Recent Developments in Bankruptcy Law Leave Many Commercial Real Estate Finance Issues Unresolved

Introduction

The financial crisis of the last decade set bankruptcy law and real estate finance on a collision course. Since then, the volume of real estate restructurings has risen significantly, including the high-profile chapter 11 cases *In re General Growth Properties, Inc.*; *In re Extended Stay Inc.*; *In re Innkeepers USA Trust*; and *In re MSR Resort Golf Course LLC*. Not surprisingly, the case law arising in complex real estate restructurings has developed rapidly, and many recent cases have provided guidance on important issues in real estate restructuring transactions, including equity interest foreclosures, bad-boy guaranties, bad-faith filings, the impaired consenting class requirement and cram-down interest rates. Nevertheless, there are many questions that remain unanswered as courts continue to grapple with adapting restructuring law historically developed in the context of smaller real estate cases to complex real estate structures.

Foreclosures and Equity Pledges

Lenders' rights and obligations in a typical real estate mezzanine lending stack have been the subject of several recent decisions. Typically, a mezzanine lender has several options post default: obtaining control of voting rights; a UCC foreclosure through either a private sale, public sale or strict foreclosure; or judicial foreclosure. Intercreditor agreements may impose substantive and procedural restrictions on these foreclosure rights. For example, a foreclosing lender may have to provide notice and an opportunity to cure to all junior lenders.

Recent decisions have held that an intercreditor agreement may also require a foreclosing junior lender to cure all defaults under all senior loans as a precondition to foreclosure.[1] The *Stuyvesant Town* opinion surprised many in the real estate industry who do not believe that curing defaults is a precondition to foreclosure. But, at least two other courts have directly or indirectly adopted the reasoning of *Stuyvesant Town*.[2]

Some would argue *Stuyvesant Town* appears to be established precedent, but it is likely the scope of the obligation to cure will continue to be tested. Taken to its logical conclusion, *Stuyvesant Town* and its progeny could be read to hold that all obligations of junior lenders under an intercreditor agreement are preconditions to foreclosure — including the issuance of replacement guaranties. This will likely have significant implications for real estate lending practices not only at the default stage, but also at the loan origination stage.

Bad-Boy Guaranties

There have been several significant developments with respect to parties' rights under so called "bad-boy" guaranties. Generally, bad-boy guaranties give recourse to an otherwise nonrecourse guarantor only upon occurrence of certain events that lenders hope to deter, such as bankruptcy, intentional misrepresentations, waste, improper financial reporting, wrongful transfer of collateral or misappropriation of rents, security deposits, reserve accounts or insurance proceeds. Recourse carveouts generally are either events for which the guarantor may be liable for losses sustained by the lender or full-recourse events that cause the entire loan to be recourse to the guarantor in the first instance before and regardless of the quantification of actual losses sustained by the lender.

The filing of a bankruptcy petition is a common full-recourse event. Although the U.S. Bankruptcy Code "evinces a strong predilection against the enforcement of ipso facto contract clauses which place the debtor in default due to its bankruptcy filing,"[3] recent decisions show that courts are willing to enforce such provisions with respect to *nondebtor guarantors* even where the actions of the nondebtor guarantor did not implicate the policy against "bad-boy" acts. For example, the Supreme Court of New York County, New York, held that nonrecourse carveout guaranties predicated on bankruptcy filings are enforceable even though the fiduciary duties of the directors and officers of the borrower arguably required a bankruptcy filing.[4] The court held that "there is no public policy that would authorize [guarantors] to walk away from their contractual obligations."[5]

A pair of recent cases from Michigan courts may further alter the conventional wisdom by holding that a borrower's insolvency alone can also trigger a full recourse carveout.[6] The courts in these cases determined that the plain language of the bad-boy guaranties required that the borrower remain a special purpose entity, which included by definition remaining solvent and paying debts (including mortgage debt) as they come due. This requirement — which may be found in many bad-boy guaranties — can be triggered through no fault of the guarantor, but rather as a result of real estate market fluctuations.

If these cases withstand scrutiny, they will likely affect the typical dynamic between borrowers and lenders in reaching consensual loan modifications. The trigger language involving solvency that the *Cherryland* and *Chesterfield* courts considered is common among nonrecourse carveout guaranties, and, although these opinions applied Michigan law, courts in other jurisdictions will have to consider at the very least whether the language creates a continuing solvency obligation. Notwithstanding the strong arguments against these holdings, borrowers and sponsors should be aware of the risk that courts in other jurisdictions could adopt these holdings. The practical effect of reading a solvency obligation into nonrecourse carveout guaranties could be to render the guaranties fully recourse in every instance of default. Borrowers and sponsors may also seek to diffuse these holdings at the drafting stage by explicitly removing the continuing solvency obligation and seeking to restore the commonly understood nonrecourse nature of bad-boy guaranties.

Bad Faith Filing Issues

Although the question regarding the eligibility of real estate investment structures for chapter 11 appeared to have been answered in the affirmative after the spate of complex real estate filings, recent judicial decisions suggest that the issue may not be closed. The divide is based on the typical modern structure of real estate financings in which borrowers are most commonly special purpose entities ("SPEs") designed specifically to be "bankruptcy remote." Accordingly, courts must often closely consider the issue of whether a chapter 11 filing is appropriate for these entities.[7]

The U.S. Bankruptcy Court for the Southern District of New York's decision in the chapter 11 cases of General Growth Properties — one of the nation's largest real estate investment trusts — was one of the first attempts to reconcile fundamental tenets of bankruptcy law and modern real estate finance.[8] In *GGP*, Judge Gropper held that the SPE filings were appropriate and that the Bankruptcy Code did not require a debtor to prove that it is able to confirm a plan of reorganization to commence a chapter 11 case.[9] *GGP* has ensured that SPEs have a place in chapter 11.[10]

Recently, a bankruptcy court in the District of Delaware confronted certain similar issues.[11] In *Jameson*, the court held, in contrast to *GGP*, that an inability to confirm a plan of reorganization could serve as a basis for dismissing a chapter 11 case even where the debtor had not yet had an opportunity to file a plan. Jameson had a largely divergent set of facts to *GGP*— the *GGP* debtors were a complex enterprise, which had more than 750 subsidiaries and a number of levels of interrelated debt. In contrast, the *Jameson* debtors had no meaningful intercompany claims and consisted of six entities.[12] Although the *Jameson* court stated that it should view the debtors as an enterprise, it ultimately isolated its holding to the facts surrounding a single mezzanine debtor.[13] The court also did not find the role of the independent directors in approving the bankruptcy filing relevant, focusing instead on the actions of the nonindependent director. On perhaps a similar note, the U.S. Court of Appeals for the Ninth Circuit recently held in *In re Meruelo Maddux Properties, Inc.*,[14] that the bankruptcy cases of the individual subsidiaries of a real estate holding company were each subject to the single asset real estate provisions of sections 101(51B) and 363(d)(3) of the Bankruptcy Code.

Impaired Consenting Class Issues

A common difficulty and another area of legal development in all complex bankruptcies is the requirement of an impaired consenting class.[15] Where substantive consolidation of debtors is unavailable or undesirable, many debtors have used a "joint plan" as an alternative approach to satisfy the impaired consenting class requirement. Debtors in these cases argue that the impaired consenting class is a per plan requirement rather than a per-debtor requirement and, therefore, an impaired consenting class of creditors at one debtor would satisfy the impaired consenting class requirement for all debtors covered by a particular joint plan. The U.S. Bankruptcy Court for the Southern District of New York first adopted the "joint plan" construct in *In re Enron Corp.*, holding that it was common and permissible to file a joint plan "in which a 'deemed consolidation' is proposed and approved."[16] Subsequently, in *In re Charter Communications*, the court reiterated that the impaired consenting class requirement is a per-plan requirement.[17]

The viability of the joint plan construct, however, became unsettled in the eyes of some following the U.S. Bankruptcy Court for the District of Delaware's decisions in *In re Tribune Co.*[18] and *Jameson*,[19] which adopted *Tribune* without further analysis. In these cases, two bankruptcy judges in the District of Delaware held that the impaired consenting class requirement is a per debtor requirement. But, at least one court has expressly rejected the *Tribune* decision.[20] The *Transwest* ruling is currently pending appeal before the U.S. Bankruptcy Court for the District of Arizona.

Cram-Down Interest Rates

In cases involving cram down of secured claims, common in the chapter 11 real estate context, the appropriate interest rate is typically a hotly contested issue and has continued to evolve. The seminal decision on cram-down interest rates is the U.S. Supreme Court's decision in *Till v. SCS Credit Corp*.[21] The majority of subsequent courts have interpreted *Till* to require a two-step approach in the chapter 11 context of, first, adopting the prevailing market interest rate if an efficient market for the loan exists, or, second, applying a "formula approach" combining a base rate (usually the prime rate) with a risk premium to account for "such factors as the circumstances of the estate, the nature of the security, and the duration and feasibility of the reorganization plan."[22]

A recent case in the U.S. Bankruptcy Court for the Northern District of Texas provided an example of how bankruptcy courts will calculate a cram-down interest rate in the real estate context.[23] In *Camp Bowie*, after accepting that there was no efficient market for the loans, the court adopted a formula approach, under which the debtor's expert separated the debt into three tranches of differing levels of risk and computed a blended investment rate, using a five-year treasury bond rate as a base rate. Ultimately, the court held that it would be "prepared" to approve a cram down interest rate in a range between what the debtors and lender had originally sought.[24]

Recent developments demonstrate that cram down continues to be a viable chapter 11 tool for real estate borrowers to reduce high interest rate mortgage and mezzanine debt. *Camp Bowie* offers a potential roadmap for the application of *Till*: the formula rate does not necessarily need to be based on the prime rate and debtors have some flexibility in choosing the appropriate risk-weighting approach.

Conclusion

The case law governing the intersection between bankruptcy law and real estate finance is rapidly developing. Courts are grappling with the treatment of rigid organizational structures and documents, uncertain markets and conflicting tenets of legal policy. These developments also demonstrate how relatively minor variations to the forms of documents can have significant legal implications. As a result, it is important for practitioners to both understand the current state of the law and utilize the latest approaches to documentation in this sea of uncertainty.

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1 *See, e.g., Bank of Am., N.A. v. PSW NYC LLC*, No. 651293/10, slip op. at 1 (N.Y. Sup. Ct. Sept. 16, 2010) ("*Stuyvesant Town*") (holding that junior lender must cure defaults under mortgage loan, which had already been accelerated, as a precondition to foreclosure).

2 *U.S. Bank Nat'l Assoc. v. RFC CDO 2006-1, Ltd.*, No. 11 664 (D. Ariz. Dec. 6, 2011) (citing *Stuyvesant Town* and holding that the provisions in an intercreditor agreement must be satisfied before a sale); *U.S. Bank v. Petra CRE DCO 2007-1 Ltd.*, No. 650077/12 (N.Y. Sup. Ct. Jan. 10, 2012) (citing and arguing *Stuyvesant*

Town in plaintiff's brief before ultimately settling on same outcome).

3 *In re Island Helicopter Corp.*, 63 B.R. 809, 818 (Bankr. E.D.N.Y. 1986).

4 *See UBS Commercial Mortgage v. Garrison Special Opportunities Fund L.P.*, No. 652412/10, slip op. at 1 (N.Y. Sup. Ct. Mar. 8, 2011); *Bank of Am., N.A. v. Lightstone Holdings, LLC*, No. 601853/09, slip op. at 1 (N.Y. Sup. Ct. July 14, 2011).

5 *Lightstone*, slip op. at 5.

6 *See Wells Fargo Bank, N.A. v. Cherryland Mall Ltd. P'ship*, 2011 WL 6785393, at *3 (Mich. Ct. App. Dec. 27, 2011); *51382 Gratiot Ave. Holdings, LLC v. Chesterfield Dev. Co., LLC*, No. 11 12047, 2011 WL 6153023, at *4 (E.D. Mich. Dec. 12, 2011).

7 As a general matter, a chapter 11 case may be dismissed for "cause," 11 U.S.C. § 1112(b), or if commenced in the absence of good faith. The standard for a lack of good faith varies among the circuits.

8 *See In re Gen. Growth Props., Inc.*, 409 B.R. 43, 56 (Bankr. S.D.N.Y. 2009) ("*GGP*").

9 *Id.* at 65.

10 *But cf. In re DB Capital Holdings, LLC*, No. 10–23242, 2010 WL 4925811 (10th Cir. B.A.P. Dec. 6, 2010) (holding that a limited liability company's operating agreement may limit its ability to file for bankruptcy).

11 *In re JER/Jameson Mezz Borrower II, LLC*, 461 B.R. 293, 298 (Bankr. D. Del. 2011).

12 *Jameson*, 461 B.R. at 301.

13 *Id.* at 301-303.

14 No. 10-5612 (9th Cir. Jan. 27, 2012).

15 *See* 11 U.S.C. § 1129(a)(10). Courts have increasingly shown a willingness to consider even *de minimis* impairment sufficient to satisfy section 1129(a)(10) of the Bankruptcy Code. *See In re Village at Camp Bowie I, L.P.*, 454 B.R. 702, 706 (Bankr. N.D. Tex. 2011).

16 No. 01-16034, 2004 Bankr. LEXIS 2549, at *234-35 (Bankr. S.D.N.Y. July 15, 2004).

17 419 B.R. 221, 266 (Bankr. S.D.N.Y. 2009); *see also In re Station Casinos, Inc.*, No. 09 52477 (Bankr. D. Nev. Aug. 27, 2010).

18 No. 08-13141, 2011 WL 5142420, at *39 (Bankr. D. Del. Oct. 31, 2011).

19 461 B.R. 293.

20 *See In re Transwest Resort Props., Inc.*, No. 10-37134 (Bankr. D. Az. Dec. 28, 2011).

21 541 U.S. 465, 479 (2004). Notably, *Till* was a chapter 13 case, and its applicability in the chapter 11 context has been the subject of debate. *See, e.g., In re Am. HomePatient, Inc.*, 420 F.3d 559 (6th Cir. 2005), *cert. denied*, 549 U.S. 942 (2006); *In re Nw. Timberline Enters., Inc.*, 348 B.R. 412, 433-34 (Bankr. N.D. Tex. 2006).

22 *Till*, 541 U.S. at 479; *Am. HomePatient*, 420 F.3d at 568.

23 *In re Village at Camp Bowie I, L.P.*, 454 B.R. 702, 706 (Bankr. N.D. Tex. 2011).

24 *Id.* at 715.

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