Updates
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In re Fagerdale USA-LOMPOC Inc.: Defensive Purchase of Claims to Avoid Cramdown Deemed Not "Bad Faith"

A secured lender facing the prospect of having the essential provisions of its loan re-written in a Chapter 11 plan of reorganization will look for options to prevent or minimize the likelihood of such a revision. Chapter 11 plans frequently change a loan's term, interest rate and amortization schedule over the secured lender's objection if the debtor can find (or create) at least one "impaired" class of creditors to support the plan. Secured creditors have tried a number of ways to prevent the debtor from securing the votes of an impaired class in *an effort to protect its own self-interest*, including purchasing a block of unsecured claims sufficient to prevent that "impaired" class from voting in favor of the debtor's "cramdown" plan. In a recent decision, the U.S. Court of Appeals for the Ninth Circuit held that purchasing a blocking position in an unsecured class is insufficient for a finding of bad faith and disqualification of those votes, without a finding of an "ulterior motive."

In re Fagerdala USA-LOMPOC Inc., 2018 WL 2472874 (9th Cir. 2018), the senior lender held a secured claim of approximately $4 million on the debtor's real property worth approximately $6 million. The debtor proposed a reorganization plan that impaired both the secured creditor class and a general unsecured creditor class. If the impaired general unsecured creditor class accepted the plan, the plan could be "crammed down" over the secured creditor's objections, even though it would not receive the full value of its *oversecured* claim.

The secured lender purchased a sufficient number of claims to thwart a "cramdown" effort—even though those claims were merely 10% of the value of the unsecured creditor class. The debtor moved to disqualify the secured lender's votes on the purchased unsecured claims pursuant to Bankruptcy Code section 1126(e), which provides that "the court may [disqualify] 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]."

The bankruptcy court declined to consider the lender's motivation for buying only a subset of claims and found that the lender's purchase of a small percentage of claims in that class would disadvantage the creditors who did not receive an offer to purchase their claims and that a lender's conduct, even when done to further its own interest, should not unfairly disadvantage other creditors. The Ninth Circuit rejected the bankruptcy court's "unfair advantage" test because it did not examine the motivation of the secured lender. The court concluded that a creditor may act in its own economic self-interest and that protecting its own interest does not demonstrate bad faith. Bad faith could be found if a creditor attempted to "obtain some benefit to which [it] [w]as not entitled." Examples of bad faith include purchasing claims to divert progress of the debtor's proceedings and not to maximize value of its claim or the debtor arranging to have an insider purchase claims to secure the acceptance of an impaired class.

Fagerdala allows creditors to act in their own economic interest without having to consider whether their action would disadvantage another stakeholder. This is unlike the U.S. Court of Appeals for the Second Circuit decision in *DISH Network Corp. v. DBSD North America Inc.*, 634 F. 3d 79 (2d Cir. 2011) in which a non-creditor competitor had its vote excluded ("designated" in bankruptcy parlance) because it purchased creditors' claims with the intention of defeating the debtor's plan and potentially acquiring the debtor and/or its assets. Though the Ninth Circuit provides sound reasoning and requires the bankruptcy court to examine the motivation behind a "blocking" claim purchase, the circuit courts' split warns parties looking to gain a strategic advantage to proceed carefully in a bankruptcy.

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