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NEW THREAT OF SUBSTANTIVE CONSOLIDATION FOR REAL ESTATE LENDING STRUCTURES

Groundbreaking Ninth Circuit Decision Declares Only One Class of Impaired, Consenting Creditors Is Needed to Confirm a Joint Plan Among Multiple Debtors

To Our Clients and Friends:

The Ninth Circuit's recent opinion in *In re Transwest Resort Properties, Inc.* is the first circuit-level decision to address whether, under section 1129(a)(10) of the Bankruptcy Code, a multi-debtor joint chapter 11 plan can be "crammed down" with the consent of a single impaired class (the "per plan" interpretation), or whether a class of creditors from each individual debtor entity must consent ("per debtor").[1] By adopting the per plan approach, *Transwest* puts creditors on notice that those who stand to lose out from chapter 11 plans that effectively ignore the separateness of related corporate entities—most notably, secured lenders in real estate financings—should be prepared to challenge those schemes as *de facto* substantive consolidation rather than relying on the voting requirements of section 1129(a)(10) for protection.

Before *Transwest*: Whose Votes Do We Need, Anyway?

In 2011, a Delaware bankruptcy court was the first to examine 11 U.S.C. § 1129(a)(10)—which provides that a plan of reorganization may only be confirmed if "at least one class of claims that is impaired under the plan has accepted the plan"—and conclude that this requirement must be met separately for each debtor entity included in a joint plan of reorganization.[2] In *In re Tribune Co.*, Judge Kevin Carey held that a per plan interpretation of section 1129(a)(10) was irreconcilable with the principle that "[i]n the absence of substantive consolidation, entity separateness is fundamental."[3] Moreover, he observed that a per debtor approach would be consistent with the other provisions of section 1129(a), e.g. the "best interest of creditors" requirement of section 1129(a)(7), which also must be satisfied on a per debtor basis.[4]

While the court acknowledged that it might be challenging to obtain debtor-by-debtor consent in a complex case like *Tribune*, in which two competing joint plans would have reorganized over one hundred affiliated debtors, it concluded that "convenience alone is not sufficient reason to disturb the rights of impaired classes of creditors of a debtor not meeting confirmation standards." In *Tribune*, both proposed joint plans contained provisions stating that they were *not* premised on substantive consolidation, the doctrine which, in certain circumstances, permits chapter 11 plans to treat liabilities of multiple affiliated debtors as liabilities of a single consolidated entity. As Judge Carey observed, such provisions are "not uncommon," presumably because plan proponents wish to avoid an expensive battle to impose substantive consolidation, proponents of which face a heavy evidentiary burden within bankruptcy courts

in the Third Circuit as result of circuit-level decision in *In re Owens Corning*.[5] In the absence of substantive consolidation, the *Tribune* court concluded that the joint plan in question "actually consists of a separate plan for each Debtor," and each such plan must separately satisfy the confirmation requirements of section 1129(a).[6]

Because several courts had previously held that section 1129(a)(10) could be satisfied on a per plan basis,[7] the decision in *Tribune* created a split of authority. While one subsequent Delaware case has followed the per debtor approach of *Tribune*, the Arizona bankruptcy court overseeing the chapter 11 cases of Transwest Resort Properties Inc. and its subsidiaries chose to adopt the per plan interpretation of the statute, setting in motion a string of appeals that led to the Ninth Circuit's recent precedent-setting decision.[8]

The *Transwest* Chapter 11 Cases

Compared to the conglomeration of affiliated debtors in *Tribune*, the debtors in *Transwest* were relatively few in number and straightforward in purpose. The underlying assets were two resort hotel properties in Tucson, AZ and Hilton Head, SC, each owned by an operating company (together, the "OpCo Debtors"), and each subject to a single senior mortgage with the OpCo Debtor as the sole obligor.[9] The equity of each OpCo Debtor was 100% owned by a holding company (together, the "Mezzanine Debtors") each of which incurred additional financing secured by equity in the corresponding OpCo. At the top of the corporate structure was a holding company that owned 100% of the equity of the Mezzanine Debtors. When all five entities filed for chapter 11 bankruptcy in 2010, the owner of the OpCo mortgage debt (the "Lender") filed proofs of claim against the OpCo Debtors totaling $209 million, while secured claims against the Mezzanine Debtors (claims which the Lender eventually acquired) totaled $39 million.

In March 2011, the Lender sought relief from the automatic stay in order to foreclose on its mortgage loans against the OpCo Debtors. The bankruptcy court denied this request, and also denied a June 2011 request to foreclose on the mezzanine debt, paving the way for the five Transwest debtors to propose a joint plan of reorganization (the "Plan"). Under the Plan, a third party would invest $30 million in exchange for the Mezzanine Debtors' ownership interests in the OpCo Debtors, while the Lender's senior mortgage debt would be repaid in smaller monthly installment over a longer period.[10]

The Lender, which by this time was the also the sole creditor of the Mezzanine Debtors, sought to block confirmation of the plan, arguing, *inter alia*, that, since section 1129(a)(10) requires the consent of a dissenting class from *each* debtor, the Plan could not be confirmed without the Lender's consent. Both the bankruptcy court and, on appeal, the district court concluded that the "per debtor" interpretation of section 1129(a)(10) set forth in *Tribune* was not persuasive, and that the plain language of the statute supported the per plan approach:

The statute states that "[i]f 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" then the court shall confirm the plan if additional requirements are met. 11 U.S.C. § 1129(a)(10) (emphasis added). Thus, once an impaired class has

accepted the plan, § 1129(a)(10) is satisfied as to all debtors because all debtors are being reorganized under a joint plan of reorganization.[11]

With five of ten classes having voted in favor of the joint Plan in Transwest, the lower courts concluded that section 1129(a)(10) was no obstacle to confirmation, notwithstanding the fact that the Lender, the sole creditor of the Mezzanine Debtors, had withheld its consent.

The Ninth Circuit's Decision in *Transwest*

The Lender appealed to the Ninth Circuit, which became the first federal court of appeals to address whether the strictures of section 1129(a)(10) apply on a per debtor basis or per plan basis.[12] The panel of three judges unanimously affirmed the lower courts' per plan interpretation of the statute. In a succinct opinion, Judge Milan Smith wrote that the plain language of section 1129(a) supported the per plan approach, and that neither the statutory context nor applicable rules of statutory construction altered this reading.[13] Acknowledging the Lender's concerns that the per plan approach would lead to a "parade of horribles" for similarly situated real estate lenders, the court observed that these were policy concerns best resolved by Congress. Moreover, to the extent that Lenders now argued that the Transwest debtors' Plan was, in effect, an impermissible substantive consolidation, the court declined to consider this argument since it was raised for the first time on appeal.[14]

In a separate concurrence, Judge Friedland wrote to emphasize that she shared some of the Lender's concerns with respect to substantive consolidation, though she agreed that the Lender waived them by failing to raise them earlier. Judge Friedland observed that, although the Plan provided that the various debtors "technically . . . remained separate," distributions under the Plan were devised such that "creditors for different Debtors all drew from the same pool of assets."[15] Given that this kind of *de facto* substantive consolidation is a common feature of joint plans with multiple related debtors, Judge Friedland emphasized that creditors who believe they lose out from consolidation of the debtors' assets and liabilities should make their objections promptly and clearly in the bankruptcy courts:

> [I]f a creditor believes that a reorganization improperly intermingles different estates, the creditor can and should object that the plan—rather than the requirements for 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.[16]

Conclusion

While the Ninth Circuit's opinion in *Transwest* provides a measure of comfort for plan proponents with respect to the voting requirements of section 1129(a)(10), it may foreshadow battles to come over *de facto* substantive consolidation. Moreover, for debtors and creditors in chapter 11 cases outside the Ninth Circuit, it remains to be seen whether bankruptcy courts will follow the per plan approach endorsed in *Transwest*, or whether the per debtor approach of *Tribune* will gain new adherents.

In the meantime, mezzanine lenders and other creditors whose rights are threatened by multi-debtor plans of reorganization would be well-advised to raise both objections, lest they should find themselves

in the unfortunate position of the Lender in *Transwest*, wondering whether they waived a winning argument. Failure to raise an argument in respect of a chapter 11 plan's attempt to impermissibly substantively consolidate a multi-debtor estate may frustrate the entire purpose of the senior/mezzanine financing structure, which is to isolate the collateral—and claims—of the senior lender and the mezzanine lender at the appropriate legal entity, and to limit their remedies accordingly. The "per plan" approach, requiring only one impaired accepting class, could result in creditors of a mezzanine debtor determining the treatment of the senior lender's claim at the opco debtor over the senior lender's objection.[17]

For borrowers and guarantors, the *Transwest* decision may incentivize parties to file chapter 11 bankruptcy within the Ninth Circuit. Debtors may be able to confirm a plan over the objections of certain creditor groups using the "cram down" mechanism affirmed by the *Transwest* decision's interpretation of Section 1129(a)(10).

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[1] *In re Transwest Resort Properties, Inc. (JPMCC 2007-C1 Grasslawn Lodging, LLC v. Transwest Resort Properties, Inc.)*, No. 16-16221, 2018 WL 615431 (9th Cir. Jan. 25, 2018). The Ninth Circuit addressed a second question in *Transwest* not discussed in this client alert, namely, whether a secured lender's election to have its entire claim treated as secured under 11 U.S.C. § 1111(b)(2) requires a due-on-sale clause to be included in a debtor's plan of reorganization. The Ninth Circuit's opinion, which is marked for publication, is also available for download at http://cdn.ca9.uscourts.gov/datastore/opinions/2018/01/25/16-16221.pdf.

[2] *In re Tribune Co.*, 464 B.R. 126, 183 (Bankr. D. Del. 2011).

[3] *Id.* at 182 (citing *In re Owens Corning*, 419 F.3d 195, 211 (3d Cir. 2007)).

[4] *Tribune*, 464 B.R. at 182.

[5] *In re Owens Corning*, 419 F.3d 195, 211–12 (3d Cir. 2007) ("The upshot is this. In our Court what must be proven (absent consent) concerning the entities for whom substantive consolidation is sought is that (i) prepetition they disregarded separateness so significantly their creditors relied on the breakdown of entity borders and treated them as one legal entity, or (ii) postpetition their assets and liabilities are so scrambled that separating them is prohibitive and hurts all creditors. Proponents of substantive consolidation have the burden of showing one or the other rationale for consolidation.").

[6] *Tribune*, 464 B.R. at 182.

[7] *See, e.g., In re SGPA, Inc.*, 2001 Bankr.LEXIS 2291 (Bankr. M.D. Pa. Sep. 28, 2001); *In re Charter Commc'ns*, 419 B.R. 221 (Bankr. S.D.N.Y. 2009).

[8] *In re JER/Jameson Mezz Borrower II, LLC*, 461 B.R. 293 (Bankr. D. Del. 2011); *In re: Transwest Resort Properties, Inc.*, 554 B.R. 894 (D. Ariz. 2016).

[9] *In re Transwest Resort Properties, Inc.*, 554 B.R. 894, 896–97 (D. Ariz. 2016).

[10] *Id.* at 897.

[11] *Id.* at 901.

[12] The Lender also appealed the lower court's ruling that Section 1111(b) did not require the inclusion of a due-on-sale clause in the Plan, which the Court affirmed. Accordingly, even though the Lender was entitled to be treated as fully secured under the Plan, the Lender was not entitled to certain covenants and restrictions related to the disposition of its collateral under the terms of the Plan.

[13] *In re Transwest Resort Properties, Inc.*, No. 16-16221, 2018 WL 615431 at *5 (9th Cir. Jan. 25, 2018). ("[T]he Lender provides no support for its position that all subsections [of section 1129(a)] must uniformly apply on a "per debtor" basis.")

[14] *Id.*

[15] *Id.* at *6 (Friedland, J., concurring).

[16] *Id.* at *8 (citing *In re Bonham*, 229 F.3d at 765 ("[O]nly through a searching review of the record, on a case-by-case basis, can a court ensure that substantive consolidation effects its sole aim: fairness to all creditors.")).

[17] The Ninth Circuit's endorsement of the "per plan" interpretation of section 1129(a)(10) may also prompt renewed attention toward the bankruptcy provisions, including the voting rights with respect to each borrower's bankruptcy case, in an intercreditor agreement between senior lender and mezzanine lender.

Gibson, Dunn & Crutcher's lawyers are available to assist with any questions you may have regarding these issues. For further information, please contact the Gibson Dunn lawyer with whom you usually work, any member of the firm's Business Restructuring and Reorganization practice group, or the following authors:

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