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Alert

Ninth Circuit Rejects Disqualification of Secured Lender's Vote on Plan

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" . . . [A] bankruptcy court may not designate claims for bad faith simply because (1) a creditor offers to purchase only a subset of available claims in order to block a [reorganization] plan . . . and/or (2) blocking the plan will adversely [affect] the remaining creditors," held the U.S. Court of Appeals for the Ninth Circuit on June 4, 2018. *In re Fagerdala USA-LOMPOC Inc.,* 2018 WL 2472874, *1 (9th Cir. June 4, 2018). According to the Ninth Circuit, the lower courts "erred by considering only the effect of [the lender's] actions, without respect for its motivation." *Id*. at *1, *3. "[T]he mere failure to make purchase offers to all outstanding creditors does not support a bad faith finding . . . [i]n the absence of some ulterior motive." *Id*., at *10.

Relevance

Bankruptcy Code ("Code") § 1126(e) provides that when a party moves to designate (i.e., disqualify) a creditor's vote on a reorganization plan, "the court may designate any entity whose acceptance or rejection of such plan was not in good faith, or was not solicited or procured in good faith or in accordance with the provisions of [the Code]." *In re Figter Ltd*., 118 F. 3d 635, 638 (9th Cir. 1997) ("In this context, 'designate' means disqualify from voting."). "Bad faith" — i.e., the absence of the requisite good faith — may be found when a creditor acts to further an ulterior motive unrelated to its claim or interests as a creditor. *In re P-R Holding Corp*., 147 F. 2d 895, 897 (2d Cir. 1945) ("The mere fact that a purchase of creditors' interests is for the purpose of securing the 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 of a creditor, such purchases may amount [to] 'bad faith'. . . "; *held*, purchaser of claims barred from voting); *In re Dune Deck Owners Corp*., 175 B.R. 839, 845 (Bankr. S.D.N.Y. 1995) (when "creditor voted without regard to the treatment of its claim, but instead, to achieve some benefit or goal inconsistent with interests of the estate and its creditors, the Court must inquire into those motives in order to preserve the integrity of the Chapter 11 process"). Similarly, bad faith applies "to claimants who oppose the plan for a time until they were 'bought off,'" as well as "those who refuse to vote in favor of plan unless . . . given some particular preferential advantage." *Young v. Higbee Co*., 324 U.S. 204, 211 n. 10 (1945).

The Second Circuit's 2011 decision in *DISH Network Corp. v. DBSD North America Inc*., 634 F. 3d 79 (2d Cir. 2011) (bankruptcy court properly designated vote of claim buyer who sought to defeat debtor's plan so that it might acquire debtor or its assets) makes the *Fagerdala* case critically important. As one commentator stressed, the designation holding in *DBSD* was "likely to chill the market for bankruptcy claims, particularly in cases where the claims are acquired with a view towards the acquisition of the debtor." C.W. Frost, *31 Bankr. L. Letter*, No. 5, at 1 (May 2011).

Facts

The lender ("Lender") in *Fagerdala* held a senior secured claim of about $3.95 million on the debtor's real property worth approximately $6 million. After the debtor filed a Chapter 11 petition in 2014, it proposed a reorganization plan with a secured creditor class and a general unsecured creditor class,

both of which were to be impaired. To "cram down" the plan on the Lender, the debtor "needed the approval of at least one impaired class" under Code § 1129(a)(10). *Id*., at *1.

"To block [the debtor's] proposed plan, [Lender] purchased a number of the general unsecured claims," admittedly to gain "a blocking position in the unsecured class," with the goal of maximizing its economic interest. Lender had insufficient funds to purchase all of the general unsecured claims, but was ultimately able to purchase "more than half of the claims by number, but only approximately ten percent by value . . . . (hereinafter 'Purchased Claims')." *Id*. *2.

The Lender thus had "at least 'one-half' in number' of the general unsecured class," enabling it "to block the [debtor's] plan" under Code § 1126(c). *Id*. The debtor moved to designate the votes of the Purchased Claims, "arguing that [Lender] had not purchased the claims in good faith." *Id*. During argument in the bankruptcy court, Lender's counsel stated that he "did not attempt to buy 'every claim' for good business reasons." *Id*.

The Lower Courts

The bankruptcy court stated, "as a matter of law," it was not "going to consider [Lender's] motivation or rationale for offering to purchase only a subset of claims." *Id*. Granting the debtor's designation motion, it found the following:

- Unsecured creditors would be paid in full under the debtor's plan with interest within sixty days of the plan's confirmation;
- Unsecured creditors would not be paid in a liquidation if the reorganization failed and the Lender foreclosed;
- Lender would have "an unfair advantage over the unsecured creditors who did not receive a purchase offer and who hold the largest percentage of claims with regards . . . in terms of amount";
- Lender's "conduct in further of its own interest should not result in an unfair disadvantage to other creditors"; and
- Unsecured creditors should not be prejudiced by Lender's obtaining a blocking positon by "purchasing such a small percentage of the unsecured debt."

Id. Having removed Lender's Purchased Claims from voting, the debtor had enough creditors in the general unsecured creditor class to accept the plan, enabling the bankruptcy court to confirm it. The district court affirmed confirmation of the plan and designation of Lender's claims. *Id*. *3

The Court of Appeals

The Ninth Circuit rejected the bankruptcy court's reliance only on Lender's limiting its offer to unsecured creditors and the purported prejudice to unsecured creditors. In its view, "under [Code] § 1126(e), neither of these considerations — alone or together — are by themselves sufficient to support a finding of bad faith." *Id*.

Relying on its earlier 1997 *Figter* decision, the court stressed that the "definition of 'good faith' is not provided in [the Code] and was 'left to the courts' by Congress." Because good faith is a "fluid" concept, "no single factor can be said to inexorably demand an ultimate result, nor must a single set of factors be

considered." A creditor may protect its own interests, but may not attempt "to obtain some benefit to which [it was] not entitled." "An entity acts in bad faith when it 'seeks to secure some untoward advantage over other creditors for some ulterior purpose.'" *Id*. at *3 – 4 quoting *Figter*, *118 F.3d at 638-639.

A creditor may act in its self-interest, reasoned the Ninth Circuit. Merely buying claims "for the purpose of protecting [its] own existing claim does not demonstrate bad faith or an ulterior motive." *Id*. at *4, quoting *Figter*, 118 F.3d at 639. In short, buying claims "for the very purpose of blocking confirmation of . . . [a] proposed plan . . . is not to be condemned." *Id*.

Failure To Offer To Buy All Claims in a Class Okay

" . . . [F]ailing to make an offer to all members of a class is (by itself) [not] sufficient evidence of bad faith." *Id*. Nor is offering to buy all the claims a "dispositive factor." *Id*. ". . . [O]ffering to purchase all claims is certainly an indicator of *good faith*, [but] failing to do so cannot be evidence of *bad faith*." *Id*. *(emphasis in original*). *See also In re 225 Park Plaza Assocs*. Ltd., 100 F.3d 1214, 1219 (6th Cir. 1996) ("If bad faith could be found any time a claim is purchased to block approval of a plan, there would be no incentive to purchase claims."); *DBSD*, 34 F.3d at 102 ("Merely purchasing certain claims in bankruptcy 'for the purpose of securing the approval or rejection of a plan does not of itself amount to bad faith.'"). When a creditor acts in in its own self-interest, its frustrating the debtor's "desires" is hardly bad faith. *Id*. "Doing something allowed by the Bankruptcy Code and case law, without evidence of ulterior motive, cannot be bad faith. Not offering to purchase all the claims in a class (to later use those claims to block a plan) is not — alone — sufficient to evidence the bad faith necessary to designate votes under § 1126(e). " *Id*.

No "Unfair Advantage" Test

The Ninth Circuit rejected the bankruptcy court's "unfair advantage" analysis because it "incorrectly examined only the *negative effect* of the action, not the motivation of the creditor, and failed to establish whether [Lender] had acted to 'secure some untoward advantage over other creditors *for some ulterior motive*.'" *Id*. at 5, quoting *Figter*, 118 F.3d at 639 (emphasis in original). The court focused instead "on whether the creditor has an 'ulterior motive,' and is seeking 'to secure some untoward advantage.'" *Id*. Creditors need not vote on a reorganization plan "with a high degree of altruism and with a desire to help the debtor and their fellow creditors. *Far from it*." *Id*., quoting *Figter*, 118 F.3d at 639 (emphasis added). "'[I]f [the creditor] acted out of enlightened self-interest, it is not to be condemned simply because it frustrated [the debtor's] desires.'" *Id*.

Bad faith, instead, turns on whether the creditor tried to "obtain some benefit to which [it] [w]as not entitled." *Id*. According to the Second Circuit in *DBSD*, a court may find bad faith when "[t]he purchasing party . . . was less interested in maximizing the return on its claim than in diverting the progress of the proceedings to achieve an outside benefit." *DBSD*, 634 F.3d at 104 (emphasis added). Other examples of bad faith include "a non-preexisting creditor 'purchasing a claim for the purpose of blocking an action against it,' competitors purchasing claims to 'destroy the debtor's business in order to further their own,' or a debtor arranging to have an insider purchase claims." 2018 WL 2472874, at *5. In short, simply "protecting a claim to its fullest extent cannot be evidence of bad faith." *Id*. The "bankruptcy court in *Fagerdala* erred both by considering the effect on other creditors, without additional evidence of bad faith, and not making actual findings on [Lender's] motivations."

Comment

Fagerdala reached a sensible result, ensuring creditors can act in their own economic self-interest. In contrast to the Second Circuit's *DBSD* decision, the Ninth Circuit did not condemn an "acquisitive motive alone, without specific findings of bad behavior . . ." Frost, *supra*, at 7. It also rejected another bankruptcy court decision relying on a creditor's obtaining a purported "unfair disadvantage." 2018 WL 2472874, at *5, rejecting *In re Pleasant Hill Partners L.P.*, 163 B.R. 388, 395 (Bankr. N.D.Ga 1994) (a creditor's self-interested "conduct should not result in an unfair disadvantage to other creditors or the debtor").

Authored by Michael L. Cook.

If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel the author.

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New York | Washington DC | London
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