occurred in *DBSD*.[155] This preemption is outside the boundaries of the legislative record. Finally, to the extent that Commissioner Douglas argued that seeking control of the debtor necessarily means extracting value that will not be shared by other creditors, the other creditors are free to ask for a control premium. Overall, if the acquirer's plan provides the creditors with more value than the debtor's, it is difficult to see how the acquirer is exacting undue advantages.

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152 *Id.* at 181–82 (emphasis added).

153 *Id.* at 180–82. For a modern reprisal of this theme, see *In re* Allegheny Int'l, Inc., 118 B.R. 282, 300 (Bankr. W.D. Pa. 1990) ("Here, Japonica clearly attempts to deprive creditors of the control premium by a manipulation of the reorganization process through the strategic purchase of claims.").

154 *Hearing*, *supra* note 124, at 180 (statement of William O. Douglas, Comm'r, SEC).

155 *See generally In re* DBSD N. Am., Inc., 421 B.R. 133 (Bankr. S.D.N.Y. 2009).

Even if courts read Commissioner Douglas's language as a mandate against hostile takeovers in bankruptcy, it is far from clear that the framers of § 203 adopted Commissioner Douglas's arguments. Immediately after the above comment,[156] Congressman Michener replied, "And 'good faith' will take care of that," to which Commissioner Douglas responded, "Yes sir; 'good faith' will take care of that."[157] The transcript ended after this short exchange.[158] Congressman Michener's statement appeared to clarify Commissioner Douglas's earlier testimony, rather than assent to it. By contrast, courts interpreting this legislative history make definitive statements about what precisely Congress intended by passing § 203.[159] For example, *Young v. Higbee* declared that "[t]he *history of this provision makes clear* that it was intended to apply to those stockholders whose selfish purpose was to obstruct a fair and feasible reorganization in the hope that someone would pay them more."[160]

Furthermore, *Higbee* quotes from the legislative hearing record, but every direct quote cited comes from Commissioner Douglas—a *witness* arguing the SEC's position in the hearing—not from the congressmen or the framers of § 203: "Its purpose was to prevent creditors from participating who 'by the use of obstructive tactics and hold-up techniques exact for themselves undue advantages from the other stockholders who are cooperating.'"[161] Examining the transcript itself reveals that Mr. Douglas made this statement and there is no indication of congressional assent to Mr. Douglas's declaration.[162] Fast forwarding to the modern day, the *Allegheny* court cited *Higbee*'s analysis of the legislative record.[163]

Indeed, earlier discussion in the legislative record indicates that the committee members, and at least one congressman, preferred to leave "good faith" as an open-ended term to be interpreted by the courts, rather than a blueprint laying out precisely what creditor behavior constitutes good or bad

156 *See supra* note 152 and accompanying text.

157 *Hearing*, *supra* note 124, at 182 (statement of William O. Douglas, Comm'r, SEC) (internal quotation marks omitted).

158 *Id.*

159 *E.g.*, *In re* Allegheny Int'l, Inc., 118 B.R. 282, 288 (Bankr. W.D. Pa. 1990) (citing Young v. Higbee, 324 U.S. 204, 211 (1945)).

160 *Id.* (quoting *Higbee*'s interpretation of § 203's legislative history) (emphasis added).

161 *Higbee*, 324 U.S. at 211 n.10 (quoting *Hearing*, *supra* note 124, at 180).

162 *Hearing*, *supra* note 124, at 180.

163 *In re Allegheny Int'l*, 118 B.R. at 288 (quoting *Higbee*, 324 U.S. at 211 n.10).

faith.[164] For example, another witness, Mr. Weinstein, stated, "It seems to me it would be a better policy if we would allow the courts to develop this, the scope of the meaning of 'good faith', [sic] over a reasonable period of time . . . ."[165] Immediately thereafter, Congressman Michener opined, "It is a step in an entirely new direction, and I think we are just going far enough when we go to 'good faith.'"[166]

Thus, the transcript may show that the House preferred to leave "good faith" open-ended, to be interpreted by future bankruptcy judges. At the very least, it demonstrates a lack of agreement as to what "good faith" precisely means. All in all, the position that the legislative history frowns upon takeovers through chapter 11 is underdetermined.

B. General Bankruptcy Code Justifications for the Ulterior Motive Test

The Code and the Federal Rules of Bankruptcy Procedure *support* claims trading as a general matter. For example, Bankruptcy Rule 3001(e) outlines the procedures that purchasers must follow after acquiring a claim.[167] In fact, Rule 3001(e) details different procedures for claims transferred as security interests and those transferred "other than for security."[168] The difference in treatment suggests that the framers contemplated that a market for claims would exist for more purposes than collateralizing a claimant's debts. Moreover, the Rule provides that only a transferee (the purchaser of the claim) need file a proof with the bankruptcy court, indicating that the transferee is now the holder of all the rights of the claim.[169]

In addition, the 2005 amendments to the Code signaled a shift of power from debtors to creditors. One change gives creditors more leverage to propose rival plans of reorganization; specifically, under pre-2005 law, the chapter 11 debtor enjoyed a 120-day period of exclusivity, which the courts would routinely extend for cause.[170] Routine extensions of the exclusivity period created substantial bargaining power for a debtor seeking to confirm its plan.[171]

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164 *Hearing*, *supra* note 124, at 181.

165 *Id.* (statement of Jacob I. Weinstein, Member, National Bankruptcy Conference).

166 *Id.*

167 *See* FED. R. BANKR. P. 3001(e).

168 *See id.* 3001(e)(1), (3).

169 *Id.* 3001(e)(1); *Distressed Mergers and Acquisitions*, *supra* note 1, at 156–57.

170 Nixon Peabody LLP, *New Amendments to Bankruptcy Code: Large Impact on Business Bankruptcies*, BANKR. L. ALERT, Spring 2005, at 3, *available at* http://www.nixonpeabody.com/linked_media/publications/BLA_05022005.pdf.

171 *Id.*

Previously, a debtor could drag out the chapter 11 process, forcing creditors with declining collateral or claims to submit.[172] By contrast, under the revised Code, eighteen months is the absolute limit on the debtor's exclusivity period to file a plan, and twenty months is the absolute limit on the debtor's exclusive ability to solicit votes.[173] These changes increase the opportunity for other creditors to file competing plans, and reduce the opportunity for the debtor to win a war of attrition.

More generally, the 2005 amendments distributed power from debtors to creditors in areas other than plan confirmation. For example, the revisions placed an absolute 210-day limit on the debtor's decision to accept or reject a nonresidential lease of real property.[174] Previously, the debtor could request indefinite extensions, which courts would liberally grant as long as the debtor was performing postpetition obligations under the lease.[175] The strict new time limit restricts the debtor's option to shop the lease or profit from volatility in the commercial real estate market at the creditor's expense.[176] Along the same lines, the amendments increased defenses available to creditors facing preference actions from the trustee.[177] Of course, the aforementioned changes do not directly relate to claims trading, but they do demonstrate that the allocation of power between the debtor and creditor is not fixed. Accordingly, appeals to bankruptcy policy issues from early cases may not reflect the policies embedded in the post-2005 Code. Perhaps these amendments reflect Congressional approval of a robust plan proposal process in which more creditors' voices are heard.

Moreover, the judicial scrutiny of acquisitive claims purchasers seems especially asymmetrical when compared to the other Code mechanism for acquiring a company—§ 363 sales.[178] In a 363 sale, once the debtor receives judicial permission to sell, generally anyone, creditor or otherwise, may make a bid for the company.[179] Contrast this permissive view of bidding with how the court viewed DISH, which planned to bid for the company by proposing a

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172 *See Distressed Mergers and Acquisitions*, *supra* note 1, at 102.

173 *See* 11 U.S.C. § 1121(d)(2)(A)–(B) (2012).

174 *Id.* § 365(d)(4)(B). Beyond the 210-day limit, the landlord must consent to extensions.

175 Nixon Peabody LLP, *supra* note 170, at 1.

176 *See id.* at 2.

177 *See, e.g.*, 11 U.S.C. § 547(c)(2) (broadening "ordinary course of business" defense); *id.* § 547(e)(2)(A) (increasing safe harbor for perfection of security interest).

178 *See supra* Part I.D.

179 *See* 11 U.S.C. § 363(d).

"major transaction."[180] Why would DISH be allowed to bid if the debtor had put up its assets in a 363 sale, but not allowed to bid through a chapter 11 plan? One could counter that a 363 debtor has chosen, and received court permission, to auction its assets. But a debtor whose plan includes a fulcrum security is also transferring ownership of its assets. Indeed, DBSD's plan included a fulcrum security, which DISH acquired.[181] Admittedly, a 363 debtor has some leeway to determine which bid is highest or best, but that power comes into play only *after* the bidders have submitted their bids.[182] In *DBSD*, DISH never got the chance to propose its plan because the court designated its votes.[183]

The difference in treatment between 363 sales and chapter 11 reorganizations is also puzzling given the increasing prevalence of 363 sales in chapter 11 cases. Exact numbers are difficult to come by, but one bankruptcy court recently noted that there has been a "huge increase in motions to sell substantial parts (or all) of the estate under § 363(b) prior to plan confirmation."[184] One recent law review article observed that between 1982 and 1990, over 80% of chapter 11 cases resulted in reorganizations.[185] By contrast, between 2000 and 2002, reorganizations dropped to 51%.[186] Although there may be many reasons for the prevalence of 363 sales, their upward trend stands in contrast to the judicial scrutiny of chapter 11 plans proposed by claims traders. An upsurge in 363 sales undermines judicial appeals to general bankruptcy policies, and undercuts earlier case law analyzing chapter 11 without analyzing 363 sales as well. The bankruptcy world has dramatically changed since the 1930s.

V. SUGGESTIONS FOR POTENTIAL CLAIMS PURCHASERS

This Part lays out several suggestions that, based on the case law, should help an investor minimize the risk of vote designation. As shown by the difference in courts' treatment of investors versus strategic acquirers, the level of judicial scrutiny will differ depending on a client's goals. The crude

180 *In re* DBSD N. Am., Inc., 421 B.R. 133, 137 (Bankr. S.D.N.Y. 2009).
181 *Id.* at 135.
182 *See supra* note 179.
183 *In re DBSD*, 421 B.R. at 133.
184 *In re* Gulf Coast Oil Corp., 404 B.R. 407, 419 (Bankr. S.D. Tex. 2009).
185 Harvey R. Miller & Shai Y. Waisman, *Is Chapter 11 Bankrupt?*, 47 B.C. L. REV. 129, 131 (2005).
186 *Id.*

categories of "investor" versus "strategic acquirer" will admittedly blur, as discussed in the bankruptcy case *In re Lichtin/Wade, L.L.C.*[187]

If one's client is bent on a strategic acquisition, then it will have to hurdle *DBSD* and *Allegheny*. Both are recent cases and *DBSD* was adjudicated in the Southern District of New York, an epicenter of corporate bankruptcies. Both represent the judicial high-water mark towards acquisitions. By engaging with their conclusions and justifications, the purchaser is better prepared for future § 1126(e) hearings. That said, different jurisdictions may treat acquirers more favorably. Because of the fact-specific nature of these cases, it is difficult to draw generally-applicable lessons from them. Nonetheless, several trends have emerged.

A. Cite the Heavy Burden that the Debtor Must Meet to Designate a Creditor's Vote

First, because voting is the mechanism under which the Code allows parties to protect their own interests, throwing out a creditor's vote constitutes an extreme action for a court to take.[188] Accordingly, courts are generally hesitant to designate.[189] Furthermore, the debtor bears the burden of proving the creditor's bad faith.[190] Although designation occurred in several prominent cases, such as *Allegheny* and *DBSD*, a practitioner should frame the argument to remind the court that the debtor must convincingly show why designation *should* occur.

B. Become a Preexisting Creditor

Second, courts seem to look favorably upon preexisting creditors who later purchase votes.[191] In affirming the bankruptcy court's designation of DISH, the Second Circuit noted, "We leave for another day the situation in which a *preexisting* creditor votes with strategic intentions."[192] This possibility raises

[187] *In re* Lichtin/Wade, L.L.C., No. 12-00845-8, 2012 Bankr. LEXIS 5785 (Bankr. E.D.N.C. Dec. 17, 2012).

[188] *In re* Adelphia Commc'ns Corp., 359 B.R. 54, 61 (Bankr. S.D.N.Y. 2006) ("A right to vote on a plan is a fundamental right of creditors under chapter 11.").

[189] *See* DISH Network Corp. v. DBSD N. Am., Inc. (*In re* DBSD N. Am., Inc.), 634 F.3d 79, 101 (2d Cir. 2010) ("Bankruptcy courts should employ § 1126(e) designation sparingly, as 'the exception, not the rule.'") (quoting *In re Adelphia*, 359 B.R. at 61).

[190] *Lichtin*, 2012 Bankr. LEXIS 5785, at *7.

[191] *See supra* Part II.C.1.

[192] *DISH Network*, 634 F.3d at 105 (citing *In re* Pine Hill Collieries Co., 46 F. Supp. 669, 672 (E.D. Pa. 1942)).

the question of what would have happened had DISH acquired claims before the petition. It is also not clear whether the Second Circuit intended to refer to regular prepetition creditors (such as trade creditors) or to acquirers who have the foresight to become creditors before the company files.[193] The Ulterior Motive Test should apply equally to DISH no matter when it purchased the debts—it was a competitor with strategic acquisitions both before and after the petition. To hold otherwise seems formalistic. Nevertheless, Second Circuit language favorable to prepetition creditors exists.[194]

C. Investing over Acquiring

Third, recall how courts view Passive Investors more favorably than acquirers. The claims purchaser should attempt to characterize itself as an investor rather than a hostile acquirer.[195] One recent case, *Lichtin*, is illustrative of the blurriness between categories.[196] In *Lichtin*, a real estate investment firm purchased secured notes of a property management firm, and then proposed its own plan.[197] The arguments between the debtor and creditor track exactly the investor-versus-acquirer distinction in the case law.[198] Specifically, the debtor argued that the creditor was "acting for its own ulterior motive of obtaining control of the [d]ebtor's business operations" and that the creditor "was not originally a creditor of the [d]ebtor."[199] Furthermore, the debtor contended, based on some of the creditor's investment holdings, that the creditor was "a direct or indirect competitor of the [d]ebtor."[200] The debtor's counsel was clearly trying to place his client's motion within the four corners of *DBSD* and *Allegheny*. In response, the creditor took care to distinguish itself as an investor, pointing out that the debtor's plan would "force [it] to hold a restructured note inconsistent with current market terms," and that it "ha[d] the right to exercise its own business judgment to protect its own economic interest."[201] Just like that, the parties set the stage for a § 1126(e) showdown.

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193 *Id.*
194 *Id.*
195 *See supra* Part II.D.2.
196 *In re* Lichtin/Wade, L.L.C., No. 12-00845-8, 2012 Bankr. LEXIS 5785 (Bankr. E.D.N.C. Dec. 17, 2012).
197 *Id.* at *2, *4–5.
198 *Compare id.* at *13–17, *with In re* DBSD N. Am., Inc., 421 B.R. 133, 141 (Bankr. S.D.N.Y. 2009).
199 *Lichtin*, 2012 Bankr. LEXIS 5785, at *5, *13.
200 *Id.*
201 *Id.* at *6.

Noting a § 1126(e) movant's "heavy burden with respect to whether [the creditor] rejected and voted against the plan not in good faith," the court decided not to designate the creditor's vote.[202] In particular, the court was persuaded that the creditor was acting as an investor as opposed to a competing acquirer, even though the litigants both owned similar properties.[203] The court pointed to the creditor's extensive underwriting process before purchasing the claims as probative of its investor motives.[204] So, the court may be more favorably disposed towards respecting the client's vote if one's client tracks the *Lichtin* creditor's investment process, even when the client owns a similar business as the debtor.[205]

D. Build a Creditor Coalition

Fourth, purchasers should make every effort to secure the buy-in of other creditors. Recall Commissioner Douglas's testimony equating hostile acquisitions with securing advantages not available to other creditors.[206] Having the support of the creditors' committee and other stakeholders blunts this argument.

Creditors are guaranteed to turn against an investor's plan if that plan shortchanges them in comparison to other plans, and may turn against an investor's plan if they feel that the plan leaves them with the risk of being shortchanged. Accordingly, to the extent that the investor's plan involves a business combination, or a change in capital structure, the investor should try to convince the other creditors that the proposed plan will deliver the most value. At the same time, the investor should be cautious not to step outside the Code's circumscribed limits on soliciting votes.[207]

Winning the support of other creditors probably involves paying them for it. Still, with the risk of other creditors seeking to designate the investor's vote, that may be money well spent. Similarly, one can tailor the consideration to the

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202 *Id.* at *14.

203 *Id.* at *15–16, *20 ("Based on the totality of the circumstances, the Court finds that [the creditor] purchased claims for the purpose of maximizing its investment and advancing its own economic interest rather than for the purpose of advancing a strategic competitive interest against the Debtor.").

204 *Id.* at *20.

205 The court also did not find the creditor's purchase of blocking positions as sufficient to warrant a finding of bad faith: "While it does appear that [the creditor] may have purchased claims to allow it to control certain classes to maximize its return, this is not a motive that Court's [sic] have found to show a lack of good faith." *Id.* at *21.

206 *See Hearing*, *supra* note 124, at 181–82.

207 *See* 11 U.S.C. § 1125 (2012).

specific creditor class's needs. For example, paying trade creditors and repeat customers in equity will allow the investor to save its cash while sharing any upside with those other creditors.

E. Emphasize the Second Circuit's Language over the Bankruptcy Court's

Fifth, purchasers should take note of the subtle difference between Judge Gerber's bankruptcy court opinion in *DBSD* and the Second Circuit's affirming opinion. Although Judge Gerber never stated that hostile takeovers are categorically impermissible, the opinion is extremely critical of the practice.[208] The Second Circuit affirmed, but specified that it was not banning hostile acquisitions in chapter 11: "We emphasize, moreover, that our opinion imposes no categorical prohibition on purchasing claims with acquisitive or other strategic intentions. On other facts, such purchases may be appropriate."[209]

What would other such fact scenarios look like? Here are several possibilities:

- A prescient investor purchases debt tranches of the debtor before bankruptcy. Although the Second Circuit explicitly left open the possibility that a preexisting creditor with "strategic intentions" could succeed,[210] it is unclear whether this distinction would hold up to judicial pressure.
- A strategic investor puts forth a plan that undoubtedly brings more value to the estate than the debtor's, but this plan involves unseating management.
- A strategic investor with a *complementary* business line aims to take over a bankrupt entity's business operations. For example, this would occur if a furniture store bought an insolvent trucking company, allowing the store to more efficiently deliver its goods to customers. This fact pattern represents an interesting twist because the creditor and the debtor are not competitors, thus steering clear of the bad faith case

208 *In re* DBSD N. Am., Inc., 421 B.R. 133, 140 (Bankr. S.D.N.Y. 2009) ("When an entity becomes a creditor late in the game . . . the inference is compelling that it has done so not to maximize the return on its claim . . . but to advance an 'ulterior motive' condemned in the caselaw.").

209 DISH Network Corp. v. DBSD N. Am., Inc. (*In re* DBSD N. Am., Inc.), 634 F.3d 79, 105 (2d Cir. 2010).

210 *Id.*

law forbidding putting another party out of business. However, the transaction would still be hostile to existing management, and the investor may have an interest in cutting the debtor's operational expenses, leaving the investor open to the debtor's argument that the investor is seeking to destroy it.

F. Be a Model Bankruptcy Citizen

Sixth and finally, purchasers should not act suspiciously or deviously. This final lesson seems obvious, but creditors do act otherwise. In particular, courts disapproved of the *Allegheny* and *DBSD* creditors' tactics, which included proposing a plan at the last minute and understating their acquisitive intentions to the court.[211] For example, in *Allegheny*, Japonica recited to the court that it was proposing a competing plan "to provide cash to creditors," leading the court to grant Japonica additional time to file its plan.[212] When the court learned of Japonica's acquisitive intentions, Chief Judge Cosetti bluntly remarked that "the court was misled."[213]

An illustrative, real-world example of a creditor operating openly but effectively occurred in the *Lichtin* case.[214] Instead of concealing its ties to the debtor's business, the creditor acknowledged and minimized them.[215] Specifically, the creditor argued that the percentage of overlapping business was "1% of the market" and that although one of the creditor's affiliates serviced the debtor's loans, the types of loans serviced were different.[216] In other words, the creditor engaged with the debtor's criticisms and was able to overcome them. Creditors should also be aware that bankruptcy judges permit discovery surrounding § 1126(e) motions.[217] Therefore, it is paramount to make sure that one's statements about motive will not later be contradicted by internal documents.

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211 *Supra* notes 95–97 and accompanying text.

212 *In re* Allegheny Int'l, Inc., 118 B.R. 282, 290 (Bankr. W.D. Pa. 1990).

213 *Id.*

214 *In re* Lichtin/Wade, L.L.C., No. 12-00845-8, 2012 Bankr. LEXIS 5785 (Bankr. E.D.N.C. Dec. 17, 2012)

215 *Id.* at *19–21.

216 *Id.* at *14–17, *20.

217 *See, e.g.*, *supra* note 118 and accompanying text.

CONCLUSION

Before summing up what this Article has covered, it is important to highlight what it did not. Investments, particularly acquisitions through chapter 11, also implicate critical issues of tax, antitrust, and securities law, as well as corporate governance and fiduciary duties. In order to maximize value and cabin litigation risk, claims purchasers must take these into account.

A claims investor also runs significant financial risk. If the court ends up designating the investor's vote, then the investor loses its voice in the plan process, which will determine the claim's ultimate recovery. In addition, many investors purchase claims at or near par, so without a vote, the claims are most likely out of the money in whatever plan that is ultimately successful.

Finally, claims purchasers can find themselves facing other bankruptcy law causes of action wielded by the debtor, such as equitable subordination. If the judge decides to subordinate the investor's vote, then the investor will find itself recovering even less.[218]

The two primary justifications for curtailing bankruptcy takeovers—the legislative history of § 1126(e) and principles drawn from the Code—do not justify blanket scrutiny of hostile bidders. Specifically, the good faith statutes' legislative history does not forbid hostile takeovers, nor is there any evidence that Congress has assented to an interpretation that it does. In addition, it is not evident that title 11 disfavors hostile takeovers. In fact, title 11 contains provisions explicitly supporting claims trading, as well as newly-adopted provisions enhancing a creditor's ability to propose a competing plan. Finally, the proliferation of acquisitions via § 363, where public bidding takes place through an auction, stands in sharp relief to the judicial scrutiny of an acquirer who bids through a competing chapter 11 plan. Given the courts' thin justifications, the Ulterior Motive Test is unduly overinclusive when applied to hostile takeovers.

Does the Ulterior Motive Test foreclose value or benefits that could otherwise arise in chapter 11? This is a tough question to answer analytically, and probably should be answered empirically. Furthermore, a full empirical analysis is beyond the scope of this Article. Nonetheless, some research suggests that a robust claims trading system—including claims trading resulting in hostile acquisitions of debtors—maximizes value for creditors. The

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[218] *See supra* note 106 and accompanying text.

Loan Syndications and Trading Association ("LTSA") filed an amicus brief in *DBSD* urging reversal of Judge Gerber's designation of DISH's votes.[219] In that brief, the LTSA, an organization of over 300 financial institutions and service providers, pointed out that claims investors provide liquidity allowing existing creditors to exit the bankruptcy process and redeploy their capital elsewhere.[220] In addition, investors can, among other benefits, shorten the costly bankruptcy process, deliver the debtor's capital structure because of their willingness to convert debt into equity, and propose business changes that entrenched management may resist.[221]

With regard to empirical evidence, the LTSA brief suggests that takeovers are more successful than reorganizations. In particular, the LTSA argues that 65% of takeovers "could be considered successful from an operational standpoint."[222] In addition, "[o]nly 4.8% of acquired debtors had negative operating income in their first year out of bankruptcy," while 15% of reorganized entities did.[223] Acquired debtors enjoyed operating income margins of 12.9% during the same period, while reorganized debtors booked 5.3% margins.[224]

All in all, evidence exists suggesting that takeovers, either through a merger or through a 363 Sale, are value-maximizing as opposed to the alternative. An expansive reading of § 1126(e) may deter future acquirers from running the risk of vote designation. To that end, the estate of bankrupt entities may suffer.

This Article aims to have summarized the important claims trading case law and begun to push back on the justifications for using § 1126(e) to designate bankruptcy investors' votes. It also hopes to have provided a roadmap to challenge courts' characterization of § 1126(e)'s legislative history and its place within the larger Code policies. Ultimately, it calls for a reexamination of judicial analysis of bankruptcy investments in the hopes of creating a more efficient and value-maximizing bankruptcy system.

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[219] Brief of Amicus Curiae Loan Syndications and Trading Association Supporting Appellant, DISH Network Corp. v. DBSD N. Am., Inc. (*In re* DBSD N. Am., Inc.), 634 F.3d 79 (2d Cir. 2010) (No. 10-1175).

[220] *Id.* at 2.

[221] *Id.* at 3.

[222] *Id.* at 23 (citing Paul M. Goldschmid, *More Phoenix than Vulture: The Case for Distressed Investor Presence in the Bankruptcy Reorganization Process*, 2005 COLUM. BUS. L. REV. 191, 264–65 (citations omitted)).

[223] *Id.*

[224] *Id.*