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The Ninth Circuit Vacates Bankruptcy Court's Designation Order, Holding That Purchasing a Subset of Available Claims to Block a Plan, Absent An Ulterior Motive, Does Not Constitute Bad Faith

Summary

The United States Court of Appeals for the Ninth Circuit recently held that a bankruptcy court may not designate claims for bad faith under section 1126(e) of the Bankruptcy Code (e.g., disregard them for plan voting purposes) merely because (i) a creditor offers to purchase some, but not all, of available claims in order to block a reorganization plan, and/or (ii) blocking the plan will adversely impact the remaining creditors. *In re Fagerdala USA-Lompoc, Inc.*, 2018 WL 2472874 (9th Cir. June 4, 2018). The Ninth Circuit stressed that, at a minimum, a finding of bad faith requires evidence of an ulterior motive beyond a creditor seeking to protect its claim to the fullest extent. Although the decision is largely consistent with the approach taken by other circuits, it is significant for its resistance to a broad interpretation of bad faith and its support of strategic claim purchases that bolster the position of lenders with respect to blocking plan confirmation.

Background

Fagerdala USA-Lompoc, Inc. ("Fagerdala") is a California corporation that formerly owned a plastic manufacturing business. In 2003, Fagerdala purchased certain real property to assist with its operations. Fagerdala financed the purchase and Pacific Western Bank subsequently acquired the loan, along with a senior lien on the property.

In June 2012, Fagerdala defaulted on its obligations under the loan. Fagerdala and Pacific Western Bank executed a forbearance agreement, pursuant to which Fagerdala agreed to pay the amounts due on the loan by the original maturity date. When Fagerdala failed to meet this deadline, Pacific Western Bank commenced nonjudicial foreclosure proceedings, which led, in part, to Fagerdala's chapter 11 filing on August 14, 2014.

Fagerdala's initial and first amended reorganization plan classified claims into four classes, placing Pacific Western Bank's claim in Class 1 and general unsecured claims in Class 4. To confirm the plan via a cramdown on Pacific Western Bank's Class 1 claim, Fagerdala needed at least one class of impaired creditors to consent to the plan, which it hoped would be Class 4. Unhappy with the treatment of its Class 1 claim,

Pacific Western Bank sought to block acceptance of the plan by Class 4 by purchasing enough general unsecured claims and voting them to reject the plan.

Under the Bankruptcy Code, a class is deemed to accept a plan if it has been accepted by creditors holding at least two-thirds in value and more than one-half in number of the allowed claims in the class that actually voted. Because the purchased claims equaled more than half of the claims by number (albeit only approximately 10% in value), Pacific Western Bank was able to thwart plan confirmation.

Fagerdala moved to designate Pacific Western Bank's votes of the purchased claims under section 1126(e) on the ground that they were not acquired in good faith.

Bankruptcy Court and District Court Decisions

The bankruptcy court granted Fagerdala's designation motion for two primary reasons. First, the bankruptcy court considered Pacific Western Bank's selective purchase offering to be evidence of bad faith and refused to consider any underlying motivation or rationale. To support its conclusion, the bankruptcy court relied on *In re Figter Ltd.*, 118 F.3d 635 (9th Cir. 1997), where the Ninth Circuit affirmed the bankruptcy court's denial of a designation motion, noting that the secured creditor's offer to purchase all of the unsecured claims was evidence of good faith.

Second, the bankruptcy court found that "[a]llowing [Pacific Western Bank] to block confirmation by purchasing such a small percentage of the unsecured debt . . . would be highly prejudicial to the creditors holding most of the unsecured debt." While the bankruptcy court acknowledged that purchasing claims to take a blocking position does not, *per se*, constitute bad faith under section 1126(e), it determined that designation was appropriate here because Pacific Western Bank's conduct to further its own interest would result in an "unfair advantage" over the creditors that did not receive purchase offers.

With the purchased claims removed from voting, the bankruptcy court confirmed Fagerdala's fourth amended reorganization plan. The district court affirmed the bankruptcy court's ruling and Pacific Western Bank appealed.

Ninth Circuit Decision

The Ninth Circuit first considered general principles of good faith under section 1126(e), noting at the outset that, although the concept of good faith is fluid, bad faith "explicitly does not include 'enlightened self interest, even if it appears selfish to those who do not benefit from it.'" The Court emphasized that "it is always necessary to keep in mind the difference between a creditor's self interest as a creditor and a motive which is ulterior to the purpose of protecting a creditor's interest." Quoting *Figter*, the Court noted that "the mere fact that a creditor has purchased additional claims for the purpose of protecting his own existing

claim does not demonstrate bad faith or an ulterior motive” and purchasing claims for the purpose of blocking a plan “is not to be condemned.”

Having set forth these principles, the Court held that the bankruptcy court erred in finding bad faith based on Pacific Western Bank’s decision to extend a purchase offer only to a subset of the unsecured claims. According to the Court, the bankruptcy court’s reliance on *Figter* was misplaced as that case simply found a lender’s offer to purchase all claims as one of several non-dispositive factors supporting a good faith determination. Accordingly, while offering to purchase all claims is a sign of good faith, the failure to do so is not, in and of itself, evidence of bad faith, particularly given that blocking a plan with only a numerical majority is permitted under the Bankruptcy Code.

The Ninth Circuit also held that the bankruptcy court erred by only examining the negative impact of Pacific Western Bank’s actions on the other creditors, without considering and making actual findings on its motivations. In so holding, the Court noted that “creditors do not need to approach reorganization plans with a high degree of altruism and with the desire to help the debtor and their fellow creditors.” The Ninth Circuit thus rejected the bankruptcy court’s emphasis on the “unfair advantage” obtained by Pacific Western Bank over the other creditors, finding that, in the absence of some ulterior motive, “[m]erely protecting a claim to its fullest extent cannot be evidence of bad faith.”

Consistent with this analysis, the Ninth Circuit vacated the designation order and remanded the case to the bankruptcy court.

Conclusion

Fagerdala confirms that, in the Ninth Circuit, absent an ulterior motive or actual bad faith, a creditor may make strategic and cost-effective claims purchases to block a plan and, thereby, protect its own interests without risking designation.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

Jacob A. Adlerstein

+1-212-373-3142

jadlerstein@paulweiss.com

Paul M. Basta

+1-212-373-3023

pbasta@paulweiss.com

Kelley A. Cornish

+1-212-373-3493

kcornish@paulweiss.com

Alice Belisle Eaton

+1-212-373-3125

aeaton@paulweiss.com

Brian S. Hermann

+1-212-373-3545

bhermann@paulweiss.com

Kyle J. Kimpler

+1-212-373-3253

kkimpler@paulweiss.com

Alan W. Kornberg

+1-212-373-3209

akornberg@paulweiss.com

Elizabeth R. McColm

+1-212-373-3524

emccolm@paulweiss.com

Andrew N. Rosenberg

+1-212-373-3158

arosenberg@paulweiss.com

Jeffrey D. Saferstein

+1-212-373-3347

jsaferstein@paulweiss.com

Practice management counsel Erica G. Weinberger and associate Miriam M. Levi contributed to this client memorandum.