Benchnotes

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Purchase of Unsecured Claims to Defeat Confirmation Does Not Constitute Bad Faith

In *In re Fagerdala USA-Lompoc Inc.*,[1] the Ninth Circuit Court of Appeals held that a secured creditor's purchase of just enough unsecured claims to block confirmation of a debtor's plan was not, in and of itself, bad faith such that the creditor's votes on confirmation should be designated. At a minimum, the court held that "there must be some evidence that a creditor is seeking 'to secure some untoward advantage over other creditors for some ulterior motive'" before a bankruptcy court can designate such creditor's claims for bad faith.[2]

The debtor owned real property worth approximately $6 million. Its secured lender was oversecured, with a claim of almost $4 million. The debtor filed a chapter 11 plan that placed the lender's claim in class 1 and all general unsecured claims in class 4; under the plan, unsecured claims would receive payment in full over time. Nevertheless, all claims were deemed to be impaired, thus to "cram down" the plan under § 1129(a)(10) of the Bankruptcy Code, the debtor needed the approval of at least one impaired class of creditors.

To block the debtor's plan, the secured lender purchased a number of the general unsecured claims, seeking to control the unsecured creditors' class. Ultimately, the secured creditor purchased more than half of the unsecured claims by number, but only 10 percent by value. Since the purchased claims constituted at least "one-half in number" of the unsecured class, the secured lender's votes were sufficient to block confirmation of the debtor's plan.[3]

In response, the debtor moved to designate (*i.e.*, disregard for purposes of § 1129(a)(10)) the votes of the purchased claims under § 1126(e), arguing that the secured lender had not purchased the claims in good faith. The bankruptcy court granted the debtor's motion and designated the votes. The district court also affirmed.

The Ninth Circuit began its analysis by noting that § 1126(e) permits a court to "designate any entity whose acceptance or rejection of [a] plan was not in good faith."[4] The court noted that the definition of "good faith" is not provided in the statute, but that generally "[a]n entity acts in bad faith when it 'seeks to secure some untoward advantage over other creditors for some ulterior purpose.'"[5]

Bad faith, the court continued, explicitly does not include "enlightened self-interest, even if it appears selfish to those who do not benefit from it."[6]

Turning to the specific facts of the case, the Ninth Circuit found that it was not bad faith for a secured lender to purchase just enough claims in order to obtain a blocking position, thereby protecting the creditor's own interests (even if to the detriment of others).[7] Rather, the court explained, bad faith exists when a creditor is not attempting to protect its own proper interests but is instead attempting to obtain some benefit to which it was not entitled.

The court continued by noting examples of bad faith, which could include purchasing a claim for the purposes of diverting the progress of the proceedings, purchasing a claim to block a lawsuit against the purchaser or buying claims to destroy a competitor's business. Since the lower courts failed to consider the secured lender's legitimate motivations in purchasing the claims, the Ninth Circuit reversed and vacated the rulings, and remanded for further proceedings.

Fifth Circuit Issues First Appellate Decision Regarding Enforceability of "Golden Shares"

In *In re Franchise Services of North America*,[8] the Fifth Circuit Court of Appeals became the first appellate court to weigh in on the issue of so-called "golden shares." The court held that federal law does not prevent a *bona fide* shareholder from exercising its right in the company's governing documents in order to prevent the filing of a bankruptcy petition by the company merely because it is also a creditor. The court was careful to limit the scope of its holding to the facts before it, and avoided ruling broadly on the validity of "golden share" or blocking provisions.

An investment bank made an investment of $15 million in the debtor pre-petition and received 100 percent of the debtor's preferred stock in exchange. At the same time, the debtor reincorporated in Delaware and amended its certificate of incorporation. As a prerequisite to filing a voluntary bankruptcy petition, the amended certificate required the consent of a majority of each class of the debtor's common and preferred shareholders.

Following some ill-fated business decisions, the debtor filed for bankruptcy. Fearing that its share-

1 *Pac. Western Bank v. Fagerdala USA-Lompoc Inc. (In re Fagerdala USA-Lompoc Inc.)*, 891 F.3d 848 (9th Cir. 2018).
2 *Id.* at 852.
3 *Id.* (citing 11 U.S.C. § 1126(c)).
4 *Id.* at 854 (citing 11 U.S.C. § 1126(e)).
5 *Id.*
6 *Id.* at 855.
7 *Id.* at 856-57 (citing cases).
8 *Franchise Servs. of N. Am. Inc. v. U.S. Trustee (In re Franchise Servs. of N. Am. Inc.)*, 891 F.3d 198 (5th Cir. 2018).

holders might nix the filing, the debtor never put the matter to a vote. The preferred shareholder filed a motion to dismiss the bankruptcy petition as being unauthorized. The debtor argued that the shareholder, which was also a sizable creditor, had no right to prevent the filing, relying on case law invalidating contractual provisions granting creditors the power to block a voluntary bankruptcy filing because such waivers are contrary to public policy. The bankruptcy court sided with the shareholder and dismissed the petition.

Given the frequency with which this issue has arisen in chapter 11 cases in recent years, direct appeal to the Fifth Circuit was authorized. Three questions, which broadly asked the appellate court to address the legality of "blocking provisions" or "golden shares" that give a party (whether a creditor or an equityholder) the ability to prevent a corporation from filing bankruptcy, were certified. Instead of addressing the certified questions, which the Fifth Circuit found would have required it to give an advisory opinion, the court narrowed the issue to the specific facts before it: "[W]hen a debtor's certificate of incorporation requires the consent of a majority of the holders of each class of stock, does the sole preferred shareholder lose its right to vote against (and therefore avert) a voluntary bankruptcy petition if it is also a creditor of the corporation?"[9]

The Fifth Circuit began its analysis by noting that state law determines who has the authority to file a voluntary bankruptcy petition for a company. Where, as here, the petitioners lack authorization under state law, the court stated that the bankruptcy court "has no alternative but to dismiss the petition."[10]

Acknowledging that numerous bankruptcy courts have invalidated, on federal public policy grounds, agreements whereby a lender extracts an amendment to the organization's governing documents granting the lender a right to veto a bankruptcy filing, the court held that simply being a creditor does not prevent a *bona fide* equityholder from exercising its right under a charter to block a bankruptcy filing. Under the facts of the case before it, the court found that the shareholder was a *bona fide* equityholder. There was no evidence to show that the shareholder's equity interest was "merely a ruse" in order to ensure that it would be paid on its claims against the debtor.[11]

Finally, the court rejected the debtor's argument that the shareholder's fiduciary obligations as a controlling shareholder prevented it from blocking the debtor from filing for bankruptcy. The court found that the record did not establish that the shareholder was a controlling shareholder exercising its actual control over the debtor, such that it would owe fiduciary duties under Delaware law.

Even if the shareholder were a controlling shareholder, the court concluded that "[t]he proper remedy for a breach-of-fiduciary-duty claim is not to allow a corporation to disregard its charter and declare bankruptcy without shareholder consent."[12] Rather, the debtor's remedy was under state law. Accordingly, dismissal of the debtor's bankruptcy case was affirmed.

Miscellaneous

• *Critique Services LLC v. Reed (In re Reed)*, 888 F.3d 930 (8th Cir. 2018) (Eighth Circuit Court of Appeals held that bankruptcy courts have constitutional authority post-*Stern* to sanction attorney for conduct (*i.e.*, deceiving court and failing to turn over documents as required by show-cause order) occurring during administration of bankruptcy case); and

• *Edwards v. Wells Fargo Bank NA*, 2018 WL 2424150 (E.D.N.C. May 23, 2018) (bankruptcy court erred in dismissing chapter 7 case of married doctor and professor for abuse due to debtors' ability to pay (they had gross, combined annual income of more than $300,000); district court found that debtors did not abuse bankruptcy system, stating that Bankruptcy Code "incentivizes individuals to incur debt and thereby support both creditors and our capital markets ... and if absolute depletion of one's assets were a prerequisite for bankruptcy relief, debtors and their families would be left destitute and without the means to become productive members of society"). abi

9 *Id.* at 202.
10 *Id.* at 206-06 (citing *Price v. Gurney*, 324 U.S. 100 (1945)).
11 *Id.* at 208.
12 *Id.* at 214.