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June 20, 2018 Current Issues Relevant to Our Clients

Designated Survivor: Ninth Circuit Rejects Designation of Secured Creditor's Unsecured Claim Under Section 1126(e) of the Bankruptcy Code

On June 4, 2018, the United States Court of Appeals for the Ninth Circuit issued a decision reversing a lower court's order that designated (i.e., disregarded) the vote of a secured bank creditor that had purchased claims from a subset of unsecured creditors for the admitted purpose of blocking confirmation of the debtor's plan of reorganization.[1]

The decision represents one of very few Circuit-level decisions that touch on the issue of vote designation under section 1126(e) of the U.S. Bankruptcy Code (the "Bankruptcy Code"), and the severest limit to date upon its application. The decision provides support for creditors holding large positions in senior classes to protect those positions by purchasing blocking positions in one or more junior classes without fear that its votes will be disregarded by the court.

Background

The facts are straightforward. The debtor, Fagerdala USA-Lompoc, Inc. (the *"Debtor"*) was a single-asset debtor that owned real property worth approximately $6 million. A senior secured creditor (the *"Secured Creditor"*) held a claim in excess of $3.95 million, secured by the Debtor's real estate. The Debtor's plan of reorganization, as amended twice, placed the Secured Creditor's claims in class 1, and the general unsecured claims against the Debtor in class 4 (the *"Debtor's Plan"*). All claims were deemed impaired.

The Secured Creditor did not support the Debtor's Plan, requiring the Debtor to meet the cramdown provisions of the U.S. Bankruptcy Code. Among other things, under section 1129(a)(10) of the Bankruptcy Code, at least one class of impaired claims must vote to accept the plan. A class of impaired claims accepts a plan if, other than an entity whose vote is designated under section 1126(e) of the Bankruptcy Code, at least two-thirds in amount and more than one-half in number of allowed claims in the class vote to accept the plan. Pursuant to section 1126(e) of the Bankruptcy Code, a court may disregard the vote of an entity after finding that the entity did not vote in good faith.

To obtain a blocking position in respect of the Debtor's plan, the Secured Creditor purchased a number of the Debtor's general unsecured claims. It did not make a blanket offer to buy all general unsecured claims, but rather strategically purchased only a subset of claims that had a low dollar value, allowing it to accumulate a large number of claims at a low cost, because the amounts sought by each claim were relatively small. Ultimately, the Secured Creditor purchased more than half of the number of general unsecured claims, with a value of approximately $13,000, or only 10% of the general unsecured class. By purchasing over half in number of the general unsecured claims, the Secured Debtor obtained a "blocking position" in regard to the Debtor's Plan, i.e., it ensured that it could control the vote of the general unsecured class.

During plan voting, the Secured Creditor voted to reject the Debtor's plan in both its secured class, as well as, with the general unsecured claims it had purchased, in the general unsecured class, ostensibly blocking confirmation of the Debtor's plan. The Debtor then moved, pursuant to section 1126(e) of the Bankruptcy Code, to have the Secured Creditor's vote in the unsecured class disregarded — in Bankruptcy Code terms, designated – asserting that the Secured Creditor had not purchased the claims in good faith.

The Bankruptcy Court designated the Secured Creditor's claims, permitting other unsecured creditors in sufficient amount and value to accept the plan. The court found that the Secured Creditor had acted in bad faith and placed itself at an unfair advantage to those unsecured creditors whose claims

the Secured Creditor did not offer to purchase. The Bankruptcy Court believed that although good faith does not require a creditor to act with "selfless disinterest," the Secured Creditor's failure to offer to purchase all claims in the unsecured class was conduct in further of its own interest, that resulted in an unfair disadvantage to other creditors. The Bankruptcy Court's decision was upheld by the District Court, and then timely appealed to the Ninth Circuit.

The Ninth Circuit Decision

The Ninth Circuit reversed the Bankruptcy Court's decision. The Ninth Circuit first noted that "good faith" is a fluid concept under the Bankruptcy Code, and as fluid as the concept may be, "bad faith" explicitly does not include "enlightened self interest, even if it appears selfish to those who do not benefit from it." The Ninth Circuit asserted that "'[i]t is always necessary to keep in mind the difference between a creditor's self interest as a creditor and a motive which is ulterior to the purpose of protecting a creditor's interest." The Ninth Circuit followed that purchasing claims "for the very purpose of blocking confirmation . . . is not to be condemned."

In overturning the Bankruptcy Court's decision, the Ninth Circuit relied on the principle that creditors are permitted to utilize the Bankruptcy Code for their own strategic advantage, and this use, unless evidence of an ulterior motive exists, is not bad faith. Therefore, bad faith is determined by analyzing whether a creditor was attempting to obtain a benefit to which it was not entitled, not that the creditor took an action to protect its own proper interests.

The decision is important in that it confirms that a creditor may purchase and vote claims that it cares little about, for the purpose of maximizing its return on an entirely *different* class of claim against the same debtor, and that such motivation is sufficiently intrinsic to the case so as not to constitute an "ulterior" one that would render the associated claim designable under section 1126(e). The case additionally stands for the proposition that a creditor's conflict-of-interest with other class members created by its presence in another class also is not sufficient cause to justify vote designation.

Unless and until a sister Circuit weighs in, *Fagerdala* confirms the validity of strategic claims purchasing by creditors even outside the classes wherein their main economic interests lie.

Importantly, employing such a claims buying strategy is often not only possible, but also practical and cost effective, particularly in the case of a senior creditor buying claims in a junior class.

Consider the example of a fully secured creditor that wishes to prevent the acceptance of a plan of reorganization because the plan proposes treatment for its secured claim that the secured creditor opposes. The debtor, meanwhile, believes that it can "cram down" the plan against the objecting secured creditor, because it hopes to obtain the acceptance of unsecured creditors, which would provide the debtor with the "accepting impaired class" that is a prerequisite for any cram-down. Assume further that there are a total of thirty unsecured creditors entitled to vote, and that the plan of reorganization proposes to pay unsecured creditors fifteen cents on the dollar, a percentage that varies greatly from case to case but certainly would not be atypical.

Under the foregoing fact pattern, if the secured creditor wishes to ensure that the plan is not confirmed over its objection, it can purchase the *smallest* fifteen claims in the unsecured class at a meaningful premium to the recovery promised by the plan of reorganization (say, 25 cents on the dollar instead of the fifteen cents offered under the plan). The economy of this strategy is highly sensitive to the particular economics of each chapter 11 debtor, but because acceptance of a plan under the Bankruptcy Code requires not only two-thirds of voted claims as measured by amount, but also the affirmative acceptance of a majority of individual creditors voting within the class (a requirement commonly referred to as "numerosity,") it is not hard to see how a small dollar claims purchase by a secured creditor can yield significant dividends in terms of providing a large secured creditor with the ability to wrest control of the plan process from the debtor and, often, its unsecured creditors' committee as well.[2]

Moreover, even in very large cases, a first lien creditor could buy second lien claims in an amount greater than (i) one-third in amount of the claims in the second lien class or (ii) half in number of claims in such class , often at a significant discount to par, with the goal of controlling the second lien class and preventing it from voting in favor of a plan that the first lien creditor believes overvalues the debtor, and therefore provides second lien lenders with too much of a recovery at the expense of the first lien lenders.

It will also be worth watching to see whether other Circuit courts follow the Ninth Circuit's lead, particularly courts such as the Second and Third Circuit Courts of Appeal, which cover the lion's share of major corporate chapter 11 activity. Notable in that regard is that one published decision from a preeminent bankruptcy court within the Second Circuit explicitly stated, in a 1995 case, albeit in *dicta,* that "the Code's legislative history makes clear that the Court can designate the vote of a creditor who has a conflict of interest with the class in which it votes."[3]

In addition, left for future appellate determination is whether other pecuniary motives related to a particular debtor (for example, a stockholder's desire to maximize a recovery on its equity position in the same debtor) also would be insufficiently "ulterior" for the purpose of designating that stockholder's claim under section 1126(e), although the logical basis for distinguishing the two do not seem readily apparent.

For More Information

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1 *Pac. W. Bank v. Fagerdala USA-Lompoc, Inc. (In re Fagerdala USA-Lompoc, Inc.)*, 2018 WL 2472874, ___ F.3d ___, (9th Cir. June 4, 2018) [hereinafter, *"Fagerdala"*].

2 As to the question of why "numerosity" does not disappear once multiple claims are assigned to a single holder, see generally Can You Vote More Than Once? The Bankruptcy Code's Current "Numerosity" Standard Under § 1126(c) and Possible Reform, Chapman Client Alert, June 15, 2015 (available at https://www.chapman.com/media/publication/654_Chapman_Bankruptcy_Code_Current_Numerosity_Standard_Possible_Reform_061515.pdf)

3 *In re Dune Deck Owners Corp.*, 175 B.R. 839, 845 (Bankr. S.D.N.Y. 1995)

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