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February 13, 2018

9th Circuit Affirms "Per Plan" Approach to Interpret "Impaired Accepting Class" for Plan Confirmation Purposes Threatening Senior Mortgage Lender Protections in Common Real Estate Financing Structures: *In re Transwest Resort Properties, Inc.*

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Context

As described in our earlier **client alert, dated September 13, 2016**, under certain specific circumstances, section 1129 of title 11 of the United States Code (the "Bankruptcy Code") permits a bankruptcy court to confirm a Chapter 11 plan and rewrite the terms of a debt instrument (including mortgage debt or mezzanine debt), including the interest, amortization, and maturity. One of the principal statutory requirements to confirm such a plan requires the affirmative vote to the proposed plan by one class of creditors which is "impaired" by the plan -- without including an acceptance of the plan by any "insider." See 11 U.S.C. § 1129(a)(10). Confirmation of such a plan of reorganization is commonly referred to as a "cram down."

"Cram down" plans were all the rage during the real estate downturn of 1988 – 1993. Typically during that period, debtors in single asset real estate Chapter 11 cases attempted to effect "cram downs" of their senior mortgage debt and prevent foreclosures, by aligning themselves with the holders of junior mortgages, which themselves would otherwise be wiped out if the senior debt were not fully satisfied. In the absence of any junior mortgage creditor, debtors would attempt to create an accepting impaired non-insider creditor class, consisting of ordinary trade vendors, including utilities, service providers, or mechanic lienors, that happened to be unpaid when the chapter 11 case was filed. Indeed, clever borrowers contemplating a chapter 11 filing, would not pay trade creditors for several months before a chapter 11 filing to ensure having potential impaired creditors available to cast an affirmative vote in favor of the plan which would then be "crammed down" against their senior mortgage creditor. While these vendor creditors easily could have been paid from the property's cash-flow, instead, the debtors in chapter 11 would propose to pay only a fraction of the face of these claims under the plan in order to achieve the necessary statutory "impairment" of such claims.

When the dust settled at the conclusion of the downturn, those lenders interested in resuming to lend senior debt against real estate collateral, created new legal structures to avoid the potential of cram down, by, among other techniques, attempting to assure that their borrowers would have no other creditors that could potentially constitute an impaired creditor class should its borrower commence a chapter 11. To that end, in lieu of allowing a junior mortgage against their borrower's assets, senior lenders insisted that any subordinated debt be secured by the equity of non-consolidate-able affiliates. This construct morphed into mezzanine debt financing. In addition, senior lenders insisted upon carve-outs to the provisions of their otherwise non-recourse debt, by imposing liability on (hopefully) credit-worthy affiliates, should their borrower allow the creation of unpaid trade or other debt – all of which – could create the possibility of an impaired creditor class in any chapter 11 of their borrower. All of these protections were to achieve one goal: ***Should a borrower file chapter 11 case, prevent the creation of an impaired creditor class that could potentially cram down senior mortgage debt.***

A very recent decision of the United States Court of Appeals of the Ninth Circuit, which includes California and Arizona, undermines this legal structure and, once again, seriously exposes senior mortgage lenders to the threat of cram down plans. The 9th Circuit's decision relates to an interpretation of section 1129(a)(10)'s mandate that "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*** . . . ." 11 U.S.C. § 1129(a)(10) (emphasis added). The 9th Circuit affirmed the decision of the Arizona District Court's which held that, for purposes of plan confirmation, the affirmative vote of one impaired class under a joint plan of reorganization for multiple *nonsubstantively consolidated* debtors is sufficient to satisfy section 1129(a)(10) (generally known as the "Per Plan" approach). See *JPMCC 2007-C1 Grasslawn Lodging, LLC v. Transwest Resort Props., Inc.* (*In re Transwest Resort Properties, Inc.*), No. 16-16221, 2018 U.S. App. LEXIS 1947 (9th Cir. Jan. 25, 2018) (hereinafter "*JPMCC*"). In so ruling, the 9th Circuit rejected the reasoning of the Delaware Bankruptcy Court which held that section 1129(a)(10) is satisfied if there is an affirmative vote of an impaired class *from each debtor* under a joint plan of reorganization (generally known as the "Per Debtor" approach). See *In re Tribune Co.*, 464 B.R. 126 (Bankr. D. Del. 2011)). While the decision is troubling to those who structure real estate investments relying upon a borrower's corporate separateness from its affiliates and subsidiaries, the concurring opinion of Judge Friedland may prove to be impactful for parties seeking to preserve the separateness of entities involved in mezzanine financing and other special-purpose entity structures.

Background

Transwest was a classic real estate mezzanine financing structure. 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"). 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 "OpCo Debtors"), 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 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.

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. The Arizona District Court affirmed. See *In re Transwest Resort Props., Inc.*, 2016 WL 4087111 (D. Az. June 22, 2016).

The 9th Circuit Decision

In a fairly straight forward opinion, the 9th Circuit affirmed the Arizona District Court on two primary grounds: (1) the plain language of the statute supports the "Per Plan" approach; and (2) the Lender's argument that the jointly administered plan was, in effect, a substantive consolidation was waived because it was not raised in the Bankruptcy Court. The 9th Circuit further noted that "to the extent the Lender argues that the 'per plan' approach would result in a parade of horribles for mezzanine lenders, such hypothetical concerns are policy considerations left for Congress to resolve." *JPMCC* at 14 (citation omitted).

However, as noted above, Judge Friedland authored a concurring opinion which may have more impact on how similarly situated lenders may address jointly administered plans attempting to be confirmed under the "Per Plan" approach. Judge Friedland first "acknowledged the argument advanced by [the Lender] that it was unfairly deprived of the ability to object effectively to reorganization of the [Mezz] Debtors, despite being their only creditor." *JPMCC* at 15. However, Judge Friedland noted that the unfairness did not stem from the Bankruptcy Court's interpretation of 1129(a)(10), but was "from the fact that this particular reorganization treated the five Debtor entities as if they had been substantively consolidated – something the Lender did not object to in the [Bankruptcy Court]." *Id.* Indeed, Judge Friedland agreed that "the distribution scheme adopted by the Plan involved a degree of substantive consolidation. Debtors' respective bankruptcy estates may technically have remained separate, but the Plan treated Debtors as a single entity." *Id.* at 16.

Judge Friedland correctly observed that cases involving a reorganization that effectively merge the assets and liabilities of multiple debtors are achieved either through consensus or after a formal court review of the substantive consolidation factors: (a) whether creditors dealt with the entities as a single economic unit and did not rely on their separate identity in extending credit; or (b) whether the affairs of the debtors are so entangled that consolidation will benefit all creditors. See *Id*. at 16-17 (citing cases). In this case, the Lenders did not consent and there should have been an evaluation of whether substantive consolidation was appropriate and, thus, whether consolidation was fair to all creditors, including the Lender. See *id.* at 17. However, the Lender failed to raise the issue of substantive consolidation in the Bankruptcy Court and, thus, waived it. See *id.* at 19.

Finally, Judge Friedland noted, "if a creditor believes that a reorganization improperly intermingles different estates, the creditor can and should object that the plan – rather than the requirements of confirming the plan – results in de facto substantive consolidation. Such an approach would allow this issue to be assessed on a case by case basis, which would be appropriate given the fact-intensive nature of the substantive consolidation inquiry." *Id.* at 20. Had this been done in this case:

> the [Bankruptcy Court] might have concluded that creditors treated Debtors as separate entities, and further that the special-purpose entity structure prevented their assets from becoming

> entangled – thus rendering substantive consolidation unavailable . . . . If so, the court could have required altering the distribution scheme to maintain entity separateness, thus preserving Lender's leverage over the Plan.
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> If, however, the [Bankruptcy Court] had instead determined that this case was a candidate for substantive consolidation, then an appeal of that determination would have involved an evaluation of this particular Plan on its facts and resulting equities – rather than a challenge to the interpretation of a statue that governs all Chapter 11 reorganizations.

Id. at 19 (citations omitted).

Key Takeaway

JPMCC provides the first Circuit Court level support for the "per plan" approach and may be cause for concern for those who structure real estate investments relying upon a borrower's corporate separateness from its affiliates and subsidiaries. However, the thoughtful concurring opinion of Judge Friedland may provide a silver lining to mezzanine lenders, and a strategy for countering the effect of this opinion. Since the concurring opinion emphasized that substantive consolidation cannot be trumped by the adoption of the "per plan" approach under section 1129(a)(10), mezzanine lenders should seek (and preserve for appeal) a substantive consolidation determination when a joint plan is proposed for non-substantively consolidated debtors. Indeed, the concurring opinion appeared to suggest that in the context of special-purpose entity structures, so long as corporate separateness is in fact maintained, the lender alone should continue to be permitted to receive distributions under a plan from its borrower alone, and not share its collateral with creditors of non-substantively consolidated debtor affiliates. This is especially relevant in mezzanine financing and *JPMCC* is instructive to help preserve such a lenders bargained for rights.