

Client Alert

Financial Restructuring Practice Group

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Ninth Circuit Issues Controversial Opinion Limiting Insider Status for Purposes of Voting on a Chapter 11 Plan of Reorganization

On February 8, 2016, the United States Court of Appeals for the Ninth Circuit (the “**Ninth Circuit**”) created an opening for debtors seeking to circumvent the Bankruptcy Code’s requirement that a plan of reorganization be accepted by at least one class of non-insider impaired claims, holding that a claim held by an “insider” can count for purposes of satisfying the requirement if the claim is transferred to a non-insider prior to voting.¹

Background and Applicable Statute

When The Village at Lakeridge, LLC (the “**Debtor**”) filed bankruptcy in June 2011, it had two primary creditors: U.S. Bank National Association (“**U.S. Bank**”) held a secured claim in the amount of \$10 million, and the Debtor’s sole equity holder, MBP Equity Partners 1, LLC (“**MBP**”), held an unsecured claim in the amount of \$2.76 million.² After the Debtor filed its plan, MBP sold its claim to Dr. Robert Rabkin for \$5,000.³ Although Dr. Rabkin had no prior relationship with MBP or the Debtor, he had a close personal and business relationship with one of MBP’s members.⁴

Confirmation of a Chapter 11 plan of reorganization requires that at least one class of impaired creditors vote to accept the plan (excluding the votes of any insiders).⁵ Under applicable law, there are two categories of bankruptcy insiders: “statutory insiders” and “non-statutory insiders.” Section 101(31) of the Bankruptcy Code sets forth a definition of the term “insider”—individuals and entities that fall within the categories enumerated by that definition (e.g., a director of the debtor) are referred to as “statutory insiders.”⁶ The definition in Section 101(31) is not exclusive, and courts have developed additional categories of “non-statutory insiders.” These are individuals and entities who may not fit within the Bankruptcy Code’s definition of “insider” but are nonetheless considered insiders for purposes of the Bankruptcy Code and are subject to closer scrutiny because of their relationship with the debtor.⁷

Bankruptcy Court and Bankruptcy Appellate Panel Opinions

U.S. Bank moved to designate Dr. Rabkin’s claim and disallow it for plan voting purposes, arguing that the assignment from MBP to Dr. Rabkin was

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made in bad faith and that Dr. Rabkin was both a statutory and non-statutory insider. The Bankruptcy Court held that Dr. Rabkin was not a non-statutory insider and did not acquire the claim in bad faith. However, the Bankruptcy Court concluded that Dr. Rabkin's vote should be disregarded because he acquired the claim from a statutory insider (*i.e.*, MBP). Even though Dr. Rabkin himself did not fall within the definition of "insider" set forth in Section 101(31), the insider status of MBP tainted the claim so that Dr. Rabkin became a statutory insider when the claim was assigned to him.⁸

The Debtor appealed to the United States Bankruptcy Appellate Panel (the "BAP"). The BAP agreed with the Bankruptcy Court's ruling that the claim was not transferred in bad faith and that Dr. Rabkin was not a non-statutory insider, but disagreed with the ruling that Dr. Rabkin became a statutory insider by acquiring the claim of an existing statutory insider. The BAP reversed the Bankruptcy Court, holding that "insider status cannot be assigned and must be determined for each individual 'on a case-by-case basis, after the consideration of various factors.'"⁹

Ninth Circuit Opinion

On appeal, the Ninth Circuit sided with the Debtor, holding that Dr. Rabkin did not become a statutory insider when he acquired the claim from an insider. First, the Court noted that "bankruptcy law distinguishes between the status of a claim and that of a claimant." Insider status, the Court concluded, attaches to the claimant, not the claim.¹⁰ Second, the Court noted that insider status is a question of fact that must be determined after the person acquires the claim. The Court reasoned that a third-party assignee that acquires a claim in good faith should not be precluded from voting simply because it acquired the claim from a statutory insider.¹¹ Furthermore, the Court noted that a contrary holding would be inconsistent with the fact that an insider still remains an insider even when it acquires a claim from a non-insider. The Ninth Circuit affirmed the BAP's decision, and Dr. Rabkin was allowed to vote his claim as a non-insider.¹²

Conclusion and Lessons Learned

The Court's opinion arguably provides a roadmap for debtors to circumvent the requirement in Section 1129(a)(10) of the Bankruptcy Code that an impaired class of creditors vote (excluding insiders) to accept a plan of reorganization: insiders can simply sell their unsecured claims for a nominal amount to friendly third parties that will vote in favor of the plan. To counter this strategy, a secured lender must elicit as much evidence as possible that the third-party claimant did not acquire the claim in good faith and is simply acting at the behest of the insider. Indeed, one of the judges on the Ninth Circuit panel dissented from the majority's opinion. The dissent did not disagree with the conclusion that insider status does not attach to a claim when transferred; rather, the dissent concluded that the evidence demonstrated that Dr. Rabkin should be viewed as a non-statutory insider because the transaction was not at arms-length and was clearly designed to circumvent the requirements of Section 1129(a)(10).¹³ Unfortunately, the Bankruptcy Court did not draw the same conclusion from the facts, and the majority of the Ninth Circuit panel concluded that the Bankruptcy Court's factual determination was plausible and not clearly erroneous.

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¹*U.S. Bank N.A. v. The Village at Lakeridge (In re The Village at Lakeridge)*, Case No. 13-60038 (9th Cir. Feb. 8, 2016).

² *Id.* at 6.

³ *Id.*

⁴ *Id.*

⁵ 11 U.S.C. § 1129(a)(10).

⁶ 11 U.S.C. § 101(31).

⁷ 2 COLLIER ON BANKRUPTCY ¶ 101.31.

⁸ *The Village at Lakeridge*, Case No. 13-60038, at 8.

⁹ *Id.* at 9.

¹⁰ *Id.* at 12.

¹¹ *Id.* at 13.

¹² *Id.* at 13.

¹³ *Id.* at 21.