

Committee Educational Session

Investment Banking Senior Lenders and Their Strategic Alternatives in Restructuring Situations: Loan Modifications, Out-of-Court Workouts, 363 Sales, Chapter 11 Plans and Other Options

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Investment Banking Panel:
Senior Lenders and Their Strategic Alternatives in Restructuring
Situations: Loan Modifications, Out-of-Court Workouts, 363
Sales, Chapter 11 Plans and Other Options

**DESIGNATING CLAIMS-- DENYING THE VOTE OF
PURCHASED DEBT**

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Trading claims has grown tremendously over the last decade. Along with this phenomenon, numerous issues have arisen involving claim purchases including issues regarding actions by claims purchasers and credit bidding. Following along with other controversies, this writer believes that the issues dealing with whether a claim should be designated pursuant to Section 1126(e) will assume a more important role during the next several years. Section 1126(e) provides:

On request of a party in interest, and after notice and a hearing 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 this title.

“Designation” simply means that the entity holding a claim that is designated may not have its vote counted for purposes of determining whether a plan of reorganization has been accepted or rejected.

Why are claims traded? From the sellers viewpoint, the motives are pretty simple. The seller either wants to minimize its losses or maximize its gain.¹ In order to exit a credit, both secured lenders and unsecured creditors may seek to sell its claim in a bankrupt entity, most often at a discount.² Buyers of claims (Purchasers) have many different and often times opaque agendas. Some may be investors seeking to acquire a debtor company. For example, a Purchaser may buy secured debt at a discount and use the entire value of the secured debt in the bankruptcy process, often through a credit bid 11 U.S.C. 363 process (a “363 Sale”). A Purchaser of unsecured claims may want to buy enough claims in number or dollar amount to block an affirmative vote by the general unsecured creditors class for a plan the Purchaser wishes to defeat.

One of the risks associated with the purchase of debt for the purpose of gaining control over a sale process, is that the debtor may seek to conduct a 363 Sale through a plan process or seek to confirm a plan over the secured lender’s objection and thwart the Purchaser’s ability to utilize the secured debt to extent anticipated.³

¹ Because of the robust market for claims, many funds trade claims just as they may trade stocks and bonds. If a trader buys debt at one price and can sell at a higher price, it will have a gain.

² Sellers, including secured lenders’ goal is to sell the debt and be done with the matter (i.e. a “clean break”) while buyers will often seek indemnities and will need to conduct due diligence which could impact the ability to complete the sale. *See Fortgang and Mayer, P.19* (“The importance of such representations, warranties and indemnities should not be underestimated. Failure to agree on these provisions has destroyed a surprisingly large number of deals after claims buyers and claims sellers agreed on economic terms.”)

³ See, for example, the recent cases of *Philadelphia Newspapers, LLC*, 418 B.R. 548, 572 (E.D. Pa.2009) (reversing bankruptcy court and providing that pre-plan bid procedures

One of the ways the debtor may seek to block to the Purchaser's goal is by seeking to designate the Purchaser's claims from voting under Section 1126(e) as quoted above. The Bankruptcy Code does not define the term good faith and the courts have developed various definitions of what constitutes bad faith.

One of the reasons that that this writer believes that this theory of combating claim purchasers will increase, is based on a recent case tried by one of the writer's firm partner in the Eastern District of Michigan. In that case a owner and operator of senior living facilities purchased a defaulted HUD mortgage loan in a senior living facility for a substantial discount from HUD. The loan was purchased approximately a year before the mortgagor filed for chapter 11. The mortgagor was not the operator, but just a owner of the senior living facility. The operator was an entity that was related to the debtor but not itself in bankruptcy. The Court found, as a matter of fact, that the note was purchased from HUD with the intent to "take over" the building. The Court found it insignificant that the purchaser bought the note a year before the bankruptcy, when no bankruptcy filing was threatened, and that under state law the mortgagee could have foreclosed the interest of the holder. The court's finding that the mere motive of the mortgage purchaser to take over the facility when it purchased the note was a sufficient basis for the court to hold that the HUD successor was not acting in good faith. The decision was not transcribed. A broad reading of the statute as was done by the bankruptcy judge in this matter, it is believed, will greatly expand the application of Section 1126(e).

So what actions are likely to make a purchaser of debt (secured or unsecured) considered designated as having been in *bad faith*? Cases highlighting categories of issues are outlined below.⁴

A Note of Caution: *"Concept of good faith is a fluid one, and no single factor can be said to inexorably demand an ultimate result."*

- *In re Figter Ltd.*, 118 F.3d 635 (9th Cir. 1997)

Burden of Proof

- As the party seeking to have ballots disallowed, the Debtor bears a heavy burden of proof. *In re United Marine, Inc.*, 197 B.R. 942 (Bankr. S.D. Fla. 1996); *In re Kovalchick*, 175 B.R. 863 (Bankr. E.D. Pa. 1994).

which do not provide for credit bidding can be approved. Section 1129(b)(2)(A) provisions are read disjunctively and there is no right to credit bid pursuant to §1129(b)(2)(A)(iii). Court noted it was not determining whether plan satisfies fair and equitable or indubitable equivalent standards); *In the Matter of the Pacific Lumber Co.* 584 F.3d 229 248-49 (5th Cir. 2009) (plan which denied credit bidding and proposed a sale "did not violate the absolute priority rule, was fair and equitable, satisfies 11 U.S.C. § 1129(b)(2)(A)(iii), and yielded a fair value of the Noteholders' secured claim.")

⁴ The following is not an exhaustive list of all cases addressing the "good faith" issue under §1126(e) but highlights the differing issues courts have considered.

Mere Self Interest is Not Bad Faith:

- The purpose of securing the approval or rejection of a plan does not itself amount to bad faith. *Park Plaza Assocs. Ltd. Partnership v. Connecticut Gen. life Ins. Co.* (*In re 255 Park Plaza Assocs. Ltd. Partnership*), 100 F.3d 1214, 1219 (6th Cir. 1996).
- “A vote cannot be said to have been cast in bad faith simply because it was voted for the purpose of blocking confirmation of a reorganization plan.” However, it should be noted that the court mentioned that “In addition, SunAmerica has not proposed a competing reorganization plan. SunAmerica's rejection of Debtor's reorganization plan was motivated by a desire to protect its best interests as a creditor, not by a desire to promote a competing reorganization plan.” [In this case, Sun America purchased a \$60 million note secured by a first mortgage on the debtor's shopping center for \$41.5 million. Sun America voted both its secured claim and its unsecured deficiency claim against the plan. The bankruptcy court designated Sun America's unsecured deficiency claim under Code §1126(e) on the grounds that Sun America's vote was motivated by a desire to purchase the debtor's shopping center. The district court reversed]. *In re Marin Town Center* 142 B.R. 374, 379 (N.D. Cal 1992)
- “[Purchaser]” is attempting to submit an alternative plan which may ultimately be more favorable, not only with respect to [Purchaser] but also to other interested parties, such as the unsecured creditors. Furthermore, the good faith voting requirement set forth in § 1126(e) does not require, nor can it expect, a creditor to act with selfless disinterest.” [Management company that purchased claims and proposed competing plan which continued its management contract held not to be in bad faith.]. *In re First Humanics Corp* 124 B.R. 87 (Bankr. W.D. Mo 1991).
- Bad faith does not occur when a creditor acts to preserve what he reasonably perceives as his fair share of the debtor's estate. *In re Gilbert*, 104 B.R. 206, 217 (Bankr. W.D. Mo. 1989).
- No bad faith is committed by a pre-existing creditor who votes against a plan of a debtor whose only asset is a pending lawsuit against the creditor as the creditor is merely protecting his self-interest. *Insinger Mach. Co. v. Federal Support Co.* (*In re Federal Support Co.*), 859 F.2d 17, 19 (4th Cir. 1988).
 - *But see In re Keyworth*, 47 B.R. 966, 971-972 (D. Colo. 1995): Finding bad faith where a company, that was not a preexisting creditor, purchased claim for the purpose of blocking an action against it.

Obstructive Tactics and Hold Up Techniques Constitute Bad Faith:

- The purpose of §1126(e) is to prevent the use of obstructive tactics and hold-up techniques that would give some creditors an unfair advantage over other creditors in the confirmation process. *Young v. Higbee Co.*, 324 U.S. 204 (1945).

Insider-Buyer Acting in Bad Faith:

- “[T]he purchasing of claims by an affiliate or insider of the Debtor for the sole or principle purpose of blocking a competitor from purchasing such claims is an obstructionist tactic done in contemplation of gaining an unfair advantage over other creditors. Such conduct cannot, as a matter of law, be in good faith.” The court found bad faith where the debtor’s insider, sister company, purchased claims to gain a blocking position that would allow it to aid Debtor by defeating a competing plan. *In re Applegate Property Ltd.*, 133 B.R. 827, 835 (Bankr. W.D. Tex., 1991).
- The 3rd Circuit found bad faith where the claims purchaser had a fiduciary duty to the debtor and thus to other creditors while the debtor was in bankruptcy. The creditor purchased claims at a discount using non-public information acquired as a fiduciary for the purpose of making a profit for itself and influencing the reorganization in its self-interest without disclosure of its purchasing plans to the bankruptcy court, debtor, or the creditors committee. The court subordinated the claims of the insider-buyer even where insider ultimately declined to vote its claims. *Citicorp Venture v. Committee of Creditors Holding Unsecured Claims*, 160 F.3d 982 (3rd Cir. 1998).

Ulterior Motives Constitute Bad Faith:

- The Fourth Circuit has indicated that the court will examine the motives of a claims purchaser, stating that: “One who casts his vote with a purpose of coercing payment to him of more than he might reasonably perceive as his fair share of the debtor’s estate, does not cast his vote in good faith.” The only asset of the debtor was an antitrust claim. The primary focus of the designation of claim issue involved a creditor which was the subject of the lawsuit. Debtor asserted that the defendant’s vote should be designated as it had an ulterior motive. The Court found that the creditors self-interest does not provide an ulterior motive, and that, without other evidence, the pendency of a lawsuit itself is not enough to support and inference of a lack of good faith. *Insinger Mach. Co. v. Federal Support Co. (In re Federal Support Co.)*, 859 F.2d 17, 19 (4th Cir. 1988).
- “Subjective ill will between Debtor and [purchaser] is insufficient to establish a lack of good faith to support disqualification of [purchaser] votes.” *In re Pleasant Hill Partners*, 163 B.R. 388, 395 (Bankr. N.D. Ga. 1994).
- **Pure Malice, Strikes, and Blackmail:** A creditor may not cast his vote for an ulterior purpose and expect to have it counted. Ulterior motives have been held to include “pure malice, strikes and blackmail, and the purpose to destroy an enterprise in order to advance the interests of a competing business.” *Insinger Mach. Co. v. Federal Support Co. (In re Federal Support Co.)*, 859 F.2d 17, 19 (4th Cir. 1988); *Accord Park Plaza Assocs. Ltd. Partnership v. Connecticut Gen. life Ins. Co. (In re 255 Park Plaza Assocs. Ltd. Partnership)*, 100 F.3d 1214, 1219 (6th Cir. 1996).
- **Destroying Debtor’s Business to Further Interests of Competitor:** Former employees creditors were found to vote in bad faith where the Court found the former employees had the ulterior purpose of destroying or injuring debtor in its business in

order to further the interests of the competing business they started. *In re Macleod Co., Inc.*, 63 B.R. 654, 655-56 (Bankr. S.D. Ohio 1986).

- **Acquiring Debtor's Assets to Further Interests of Competitor:** The court found bad faith where an investor of Chapter 11 debtor's competitor purchased all of debtor's first lien debt for 100 cents on the dollar after the disclosure statement was filed in order to block the debtor's plan of reorganization. The court found that the investor purchased the claims with the ulterior motive of acquiring control of the debtor's strategic assets for a competitor. The court stated that factors indicating bad faith include (1) assuming control of the debtor; (2) putting debtor out of business or otherwise gaining competitive advantage; (3) destroying debtor out of pure malice; or (4) obtaining benefits available under private agreement with third party which depends on debtor's failure to reorganize. *In re DBSD North America, Inc.*, 421 B.R. 133 (Bankr. S.D.N.Y. 2009).

Other Factors Collectively Indicating Bad Faith: Timing, Amount of Claims Purchased, Proposal of Alternative Plan.

- Designating creditor's votes as lacking good faith where creditor sought to block plan by purchasing almost exactly amount of claims necessary to block, beginning to purchase claims only once voting began on the debtor's reorganization plan, and proposing a competing plan that would transfer ownership and control to it. *In re Allegheny Intern, Inc.*, 118 B.R. 282 (Bankr. W.D. Pa. 1990).⁵
 - *But see In re Figter Ltd.*, 118 F.3d 635 (9th Cir. 1997): No bad faith where sole secured creditor purchased 21 of 34 unsecured claims against debtor in order to block debtor's proposed plan and pass its own alternate plan of obtaining the single real estate asset of the debtor in return for its secured claim. Creditor had offered to buy all unsecured claims, was not a competing business, and had bought claims prior to the time when plans were proposed.

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⁵ Allegheny is an exceptionally important case, in which, appears to be an angry court, made broad statements against a very late to the party (which started buying during the hearing on the 10th Amended Disclosure Statement hearing) purchaser. The case is well-summarized at Fortgang and Mayer, p. 83.