Supreme Court Ruling on Insider Status for Cram-Down Plan Threatens Lender Protections in Real Estate Financing Structures

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The authors of this article discuss a recent case from Nevada, which started in bankruptcy court and ended up in the U.S. Supreme Court, that exposes a risk to the protections sought by senior lenders through claims trading.

Since 1993, a central tenet in the structure of senior real estate lending documentation is the prevention of what is commonly referred to as "cram down." Under a "cram down," a borrower in Chapter 11, if certain statutory requirements are met, may have its Chapter 11 plan confirmed by the bankruptcy court administering its case that re-writes the essential provisions of the secured loan, including term, interest rate and amortization. To achieve "cram down," a central requirement under Section 1129(a)(10) of the Bankruptcy Code is that the proposed Chapter 11 plan needs to be accepted by at least one impaired, "non-insider" creditor class.

Senior lenders in real estate financing transactions, therefore, strive to ring-fence their borrower (and its collateral) to assure that there is no other creditor class that can become an impaired accepting class under a Chapter 11 plan and "cram down" the senior lender's debt over its objection.[1] Senior lenders have created devices to prevent "cram down," including mezzanine financing coupled with non-substantively consolidate-able separate borrowers (for the senior and mezzanine loans, respectively), "golden shares," non-recourse carve-outs, and "bad boy" guarantees.

A recent case from Nevada, which started in bankruptcy court and ended up in the U.S. Supreme Court, exposes a risk to the protections sought by senior lenders through claims trading. Specifically, the sole equity holder of the borrower sold an unsecured claim it had for funds advanced to its borrower, at pennies

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on the dollar, to a friendly third party and through that transfer the purchaser lost the insider status and its vote to accept the borrower-debtor's cram-down of its mortgagee was counted.[2] To fully understand the potential implications of this case, it is important to review its facts, and its tortuous journey up from the bankruptcy court to the circuit court, and ultimately the U.S. Supreme Court.

The Bankruptcy Court Proceeding

After it filed for Chapter 11, The Village at Lakeridge, LLC (the "Debtor") filed a plan and disclosure statement that contained two classes of claims: (1) a $10 million secured claim held by U.S. Bank National Association, as successor trustee to Greenwich Financial Products, Inc. ("US Bank"); and (2) a $2.76 general unsecured claim held by the Debtor's sole owner MBP Equity Partners 1, LLC ("MBP"), both of which were impaired under the plan.[3] US Bank did not accept its treatment making confirmation of the plan on a consensual basis impossible and MBP was a statutory insider so its vote on account of its claim would not be counted under Section 1129(a)(10). Shortly thereafter, a member of MBP's board, Kathie Bartlett ("Bartlett") approached Robert Rabkin ("Rabkin") to have him purchase MBP's general unsecured claim. Rabkin was not asked to vote in favor of the plan as a condition to his purchase of the claim. Rabkin purchased MBP's claim for $5,000, representing 0.2 percent of the face value of the claim.

US Bank sought to disqualify Rabkin's vote on the cram-down plan on several grounds: (1) Rabkin was a statutory insider through the assignment of the claim held by an insider (MBP); (2) Rabkin was a non-statutory insider because of his relationship with Bartlett; and (3) the assignment of the MBP claim was made in bad faith. At trial, Rabkin acknowledged the following facts: (a) he had both a business and close personal relationship with Bartlett; (b) he saw Bartlett regularly, including on the day of his deposition; and (c) he purchased MBP's claim for $5,000 as a business investment and expected to be paid a pro rata dividend of $30,000 under the proposed plan.[4]

In denying US Bank's motion, the bankruptcy court concluded that Rabkin was not a non-statutory insider because the sale of the MBP claim appeared to be negotiated at arm's length. The bankruptcy court found that (a) Rabkin did not exercise control over the Debtor; (b) Bartlett did not exercise control over Rabkin; (c) Rabkin did not cohabitate with Bartlett and they did not pay each other's bills or living expenses; and (d) Rabkin and Bartlett never purchased expensive gifts for each other.[5] The bankruptcy court also determined that MBP's unsecured claim was not assigned to Rabkin in bad faith because it was purchased for a legitimate business purpose and Bartlett never asked him to vote in favor of the plan.[6] However, the bankruptcy court found that, as a matter of law, Rabkin was a statutory insider because MBP was a statutory insider and, as the assignee of MBP's claim, Rabkin acquired the status of statutory insider.[7] Accordingly, the bankruptcy court determined that despite the existing relationship between buyer and seller, the purchase of the claim was in fact made at "arm's length" and therefore the buyer was not a non-statutory insider, but was a statutory insider when it purchased the debt owned by an insider.

The Appeal to the Ninth Circuit BAP

Both parties appealed to the Bankruptcy Appellate Panel for the Ninth Circuit ("BAP") which reviewed the determination of whether Rabkin qualified as a non-statutory for "clear error."[8] "In making this determination, the bankruptcy court must determine, 'on a case-by-case basis whether the relationship between a creditor and its debtor, considered in the light if the statutory scheme, amounts to an 'insider' relationship.'"[9] Although people might come to different conclusions, the BAP affirmed the bankruptcy court's determination that Rabkin was a non-statutory insider based on the facts before it.[10]

However, finding that the bankruptcy court's conclusion was not supported by the cases cited, the BAP reversed the bankruptcy court's ruling that Rabkin acquired the status of an insider when it acquired MBP's claim from an insider.[11]

The Appeal to the Ninth Circuit Court of Appeals[12]

The U.S. Court of Appeals for the Ninth Circuit framed the legal standard to determine whether a creditor qualifies as a non-insider as follows: (1) the closeness of its relationship with the debtor is comparable to that of the enumerated insider classification in the Bankruptcy Code; and (2) the relevant transaction is negotiated at less than arm's length.[13] The court of appeals stated that the court must conduct a fact intensive analysis to determine these questions and subject to a review under a standard of "clearly erroneous," namely, that the bankruptcy court's decision of factual issues is to be upheld unless the court of appeals concluded that they were "clearly" in error. The court of appeals determined that, while a different trier of fact could weigh the evidence differently, under the deferential clear error standard, the bankruptcy court's finding that Rabkin was not a non-statutory insider would not be disturbed.[14] The court of appeals also affirmed the BAP's determination that Rabkin did not become a statutory insider when it acquired MBP's claim.

The Appeal to the U.S. Supreme Court

As noted above, the U.S. Supreme Court accepted the lender's appeal on a single issue: In reaching the conclusion that the claims buyer had purchased the claim in any arm's length sale, whether the Ninth Circuit was right that it needed to accept the factual determinations of the bankruptcy court unless they are "clearly" wrong — or whether the Ninth Circuit could independently review the facts without any deference to the bankruptcy court?[15]

On March 5, 2017, Justice Kagan, delivered the opinion of the Supreme Court and held that the bankruptcy court's factual determination that the assignment of the claim was made at arm's-length was entitled to the deferential standard of "clear error" and, therefore, the purchaser was not a non-statutory insider and could cast a vote accepting the plan resulting in a "cram down" on the senior lender.[16] In reaching its decision, the Supreme Court noted that the question of whether a creditor is a non-statutory insider was a mixed question of law and fact and since, in this case, the question was much more fact intensive, the clear error standard of review would apply.

The Supreme Court's decision was accompanied by two concurring opinions of Justices Kennedy and Sotomayor. Justice Kennedy wrote that while he agreed with the opinion of the Court on the narrow question of the standard of review, he emphasized that "courts of appeals may continue to elaborate in more detail the legal standards that will govern whether a person or entity is a non-statutory insider under the Bankruptcy Code . . . In particular, courts should consider the relevance and meaning of the phrase 'arms-length transaction' in this bankruptcy context. As courts of appeals address these issues and make more specific rulings based on the facts and circumstances of individual cases, it may be that instructive, more specifically defined rules will develop."[17] Justice Kennedy questioned whether further inquiry may have yielded different results. In particular, Just Kennedy suggested that Bartlett's failure to market MBP's debt to other parties could have provided other indicia that the transaction was not conducted at arm's length.[18]

Justice Sotomayor (with whom Justices Kennedy, Thomas, and Gorsuch joined) also agreed on the appropriate standard of review but observed that she questioned whether the Ninth Circuit's two-prong test to determine non-statutory insider status was correct.[19] As noted above, that test is (1) the closeness of its relationship with the debtor is comparable to that of the enumerated insider classification in the Bankruptcy Code; and (2) the relevant transaction is negotiated at less than arm's length.[20] Justice Sotomayor observed that since the test was stated in the conjunctive, no matter how close the creditor and insider could be, the test could be defeated if a court determines the transaction to be at arm's length. Justice Sotomayor advocated for the development of a "principled method of determining what other individuals or entities fall within the term 'insider' other than those expressly provided" in section 101(31) of the Bankruptcy Code."[21] More specifically, Justice Sotomayor suggested the following two legal standards: (1) the inquiry should focus solely on the comparison between the characteristics of the alleged non-statutory insider and the enumerated insiders, and if they share sufficient commonalities, the alleged person or entity should be deemed an insider regardless of the apparent arm's-length nature of any transaction; or (2) the test should focus on a broader comparison that includes consideration of the circumstances surrounding any relevant transaction.[22]

Final Thoughts

As the case above makes clear, the standard by which a creditor may be considered a non-insider is far from settled and we can expect many more cases attempting to establish a bright-line test, or failing that, some better defined standards. What is settled, however, is that a bankruptcy court's factual determinations of whether or not a creditor meets the stated legal test to be a non-statutory insider will be afforded great deference by, if not totally binding upon, the appellate courts. Lenders should, therefore, closely reexamine their form loan documents, and in particular the carve-outs to the non-recourse provisions, to prevent the strategies their borrowers may employ after this decision to find an impaired accepting class by letting insiders create claims and thereafter trade them to third parties. Anticipating these strategies and sufficiently addressing them in the underlying documentation may avoid an unwanted result (or at least protracted litigation) in the future.

NOTES:

[1] *See* 11 U.S.C.A. § 1129(a)(10).

[2] *See In re The Village at Lakeridge, LLC*, No. 11-51994 (Bankr. D. Nev. Aug. 20, 2012).

[3] *See In re The Village at Lakeridge, LLC*, No. 11-51994 (Bankr. D. Nev. Aug. 20, 2012) (Docket no. 254) (hereinafter, the "*Order*") at 5.

[4] *See Order* at 4.

[5] *See Order* at 4.

[6] *See Order* at 5.

[7] *See Order* at 5.

[8] *See In re The Village at Lakeridge, LLC*, (9th Cir. BAP April 5, 2013) at 8.

[9] *Id.*

[10] *Id.* at 14.

[11] *Id.* at 15–16.

[12] The court of appeals affirmed the BAP's determination that Rabkin did not become a statutory insider when it purchased the claim held by MBP — a statutory insider. That issue was not appealed to the Supreme Court.

[13] *See In re The Village at Lakeridge, LLC*, 814 F.3d 993, 1001, 62 Bankr. Ct. Dec. (CRR) 44, 75 Collier Bankr. Cas. 2d (MB) 125, Bankr. L. Rep. (CCH) P 82921 (9th Cir. 2016), certiorari granted in part, 137 S. Ct. 1372, 197 L. Ed. 2d 553 (2017) and aff'd, 138 S. Ct. 960, 200 L. Ed. 2d 218, 65 Bankr. Ct. Dec. (CRR) 91, Bankr. L. Rep. (CCH) P 83220 (2018).

[14] *See Id.* at 1002.

[15] *See U.S. Bank Nat'l Assn. v. The Village at Lakeridge, LLC*, 583 U.S. __ (2018) (Kagan, J.) at 5.

[16] *See U.S. Bank Nat. Ass'n ex rel. CWCapital Asset Management LLC v. Village at Lakeridge, LLC*, 138 S. Ct. 960, 200 L. Ed. 2d 218, 65 Bankr. Ct. Dec. (CRR) 91, Bankr. L. Rep. (CCH) P 83220 (2018).

[17] *U.S. Bank Nat'l Assn. v. The Village at Lakeridge, LLC*, 583 U.S. __ (2018) (Concurring, Kennedy, J.) at 1.

[18] *Id.* at 2.

[19] *U.S. Bank Nat'l Assn. v. The Village at Lakeridge, LLC*, 583 U.S. __ (2018) (Concurring, Sotomayor, J.) at 1.

[20] *See In re The Village at Lakeridge, LLC*, 814 F.3d 993, 1001, 62 Bankr. Ct. Dec. (CRR) 44, 75 Collier Bankr. Cas. 2d (MB) 125, Bankr. L. Rep. (CCH) P 82921 (9th Cir. 2016), certiorari granted in part, 137 S. Ct. 1372, 197 L. Ed. 2d 553 (2017) and aff'd, 138 S. Ct. 960, 200 L. Ed. 2d 218, 65 Bankr. Ct. Dec. (CRR) 91, Bankr. L. Rep. (CCH) P 83220 (2018).

[21] *U.S. Bank Nat'l Assn. v. The Village at Lakeridge, LLC*, 583 U.S. __ (2018) (Concurring, Sotomayor, J.) at 4.

[22] *See Id.* at 4–5.