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The 2nd Circ. Stance On DBSD

Law360, New York (October 26, 2010) -- The Chapter 11 case of DBSD North America Inc., f/k/a ICO North America, has been marked by aggressive tactics and extreme positions from its commencement.

DBSD, a nonoperating satellite communications company, and its second-lien noteholders made clear their intent to cram down a plan of reorganization (the plan) on DBSD's first-lien lenders. A competitor of DBSD bought the first-lien debt and then found itself sanctioned for seeking to use its acquired position to effect a takeover of DBSD.

The competitor appealed the plan confirmation order, and the Second Circuit, on the eve of the plan becoming effective, issued a stay "to preserve the status quo pending the outcome of this appeal."

Prepetition, DBSD had a first-lien loan of $40 million (the senior debt) and second-lien secured notes of approximately $750 million (the junior debt). The senior debt was secured by all of DBSD's operating assets plus its only liquid assets — a portfolio of auction-rate securities (the securities).

The noteholders agreed to exchange the junior debt for equity in reorganized DBSD. The plan proposed to provide the senior debt with a new note that extended the maturity of the senior debt from one year to four years, provided payment in kind (PIK) interest, and liens on all of reorganized DBSD's operating assets — but not on the securities, which were to be used to help fund ongoing operations.

The original first-lien lenders sold 100 percent of the senior debt at par value to the competitor, which then voted to reject the plan.

The bankruptcy court took the highly unusual step of designating (i.e., disallowing) the competitor's rejecting plan vote as "not in good faith" under Section 1126(e) of the Bankruptcy Code. The court determined that "good faith" was lacking because the competitor was acting with a "strategic purpose," rather than merely seeking to further its interest as a creditor looking to be repaid.

The court based its ruling, among other things, on the competitor's payment of par value for the senior debt at a point when the disclosure statement for the plan had already been approved. This decision has caused great concern among distressed investment funds that routinely buy up debt at a discount as a means of acquiring companies out of Chapter 11 cases.

The next part of the court's decision further raised eyebrows throughout the bankruptcy community. The court determined that because the competitor was the sole member of its plan class, the plan class should be deemed to have accepted the plan. As a result, the court held that the plan did not have to satisfy the cramdown standards of Section 1129(b)(2)(A) of the Bankruptcy Code with respect to the competitor.

These events have justifiably drawn attention. Less noticed, however, has been the next part of the court's ruling.

After candidly noting that the issue of treating the designated rejecting vote of a single creditor class as an accepting vote is "one of first impression" and "[a]s against the possibility that a higher court in this Circuit might adopt the contrary view," the court went on and determined that the proposed plan treatment of the senior debt did in fact meet the cramdown standard of Section 1129(b)(2)(A)(iii), by providing the competitor with the "indubitable equivalent" of its claim.

The "indubitable equivalent" standard under Section 1129(b)(2)(A)(iii) has generally been viewed as allowing a debtor to cram down a plan on an objecting secured creditor so long as it gives the creditor the present value of its secured claim and provides substitute collateral that is of equal value and of no greater risk than its existing collateral.

In addition to appealing the designation of its plan vote, the competitor has argued to the Second Circuit that it cannot be forced to accept a diminished collateral package that deprives it of its lien on the securities with no substitution.

It is this aspect of DBSD that, if affirmed by the Second Circuit, will likely have a greater impact in future cases on the relative leverage between secured creditors, and debtors and junior creditors. The court's decision to designate the competitor's vote, while of understandable concern to distressed investment funds, was very fact-specific and narrowly focused.

On the other hand, the court's determination that a one-year loan facility secured by all of DBSD's assets — including the securities — could be replaced under the "indubitable equivalent" standard by a four-year PIK facility under the same rate of interest, with a reduced collateral package that lacks such securities, could have a broad impact by opening the door to all manner of creative and aggressive attempts to cram down (or perhaps more precisely, "cram up") secured lenders.

The Second Circuit's recent issuance of a stay suggests that it may very well recognize the ramifications of the court's decision.

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Kelley Drye represented the agent for the first lien lenders in the case discussed in this article. The firm was not involved in the litigation over the confirmation of the plan of reorganization or in the proceedings before the Second Circuit.

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