Arnold & Porter

June 26, 2018

Ninth Circuit Upholds Lender's Defensive Purchase of Blocking Position in Junior Debt to Protect Existing Claim

Advisory

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In a decision of significance for secured lenders, the Ninth Circuit recently affirmed a lender's ability to purchase a "blocking position" in junior debt to prevent confirmation of a "cramdown" plan. *See In re Fagerdala USA-LOMPOC Inc.*, 2018 WL 2472874 (9th Cir. June 4, 2018).

Specifically, the panel held that the bankruptcy court erred when it disqualified the lender's vote with respect to claims it purchased in the general unsecured class, on the basis that (i) the lender offered to purchase only enough claims to provide a block (in this case, a majority in number of claims), and (ii) blocking the plan unfairly prejudiced the remaining creditors. In reaching its result, the panel held that the relevant inquiry is whether the lender acted with an improper "ulterior motive" that would support a determination that the lender acted in "bad faith."

Background

Section 1126(e) of the Bankruptcy Code authorizes a bankruptcy court to "designate" a creditor's vote where not cast in "good faith," or not solicited or procured in good faith. The measure of "good faith" is a subjective one and in this contest, according to the Ninth Circuit, must focus on the creditor's motivations for acquiring claims and voting against the plan.

The lender in *Fagerdala* held an existing claim secured by the debtor's real property. The claim had a face amount of $4 million and the estimated value of the property was $6 million. In an effort to avail itself of the apparent equity in the property, the debtor proposed a "cramdown" plan that sought to extend and modify the terms of the mortgage without the lender's consent. In an effort to protect itself, the lender purchased a majority in number of the claims in the general unsecured class and voted them against the plan. Ultimately, the purchased claims amounted to less than 10% in dollar amount of the general unsecured class, or a face amount of $13,000.

The lender's unsecured votes were sufficient to block confirmation, so the debtor moved to disqualify the votes, alleging that the lender acted in "bad faith." There was no dispute that the lender bought only a small percentage of the unsecured debt and did so admittedly to defeat the plan. The bankruptcy court agreed with the debtor, disqualified the lenders' unsecured votes, and confirmed the plan. As the basis for its decision, the bankruptcy court concluded that the purchased claims gave the lender an "unfair advantage" over creditors whose claims it did not offer to purchase and who, in a liquidation, would not fare as well. The bankruptcy court focused almost entirely on the "prejudice" to other creditors and refused to consider the lender's possible motives for acquiring a blocking position. On appeal, the district court affirmed.

Ninth Circuit's Decision

On further appeal, the Ninth Circuit reversed, overturning the designation of the lender's unsecured votes and denying confirmation of the plan. The panel held that a creditor buying claims "for the purpose of protecting [its] own existing claim does not demonstrate bad faith or an ulterior motive."[1] Offering to purchase less than all of the class is not sufficient evidence of bad faith to compel vote designation.[2] Rather, the proper inquiry is whether the lender acted in "bad faith" because it had an "ulterior motive" and was seeking to obtain some benefit to which it was not entitled.[3]

The Ninth Circuit cited with approval examples of "bad faith" cases where vote designation might be appropriate. Those examples included: where a creditor purchases junior claims as a means to block potential litigation against it; where a competitor purchases debt to damage a debtor's business and enhance its own competing business; or where a debtor

arranges for an insider to purchase claims.[4] Notably, however, the mere act of a creditor "protecting a claim to its fullest extent cannot be evidence of bad faith."[5]

Strategic Implications

The Ninth Circuit's decision provides assurance to lenders that purchasing a blocking position in junior debt for *defensive* purposes is a viable strategy to protect an *existing* claim. This can be an effective means for a lender to protect itself when faced with a debtor who threatens to pair up with junior creditors, such as bondholders, and propose a plan that would "cram-up" the lender's senior claim or reinstate the lender's loan on existing terms that are no longer market terms.

As a general rule, a lender can acquire a blocking position by accumulating, on its own or with others, (i) more than one-third in face amount of claims in a class or (ii) one-half in number of claims in a class. In some cases, the lender may be able to purchase the block in a junior class at a steep discount, thus obtaining significant leverage at what may be a relatively modest price.

A key question left open by the Ninth Circuit is whether it is appropriate for a strategic investor to buy a blocking position for "offensive" use, such as to oppose a plan as part of a larger scheme to obtain the business for itself. There is a long line of cases considering whether it is appropriate to purchase claims for such "offensive" purposes, dating back to the seminal case of *In re Alleghney Int'l Inc.*, 118 B.R. 282 (Bankr. W.D.Pa. 1990) (designating votes on claims purchased by investor that acquired blocking position and voted against debtor's plan because investor favored a competing plan that would have given it ownership of the debtor).

The bulk of cases that have considered requests to designate votes under section 1126(e) of the Bankruptcy Code have declined to grant such relief. However, where there is clear evidence that a competitor or other "strategic investor" purchased claims to block a plan and acquire the business for itself, the purchaser may be at risk of having its votes designated.[6] These are fact-specific inquiries and courts treat vote designation as an extreme remedy, to be granted sparingly. However, strategic investors considering whether to buy a block in a class for offensive use, as part of an acquisition strategy or otherwise, should carefully assess the risk of possibly having their votes designated, and the narrow scope of the Ninth Circuit's decision is unlikely to impact that analysis.

1 Id. at *4 (*quoting Figter Ltd. v. Teachers Ins. & Annuity Ass'n of Am.* (*In re Figter*), 118 F.3d 635, 639 (9th Cir. 1997)).

2 Id. at *5.

3 Id. (*quoting Figter*, 118 F.3d at 639).

4 See id. (further citation omitted).

5 Id.

6 See, e.g., Dish Network Corp. v. DBSD North America Inc., 634 F.3d 79, 102 (2d Cir. 2011) (affirming vote designation against a "strategic investor" that owned a competitor and purchased claims to oppose a plan and acquire control for its own benefit).