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Bankruptcy Voting and the Designation Power

by

Christopher W. Frost*

Chapter 11 of the Bankruptcy Code is the only form of bankruptcy that requires winning the consent of the creditor body. Creditors are given the right to vote based on an underlying assumption that they will cast their votes to maximize recovery on their claims. When creditors collectively vote to further these distributional goals, then the estate in turn should realize the maximum value for its assets. "Value maximization" is one of the fundamental goals of chapter 11, and voting in bankruptcy is an important way of achieving that goal.

The problem with these assumptions is that creditors sometimes vote for reasons other than their distributional goals. For example, if a creditor owns a competing business, it may be less concerned with maximizing recovery on its claim and more concerned with putting the debtor out of business no matter what terms the debtor offers. When creditors cast their votes for reasons other than their distributional goals, then the collective vote may no longer reflect the value-maximization goal of chapter 11.

The Bankruptcy Code provides the courts with a mechanism to guard against the exercise of "voting" power based on these non-distributional motivations. Section 1126(e) allows a court to "designate" or disqualify a vote that was not cast "in good faith, or was not solicited or procured in good faith or in accordance with the provisions of this title." The Code does not define the phrase "in good faith," leaving courts to fill this breach on a case-by-case basis. Broadly speaking, courts have held that a vote should be disqualified when it is cast for a reason other than the creditor's desire to maximize its recovery on its claim.

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211 U.S.C. § 1126(e). The power to disqualify votes also extends to shareholders votes, but all of the cases examining the designation power have arisen in the context of creditor votes. Accordingly, this article focuses on the designation of claims and not interests. However, most, if not all, of the observations made here would apply equally to questions regarding the disqualification of shareholder votes.

3See In re Save Our Springs (S.O.S.) Alliance, Inc., 388 B.R. 202, 230 (Bankr. W.D. Tex. 2008) ("[C]ourts have developed the meaning of good (and bad) faith on the basis of the facts of each particular case.")., aff'd, 2009 WL 8637183 (W.D. Tex. Sept. 29, 2009), aff'd, 632 F.3d 168 (5th Cir. 2011).
In many areas, the courts have faithfully fulfilled this duty to screen outside influences that creep into the voting process. In the last two decades, however, the proliferation of claims trading in bankruptcy cases has increased the prevalence of voting based on outside influences, and the effectiveness of creditors who seek to influence the bankruptcy process for non-distributional ends. There is nothing new in a creditor buying other claims to influence the vote on a plan, but the amount of claims trading and the motivations behind it have dramatically changed over time. Some of these motivations are not known to the debtor, let alone the court, making it more difficult to regulate the voting process. This is especially true in cases of credit swaps, total return swaps, and other derivative agreements that are becoming more and more commonplace in large bankruptcy cases. Another significant change in practice is the frequency with which chapter 11 is used as a means of acquiring assets rather than its more historical use of reorganizing a business. With these changing dynamics, courts need to reevaluate the use of their designation power.

Part I of this article begins with an identification of the underlying purpose that creditor voting is intended to fulfill. Part II explores the courts’ traditional use of designation powers to uphold this purpose. In Part III, this article identifies three major areas in which the courts should expand the use of designation powers to ensure that voting is serving its intended purpose, especially in light of modern day practices. It also recognizes one area in which some courts’ current application of this power may be contrary to the value-maximization goal of chapter 11.

I. THE PURPOSE BEHIND BANKRUPTCY VOTING

Voting serves an efficiency function in bankruptcy similar to shareholder voting in corporate law. Bankruptcy reorganizations are economically akin to other fundamental corporate transactions, such as mergers, recapitalizations, dissolutions and asset sales. Outside of bankruptcy, shareholder voting on those issues, as well as shareholder voting to elect board members, is based on the idea that shareholders hold a shared incentive to maximize the value the corporation.

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4See infra Part III for a discussion regarding these types of instruments.
5See Douglas G. Baird & Robert K. Rasmussen, The End of Bankruptcy, 55 Stan. L. Rev. 751, 751 (2002) ("Corporate reorganizations have all but disappeared. Giant corporations make headlines when they file for chapter 11, but they are no longer using it to rescue a firm from imminent failure. Many use chapter 11 merely to sell their assets and divide up the proceeds."); Douglas G. Baird & Robert K. Rasmussen, Chapter 11 at Twilight, 56 Stan. L. Rev. 673, 674 (2003) ("As we claimed in The End of Bankruptcy, traditional reorganizations have largely disappeared."). There may be evidence that this trend is reversing, however. See Lynn LoPucki & Joseph W. Doherty, Bankruptcy Fire Sales, 106 Mich. L. Rev. 1, 42-43 (2007).
This incentive is arrived at somewhat indirectly. Shareholders do not specifically care about the value of the corporation, as such, but they are vitally interested in the value of their shares. Holding the residual claim to the corporation's earnings, they obtain the marginal gains and losses from corporate decisions. Because they stand to gain or lose the most, the shareholders' investment incentives are best aligned with the overall goal of value maximization. 6

In chapter 11, all of the claimants who will be forced to receive something less than full payment occupy a position that is roughly comparable to the shareholders of a solvent corporation. 7 Chapter 11 places voting power in the hands of that group of claimants—effectively disregarding the votes of claimants whose rights are unimpaired 8 and the votes of claimants who are “out of the money.” 9 Those residual claimants are in the best position to evaluate the reorganization transactions and to compare their recovery under the plan to other alternatives, such as liquidation, another potential plan, or an auction of the business as a going concern. By focusing on the value of their own claims, creditors occupying the residual class should wind up choosing a course of action that maximizes the value of the corporation itself.

In both shareholder and bankruptcy voting, sometimes conflicts exist between the private interests of particular voters and the interests of the other members of the voting class; which conflicts call into question the efficacy of the voting process. Outside of bankruptcy, shareholders often do not hold

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6 See Frank H. Easterbrook & Daniel R. Fischel, Voting in Corporate Law, 26 J. LAW & ECON. 395, 403 (1983) ("As the residual claimants, the shareholders are the group with the appropriate incentives (collective choice problems to one side) to make discretionary decisions."); see also, Laura Lin, Shift of Fiduciary Duty Upon Corporate Insolvency: Proper Scope of Directors' Duty to Creditors, 46 VAND. L. REV. 1485, 1497 (1993) ("Requiring directors to maximize shareholder interest provides a fairly accurate benchmark for maximizing the long-term, wealth-producing capacity of the firm.").

7 See Henry T. C. Hu & Bernard Black, Equity and Debt Decoupling and Empty Voting II: Importance and Extensions, 156 U. PA. L. REV. 625, 734 (2008) ("Voting in bankruptcy, in proportion to principal amount of debt held, rests on the same logic as a one-share-one-vote regime on the equity side—that control rights should be held by those with an incentive to increase the value of the firm, or at least the value of the asset class that is held.").

8 Under 11 U.S.C. § 1124, a class is unimpaired if the plan leaves the legal, equitable and contractual rights of the holders of claims or interests in the class unaffected. The Code effectively disregards the voting rights of unimpaired creditors. Under 11 U.S.C. § 1126(f), a class that is unimpaired is conclusively presumed to have accepted the plan and the plan proponent is under no obligation to solicit acceptances of the plan.

9 See David A. Skeel, The Nature and Effect of Corporate Voting in Chapter 11 Reorganization Cases, 78 VA. L. REV. 461, 480 (1992) ("[T]he Bankruptcy Code still seems to focus voting authority on the residual class. The residual class is the first class that will be impaired if the plan proponent seeks to compensate as many classes in full as the firm's assets will allow. Because unimpaired classes of claims or interests are deemed to accept a reorganization plan, full compensation eliminates the ability of a class to vote against the plan. Therefore, the residual class will vote in nearly every chapter 11 case (unless the reorganization plan proposes to pay the residual owners in full but impairs a higher class), and its vote frequently will prove pivotal.").
homogenous incentives. For example, managers and employees with stock ownership of the company may be significantly more risk averse than well diversified investors. Controlling shareholders may view corporate transactions in a much different light than do the minority shareholders. Pension funds may be motivated in part by interests in corporate responsibility that are not shared by other investors. Share ownership by sovereign wealth funds has created significant concerns regarding the motivations of the sovereign controlling the shares. In general, corporate law has not inquired into the motivations of particular shareholders. It does not have a mechanism for disqualifying the votes of shareholders with unique or perverse incentives.

Bankruptcy cases involve similar sorts of conflicts, and these conflicts form the basis for most of the vote designation cases. It is not unusual to find creditors who have interests separate from those held by otherwise similarly situated creditors. Trade creditors and labor unions may have an interest in seeing the debtor continue as an ongoing business, even if that outcome does not maximize recovery on their claims. On the other end of the spectrum, a creditor that is well hedged, perhaps through ownership of a total return swap or some other interest that would benefit from the failure of the debtor to reorganize, might seek liquidation even if it would mean a loss on that creditor’s claim. Some of these conflicts threaten to undermine the value-maximizing goal of chapter 11.

The problems presented by these conflicts have been exacerbated by changes in the reorganization landscape. Chapter 11 was once dominated by creditors and suppliers and other parties in a long-term economic relationship with the debtor. Today, the process has increasingly come to include claim buyers who have simply purchased claims, and the accompanying right to vote, from longer-term, relational creditors.

The claims trading phenomenon has been somewhat controversial. Harvey Miller has decried the practice, stating that claims traders’ short-term time horizons have destroyed the “symbiotic relationship of debtor and creditor,” making reorganizations less likely as traders “sacrifice the long-term viability of the debtor” for a quick return. Adam Levitin has praised the development, noting that a robust market for distressed debt permits early exit by creditors who do not have the time, expertise or liquidity to partic-

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10Shaun Martin & Frank Partnoy, Encumbered Shares, 2005 U. ILL. L. REV. 775, 788 (“Homogeneity of preferences is a key assumption in the law and economics model of corporate voting.”).

11See id. at 792-94 (discussing possible conflicting interests); Grant M. Hayden & Matthew T. Bodie, One Share, One Vote and the False Promise of Shareholder Homogeneity, 30 CARDOZO L. REV. 445, 481-94 (2008) (describing a variety of factors that may affect shareholder homogeneity).

12See infra Part III.A.1.

Levitan further argues that claims trading promotes efficiency by consolidating creditor claims. It also creates a market for control in bankruptcy that may result in maximizing asset values—either through a liquidation of the business or through a sale as a going concern.

The chapter 11 supermajority voting requirement makes it somewhat easier for claims traders to obtain a controlling voice. Each creditor votes as a member of a class of creditors. A class is deemed to have accepted the plan if at least two-thirds of the dollar amount of claims and more than one-half of the number of claims held in the class, vote to accept the plan. This supermajority provision represents a compromise. It is intended to provide a creditor with the right to dissent from its proposed treatment under the plan, but to also eliminate the hold-out problem that often plagues non-bankruptcy work-outs. Outside of bankruptcy, workouts are made more difficult by a creditor's natural incentive to delay acceptance of a settlement in hopes that it will be the last party whose consent is essential to the entire deal. Such a creditor is in a position to hold out for better treatment under the settlement. Recognizing that such hold-outs are likely to exist, creditors otherwise inclined to accept the settlement offer will be reluctant to enter into a deal that has not been accepted by everyone. A classic collective action problem, the hold-out issue stands as a serious obstacle to nonbankruptcy reorganizations.

Bankruptcy reduces, but does not eliminate the hold-out problem. Because creditors can bind dissenting members through the supermajority vote requirement, creditors have less of an ability to hold out for better treatment. On the other hand, the supermajority requirement reduces the number of claims one must hold, or acquire, to swing the vote. Obtaining either 34% of the dollar amount of the class claims or 51% of the number of claims will allow a group or party to control the class vote. Also, the plan proponent

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15 Id.
16 See 11 U.S.C. §§ 1123(a)(1), 1126(c), 1129(a)(8), 1129(a)(10) (2006). Chapter 11 voting is conducted by classes of creditors and shareholders, the members of which hold similar claims. Section 1122(a) provides that "a plan may place a claim or an interest in a particular class only if such claim or interest is substantially similar to the other claims or interests of such class." 11 U.S.C. § 1122(a). Once classified, the plan must specify the treatment of the classes of claims or interests, 11 U.S.C. § 1123(a)(3), and must provide for the same treatment of all of the claims or interests in each class unless a holder agrees to less favorable treatment, 11 U.S.C. § 1123(a)(4).
17 11 U.S.C. § 1126(c). Only those creditors actually voting are counted, however, and claims that are designated are not counted toward either the total number of acceptances or the total amount and number of claims. Acceptance by shareholders works the same way, except that there is no requirement that one-half of the shareholders vote to accept the plan.
cannot confirm its plan unless it obtains the acceptance of at least one impaired class. Therefore if a creditor holds a blocking position in the only class of impaired claims likely to accept the plan, then that creditor can block the plan in its entirety. The acquisition of a blocking position provides a strategic advantage that often animates vote designation decisions.

Claims trading plays a role in many of the situations discussed in this article. The presence of claims traders does not necessarily signify the presence of a conflicting interest or improper motive. But, the market for bankruptcy claims and the nature of the voting process provides opportunities for creditors with a motive other than to maximize the value of their bankruptcy distribution, to increase their voice in the bankruptcy process. Thus, while in many cases claims trading does not form a substantial part of the doctrinal discussion of vote designation, the fact that a creditor has bought its claims to increase its control over the process is an important background fact.

II. WIDELY ACCEPTED USES OF THE DESIGNATION POWER

In 1938, Congress adopted § 203 of chapter X of the Bankruptcy Act, the predecessor to § 1126(e), which gave courts the power to designate votes. It passed this law in reaction to the case of Texas Hotel Securities Corp. v. Waco Development Co. In this case, a parent corporation, controlled by Conrad Hilton, bought up claims in order to block the debtor's plan. Hilton's purpose was to attempt to reacquire hotel assets that the entity had earlier transferred to the debtor. Finding that the Hilton entity had the intent to thwart the debtor from confirming any plan of reorganization, the district court refused to count its votes. The Fifth Circuit rejected the lower court's view, finding that Texas Hotel Securities' intent was not "wholly obstructive," and that instead it simply hoped for a "lawful advantage to be openly gained." The Fifth Circuit held that, given that Texas Hotel Securities' actions were not "in malice or to embarrass justice, or surreptitiously to sell its vote," the court lacked the authority to disregard the votes and denied confirmation of the plan on the basis of Texas Hotel Securities' objection. Congress responded quickly to rectify this omission with the passage of § 1126(e)'s predecessor.

20 See, e.g., Principal Mut. Life Ins. v. Lakeside Assocs. (In re DeLuca), 194 B.R. 797, 801 (Bankr. E.D. Va. 1996) (noting that the secured creditor bought a blocking position in the only impaired class that might have assented to the debtor's plan).
22 Id. at 397.
23 Id. at 399.
24 Id.
25 Id. at 400-01.
In one of the earliest cases to interpret the new good faith requirement, *In re Pine Hill Collieries Co.*, the court held that votes based on an “ulterior motive” must be designated. “[P]ure malice, ‘strikes’ and blackmail, and the purpose to destroy an enterprise in order to advance the interests of a competing business, all plainly constituting bad faith, are motives which may be accurately described as ulterior.” The court was careful to distinguish actions that are merely self-interested, noting that

What is selfishness from the standpoint of those who derive no benefit from conduct under scrutiny often becomes enlightened self interest if viewed from the standpoint of those who gain by it. If a selfish motive were sufficient to condemn reorganization policies of interested parties, very few, if any, would pass muster.

The court recognized that conflicts are inevitable and that a mere disagreement over the proper course of action does not warrant disqualification. Nor did it denounce the practice of purchasing claims to block plan confirmation. “[T]here must be more evidence of an ulterior purpose than the mere fact that the controlling votes were acquired during the progress of the proceedings, without regard to their intrinsic value and for the purpose of defeating the plan.”

Courts today continue to make this same distinction between ulterior motives that justify designation and the merely self-interested reasons by which all creditors appraise a proposed plan. Thus, acting in a self-interested manner is not prohibited. In fact, if the ultimate goals of reorganization are to be accomplished, creditors must vote their self-interests. These are the distributional goals that, in theory at least, will further the ultimate goal of maximizing the value of the estate’s assets. What is antithetical to this value-maximization goal is for creditors to vote for a reason that is contrary to their distributional goals. An ulterior motive exists then when the creditor votes to further an interest unrelated to its interests as a creditor. An ulterior motive also exists when, although the creditor is voting to further its interest as a creditor, it does so to blackmail the plan proponent into giving it something further to which it is not entitled. The Supreme Court concluded that § 203 of the Bankruptcy Act was meant to disqualify the votes of creditors

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26 *In re Pine Hill Collieries Co.*, 46 F. Supp. 669, 671 (E.D. Pa. 1942) (“No decision has been brought to my attention, nor have I found any, dealing with ‘good faith’ in Section 203 of Chapter X [of the Bankruptcy Act, 11 U.S.C. § 603].”)

27 *id.*

28 *id.*

29 *id.*

"whose selfish purpose was to obstruct a fair and feasible reorganization in the hope that someone would pay them more than the ratable equivalent of their proportionate part of the bankrupt assets."\textsuperscript{31}

Discerning a creditor’s true motivation is necessarily a fact intensive inquiry.\textsuperscript{32} It is also a determination that must be arrived at carefully. In \textit{In re Adelphia Communications, Corp.}, the court stated that the “ability to vote on a reorganization plan is one of the most sacred entitlements that a creditor has in a chapter 11 case. And in my view, it should not be denied except for highly egregious conduct . . . .”\textsuperscript{33} On the other hand, § 1126(e) and its predecessor were enacted specifically to permit the court the flexibility to police the voting process.

While there are some areas in which courts need to expand their use of the designation power, they have not been hesitant to use it in the five areas outlined below. These five areas reveal some common threads. Voting must be based on an assessment of the viability of the debtor’s business or the value of its assets, uninfluenced by an outside economic interest that would benefit from the debtor’s lessened chances of a successful reorganization. In addition, voting must not be used as a means to extort something to which the creditor is not entitled or to undermine the important checks and balances built into the plan solicitation and approval process. In all of these situations, courts appear to be motivated by a desire to assure that the voting process aligns with chapter 11’s value-maximizing goal.

A. The Competitor: Motive to Destroy Debtor’s Business

Perhaps the most obvious form of an ulterior motive is the attempt to eliminate the debtor as a competitor. In \textit{In re McLeod Co., Inc.}, the court disqualified the “no” votes of a group of former employees.\textsuperscript{34} It held that their votes violated the good faith standard of § 1126(e) because they had been cast “for the ulterior purpose of destroying or injuring debtor in its business so that the interests of the competing business with which the named individuals were associated, could be furthered.”\textsuperscript{35} The objectives of the bankruptcy process do not include the liquidation of viable businesses.


\textsuperscript{32}For this reason, the standard of review applied on appeal is the clearly erroneous standard afforded to factual findings. Figter Ltd. v. Teachers Ins. & Annuity Ass’n of Am. (In re Figter Ltd.), 118 F.3d 635, 638 (9th Cir. 1997); Wells Fargo Bank, N.A. v. Loop 76, LLC (In re Loop 76, LLC), 465 B.R. 525, 544 (B.A.P. 9th Cir. 2012) (“In considering that standard of review, . . . we must afford the bankruptcy court great deference regarding the credibility of witnesses . . . .” (citing Retz v. Samson (In re Retz), 606 F.3d 1189, 1196 (9th Cir. 2010))).

\textsuperscript{33}In re Adelphia Comm’ns Corp., 359 B.R. 54, 56-57 (Bankr. S.D.N.Y. 2006).


\textsuperscript{35}Id. at 656.
The debtor in this case may or may not have been viable, but the bankruptcy court was unwilling to count the vote of claimants who had a demonstrable incentive to liquidate the debtor regardless of its viability. This form of ulterior motive is usually well known to the debtor and, thus, the debtor will have no difficulty in bringing it to the attention of the court.

B. THE BLACKMAILER: MOTIVE TO EXTORT BEYOND CREDITOR’S RIGHTS

Using votes or the threat of a negative vote to extract a greater share of the estate than is paid to other similarly situated creditors is another traditional basis for designation. The Supreme Court considered this ulterior motive indirectly in *Young v. Higbee*. Here, two preferred shareholders objected to the debtor’s plan, claiming that certain insider debts provided for in the plan should be subordinated. The bankruptcy court nevertheless confirmed the plan. After the two objecting shareholders appealed, the insiders then offered them a settlement, which the shareholders accepted, that paid them substantially more than the market price for their shares in order to get them to drop the appeal. Offended by this practice, the Supreme Court ordered the shareholders to turn over the profits they realized by “selling out” the entire class of preferred shareholders. The Court disapproved of this use of litigation tactics to extract additional consideration. In dicta, the Court mentioned that, had these shareholders cast their votes for such an improper purpose, their votes might be designated under the new statute. It explained the purpose of the pre-Code vote designation statute 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.” Bad faith was to be attributed to claimants who opposed a plan for a time until they were “bought off”; those who “refused to vote in favor of a plan unless . . . given some particular preferential advantage.”

In *In re Featherworks Corp.*, the court applied the Supreme Court’s dicta in *Young*. It designated the claim of a secured creditor who, upon receiving a payment from the debtor’s corporate parent, sought to change its “no” vote on the debtor’s plan to an acceptance. The court made clear that

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36*Young v. Higbee Co.*, 324 U.S. 204 (1945).
37*Id.* at 211 n.10 (quoting Hearings on Revision of the Bankruptcy Act before the Committee on the Judiciary of the House of Representatives, 75th Cong., 1st Sess. on H.R. 6439, Serial 9, pp. 180-82).
39*Id.* at 641.
the purpose of the prohibition against side payments is necessary to assure that the voting process accomplishes its economic objective:

The Code depends upon the self-interest of the creditors to act as a barrier against abuse of the bankruptcy laws. If a majority in number and amount of all creditors vote for a plan, there is good reason to believe that that plan is in the best interest of all creditors, since it would not receive such a vote otherwise. However, if any creditor receives some special consideration peculiar to him, his vote is no longer disinterested and unbiased and the Code’s built-in controls are neutralized.40

Side payments mask the informational value of the vote and interfere, not only with the distributional equity, but also with the value-maximizing function of the process. It is, therefore, easy to see why the courts would disqualify votes in such circumstances.41

C. THE INTIMIDATOR: UNFAIR DISCRIMINATION AND COERCION IN THE ACQUISITION OF CLAIMS

Another traditional basis for designating votes focuses on the process employed to acquire claims, rather than on the post-purchase behavior of the party who acquired the claims. When claims purchasing results in unfair discrimination between selling and non-selling creditors, courts have designated the purchased claims. One of the first cases to designate votes on this basis was In re P-R Holding Corp.42 The details of the facts in this case are sketchy, but it appears that two parties had proposed a plan of reorganization to acquire the debtor. The plan offered creditors a combination of cash and mostly new securities, representing payment of 50% of the face amount of the claims. When it did not appear that the plan had the necessary votes for approval, the referee extended voting for an extra day. The plan proponents went to work, primarily purchasing votes that had previously been cast against the plan. To purchase the claims, the plan proponents offered an all-cash payment of 50% of the face value of the claims. The SEC objected to

40Id. Two commentators have also noted that the court in Featherworks seemed to come very close to making a criminal referral on the basis of this conduct. Chaim J. Fortgang & Thomas M. Mayer, Trading Claims and Taking Control of Corporations in Chapter 11, 12 CARDOZO L. REV. 1, 99 (1990); Sally S. Neely, Claims Trading and Disqualification of Votes: Derivation, History, DBSD North America and Adelphia, in Chapter 11 Business Reorganizations, at n.3 (ALI-ABA Course of Study, April 28-29, 2011), available at Westlaw SS029 ALI-ABA 137.

41See Windsor on the River Assocs., Ltd. v. Balcor Real Estate Fin., Inc. (In re Windsor on the River Assocs., Ltd.), 7 F.3d 127, 132 (8th Cir. 1993) (stating that one of the primary functions of bankruptcy law is “to discourage ‘side dealing’ between the shareholders of a corporation and some creditors to the detriment of other creditors”).

42In re P-R Holding Corp., 147 F.2d 895 (2d Cir. 1945).
this practice because it left the non-selling creditors with less favorable terms under the plan since they would receive a combination of cash and securities, rather than the all-cash payment given to the selling creditors.

The Second Circuit was careful to first note that it was not bad faith per se to acquire claims or even to do so for the purpose of buying the necessary votes to control the confirmation process. Nor did it erect an outright prohibition on the use of claims purchasing to gain the ability to acquire the debtor, although it acknowledged that this acquisition motivation “may amount to ‘bad faith.’”\(^4\) Although the case may be read to condemn the creditors’ motive to acquire the business, in fact, the court was far more concerned with the discriminatory nature of the purchases.\(^4\)

Discrimination in the treatment of similar claims is a concern because it may have a coercive effect on creditors. Coercion arises because the creditors are caught in a bind, not knowing whether to accept the offer in hand or to take their chances with a plan. Like the classic two-tiered tender offers of the 1980s,\(^4\) claims purchases that do not promise all creditors in a class equal treatment may leave the creditors, facing the prospect of an uncertain payout under a plan of reorganization, with little choice but to sell their claims to the claim buyer.\(^4\) Not only does this hurt the creditors, but it also has the potential to interfere with the value-maximizing function of bankruptcy voting. First, the claims purchaser acquires a blocking vote for less because it creates a buying and selling frenzy. Having acquired a controlling voice, the claim buyer may propose a plan that offers less for the debtor’s assets than others might offer in a truly competitive environment.

The acquisition-based motive and the coercive nature of the plan proponents’ actions in P.R. Holding caused the Second Circuit to affirm the designation of the purchasers’ votes. But interestingly, it rejected the SEC’s request to “preserve the integrity of the reorganization process” by reversing the confirmation order.\(^4\) Instead, the claim buyers agreed not to take any compensation for those claims, to distribute the cash that would have been

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4Id. at 897.

4Having found that the claim buyers were acting in bad faith, the court considered two further questions. The first question addressed by the opinion is whether the “yes” votes should merely be disqualified; or, instead, counted as “no” votes. If the court counted the votes in accordance with the pre-purchase “no” votes by the selling creditors, the plan could not be confirmed. Simply disqualifying the votes would result in the approval of the plan by the requisite claimholders. The court did not convert the votes, stating that that action would allow parties who no longer held an interest in the plan to control its acceptance and would disregard the affirmative votes of the remaining creditors. Id. at 898.

4See Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 956 (Del. 1985) (describing the coercive effect of such an offer).


47In re P-R Holding Corp., 147 F.2d at 899.
paid on those claims to the other creditors, and to reduce a mortgage obliga-
tion. The court noted that this new offer by the proponents was the best
available and made the plan even more attractive. By allowing the confirm-
ination order to stand, securing the plan proponents' added value, and counting
only the remaining votes to satisfy the supermajority requirement, the court
demonstrated that the underlying goal in this area is to achieve the greatest
return for the creditors by maximizing the value of the business assets.

D. THE CHEATER: CIRCUMVENTING THE PLAN PROCESS

The chapter 11 confirmation process provides important limitations on
the behavior of plan proponents, which limitations are designed to assure that
creditor votes accurately reflect creditors' informed judgments and are unin-
fluenced by strategic behavior or misinformation. Notably, § 1125(b) prohib-
its the solicitation of acceptances or rejections of a plan prior to the
dissemination of a disclosure statement containing “adequate information.”
In addition, bankruptcy courts are authorized to fix a time period for vot-
ing, and retain discretion regarding the debtor’s exclusivity period, and
the scheduling of hearings on competing plans. These provisions provide
the court with substantial control over the plan process—control that may be
necessary to assure a full consideration of alternative plans. Interference with
that control, therefore, may provide grounds for a finding of bad faith suffi-
cient to justify disqualifying a creditor's vote.

In re Allegheny International Inc. is perhaps the most famous example of a
court using its designation powers to counter a would-be acquirer's efforts to
circumvent the confirmation process. In that case, Japonica Partners, the
potential acquirer, bought a small amount of subordinated debentures imme-
diately prior to the debtor's filing of a plan and disclosure statement. Relying
on its newly-acquired creditor status, Japonica filed a plan just before the
conclusion of the disclosure statement hearings on the debtor's plan. Japon-

4811 U.S.C. § 1125(b) (2006). Section 1125(a)(1) imposes a contextual test for adequacy, stating that
the information must be of a kind and detail that is “reasonably practicable in light of the nature and
history of the debtor and the condition of the debtor's books and records” and requires information that
would “enable such a hypothetical investor ... to make an informed judgment about the plan.” 11 U.S.C.
§ 1125(a)(1).
5011 U.S.C. § 1121(d) (permitting the court, for cause, to extend or limit debtor exclusivity).
51See Colo. Mountain Express, Inc. v. Aspen Limousine Serv., Inc. (In re Aspen Limousine Serv., Inc.),
193 B.R. 325, 332-33 (D. Colo. 1996) (permitting voting on the debtor's plan prior to consideration of
competing plan, notwithstanding the expiration of the exclusivity period in a small business case.); see also
Bankr. P. 3016 and noting that the change “does not affect the court's discretion with respect to the
scheduling of hearings on the approval of disclosure statements when more than one plan has been filed.”).
53Id. at 286.
ica envisioned a distribution of both plans and a joint ballot. The court set separate schedules for confirmation, but promised that it would give creditors an opportunity to vote on the Japonica plan before entering any confirmation order.54

Unsatisfied with competing on this basis, Japonica immediately began purchasing claims in a strategy to win confirmation of its plan. The strategy, which the court described as "chutzpah with a vengeance," involved the purchase of a blocking position in secured claims held by bank lenders.55 Japonica acquired 33.87% of the claims for a price of up to 95% of face amount.56 This purchase effectively gave Japonica a veto over any consensual plan of reorganization—a status that the court found sufficient to justify designating Japonica's vote.

The Allegheny court also recognized the general rule that a creditor may purchase claims for the purpose of influencing the vote on a plan, but where the creditor does so "in aid of an interest other than an interest as a creditor, such purchases may amount to 'bad faith'"57 The court found Japonica's purpose was to take over the debtor and to control the reorganization progress. But it was not simply Japonica's desire for control that led the court to designate the votes. Japonica launched a public tender offer for the debtor's subordinated debentures before the court approved Japonica's disclosure statement, a move that the court characterized as an "end run" around the bankruptcy process.58 In addition, as a plan proponent, Japonica had sought and received inside information to enable it to fashion its plan and disclosure statement. Although Japonica was entitled to that information, the court concluded that Japonica "exploited its special access to information, personnel and the premises of the debtor to attempt to assert its influence and control."59 Overall, the court found, "a pervasive pattern of bad faith designed to control the debtor and manipulate the bankruptcy process."60

Allegheny stands for the principle that claims buyers who seek control must work within the statutory plan confirmation process. This principle is consistent with the goals underlying bankruptcy voting. Although the value-maximizing goals of chapter 11 might be advanced by the presence of competing bidders under competing plans, the process cannot become a free-for-all. The role of the court is to set out an orderly process for creditor consideration and to maintain control over it.

54Id.
55Id. at 297.
56Id. at 287.
57Id. at 289 (quoting In re P-R Holding, 147 F.2d 895, 897 (2d Cir. 1945)).
58Id. at 295.
59Id. at 298.
60Id. at 299.
E. THE CONSPIRATOR: CONFLICTING THIRD PARTY AGREEMENTS

The final traditional basis for designation arises when a creditor is voting its claims to further an economic interest set forth in an agreement with a third party that is contrary to its interests as a creditor. A classic example of this situation is illustrated by In re Dune Deck Owners Corp. There, the secured creditor, KHD, purchased a sufficient number of unsecured claims to allow it to block the debtor's plan. Finding nothing amiss in the acquisition of the claims, the court nevertheless ordered an evidentiary hearing to inquire further into this creditor's motivation. The record contained "evidence that the creditor has voted without regard to the treatment of its claim, but instead, to achieve some benefit or goal inconsistent with interests of the estate and its creditors, [and, therefore,] the Court must inquire into those motives in order to preserve the integrity of the chapter 11 process." 62

In Dune Deck, the debtor owned an apartment building, turned co-operative, and held a long term lease of the land on which the building sat. The sponsor of the debtor's conversion to a co-operative owned other contiguous, but separately incorporated, co-operatives. Together these properties comprised a resort. In marketing the debtor's units, the sponsor touted the unit owner's ability to enjoy the common areas of the resort, including a bath and tennis club and the marina. It recorded a Declaration of Covenants, Restrictions, Easements, Charges and Liens (the "Declaration"), granting reciprocal rights to the various properties to enjoy these common areas.

The bank that had been the debtor's original lender sold its secured position to another entity. That entity, in turn, assigned its rights to KHD. The latter assignment was subject to a side agreement that provided an incentive for KHD to foreclose on the property and terminate the Declarations. Although not fully disclosed in this decision, it appears that KHD and/or its predecessor held other interests in the resort that might benefit from the termination of the Declaration through such a foreclosure. The court surmised that the debtor's property would suffer a corresponding decrease in value if it were to lose the rights granted in the Declaration. The court found KHD's side agreement required an evidentiary hearing as to whether KHD's opposition to the plan was motivated by its business judgment that it would realize more on its secured claim through foreclosure, or whether it was motivated by an economic interest in its agreement with its assignor, involving the termination of the Declaration. If it were the latter, the court forecasted that it would designate the creditor's votes.

In re Landing Associates, Ltd. presented a closer call. 63 As part of its

62 Id. at 845.
purchase of the debtor's loan from the Federal Savings and Loan Insurance Corporation ("FSLIC"), Bank United entered into an Assistance Agreement with FSLIC. It provided financial incentives to the bank for managing the various assets covered by the agreement, including the debtor's apartment building. Under this agreement, Bank United was entitled to receive guaranteed yield payments if it incurred losses on any non-performing asset that it continued to manage. On the other hand, if it liquidated the asset for more than its adjusted book value, Bank United would be allowed to keep ten percent of the profit, free of any tax consequences. These incentives, however, were only available to it until December 31, 1995. The debtor had proposed a ten-year plan, with a large balloon payment due in 2003 at the earliest. Thus, the Assistance Agreement created an immediate incentive for Bank United to reject any reorganization plan in favor of foreclosure.

The court acknowledged that this side agreement had motivated the bank to reject the plan. On the other hand, it found the agreement's effect to be little different than the motivation of many secured creditors who vote to resist reorganization based on a "return on investment" concern that motivates them to favor immediate liquidation in lieu of reorganization, so that the investor's money tied up in the loan can be reinvested at more favorable rates."64 Perhaps more importantly, the court was hesitant because "then the same charge could be leveled at the RTC and the FDIC in their administration of the assets of failed institutions—a result this court, with some misgivings, nonetheless shrinks from."65 Consequently, the court found this case presented "an admixture of creditor-related and non-creditor-related motives."66 Based on the fact that the creditor could articulate several creditor-related reasons for its vote against the plan, the court did not designate the vote.67

Both Landing Associates and Dune Deck involved third party agreements which gave the creditor a financial incentive to vote against reorganization, regardless of the terms proposed in the plan. While it is possible to distinguish the contrary results in these cases, as discussed in the next part, there exists a good argument that Landing Associates was wrongly decided.

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64Id. at 807.
65Id. at 809 (emphasis in original).
66Id. at 808.
67Although the court did not designate Bank United's vote, it took great pains to issue several stern lectures to the creditor regarding its extremely litigious behavior in this case, which it attributed to the fee reimbursement provisions of the Assistance Agreement, drafted by the FSLIC. Id. at 808-09; see also Fleming, infra note 75 at, 206-08 (discussing of this aspect of Landing Assoc.).
III. EXPANDING AND CONTRACTING THE USE OF DESIGNATION POWERS

There are four areas in which the designation power should be either expanded or contracted to more closely align voting with chapter 11’s value-maximization goal. The first is a continuation of the discussion immediately above regarding the need to expand its use to cover outside influences contained in third party agreements that motivate a creditor to vote against any plan of the debtor. The second involves the use of voting as a tactic to benefit the creditor in significant litigation with the debtor or a trustee. In this area, courts generally have not been willing to exercise their designation power, but this reluctance should be revisited. Third, on a case-specific basis, courts should consider expanding the use of this power to prevent creditors from voting their interests in one class only to benefit their interests in another class of claims. Finally, the power should not be used, as it currently is, to prevent would-be acquirers from voting against the debtor’s plan and in favor of their own competing plan to purchase the debtor’s assets. The estate may benefit greatly from this form of competitive bidding for the assets.

A. THE GAMBLER: SWAPS AND OTHER DERIVATIVE AGREEMENTS

In Part II, this article discussed the mixed reaction of the courts in Dune Deck and Landing Associates toward third party agreements that give a creditor an economic incentive to reject any plan filed by the debtor. In Dune Deck, the court set an evidentiary hearing to determine whether the agreement between the debtor’s primary secured lender and its assignor obligated it to follow a pre-arranged course of action designed to force the elimination of restrictive covenants that benefitted the debtor’s property, but burdened the lender’s other property. If so, then its vote was based on its interest as an adjacent property owner, not as a creditor. In Landing Associates, the creditor voted to block the plan so that it could obtain relief to foreclose. If successful, under its agreement with FSLIC, it had the potential to realize tax-free profits on the property’s resale, but only if it could foreclose before the FSLIC agreement expired.

It is possible to distinguish these two cases. The Dune Deck creditor may have voted its interest as an adjacent property owner, while the Landing Associates creditor was trying to maximize its recovery as a lender. But in both cases, a separate agreement had shifted the creditor’s decision away from a consideration of the viability of the debtor’s business and the value of its assets toward another financial incentive set forth in a third party agreement.

58 See supra Part II.E.
Although the Landing Associates court was correct in noting that the creditor had a legitimate interest in maximizing its recovery on the loan, the recovery would come not from maximizing the value of the estate, but instead from the FSLIC interest. When an outside interest skews voting away from a decision based on the best possible recovery from the estate and its assets, then the vote is no longer serving the value-maximization policy of chapter 11. Thus courts should require that the creditor’s vote be based on an assessment of the viability of the debtor’s business and/or the value of the debtor’s assets, uninfluenced by an outside economic interest that would benefit from outcomes that do not maximize the value of the assets. The need to adopt this view is especially important today in this era of distressed-debt investing and the proliferation of derivative agreements. These new practices, discussed below, have given many creditors undisclosed economic incentives to vote their claims in pursuit of the debtor’s demise.

1. A Brief Primer on Equity and Credit Derivatives

An increasing body of corporate law scholarship has examined the potential that derivatives, short sales and other financial instruments commonly employed today may skew the incentives of individual shareholders away from the interests of the group. Similar arrangements exist in the credit world. These types of instruments may decouple the holder’s voting rights from its true economic interests. Before discussing the need to designate votes cast by creditors holding such instruments, it is important for the uninitiated to understand the nature of these relationships.

A shareholder who has hedged the economic risk of its investment may hold voting power greater than its economic exposure, a phenomenon known as “empty voting.” For example, a shareholder may hold both “long” and “short” positions in a security. The long position involves securities purchased with the expectation that the security will increase in value. In a short position, an investor borrows stock from a broker and sells that stock on the open market. Eventually, the investor must return the borrowed security to the broker by buying it back on the open market. If the stock has fallen in price, as the investor anticipated, then the investor may buy it back on the market for less than the amount received in the earlier sale, thereby generating a profit. When the investor holds both long and short positions, it has hedged its investment, should the value of the security rise or fall. At any point in time, if the investor has sold short the same number of shares as

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71 See, e.g., Hu & Black, supra note 7, at 640-43 (discussing decoupling of voting power and economic risk through the use of equity derivatives); Marcel Kahan & Edward B. Rock, Hedge Funds In Corporate Governance and Corporate Control, 155 U. Pa. L. Rev. 1021, 1075-77 (2007) (discussing conflicts of interest caused by hedging strategies).

72 Hu & Black, supra note 7, at 638 (“We refer to anyone who has substantially greater voting than economic ownership as an ‘empty voter.’”).
the shareholder owns, it would have voting power on the shares owned outright; but, because of the short position, the shareholder would hold no economic interest in the corporation. An increase in the value of the corporation, and thus in the share price, would benefit the shareholder’s long position, but that gain would be offset by an equal loss in the shareholder’s short position.73

In an extreme case, a shareholder holding a “net-short position” would benefit from actions that reduce the value of the shares that the shareholder is voting. A net-short position is one in which the shareholder’s short position is greater than his or her long position. Assume that a shareholder has sold twice as many shares short as that shareholder owns. That shareholder would benefit from a decrease in the value of those shares twice as much as the shareholder would lose on the shares owned outright. Thus, the shareholder would have an incentive to vote in ways that would cause the corporation to lose money.74

Creditors can also wind up with incentives that do not match those that are held by other creditors. Credit default and total return swaps are instruments in which a third party agrees to make payments to compensate the buyer of the swap for losses caused by credit events or the deterioration of the value of the credit instruments. In a credit default swap, one party, the “protection buyer,” pays a fee to a “protection seller” in exchange for the protection seller’s agreement to make payments when the entity issuing the underlying credit instrument defaults, files a bankruptcy, or restructures its debts (the swap agreement normally defines the type of events that constitute “credit events”). The payment, or “settlement,” often takes the form of a cash payment equal to the difference between the market value of the debt instrument post-credit event, and some fixed “notional value” defined in the swap agreement.75 The “notional value” could be the principal amount of the debt, the market value at the time the swap is created, or it could be some other value determined by the parties—it is simply the benchmark value below which the protection buyer has purchased its protection.

Assume, for example, a creditor has purchased a credit default swap on a bond with a notional value of $1,000. If the debtor’s default causes the market value of the bond to decline to $500, the protection seller will make a

75See Patrick D. Fleming, Credit Derivatives Can Create a Financial Incentive for Creditors to Destroy a Chapter 11 Debtor: Section 1126(e) and Section 105(a) Provide a Solution, 17 AM. BANKR. INST. L. REV. 189, 193-94 (2009).
payment of $500 to the protection buyer. In this way credit default swaps act as insurance against losses caused by defined credit events.

A total return swap works roughly the same way, but does not rely on a credit event. In a total return swap, the parties make periodic payments based on the difference between the market price of the debt and the swap's notional value. When the market value is below the notional amount, the protection seller makes a payment to the protection buyer, and when the market value is higher, the protection buyer makes a payment to the protection seller. For example, if the holder of a bond with a market value of $1,000 enters into a $1,000 notional value total return swap as a protection buyer, that holder has completely eliminated his economic risk of holding the bond. If the value declines, the bondholder receives payments equal to the amount of the decline. If the value increases, the bondholder will make payments equal to the increase.

Thus, these instruments, like equity derivatives, also create a potential for empty voting. The owner of the bond is permitted to vote under the indenture, or in a bankruptcy case, despite the fact that it no longer holds an equivalent economic interest. Even worse, the fact that derivatives can be purchased in amounts exceeding the actual amount of debt holdings creates the possibility that voting creditors may hold a net-short position. For example, assume a creditor holding 10,000 bonds each with a value of $1,000 has purchased protection in the form of a total return on 20,000 bonds each with a notional value of $1,000. Assuming that the company liquidates and suffers a severe decline in market value, the losses on the protection buyer's long position (its $10 million claim) would be offset by payment on the swap by a 2:1 margin. This creditor is "net short" by $10 million, and yet has the power to vote its $10 million claim. Such creditors would benefit on the derivatives more by a failure of the corporation and loss on the debt than they would lose on their credit claim and, thus, have an incentive to vote for value minimizing actions—such as the liquidation of a viable company.

2. Expanding the Use of the Designation Power and Bankruptcy Rule 2019 to Address Net Short Positions

No cases have directly addressed the problem of creditors voting claims where they hold a net short position. One bankruptcy judge, however, has made clear in dicta that he would designate the claims of such creditors. In In re DBSD, the court described an earlier case it had presided over, In re Adelphia Communications, in which a designation motion had been filed against two distressed debt investors holding net short positions. The mo-
tion was later withdrawn when it became clear that those investors’ votes would not have mattered, but Judge Gerber in DBSD wrote of that earlier case:

If the motion had not been withdrawn, and if the evidence the Court heard was not refuted, the Court would have designated their votes in a heartbeat. Profiting from another constituency’s pain or from losses to everybody from delay in the case would be a classic example of an unprotected ulterior motive.  

Commentators agree with Judge Gerber’s sentiments.

The likely reason courts have not yet addressed the conflicts created by derivatives and similar financial instruments is because it is not easy to know when a creditor holds one of these instruments. Recently amended Bankruptcy Rule 2019 now imposes limited disclosure requirements aimed at these types of arrangements. In general, this rule requires every group or ad hoc committee that represents multiple creditors or equity security holders in a chapter 9 or 11 case to file verified statements as to every “disclosable economic interest” held by the group. These interests include “any claim, interest, pledge, lien, option, participation, derivative instrument, or any other right or derivative right granting the holder an economic interest that is affected by the value, acquisition, or disposition of a claim or interest.” Failure to comply may result in a loss of standing to “be heard or to intervene in the case.” It also may cause the court to “hold invalid any authority, acceptance, rejection, or objection given, procured, or received by the entity,

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78Id. at 142 n.44.

79See Fleming, supra note 75, at 208-09 (“A court would likely not hesitate to find that a creditor is not advancing an interest as a creditor qua creditor when his vote is motivated by an interest in a third party contract, such as a [credit default swap] or a [total return swap], that results in a desire to destroy value in his claim.”); Daniel J. Bussel & Kenneth N. Klee, Recalibrating Consent in Bankruptcy, 83 AM. BANKR. L.J. 653, 734 (2009) (suggesting the need for more disclosure and a more aggressive use of § 1126(e) as a response to the problems posed by credit derivatives); Samuel M. Kidder, Comment, What’s Your Position? Amending the Bankruptcy Disclosure Rules to Keep Pace with Financial Innovation, 58 UCLA L. REV. 803, 840 (2011) (“Judge Gerber’s opinion in In re DBSD] would seem to lend strong support to courts seeking to designate the votes of empty and net short creditors who vote against the best interests of the estate for the purpose of profiting on their short positions.”); see also, Hu & Black, supra note 7, at 734 (“Voting in bankruptcy, in proportion to principal amount of debt held, rests on the same logic as a one-share-one-vote regime on the equity side—that control rights should be held by those with an incentive to increase the value of the firm, or at least the value of the asset class that is held. Large-scale, hidden debt decoupling weakens our ability to rely on these assumptions.”); Douglas G. Baird & Robert K. Rasmussen, Antisignbankruptcy, 119 YALE L.J. 648, 651 (2010) (noting that “failure of the business can mean large returns to some creditors.”).

80Fed. R. BANKR. P. 2019(a)(1). The rule was recently amended effective December 1, 2011 to clearly include ad hoc committees.

group, or committee." The rule's reference to acceptances and rejections no doubt refers to votes cast on a plan of reorganization.

This rule is inadequate for several reasons. First, it only applies to groups, not individual creditors. Second, it only applies when the group "represents" multiple creditors or security holders. "[R]epresents' means to take a position before the court or to solicit votes regarding the confirmation of a plan on behalf of another." Thus, the rule does not apply to an individual creditor, who acts alone, does not solicit other votes, and does not object to confirmation. It does not apply even though this individual creditor may hold a conflicting interest, such as a derivative agreement, and may be in a position to control the vote of the class in which it holds claims. Thus, the rule is not sufficiently inclusive.

Nor are the sanctions for non-compliance sufficient. Assume that a group holds a swap agreement, fails to disclose it, votes and solicits other votes to reject the plan, and objects to confirmation. Assuming the debtor somehow discovers the swaps held by the group and brings the non-disclosure to the court's attention, the court may then overrule the confirmation objection and disqualify the votes. This leaves the group no worse off than it would have been if it had made the disclosure. As a result, it has every incentive to try to get away with non-disclosure, hoping the debtor will not discover its conflicting interests. While the rule also contains a catch-all provision allowing the court to "grant other appropriate relief," it is unclear whether a court will interpret that authority so broadly as to allow monetary sanctions, including punitive damages, or to otherwise affect the substantive property interests of these parties. This is particularly true because the examples of sanctions set forth in the rule are merely aimed at limiting the group's voice in the bankruptcy proceedings.

Consequently, the pernicious effect of swap agreements and similar financial incentives may go largely unchecked by Rule 2019 in its current form. Nevertheless, the amendments to the rule are a step in the right direction. They represent a Congressional acknowledgement of the corrupting influence of these outside interests. But both the rule's scope of coverage and its sanctions for non-compliance should be expanded. And when these conflicts

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come to light, courts should not hesitate to designate votes cast by the conflicted creditor.

B. THE LITIGATOR: MOTIVE TO ADVANCE LITIGATION STRATEGY

Debtors have also requested the designation of creditor votes believed to have been cast for an ulterior motive related to ongoing litigation between the debtor and the creditor, but without much success. These requests have arisen in two very different kinds of contexts, described below. Regardless of the context, a majority of courts have refused to disqualify votes on this basis. The minority view, however, has recognized that in some cases creditors may be casting their votes based, not on their status as creditors, but as part of a litigation strategy. Using bankruptcy votes as a chess move in litigation not only violates the purpose of bankruptcy voting, but it may also have a direct effect on value maximization, when the litigation claim is itself one of the estate's valuable assets. Thus, this is an area in which some courts need to reexamine their reluctance to designate votes.

In In re Federal Support Co., the Fourth Circuit held that the mere fact of litigation between the debtor and the creditor was not sufficient to support an inference of a lack of good faith. Several of the debtor's employees formed a competing business and took with them the debtor's only customer, the U.S. Navy, leaving the debtor without means of generating revenue. In its chapter 11 case, the debtor's only assets were litigation claims against the competing business and one of the creditors. The estate had no funds to pursue the litigation, but several of its officers offered to fund the litigation if the plan was confirmed. The creditor who was a target of litigation voted to reject the plan. The debtor argued that the creditor's vote should be designated because it had voted its claim based on its desire to avoid litigation rather than to maximize its recovery on its claim. If the plan was not confirmed, and the case converted to a chapter 7 proceeding, the debtor claimed that it was very unlikely the trustee would pursue the litigation because the estate had no resources to do so. The Fourth Circuit rejected these concerns, stating that if the litigation had merit, a trustee would find a way to pursue it and that the defendant/creditor was merely voting its own self interests. Other courts have adopted similar reasoning.

Debtors have also raised litigation as a basis for vote designation in a very different context. In In re Kovalchick, the debtor sought to disallow the votes

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88 E.g., In re Landau Boat Co., 8 B.R. 432, 436 (Bankr. W.D. Mo. 1981) (holding, in a similar situation, that there was "no evidence to suggest that the trustee would be less vigorous in pursuing it than would debtor's counsel," and therefore no grounds to designate the defendant's claim.); In re Lloyd McKee Motors, Inc., 157 B.R. 487, 489 (Bankr. D.N.M. 1993) (holding that litigation motive was "entirely speculative," but, in any event, the creditor was entitled to pursue its own self-interests).
of a creditor based on the creditor's litigiousness in the bankruptcy case.\textsuperscript{89} Here, the creditor wanted only to foreclose on its collateral and put up every roadblock it possibly could to the debtor's reorganization efforts, including excessive criticism of the disclosure statement, motions to dismiss, and inconsistent positions in various contested matters.\textsuperscript{90} The court refused to designate the claims, stating:

Courts have also held that the presence of any of the following circumstances does not necessarily equate with bad faith: (1) pending litigation between the claimant and the debtor; (2) past attempts by claimant to have the debtor's bankruptcy case dismissed; (3) refusal to cooperate with debtor's reorganization efforts; and (4) excessive and expensive litigation with the debtor.\textsuperscript{91}

The courts should recognize a fundamental distinction between the facts of \textit{Kovalchick} and \textit{Federal Support Co}. In \textit{Kovalchick}, the creditor was pursuing its own agenda in order to maximize the recovery on its claim, however self-interested and obnoxious its actions may have been. There are other sanctions available to deter litigious behavior besides designating a creditor's vote. In \textit{Federal Support}, the creditor was likely casting its vote to avoid the expense and risk of significant litigation. This is not significantly different than a creditor voting to destroy a competing business or to benefit an adjoining property. It is a vote cast to achieve an economic interest unrelated to the distributional outcome of the case. The court may have been naïve to think that the creditor in \textit{Federal Support} did not achieve a tactical advantage in blocking the plan. The insiders of the debtor who understood the claims and were willing to fund the litigation were unlikely to do so with a bankruptcy trustee in control of the claims. Thus, the court's refusal to designate the creditor's vote likely had a direct impact on value maximization.

There are some courts that have recognized the need to police the use of voting as a litigation defense. In \textit{In re Combustion Engineering, Inc.}, the Third Circuit remanded the case for a consideration of, among other things, whether the votes of certain asbestos claimants had been procured in good faith.\textsuperscript{92} The debtor in this case entered into a prepetition settlement with claimants who held existing, as opposed to future, asbestos claims. The debtor transferred $400 million into a trust that provided for varying percentages of payment, based on the length of time that the claim had been pending. For example, claimants who had already filed suit and settled, were

\textsuperscript{89}In \textit{re Kovalchick}, 175 B.R. 863, 875 (Bankr. E.D. Pa. 1994).
\textsuperscript{90}Id.
\textsuperscript{91}Id.
\textsuperscript{92}In \textit{re Combustion Eng'g, Inc.}, 391 F.3d 190, 247 (3d Cir. 2004).
to receive 95% of their claims and those claimants who had not yet filed suit received a lesser percentage. The unpaid portion of each claim was treated as a “stub claim,” which the claimant would use to vote in favor of the plan, as it was always anticipated that the debtor would file chapter 11. The settlement trust for the existing claimants was established and funded eighty-seven days before the bankruptcy filing. In its plan, the debtor offered to establish a separate trust for the future claimants, but they were to receive payment of only approximately 28% of their claims. The Third Circuit analyzed at length the potential preference liability that the existing claimants faced. It noted that, although the plan was later modified, at the time the existing claimants cast their votes, the plan provided these claimants with a release of liability against any future avoidance actions. On remand, the bankruptcy court was to consider whether the existing claimants had voted their stub claims based on an ulterior motive. Not only was the discriminatory treatment an issue, but these claimants may have voted their claims to avoid preference liability. Thus, this court recognized that a desire to avoid litigation claims may itself be an “ulterior motive.”

Similarly, in Zentek GBV Fund IV v. Vesper, an insider of the debtor faced potential fraudulent conveyance liability.93 He formed a family trust and had the trust purchase claims against the debtor to block any plan that would allow the chapter 11 trustee to sue him to recover fraudulent conveyances. The bankruptcy court designated the votes cast on behalf of his family trust. On appeal, the Sixth Circuit upheld the designation. Even though the proxy for voting had changed hands from the insider to others at the time of voting, the court recognized that “[c]ourts have not limited their inquiries to only the moment of voting but have also examined the motivation underlying the purchasing of claims.”94

C. THE BETRAYER: VOTING IN ONE CLASS TO BENEFIT AN INTEREST IN ANOTHER CLASS

As the case law demonstrates, the power to designate votes is intended to ensure that a creditor is voting on the basis of its interest as a creditor, not to benefit some other economic interest, such as an interest in a competing business, an adjoining property, or separate contract. But does this mean that the creditor who holds claims in more than one class, or who has claims against multiple debtors, must cast its vote in each class based only on its interests in that particular class? For example, may a secured creditor vote its unsecured claims (whether it is a deficiency claim or claims it has pur-
chased for this purpose) to reject the plan in order to further its interests as a secured creditor who wants to foreclose? Is such a vote cast in good faith?

It is not uncommon in single asset real estate cases for the secured party to purchase all or a controlling portion of unsecured claims in an effort to block reorganization. In re Figter Ltd. illustrates this dynamic well. There, the secured creditor, Teachers Insurance and Annuity Association ("Teachers"), objected to the debtor’s plan that would convert its residential apartment complex into condominiums and require Teachers to grant a partial release of its lien with each sale of an individual unit. To block the plan, Teachers purchased more than half of the unsecured claims at full face value. This purchase gave Teachers the power to block the plan by eliminating the one impaired class of dissenting creditors required for confirmation. Teachers' purchase cost it a mere $14,588.62 and, for that amount, it was able to protect its secured claim of almost $18 million. Of course it voted its unsecured claims to further its secured creditor agenda, but the court viewed § 1126(e)'s requirement broadly. It found Teachers had been motivated by its self interest in receiving "[its] fair share of the debtor's estate" and that Teachers "acted to protect its interests as Figter's major creditor." It did not distinguish between its interests as a member of a particular class as opposed to its interests held as a creditor generally.

In re Adelphia Communications Corp. presents the classic case of conflicts that arise between the creditors holding claims, not only in separate classes, but also against separate but related debtors. Adelphia is typical of the large, multi-debtor bankruptcy cases that have captured the imagination

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95 Single asset real estate cases are those in which the debtor owns "real property constituting a single property or project, other than residential real property with fewer than 4 residential units, which generates substantially all of the gross income of a debtor who is not a family farmer and on which no substantial business is being conducted by a debtor other than the business of operating the real property and activities incidental thereto." 11 U.S.C. § 101(51B) (2006). These cases are considered somewhat unique in that there are few creditors involved other than a secured creditor and some believe that the general goals of reorganization do not apply to such cases. See generally, Kenneth N. Klee, One Size Fits Some Single Asset Real Estate Bankruptcy Cases, 87 CORNELL L. REV. 1285, 1296-1301 (2002) (providing arguments for and against the application of general bankruptcy principles to single asset real estate cases).


97 Figter Ltd. v. Teachers Ins. & Annuity Ass'n of Am. (In re Figter Ltd.), 118 F.3d 635 (9th Cir. 1997).

98 See supra note 19-20 and accompanying text for a discussion of this confirmation requirement.

99 In re Figter Ltd., 118 F.3d at 637.

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

101 Id. at 640.

and attention of many bankruptcy commentators—and of distressed debt investors. One of the significant issues in the case arose out of disputes between related companies—disputes that the proposed plan of reorganization settled. But the creditors of one debtor, referred to as ACC, believed that the settlement favored the creditors of another subsidiary, Arahova. The litigation that ensued was fierce.

Bondholders who held claims only against ACC sought to designate the votes of bondholders who held claims against both ACC and Arahova (the “Targeted Creditors”), claiming the Targeted Creditors had extracted special benefits as a result of their “overly aggressive and overreaching” conduct and their “scorched earth litigation strategy.” The court acknowledged the litigious actions of the Targeted Creditors, but was unwilling to designate their votes on this basis. The ACC bondholders then pointed out the conflict of interest held by the Targeted Creditors. “[T]he Targeted Creditor votes in favor of the Plan in the ACC Senior Notes Class were driven by an ulterior motive—a desire to get a maximized recovery in another class, of another Debtor, under the Plan (that of the class of Arahova notes).” The court rejected this basis for designation as well. “Inter-company debts and liabilities, which enhance recoveries of some creditors and dilute recoveries of others, are inherent in any multi-debtor bankruptcy.” The court concluded that “I do not believe that holding (or acquiring) claims of different debtors in the same chapter 11 case fairly can be regarded as representing the kind of ulterior motive or ‘bad faith’ that has heretofore been held to warrant vote designation.”

Both of these cases illustrate the need for courts (or Congress) to consider whether voting need only be based on some creditor interest, or whether a creditor must vote its interests in a particular class based on the economic interest it holds in that class. At present, courts have not really grappled with this issue. There is an underlying assumption that designation should be reserved for especially egregious conduct. The court in Adelphia stated:

103See In re Adelphia Commc’ns Corp., 336 B.R. 610, 622-23 (Bankr. S.D.N.Y. 2006) (opinion on appointment of a trustee and termination of exclusivity) (“[D]istressed debt traders and other investors in claims have been a major presence in these cases, and since the filing of these cases in 2002, there was a substantial turnover in the membership of the Creditors’ Committee.”), aff’d, 342 B.R. 122 (S.D.N.Y. 2006).

104In re Adelphia Commc’ns Corp., 359 B.R. at 57. The inter-debtor dispute also formed the core of an earlier dispute over the appointment of a trustee and the termination of the debtor’s exclusive right to propose a plan of reorganization. See In re Adelphia Commc’ns Corp., 336 B.R. at 617.

105In re Adelphia Commc’ns Corp., 359 B.R. at 62.

106Id. at 58 (citing In re Adelphia Commc’ns Corp., 336 B.R. at 618-19).

107Id. at 63.

108Id. at 64.

109Id.
The ability to vote on a reorganization plan is one of the most sacred entitlements that a creditor has in a chapter 11 case. And in my view, it should not be denied except for highly egregious conduct—principally, seeking to advance interests apart from recovery under the Plan, or seeking to extract plan treatment that is not available for others in the same class.\textsuperscript{110}

This sentiment is no doubt engendered by the Code’s use of the phrase “in good faith” and pre-Code case law’s reference to “ulterior motives.” These phrases conjure notions of nefarious conduct. If, however, the underlying purpose behind the designation power is to count only the votes of creditors who are voting based on their assessment of the viability of the debtor’s business and whether the plan will achieve the best possible distribution on their claim, thereby maximizing the value of the debtor’s assets, then courts must be willing to look beyond this narrow use of the designation power.

In fact, Congress considered adding language that would expressly eliminate the kind of conflict of interest represented by voting in one class to benefit an interest held in another class. “The original House Bill . . . expressly authorized the Court to designate the vote of an ‘entity that has, with respect to such class, a conflict of interest that is of such a nature as would justify exclusion . . . ’”\textsuperscript{111} The Senate Bill did not contain this language nor was it enacted in the Code.\textsuperscript{112}

The Adelphia court viewed its omission as an indication that Congress had considered, but dismissed, the requirement.

Congress could, if it wished, declare that when creditors hold claims of multiple classes or debtors in multi-class or multi-debtor chapter 11 cases, they must choose the particular class or debtor with which they will wish to be allied. But it did not enact a provision that would have done exactly that. I cannot now establish such requirements in the absence of a legislative direction, especially retroactively, when no court has previously so held, and creditors had no advance notice that such rules would be applied to take away their statutory right to vote.\textsuperscript{113}

On the other hand, in dicta, the Dune Deck court reached the opposite conclusion, quoting from legislative history. “Congress deemed the provision un-

\textsuperscript{110}Id. at 56-57.


\textsuperscript{112}Id. (citing S. 2266, 95th Cong., 2d Sess. (1978)).

\textsuperscript{113}In re Adelphia Commc’ns Corp., 359 B.R. at 65.
necessary because in its view, Section 105 "constitutes a sufficient power in
the court to designate exclusion of a creditor's claim on the basis of a conflict
of interest."\textsuperscript{114}

Given the disparate interpretations based on congressional silence on this
issue, should Congress now amend the statute to include this language? This
may be an area of the law that is better left to judicial interpretation. In the
single asset real estate cases, like Figter, it may not offend the value-maximiza-
tion goals of chapter 11 to allow a secured creditor to purchase a blocking
position in the unsecured class and to cast its vote in a way that fosters its
secured claim. Single asset real estate cases are often essentially two-party
disputes. The small amount of trade debt that arises in the month or two
before filing bankruptcy is often relatively insignificant. In Figter, all of the
unsecured creditors received an offer of full payment from Teachers.\textsuperscript{115}
Thus, Teachers' purchase did not unfairly discriminate, nor was the offer
coercive. The Ninth Circuit noted that the bankruptcy court found that
Teachers did not "seek to purchase a small number of claims for the purpose
of blocking Figter's plan, while injuring other creditors."\textsuperscript{116} Other cases have
drawn this distinction.\textsuperscript{117} Moreover, given that this was a single asset real
estate case,\textsuperscript{118} there may have been little benefit to reorganizing. The value
of an enterprise holding only a single real estate asset usually does not depend
on whether the debtor is reorganized or liquidated. The value of the prop-
erty rarely depends on the identity of the property's owner.\textsuperscript{119} Thus, in cases
like Figter, the value-maximizing policies underlying chapter 11 are not likely

6, 1978) (statement of Sen. DeConcini)).

\textsuperscript{115}Figter Ltd. v. Teachers Ins. & Annuity Ass'n of Am. (In re Figter Ltd.), 118 F.3d 635, 637 (9th Cir.
1997).

\textsuperscript{116}Id. at 640.

Ltd. P'ship), 100 F.3d 1214, 1215 (6th Cir. 1996) ("Connecticut General certainly did not take advantage
of other creditors, since it offered to purchase for full value the claims of all non-insider unsecured credi-
1996) ("Principal Mutual paid 100 cents on the dollar for the claims it purchased, and it extended the
purchase offer to every unsecured creditor. The amount it paid is the same (100%) as the amount proposed
by the debtor's Fourth and Fifth amended plans."); In re Pleasant Hill Partners, L.P., 163 B.R. 388, 390
(Bankr. N.D. Ga. 1994) (noting FHLMC offered to purchase claims for the full amount claimed and pur-
chased all of the unsecured claims.).

\textsuperscript{118}See 11 U.S.C. § 101(51B) (defining single asset real estate as "a single property or project . . . on
which no which no substantial business is being conducted").

\textsuperscript{119}See Christopher W. Frost, Single Asset Bankruptcy Cases: Drawing the Line Between Operating the
Property and Operating a Substantial Business, 28 No. 2 BANKR. L. LETTER 1 (Feb. 2008); Brian S. Kat,
Single Asset Real Estate Cases and the Good Faith Requirement: Why Reluctance to Ask Whether a Case
Belongs in Bankruptcy May Lead to the Incorrect Result, 9 BANKR. DEV. J. 77, 83-85 (1992). But see Klee,
One Size Fits Some, supra note 95, at 1297-1301 (discussing benefits of chapter 11 reorganization for the
real estate market).
to be compromised by the secured creditor’s strategic vote of its unsecured claims.

In a context like the Adelphia case, with multiple debtors and potentially conflicting interests between them, it is still difficult to fashion a hard and fast rule. In some cases, a plan that benefits one debtor and its creditors more significantly might still be in the best interests of another debtor because the less favored estate may realize significant benefits from the strengthening of the enterprise as a whole. For these reasons, it may be better to maintain a flexible approach in deciding when to designate votes.

Rather than adopting stricter language in § 1126(e), the better course is for courts to view their designation powers more broadly. Instead of policing only egregious behavior when asked to designate votes, courts should consider whether allowing the votes will in some way frustrate the underlying purpose of voting. The extreme reluctance to deny creditors a vote should give way to the bigger purpose to be served, namely value maximization. Designating a vote is not the same as disallowing the claim; it does not rob the creditor of its distribution under the plan. It does not even deny the creditor the ability to object to confirmation. It merely reflects a judicial decision that the vote cast does not reflect the creditor’s assessment of the debtor’s viability and/or whether the plan represents its best chance for recovery on its claim. When a vote does not foster these aims, it is better to consider only those votes that do.

D. The Purchaser: Motive To Acquire Debtor’s Assets

Contemporary chapter 11 cases are often better conceptualized as a component of the mergers and acquisitions market, rather than a safe haven for businesses in danger of dismemberment by an angry mob of creditors. Creditors often push for early asset sales and insist on replacing managers. Auctions and negotiated sales of the entire business provide a means of quickly moving assets into the hands of new owners, leaving cash or other easily valued assets to be distributed to the claimants according to their respective priorities.

Sometimes non-creditors purchase creditor claims as part of a strategic move to acquire the debtor or its assets. Recently, in the case of In re DBSD North America, Inc., the Second Circuit affirmed the designation of a would-be acquirer’s vote. Although it was a competitor, the acquirer did not reject the plan in order to run the debtor out of business, leaving creditors unpaid. Instead it sought to propose a competing plan that would enable it to acquire the debtor’s assets. While the Second Circuit viewed this agenda

120 DISH Network Corp. v. DBSD North Am., Inc. (In re DBSD North Am., Inc.), 634 F.3d 79, 101-05 (2d Cir. 2011).
as an "ulterior motive," such motivation may actually foster the Bankruptcy Code's overarching goal to maximize the value of a debtor's assets.

The debtor in DBSD owned a satellite and land-based mobile communications network. Its capital structure was comprised of first and second lien debt, unsecured debt, and equity. The debtor's plan proposed to pay the first lien debt with new bonds that had the same principal amount and interest rate as the existing debt, but for the first four years, the holders would be paid in kind—with additional debt, rather than cash. Holders of second lien debt would receive substantially all of the equity in the reorganized debtor, with a tiny portion of the equity going to holders of unsecured claims. The prebankruptcy equity holders were to receive shares and warrants as well; but they would receive those interests indirectly through a "gift" from the second lien debt holders, who would otherwise have been entitled to receive all of the equity interests.121

DISH Network had not been a prebankruptcy creditor of DBSD. It had a substantial investment in a company known as TerreStar, which also was a development-stage telecommunications company that the bankruptcy court found was a direct competitor of the debtor. After the bankruptcy, DISH purchased 100% of the first lien debt at par and around 17% of the second lien debt for about 30 cents on the dollar. Internal documents of DISH expressed an intent to "control the bankruptcy process" to enable it to purchase either the debtor itself or some portion of the debtor's assets.

The purchase of the first lien debt gave DISH a blocking position over that class of claims. The bankruptcy court disqualified the votes based largely on the fact that DISH was taking its actions, not to maximize its return as a creditor, but instead to advance its agenda as a potential purchaser.122 The Second Circuit affirmed, characterizing its plan as an effort to "bend the bankruptcy process toward its own strategic objective of acquiring DBSD's spectrum rights."123

Like many courts, the Second Circuit in DBSD stated that it did not intend to create a categorical prohibition against purchasing claims for strategic reasons, but in fact that was its implied ruling. There were no allegations of bad conduct or other ulterior motives. This case did not involve the unfair discrimination and coercion concerns raised in P-R Holding, where the selling creditors received better treatment than the non-selling creditors.124 DISH

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121 Id. at 87. This gift prompted an absolute priority rule objection by Sprint, an unsecured creditor; which objection ultimately derailed the debtor's plan.


123 In re DBSD North Am., Inc., 634 F.3d at 104.

124 See supra notes 42-47 and accompanying text.
was not a plan proponent that was attempting to purchase claims to avoid the prohibition on vote solicitation that had been present in the Allegheny case.125

The Second Circuit did not engage in an extensive analysis of the facts of these earlier cases. It simply pointed to the fact that DISH sought control, was a competitor of DBSD, and was willing to overpay for the claims it bought as evidence of its bad faith. The bankruptcy court's findings were slightly more extensive. That court pointed to the fact that DISH "purchased all of the First Lien Debt at par, knowing that the plan proposed replacing the First Lien Debt with an Amended Facility that DISH did not want."126 The only other thing the court could point to was that DISH had filed a motion to terminate exclusivity so that it could propose a competing plan. These actions, however, only serve to show that DISH bought the debt in pursuit of its acquisition of the debtor's assets through a competing plan.

The Second Circuit's opinion appears to have condemned DISH's actions principally because they were motivated by its desire to acquire the debtor's assets. In addition, the court condemned DISH's efforts to exert control over the bankruptcy case.127 The court observed:

DISH had every right to propose for consideration whatever strategic transaction it wanted—a right it took advantage of here—and DISH still retained this right even after it purchased its claims. All that the bankruptcy court stopped DISH from doing here was using the votes it had bought to secure an advantage in pursuing that strategic transaction.128

Neither the bankruptcy court nor the Second Circuit was clear about what that advantage might be. Based on the facts in the reported opinions, DISH's efforts to even make a serious proposal to the creditors may well have relied on stopping the debtor's plan of reorganization. Had DISH succeeded in stopping the confirmation of the debtor's plan—a plan that was ultimately denied confirmation because of a flawed inter-class give-up129—DISH might

125 See supra notes 52-60 and accompanying text.
126 In re DBSD North Am., Inc., 421 B.R. at 140 (emphasis original).
127 Other courts have also listed "control" as one of the factors considered in a finding of bad faith under § 1126(e). See, e.g., In re Dune Deck Owners Corp., 175 B.R. 839, 844-45 (Bankr. S.D.N.Y. 1995). But these courts fail to explain how control by itself is harmful to the estate or its creditors. In fact, battles over control in a bankruptcy case are commonplace. Control is the underlying issue in motions for relief from the automatic stay, extensions or terminations of exclusivity, and the appointment of a trustee. It is only when control is exercised to achieve an end that is inconsistent with the Bankruptcy Code that it problematic.
128 In re DBSD North Am., Inc., 634 F.3d at 105.
129 See supra note 121 and accompanying text.
have been starting from zero, not from a position of strategic advantage. After all, the defeat of the debtor’s plan would not have amounted to a complete victory by DISH. Any plan or strategic transaction DISH proposed would be subject to the same scrutiny as the debtor’s plan.

The Second Circuit stated that DISH sought somehow “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.” The court went on to state, “[i]n effect, DISH purchased the claims as votes it could use as levers to bend the bankruptcy process toward its own strategic objective of acquiring DBSD’s spectrum rights, not toward protecting its claim.” To be sure, if DISH hoped to have an opportunity to acquire the assets through the bankruptcy, it would have to defeat confirmation of the debtor’s plan of reorganization, and that effort was facilitated by the acquisition of the first lien claims. But the court was not clear what advantages that gave DISH or why its use of the “levers” was wrongful.

Acquisitions are a legitimate and often welcome outcome in chapter 11 cases. In a more recent unpublished case, In re Trikeenan Tileworks, Inc., the court considered that very question in the context of the debtor’s objection and allegation that a competing plan had not been filed in good faith, as required by § 1129(a)(3). In this case, a competing tile manufacturer had purchased a small claim for the sole purpose of filing a competing plan. When the debtor’s plan was not confirmed, the debtor tried to stave off the competing plan, by claiming it was bad faith to purchase a claim solely for the purpose of gaining standing to file a plan, and through the plan to destroy its competitor. It asked the court to hold the plan proponent to the same standards that apply to the designation of votes by creditors who hold an “ulterior motive.”

The Trikeenan court held that it was not bad faith to acquire a claim for the purpose of filing a competing plan, even one in which a competitor sought to acquire the debtor or its assets.

Debtors have failed to explain how Butler’s Plan is in contravention of the policy goals of the Bankruptcy Code. Being a competitor who proposes a competing plan to take over the debtor does not equal bad faith per se. To the contrary, the Supreme Court has noted that lifting exclusivity to propose a competing plan opens the door for other parties to bid for

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130 In re DBSD North Am., Inc., 634 F.3d at 104 (quoting In re DBSD North Am., Inc., 421 B.R. 133, 139-40 (Bankr. S.D.N.Y. 2009)).
131 Id.
133 Id. at *8.
the equity of the company. There is no requirement that a competing plan must be friendly to the existing management or ownership of a debtor. Nor is there any bar in the Bankruptcy Code against a competitor proposing a takeover of the debtor.134

Thus, the Trikkenan decision is at odds with the DBSD decisions in its view of the beneficial purpose of allowing claims purchasers to participate in the bankruptcy process to acquire the debtor or its assets.

Hindsight in the DBSD case also shows the benefits to be realized from allowing parties to cast their votes based on an acquisition motive. To understand the subsequent history, a little more background is required. There was a second appeal in DBSD filed by Sprint Nextel Corporation, the holder of a disputed $211 million unsecured claim that dominated the unsecured class. It had objected to the plan on the basis of the absolute priority rule. Although the unsecured creditors were not paid in full, the plan allowed the equity holders to receive a small amount of equity in the reorganized debtor. The bankruptcy court found that the issuance of new equity to old equity holders was not given by the debtor but was a “gift” made by the second lienholders, to whom all of the equity was owed under the absolute priority rule. It reasoned that a secured creditor could give away whatever it wished to whomever it wished, without violating the absolute priority rule. The Second Circuit did not agree and reversed on this basis.

In finding that all of the equity in the reorganized debtor would otherwise belong to the second lienholders, the bankruptcy court relied on the assumed value of DBSD of $692 million. The second lien holders were owed $750 million. Since they could not be paid in full, the decision to transfer some of the equity to old equity holders might be considered a transfer of property belonging to the second lienholders. At a higher valuation, however, transfers of equity to the shareholders would be transfers that should have gone to the dissenting class of unsecured creditors.135

Following the Second Circuit’s reversal of the confirmation order based on Sprint’s appeal, DISH made an initial bid for the debtor’s assets of $1 billion. At auction, DISH was the successful bidder for a price of $1.4 billion—an amount sufficient to pay all of the creditors and to leave old equity with a cash distribution of $325 million.136 Thus, with hindsight, it is clear

134Id. at *7 (citation omitted) (citing Bank of America Nat’l Trust & Sav. Assoc. v. 203 N. LaSalle St. P’ship, 526 U.S. 434, 457-58 (1999)).
135See Ralph Brubaker, Taking Chapter 11’s Distribution Rules Seriously: “Inter-Class Gifting is Dead! Long Live Inter-Class Gifting!” 31 No. 4 BANKR. L. LETTER 1 (April 2011).
that allowing competitors or others with an acquisition motive to participate in the bankruptcy process may realize a far greater value for the debtor's assets. For this reason, courts would do well to follow the lead of the *Trikeenan* court in reconsidering the use of the designation power in this area.

This is not to say, however, that anything goes in these acquisition cases. Courts must remain vigilant to guard against creditor actions that are designed to drive down the value of those assets by interfering with the confirmation process or obstructing creditor votes on other competing plans. At a minimum, however, the decision to designate a potential acquirer's vote against the debtor's plan should be justified by evidence of behavior that the creditor is taking actions to forestall consideration of other plans or has engaged in coercion in the acquisition of its claims. Further, designation of such creditor's votes should normally be accompanied by a termination of debtor exclusivity so that competing plans may be offered.

IV. CONCLUSION

With some exceptions, cases considering vote designation indicate a strong fidelity to basic bankruptcy principles and relate directly to the kinds of motivations and actions that interfere with the purpose of the chapter 11 voting process. Voting in bankruptcy is designed to further the goal of maximizing the value of the chapter 11 debtor's business assets. The creditors' assent to a plan of reorganization is thought to be based on their view that the plan maximizes their total recovery. Most of the voting power is in the hands of creditors who occupy the residual position; thus, maximizing those creditors' return should maximize asset value.

Claim designation cases generally focus on the types of behaviors and motivations that interfere with the ability of bankruptcy voting to achieve that value-maximizing goal. Thus, where a creditor is motivated by a desire to destroy a competitor, that creditor’s vote is directly at odds with the value-maximizing goals of the bankruptcy process and courts should and do disqualify such votes. The extortionate motives of the blackmailer and the coercive efforts of some claim buyers similarly lead to distortions in the vote that may interfere with value maximization. Actions that circumvent the authority that the Code grants bankruptcy courts to control the plan confirmation process may also lead to designation.

Some courts have a harder time recognizing when a creditor’s motivations are at odds with the value-maximizing goals of the process. Side agreements that create a motive to decrease, rather than maximize, the value of the assets may be difficult to uncover. Even where the agreements come to light, courts occasionally fail to recognize the fact that the creditor’s vote may be at odds
with a central goal of chapter 11. Resistance to a plan to gain an advantage in litigation between the estate and the creditor normally should also result in disqualification. Here again, courts only sometimes recognize the conflict. Cases in which the creditor holds or purchases claims in multiple classes—each with differing incentives and motivations—may create conflicts that are best resolved on a case-by-case basis.

Finally, cases in which a creditor seeks to acquire the debtor or its assets do not necessarily present a conflict that warrants disqualification. Asset purchases in bankruptcy have become a common and accepted means of resolving chapter 11 cases and may, in fact, achieve the highest value for the debtor’s assets. Thus, a goal of acquiring the debtor should not be a per se basis for designating the claims. Only where this acquisition goal is accompanied by actions that appear designed to coerce the sale of claims or to drive down the value of the debtor should the court consider the use of the designation power.