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Split Ninth Circuit Narrows Definition of Bad Faith Insider in Cramdown Case

Michael L. Cook*

A split panel of the U.S. Court of Appeals for the Ninth Circuit recently found that a particular creditor did "not qualify as a statutory or non-statutory insider" for voting on the debtor's Chapter 11 cramdown plan. The author of this article discusses the majority decision, the dissent, and the implications.

"A creditor does not become an insider simply by receiving a claim from a statutory insider," held a split panel of the U.S. Court of Appeals for the Ninth Circuit on February 8, 2016.[1] According to the court, "Insiders are either statutory [per se] [e.g., officers, directors] or non-statutory [de facto]."[2] For a person to be a de facto insider, "the creditor must have a close relationship with the debtor and negotiate the relevant transaction at less than arm's length," explained the court in finding that a particular creditor ("R") did "not qualify as a statutory or non-statutory insider" for voting on the debtor's Chapter 11 cramdown plan.[3]

The powerfully persuasive dissent agreed with the majority's legal analysis as to the elements of insider status, but, "on the facts of this case," deemed R a de facto insider.[4] In its view, "Without the sale of [the insider's] claim to [R] and his anticipated vote to approve the [debtor's cramdown] plan, that plan [was] dead in the water."[5] According to the dissent, the "savvy debtor" here formulated "a reorganization plan . . . providing a payout on [an] insider claim" and then sold "the claim to a friendly third party for a price lower than the payout . . . ensuring [an acceptance] and thereby allowing the debtor to effectively avoid the requirement under [Bankruptcy Code] § 1129(a)(10) that

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1 *In re The Village at Lakeridge, LLC*, 2016 U.S. App. LEXIS 2124, at *1 (9th Cir. Feb. 8, 2016) (2-1).

2 *Id.*

3 *Id.*

4 *Id.* at *24.

5 *Id.* at *26.

at least one non-insider . . . approve the plan."[6]

In an accompanying unpublished memorandum opinion, the entire three-judge panel also held that R had *not* accepted the debtor's reorganization plan "in bad faith," affirming the lower court's refusal to "designate" (i.e., disqualify) R's vote under Bankruptcy Code ("Code") Section 1126(e).[7]

STATUTORY CONTEXT

The relevant statutory requirements for confirmation of a reorganization plan are contained in Code Section 1129(a)(10) ("at least one class of claims that is impaired under the plan has accepted [it]," excluding "any acceptance of the plan by an *insider*") (emphasis added) and in Section 1126 (e) ("court may designate any entity whose [vote] . . . was not in good faith"). The published *Lakeridge* decision had to resolve whether R, the sole unsecured creditor, was an insider because his acceptance of the debtor's reorganization plan was essential to confirmation. The separate memorandum opinion only dealt with the issue of whether the bankruptcy court had properly declined to "designate" R's claim that had been assigned to him by an insider of the debtor.

RELEVANCE

Insider status in bankruptcy cases is important. It can affect a creditor's liability for:

- preferences;
- equitable subordination;
- disallowance or recharacterization of its claims;
- the debtor's obligations to other creditors; or
- harm caused to the debtor.

In *Lakeridge*, confirmation of the debtor's plan turned on R's not being an insider, for there was no other accepting impaired creditor class.

When liability turns on insider status, a de facto lender's exposure will usually require a "finding that something more exists between the debtor and creditor than an arm's length, debtor-creditor relationship."[8]

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[6] *Id.* at *34.

[7] *In re The Village at Lakeridge, LLC*, 2016 U.S. App. LEXIS 2307, at *1 (9th Cir. Feb. 8, 2016).

[8] *See In re Winstar Communication, Inc.*, 554 F.3d 382 (3d Cir. 2009) (*held*, in affirming preference judgment against de facto insider, "actual control not required"; instead, question was

Whether a court can "designate" or disqualify a creditor's vote on a reorganization plan turns on whether "a party steps over the boundary of good faith."[9] As the U.S. Court of Appeals for the Second Circuit stressed, "neither we nor the Supreme Court had many precedents on the 'good faith' voting requirement in any context."[10] But when "an indirect competitor" of the debtor "bought a blocking position in . . . a class of claims . . . with the intention . . . to use [creditor] status . . . to provide advantages over proposing a plan as outsider [and] purchased the claims as votes it could use . . . to bend the bankruptcy process," its claims were properly designated.[11]

FACTS

The debtor limited liability company in *Lakeridge* had an insider ("B") who shared a "close business and personal relationship with" R.[12] The debtor also had only two creditors, a Bank with "a fully secured claim worth about $10 million, and [an insider group with] an unsecured claim worth $2.76 million."[13]

The debtor proposed a Chapter 11 plan to deal with the claims of its two creditors. Because the Bank rejected the plan, the debtor sought to cram down the Bank's secured claim. Shortly after filing its plan and disclosure statement, the debtor's insider group sold its unsecured claim to R for $5,000, enabling the debtor to classify R's claim as a "general unsecured claim."[14]

The Bank moved to designate R's claim and disallow it for plan voting purposes.

After an evidentiary hearing, the bankruptcy court held that R "was not a [de facto] insider," essentially because R had no "control over" the debtor. But the bankruptcy court "designated [R's] claim and disallowed it for plan voting," reasoning that R "had become a statutory insider by acquiring a claim from [the insider group]."[15]

The Bankruptcy Appellate Panel vacated the designation of R's claim and

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whether a close relationship existed between debtor and creditor).

[9] *In re DBSD North America, Inc.*, 634 F.3d 79, 101 (2d Cir. 2011) (2-1).

[10] *Id.*

[11] *Id.* at 104–05.

[12] 2016 U.S. App. LEXIS 2124, at *4.

[13] *Id.*

[14] *Id.* at *5.

[15] *Id.* at *7.

"reversed the finding that [R] had become a statutory insider as a matter of law by acquiring [the insider] claim, [but] affirmed the findings that [R] was not a [de facto] insider and that the claim assignment was not made in bad faith." As a result, R "could vote to accept the [debtor's] plan under [Code] § 1129(a)(10) because he was an impaired creditor who was not an insider."[16]

NINTH CIRCUIT: MAJORITY OPINION

De Facto Insider Status A Fact Issue

According to the majority of the Ninth Circuit panel, de facto insider status "is a question of fact."[17] In its view, a de facto insider "is a person who is not [an insider per se], but who has a sufficiently close relationship with the debtor to fall within the definition" of statutory insider.[18]

A "person does not become a statutory insider solely by acquiring a claim from a statutory insider," reasoned the majority. First, because "insider status is not a property of a claim, general assignment law—in which an assignee takes a claim subject to any benefits and defects of the claim—does not apply." Contrary to the Bank's argument, the "term 'insider' is not . . . an adjective used to describe the property of a claim."[19] Finally, the insider status "factual inquiry . . . must be conducted on a case-by-case basis."[20]

The court stressed "a number of [statutory] safeguards for secured creditors" like the Bank "who could be negatively [affected] by a debtor's reorganization plan."[21] Relevant here is the requirement of Code Section 1129(a)(10) that "at least one class of impaired claims has accepted the plan (and no insider can vote)."[22] Although the Bank argued that "debtors will begin assigning their claims to third parties in return for votes in favor of plan confirmation," R had "not become a statutory insider by way of assignment and was not a statutory insider in his own capacity."[23] The remaining issue, therefore, was whether R was a de facto insider.

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16 *Id.* at *8.

17 *Id.* at *10.

18 *Id.*, citing *In re Winstar Comm., Inc.*, 554 F.3d 382, 395 (3d Cir. 2009).

19 *Id.* at *12–13.

20 *Id.* at *13.

21 *Id.* at *14.

22 *Id.*

23 *Id.* at *14–15.

But a creditor will not become a de facto insider unless: "(1) the closeness of its relationship with the debtor is comparable to that of the enumerated insider classifications in [Code] § 101(31) [i.e., statutory insider], and (2) the relevant transaction is negotiated at less than arm's length."[24] Merely because "the creditor and debtor share a close relationship" does not make the assignee of a claim an insider. Therefore, a court "must conduct a fact-intensive analysis to determine if a creditor and debtor shared a close relationship and negotiated at less than arm's length." Control alone "is one of many indications that a creditor may be a [de facto] insider, but actual control is not" essential.[25]

The "Clearly Erroneous" Rule Applied

The court found the bankruptcy court's factual findings "not [to be] clearly erroneous."[26] Nothing in the record showed "a relationship between R and" the debtor. Indeed, R "had little knowledge of" the debtor or its insider group "prior to acquiring [its] unsecured claim, much less access to inside information."[27] R did not "control" any insider or the debtor, and the debtor and its insiders had no "control" over R. Despite R's "close personal and business relationship with [B]," B only approached R with an offer to sell the insider claim. But B did not "control" the debtor. R "did not know, and had no relationship with, the remaining" insiders. Finally, although R knew the debtor was the subject of a bankruptcy case and that "purchasing a claim was a risky investment," R "did not know about [the debtor's] plan of reorganization or that his vote would be required to confirm it," believing that "it was a small investment." Therefore, the majority of the court found the bankruptcy court's fact findings to be "entirely plausible," even if it might have "weighed the evidence differently."[28]

THE DISSENT

The dissent accepted the majority's legal analysis but rejected its application to "the facts of this case."[29] It stressed the following undisputed facts from the record:

- R paid $5,000 for a nominal claim of $2.76 million held by the insider

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[24] *Id.* at *16–17.

[25] *Id.* at *17.

[26] *Id.* at *19–20.

[27] *Id.* at *19–20.

[28] *Id.* at *20–23.

[29] *Id.* at *23–24.

group.

- The selling insider group creditor did not offer their claim to any other party.
- R did not solicit the claim.
- B, an insider, proposed to R that he buy the claim.
- Neither R nor B negotiated over the price for the claim.
- R knew nothing or little about the debtor before buying the claim.
- R made no investigation regarding the value of the claim before or after his purchase of the claim.
- R knew nothing regarding the debtor's proposed treatment of the claim under its plan prior to his later deposition by the Bank.
- After learning of a $30,000 distribution on the claim during his deposition, R still rejected the Bank's offer to purchase the claim for $60,000.
- The motives of B and the other insiders were undisputed: They needed R's acceptance of the plan, which could not "be approved unless there is a class of creditors willing to vote to approve it."
- The debtor's insiders were "primarily motivated to place the unsecured claim in the hands of a friendly creditor who could be counted on to vote in favor of the reorganization plan, opening the door to . . . approval of the proposed plan."
- R had a "close business and personal relationship" with B, the person who proposed the sale of the claim to him.[30]

The dissent's characterization of R as a de facto insider turns on the premise that the sale of the claim was not negotiated at arm's length.[31] It accepted the majority's analysis requiring a close relationship and a transaction "negotiated at less than arm's length."[32] Relying on the definition of "arm's length transaction" contained in *Black's Law Dictionary*,[33] the dissent stressed that R and B were *not* "unrelated and unaffiliated parties."[34] Although the bankruptcy court found that R and B were "separate financial entities," it did not and could not find

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[30] *Id.* at *24–28.

[31] *Id.* at *24.

[32] *Id.*

[33] 10th ed. 2014.

[34] 2016 U.S. App. LEXIS 2124, at *27–28.

that the transaction "was conducted as if they were strangers."[35]

The dissent also rejected the majority's reliance on the so-called "clearly erroneous rule" in accepting the bankruptcy court's fact findings.[36] According to the dissent, "the problem here is not with the facts as found by the bankruptcy court but with the legal test that the bankruptcy court applied." Because that court never discussed whether the sale of the claim "was conducted at arm's length," whether R was a de facto insider was "a mixed question of law and fact, subject to de novo review" by the Ninth Circuit.[37] In any event, "even if the clear error standard applies, the finding that [R] was not a [de facto] insider cannot survive scrutiny." No reviewing court, in the dissent's view, "could reasonably conclude that this transaction was conducted as if [R] and [B] were strangers." Because the "bankruptcy court never actually [found] that the transaction was at arm's length or that the parties conducted the transaction as if they were strangers," R had to be a de facto insider.[38]

The majority's holding, said the dissent, "effectively negates" the Code's requirement "that at least one class of impaired creditors—excluding insiders—vote for a plan before it can be approved."[39] In the dissent's view, the majority "effectively rendered that statutory requirement [Section 1129(a)(10)] meaningless because its holding enables "insiders . . . to evade the requirement simply by transferring their interest for a nominal amount . . . to a friendly third party, who can then cast the vote the insider could not have cast itself."[40]

COMMENT

The strong dissent will undoubtedly encourage the Bank to seek an en banc rehearing by the entire Ninth Circuit. The majority's holding, if it stands, can have a long term negative effect on the formulation of reorganization plans in other cases. It will facilitate creative plan manipulation by "savvy" debtors.

In contrast, the U.S. Court of Appeals for the Sixth Circuit recently held that a Chapter 11 plan's contrived impairment of two unsecured claims held by the debtor's former lawyer and accountant "was transparently an artifice to

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[35] *Id.*

[36] *Id.* at *28–29.

[37] *Id.*

[38] *Id.* at *30–31.

[39] *Id.* at *34–35.

[40] *Id.* at *33–34.

circumvent the purposes of" the Bankruptcy Code.[41] Affirming the reversal of the bankruptcy court's finding in *Village Green* that the debtor had "proposed its plan in good faith" under Code Section 1129(a)(3), the Sixth Circuit rejected the debtor's "assertion that it could not safely pay off the [two] minor [friendly] claims (total value: less than $2,400) up front rather than in over sixty days."[42] Had the Bank in *Lakeridge* raised the debtor's lack of good faith in proposing its plan, as evidenced by the apparently collusive sale of the insider claim to R, the result might have been different.[43]

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[41] *In re Village Green I GP*, 811 F.3d 816,817–18 (6th Cir. 2016).

[42] *Id.* at 819.

[43] *See also In re KB Toys, Inc.*, 736 F.3d 247, 255 (3d Cir. 2013) ("Claim purchasers are entities who knowingly and voluntarily enter the bankruptcy process . . . . [A] purchaser should know that it is taking on the risks . . . attendant to the bankruptcy process . . . . [A] claim purchaser's opportunity to profit is partly created by the risks inherent in bankruptcy. Disallowance of a claim . . . is among these risks"; transferred claim disallowed because transferor had received preference); *In re Metiom, Inc.*, 301 B.R. 634, 642 (Bankr. S.D.N.Y. 2003) (because the Code "disallows the *claim* . . . [t]he claim and the defense to the claim . . . cannot be altered by the claimant's subsequent assignment of the claim to another entity") (emphasis in original).