The Banking Law Journal

Established 1889

AN A.S. PRATT & SONS PUBLICATION

MARCH 2013

HEADNOTE: FORTRESS AMERICA
Steven A. Meyerowitz

FORTRESS AMERICA: THE FEDERAL RESERVE'S PROPOSAL TO IMPOSE U.S. TERRITORIAL RESTRICTIONS ON LARGE FOREIGN BANKS
Douglas Landy, Jillian Ashley, and Rebecca Smith

BASEL OVERSIGHT COMMITTEE ENDORSES REVISED LIQUIDITY STANDARDS AND EXTENDS FULLY PHASED-IN COMPLIANCE TO 2019
Lee A. Meyerson, Stacie E. McGinn, and Mark Chorazak

INDENTURE "NO-ACTION" CLAUSES BAR INDEPENDENT CLAIMS BY SECURITYHOLDERS
James Gadsden

SUPREME COURT STAYS ACTIVE IN THE ARBITRATION ARENA
John R. Snyder

A HAIL MARY OR BAD FAITH FILING? WHY ASSIGNMENT OF INSIDER CLAIMS TO NON-INSIDER PARTIES CANNOT BE USED TO CONFIRM A CRAMDOWN PLAN
Hamid R. Rafatjoo, Keith C. Owens, and Jennifer L. Nassiri

INTELLECTUAL PROPERTY UPDATE: TRENDS IN THE PATENTABILITY OF FINANCIAL PROCESSES SINCE THE SUPREME COURT'S *BILSKI* DECISION
Stephen T. Schreiner and Noah M. Lerman

BANKING BRIEFS
Terence G. Banich

A Hail Mary or Bad Faith Filing? Why Assignment of Insider Claims to Non-Insider Parties Cannot Be Used to Confirm a Cramdown Plan

HAMID R. RAFATJOO, KEITH C. OWENS, AND JENNIFER L. NASSIRI

This article explores the circumstances in which a debtor may seek to assign an insider claim to a non-statutory insider in an attempt to gerrymander an impaired class to vote to accept the debtor's plan of reorganization, and suggests possible responses for objecting creditors.

Bankruptcy attorneys are always looking for creative ways to confirm a Chapter 11 plan over the objection of non-consenting creditors. A debtor with a large body of trade creditors is often able to confirm a plan over the secured creditor's objection if the plan proposes to pay such

---

Hamid R. Rafatjoo, a partner with Venable LLP, focuses his bankruptcy practice on insolvency and corporate restructurings, either through an out-of-court workout process or through a Chapter 11 filing, corporate transactions, and mergers and acquisitions. Keith C. Owens, who also is a partner with the firm, represents debtors-in-possession, creditors committees, secured and unsecured creditors, trustees and receivers, asset purchasers, parties to contracts, and other constituencies in a wide range of bankruptcy, liquidation and workout matters throughout the United States. Jennifer L. Nassiri, of counsel to the firm Angeles office, has a practice that includes the representation of secured and unsecured creditors, creditors' committees and equity interests in various stages of Chapter 11 bankruptcy proceedings. Resident in the firm's office in Los Angeles, the authors can be reached at hrrafatjoo@Venable.com, kowens@Venable.com, and jlnassiri@Venable.com, respectively.

Published by A.S. Pratt in the March 2013 issue of *The Banking Law Journal*.
Copyright © 2013 THOMPSON MEDIA GROUP LLC. 1-800-572-2797.

creditors more than they would recover in a hypothetical liquidation.[1] This is known as "cramdown" in bankruptcy parlance. However, debtors are more likely to face difficulties confirming plans in single asset real estate cases, or small business cases, that primarily involve two-party disputes. Desperate debtors will occasionally cross the line and attempt to confirm a plan by separately classifying similar claims to create at least one "impaired"[2] class of creditors to vote in favor of the plan, or manipulating the bankruptcy process in such a way that is inconsistent with the Bankruptcy Code. Courts frequently deny confirmation of such plans as bad faith filings.

Because the votes of an "insider"[3] cannot be counted in connection with a creditor's acceptance or rejection of a Chapter 11 plan,[4] debtors occasionally seek to orchestrate an insider's assignment of his or her claim to a non-insider, third party in order to create an impaired, consenting class to vote in favor of the debtor's plan of reorganization over the objection of other creditors. There have been several published and unpublished decisions involving a Chapter 11 debtor's assignment of an insider claim to a non-statutory insider for this purpose. As discussed below, there are no published court of appeals decisions that address this issue. However, several lower courts have intimated that an assignment of an insider claim to a third party does not transform the nature of the claim under the general law of assignments, and thus, the assignee stands in the shoes of the assignor with the same benefits and disabilities as the insider had.

This article explores the circumstances in which a debtor may seek to assign an insider claim to a non-statutory insider in an attempt to gerrymander an impaired class to vote to accept the debtor's plan of reorganization. As described herein, the objecting creditor should argue that the proposed assignment of an insider claim to a non-statutory insider creditor should not be counted for voting purposes to confirm a Chapter 11 plan because the claim retains its status as an "insider" claim under general principles of assignment law. Alternatively, the creditor may argue that even if the assignee is not a statutory insider by virtue of the assignment, he should still be treated as a non-statutory insider, and therefore, his vote should not be counted for purposes of plan confirmation.

CRAMDOWN PLANS IN GENERAL

Chapter 11 plans must classify claims against the debtor, specify the treatment to be given to each class of claim, and provide the means for carrying out the plan. In order to be binding, a plan must be confirmed by the bankruptcy court. For a Chapter 11 plan to be confirmed, it must be accepted by at least one class of impaired claims. "A class of claims has accepted a plan if such plan has been accepted by creditors, other than any entity designated under subsection (e) of this section[5] that hold at least two-thirds in amount and more than one-half in number of the allowed claims of such class held by creditors, other than any entity designated under subsection (e) of this section, that have accepted or rejected such plan."[6] Assuming that the plan proponent has sufficient votes of an impaired class that accepts the plan, the plan can only be confirmed if it satisfies the statutory requirements for confirmation, which include findings by the bankruptcy court that the plan was proposed in good faith, the plan is fair and equitable and does not unfairly discriminate against similarly-situated creditors, the plan is feasible, the plan provides creditors with at least as much as the creditors would receive in a hypothetical liquidation, equity does not retain its interests[7] unless all holders of claims senior to equity are paid in full or the creditors holding such claims consent to equity's retention of its interests, and the confirmed plan is not likely to be followed by a later liquidation, among other things.

Under certain circumstances, the bankruptcy court may "cram down" a plan over the objection of creditors. In order to confirm a Chapter 11 plan over the objection of a secured creditor, a holder of a secured claim must receive the entire value of the property securing the claim or the entire value of the claim, whichever is smaller. In order for a bankruptcy court to confirm the plan of reorganization that has been rejected by at least one impaired class of creditors, the debtor must have at least one, assenting impaired class that votes to accept the plan, and meet its burden of demonstrating that the plan meets the other statutory requirements for confirmation including that the plan is fair, equitable and does not discriminate against a class of creditors. Although entitled to participate in a distribution, the votes of holders of insider claims cannot be counted for cramdown purposes under Sections 1126(c) and 1129(a)(10) of the Bankruptcy Code.

As discussed above, the votes of insiders cannot be counted in determin-

ing whether to confirm a plan of reorganization. However, in order to create an impaired, assenting class for purposes of cramdown, some Chapter 11 debtors have attempted to manipulate the bankruptcy process by causing the insider claims to be assigned to non-statutory insiders who will vote to accept the plan. These debtors will argue that the characterization of the claim prior to the assignment is largely irrelevant, and that courts must look at whether the holder of the claim is an insider at the time of voting. Since the assignees will frequently be unrelated third parties, the debtor will argue that they do not fall within the definition of an "insider" and therefore, their votes to accept or reject a plan should be counted.

Creditors who vote to reject the plan can object to the ability of these votes to be counted in order to confirm a plan over their consent on the basis that (a) an insider claim maintains its character as an insider claim notwithstanding assignment of the claim to a non-statutory insider, and (b) the relationship between the debtor and assignee is such that the assignee should be deemed to be a non-statutory insider.

PROCEDURE FOR DESIGNATING THE VOTES OF CREDITORS WHOSE VOTES WERE SOLICITED OR PROCURED IN BAD FAITH OR NOT IN ACCORDANCE WITH THE PROVISIONS OF THE BANKRUPTCY CODE

Section 1126(e) of the Bankruptcy Code provides that "[o]n 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."[8] Bankruptcy courts are empowered to decide a preemptory motion to disallow ballots of a creditor prior to plan confirmation.[9]

THE POST-PETITION ASSIGNMENT OF AN INSIDER CLAIM TO A THIRD PARTY DOES NOT TRANSFORM THE NATURE OF THE CLAIM

Several courts have held that the transfer of an insider claim to a third party does not transform the original nature of the claim.[10] "As a general

rule, 'an entity which acquires a claim steps into the shoes of that claimant, enjoying both the benefits and limitations of the claim, as a successor in interest.'"[11] In another context, the Ninth Circuit, in approving an assignee's ability to pursue a non-dischargeability action against the debtor under 11 U.S.C. § 523(a)(2)(B), rejected a similar argument that the bankruptcy courts must disregard general assignment law and look to the nature of the claimant rather than the underlying claim itself:

> …Congress was undoubtedly aware that under general principles of assignment law an assignee steps into the shoes of the assignor. Had Congress wished for assigned debts to be treated differently under § 523(a)(2)(B), it would have done more than rely on the word 'is" in subsection (iii). In the absence of such specific language, we believe that Congress intended that the general law of assignment remain applicable. That is, assuming [the assignee] was indeed the recipient of a general assignment of the original judgment, it can stand in the shoes of its assignor and pursue a non-dischargeability action under § 523(a)(2)(B).[12]

Numerous other courts have reached similar conclusions that an assignee stands in the shoes of an assignor and takes whatever rights the assignor had subject to all of the assignor's disabilities.[13] The rationale for applying the general law of assignments to section 1129(a) absent clear congressional intent to the contrary, is clear: "[T]he operation of section 1129(a) would be seriously undermined [if the] Debtor[ ] [who is] unable to obtain the acceptance of an impaired creditor[,] simply could assign insider claims to third parties who in turn could vote to accept. This the court cannot permit."[14] As the United States Bankruptcy Court for the Southern District of New York has noted, "it is incumbent…on the prospective assignees to take into account possible claim defenses when they negotiate the terms of their assignments."[15]

Notwithstanding the overwhelming authority to the contrary, at least one court has held that insider status does not transfer with the claim.[16] In *Concorde Square*, the Ohio bankruptcy court held without any analysis that "[t]he status of the claim-holder is not imputed to the transferee, but is a matter of fact to be determined from evidence of the relationship between the debtor and the third party transferee…."[17] However, the court relied on

a single bankruptcy case to reach this conclusion. In *Hempstead Realty*,[18] the New York bankruptcy court was asked to decide the senior lienolder's motion to dismiss or convert a case to Chapter 7 on the basis that the debtor was not capable of confirming a Chapter 11 plan due to the debtor's inability to have at least one consenting impaired class.[19] The court denied as premature the motion, but speculated without any analysis or citation that "various possibilities might occur between now and any proposed confirmation" including that "the insider status ascribed to [an insider claimant] could be cured by the assignment of the [insider's] second mortgage to a noninsider entity whose interest might be impaired by a proposed plan."[20]

Similarly, the court in *In re MCorp Financial, Inc.* stated in *dictum* that the "determination of insider status is made at the time the vote is taken, not at the time the claim arises." The bankruptcy court held that the debtors "failed to sustain their burden of proof in establishing that at least one impaired class …voted to accept the plan."[21] The court, among other things, held that "the ballot cast by MTrust Corporation n/k/a Ameritrust Corp. should be disregarded and not counted *as it was filed untimely and not voted by the entity that owned the claim*."[22] Because the claim had been voted by MTrust after it had been transferred to Ameritrust, the court properly concluded that MTrust did not have standing to vote the claim. However, the discussion on whether the MTrust ballot was cast by an insider, and when the determination of insider status is made, is *dictum*. Indeed, the bankruptcy court in *MCorp Financial* never analyzed the law on general assignments, or its applicability to section 1129(a). Therefore, a debtor's reliance on the holdings of *Hempstead Realty* and *MCorp Financial* should not be afforded much weight.

Finally, while there have not been any published court of appeals decisions that have addressed the issue, the Ninth Circuit Court of Appeals held in an unpublished decision that an insider claim transferred to a non-insider cannot be counted for voting purposes.[23] The court stated:

> We approve the bankruptcy court's approach, which is amply supported by case law. "As a general rule, 'an entity which acquires a claim steps into the shoes of that claimant, enjoying both the benefits and the limitations of the claim, as a successor in interest.'" *In re Holly Knoll Partnership*, 167 B.R. 381, 385 (Bankr.E.D.Pa.1994) (quoting *In re Applegate Property,*

> *Ltd.*, 133 B.R. 827, 833 (Bankr.W.D.Tex.1991)). This rule makes abundant sense in a case such as this in which there is a strong incentive for the debtor to make sure that at least one class of impaired claims remains in sympathetic hands. Were courts to allow purchasers of insider claims to approve Chapter 11 plans without any judicial scrutiny, "[d]ebtors unable to obtain the acceptance of an impaired creditor simply could assign insider claims to third parties who in turn could vote to accept. This the court cannot permit." *In re Heights Ban Corp.,* 89 B.R. 795, 799 (Bankr.S.D.Iowa 1988).[24]

Although the Ninth Circuit's decision is not binding and cannot be cited as having any precedential value, the rationale should be applied in future cases. Based on the foregoing, it is likely that a bankruptcy court will find that an insider claim transferred to a non-statutory insider retains its insider status, and cannot be considered for purposes of creating an impaired, assenting class.

HOLDERS OF INSIDER CLAIMS THAT HAVE BEEN ASSIGNED MAY BE FOUND TO BE NON-STATUTORY INSIDERS

It is not unusual for the third parties who acquire an insider claim immediately prior to or after a bankruptcy filing to have a sufficiently close relationship with the debtor such that they should be deemed a "non-statutory" insider. In the event that the bankruptcy court does not find the assignee of an insider claim to be a statutory insider, the court may nevertheless conclude that the assignee is a non-statutory insider whose vote cannot be considered in connection with confirmation of the debtor's Chapter 11 plan depending upon the relationship between the assignee and the debtor. Specifically, in determining whether a creditor is a non-statutory insider, courts consider: (1) the closeness of the relationship between the debtor and the transferee; and (2) whether the transaction between the transferee and the debtor was conducted at arm's length.[25] The legislative history makes clear that an "insider" is "one who has a sufficiently close relationship with the debtor that his conduct is made subject to closer scrutiny than those dealing at arm's length with the debtor."[26]

Several courts have held that persons who have a close relationship with the debtor, but who do not necessarily have control over the debtor or its business operations, may still be considered non-statutory insiders.[27] Indeed, several courts have held that insider status can be based on a romantic relationship between a debtor and another individual.[28]

In addition, close friends and former family members have been held to be insiders.[29]

Accordingly, if an assignee if an insider claim has control over the debtor, or a very close personal or romantic relationship with the debtor, such that the transaction was not entered into at arm's length, a bankruptcy court may find the assignee to be a non-statutory insider.

CONCLUSION

Debtors who seek to rely on the assignment of an insider claim to confirm a cramdown plan do so at their peril. As discussed above, creditors can challenge these votes by seeking to designate the claims for voting purposes on various grounds including: (a) the claim maintained its status as an insider claim under the general law of assignment, or (b) the assignee is a non-statutory insider whose vote cannot be counted for purposes of confirming a Chapter 11 plan. Bankruptcy courts should carefully scrutinize assignment of insider claims to determine whether the assignment is intended to circumvent the spirit (if not the letter) of the Bankruptcy Code. As courts seek to cut off this avenue of manipulation, debtors' counsel will find new ways to use the Bankruptcy Code's ambiguity to advocate their position. An experienced bankruptcy lawyer can help creditors navigate through troubled waters.

NOTES

[1] Secured creditors may attempt to block confirmation by purchasing such claims in order to control the class of unsecured creditor. Such action is permitted if the purpose is to protect an existing creditor's position, and not for any ulterior motive such as putting a competitor out of business. *See Figter, Ltd. v. Teachers Ins. & Annuity Ass'n*, 118 F.3d 635, 639 (9th Cir.1997).

[2] Only classes of creditors that are "impaired" are entitled to vote in favor of or

against a Chapter 11 plan. 11 U.S.C. § 1126(f). Impaired claims are generally claims that will not, under the plan, be paid in full or whose legal rights are adjusted by the plan.

[3] The term, "insider" is defined in the Bankruptcy Code, which sets forth eighteen examples of what constitutes a statutory insider, including: (i) a director of the debtor corporation; (ii) an officer of the debtor corporation; (iii) a person in control of the debtor; (iv) a partnership in which the debtor is a general partner; (v) a general partner of the debtor; or (vi) a relative of a general partner, director, officer, or person in control of the debtor, among others. 11 U.S.C. § 101(31). The list of statutory insiders is not exhaustive.

[4] 11 U.S.C. § 1129(a)(10).

[5] Section 1126(e) of the Bankruptcy Code permits "the designation of 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…."

[6] 11 U.S.C. § 1126(c).

[7] Under certain circumstances, equity may retain its interest even if creditors holding claims senior in priority are not paid in full if equity contributes substantial new value under the plan. *Bank of America Nat'l Trust & Savings Ass'n v. 203 North LaSalle Street Partnership*, 119 S.Ct. 1411 (1999).

[8] 11 U.S.C. § 1126(e).

[9] *See In re Kovalchick*, 175 B.R. 863, 874 (Bankr. E.D. Pa. 1994) (considering motion to designate claim prior to plan confirmation); *In re Pleasant Hill Partners, L.P.*, 163 B.R. 388, 389 (Bankr. N.D. Ga. 1994) (same).

[10] *See, e.g., Matter of Heights Ban Corp.*, 89 B.R. 795, 799 (Bankr. S.D. Iowa 1988).

[11] *In re Holly Knoll P'ship*, 167 B.R. 381, 385 (Bankr. E.D. Pa.1994) (quoting *In re Applegate Property, Ltd.*, 133 B.R. 827, 833 (Bankr. W.D.Tex.1991)).

[12] *In re Boyajian*, 564 F.3d 1088, 1091 (9th Cir. 2009).

[13] *See, e.g., Septembertide Publishing v. Stein & Day, Inc.*, 884 F.2d 675 (2d Cir. 1989) ("It has always been the law in New York that an assignee stands in the shoes of its assignor and takes subject to those liabilities of its assignor that were in existence prior to the assignment.") (citations omitted); *Enron Corp. v. Springfield Assoc., LLC (In re Enron Corp.)*, 379 B.R. 425, 435-36 (S.D.N.Y. 2007) ("[A]n assignee stands in the shoes of the assignor and [is] subject to all equities against the assignor. In other words 'an assignee of a claim takes with it whatever limitations it had in the hands of the assignor.'…"); *In re KB Toys, Inc.*, 470 B.R. 331, 335 (Bankr. D. Del. 2012) (holding that "the plain language, legislative history, and decisional law support the view that a claim in the hands of a transferee has the same rights and disabilities as the claim had in the hands of the original claimant. Disabilities attach to and travel with the claim.").

[14] *Three* Flint *Hill Ltd. P'ship v. Prudential Ins. Co. (In re Three Flint Hill Ltd P'ship)*, 213 B.R. 292, 299 (D. Md. 1997) (denying confirmation, noting that claimant's purchase of claim was not a "carefully reasoned business decision," but instead an accommodation to a friend or business partner).
[15] *In re Metiom, Inc.*, 301 B.R. 634, 642-43 (Bankr. S.D.N.Y. 2003).
[16] *See In re Concorde Square Apartments of Wood County, Ltd.*, 174 B.R. 71 (Bankr. S.D. Ohio 1994)).
[17] *Concorde Square*, 174 B.R. at 75.
[18] *In re Hempstead Realty Assocs.*, 38 B.R. 287, 290 (Bankr. S.D.N.Y. 1984),
[19] *Id.*
[20] *Id.*
[21] *Id.* at 231.
[22] *Id.* (emphasis added).
[23] *See In re Greer West Inv. Ltd. P'ship.*, 81 F.3d 168 (9th Cir. March 25, 1996) (unpublished).
[24] *Id.*
[25] *See In re matter of Krehl*, 86 F.3d 737, 741-42 (7th Cir. 1996); *Shubert v. Lucent Techs., Inc. (In re Winstar Commc'ns, Inc.)*, 554 F.3d 382, 396-97 (3d Cir. 2009) (same) (citations omitted).
[26] H.R.Rep. No. 95-595 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6269, 1977 WL 9628; S.Rep. No. 95-989 (1978), *reprinted* in 1978 U.S.C.C.A.N 5787, 5810, 1978 WL 8531; *see also Missionary Baptist Foundation of America, Inc. v. Huffman*, 712 F.2d 206, 210 (5th Cir. 1983 (citing S.Rep. No. 95-989, 95th Cong.2d Sess).
[27] *See, e.g., In re Winstar Communications*, 554 F.3d at 396-97 (rejecting argument that only a "person in control" could be an insider, and holding that "the question is whether there is a close relationship [between debtor and creditor] and ... anything other than closeness to suggest that any transactions were not conducted at arm's length.") (internal citations omitted); *In re U.S. Med., Inc.*, 531 F.3d 1272, 1280) (10th Cir. 2009) (rejecting control test for non-statutory insiders, and holding that a creditor may be a non-statutory insider when the "creditor and debtor did not operate at arm's length at the time of the challenged transaction.") (citing S. Rep. No. 95-595, at 25 (1978); H.R. Rep. No. 95-595, at 312 (1977); Resnick & Henry J. Sommer, Collier on Bankruptcy, P 547.03[6] (15th rev. ed. 2008)); *In re Friedman*, 126 B.R. 63, 70 (B.A.P. 9th Cir. 1991) (noting that non-statutory insider status may be based on either control by the creditor over a debtor, or under circumstances "where such relationship compels the conclusion that the individual or entity has a relationship with the debtor, close enough to gain an advantage attributable simply to affinity rather than to the course of business dealings between the parties"); *In re Winslow*, 2012 WL 2161598, at *7 (E.D.N.C. Feb. 22, 2012) (rejecting "control

test" to determine whether auction company employed by debtor was a non-statutory insider, and focusing instead on the closeness of the relationship between the non-statutory insider and the debtor); *In re Three Flint Hill*, 213 B.R. at 301 (D. Md. 1997) (noting that "control is not dispositive" and focusing more broadly on the closeness of the relationship between the parties and on whether the parties' transactions were made at arm's length*); In re Locke Mill Partners*, 178 B.R. 697, 702 (Bankr. M.D.N.C. 1995) (noting that the degree of control over a debtor is only "one of the…considerations" when determining non-statutory insider status, and that "[t]he word 'insider' should be applied flexibility to include a broad range of parties who have a close relationship with the debtor" such that their "conduct is made subject to closer scrutiny than those dealing at arms['] length with the debtor") (citations omitted).

[28] *See e.g., Kaisha v. Dodson*, 423 B.R. 888, 901 (N.D. Cal. 2010) (finding the woman the debtor was romantically involved with prior to the transfer of stock to be an insider even though they asserted they were not together at the time of the transfer); *Walsh v. Dutil (In re Demko),* 264 B.R. 404, 408 (Bankr. W.D. Pa. 2001) (cohabitation by two people may render individual an insider); *Freund v. Heath (In re McIver)*, 177 B.R. 366 (Bankr. N.D. Fla. 1995) (live-in girlfriend may be an insider).

[29] *See, e.g., In re Holloway*, 955 F.2d 1008, 1011-12 (5th Cir. 1992) (former spouse and friend of debtor was a non-statutory insider for preference purposes); *In re Curry*, 160 B.R. 813 (Bankr. D. Minn. 1993) (debtor's very close friend and business associate was an insider for purposes of fraudulent conveyance liability); *In re Standard Stores*, Inc., 124 B.R. 318, 325 (Bankr. C.D. Cal. 1991) (corporate debtor's president's ex-brother-in-law was a non-statutory insider for preference purposes).