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

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PRACTICES Commercial Real Estate Leasing, Distressed Real Estate, Real Estate, Restructuring

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 So, if a mortgage loan had been originally made in the sum of $10 million, but now the property was worth only $5 million, the bankruptcy court could approve a plan of reorganization that would give the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.

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