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Claim Purchasing as a Strategy to Avoid a Cramdown

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While there are many factors that can lead a business or individual to file a chapter 11 bankruptcy petition seeking to reorganize a business, often times, particularly in a single-asset real estate case, the primary impetus for the filing is a two-party dispute between a debtor and its primary secured lender. The debtor's goal will often be to restructure its loan(s) with that lender based on changed economic circumstances such as decreased occupancy or changing interest rates. In some cases, the debtor and lender will be able to negotiate mutually acceptable modifications to the loan(s), and incorporate them into a consensual chapter 11 bankruptcy plan. In most cases, if the debtor and its primary secured creditor in the case can agree on a plan, unsecured creditors received a reasonable dividend, and there are no "absolute priority rule"[1] issues, a bankruptcy court will approve the consensual plan.

However, in many cases, a lender may either not want to continue its relationship with the debtor, or may find the revised loan terms proposed by the debtor unacceptable. Despite the lender's desire to no longer do business with the debtor, or at least not under the terms proposed by the debtor, a debtor has a very powerful arrow in its quiver in the form of the "cramdown" provisions contained in § 1129(b) of the Bankruptcy Code. Section 1129(a) requires that a chapter 11 plan satisfy 16 requirements listed therein, including the requirement under paragraph § 1129(a)(8) that each class of claims has either voted to accept the plan, has a claim that is unimpaired[2], or receives at least as much as it would receive if the debtor's assets were liquidated in a chapter 7 case. In almost all contested chapter 11 cases, a secured lender's claim is impaired. However, even if a secured lender with an impaired claim votes against the chapter 11 plan, a debtor may nevertheless confirm a plan under § 1129(b) if the plan satisfies all of the § 1129(a) requirements other than subsection (a)(8), "does not discriminate unfairly," and is “fair and equitable” with respect to each impaired class which has not voted to accept the plan. With respect to a secured claim, "fair and equitable" is defined in § 1129(b)(2)(A) to mean that the secured lender retains its liens, and that it "receive on account of such claim deferred cash payments totaling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder's interest in the estate's interest in such property."

Paragraph (10) of § 1129(a) sets forth the requirement that at least one class of impaired claims votes to accept the plan, excluding insider claims. As such, when a secured lender opposes a debtor's plan, the debtor will often seek out an "impaired, accepting class of claims" to confirm a plan under § 1129(b). A counter-tactic a secured lender can utilize in order to prevent the debtor from securing the vote of an impaired, accepting class of claims is to buy a controlling share of the claims of said class(es), and vote against the plan. Most impaired creditors are happy to sell their claims for the same amount they would receive under the Plan, or perhaps even a lesser amount given that they are receiving a lump sum, and do not have to wait for plan confirmation and perhaps payout period under the plan to receive payment of their claim.

In response to this claim buying strategy, the debtor may seek to have the secured creditors votes designated as not have been made in good faith, and disqualified from being tabulated for purposes of confirmation pursuant to the provisions of § 1126(e).[3] A debtor will typically argue that the secured lender is acting in bad faith by purchasing claims solely to defeat a plan it does not like. While it is true that the lender is clearly

purchasing the claims in order to defeat what it deems to be an unacceptable plan, that does not mandate a finding that the lender has acted in bad faith.

Recently, in the case *In re: Monticello Realty Investments, LLC*, 526 B.R. 902 (Bankr. M.D. Fla. Mar. 6, 2015), the situation described above wherein a secured lender purchased a claim in order to avoid a cramdown was evaluated by a bankruptcy court. In *Monticello*, the debtor and its primary secured lender had tentatively agreed to terms under which the bank was to be repaid under a proposed chapter 11 plan. The agreement contemplated that new loan documents acceptable to the bank would be executed. However, when the debtor balked at executing the bank's standard loan documents and sought to remove customary provisions such as the obligation to pay property taxes and insure the property, and a "due on sale" provision, negotiations broke down, and the debtor sought to confirm a plan over the bank's objection. In an attempt to prevent the cramdown, the bank purchased the impaired claim of an unsecured creditor such that it controlled the only other impaired class of claims in the case.

The debtor argued that the bank's purchase of the impaired claim in order to prevent a cramdown constituted bad faith under 1126(e), and as such, the lender's "ballots should be designated and disqualified from being tabulated for purposes of confirmation." The bankruptcy court noted that "[b]ecause the designation of a creditor's vote is a drastic remedy, it is the exception rather than the rule." It also cited to cases which hold that "'[a]s long as a creditor acts to preserve what he reasonably believes to be his fair share of the debtor's estate, bad faith will not be attributed to his purchase of claims to control a class vote.'" (quoting *In re Gilbert*, 104 B.R. 206, 217 (Bankr. W.D. Mo. 1989). The court indicated that "'badges of bad faith' which may justify disqualification include efforts to: 1) assume control of the debtor; 2) put the debtor out of business or otherwise gain a competitive advantage; 3) destroy the debtor out of pure malice; and 4) obtain benefits available under a private agreement with a third party which depends on the debtor's failure to reorganize." (citing *In re DBSD North America, Inc.*, 421 B.R. 133, 138 (Bankr. S.D.N.Y. 2009)).

In *Monticello*, based largely on the unrebutted testimony of the bank's loan officer, the court refused to find that the bank acted in bad faith by purchasing the impaired claim to avoid a cramdown. The loan officer testified that if the plan were to be confirmed without loan documents containing the standard tax, insurance and "due on sale" provisions included, the loan would be adversely rated by federal regulators, and the bank would have to set aside reserves. There was no indication that any of the "badges of bad faith" were present. The court concluded that the bank's requests were not overreaching and the purchase of the claim to protect its interests and strengthen its bargaining position did not constitute bad faith. As such, the end result was that the bank was able to avoid a cramdown.

Although the result in *Monticello* was not surprising given the precedent cited therein, it does provide valuable insight for a secured creditor seeking to avoid a cramdown by purchasing claims. Specifically, if a secured creditor intends to defeat a plan or improve its negotiating position by purchasing claims, it should be cautious not to be overreaching in its requests for documentation of a restructured loan, and should be prepared to have a witness testify as to the adverse effects it could suffer if a debtor does not comply with its reasonable documentation requests. While the avoidance of a cramdown cannot be guaranteed via a claim-purchasing strategy, if done correctly and with a lack of malice, it remains a solid strategy for a secured lender to improve its bargaining position in a chapter 11 case.

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[1] In very general terms, the "absolute priority rule" prevents the owner(s) of equity in a company from retaining its equity unless every other creditor in the case is paid in full.

[2] Under § 1124 of the Bankruptcy Code, a creditor's claim is generally considered impaired under a chapter 11 plan unless its legal, equitable and contractual rights are unaltered.

[3] 11 U.S.C. 1126(e) provides as follows: "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."