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# Ninth Circuit Rules That Debtor's Insider Can Sell Claims to Friendly Third Parties and Garner Critical Acceptance Votes on Its Plan

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Earlier this month, the Ninth Circuit ruled that an insider can sell its claim to a friendly third party, whose vote fulfills Bankruptcy Code section 1129(a)(10)'s requirement of an impaired consenting class, unless the third party has a close relationship with the debtor and negotiated the claim purchase at less than arm's length. See *U.S. Bank N.A. v. The Village at Lakeridge, LLC (In re The Village at Lakeridge, LLC)*, 2016 WL 494592 (9th Cir. Feb. 8, 2016).

When the Village at Lakeridge (the debtor) filed for bankruptcy, it had two primary creditors: the bank with a $10 million secured claim and the debtor's sole equity holder (MBP) with a $2.76 million unsecured claim. After the debtor filed a plan seeking to cram down the bank, MBP sold its claim to a third party (Rabkin) for $5,000. Rabkin had no prior relationship with the debtor but had a close and personal relationship with one of MBP's members.

To confirm the plan over the dissent of the bank, the debtor had to satisfy Bankruptcy Code section 1129(a)(10), which requires that at least one class of impaired creditors vote to accept the plan, excluding the votes of any insider. Bankruptcy Code section 101(31) defines "insider" as individuals and entities that fall within certain categories (e.g., officers, directors, affiliates, etc.), referred to as "statutory insiders." Section 101(31) is not exclusive ("[t]he term 'insider' *includes*"), and courts have developed additional categories of "non-statutory insiders."

The bank moved to designate Rabkin's vote. The bankruptcy court held that although Rabkin was not a non-statutory insider and did not acquire the claim in bad faith, his vote should be disregarded because he acquired the claim from a statutory insider and the insider status tainted the claim. On appeal, the Bankruptcy Appellate Panel (BAP) reversed the ruling that Rabkin became a statutory insider by acquiring the claim of an existing statutory insider.

To begin, the Ninth Circuit agreed with the BAP that Rabkin was not a statutory insider. "A person does not become a statutory insider solely by acquiring a claim from a statutory insider for two reasons. First, bankruptcy law distinguishes between the status of a claim and that of a claimant. Insider status pertains only to the claimant; it is not a property of a claim. Because insider status is not a property of a claim, general assignment law – in which an assignee takes a claim subject to any benefits and defects of the claim – does not apply. Second, a person's insider status is a question of fact that must be determined after the claim transfer occurs."

Next, the circuit court upheld the bankruptcy court's finding that Rabkin was not a non-statutory insider because his claim purchase did not meet the following standard: "(1) the closeness of its relationship with the debtor is comparable to that of the enumerated insider classifications in § 101(31), and (2) the relevant transaction is negotiated at less than arm's length." The court remarked that

"[n]othing in § 101(31) or case law indicates it would be improper for a debtor to sell, or even give, a claim to a friend if the friend is acting of his own volition and neither party is engaged in bad faith."

Judge Richard Clifton dissented in part, arguing that Rabkin should be viewed as a non-statutory insider. "The facts make it clear that this transaction was negotiated at less than arm's length. Rabkin paid $5,000 to MBP (the sole member of the debtor, Lakeridge), for an unsecured claim against Lakeridge nominally worth $2.76 million. MBP did not offer the interest to anyone else. The purchase was not solicited by Rabkin. It was proposed to Rabkin by Kathie Bartlett, a member of the MBP board. There was no evidence of any negotiation over price – Rabkin didn't offer less, and MBP didn't ask for more."

Under the majority opinion "insiders are free to evade the requirement [of section 1129(a)(10)] simply by transferring their interest for a nominal amount (perhaps a few peppercorns) to a friendly third party, who can then cast the vote the insider could not have cast itself. . . . By this standard, a savvy debtor can comply with the good faith requirement by following a simple formula: develop a reorganization plan that would provide a payout on the insider claim if approved, and then sell the claim to a friendly third party for a price lower than the payout. This enables the debtor to maneuver the third party into a position where it would be foolish not to vote for approval of the reorganization plan, ensuring a 'yes' vote and thereby allowing the debtor to effectively avoid the requirement under § 1129(a)(10) that at least one noninsider must approve the plan."

As highlighted by the dissent, the Ninth Circuit's opinion ostensibly provides debtors with a roadmap to circumvent the requirement in Bankruptcy Code section 1129(a)(10) that an impaired consenting class of creditors (excluding insiders) vote to accept a plan of reorganization. Insiders can sell their claims for a nominal amount to friendly third parties that will vote in favor of the plan. To defeat this strategy, creditors must gather and present evidence that the third party did not acquire the claim in good faith, but rather solely to do the insider's bidding, in less than an arms-length transaction.

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