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Single Asset Real Estate Cramdown: Analyzing Impaired Accepting Class and Per-Plan vs. Per-Debtor Under Sec. 1129

Navigating Plan Confirmation Challenges for Real Estate Debtors and Senior Mortgage Lenders

WEDNESDAY, DECEMBER 21, 2016

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

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Single Asset Real Estate ("SARE") Overview

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December 21, 2016

SECTION I: SINGLE ASSET REAL ESTATE INTRODUCTION

Single Asset Real Estate Introduction

- If a debtor’s estate constitutes a single asset real estate (a “SARE”), the Bankruptcy Code contains certain restrictions designed to limit the length of the case and the economic imposition that may be placed on creditors whose claims are secured by the debtor’s real property.
- SARE debtors are required to propose a confirmable plan within a short time frame or commence making payments equal to the non-default contract rate of interest on the loan or be subject to foreclosure proceeding by their secured creditors after they obtain relief from the automatic stay.

SARE Definition

- The Bankruptcy Code defines "single asset real estate" to mean:

  [R]eal property constituting a single property or project, other than residential real property with fewer than 4 residential units, which generates substantially all of the gross income of a debtor who is not a family farmer and on which no substantial business is being conducted by a debtor other than the business of operating the real property and activities incidental. 11 U.S.C. § 101(51B).

SARE Definition (cont'd)

- To fall within the SARE definition, a chapter 11 debtor must satisfy three conditions:

1. Single Property or "Single Project"
2. Property/Single Project Generating Substantially All Revenue
3. No Business Other Than The Operation Of The Real Property And Activities Incidental Thereto

- Common Examples of a SARE:
  - Apartment building. *See Centofante v. CBJ Dev. Inc*. (In re CBJ Dev. Inc.), 202 B.R. 467 (B.A.P. 9th. Cir. 1996).
  - Developable tract(s) of real property. *Kara Homes, Inc. v. Nat'l City Bank (In re Kara Homes, Inc.)*, 363 B.R. 399 (Bankr. D.N.J. 2007); *In re Webb MTN, LLC*, 2008 WL 656271 (Bankr. E.D. Tenn., March 6, 2008)
  - Housing co-operative. *In re 83-84 116th Owners Corp.*, 214 B.R. 530 (Bankr. E.D.N.Y. 1997).

SARE Definition (cont'd)

1. Courts have rejected a "common entity" theory for a holding company with a number of SARE subsidiaries, at least in cases where debtors have not been substantively consolidated:

> the plain language of § 101(51B) gives no basis for a 'whole business enterprise' exception. Absent a substantive consolidation order, we must accept [the debtor's] chosen legal status as a separate and distinct entity ... and look only to its assets, income, and operations in determining whether [it] is a single asset real estate. *In re Merulelo Maddux Properties, Inc.*, 667 F.3d 1072, 1077 (9th Cir. 2012)

Substantive Consolidation

- Substantive consolidation: an equitable doctrine where the assets and liabilities of two separate companies are combined.
  - Substantive consolidation is an extraordinary remedy vitally affecting substantive rights because every entity is likely to have a different debt-to-asset ratio, thus consolidation almost invariably redistributes wealth among creditors of the various entities.
  - To date, there are no reported cases where debtors have attempted to use substantive consolidation to avoid the SARE designation

Substantive Consolidation (cont'd)

- When does a court order substantive consolidation?
  - Creditors dealt with the to-be-consolidated entities as a single unit and did not rely on their separate identities when extending credit; or
  - The affairs of the debtor are so entangled that consolidation will benefit all creditors because disentangling is either impossible or so costly as to consume the assets of the to-be-consolidated entities.
- If corporate formalities (e.g., separateness covenants) are not observed, an entity can be pulled into a bankruptcy case if it is consolidated with one of its bankrupt affiliates.

What is not a SARE

- Golf course and club. *In re Larry Goodwin Golf, Inc.*, 219 B.R. 391 (Bank. M.D.N.C. 1997); *In re Club Golf Partners, L.P.*, 2007 WL 1176010 (E.D. Tex., Jan. 23, 2007).
- Golf and ski resort. *In re Prairie Hills Golf & Ski Club*, 255 B.R. 228 (Bankr. D. Neb. 2000)
- Hotel. *Centofante v. CBJ Dev. Inc. (In re CBJ Dev. Inc.)*, 202 B.R. 467 (B.A.P. 9th. Cir. 1996); *In re Whispering Pines Estate, Inc.*, 341 B.R. 134 (Bankr. D.N.H. 2006); *but see In re 5877 Poplar, L.P.,* 268 B.R. 140, 144 (Bankr. W.D. Tenn. 2001) (hotel a single asset real estate).
- Marina. *In re Kkemko, Inc.*, 181 B.R. 47 (Bankr. S.D. Ohio 1995) (the debtor's business was more than just the rental of moorings; the sale of food and fuel, the availability of a pool and the maintenance of boats are not activities incidental to provision and rental of moorings).
- Timber company*. Ad Hoc Group of Timber Noteholders v. The Pacific Lumber Co. (In re Scotia Pacific Co., LLC)*, 508 F.3d 214 (5th Cir. 2007). And by analogy, mining, oil and gas drilling companies, and large commercial farms. *Id*. at 225.

What is not a SARE (cont'd)

- Courts that have determined a debtor was not a SARE are most often deciding whether the business of the debtor is one "other than the business of operating the real property and activities incidental." The definition excludes debtors who may own a real estate property or project but also have other income-generating operations.
- In 2007, the Firth Circuit – and only circuit court so far to have interpreted Section 101(51) – analyzed whether a timber company qualified as a SARE. *Scotia Pacific*, 508 F.3d 214. The Court's analysis focused on the whether the debtor had diverse business activities and whether it had passive or active revenue streams. The Court concluded that the debtor in Scotia Pacific "performed its business on the real estate for the purpose of selling timber – not the underlying real estate," and that the record supported business activities "much more diverse than the activities of golf clubs, marinas, and hotels" discussed in other non-SARE cases. *Id.* at 223.

SARE and the Automatic Stay

- Pursuant to Bankruptcy Code § 362(d)(3), a bankruptcy court shall grant relief from the automatic stay against a SARE and to a creditor whose claim is secured by an interest in such real estate, unless
  - A SARE debtor files a plan (that has a reasonable possibility of being confirmed within a reasonable time) within the later of (A) 90 days after the commencement of the bankruptcy case (or such date determined by the court for cause by an order entered during the first 90 days of the case); or (B) 30 days after the court determines the debtor is subject to the SARE requirements, whichever is later; or
  - the SARE debtor has commenced monthly payments that-- (i) may, in the debtor's sole discretion, notwithstanding section 363(c)(2), be made from rents or other income generated before, on, or after the date of the commencement of the case by or from the property to each creditor whose claim is secured by such real estate (other than a claim secured by a judgment lien or by an unmatured statutory lien); and (ii) are in an amount equal to interest at the then applicable nondefault contract rate of interest on the value of the creditor's interest in the real estate. 11 U.S.C. § 362(d)(3).

SARE and the Automatic Stay (cont'd)

- 11 U.S.C. § 362(d)(3) originally did not apply if debts exceeded $4 million but the 2005 amendments to the code removed the $4 million "cap"
- Section 362(d)(3) of the Bankruptcy Code effectively shortens the time periods set forth under section 1121 of the Bankruptcy Code if the debtor has not commenced monthly payments equal to the non-default rate of interest on the secured claim of the creditor seeking stay relief
- Requirements generally viewed as mandatory. *See In re LDN Corp.*, 191 B.R. 320, 326-27 (Bankr. E.D. VA. 1996). However courts may extend the 90 day period. *See In re Windwood Heights, Inc.* 385 B.R. 832, 841 (Bankr. N.D. W. Va. 2008) (finding debtor's plan to be "patently unconfirmable" but granting an additional 30 days to file a plan noting "substantial equity cushion").

Loans to SARE Entities: Multiple Lender Structures

- First/Second Lien Structures, or so-called "contractual subordination."
  - First and Second Lien Lenders share lien in common collateral, but Second Lien Lender agrees to subordination of lien, including standstill of enforcement remedies and "silent" rights regarding release of collateral, bankruptcy financings, and bankruptcy sales.
- Senior/Mezzanine Structures, or so-called "structural subordination."
  - Senior-Mortgage Lender makes a loan secured by the real property of the mortgage borrower.
  - Junior-Mezzanine Lender makes a loan to mezzanine borrower secured by a pledge of the membership interests in the mortgage borrower.
  - Senior/Mezzanine structure was thought to provide the Senior-Mortgage Lender additional protection against a "cramdown" in bankruptcy (see following slides)

SECTION II: OVERVIEW OF CRAMDOWN

Acceptance of a Plan of Reorganization

- Acceptance of a plan by an impaired class of claims requires acceptance by a class of creditors holding at least two-thirds in amount and more than half in number of the allowed claims actually being voted.
- In determining these percentages, only claims that actually vote are counted.
- If a class of claims is not impaired under a plan, there is a conclusive presumption that the plan has been accepted by the class and by the holder of each claim.
- A class that receives nothing under a plan is deemed to have rejected the plan.
- At least one class of non-insider, impaired claims must vote to accept the plan in order for a plan to be confirmed.
- If all classes of claims or interests vote to accept the plan, then the plan will be confirmed provided the requirements for confirmation set forth in Section 1129 are met.

Cramdown of the Non-Consensual Plan

- When a class of creditor's votes to reject the plan – Now what?
- Chapter 11 of the Bankruptcy Code provides a manner in which the rights of creditors may be readjusted even without the consent of all parties whose rights are modified by the plan of reorganization
- A plan may be confirmed even if an impaired class rejects the plan through a process called "cramdown" provided the plan does not unfairly discriminate and is fair and equitable with respect to each dissenting impaired class.

Plan of Reorganization: "Cramdown" Treatment

- Cramdown. Section 1129(b) of the Bankruptcy Code allows the confirmation of a plan over the "no" vote of a class of creditors, even if the creditor class is senior and secured (known colloquially as "cramdown").
- Cramdown is a powerful tool because it binds an entire class of creditors to a plan they have voted to reject.
- Two key components to confirm a "cramdown" plan:
  - The plan must not discriminate unfairly; and
  - The plan must be "fair and equitable."
- Cramdown requires the acceptance of an impaired consenting class of creditors.

Plan of Reorganization: Unfair Discrimination

- A Plan will be found not to discriminate unfairly if, among other things, a dissenting class receives relative value equal to the value distributed to all other similarly situated classes.
- For example, for cramdown purposes, a Plan may not segregate two similar claims or groups of claims into separate classes, and provide disparate treatment for those classes.
- It is not required that more than one impaired class accepts the plan.

Fair and Equitable

- The Bankruptcy Code has three different tests to determine whether a plan is fair and equitable demanding on wither the dissenting class is comprised of secured claims, unsecured claims or ownership interests.

Cramming Down the Unsecured Creditor

- A Plan will be found to be fair and equitable as to a particular dissenting class of unsecured creditors or equity interests if either:
  A. members of that class receive cash, property or securities equal to the full allowed amount of their claim or interest, or
  B. no junior class receives, or retains, any property of or interest in the debtor.
- This is known as the "absolute priority rule."

Cramming Down the Secured Creditor

- A Plan will be found to be fair and equitable as to a particular dissenting class of secured claims, if secured creditors:
  A. keep their liens on their collateral and receive deferred cash payments equal to the value as of the effective date of the plan of the value of their liens;
  B. if the property is sold, are given liens in the proceeds of their collateral and are treated as provided in clause (a) above or
  C. realize the indubitable equivalent of their claims.
- If the property is sold, secured creditors may credit bid the amount of their claims.

Plan of Reorganization: "Cramdown" Treatment (cont'd)

- For secured creditors, a plan is "fair and equitable" if it satisfies one of three criteria:
  - <u>Sale</u>. The collateral securing the debt is sold free and clear, and the liens attach to the sale proceeds.
  - <u>Return of the Collateral</u>. The secured creditor is provided with the "indubitable equivalent" of its claims.
  - <u>New Loan</u>. The secured creditor retains liens on the property and receives deferred payments: (1) totaling the amount of the allowed secured claim, and (2) equal to the value, as of the plan effective date, of the creditor's interest in the estate's interest in property.

Plan of Reorganization: "Cramdown" Treatment (cont'd)

- New Loan. This cramdown treatment presents the greatest risk that secured creditors will not receive a full recovery.
- Paid over time. As the new loan will be paid over time, a rate of interest on the loan must be determined to ensure the creditor receives present value of claim.
- Two Approaches:
  - Prime Plus/Formula Approach. Interest rate on the new loan set at the prime rate (as of the plan effective date) plus a nominal increase to account for credit risk of loan to reorganized debtor.
  - Market Approach. Where a market exists for the type of loan being offered to the secured creditor, the interest rate should be set at the market rate.

Cramming down – Ownership Interests

- With respect to a class of ownership interests, the fair and equitable standard is similar to that of unsecured creditors:
  A. the holder must receive the liquidation preference or fixed redemption price or value of the interest, or
  B. no holder of a junior interest may receive anything.

Plan of Reorganization: "Cramdown" Treatment (cont'd)

- Impaired Consenting Class: The "Per Debtor" vs. "Per Plan" Approach
  - "Per Debtor" approach for cramdown requires that section 1129(a)(10) of the Bankruptcy Code must be satisfied by each debtor to a joint plan. Thus, each debtor must have at least one impaired accepting class to confirm the plan.
  - "Per Plan" approach for cramdown requires that section 1129(a)(10) must be satisfied by a plan. Thus, a joint plan only needs a single impaired accepting class even though the debtors under a joint plan may not be substantively consolidated.
- Even though a mezzanine borrower is structured to have one creditor, the mezzanine lender, the "per plan" approach to cramdown can undermine the purpose of this structure commonly used in SARE cases. *See, e.g.*, *In re Transwest Partners* (D. Ariz. June 22, 2016).

Plan of Reorganization: The 1111(b) Election

- Under certain circumstances, an undersecured creditor can elect to have its claim treated as fully secured – the 1111(b) election.
- A secured creditor making an 1111(b) election is entitled to receive:
  - payments over the life of the plan aggregating the secured claim, but
  - payments over time equal the present value of the secured claim.
- Strategic considerations for making the 1111(b) election:
  - Secured creditor may benefit from a fully secured claim if the collateral appreciates in value (e.g., in the event of a sale or refinance).
  - Secured creditor may benefit from having an unsecured deficiency claim that controls the vote of the class of unsecured claims.

SECTION III: IMPAIRED ACCEPTING CLASS

Impairment

- A class of claims is impaired under a plan if:
  A. The legal, equitable or contractual rights to which the claimholder is entitled are altered; or
  B. The claim is not paid in full on the effective date of the plan.

Classification of Claims

- The economic protection that the holder of a given claim must receive under the plan in order for it to be confirmed depends on whether the class has accepted the plan.
- If a class has not accepted the plan, each claim is entitled to the additional protection afforded to dissenting classes under the cramdown provisions.
- Section 1122 provides that a claim may be placed in a particular class only if it is substantially similar to the other claims in the class.
- Generally, similarly situated claims must be classified together and treated similarly, and any discrimination among them needs to be reasonable, necessary for the plan's consummation, proposed in good faith, and limited to the amount supported by the rationale for such discrimination.
- The Bankruptcy Code contemplates that there may be different "kinds' of unsecured claims, that the interests and the viewpoint of the holders of certain kinds of unsecured claims might differ from other unsecured claimholders.
- The Bankruptcy Code also provides that when the claim of a secured creditor exceeds the value of its collateral, the creditor has two claims – a secured claim and an unsecured claim – that should be classified separately.

Artificial Classification

Thou shall not classify similar claims differently in order to gerrymander an affirmative vote on a reorganization plan. *Matter of Greystone III Joint Venture*, 995 F.2d 1274, 1279 (5th Cir. 1991)

- Artificial classification can occur in single asset real estate cases where the secured creditor of the real estate is undersecured
- The lender generally has a secured claim up to the value of the collateral and an unsecured claim for the remaining amount owed
- This can doom the debtor's plan to failure if the secured lender is impaired and rejects the plan as the secured lender's claim by block acceptance of all unsecured claims if it represents more than 2/3 of the amount of unsecured claims
- However, the Bankruptcy Code does not bar placing substantially similar claims in different classes

Legitimate Business Reason for Separate Classification

- Improper artificial classification where the debtor offers no legitimate business reason for its separate classification
- However, it may be acceptable to separately classify trade creditors from an undersecured creditor and treat them more generously if doing so is necessary to the debtor's ongoing business.
- 2nd, 3rd, 4th, 5th, 8th and 9th Circuits require the debtor show a reason for separate classification
- 1st Circuit requires all legally similar claims to be placed in a class together regardless of business or economic issues

Impaired Consenting Class – Classification Issues

- Classification competing views:

1. Required to place secured lender's unsecured deficiency claim in the same class as other unsecured creditors. *See In re 18 RVC, LLC*, 485 B.R. 492 (Bankr. E.D.N.Y. 2012) ("the existence of a personal guarantee, without more, is not a legitimate reason for separately classifying the unsecured deficiency claim of a secured lender")
2. Can separately classify unsecured deficiency claim from other unsecured creditors. *See In re Loop 76, LLC*, 465 B.R. 525, 541 (B.A.P. 9th Cir. 2012) (personal guarantee allows unsecured deficiency claim to be classified separately).

    - In SARE case a large unsecured deficiency claim can often prevent an impaired consenting class if required to be classified with other unsecured creditors

Impaired Consenting Class – Artificial Impairment

- Fifth and Ninth Circuits permit a debtor to artificially impair a class to create a consenting class. Both assess whether artificial impairment is permissible under good faith requirement of 1129(a)(3). *In re Village at Camp Bowie I, L.P.*, 710 F.3d 239 (5th Cir. 2013); *Matter of L&J Anaheim Associates*, 995 F.2d 940 (9th Cir. 1993)
- Eighth Circuit does not allow artificial impairment to create an impaired consenting class. *See Matter of Windsor on the River Associates, Ltd.*, 7 F.3d 127, 132-33 (8th Cir. 1993)

Perspectives for Secured Mortgage Lenders

- Future SARE debtors may avoid filing in Delaware to avoid per plan approach
- Secured Lender should confirm whether debtor has designated itself as a SARE case and immediately file a motion to do so if not
- Recent cases may remove some of secured lender's leverage over confirmation process
    - Danger of combination of Per Plan approach, separate classification of unsecured deficiency claim and artificial impairment of unsecured class
    - Lenders have additional incentive to make the 1111(b) election if deficiency claim may be classified separately

Selling an Insider Claim and Buying Plan Confirmation

- *In re Village at Lakeridge, LLC*, 814 F.3d 993 (9th Cir. 2016), 9th Cir. Held that the post-filing assignment of an insider's claim to a non-insider, such that the non-insider is permitted to vote for the plan was acceptable.

Facts of Lakeridge Case

- Single Asset Real Estate debtor with just 2 creditors
- Undersecured secured lender owed $10 million
- Debtor's unsecured manager MBP owed $2,761,00
- MBP was also Debtor's sole member, thus an insider pursuant to Section 101(31)
- Days before hearing on disclosure statement and deadline for making the 1111(b) election, debtor disclosed that MBP transferred its claim to Rabkin for $5,000
- MBP claimed economic benefit in selling claim since it could not vote and the claim was worthless if it could not confirm a plan
- Rabkin has a business and romantic relationship with Ms. Bartlett, 1 of 5 MBP members
- Rabkin and Bartlett did not live together, pay each other's bills and did not give expensive gifts to each other
- MBP did not solicit other buyers
- MBP and Rabkin did not negotiate the purchase price
- Rabkin made no investigation into the value of the claim or the bankruptcy
- Rabkin, a retired surgeon, viewed the purchase as a small investment
- Projected return under the plan was $30,000
- Rabkin rejected higher offer of $60,000 during deposition by lender
- Court criticized lender's pressure tactics
- Bartlett never asked Rabkin to vote for the debtor's plan
- Bartlett informally agreed to increase Rabkin's payment after he complained

Secured Lender Moved to Designate Rabkin's Vote

- Rabkin is a statutory insider by receipt of an insider's claim
- Rabkin is a non-statutory insider based on his relationship with Bartlett
- Claim was transferred to Rabkin in bad faith (Section 1125(e)

Court's Ruling on Lender's Motion

Bankruptcy Court:

- Facts did not support a finding that Rabkin was a non-statutory insider or that the claim was transferred in bad faith; he bought it as an investment
- But, assignment from an insider conferred insider status on Rabkin

Bankruptcy Appellate Panel:

- Reversed: assignment from an insider does not automatically make assignee an insider, still subject to a factual analysis
- Affirmed the bankruptcy court on the finding that Rabkin was not a non-statutory insider and that the claim was not transferred in bad faith

Ninth Circuit – Affirmed:

- Insider applies to the claimant; not the claim
- Holding otherwise would prevent a third-party, arms-length assignee from voting a claim acquired from an insider

Perspectives From the Debtor

In *Lakeridge*, the Ninth Circuit decision is largely an affirmation of the factual findings of the bankruptcy court.

Debtors should be careful to comply with the other safeguards/requirements in the bankruptcy code like:

- Demonstrate that the plan is proposed in good faith
- Plan is fair and equitable with respect to each claim that is impaired
- Ensure that the assignee of the claim will not qualify as a non-statutory insider
- Ensure that the assignment was sold as a result of arm's length negotiations
- What if the secured creditor's purchase offer was not made at the deposition
- A close relationship between the debtor and the assignee of the claim is not sufficient to establish insider status

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Mr. Newman has been named as one of California's leading lawyers in business and restructuring by *Chambers USA – America's Leading Business Lawyers* and recognized by his peers as one of *The Best Lawyers in America®* in the area of Bankruptcy and Creditor-Debtor Rights Law. Mr. Newman has also been named as a Southern California Super Lawyer in the area of Bankruptcy & Creditor/Debtor Rights.

Mr. Newman's speaking engagements include *Debtor In Possession Financings: Current Developments*, Los Angeles County Bar Association, *When Lenders Fail: The Ultimate Indignity*, The Financial Lawyers Conference; *The Subprime Meltdown From an Insolvency Litigation Perspective*, 11th Annual Southwest Bankruptcy Conference of the American Bankruptcy Institute; *The Subprime Lending Industry: A Look at the Restructuring of a Market in Turmoil*, the American Bar Association Annual Meeting, Section of Business Law; *When Good Loans Go Bad: An In-Depth Discussion of the Subprime Lending Industry*, Turnaround Management Association.

Mr. Newman is admitted to practice law in California. He earned his law degree *magna cum laude* from Georgetown University Law Center where he was elected to the Order of the Coif. He received a Bachelor of Science degree in Foreign Service from Georgetown University's School of Foreign Service in 1992. Prior to joining Gibson, Dunn & Crutcher LLP, Mr. Newman held political and fundraising positions with the Democratic National Committee (DNC) in Washington, DC and served in legislative and policy positions for Senator John Glenn (OH) and Representatives Gary Ackerman (NY) and Rob Andrews (NJ). He lives in Manhattan Beach, California with his wife, Katja, and their children Jakob and Max.

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Eric has advised clients on, and litigated at the trial and appellate levels, the significant legal issues that arise in today's business climate, ranging from the need to delever a client's balance sheet to defending "bet the company" litigation.

APPELLATE DECISIONS

In re Scotia Pacific Co., LLC, 508 F.3d 214 (5th Cir. 2007) (holding, among other things, debtor conducted "substantial business" other than operation of the real estate and thus did not qualify as a SARE debtor).