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In re Transwest Resort Properties, Inc.: *Arizona District Court Interpretation of "Impaired Accepting Class" for Plan Confirmation Purposes Threatens Senior Mortgage Lender Protections in Common Real Estate Financing Structures*

By: Lawrence Mittman and Geoffrey Raicht

The enactment of the Tax Reform Act of 1986, which ended the many tax shelter advantages previously available to real estate investors, coupled with the savings and loan crises, effectively collapsed the real estate boom of the early-to-mid 1980's. From 1988 to 1993, countless numbers of real estate loans went into default and many real estate borrowers sought to involuntarily restructure their loans through the "cram-down" provisions of Chapter 11 under title 11 of the United States Code (the "Bankruptcy Code").

At that time, the typical real estate borrower structure contained a single asset, with senior and junior mortgages against it, and a month or two's worth of non-material, in dollar amount, of trade payables. By the time of the commencement of the typical Chapter 11 case of this period, property values had so plummeted from when the mortgage loans were first made, a year or two beforehand, that the senior mortgage often found itself without collateral coverage (*i.e.* undersecured) for half its outstanding debt, and the junior mortgage were inevitably totally "underwater"- - without any collateral coverage (*i.e.* fully unsecured). Thus, if a foreclosure were to have occurred, the senior mortgagee would be able to "bid-in" or "credit bid" the full amount of its mortgage debt, and unless the junior mortgage were willing to pay-off the senior mortgage in full (principle, interest – simple and default – plus the fees, costs and expenses of the senior mortgagee), the junior mortgagee would be wiped out entirely. From the borrower's perspective, it would need to pay off, in full, both mortgages to maintain ownership of the asset. Rather than face foreclosure, borrowers filed Chapter 11 and sought to have the bankruptcy court involuntarily extend and reduce the mortgage debt under the "cram-down" standards of the Bankruptcy Code, by giving the subject mortgage lender the "indubitable equivalent" of the value of its collateral interest in the property as of confirmation of the plan. So, if a mortgage loan had been originally made in the sum of $10 million, but now the property was worth only $5 million, the bankruptcy court could approve a plan of reorganization that would give the lender a new note extended over years, with other terms that the court approved, so long as it had a present value of $5 million. As explained below, however, to successfully effect a cram-down, one class of non-borrower affiliated creditors would need to vote in favor of the plan. Since a junior mortgagee would otherwise be wiped-out in an ordinary foreclosure, the junior mortgagee was typically prepared to provide the affirmative vote to any cram-down plan proposed by the borrower that provided it with any type of recovery.

When the downturn ended in about 1993, and lenders began to contemplate new real estate mortgage loans, they were no longer willing to lend into a structure that potentially provided for a competing creditor vote in a Chapter 11. Simply put, prospective mortgage lenders wanted no other potential creditors in their borrower's legal structure. Thus, the mezzanine loan structure was born. Loans that were previously junior to senior mortgages would now be structured completely outside the four-corners of the single asset collateral owner. The "mezzanine lender" would typically be secured by a pledge of the equity of the entity that owned the collateral subject to the mortgage. Thus, if the collateral owner were to file a Chapter 11, other than the senior mortgage, there would be no other impaired creditor who could vote in favor of a plan making the plan eligible for "cram-down". A key element to the senior loan structure, therefore, was that each borrower had only one asset, with one mortgage lender. The relationship between the senior mortgage lender and the mezzanine lender (with no mortgage, but an equity pledge) was further defined by an inter-creditor agreement.

A recent decision from the bankruptcy court in Arizona may dramatically undermine this structure to the detriment of the senior mortgage lending community.

In re Transwest Resort Properties, Inc.

The Arizona District Court recently affirmed a bankruptcy court decision which held that, for purposes of plan confirmation, the affirmative vote of *one* impaired class under a joint plan of reorganization for multiple non-substantively consolidated debtors is sufficient to satisfy section 1129(a)(10) of the Bankruptcy Code. *See In re Transwest Resort Properties, Inc.*, 2016 WL 4087111 (D. Az. June 22, 2016). This "per-plan" approach has been acknowledged favorably by the bankruptcy courts for the Southern District of New York, *see In re Charter Communications*, 419 B.R. 221 (Bankr. S.D.N.Y. 2009); *see also In re Enron Corp.*, No. 01-16034 (Bankr. S.D.N.Y. Jul. 15, 2004), and the Middle District of Pennsylvania. *See In re SGPA, Inc.*, 2001 WL 34750646 (Bankr. M.D. Pa. Sept. 28, 2001). However, the United States Bankruptcy Court for the District of Delaware has twice held that satisfaction of section 1129(a)(10) requires acceptance of the plan by an impaired consenting class *for each debtor* in non-substantively consolidated, multiple debtor cases (i.e. the "per-debtor" approach). *See In re Tribune*, 464 B.R. 126 (Bankr. D. Del 2011); see also *In re JER/Jameson Mezz Borrower II, LLC*, 461 B.R. 293 (Bankr. D. Del. 2011). In addition to the reasons discussed above, the *Transwest* decision is important because the Arizona Bankruptcy Court's opinion (affirmed by the District Court) engaged in a detailed rebuke of the Delaware Bankruptcy Court's analysis supporting the "per-debtor" approach. The issue is of high importance to any company looking to reorganize complex corporate structures, but it is especially important when structuring real estate investments that rely upon a borrower's corporate separateness from its affiliates and subsidiaries. The District Court's decision in *Transwest* is currently on appeal to the 9th Circuit Court of Appeals.

1. **<u>Per-Plan vs. Per-Debtor</u>**

Section 1129(a)(10) of the Bankruptcy Code is one of the elements that must be satisfied in order for a debtor to confirm its plan. Section 1129(a)(10) provides that the court shall only confirm a plan when, "if a class of claims is impaired under the plan, at least one class of claims that is impaired under the plan has accepted the plan, determined without including any acceptance of the plan by any insider." 11 U.S.C. § 1129(a)(10). The requirement of 1129(a)(10), while seemingly simple, becomes nettlesome when applying it to cases involving multiple debtors who are not substantively consolidated and seek to reorganize under a single joint plan. Indeed, it is not uncommon for large and complex businesses to seek protection under chapter 11 and reorganize dozens of subsidiaries and affiliates. The fundamental question with respect to satisfaction of section 1129(a)(10) is as follows: If multiple debtors propose a joint plan on a non-substantively consolidated basis, may section 1129(a)(10) be satisfied if one impaired class of creditors with claims against only one of the debtors rejects the plan but another impaired class of creditors with claims against a different debtor accepts the plan? The answer depends upon whether the court applies the "per-plan" or "per debtor" approach.

A. "Per Debtor"

The leading case advocating the "per-debtor" approach is the Delaware bankruptcy court's 2011 decision in *In re Tribune*, 464 B.R. 126 (Bankr. D. Del. 2011). In that case, the Delaware bankruptcy court concluded that absent substantive consolidation or consent, section 1129(a)(10) must be satisfied by each debtor to a joint plan. In other words, each debtor must separately satisfy all the requirements of section 1129 in order to have a confirmable plan even if the debtors are reorganizing under a single plan document. In reaching its conclusion, the Delaware bankruptcy court affirmed that unless the debtors are substantively consolidated, "entity separateness is fundamental." *Id.* at 182. The Delaware bankruptcy court reasoned that only if section 1129(a)(10) applied to each debtor could the other confirmation standards of 1129(a) make sense. For example, section 1129(a)(1) provides that the plan must be proposed in good faith. In multiple debtor cases, that standard cannot be satisfied if only one debtor, and not the others, proposes a plan in good faith. See *id*. at 183. In addition, section 1129(a)(7)'s best interests of creditors test (which requires either that the creditor accepts the plan or the plan allows them to receive or retain under the plan property of a value that is not less than the amount they would receive or retain if the debtor were liquidated under chapter 7) can only be read fairly by meaning an entitlement to the prescribed treatment for every impaired class of creditors for each debtor which is a part of the plan. *See id*. The Delaware bankruptcy court noted that in large complex multi debtor cases a single distribution scheme is often proposed where the sources of funding and distribution are made without regard to where the assets are found or the liabilities lie. However, those mechanisms are usually done on consensus or without objection. See *id*.[1]

B. "Per Plan"

At least two courts have found section 1129(a)(10) is satisfied with respect to multiple non-substantively consolidated debtors where the plan contained a single impaired accepting class. See *In re Charter Communications*, 419 B.R. 221 (Bankr. S.D.N.Y. 2009); *In re SGPA, Inc.*, case no. 01-02609, 2001 WL 34750646 (Bankr. M.D. Pa. Sept. 28, 2001). However, neither court engaged in a detailed analysis of the statute. In *SGPA,* the court viewed the financial restructuring as necessary to right size the debtors' balance sheet. The court acknowledged that while it was true that "various corporations are affected by the Plan, the business of the debtors remains the same" and "whether these [d]ebtors were substantively consolidated or jointly administered would have no adverse effect on the [objecting creditors]." *In re SGPA, Inc.*, 2001 WL 34750646 at 5. In *Charter Communications*, the court's section 1129(a)(10) analysis focused primarily on the creditors' argument that classes were gerrymandered and impaired classes were artificially created. After the court rejected the creditors' argument, the court ruled in the alternative that the appropriate test under 1129(a)(10) is on a per plan basis. See *In re Charter Communications*, 419 B.R. at 266 (*citing In re Enron Corp.*, No. 01-16034 (Bankr. S.D.N.Y. Jul. 15, 2004) (using the per-plan approach with respect to substantively consolidated debtors); *In re SGPA, Inc.*, case no. 01-02609, 2001 WL 34750646 (Bankr. M.D. Pa. Sept. 28, 2001)).

2. <u>Bankruptcy Court Decision</u>

In 2007, Transwest Partners, a real estate development and investment firm, formed five related special purpose entities to acquire the Westin Hilton Head Resort and Spa in Hilton Head Island, South Carolina (the "Hilton Head Resort"), and the Westin La Paloma Resort and Country Club in Tucson, Arizona (the "La Paloma Resort" and together with the Hilton Head Resort, the "Resorts") for an aggregate purchase price of $270 million. The purchase was financed through $30 million in cash, a $209 million mortgage (the "Mortgage") and mezzanine financing in the amount of $21.5 million (the "Mezz Loan").[2] Transwest Resort Properties, Inc. ("TRPI") was the ultimate holding company. TRPI owned 100 percent of the shares of Transwest Tucson II, LLC ("Tucson II") and Transwest Hilton Head II, LLC ("Hilton Head II" and together with Tucson II, the "Mezz Debtors"). Tucson II owned 100 percent of the shares of Transwest Tucson Property, LLC ("Tucson OpCo"), which was the operating entity for and owned the La Paloma Resort. Hilton Head II owned 100 percent of the shares of Transwest Hilton Head Property, LLC ("Hilton Head OpCo" and together with Tucson OpCo, the

[1] In *In re JER/Jameson Mezz Borrower II, LLC*, 461 B.R. 293 (Bankr. D. Del. 2011), Judge Walrath cited *Tribune* favorably for the per-debtor approach in the context of a motion to dismiss a bankruptcy filing on bad faith grounds.
[2] The purchase price also included a $10 million junior mezzanine carry-back loan.

"OpCo Debtors"),[3] which was the operating entity for and owned the Hilton Head Resort. The acquisition closed on December 7, 2007.

The OpCo Debtors were the sole obligors under their respective Mortgage notes. Each Mortgage note was secured by a first lien on, among other things, the respective Resort. The Mezz Loan was secured by the Mezz Debtors' respective equity interests in the OpCo Debtors.

In 2008, the Debtors failed to make the required debt service payments resulting in a default under both the Mortgage and Mezz Loan. For nearly two years, the Debtors and their lenders attempted to reach a consensual out of court solution but were unsuccessful.

On November 17, 2010 (the "Petition Date"), each of the Debtors filed separate Chapter 11 petitions in the United States Bankruptcy Court for the District of Arizona (the "Bankruptcy Court"). The five cases were jointly administered but not substantively consolidated. JPMCC 2007-C1 Grasslawn Lodging, LLC (the "Lender"), obtained the mortgage prior to the Petition Date and filed proofs of claim against the OpCo Debtors in the amount of $209 million. PIM Ashford Subsidiary I LLC ("PIM") acquired the Mezz Loan in 2008 and filed proofs of claim against the Mezz Debtors totaling $39 million.

On March 17, 2011, the Lender filed a motion against the OpCo Debtors for relief from the automatic stay. The Lender sought relief so it could enforce its rights and remedies with respect to the Resorts, including the appointment of a receiver and sale of the Resorts through foreclosure. The Debtors and the Lender ultimately stipulated that the value of the Resorts were, collectively, $92 million for purposes of determining the value of the Lender's claim in connection with confirmation of the Plan. On June 14, 2011, PIM filed a motion against the Mezz Debtors for relief from the automatic stay. PIM sought relief so it could exercise its rights and remedies with respect to its pledge on the Mezz Debtors' membership interests in the OpCo Debtors. Ultimately, the Bankruptcy Court denied both motions.

On July 31, 2011, the Debtors filed a single, joint plan of reorganization (as amended and restated, the "Plan"). While a single Plan was filed on behalf of all of the Debtors, the Plan did not seek substantive consolidation of the Debtors' estates. The Debtors' overall restructuring was based upon the transfer of the ownership of the OpCo Debtors to a new third party. Under the Plan, a third party investor, Southwest Value Partners Fund XV, LP ("SWVP"), would invest $30 million directly into the OpCo Debtors in exchange for 100 percent of the membership interests in the OpCo Debtors. The membership interests held by the Mezz Debtors as of the Petition Date were to be cancelled and extinguished. As an incentive for the holders of the Mezz Loan to vote in favor of the Plan, the Debtors offered them a potential recovery of a small amount of cash and the potential of receiving a small portion of the excess cash flow from the reorganized debtors operations. After the Plan was filed, the Lender acquired the Mezz Loan from PIM. The Lender then voted to reject the plan on account of both the Mortgage and the Mezz Loan.

[3] TRPI, Tucson II, Hilton Head II, Tucson OpCo and Hilton Head OpCo are collectively referred to as the "Debtors".

The Plan had ten classes of claims and interests:

Class	Name of Class	Type of Claim	Impaired	Reject or Accept
Class 1	Senior Lender Secured Claim	Lender's secured claim against the OpCo Debtors on account of the Mortgage	Y	Reject
Class 2	EZ Trade Secured Claim	Secured claim against the OpCo Debtors in the aggregate amount of $53,000	Y	Accept
Class 3	GE Capital Secured Claim	Secured claim against Tucson OpCo on account of equipment leases totaling approximately $1 million	Y	Accept
Class 4	Convenience Class	Claims of creditors who elect to accept a one-time cash payment up to $5,000 by the reorganized OpCo Debtors	Y	Accept
Class 5	Unsecured Trade Creditor Claims	Trade claims against each of the OpCo Debtors	Y	Accept
Class 6	General Unsecured Claims	Unsecured claims against each of the OpCo Debtors	Y	Accept
Class 7	Mezzanine Lender Claims	Claims on account of the Mezz Loan against the Mezz Debtors in the amount of $21.5 million	Y	Reject
Class 8	Subordinated Penalty Claims	Pre-petition claims, fines and penalties, including claims for default interest under the Mortgage or penalty interest owed on taxes to governmental entities	Y	Deemed to Reject
Class 9	TRP Creditors	All trade claims against TRPI	N	Deemed to Accept
Class 10	Equity Interests and Subject Insider Claims	Equity interests in the OpCo Debtors and the Mezz Debtors and claims by affiliates	Y	Deemed to Reject

Despite the rejection of the Plan by both Class 1 and Class 7, the Plan could still be confirmed under the cramdown standard of section 1129(b) if there was an impaired accepting class under 1129(a)(10).[4]

[4] Under the Debtors' joint Plan, classes 2, 3, 4, 5 and 6 were all impaired and accepted the Plan.

Whether the overall restructuring could occur depended upon whether the Bankruptcy Court would require compliance with 1129(a)(10) for each Debtor or under a single plan. Through a bench decision, the Bankruptcy Court ruled that the Plan satisfied section 1129(a)(10) using the “per-plan” approach, which then paved the way for overall confirmation of the Plan under the cramdown standards.

In reaching its decision, the Bankruptcy Court rejected the Delaware bankruptcy court’s reasoning in *In re Tribune*[5] and relied upon its own plain reading of the statute. First, the Bankruptcy Court noted that section 1129(a)(10) uses the word “plan” and not “proponent of a plan,” which can have separate obligations. *See In re Transwest Resort Properties*, case no. 10-37134 (Bankr. D. Az. Dec. 16, 2011), Tr. at 5-6 (comparing 11 U.S.C. § 1129(a)(2) and 1129(a)(10)). In particular, the Bankruptcy Court took aim at the Delaware bankruptcy court’s analysis that a “per-plan” approach would render the best interest of creditors test under section 1129(a)(7) meaningless. The Bankruptcy Court ruled that satisfaction of 1129(a)(7) doesn’t turn on where the proceeds for distribution come from, but rather, the focus of section 1129(a)(7) is whether the creditor does better under the plan than under chapter 7. *See id*. at 6.

The Bankruptcy Court also drew factual distinctions against *Tribune.* The Bankruptcy Court posited that the joint plan in *Tribune* was really a series of separate plans for each debtor. But in *Transwest*, if Class 7 (i.e. claims on account of the Mezz Loan) voted in favor of the Plan, it would have been eligible to receive some of the surplus cash flow from the operations of the reorganized OpCo Debtors. Therefore, the Bankruptcy Court reasoned, “[w]hile I recognize that there is language in the plan that says its not seeking substantive consolidation, at least with respect to the Mezzanine’s creditor claim, the plan provides treatment which it would have received if the cases had been substantively consolidated.” *Id*. at 7. Moreover, holders of claims on account of the Mezz Loan were not giving up any bargained for rights in particular collateral to share in a general pool with other general unsecured creditors. The Mezz Loan was collateralized by a pledge of the Mezz Debtors membership interests in the OpCo Debtors. The membership interests only had value to the extent the OpCo Debtors were profitable. Therefore, it was the Bankruptcy Court’s position that if the holders of claims on account of the Mezz Loan gave up anything, it was their right to foreclose of worthless stock. *See id.*

3. <u>District Court Decision</u>

On appeal, the Lender argued that the bankruptcy court misapplied section 1129(a)(10) and the “per-debtor” interpretation should be adopted. *See In re Transwest Resort Properties, Inc.*, 2016 WL 4087111 (D. Az. June 22, 2016) at *2. The Lender argued that because it was the only creditor for the Mezz Debtors and the Debtors had not substantively consolidated, section 1129(a)(10) can only be satisfied if Lender votes in favor of the plan. *See id.* In response, the Debtors relied on *In re SPGA, Inc., In re Enron Corp.* and *In re Charter Communications*, for the proposition that the plain language of section 1129(a)(10) supports the view that the affirmative vote of one impaired class under the joint plan of multiple debtors is sufficient to satisfy section 1129(a)(10). *See id* at *5.

The District Court affirmed the Bankruptcy Court’s decision and found that section 1129(a)(10) applies on a “per-plan” basis. *See id.* First, unlike in *Tribune*, the District Court found the plain language of the statute to be dispositive. “The statute states that ‘[i]f a class of claims is impaired under the plan, at least one class of claims that is impaired under the plan has accepted the plan’ then the court shall confirm the plan. Thus, once

[5] “After a lot of thought and a lot of time with [the Delaware Court’s] decision, I’m not persuaded by [its] analysis.” *See In re Transwest Resort Properties*, case no. 10-37134 (Bankr. D. Az. Dec. 16, 2011), Transcript of Hearing (docket no. 741) (“*Tr.*”) at 5.

an impaired class has accepted the plan, section 1129(a)(10) is satisfied as to all debtors because all debtors are being reorganized under a joint plan of reorganization." *Id.* (citations omitted).

Second, the District Court also affirmed the Bankruptcy Court's decision to cancel the Lender's equity in OpCo Debtors. The Mezz Loan was secured solely by the equity of the OpCo Debtors and repayment of that loan was always dependent on the OpCo Debtors being profitable. The District Court reasoned that because the OpCo Debtors were insolvent, the Lender's equity in the OpCo Debtors was also valueless. *See id.*

As noted above, the District Court's decision has been appealed to the 9th Circuit Court of Appeals.

Conclusion

The application of the "per-plan" or "per-debtor" analysis to section 1129(a)(10) is of critical importance to any lender who intends to look only to their specific borrower for repayment of a loan. This is especially true in the real estate context where great care is taken to structure loans so that the borrower is isolated from its affiliates. As demonstrated from the fact pattern in *Transwest*, the section 1129(a)(10) analysis was the difference between the Lender preserving its collateral under the Mezz Loan and getting crammed down under 1129(b).

To put this point in concrete terms, the chart below shows the voting results of the classes in *Transwest* if the Bankruptcy Court adopted the "per-debtor" approach.

Debtor	Deemed Accepting Classes	Deemed Rejecting Classes	Impaired Accepting Classes	Impaired Rejecting Classes	Confirmable Plan?
TRPI	Class 9				Yes
Tucson II		***Class 10***		***Class 7***	***No***
Hilton Head II		***Class 10***		***Class 7***	***No***
Tucson OpCo		Class 10	Classes 2, 3, 4, 5 and 6	Class 1	Yes
Hilton Head OpCo		Class 10	Classes 2, 3, 4, 5 and 6	Class 1	Yes

Since classes 10 and 7 of the Mezz Debtors rejected the Plan, in order to have a confirmable plan and reach the cramdown requirements of 1129(b), under the "per-debtor" approach, there would need to be at least one other impaired accepting class of creditors for each of the Mezz Debtors.[6] Since there were no other classes of creditors who could vote in favor of the Plan, the Plan would have been unconfirmable with respect to the Mezz Debtors. Since the transfer of the Mezz Debtors' membership interests in the OpCo Debtors was the lynchpin to

[6] All of the unsecured trade claims and secured debt (including the Mortgage, but excluding the Mezz Loan) were at the OpCo Debtor level. The only creditors of the Mezz Debtors were the holders of the Mezz Loan.

SWVP's investment in the OpCo Debtors, the overall restructuring would have failed under the "per-debtor" approach.

As demonstrated by this analysis, whether the court applies the "per-plan" or "per-debtor" test to section 1129(a)(10) may determine whether a lender is able to preserve its investment if its borrower files for chapter 11 with affiliates, even if the debtors are not substantively consolidated.

For more information contact one of the lawyers below.

Geoffrey Raicht +1 212.659.4966 geoffrey.raicht@haynesboone.com	Lawrence Mittman +1 212.659.4977 lawrence.mittman@haynesboone.com