Meet the Investors in Chapter 11 – Should Motives Matter?

JENNIFER C. HAGLE, JEREMY E. ROSENTHAL, ANNA GUMPORT, Sidley Austin LLP

Recent bankruptcy cases have highlighted a renewed focus on both the identity and motives of creditors actively participating in bankruptcy cases. Taken together, these cases reflect a growing trend to restrict the available strategies for some creditors, and in certain instances, require extensive disclosures based on their identity and perceived motives. For example, consider the following hypothetical "creditors":

MAINSTREAM BANK, N.A. – originally financed debtor at par, unfortunately now an "involuntary investor."

LONG TERM HOLDERS LLC – acquired claim at a moderate discount, believes in debtor and likes the industry, looking to maximize recovery on its debt claim.

LOAN TO OWN OPPORTUNITY FUND – acquired "out of the money" or "fulcrum" senior or subordinated secured debt at a deep discount, with the goal of converting its debt to equity.

ACTIVIST STRATEGY PARTNERS – acquired blocking position in class of claims at a discount well into the bankruptcy plan process for the purpose of defeating the plan based on a legitimate belief in an alternative strategy.

STRATEGIC ACQUISITION LP – acquired blocking position in claims at par within a class for purpose of defeating plan and proposing an alternative that gives it control of the debtor through a plan or sale, possibly to benefit an independent interest it holds.

Each of our cast of creditors acquired their claims on either the primary or secondary market, in accordance with the applicable credit documents. Each is a sophisticated investor with the knowledge, experience and resources to make an economically rational decision. Admittedly, the timing and basis of their investments differ, but they share a common motive to maximize their recovery in accordance with their institutional preferences. Based on recent bankruptcy court developments, however, some of these creditors may be denied the opportunity to fully advance their objectives as participants in the bankruptcy process. Some may have their bankruptcy votes "designated" – or disqualified. Some may be denied the right to be heard as a junior creditor or even as an unsecured creditor. Some might be forced to disclose confidential trading information to the court and competitors if they want to coordinate their efforts with similarly situated investors. Some might be precluded in the first instance from taking an assignment of a loan or even a participation interest therein.

What is the basis for these distinctions? It appears that bankruptcy judges are demonstrating an increasing desire to understand and focus on the potential "motives" and "agendas" of distressed investors – particularly at critical points within a bankruptcy case, such as plan confirmation or a major asset sale. Indeed, the perceived motive of an investor may factor decisively into a court's ultimate determination of whether and to what extent each investor should prevail with respect to its strategy – or in some cases, even be heard. Is this fair? Should motives really matter in chapter 11?

DESIGNATION OF STRATEGIC INVESTORS' VOTES

It is universally acknowledged that a creditor's ability to vote on a plan is one of its most important rights, if not the most important right, under the Bankruptcy Code. However, although the right to vote on a plan is fundamental, it is not inviolable. Under certain circumstances, courts may deny a creditor its right to vote. For example, if a court finds that a vote has not been cast to further a creditor's agenda to maximize its claim *as a creditor* but instead cast to further an ulterior agenda or perceived bad faith motive, the creditor's vote will be disregarded.

A series of recent cases, including an opinion from the Second Circuit Court of Appeals, has now held that designation is appropriate when a creditor votes its claim to pursue an agenda other than that of maximizing the value of its claims as a creditor.[1] Examples of "ulterior motives" include a competitor voting claims to thwart a proposed consensual restructuring or a creditor voting claims a certain way in exchange for payments from a third party – admittedly fairly egregious examples. More troubling, however, are the recent opinions that appear

1 *In re DBSD N. Am., Inc.*, Nos. 10-1145, 10-1201, 10-1352, slip op. at 40 (2d Cir. Feb. 7, 2011) (court may designate vote of party "who votes with an ulterior motive, that is, with an interest other than an interest as a creditor other than an Interest as a creditor") (quotations omitted) (citation omitted).

to significantly broaden the circumstances under which courts may find motives to be in "bad faith", such as when a creditor attempts to acquire a debtor in the belief that the acquisition will maximize the return on its claims.

A Primer on Designation

The Bankruptcy Code permits the designation, or disqualification, of votes if they are not cast or solicited in good faith. As a court of equity, it is certainly not unreasonable for a bankruptcy court to be concerned on some level with the motives of the parties before it. When it comes to plan confirmation, however, motives become paramount. A plan cannot be confirmed if it is not "proposed in good faith."[2] Similarly, a vote will be designated if it is not cast in "good faith, or was not solicited or procured in good faith."[3] Whether or not creditors are voting in good faith comes down to one fundamental question – are those creditors voting "'selfishly' to maximize the recovery on their claims as a creditor"?[4] If so, their vote will likely be found to be cast in good faith – however, if a creditor is perceived to be voting its claim in pursuit of any other agenda, it risks designation.

It is noteworthy that, until *DBSD North America*, bankruptcy courts rarely designated votes as a remedy in chapter 11. Indeed, the rhetoric surrounding designation suggests that it is a rarely enforced remedy, to be used only in the most egregious of circumstances. As one court observed, "[t]he ability to vote on a reorganization plan is one of the most sacred entitlements that a creditor has in a chapter 11 case. . . . [I]t 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."[5] The United States Supreme Court, interpreting Section 203 of the Bankruptcy Act, the predecessor to section 1126(e) of the Bankruptcy Code, stated, "the history of [section 203] makes clear that it was intended to apply to those stockholders whose selfish purpose was to obstruct a fair and reasonable reorganization."[6] The Supreme Court continued, the "good faith" standard was adopted "to prevent creditors from participating who by the use of obstructive tactics and hold-up techniques exact for themselves undue advantages from [those] who are cooperating."[7]

Despite the rhetoric surrounding designation suggesting that it is a remedy to be used sparingly and only under egregious circumstances, recent case law, including *DBSD North America*, has now expanded the use of designation arguably far beyond just preventing "obstructive tactics and hold-up techniques." Indeed, the category of "good faith" behavior has narrowed and the label of "bad faith" has been expanded to cover a broader range of conduct. Neither "good faith" nor "bad faith" are defined in the Bankruptcy Code; however, case law supplies a wide range of definitions. A common list of the "badges of bad faith" justifying disqualification includes "efforts to: (1) assume control of the debtor; (2) put the debtor out of business or otherwise gain a competitive advantage; (3) destroy the debtor out of pure malice; or (4) obtain benefits available under a private agreement with a third party which depends on the debtor's failure to reorganize."[8]

Of these four badges of bad faith, the first – voting a claim in order to take control over a debtor – appears to be the least obvious from a policy perspective and perhaps the hardest to justify.[9] However, it is this "badge" of bad faith that the court in *DBSD North America* relied on to designate the strategic investor's vote. The inability to assert a claim to acquire control of a debtor is presumably contrary to the expectations of many institutions that actively trade in distressed debt on the secondary market. Although the *DBSD North America* court did not explain the

2 11 U.S.C. § 1129(a)(3).

3 11 U.S.C. § 1126(e).

4 *In re DBSD N. Am., Inc.*, 421 B.R. 133, 138 (Bankr. S.D.N.Y. 2009) ("*Collier* recognizes the ability of creditors to vote 'selfishly' to maximize the recovery on their claims, and to act in their economic interest, 'as long as the interest being served is that of a creditor as creditor, as opposed to creditor in some other capacity.' But *Collier* goes on to expressly state: 'On the other hand, a vote to block a reorganization plan in order to acquire the debtor company for one's self may justifiably result in disqualification of the vote.'") (quoting 7 *Collier on Bankruptcy* ¶ 1126.06[1]-[2] (15th ed. rev. 2009)).

5 *In re Adelphia Commc'ns Corp.*, 359 B.R. 54, 56-57 (Bankr. S.D.N.Y. 2006); see also id. at 61 ("A right to vote on a plan is a fundamental right of creditors under chapter 11. Designation of a creditor's vote is a drastic remedy, and, as a result, designation of votes is the exception, not the rule.").

6 *Young v. Higbee Co.*, 324 U.S. 204, 211, 89 L. Ed. 890, 65 S. Ct. 594 (1945).

7 *Id.* at 211 n.10 (quotations omitted).

8 *In re DBSD N. Am., Inc.*, 421 B.R. at 138; *In re Dune Deck Owners Corp.*, 175 B.R. 839, 844-45 (Bankr. S.D.N.Y. 1995), *In re Adelphia Commc'ns Corp.*, 359 B.R. at 61. The court in *Adelphia* proposed its own summary of when votes are designated for bad faith, including: "(1) if the claimant is using obstructive tactics and hold-up techniques to extract better treatment for its claim compared to the treatment afforded similarly situated claimholders in the same class; or (2) if the holder of the claim casts its vote for the ulterior purpose of securing some advantage to which it would not otherwise be entitled; or (3) when the motivation behind its vote is not consistent with a creditor's protection of its own self-interest." *In re Adelphia Commc'ns Corp.*, 359 B.R. at 60.

9 *Dune Deck cites In re Landing Assocs., Ltd.*, 157 B.R. 791 (Bankr. W.D. Tex. 1993), in support of the principle that assuming control is a badge of bad faith. However, *Landing* did not involve an attempt by the creditor to assume control of the debtor; instead, the creditor was allegedly acting in the bankruptcy case to enhance contractual rights it had with the FDIC in a side agreement. The sole reference to control as bad faith came from the *Landing* court's citation of *Allegheny International* for the principle that "voting to block a plan in order to acquire the company ones' self justifiably results in disqualification, as it did in *Allegheny Int'l*." *In re Landing Assoc., Ltd.*, 157 B.R. at 807-08 (citing *In re Allegheny Int'l, Inc.*, 118 B.R. 282, 293 (Bankr. W.D. Pa. 1990)).

policy behind its finding that seeking to control a debtor via exercise of voting rights constitutes bad faith, the implicit rationale appears to be a concern that the strategic investor is using its debt claim to capture the enterprise value of the debtor for itself (the so-called "control premium"), without using a Bankruptcy Code-sanctioned acquisition vehicle, such as a section 363 asset sale or plan of reorganization.[10] The fear is that by not using such a vehicle, the investor is circumventing the value-maximizing protections of competitive bidding, public marketing and/or competing plans (with all of the attendant notice requirements) intended to protect other interested parties in a manner that maximizes the recovery for all stakeholders.

DBSD North America (DISH Network)

In *DBSD North America*, the Second Circuit validated a powerful potential weapon against strategic and activist investors.[11] Under Second Circuit law, the intent to vote claims to further the "ulterior motive" of acquiring the debtor is sufficient (without the need to show any other misconduct) to designate a creditor's vote. Bankruptcy Judge Robert Gerber described "bad faith" as the "absence of the requisite good faith" and held that it was "bad faith" in *DBSD North America* "where a claim holder attempts to extract or extort a personal advantage not available to other creditors in the class, or, as relevant here, where a creditor acts in furtherance of an ulterior motive, unrelated to its claim or its interests as a creditor."[12]

While the facts in *DBSD North America* are extreme in some regards, the court did not make any findings that DISH Network – a competitor and strategic acquirer – engaged in fraud or deceptive practices when it acquired its claims. The fundamental issue appears to be that DISH Network was attempting to acquire the debtor by circumventing Bankruptcy Code-sanctioned methods of obtaining control such as through a section 363 asset sale or a plan of reorganization.[13] Instead of pursuing one of these avenues, the court found that DISH Network waited until DBSD's disclosure statement was approved and then targeted the senior secured creditors and the fulcrum creditors that would be equitized under the plan, purchased 100% of the senior debt *at par* and offered to acquire any fulcrum debt that was not subject to a plan support agreement. DISH Network then used its claims to vote down the debtor's plan. The court also found that at the same time as DISH Network was acquiring claims and then voting down the debtor's plan, it was making several confidential proposals to DBSD to acquire it in a strategic transaction, reaffirming the court's conclusion that DISH Network's end game was control of DBSD. Finally, after having its offers rebuffed and after voting down the debtor's plan, DISH Network filed its own competing plan to acquire DBSD.

In making his findings and supporting designation of DISH Network's votes, Judge Gerber focused on the fact that (i) the claim purchases occurred after the debtor's disclosure statement was approved and proposed recoveries were known, and (ii) claims were acquired at par, ensuring that DISH Network would have no investment gains on its claims as a creditor. Judge Gerber held that paying par for first lien debt precluded any argument that DISH Network was voting its claims to further its interest as a creditor. The court stated "[w]hen an entity becomes a creditor late in the game paying 95[cent] on the dollar (as in Japonica) or 100[cent] on the dollar, as here, the inference is compelling that it has done so not to maximize the return on its claim, acquired only a few weeks earlier, but to advance an 'ulterior motive' condemned in the caselaw."[14]

Based on these findings, the court held, "DISH made its investment in this chapter 11 case, and has continued to act, not as a traditional creditor seeking to maximize its return on the debt

10 *See In re Allegheny Int'l, Inc.*, 118 B.R. at 300-01 (designating the votes of a strategic investor and imposing a remedy that put the acquirer's stock in trust with restrictions designed to ensure that "any premium price paid for control must also be shared with other [post-reorganization] stockholders"). In articulating why acquiring control of a debtor is bad faith, the court explained: "Here, Japonica clearly attempts to deprive creditors of the control premium by a manipulation of the reorganization process through the strategic purchase of claims. Acquiring claims with the clear purpose of achieving control of the debtor, thereby earning a control profit, does not maximize the result for all creditors." *Id.* at 300.

11 *In re DBSD N. Am., Inc.*, Nos. 10-1145, 10-1201, 10-1352 (2d Cir Feb. 7, 2011).

12 *In re DBSD N. Am., Inc.*, 421 B.R. at 138.

13 *See id.* at 139-40 ("[A]s DISH's actions and documents make clear, its purpose was as a strategic investor – and, it may fairly be inferred, 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.").

14 *Id.* at 140 ("DISH's purpose, or course, was not that of the typical creditor – either a victim of financial distress left holding the bag when a debtor fails, or even an investor in distressed debt seeking to profit from the spread between its purchase price for the distressed debt and its ultimate distributions under a plan."). The Second Circuit noted that buying claims at par cannot be the sole basis for designation because "purchasers may have many good business reasons for buying debt at par, especially when, as in this case, the debt is well secured and interest rates dropped between the original issuance of the debt and its purchase." *In re DBSD N. Am., Inc.*, Nos. 10-1145, 10-1201, 10-1352, slip op. at 45 n.13 (2d Cir. Feb. 7, 2011). However, the Second Circuit found that DISH's decision to purchase claims at par was "circumstantial evidence of its intent" because "a willingness to pay high prices may tend to show that a purchaser is interested in more than the claim for its own sake." *Id.*

it holds, but as a strategic investor, 'to establish control over this strategic asset.'"[15] The court concluded that DISH Network's conduct was in "bad faith" as it acted "in furtherance of an ulterior motive, unrelated to its claim or its interests as a creditor."[16] As a remedy, not only did the court designate all of DISH Network's votes on the debtor's plan, but to the extent that its votes were necessary to have its classes of claims support the debtor's plan for cramdown purposes (especially its holding of 100% of the senior most class of claims), then either its class would be considered vacant for purposes of voting or its class would "be regarded as an accepting class."[17]

With the Second Circuit affirming the designation of a strategic acquirer's votes, one may expect to see a significant increase in challenges to the "good faith" of activist and strategic investors in plan confirmation battles.[18]

Allegheny International (Japonica)

Allegheny International, a case over twenty years old, was the leading modern case on designation prior to *DBSD North America*.[19] During this period, the vast majority of courts facing designation challenges declined to designate creditor votes. These courts, including Judge Gerber in *Adelphia*, found that even though a creditor may act reprehensibly, so long as it was seeking to maximize its recoveries as a creditor its votes could not be designated.[20] However, despite the broad latitude given to creditors to single-mindedly attempt to maximize their recovery as creditors, under *Allegheny International*, if a creditor uses its claims to pursue an ulterior motive other than maximizing the recovery on its claim, its votes can be designated.

Faced with egregious conduct from all parties and three different designation motions, the court in *Allegheny International* designated the votes of Japonica Partners, a distressed investor that was trying to acquire Allegheny and its Sunbeam subsidiaries. Through a complicated series of private sales and a tender offer, Japonica acquired over 1/3 of the senior secured notes for up to 95% of their face value. Japonica also agreed to indemnify the selling lenders against litigation brought by the creditors committee that would benefit a class of subordinated creditors. At the same time, Japonica acquired a little less than 1/3 of the claims of the subordinated creditors that would benefit from the litigation and paid 66% of the face amount for the subordinated claims. Japonica acquired its blocking position in both the senior secured class and the subordinated class after the debtor's disclosure statement was approved. In addition, Japonica filed its own competing plan just prior to the conclusion of the disclosure statement hearing. Its plan was largely identical to the debtor's plan but provided for Japonica to acquire the majority of the equity in the reorganized debtor.

The *Allegheny International* court found that "Japonica, by acquiring a blocking position, has defeated the debtor's plan and can defeat any other plan and thereby obstruct a 'fair and feasible reorganization.'"[21] The court noted that the "mere fact that a purchase of creditors' interests is for ... securing approval or rejection of a plan does not of itself amount to 'bad faith.' When that purchase is in aid of an interest other than an interest as a creditor, such purchases may amount to 'bad faith.'"[22] The court then held that Japonica's acquisition of sufficient claims to block any plan it did not approve of was achieved "in aid of an interest other than an interest as a creditor."[23] On this basis, the court designated Japonica's vote. The court concluded that even though designation under section 1123(e) of the Bankruptcy Code is permissive, "[v]otes must be designated when the court determines that the 'creditor has cast his vote with an ulterior purpose aimed at gaining some advantage to which he would not otherwise be entitled in his position.'"[24] According to the court, the policy justification for this holding is that if "an outsider to the process can purchase a blocking position, those [existing] creditors and interest holders are disenfranchised.... If a plan proponent, such as Japonica, can purchase a blocking position, the votes of the other creditors and interest holders are rendered meaningless."[25]

---

15 *In re DBSD N. Am., Inc.*, 421 B.R. at 137 (quoting internal DISH Network memorandum stating its justifications for investing in DBSD debt).

16 *Id.* at 138.

17 *In re DBSD N. Am., Inc.*, 09 Civ. 10156 (LAK), 09 Civ. 10372 (LAK), 09 Civ. 10373 (LAK), 2010 U.S. Dist. LEXIS 33253, at *9 (S.D.N.Y. Mar. 24, 2010) (quotation omitted).

18 *In re DBSD N. Am., Inc.*, Nos. 10-1145, 10-1201, 10-1352 (2d Cir. Feb. 7, 2011).

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

20 *See, e.g.*, *In re Adelphia Commc'ns Corp.*, 359 B.R. at 62-63 ("Without question, at least some of it was overly aggressive and overreaching. But it was, once more, an effort to maximize recoveries as a creditor under a prospective plan" and "boil[s] down to activities that, while distasteful and heavy handed, are sufficiently within what the law permits, and sufficiently tied to maximize creditor recoveries, that I should not disenfranchise creditors from their statutory rights.").

21 *In re Allegheny Int'l, Inc.*, 118 B.R. at 289.

22 *Id.* (quoting *In re P-R Holding Corp.*, 147 F.2d 895, 897 (2d Cir. 1945)) (ellipses in original).

23 *Id.*

24 *Id.* at 290 (quoting *In re Gilbert*, 104 B.R. 206, 216 (Bankr. W.D. Mo. 1989) (quotation omitted)).

25 *Id.*

Like the court in *DBSD North America*, the court in *Allegheny International* attempted to fashion an aggressive remedy that would completely preclude the strategic investor from benefiting from its acquisition even after its votes were designated. In *DBSD North America*, that goal was achieved by treating DISH Network's votes against the plan as votes affirmatively in favor of the plan, if necessary. In *Allegheny International*, Japonica held so many claims in different classes that it would still be in a position to acquire a majority of the debtor's equity under the debtor's plan even if its votes were designated. Therefore, to prevent Japonica from realizing the control premium that the court found so offensive, the court imposed an injunction designed to force Japonica to share any control premium it received with all equity and warrant holders.[26] The court denied Japonica the right to vote its new equity unless, within 45 days of confirmation, Japonica demonstrated the ability and willingness to accept puts from minority equity holders. If Japonica agreed to honor the puts, then minority equity holders would immediately be authorized to put their equity to Japonica. If Japonica failed to demonstrate that it would honor the puts within 45 days, then its shares would be placed in trust and precluded from being voted for three years. The court explained, "[t]he remedies this court has selected do not deny at this time the bargain Japonica may have achieved on its trading in claims. The remedies are designed to deny control and the control profit through the denial of the voting power of those shares."[27] The arguably harsh (yet extremely creative) judicial remedies imposed in these cases – clearly intended to level the playing field among the strategic investors and existing creditors – illustrate the critical impact a creditor's perceived motives can have on its recovery in bankruptcy.

Given the foregoing, investors like our hypothetical Activist Strategy Partners and Strategic Acquisition LP are well advised to carefully assess the risk that their pursuit of an alternative and aggressive strategy may prevent them from voting the very claims that they acquired to further those strategies. This is especially true if the acquirer's vote alone is necessary to confirm its plan or reject a competing plan because it has not been able to persuade a sufficient number of other creditors to support its proposal. Additional consideration should also be given to the amount paid for the debt (is there a possibility to increase the return?), the timing of the purchase (before or after plan confirmation is well underway?) and whether the creditor has made offers to acquire the company (which could be used as further evidence of a bad faith motive).

ENFORCEMENT OF INTERCREDITOR AGREEMENTS

The perceived motives of a subordinated creditor may also factor significantly into a court's decision whether to strictly enforce the terms of an intercreditor agreement. Until 2009, there were a limited number of published cases interpreting intercreditor agreements. Since then, three published decisions have been issued that reach two very different results. The bankruptcy courts in *Ion Media* and *Erickson Retirement* strictly enforced intercreditor agreements against junior creditors – preventing them from challenging the senior creditors and even denying them standing to appear.[28] The bankruptcy court in *Boston Generating*, however, distinguished both of these cases, finding that the junior creditor had standing to object to the sale consented to by the senior creditors.[29] Perhaps the most telling difference between these opinions is that, in each of *Ion Media* and *Erickson Retirement*, the courts found that the junior creditor was driven by an improper motive, while in *Boston Generating*, the court found that the junior creditor's motives were reasonable.

In *Ion Media*, the court found that the junior creditor "has an undisguised economic objective – to use its role as a potential spoiler to gain leverage that may lead to enhanced recoveries or perhaps even an outright acquisition . . ."[30] In *Erickson Retirement*, the court found that the junior creditor's motion "is unmistakably aimed at slowing down the confirmation process and gaining leverage to enhance or create recoveries for the Subordinated Creditors. This is the very type of obstructionist behavior that [intercreditor] agreements are intended to suppress."[31] The court in *Boston Generating*, however, expressly declined to follow either *Ion Media* or *Erickson Retirement*. The court conceded that its "reading of the Intercreditor Agreement [was], to say the least, a very close call" but found that "[w]hile not dispositive, additional

26 *Id.* at 301. The injunction was imposed at the request of the 2/3 of the senior secured lenders that did not sell their interests to Japonica and was intended to enforce a change of control provision in the debtor's operating documents (that Japonica stated it would not honor) that required sharing any change of control premium through a put right available to minority equity holders. *Id.* at 300-01.

27 *Id.* at 304. The court reaffirmed its ruling following several motions for reconsideration and further clarified the scope and terms of the Japonica injunction. *See In re Allegheny Int'l, Inc.*, 118 B.R. 282 at 324 (Bankr. W.D. Pa. 1990).

28 *Ion Media Networks, Inc. v. Cyrus Select Opportunities Master Fund, Ltd. (In re Ion Media Networks, Inc.)*, 419 B.R. 585 (Bankr. S.D.N.Y. 2009) (holding that junior creditor lacked standing to object to plan or contest scope of senior creditor's liens); *In re Erickson Ret. Communities, LLC*, 425 B.R. 309 (Bankr. N.D. Tex. 2010) (holding that junior creditor did not have standing to seek appointment of examiner).

29 *In re Boston Generating, LLC*, Case No. 10-14419, 2010 Bankr. LEXIS 4335 (Bankr. S.D.N.Y. Dec. 3, 2010) (permitting junior creditor to object to bid procedures and, ultimately, sale of substantially all of debtors' assets in section 363 sale).

30 *In re Ion Media Networks, Inc.*, 419 B.R. at 602.

31 *In re Erickson Ret. Communities, LLC*, 425 B.R. at 315.

facts that enter in the Court's analysis include . . . the Second Lien Lenders are on the 'cusp' of a recovery and are not engaging in the type of obstructionist behavior identified by the Court in *Ion Media*."[32] Although the *Boston Generating* court specifically noted that the interpretation and enforcement of a contract should not ultimately be dictated by the motives of the parties, it certainly seemed to take into account the junior creditor's motives in allowing a creditor on the "cusp" of a recovery that had not engaged in "obstructionist behavior" to have standing to oppose the sale supported by the senior creditor.[33]

Although the *Boston Generating* court declined to find that the intercreditor agreement barred the junior creditor from objecting to a section 363 sale, it is noteworthy that the court observed that it may have come to a different conclusion if the senior creditor had argued that its consent to the section 363 sale was an *exercise of remedies* triggering a separate, less ambiguous, provision of the intercreditor agreement. Indeed, counsel for the senior creditor stipulated during argument that its consent to the sale free and clear of liens was not an exercise of remedies under its credit agreement or the intercreditor agreement. The court was at a loss to understand counsel's position and stated, "absent this stipulation, I may have concluded that the consent under section 364(f)(2) is an exercise of the rights afforded to a secured creditor and is thus an exercise of remedies. This may have altered my conclusion herein regarding standing and whether or not the objections asserted by the [junior creditors] were a violation of the Intercreditor Agreement."[34]

In addition to distinguishing the motives of the junior creditors, the *Boston Generating* court distinguished *Ion Media* and *Erickson Retirement* on the basis that the intercreditor agreement in *Boston Generating* was "not a model of clarity."[35] Both the *Ion Media* and *Erickson Retirement* courts found the intercreditor agreements at issue to be "unambiguous" or to be reasonably understood to require the junior creditor to "stand still."[36] Given the fact that intercreditor agreements tend to be long and complicated agreements to parse, it is important to understand that (i) motives may matter – and even be determinative – when close questions of law are at issue, and (ii) practitioners should take specific precautions to ensure that specific waivers (in the case of senior creditors) or authorizations to act (in the case of junior creditors) are unambiguous if they want to maximize their chances of enforcing their intercreditor agreements in bankruptcy court.[37] The court in *Boston Generating* specifically cited the American Bar Association's Model Intercreditor Agreement as an example of clear bankruptcy waivers.[38]

Based on the foregoing, it is very important that any subordinated creditor, such as our Loan to Own Opportunity Fund, carefully evaluate any intercreditor agreement to which it is a party and, based on the relative strength or weakness of its provisions, tailor its approach to the case accordingly, in order to maximize its ability to participate and be fully recognized as a subordinated creditor within the parameters of the agreement and/or as an "unsecured creditor", free of the restrictions in any applicable intercreditor agreement. At the same time, it is important to take the lessons of *Ion Media* to heart: choose one's battles and minimize antagonizing the court and risking raising the court's concerns about motive to a level where those concerns outweigh otherwise compelling legal considerations. The *Ion Media* court's blunt assessment of the subordinated creditor's motive is telling – having determined that the junior creditor was "an activist distressed investor that purchased certain deeply discounted second lien debt . . . for pennies on the dollar. . . . [Its] motivations are easy enough to recognize. It has been

32 *In re Boston Generating, LLC*, 2010 Bankr. LEXIS 4335, at *43.

33 *In Ion Media*, the junior creditor was "economically motivated and woefully out of the money." *In re Ion Media Networks, Inc.*, 419 B.R. at 590.

34 *In re Boston Generating, LLC*, 2010 Bankr. LEXIS 4335, at *36 (citing *In re Chrysler LLC*, 405 B.R. 84, 101-02 (Bankr. S.D.N.Y. 2009)). The court in *Chrysler* held, "the Administrative Agent's consent to the sale of the assets and its direction to the Collateral Trustee to consent, under section 363(f)(2) of the Bankruptcy Code, satisfies that section [of the credit agreement dealing with the agent's exclusive right to exercise remedies] and allow[s] for the purchased assets to be sold free and clear of the liens on the property held by the Collateral Trustee." *In re Chrysler LLC*, 405 B.R. at 102.

35 *In re Boston Generating, LLC*, 2010 Bankr. LEXIS 4335, at *36.

36 *In re Ion Media Networks, Inc.*, 419 B.R. at 590 ("Here, a sophisticated, economically motivated and woefully out of the money creditor has deliberately chosen to ignore the terms of an unambiguous agreement that, read literally, precludes it from opposing confirmation."); *In re Erickson Ret. Communities, LLC*, 425 B.R. at 315 ("[A] reasonable person . . . would understand that the meaning of the Subordination Agreements to be that . . . [the junior creditor] must 'stand still.'").

37 The court in *Boston Generating* stated "Although I believe it goes against the spirit of the subordination scheme in the Intercreditor Agreement to allow the Second Lien Lenders to be heard and to attempt to block the disposition of the Collateral supported by the First Lien Agent, I am now . . . constrained by the language of the Intercreditor Agreement. . . . Here, the perfect storm of a poorly drafted agreement, the ill-defined scope of [the relevant section of the intercreditor agreement], and the fact that, pursuant to the Secured Parties' own stipulation, there is 'no exercise of remedies' leads me to conclude that the Second Lien Agent and Second Lien Lenders have standing to object to the 363 sale." *In re Boston Generating, LLC*, 2010 Bankr. LEXIS 4335, at *42-43.

38 *See id.* at *38-39. The American Bar Association's Model Intercreditor Agreement, including commentary, was published in the May 2010 issue of the *Business Lawyer*, as part of the American Bar Association's *Report of the Model First Lien/Second Lien Intercreditor Agreement Task Force*. A copy of the Model Intercreditor Agreement can be found at http://goo.gl/6ku4P.

using aggressive bankruptcy litigation tactics as a means to gain negotiating leverage or obtain judicial rulings that will enable it to earn outsize returns on its bargain basement debt purchases at the expense of the First Lien Lenders."[39] Senior lenders like Mainstream Bank, N.A., and Long Term Holders LLC, should also consider structuring their rights to take affirmative action and their consents to a debtor's actions as the exercise of their remedies as senior lenders, in order to take advantage of provisions in intercreditor agreements that typically place strict limits on the ability of subordinated creditors to oppose the senior creditors' exercise of remedies.

RULE 2019 AND CREDITOR DISCLOSURES

The enhanced judicial emphasis on the importance of motives in bankruptcy is perhaps nowhere more evident than with respect to application of Rule 2019 of the Federal Rules of Bankruptcy Procedure ("Rule 2019"). Rule 2019 is a rule of disclosure that courts and parties often rely on in attempting to ascertain the economic incentives – i.e. motives – of creditors who decide to organize as a group in asserting their claims. The controversy over the scope and application of Rule 2019 has led to two divergent lines of cases interpreting the rule and the development of a new compromise proposed rule that, if adopted by the United States Supreme Court, could become effective as early as the end of this year.

As currently drafted, Rule 2019 requires extensive disclosure of economic interests from certain entities participating in the bankruptcy process on behalf of themselves and similarly situated stakeholders. The disclosure requirements include: (i) "the name and address of [each] creditor or equity security holder" that is a member of the group; (ii) "the nature and amount of [their] claim or interest and the time of acquisition" unless acquired more than one year prior to the petition date; (iii) "the pertinent facts and circumstances in connection with the employment of the entity [representing multiple stakeholders]. . . and, in the case of a committee, the name or names of the entity or entities at whose instance, directly or indirectly, the employment was arranged or the committee was organized"; and (iv) "the amounts of claims or interests owned by the entity, [or] the members of the committee" as of the date of employment or formation, as well as "the times when acquired, the amounts paid therefor, and any sales or other disposition thereof."[40]

Split of Authority re Disclosure

Creditors and equity holders in large chapter 11 cases often form informal or *ad hoc* groups to advocate their interests. These *ad hoc* groups tend to form around a particular class of security and seek to advance the common economic agenda of the group while sharing the costs of counsel and other professionals. The groups typically strive to represent a significant amount of the outstanding claims in their class in order to use their representation to enhance their leverage in plan negotiations. Generally, while these *ad hoc* groups represent economic interests common to their class, they do not purport to represent creditors or equity holders that are not expressly members of the group. However, there have been some instances where courts have concluded that an *ad hoc* group purported to reflect the interests of all creditors in its class even though it had not been formally designated as the representative of each creditor.[41]

Historically, these *ad hoc* groups have not been required to make detailed disclosures about their members or their members' investments. However, more recently courts and various stakeholders have seized upon Rule 2019 as a tool for forcing disclosure of economic interests as a means of discerning the potential motives of the *ad hoc* groups in bankruptcies. Many would characterize motions attempting to force Rule 2019 disclosures less charitably, concluding that such tactics do not represent legitimate attempts to glean motive, but rather constitute efforts by antagonistic stakeholders to leverage against or even silence *ad hoc* groups with the threat of forcing detailed disclosures of confidential trading data.

Courts grappling with the scope and application of Rule 2019 have split into two camps. *Northwest Airlines* and *Washington Mutual* have applied Rule 2019 to *ad hoc* groups. These courts focus on the importance of disclosure of a creditor's economic interests as a vital tool in assessing a group's conduct against the backdrop of its motives. In contrast, the courts in *Six Flags* and *Philadelphia Newspapers* found that Rule 2019 was inapplicable to informal groups of creditors that did not purport to represent

39 *In re Ion Media Networks, Inc.*, 419 B.R. at 588-89.

40 Fed. R. Bankr. P. 2019(a).

41 *See In re Washington Mutual, Inc.*, 419 B.R. 271, 279 (Bankr. D. Del. 2009) (rejecting *ad hoc* group's argument that it did not represent nor have duties to any creditors outside the group, stating, "[i]t is not necessary, at this stage, to determine the precise extent of fiduciary duties owed but only to recognize that collective action by creditors in a class implies some obligation to other members of that class."); *In re Northwest Airlines Corp.*, 363 B.R. 701, 703 (Bankr. S.D.N.Y. 2007) ("By appearing as a 'committee' of shareholders, the members purport to speak for a group and implicitly ask the court and other parties to give their positions a degree of credibility appropriate to a unified group with large holdings.").

the interests of non-members.[42] These courts reject the idea that the mere fact that members of an *ad hoc* group are coordinating their efforts to increase their effectiveness and efficiency in a bankruptcy case should subject them to the invasive disclosures required under Rule 2019.

***Northwest Airlines* and *Washington Mutual* – Full Disclosure**

In *Northwest Airlines*, the court held that members of an *ad hoc* "committee" were required to make detailed disclosures under Rule 2019, including the amounts paid for claims or interests, the dates the claims or interests were acquired, and any sales or other disposition thereof. The court also declined to allow the *ad hoc* committee members to file their disclosures under seal, explaining, "Rule 2019 is based on the premise that the other shareholders have a right to information as to Committee member purchases and sales so that they make an informed decision whether this Committee will represent their interests or whether they should consider forming a more broadly-based committee of their own."[43] The court found that any interest the *ad hoc* committee members had in keeping pricing information confidential was subordinate to the legitimate need for disclosure to understand the members' motives – even if disclosure meant the release of confidential trading information.

The court found that two facts present in *Northwest Airlines* compelled disclosure under Rule 2019. First, the court noted that the committee members (in this case, a committee of equity holders) owned a significant amount of debt in addition to their equity in the debtor. The court noted that these inherently divergent economic interests could lead to conflicts that could impair the *ad hoc* committee's collective effectiveness on behalf of equity holders. Second, certain committee members had reserved the right to sell their interests at any time. Consequently, the court believed that this posed a risk of the members selling all or most of their positions but remaining on the committee, leaving shareholders that were not members of the committee without effective representation.

In *Washington Mutual*, the court similarly pointed to concerns about the motives of creditors in an *ad hoc* group and granted another creditor's motion to compel disclosure. The court observed, "The proliferation of short-selling and the advent of myriad derivative products now allow creditors to take multiple stakes in the capital structure of debtors. Such varied holdings have the potential to create complex, conflicting incentives for large creditors."[44] The court then ruled that these conflicting incentives must be disclosed so that all parties can determine where they stand.[45]

***Six Flags* and *Philadelphia Newspapers* – No Disclosure Required**

In *Six Flags* and *Philadelphia Newspapers*, the courts declined to follow *Northwest Airlines* and *Washington Mutual*, refusing to apply Rule 2019 to informal groups of creditors. Noting that various provisions of the Bankruptcy Code already constrained creditors from overreaching and pursuing conflicting agendas, the *Six Flags* court stated that "there is nothing neither nefarious nor problematic, in and of itself, in disparate parties banding together to increase their leverage. Indeed, enabling such is one of the primary rationales for the existence of the Bankruptcy Code."[46] The court also questioned the official committee's motives in bringing the motion to compel disclosure, which the court viewed as a "litigation tactic" and an "end run" around a previous ruling denying the official committee's request for discovery of similar information.[47] The court observed that its dim view of the official committee's tactical motion was supported by the fact that the official committee had not sought disclosures from the *ad hoc* committee of noteholders with which it was allied. The court in *Six Flags* also concluded that the policy justification for Rule 2019 derived from concerns relevant under the Bankruptcy Act that are now irrelevant under the Bankruptcy Code.[48]

The *Philadelphia Newspapers* court agreed with *Six Flags* that the original policy justification for Rule 2019 was obsolete and that Rule 2019 did not apply to *ad hoc* groups. However, the court did express support for the need for disclosure, but refused to order disclosure absent an amendment to Rule 2019 extending its scope to *ad hoc* groups. The *Philadelphia Newspapers* court acknowledged that the debate over the scope and application

42 *In re Premier Int'l Holdings, Inc.*, 423 B.R. 58 (Bankr. D. Del 2010) ("Six Flags"); *In re Phila. Newspapers, LLC*, 422 B.R. 553 (Bankr. E.D. Pa. 2010).

43 *In re Northwest Airlines Corp.*, 363 B.R. 704, 709 (Bankr. S.D.N.Y 2007) (ruling on motion to file disclosures under seal filed after earlier *Northwest Airlines* decision holding that disclosures were required under Rule 2019).

44 *In re Washington Mutual, Inc.*, 419 B.R. at 279.

45 *Id.* at 280 ("[T]he unique problems associated with collective action by creditors through *ad hoc* committees or groups requires disclosure for those groups in particular.").

46 *In re Premier Int'l Holdings*, Inc., 423 B.R. at 76.

47 *Id.* at 75.

48 *Id.* at 72-73. The court explained, "Even if an informal committee were to try to exercise the powers formerly available to protective committees, it would be prevented by the Bankruptcy Code. Thus, Rule 2019 is also, for all intents and purpose[s], superfluous – the problem it was designed to address by requiring certain disclosures simply no longer exists." *Id.* at 73.

of Rule 2019 was rooted in the clash between fundamental bankruptcy principles of transparency and market participants' desire to protect confidential trading information.[49] Given this clash, the court limited its decision to the plain meaning of Rule 2019 and refrained from taking sides in the policy debate surrounding Rule 2019.

Compromise and a New Rule 2019

The judicial split over Rule 2019 reflects a growing tension between (i) the concern that potential economic conflicts will interfere with an entity's participation within an *ad hoc* group and (ii) the need to protect sensitive trading data (which trading strategies could be determined) from public disclosure. The committee of judges and attorneys responsible for revising the Federal Rules of Bankruptcy Procedure (the "Rules Committee") has responded to this tension by negotiating and proposing revisions to Rule 2019, attempt to strike a fair balance between the competing concerns.

The proposed revisions ("Proposed Rule") contain several notable changes designed to reconcile the conflicting agendas of protecting confidential trade information with general bankruptcy principles of transparency, adequate representation, and fundamental fairness.[50] Some of the key changes in the Proposed Rule are:

- It greatly expands the groups and entities that are required to make disclosures to include any groups, committees, or entities that "consist of or represent" multiple creditors or equity security holders that are "acting in concert to advance their common interests," except those composed entirely of affiliates or insiders of one another. Any group that consists of multiple creditors is subject to disclosure requirements. This change requires disclosures of the interests of members of official committees (they were formerly exempted from Rule 2019) and could discourage a creditor from participating in an official committee. Administrative agents and indenture trustees are exempted from these new disclosure requirements. The Proposed Rule also defines "represent" counterintuitively to mean "to take a position before the court or solicit votes regarding the confirmation of a plan on behalf of another," as opposed to meaning "represent" in the form of an attorney-client representation. Through this definitional oddity, the Proposed Rule attempts to avoid requiring disclosure of interests of individual creditors merely because they share common counsel if the creditors are not "acting in concert to advance their common interests."[51]

- It expands required disclosures to include any "disclosable economic interest," a term defined as "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," including short positions, credit default swaps, and total return swaps.[52] This change is intended to capture the panoply of economic interests, both long and short, that a creditor or equity holder might have. It also of course implicates the disclosure of formally confidential transactions that are ordinarily subject to confidentiality agreements such as participations, derivative transactions and swaps.

- It requires each entity or member of a group or committee covered by the Proposed Rule to disclose, in a verified disclosure statement filed with the court, the following detailed information, among other things: (i) the "pertinent facts and circumstances" of the formation of the group and employment of counsel; (ii) contact information for each member and any other entities the group represents; (iii) the nature and amount of each member's disclosable economic interest as of the date the group was formed and those of any other entities the group represents; and (iv) a copy of any document authorizing the group to act on behalf of its members. Material changes must also be disclosed if the group continues to take positions before the court or solicit votes on a plan. If the group (other than an official committee) does not purport to represent the interests of non-members, then it does not need to disclose pricing data such as the date of acquisition of its interests. If the group does purport to represent the interests of others,

49 *In re Phila. Newspapers, LLC*, 422 B.R. at 568.

50 A copy of the Proposed Rule is available at http://goo.gl/mFlu3. See also Report of the Judicial Conference Committee on Rules of Practice and Procedure to the Chief Justice of the United States and Members of the Judicial Conference of the United States, pp. 7-8 (Sept. 2010), available at http://goo.gl/23liH (*"Rules Committee Report"*) (amendments to Proposed Rule 2019 are designed "to facilitate openness and transparency by revealing potentially divergent economic interests within groups of creditors or equity security holders" but also seek to protect market participants' "proprietary business information" to avoid "giv[ing] industry participants unfair insight into competitor's trading strategies" or "discourag[ing] investors from purchasing distressed debt").

51 Proposed Rule 2019(a)(2); Proposed Rule 2019(a) Committee Note ("The definition provides that representation requires active participation . . . either by taking a position on a matter or by soliciting votes on the confirmation of a plan. Thus, for example, an attorney who is retained and consulted by a creditor or equity security holder . . . , but who does not advocate any position on behalf of that client, does not represent the creditor for purposes of this rule.").

52 Proposed Rule 2019(a)(1); Proposed Rule 2019(a) Committee Note.

then its members must disclose the date of acquisition of their interests by quarter and year.

Although the Proposed Rule does not require the initial disclosure of additional detailed claims trading data, the Committee Note states that the Proposed Rule does not preclude the discovery of such information or its disclosure pursuant to court order.[53]

If enacted, the Proposed Rule will supersede the holdings in *Six Flags* and *Philadelphia Newspapers* that Rule 2019 is inapplicable to *ad hoc* groups that do not purport to represent third parties. In so doing, the Rules Committee sides heavily with the policy goal of greater transparency at the expense of preserving the confidentiality of information. The Rules Committee Notes accompanying the Proposed Rule justify these disclosures as necessary to allow creditors and security holders to determine whether the *ad hoc* group will adequately represent their interests, and to help identify potential conflicts of interest.[54]

In contrast to the expansive disclosure requirements for the nature and amount of claims, however, the Proposed Rule adopts a more restrictive approach to the most sensitive pieces of information – trading data. The Proposed Rule does not require disclosure of trading data, including the specific dates of trades or acquisition prices, unless the creditor is a member of a group that purports to represent the interests of others, and even then, only the quarter and year in which the member's interest was acquired needs to be disclosed. However, bankruptcy courts are still empowered to require the disclosure of more detailed information if they believe its disclosure serves a valid bankruptcy purpose.

Proposed Rule 2019 reflects a growing trend toward increased disclosure and transparency, supported by the belief that the ability of the court and interested parties to assess a creditor's motives is critical to the bankruptcy process. Exactly how the Proposed Rule, which could become effective by December 1, 2011, will affect investors' roles in bankruptcy cases and their willingness join official or unofficial committees or groups remains to be seen.[55]

BORROWER AND AGENT CONSENT RIGHTS TO ASSIGNMENTS

Assignments are yet another area where perceived motives may significantly impact an investor's ability to achieve its economic goals. It is customary for loan agreements to contain restrictions on assignments in favor of both the agent and the borrower. Typically, credit agreements require both the agent and borrower's consent, which generally cannot be unreasonably withheld, for any assignments of a lender's interest as a lender. However, there is a growing trend for borrowers and agents to withhold their consent outright or to delay the giving of consent. In certain cases, the justification for withholding consent may not just be due to concerns regarding the solvency or financial sophistication of the assignee, but may also be based upon a distrust or disagreement with the perceived motives or market reputation of the proposed assignee.

Concerns regarding the solvency or financial wherewithal of the potential assignee have been largely addressed pursuant to standard credit agreement provisions that require any potential assignee to satisfy the definition of "Eligible Assignee", typically, an "accredited investor" with a certain minimum amount of assets under management and recognized experience in making or purchasing bank loans. Based on these requirements, consent is provided with respect to the vast majority of assignments.

In certain cases, however, the borrower or agent's determination to consent to an assignment will not end with just an evaluation of financial wherewithal. Rather, both parties are accorded discretion with respect to their consent, with the typical qualifier that such consent is not to be "unreasonably withheld". The question is – is it "reasonable" to withhold consent based on a concern with respect to the perceived motive or market reputation of a strategic acquirer or investor?

The concept of "reasonableness" as applied to consent is not well defined and is evolving. Case law provides no real guidance, as there are limited cases that focus on when it is "reasonable" for either the borrower or the agent to consent in the context of an assignment of debt. In other contexts, courts have acknowledged that it is not unreasonable to withhold consent for a legitimate

53 Proposed Rule 2019(c) Committee Note ("[N]othing in this rule precludes either the discovery of that information or its disclosure when ordered by the court pursuant to authority outside this rule.").

54 *See* Rules Committee Report p. 7 (stating that disclosure of *ad hoc* group members' economic interests "is important to evaluate positions taken by these groups and entities. For example, it is important to know that members of a committee purporting to represent the debtor's bond holders also hold a derivative position the value of which is inverse to that of the bonds.").

55 The Judicial Conference approved the Proposed Rule for transmission to the Supreme Court, which must in turn transmit the Proposed Rule to Congress by May 1, 2011. If Congress does not enact legislation to reject, modify, or defer the Proposed Rule, the Proposed Rule will take effect on December 1, 2011.

business reason, as long as the consent is withheld in good faith. On that basis, it would be reasonable to withhold consent because a proposed assignee is not a creditworthy or sophisticated financial institution. An institution's creditworthiness is particularly important to the borrower if the loan is a revolver or delayed draw term loan and to the agent with respect to indemnification provisions. Recently, however, there is a growing trend for borrowers and agents to restrict assignments for broader reasons, refusing to consent to assignments to institutions that they do not think will be supportive of any amendments, forbearances or restructurings that are under consideration, or to hedge funds or alternative investment vehicles which are perceived to be overly aggressive or disruptive to a group that has already reached a consensus regarding strategy. It is also common for an agent in a distressed situation to be particularly concerned with consenting to assignments which will result in lenders holding "crossover" claims in both the senior and subordinated facilities or holding both debt and equity, in order to avoid the inherent economic conflicts of interest or the inadvertent sharing (notwithstanding confidentiality agreements and other protections) of confidential strategies and information. In these circumstances, consents may often be suspended for a temporary period until the restructuring is consummated (forcing the parties to the assignment to settle on proceeds or as a participation) or denied entirely.

An additional justification for denying consent – that the assignment will put the borrower at a competitive disadvantage – has just been validated by the Second Circuit Court of Appeals.[56] In *Empresas Cablevision*, the borrower denied a request from the agent and lender to assign 90% of the loan to a bank under common ownership with a key competitor of the borrower. After the borrower denied consent to the assignment, the lender instead negotiated a participation of 90% of the loan to the same bank and included terms that would give the participant rights similar to those of an assignee (such as the right to cause the lender to request any financial or business information the participant wanted and to which the lender was entitled under the credit agreement) and that would automatically convert the participation into an assignment following an event of default (including a default that could be precipitated through the borrower's non-compliance with an information request initiated by the participant). The court held that the participation was in reality a disguised assignment and that while the participation was technically in compliance with the four corners of the credit agreement, it was nevertheless impermissible.[57] Although the facts in *Empresas Cablevision* are somewhat extreme, the court nevertheless ruled that a borrower can prevent a participation – even if it has no direct contractual right to do so – if the rights conveyed pursuant to the participation agreement carry the hallmarks of an assignment that would otherwise be subject to the borrower's consent. The court held that by pursuing the participation, the lender violated its "covenant of good faith and fair dealing automatically implied by law in the Credit Agreement."[58] The court then issued a preliminary injunction to protect the borrower from the consequences of the participation.

As part of its conclusion that the participation was a disguised and improper assignment, the *Empresas Cablevision* court noted that a borrower is entitled to restrict assignments "to protect against the possibility of an unsuitable party being given the rights to enforce restrictive covenants or to receive information under the loan."[59] What makes a party "unsuitable" is not defined. However, the Second Circuit, in affirming the decision to grant injunctive relief, limited the scope of the injunction, allowing the lender to "proceed" with the participation (as the participation had already occurred) but enjoining the "exercise of any right under any provision of the Participation Agreement that might either tend to give [the participant] or its affiliates a competitive advantage over [borrower], or to put [borrower] at a competitive disadvantage."[60] Thus, in crafting the injunction, the Second Circuit focused on what it found to be the participant's improper motive of seeking a competitive advantage over the borrower. Based on the district and circuit court opinions in *Empresas Cablevision*, the risk that an assignee or participant will put the borrower at a competitive disadvantage may be considered as an additional "reasonable" basis for withholding consent to an assignment or participation.

Prior to the global financial crisis, assignments of loans in the secondary loan market were rarely questioned, let alone denied, as long as the assignee otherwise satisfied the applicable definition of "Eligible Assignee". Given the vast number of workouts and restructurings that are a direct result of the financial fallout,

56 *See Empresas Cablevision, S.A.B. de C.V. v. JPMorgan Chase Bank, N.A.*, 680 F. Supp. 2d 625 (S.D.N.Y. 2010); aff'd, 381 Fed. Appx. 117 (2d Cir. 2010).

57 *See id.* at 631 (finding that although the participation technically complied with the terms of the agreement, "this narrow focus obscures the gist of [the borrower's] argument, which is that [the lender], acting in bad faith, used the guise of a purported 'participation' to effectuate what is in substance a forbidden assignment, with unusual provisions demanded by [the participant] that are calculated to give [the participant] exactly what the assignment veto in the Credit Agreement was designed to prevent.").

58 *Empresas Cablevision*, 680 F. Supp. 2d at 631.

59 *Id.*

60 *Empresas Cablevision*, 381 Fed. Appx. at 118.

one may expect the number of instances where requisite consents to assignments will be withheld to increase significantly. *Empresas Cablevision* is one of the first reported cases to examine the right of a borrower and agent to withhold consent to an assignment (which the court interpreted the participation to be in that case). As both the law and practice related to assignments evolve, however, there is likely to be increased uncertainty in the secondary market as to whether and under what circumstances an assignment will ultimately be authorized by the borrower and/or agent.

CONCLUSION

Whether or not one believes as a philosophical matter that an investor's motives should matter – the reality is that they do. It is incumbent on investors and their counsel to consider this reality when framing a strategy to achieve the investor's goals. Avoiding designation, navigating the rights and restrictions in intercreditor agreements, choosing how the investor participates in a case to manage disclosure obligations, and dealing with restrictions on assignments posed by consent requirements all require strategic choices and the alignment of the institution's tactical choices with its actual and perceived motives. Managing an investor's motives in the eyes of courts, debtors, competitors and other constituents can have a significant impact on the investor's ultimate success in pursuing its goals. When it comes to the prototypical "close case," perceived motives take on even greater importance and may even dictate the result. Regardless of where on the spectrum an investor falls – whether it finds itself taking the role of Mainstream Bank, N.A., Loan to Own Opportunity Fund or Strategic Acquisition LP, or an investor somewhere in-between, the investor's perceived and actual motives could end up playing a significant role in whether it can successfully achieve its objectives in bankruptcy.