

I N S I D E   T H E   M I N D S

# Chapter 11 Bankruptcy and Restructuring Strategies

*Leading Lawyers on Navigating Recent Trends,  
Cases, and Strategies Affecting Chapter 11 Clients*



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Lessons for Distressed  
Investors from Chapter 11  
Decisions in 2014

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## Introduction

The role of distressed investors in bankruptcy proceedings shows no signs of slowing. Distressed investors, whether holding debt, equity, or both, are prominent players in Chapter 11 negotiations and related litigation. Several significant decisions rendered in 2014 serve as strong reminders for financial parties to be diligent and to appreciate risk, in both investment and strategic decision making. This chapter highlights three sets of decisions that made headlines in 2014 for the distressed investment community. First, we present lessons learned from the Chapter 11 cases of MPM Silicones, LLC (MPM) and its affiliates (together, “Momentive”) concerning the need for precise drafting of prepayment premiums. We next discuss the implications for credit bidding in light of the *Fisker Automotive*<sup>1</sup> and *Free Lance-Star Publishing Co.*<sup>2</sup> decisions. Third, we turn to the disputes in the *LightSquared* bankruptcy, which are a reminder that bankruptcy courts will not hesitate to exercise their equitable powers when they believe that a creditor’s actions have harmed a debtor’s estate or its other creditors, and that the relief will be measured.

## Make-Whole Claims, Cram-Up Notes, and Intercreditor Disputes: *Momentive*

The recent *Momentive* Chapter 11 cases involved a complex capital structure that included (among other indebtedness): (i) first lien, senior notes (the “First Lien Notes”); (ii) so-called “1.5” lien, senior secured notes (the “1.5 Notes” and together with the senior secured notes, the “Senior Debt”); (iii) senior subordinated, unsecured notes (the “Senior Sub Debt”); and (iv) second priority, springing lien notes (the “Second Lien Debt”). Momentive’s plan of reorganization, supported by the holders of the Second Lien Debt, contemplated repayment in full of the Senior Debt either (a) in the form of cash, with no make-whole premium with respect to the old debt, for those voting in favor of the plan or (b) in the form of new

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<sup>1</sup> *In re Fisker Auto. Holdings, Inc.*, 510 B.R. 55 (Bankr. D. Del. Jan. 14, 2014) (“*Fisker*”), appeal denied by *Hybrid Tech. Holdings LLC v. Official Comm.*, No. 14-CV-99, 2014 WL 546036 (D. Del. Feb. 7, 2014); motion for direct appeal denied by *Hybrid Tech. Holdings LLC v. Official Comm.*, No. 14-CV-99, 2014 WL 576370 (Bankr. D. Del. Feb. 12, 2014).

<sup>2</sup> *In re Free Lance-Star Publ'g Co. of Fredericksburg, VA*, 512 B.R. 798 (Bankr. E.D. Va. April 14, 2014) (“*Free Lance-Star Publishing Co.*”).

long-term debt in an amount including the make-whole, but only to the extent the bankruptcy court determined the make-whole to be payable, for those voting against the plan (the “Cram-Up Notes”).

Momentive commenced a pair of virtually identical adversary proceedings, each seeking declaratory judgment with respect to make-whole obligations of the Senior Debt. In a separate adversary proceeding, U.S. Bank, as indenture trustee for the Senior Sub Debt, sought a declaratory judgment that the Senior Sub Debt was senior in right of payment to the Second Lien Debt. The bankruptcy court addressed all three adversary complaints, among other issues, in its bench opinion addressing the confirmation of *Momentive’s* plan.<sup>3</sup>

### *What Is Senior Debt?*

The indenture governing the Senior Sub Debt contained express provisions subordinating the debt in right of payment to the Senior Debt. The Second Lien Debt was subject to an intercreditor agreement with the First Lien Debt and the 1.5 Lien Debt, pursuant to which the holders of the Second Lien Debt had agreed to be subordinated with respect to their collateral position. The Senior Sub Debt asserted that, under the terms of the relevant documents, the Second Lien Debt was not “Senior Indebtedness,” and was junior to the Senior Sub Debt in right of payment. The Senior Sub Debt based their argument on the carve-outs in their indenture from the definition of Senior Indebtedness, which excluded “any Indebtedness or obligation of the Company or a Restricted Subsidiary that by its terms is subordinated or junior in any respect to any other Indebtedness or obligation of the Company.”<sup>4</sup> The Senior Sub Debt took the position that “junior in any respect” was intended to pick up lien subordination, not just subordination in right of payment.

Judge Drain, however, found that the language did not apply to lien subordination: “The highlighted word ‘its’ refers to the terms of the Indebtedness or the obligation—which are separate from the terms of a lien, mortgage, security interest, encumbrance, etc.—as being junior to any

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<sup>3</sup> *In re MPM Silicones, LLC*, No. 14-22503-rdd, 2014 WL 4436335 (Bankr. S.D.N.Y. Sept. 9, 2014) (the “*Momentive Confirmation Op.*”).

<sup>4</sup> *Id.* at \*6.

other Indebtedness or obligation, not to the terms of a lien being junior to any other lien.”<sup>5</sup> Further, while the Senior Sub Debt predated the Second Lien Debt by several years, the underlying indenture did not contain an anti-layering provision precluding the future issuance of senior debt. Accordingly, the court determined that Second Lien Notes were “Senior Indebtedness,” senior in right of payment to the Senior Sub Notes.<sup>6</sup>

### *Applicability of Make-Whole Provisions*

The indentures underlying the Senior Debt included make-whole provisions entitling holders to prepayment premiums upon an early repayment. Judge Drain, relying upon the “well-settled” New York common law rule of “perfect tender” that precludes a borrower from early loan repayment absent contractual provisions to the contrary, noted that early acceleration by a lender causes the forfeit of any prepayment consideration provided for in the underlying documentation, absent clear language preserving the prepayment right (or intentional breach by the borrower).<sup>7</sup> The *Momentive* bankruptcy resulted in the automatic acceleration of the Senior Debt pursuant to the indentures, advancing the maturity of the loan. The indentures, however, did not include specific language requiring the payment of make-whole premiums

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<sup>5</sup> *Id.* at \*7.

<sup>6</sup> In separate adversary proceedings, the holders of the First Lien Notes and 1.5 Lien Notes have each sued the holders of the Second Lien Notes, asserting that, among other things, the Second Lien Noteholders violated the terms of their intercreditor agreement through their support of the Plan (including entry into an Restructuring Support Agreement and supporting Momentive in contesting make-whole); their support of Momentive’s debtor-in-possession financing and alleged contesting of the holders of Senior Debt receiving adequate protection; and their acceptance of payment that constituted common collateral (including payment of professional fees and expenses). The complaint also asserted a breach of the implied covenant of good faith and fair dealing. Judge Drain dismissed each count of the complaint, authorizing the plaintiffs to file an amended complaint only with respect to the counts he had dismissed under *Twombly/Iqbal*, but not on any other basis. See *BOKF, N.A. v. JPMorgan Chase Bank, N.A.*, 518 B.R. 740 (Bankr. S.D.N.Y. Oct. 14, 2014). On November 14, 2014, the holders of Senior Debt filed their amended complaints, which continue to assert breach of contract claims arising from the alleged contesting by the Second Lien Noteholders of adequate protection; receipt by the Second Lien Holders of collateral (in the form of professional fees and expenses); and a breach of the implied covenant of good faith and fair dealing. Judge Drain reportedly dismissed the amended complaints on January 16, 2015, once again granting leave to amend. See *Judge Drain Rejects 1st/1.5 Lien Trustee Motion to Amend Complaint, Will Allow Third and Final Attempt*, REORG RES. (Jan. 16, 2015).

<sup>7</sup> *Momentive Confirmation Op.*, 2014 WL 4436335 at \*12-13.

notwithstanding the acceleration or advancement of maturity. Accordingly, Judge Drain found that the make-whole language was too ambiguous with respect to automatic acceleration to conclude that Momentive was required to pay foregone future interest payments:

Indeed, in each of the reported cases that quote language that would be explicit enough to overcome the waiver of the make-whole upon acceleration under New York law, more was required than is contained in the relevant sections of the indentures and notes . . . either an explicit recognition that the make-whole would be payable notwithstanding the acceleration of the loan or . . . a provision that requires the borrower to pay a make-whole whenever debt is repaid prior to its original maturity.<sup>8</sup>

Judge Drain's determination not to award a prepayment premium in *Momentive* is consistent with recent holdings of other bankruptcy judges declining to enforce make-whole provisions in bankruptcy that are not explicit. Judge Drain also ruled that the holders of Senior Debt could not issue a notice rescinding the contractual acceleration of maturity so as to reinstate the make-whole obligations, ruling that the automatic stay precluded such a notice, that the safe harbor provisions of the Code that exclude securities transactions from the stay did not extend to cover the indentures, and determining that cause did not exist to lift the stay to permit such a rescission.

The economic result of Judge Drain's decision was to deny the senior noteholders approximately \$200 million in make-whole payments for the early refinancing of their debt. The practical import is that, to prevent debtors from refinancing for free, investors should follow Judge Drain's suggestion and demand stricter language requiring the payment of make-whole premiums. Those counseling investors buying existing debt should carefully scrutinize underlying documentation, and price their risk accordingly.

#### *Appropriate Rate of Interest on the Cram-Up Notes*

After failing to prevail on the make-whole issue, the holders of Senior Debt belatedly sought to change their "no" votes against Momentive's plan to

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<sup>8</sup> *Id.* at \*15.

“yes,” a move that the bankruptcy court rejected.<sup>9</sup> Thus, the holders were to receive under the *Momentive* plan only the replacement notes, subject to the bankruptcy court’s determination that the cramdown provisions of the Bankruptcy Code were satisfied. Specifically, holders of the First Lien Notes would receive replacement notes bearing interest at the seven-year Treasury rate plus 1.5 percent (or 3.6 percent), and the holders of 1.5 Lien Notes would receive replacement notes bearing interest at the seven-and-a-half year Treasury rate plus 2 percent (or 4.09 percent). The pre-petition First Lien Notes had borne interest at 8.875 percent, and the pre-petition 1.5 Lien Notes, at 10 percent.

Judge Drain, applying the “formula approach” present value test articulated in *Till v. SCS Credit Corp.*<sup>10</sup> (*Till*) and *GMAC v. Valenti (In re Valenti)*<sup>11</sup>—both Chapter 13 cases—rejected a market approach, determining that the interest rate “should focus on a rate that does not take market factors into account, but, rather, starts with the riskless rate applicable to all obligations to be paid over time, adjusted for the risks unique to the debtor in actually completing such payment.”<sup>12</sup>

Applying a risk premium, Judge Drain ruled that the replacement debt to be issued to holders of First Lien Notes should be raised by a half-percentage point, and the replacement debt to be issued to holders of 1.5 Lien Notes should be increased by three-quarters of a percentage point. The increase resulted in rates of Treasury plus 2 percent and Treasury plus 2.75 percent, still significantly below the original interest rates on the pre-petition Senior Debt.

Both the make-whole and interest issues are of significant importance to distressed lenders and their advisors. The need for explicit make-whole provisions requires a revisit of all credit documents to determine if the make-whole language passes muster (and, for purchasers buying outstanding debt, a careful review of existing documentation and corresponding risk allocation). Also, the application of *Till*, if upheld, could be a game changer for restructuring negotiations involving secured lenders.

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<sup>9</sup> See *In re MPM Silicones, LLC*, No. 14-22503-rdd, 2014 WL 4637175 (Bankr. S.D.N.Y. Sept. 17, 2014).

<sup>10</sup> *Till v. SCS Credit Corp.*, 541 U.S. 465 (2004).

<sup>11</sup> *GMAC v. Valenti*, 105 F.3d 55 (2d Cir. 1997).

<sup>12</sup> *Momentive Confirmation Op.*, 2014 WL 4436335 at \*25.



## Credit Bidding: *Fisker Automotive* and *Free Lance-Star Publishing*

The right of a secured lender to credit bid is found in 11 U.S.C. §363(k) and has been explicitly endorsed by the Supreme Court.<sup>13</sup> That right, however, is not without limitation; the statute provides that a holder of a secured claim may bid on the assets that secure its debt “unless the court for cause orders otherwise.”<sup>14</sup> A pair of recent decisions limited the rights of secured lenders to credit bid in sales under 11 U.S.C. § 363, where their collateral packages were in doubt and their actions would have chilled competitive bidding.

### *Fisker*

In November 2013, Fisker Automotive, Inc. and its parent, Fisker Automotive Holdings, Inc., filed Chapter 11 with the United States Bankruptcy Court for the District of Delaware, with the intention of selling substantially all of their assets to Hybrid Tech Holdings LLC (Hybrid) in an expedited sale. Only weeks before the bankruptcy, Hybrid had purchased Fisker’s \$168.5 million of senior secured indebtedness from the US Department of Energy for \$25 million (or, as Judge Gross noted, about \$.15 on the dollar). The actual value of Hybrid’s perfected secured liens was unclear—Hybrid’s interest in certain collateral was, at best, disputed—yet Hybrid proposed to acquire substantially all of the debtors’ assets in a private sale, with a \$75 million credit bid.

The official committee of unsecured creditors (the “Committee”), which objected to the private sale to Hybrid, instead proposed an auction, offering up as an alternate bidder Wanxiang America Corporation (Wanxiang). Wanxiang had conditioned its further participation on a \$25 million cap on Hybrid’s bid. In addition to the unclear nature of Fisker’s collateral, the Fisker debtors and the Committee stipulated, among other things, that (i) eliminating or limiting Hybrid’s credit bid to \$25 million would foster a competitive auction process and (ii) not capping the bid likely would eliminate the possibility of an auction, and asked the court to determine whether the stipulated circumstances permitted the limitation of Hybrid’s credit bid. The Committee agreed to withdraw its objection pending the court’s determination on Hybrid’s ability to credit bid.

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<sup>13</sup> See *Radlax Gateway Hotel, LLC v. Amalgamated Bank*, 132 S. Ct. 2065 (2012).

<sup>14</sup> 11 U.S.C. § 363(k); *In re Philadelphia Newspapers, LLC*, 599 F.3d 298 (3d Cir. 2010).

The bankruptcy court focused on the fact that an unchecked credit bid would effectively mean no auction. Concerns over bid chilling, the court determined, provided cause to limit the credit bid under 11 U.S.C. §363(k).<sup>15</sup> The court was also concerned by what it perceived as an unnecessary rush from the bankruptcy filing to approval of the sale, noting that neither the debtors nor Hybrid “ever provided the Court with a satisfactory reason” for the requested twenty-four-day timeline.<sup>16</sup> Moreover, the questions regarding the validity of Hybrid’s liens gave the court a further basis to limit the credit bid. The court distinguished Hybrid’s claim, the allowed nature of which was as yet undetermined, from the claim of an undersecured but perfected creditor, which could credit bid the entirety of its properly perfected secured claim, even though the collateral underlying the claim was deficient to secure it. Accordingly, the bankruptcy court permitted Hybrid to credit bid, but limited the credit bid to \$25 million—the amount that Hybrid had paid to acquire the debt. The district court declined to hear an appeal, and Wanxiang ultimately prevailed over Hybrid at auction, with a winning bid of \$149.2 million.

In *Fisker*, the bankruptcy court effectively valued the collateral underlying the senior debt at \$25 million for purposes of the auction, even though the parties had not litigated the lien and perfection issues or valuation, and regardless of the face value of the debt, forcing Hybrid to produce additional cash to improve its bid. Still, while ultimately losing the auction, Hybrid made a handsome return on its investment, reportedly receiving at least \$90 million of sale proceeds.<sup>17</sup>

*Free Lance-Star Publishing Co.*

In *Free Lance-Star Publishing Co.*, the United States Bankruptcy Court for the Eastern District of Virginia sharply curtailed the credit bidding rights of DSP Acquisition, LLC (DSP), an affiliate of the debtors’ “loan-to-own” below-par purchaser, which the court determined had acted inequitably by unilaterally (and without informing the borrowers) filing fixture financing

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<sup>15</sup> *Id.* at 60 (“Thus, the ‘for cause’ basis upon which the Court is limiting Hybrid’s credit bid is that bidding will not only be chilled without the cap; bidding will be frozen.”).

<sup>16</sup> *Id.*

<sup>17</sup> See, e.g., Peg Brickley, *Fisker Creditors Reach Deal to Split Cash From Sale of Operations*, WALL ST. J., April 14, 2014, <http://www.wsj.com/articles/SB10001424052702304117904579501541419653338>.

statements on so-called broadcast-related “Tower” assets that were not, and had never been, part of the collateral package securing the debt.

The debtors were a media company with print and broadcast assets. DSP’s affiliate, Sandton Capital Partners, had acquired debt with a face amount of nearly \$46 million from the debtors’ pre-petition secured lender. Although the collateral package underlying the debt did not include a lien on the Tower assets, DSP filed financing statements on those assets, and then sought to negotiate with the borrowers a Chapter 11 filing to be followed by a quick sale, with DSP intending to credit bid. The relationship chilled, however, and the debtors commenced their Chapter 11 cases without DSP’s support. Just before the filing, DSP recorded additional financing statements without notice to the debtors and, at a contested hearing on the use of DSP’s cash collateral, requested replacement liens on the Tower assets.

The bankruptcy court denied that request and, in a separate opinion, determined that DSP did not have a lien on the Tower assets.<sup>18</sup> The court, while not altogether denying DSP the ability to credit bid, limited the bid to \$1.2 million for broadcast-related assets and \$12.7 million for assets related to the debtors’ print media business. While stopping short of calling DSP’s actions fraudulent, the court noted DSP’s inequitable conduct, and lamented the chilling of bids caused by DSP’s actions. The district court denied an appeal. DSP was ultimately the prevailing bidder at auction, acquiring most of the debtors’ assets pursuant to separate purchase agreements in a bid reportedly totaling approximately \$30.2 million.<sup>19</sup> Thus, while DSP prevailed, it had to dig into its pockets to do so.

Entities acquiring below-par debt in a “loan to own” strategy should take heed of the lessons from *Fisker* and *Free Lance-Star Publishing*. Creditors should not assume they can rush their borrowers to a private sale, that a court will overlook significant impairments in a collateral package, or that a court will ignore inequitable attempts to strong-arm a debtor. Advisors to

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<sup>18</sup> See *DSP Acquisition Co. LLC v. Free Lance-Star Publ'g Co. of Fredericksburg, VA*, 512 B.R. 798 (Bankr. E. D. Va. 2014) (holding that DSP did not have a valid lien on the debtors’ Tower assets, motor vehicles, FCC licenses, insurance policies, or bank account deposits).

<sup>19</sup> Bill Frehling, *Sandton Capital submits top bid for The Free Lance-Star's assets*, THE FREE-LANCE STAR (May 22, 2014), [www.fredericksburg.com/news/sandton-capital-submits-top-bid-for-the-free-lance-star/article\\_aede431b-ba1d-5ebe-b2c0-eb651f05cefb.html](http://www.fredericksburg.com/news/sandton-capital-submits-top-bid-for-the-free-lance-star/article_aede431b-ba1d-5ebe-b2c0-eb651f05cefb.html).

potential acquirers should diligence their collateral packages and price their risk accordingly; they also should be wary of needlessly aggressive schedules and avoid actions that can backfire before a court of equity.

### **Equitable Subordination and Debtor Inaction: *LightSquared***

The bankruptcy cases of *LightSquared Inc.* and its affiliates (together, “LightSquared”) were commenced in 2012 and, as of this writing, remain in Chapter 11.<sup>20</sup> A recent decision by the United States Bankruptcy Court for the Southern District of New York is a cautionary tale not only for bad faith investors, but for the debtors (and their equity holders) who turn a blind eye to them.<sup>21</sup>

#### *Background*

LightSquared, a communications company formed to provide voice and data services to mobile devices, sought bankruptcy protection on May 14, 2012, after failing to pass regulatory muster with the Federal Communications Commission (FCC). More than a year after the filing, LightSquared’s majority equity holders, Harbinger Capital Partners LLC and several affiliated funds (together, “Harbinger”), sued, among others, Charles Ergen, the majority owner of DISH Network Corporation (DISH) and EchoStar Corporation (EchoStar), both of which were also defendants, and SP Special Opportunities LLC (SPSO), in an adversary proceeding in which LightSquared sought to intervene. The suit arose out of Ergen’s acquisition through SPSO, before and during the bankruptcy, of a majority of the \$1.5

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<sup>20</sup> On December 18, 2014, following several months of mediation, the debtors, together with their majority equity holders, Harbinger Capital Partners LLC, and several affiliated funds and several other constituencies, filed a Specific Disclosure Statement for Joint Plan Pursuant to Chapter 11, No. 12-12080 (Bankr. S.D.N.Y. Dec. 18, 2014) that is supported by all of the debtors’ constituents other than SPSO. *See Second Specific Disclosure Statement*, No. 12-12080 (Bankr. S.D.N.Y. Jan. 20, 2015) (the “*Disclosure Statement*”) at 11. At a hearing on January 20, 2015, the bankruptcy court approved the Disclosure Statement, clearing the way for voting to commence on the Joint Plan. *See Order Approving (A) Second Amended Specific Disclosure Statement for Second Amended Joint Plan Pursuant to Chapter 11 of Bankruptcy Code and (B) Solicitation Procedures and Shortened Deadlines With Respect to Confirmation of Such Plan*, No. 12-12080 (Bankr. S.D.N.Y. Jan. 20, 2014).

<sup>21</sup> *LightSquared LP v. SP Special Opportunities LLC*, 511 B.R. 253 (Bankr. S.D.N.Y. June 10, 2014). The Bankruptcy Court’s 175-page opinion contains highly specific findings of fact, which are summarized here.

billion of senior secured term debt of LightSquared LP, allegedly in violation of the credit agreement (the “Credit Agreement”) underlying that debt, and his actions in connection with that acquisition.

The Credit Agreement contained a provision prohibiting those other than “Eligible Assignees” from holding debt. Neither any natural person nor any “Disqualified Company”—certain enumerated competitors of LightSquared set forth on a schedule and their known subsidiaries—was an Eligible Assignee. Among the Disqualified Companies was EchoStar and, following an amendment to the Credit Agreement made just before the bankruptcy filing—but after SPSO’s initial purchases—DISH. Affiliates were not carved out of the definition of Eligible Assignees; further, while the carve-out included any entity that was a “known subsidiary,” it did not incorporate the more broadly defined term “Subsidiary.”

In fall 2011, having been advised that neither he, DISH nor EchoStar was an Eligible Assignee, Ergen began to acquire LightSquared LP debt through SPSO, a fund formed by investment management and advisory firm, Sound Point Capital Management LP (Sound Point). Because SPSO actually made the trades, it was not clear that Ergen was acquiring the debt on his own behalf. Ergen had a DISH/EchoStar executive, Jason Kiser, arrange the trades through Sound Point.

Ergen’s initial transactions, made in the days leading up to the bankruptcy at prices well below par (and totaling approximately \$287 million in face amount), caused immediate speculation. Ergen’s role, however, was not disclosed—including to the DISH board of directors or to senior management (other than Kiser)—and neither the Ergen-controlled DISH board nor management asked more than cursory questions about Ergen’s trading activity. As the bankruptcy progressed, Sound Point arranged additional trades during the bankruptcy at Ergen’s request in the hundreds of millions—in some cases, nearly at par—with Ergen often delaying closing for months at a time. In doing so, Ergen effectively hamstrung the debtors’ bankruptcy proceeding.

In spring 2013, having effectively achieved a blocking position, Ergen finally disclosed his involvement to DISH’s board, which formed a special committee to consider Ergen’s purchases and a potential transaction with LightSquared. In the meantime, however, and without disclosure to the

board or the special committee, Ergen made an unsolicited bid on the LightSquared debtors' spectrum assets for approximately \$2 billion, allegedly on his own behalf, but—as the court determined—with the intent that DISH would step in.<sup>22</sup>

During this period, LightSquared, Harbinger, and an ad hoc group of senior secured lenders had been negotiating a consensual plan, including a term sheet pursuant to which LightSquared would emerge still holding its spectrum assets. SPSO joined the group in June 2013, after which the ad hoc group threw its support to a plan that supported the LBAC/DISH bid. Ultimately, however, an auction was not held and, after contested proceedings—including a demand by the ad hoc group for specific performance—the bankruptcy court determined that the LBAC bid was validly terminated in early 2014 because of the LightSquared debtors' failure to satisfy certain milestones.<sup>23</sup>

### *The Adversary Proceeding*

Harbinger filed the initial complaint in August 2013, and LightSquared intervened. After protracted motion practice, the bankruptcy court dismissed all or portions of Harbinger's and LightSquared's complaints.<sup>24</sup> A trial spanning several days was held in January 2014.

The bankruptcy court determined that, in the plain words of the Credit Agreement, SPSO was an Eligible Assignee. The carve-out for "Disqualified Companies" did not apply because, while DISH and EquiStar were on the

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<sup>22</sup> The special committee ultimately recommended pursuing the bid at \$2.2 billion, but subject to a number of conditions. The special committee, however, was disbanded almost immediately, well before those conditions could be satisfied. Ergen sold the bidder entity, L-Band Acquisition LLC (LBAC), to DISH for \$1.

<sup>23</sup> See Transcript of Hearing, *LightSquared Inc.*, No 12-12080-scc (Jan. 22, 2014).

<sup>24</sup> The bankruptcy court permitted the following of LightSquared's claims to proceed: (i) its request for declaratory judgment that SPSO is not an "Eligible Assignee" under the Credit Agreement; (ii) its allegation of SPSO's alleged breach of contract (i.e., the Credit Agreement); (iii) its request for disallowance of SPSO's claim under 11 U.S.C. § 502(b); and (iv) its claim for tortious interference against DISH, Echostar, and Ergen. As relief, LightSquared sought equitable subordination of SPSO's claims, and compensatory and punitive damages against all defendants. With respect to Harbinger's claims, the bankruptcy court dismissed all but the disallowance claim against SPSO under 11 U.S.C. § 502(b). The court agreed to consider Harbinger's request for equitable subordination of SPSO's claim in the context of a confirmation hearing on a plan providing for that relief.

list, SPSO was not a subsidiary of either. Accordingly, the court also found no breach of the Credit Agreement, nor any support for the tortious interference claim. The bankruptcy court did determine, however, that the transactions violated the spirit of the Credit Agreement and the covenant of good faith and fair dealing automatically implied by law. Still, because the Credit Agreement did not contain language invalidating transfers made in violation of either an express breach or a breach of the implied covenant of good faith and fair dealing, the court could not invalidate the transfers to SPSO.

The court, however, was not altogether willing to overlook Ergen's end-run around the Credit Agreement, his failure to inform the DISH Board, and his flouting of the rules in acquiring LightSquared LP debt on DISH's behalf.<sup>25</sup> Accordingly, while declining to altogether disallow SPSO's claim in the bankruptcy, the bankruptcy court determined that equitable subordination of SPSO's claim was appropriate under the test articulated in *In re Mobile Steel*:<sup>26</sup> (i) SPSO's and Ergen's end-run around the Credit Agreement, and their needless, purposeful delay in closing trades, amounted to misconduct, which (ii) resulted in injury to creditors, to be later quantified, due to the delay, uncertainty, and increased costs to the LightSquared estates.

### *Lessons to Equity*

The *LightSquared* analysis does not begin and end with the conduct of Charles Ergen and SPSO. The bankruptcy court also focused on the actions—and inactions—of Harbinger and its chief executive, Philip Falcone, in determining not to disallow SPSO's claim. Speculation that Ergen was behind SPSO began before the LightSquared filing, yet the court found that neither LightSquared nor its equity holders ever took decisive action to find out for certain. For example, the court highlighted:

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<sup>25</sup> *LightSquared* is not the first bankruptcy in which Ergen has been accused of skirting the rules to reach a desired result. See, e.g., *In re DBSD North America, Inc.*, 421 B.R. 133 (Bankr. S.D.N.Y. 2009) (designating DISH's vote on DBSD's plan after determining that DISH had acquired debt solely to vote against plan for strategic purposes); *In re DBSD North America, Inc.*, 634 F.3d 79 (2d Cir. 2011) (affirming designation of DISH's vote).

<sup>26</sup> The *Mobile Steel* test considers the following: (i) the claimant must have engaged in some type of inequitable conduct; (ii) the misconduct must have resulted in injury to the creditors of the bankrupt or conferred an unfair advantage on the claimant; and (iii) equitable subordination of the claim must not be inconsistent with the provisions of the Bankruptcy Act. See *Benjamin v. Diamond (In re Mobile Steel Corp.)*, 563 F. 2d 692, 700 (5th Cir. 1977). Equitable subordination is now codified in 11 U.S.C. § 510(c).

- Falcone’s communications with financial entities and the press speculating as to the individual behind SPSO;
- Harbinger’s seeming ambivalence as to whether the acquisition might actually be positive for LightSquared;
- Harbinger’s own gamesmanship with respect to SPSO’s pre-petition debt purchase by adding DISH to the list of Disqualified Purchasers just before the bankruptcy filing, to trap Ergen in a minority position; and
- The debtors’ failure to use Federal Rule of Bankruptcy Procedure 2004 during the bankruptcy proceedings to obtain more information.

Because the court found that LightSquared took no action for over a year to establish with certainty the purchaser of the LightSquared LP debt, the bankruptcy court held that LightSquared was estopped from seeking affirmative damages for the asserted contract breach. Thus, counsel to equity investors should advise them to take a proactive role against, and not to ignore, the questionable actions of third parties.

#### *Related Contested Plan Proceedings*

The extent of the equitable subordination of SPSO’s claim is, as yet, undetermined (and, under the current plan of reorganization, SPSO may avoid subordination altogether if it elects to support the Plan).<sup>27</sup> In July 2013, the bankruptcy court denied confirmation of the debtors’ Third Amended Joint Plan of Reorganization, which would have separately classified SPSO’s claim from other claims arising under the Credit Agreement, and subordinated SPSO’s claim in its entirety—leaving SPSO with a seven-year, third lien note that accrued PIK interest at the rate of LIBOR plus 12 percent—despite the payment in full, in cash, of similar claims.<sup>28</sup> The bankruptcy court determined that 11 U.S.C. §1122 permitted the separate treatment of SPSO’s claim (as opposed to the claim of other senior secured debt holders), based on its finding that SPSO’s interests were aligned with those of DISH, and its behavior and actions to date had benefited DISH, and not the debtors. The court found, however, that the

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<sup>27</sup> See Disclosure Statement at 12 (noting that the proposed plan treats SPSO identically with other senior secured holders notwithstanding the proponents’ ability to seek equitable subordination, subject to a reservation of rights if SPSO rejects the plan).

<sup>28</sup> *In re LightSquared, Inc.*, 513 B.R. 56 (Bankr. S.D.N.Y. July 11, 2014).



plan went too far, as “separate classification cannot be used to mistreat a creditor, out of personal animosity or otherwise.”<sup>29</sup>

The bankruptcy court also refused to designate SPSO’s vote against the plan under 11 U.S.C. § 1126(e), finding that the SPSO’s vote against the plan was justified, as it “not only deprives it of its first lien security interest but provides it with plan consideration that is virtually indistinguishable from equity interests.”<sup>30</sup> In doing so, the bankruptcy court refused to extend the holding of *DBSD*, where the bankruptcy court had designated votes of Ergen’s DISH where DISH had acquired claims exclusively for voting against a plan. The bankruptcy court also determined that SPSO’s claim would be subordinated only to the extent of the harm to other creditors, and that the proposed treatment of SPSO’s claim under the plan was so disparate that it was not “fair and equitable” under 11 U.S.C. § 1129(b)(2)(A), finding, among other things, that it failed the “indubitable equivalent” test under Section 1129(b)(2)(A)(iii), and unfairly discriminated against SPSO.<sup>31</sup>

### *Drafting Takeaways*

In addition to its warnings regarding gamesmanship and allowing acrimony to impede progress, *LightSquared* also provides a useful lesson regarding credit documents. When considering a debt purchase, investors should

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<sup>29</sup> *Id.* at 88.

<sup>30</sup> *Id.* at 90.

<sup>31</sup> Notably, the bankruptcy court also remarked upon Harbinger’s animosity toward Ergen and the DISH parties when denying the Third Amended Plan, finding that turnabout is not fair play:

Against the backdrop of allegations—and findings—that SPSO and Mr. Ergen indeed orchestrated an end-run around the restrictions on the Prepetition LP Credit Agreement, it is remarkable that the Debtors and those parties who support the Plan have constructed a plan of reorganization that is a gerrymandered end-run around their inability to disallow the SPSO Claim. . . . And the trial record leaves no doubt that subordinating the SPSO Claim—with or without a finding of equitable subordination—was the *sine qua non* of the Harbinger-driven plan process. This was a plan that was orchestrated by Mr. Falcone and those he sought to “protect;” it provides the Ad Hoc Secured Group with the quick cash payout it had hoped to obtain from LBAC’s purchase of the LP assets; and it assumes a result in the Adversary Proceeding that is not to be.

*Id.* at 103-04.

carefully review the documents to confirm that the relevant agreements: (i) use a broad brush to include subsidiaries and affiliates of competitors and other relevant entities as those parties prohibited from holding debt, to avoid the possibility that undesirable holders will sneak through unintended loopholes, and (ii) include language stating that transfers in violation of the terms of the agreement are invalid and void.

## **Conclusion**

The foregoing cases all provide reminders that bankruptcy courts are courts of equity and that both overly aggressive investors and passive debtors may suffer the consequences of their conduct. The more practical common lesson among the decisions discussed above is to scrutinize closely and understand deal documentation—particularly when buying into existing debt—and price risk accordingly. Among other things, investor diligence should include:

- a. Careful review of prepayment and similar provisions that may be limited in a bankruptcy;
- b. Understanding the scope of and any risks relating to priority of payment, collateral position, and perfection; and
- c. Consideration of scenarios pursuant to which undesirable holders may acquire debt and impede proceedings.

Distressed investors and their advisors should keep abreast of these and other new developments that could affect their investment strategy and the nature of the role they may play in a Chapter 11 case.

## **Key Takeaways**

- Note that several significant decisions rendered in 2014 serve as strong reminders for financial parties to be diligent and to appreciate risk, in both investment and strategic decision making.
- Advise creditors that they should not assume they can rush their borrowers to a private sale, that a court will overlook significant impairments in a collateral package, or that a court will ignore inequitable attempts to strong-arm a debtor.
- Advise potential acquirers to diligence their collateral packages and price their risk accordingly. They also should be wary of needlessly

aggressive schedules and avoid actions that can backfire before a court of equity. Equity investors should take a proactive role against, and not ignore, the questionable actions of third parties.

- Inform investors who are considering a debt purchase to review carefully the documents to confirm that the relevant agreements: (i) use a broad brush to include subsidiaries and affiliates of competitors and other relevant entities as those parties prohibited from holding debt and (ii) include language stating that transfers in violation of the terms of the agreement are invalid and void.
- Remind clients that bankruptcy courts are courts of equity, and that both overly aggressive investors and passive debtors may suffer the consequences of their conduct. Closely scrutinize and understand deal documentation—particularly when buying into existing debt—and price risk accordingly.
- Keep abreast of new developments that could affect your clients' investment strategies and the nature of the role they may play in a Chapter 11 case.

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