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New Challenges For Real Estate Restructurings

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Law360, New York (September 11, 2012, 12:19 PM ET) -- Judges Kevin Carey and Mary Walrath of the United States Bankruptcy Court for the District of Delaware issued opinions in In re Tribune Co.[1] and In re JER/Jameson Mezz Borrower II LLC,[2] respectively, that shake up the landscape for restructuring real estate investments with multiple layers of debt.

The crux of the issue that was addressed in Tribune — and later affirmed in JER — was whether, absent substantive consolidation,[3] a plan of reorganization for jointly administered debtors must have an impaired consenting class of creditors for each debtor, or whether a single impaired consenting class under a joint plan satisfies section 1129(a)(10)[4] of Chapter 11 of Title 11 of the United States Code, 11 U.S.C. § 101 et seq. (the “Bankruptcy Code”). In other words, whether the voting requirements under section 1129 of the Bankruptcy Code should be treated on a “per plan” or “per debtor” basis, an issue on which little decisional authority exists.

Tribune, as later supported by JER, held that the strictures of section 1129(a)(10) of the Bankruptcy Code require that joint plans in multidebtor cases (absent substantive consolidation) must be accepted by an impaired consenting class on a per debtor basis and not on a per plan basis. That is, each jointly administered debtor entity must have their own impaired consenting class of creditors to satisfy section 1129(a)(10) of the Bankruptcy Code.

Tribune’s holding raises several challenges for complex reorganizations with multiple layers of debt — particularly in the real estate context[5] — where corporate structures are designed to have multiple, bankruptcy-remote[6] entities holding multiple tranches of debt, with a single creditor per debtor, thereby making it extremely difficult, if not impossible (under the Tribune “per debtor” standard), to cram down a plan of reorganization on that lone creditor class.

This article provides a brief discussion of the Tribune and JER opinions; and the potential implications of these opinions on real estate restructurings including the availability of "cramdown"[7] under section 1129(b) of the Bankruptcy Code.

Tribune

In Tribune, Judge Carey issued a 126-page opinion denying confirmation of two competing plans of reorganization because, among other things, the plans did not satisfy section 1129(a)(10) of the Bankruptcy Code. Under one of the plans, only two of 111 debtors had an impaired consenting class and under an alternative plan, only 72 of 111 debtors had an impaired consenting class.

Judge Carey's ruling, relying largely on statutory interpretation, highlights that section 1129(a)(10), in the absence of substantive consolidation, must be satisfied on a per debtor basis and not on a per plan basis. The practical outcome of this conclusion is that section 1129(a)(10) required each of the 111 debtors to have an impaired consenting class and that, absent substantive consolidation, having only one impaired class from any (rather than each) debtor under a jointly administered plan will not satisfy section 1129(a)(10) of the Bankruptcy Code.

JER

JER is a case with different facts than Tribune but nonetheless affirms Tribune's section 1129, per-debtor analysis. JER/Jameson Mezz Borrower II LLC ("Mezz 2") filed for Chapter 11 protection on the eve of its sole creditor's ("Colony") planned UCC auction of its sole asset, the membership interest in its subsidiary, who itself was the borrower under a structurally senior mezzanine loan.

Colony sought to, among other things, dismiss Mezz II's bankruptcy case for bad faith as a litigation tactic to forestall the auction, and claimed that Mezz II had no rehabilitation prospects as a going concern because the entity had no active operations or direct employees.

Relying on Tribune, Judge Walrath dismissed the case and agreed that there was no realistic chance of reorganization because, among other things, no plan could be confirmed absent Colony's consent.[8] Absent substantive consolidation with its other debtor affiliates, Mezz II would need at least one impaired consenting class to confirm a plan, however, because Colony was the sole creditor entitled to vote on the plan, no such other impaired consenting creditor existed.[9]

Real Estate Restructuring Implications

Although at this juncture it is unclear whether other jurisdictions will adopt the "per debtor" analysis utilized in Tribune and JER, these decisions raise many issues for real estate companies evaluating restructuring considerations.[10]

Notably, real estate companies are often structured with the use of many bankruptcy-remote (special purpose) entities that have no active operations or employees and a sole asset securing indebtedness from a single creditor. Under Tribune and JER, entities in such structures would not be able to satisfy the cramdown requirements of the Bankruptcy Code absent substantive consolidation.

Furthermore, emboldened by the precedent set by Tribune and JER, creditors may object more often to debtor plans that incorporate a "per plan" impaired consenting class scheme. These constraints may cause real estate companies to reevaluate which debtors they place into bankruptcy or alternatively, seek substantive consolidation.

In addition, joint plans of reorganization are traditionally utilized for the convenience of the parties and the court. As the Tribune court notes, however, while joint plans may propose a single distribution

scheme, in which sources of plan funding and distribution are designed without regard to where assets are found or where liabilities lie, typically, those distribution schemes are reached after consensus is reached between the various stakeholders (or the lack of an objection).

But, as Tribune and JER highlight, convenience alone is not sufficient reason to disturb the rights of impaired classes of creditors of a debtor not meeting the confirmation standards of section 1129 of the Bankruptcy Code. In other words, in real estate restructurings with multiple layers of debt, parties may need to focus on consensus far earlier and far more aggressively than before Tribune and JER.

Ultimately, Tribune and JER raise interesting and novel issues for companies with complex capital structures where, absent substantive consolidation, corporate separateness will be enforced throughout the bankruptcy case. In such cases, plan proponents will need to develop a new methodology for obtaining the requisite impaired consenting class vote on a “per debtor” basis.

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[1] In re Tribune Co., 464 B.R. 126 (Bankr. D. Del. 2011); subsequent confirmation-related opinions have been issued but do not bear on the topics covered in this article.

[2] In re JER/Jameson Mezz Borrower II LLC, 461 B.R. 293 (Bankr. D. Del. 2011).

[3] Substantive consolidation enables bankruptcy courts to disregard the legally separate status of multiple debtors, pooling their assets and administering them as though held by a single entity. 2 Collier on Bankruptcy ¶ 105.09[1][a]–[b] (15th ed. 2005), citing In re Continental Vending Machine Corp., 517 F.2d 997 (2d Cir. 1975), cert. denied sub nom. James Talcott Inc. v. Wharton, 424 U.S. 913 (1976). An order approving substantive consolidation usually creates a common fund of assets to satisfy the liabilities of separate debtor entities, cancels claims between affiliates, and allows creditors of different companies to vote together on reorganization plans. See, e.g., In re Augie/Restivo Baking Co., Ltd., 860 F.2d 515, 518 (2d Cir. 1988). The bankruptcy court in the Western District of Texas provides a good overview of the two primary substantive consolidation tests relied on in various jurisdictions. See In re Introgen Therapeutics, Inc., No. 08-012442, 2010 Bankr. LEXIS 1431 (Bankr. W.D. Tex. April 29, 2010). Under the “traditional test,” when distilled down, courts essentially consider: (i) whether creditors dealt with the entities as a single economic unit and did not rely on their separate identity in extending credit; and (ii) whether the affairs of the debtors are so entangled that consolidation will benefit all creditors. Id. at 28 (quoting In re Augie/Restivo Baking Co., 860 F.2d 515, 519 (2d. Cir. 1988). Under the “balancing

test," if a party proposing consolidation shows that it is necessary to avoid some harm or realize some benefit, a presumption in favor of consolidation arises. The presumption is rebuttable by an objecting creditor which shows that it relied on the separateness of the debtors in extending credit and would suffer harm in consolidation. Id.; see also Charles Jordan Tabb, The Law of Bankruptcy §2.23 (2d Ed. 2009). If a creditor makes this showing, the court will determine whether to substantively consolidate by weighing the costs of consolidation against its benefits.

[4] Section 1129(a)(10) provides that if a class of claims is impaired under a plan of reorganization then there must be a separate consenting impaired class of claims (not including votes of insiders) in order to confirm such plan.

[5] See generally, Andrew R. Berman, "Once a Mortgage, Always a Mortgage" — The Use (and Misuse) of Mezzanine Loans and Preferred Equity Investments, 11 Stan. J.L. Bus. & Fin. 76 (2005).

[6] A bankruptcy-remote special purpose entity is structured "to protect the interests of secured creditors by ensuring that the operations of the borrower are isolated from business affairs of the borrower's affiliates and parent so that the financing of each loan stands alone on its own merits, creditworthiness and value." See In re Gen. Growth Props. Inc., 409 B.R. 43, 49 (Bankr. S.D.N.Y. 2009); see also Committee on Bankruptcy and Corporate Reorganization of The Association of the Bar of the City of New York, Structured Financing Techniques, 50 Bus. Law. 527 (1995) ("In its broadest sense, the requisite legal separation [of a bankruptcy-remote entity] is achieved by two structuring techniques: First, the assets that are to be the basis of the structured financing ... are transferred out of the entity receiving the benefits of the financing and into a special purpose vehicle. This transfer is structured so that it is 'absolute' in the sense that the original owner retains no legal or equitable interest in the assets following the transfer. The objective is to remove the assets from the bankruptcy estate of the transferor and isolate them in a special purpose vehicle. Second, the special purpose vehicle, its activities and its relationship with the transferor are structured so that the special purpose vehicle is unlikely to become the subject of a bankruptcy case and also so that its assets are unlikely to be considered part of the assets of the transferor in the event of the transferor's bankruptcy.").

[7] Section 1126(a) of the Bankruptcy Code provides that each holder of an allowed claim or interest has the right to vote to accept or reject a plan. 11 U.S.C. § 1126(a). In order to confirm such plan, section 1129(a)(8) of the Bankruptcy Code requires that each class of claims or interests must either vote to accept a plan or be unimpaired under a plan. 11 U.S.C. § 1129(a)(8). When any class of impaired claims does not vote to accept a plan, section 1129(a)(10) of the Bankruptcy Code provides an alternative: acceptance of the plan by at least one impaired class of claims, excluding insiders. 11 U.S.C. § 1129(a)(10). If a proposed plan of reorganization satisfies all the provisions of section 1129(a), including section 1129(a)(8), then it shall be confirmed. 11 U.S.C. § 1129(a). If a proposed plan satisfies all provisions of section 1129(a) except section 1129(a)(8), then it must also meet the requirements set forth in section 1129(b) to be confirmed. 11 U.S.C. § 1129(b). Under section 1129(b) a bankruptcy court may confirm a plan of reorganization, "if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan." Id. It is through a section 1129(b) "cramdown" that a plan of reorganization may be approved over the rejection of certain impaired classes of claims. Notably, "cramdown" or at least the threat of "cramdown" is a tactic often employed in real estate reorganizations.

[8] See JER at 19.

[9] Id.

[10] See, e.g., In re Transwest Resort Properties Inc., et al., Order Confirming Debtor's Third Amended Joint Plan of Reorganization, Case No. 10-37134 (EWH) (Bankr. D. AZ. December 29, 2011) [Docket No.

752] (rejecting the Tribune analysis and confirming a plan of reorganization that satisfied section 1129(a)(10) on a per plan basis); see also In re Charter Communs., 419 B.R. 221, 266 (Bankr. S.D.N.Y. 2009) (ruling that if a joint plan is filed for multiple debtors, “it is appropriate to test compliance with section 1129(a)(10) [,i.e. whether there is an impaired accepting class,] on a per-plan basis, not … on a per-debtor basis”).

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