Real Estate Bankruptcy Cramdown Plans—A Lender's Plan of Engagement

*Steven L. Lichtenfeld**

A bankruptcy filing by a borrower remains a significant threat to the lender. As the real estate crisis deepens, lenders need to be on their guard against this threat. The author of this article discusses the threat and lender responses to a debtor's proposed cramdown plan.

During the real estate downturn in the early 1990s real estate owners and operators often filed for bankruptcy protection as a negotiating tactic and as a means of shielding their assets from foreclosure. These cases, which often dragged on for years at enormous expense, often had the desired impact of altering the negotiating leverage with lenders.

However, during the pendency of the recent credit crisis the number of real estate bankruptcy filings was limited. The reason for this was twofold. First, amendments to the United States Bankruptcy Code (the "Code") in 2005 required debtors owning a single commercial property (i.e., single purpose borrowers) within 90 days of the filing to (i) file a plan of reorganization which has a reasonable possibility of being confirmed in a reasonable period of time or (ii) begin to make payments to the lender in an amount equal to the current rate of interest on the value of the lender's interest in the property. Second, a substantial percentage of commercial real estate loans documented since the late 1990s include a "springing" recourse guarantee that makes the loan fully recourse to one or more principals of the borrower in the event the borrower files for a voluntary bankruptcy, or colludes with creditors to cause an involuntary bankruptcy proceeding to occur. These provisions have, generally, operated as an effective "poison pill," deterring bankruptcy filings by commercial real estate borrowers. Courts have consistently upheld the validity of these guarantees. In a high profile case arising out of the bankruptcy of the Extended Stay Hotel chain, David Lichtenstein, a real estate owner and developer, argued that his partial guarantee of certain mortgage loan debt secured by the Extended Stay Hotel chain that was triggered by the filing of a petition of bankruptcy by the borrower was void because it violated public policy.[1] The New York Supreme Court, citing favorably its decision in *UBS Commercial Mortg. Trust 2007-FLI v. Garrison Special Opportunities Fund L.P.*,[2] reasoned that the Lichtenstein guarantee, like the Garrison guarantee "is a lenders assurance against borrowers being permitted to take certain

*Steven L. Lichtenfeld is a partner at Proskauer Rose LLP and is co-chair of the firm's real estate finance and capital markets groups. Jason Slutsky, an associate at the firm, assisted in the preparation of this article. The author may be contacted at slichtenfeld@proskauer.com.

acts, is a common feature in commercial loans. Such guarantees almost uniformly contain language which makes them unconditional and waives the right to assert defenses. Courts have upheld such features as valid financing arrangements." Accordingly, the court ruled that David Lichtenstein cannot escape liability under his guarantee because it is an unenforceable penalty.

The real estate bankruptcy story of the recent credit crisis does not, however, end there. In some cases, the real estate loan is already subject to full or substantial recourse to one or more principals of the borrower. This was sometimes the case in construction loans or in circumstances where underwritten cash flow did not justify the loan proceeds requested by the borrower. In circumstances where a loan that is subject to substantial recourse goes into default (pursuant to a completion guarantee or otherwise), a bankruptcy filing by the borrower might not materially increase the liability of the principals of the borrower to the lender in respect of the loan. In other circumstances, because of the credit crisis and the downturn in the economy, the principals of the borrower (who are parties to the "springing" guarantee) no longer have any material net worth. In such a circumstance, the guarantor is essentially judgment proof and, therefore, would not be deterred from putting the borrower into bankruptcy. In addition, at the height of the market in late 2006 and early 2007 and when certain private equity funds and other institutions were borrowers, no "springing" guarantees were required by the lender or, if required, may have capped the liability to the guarantor to an amount substantially lower than the full amount of the debt. Finally, in other circumstances, only the operating partner (and not the financial partner) provided the "springing" guarantee relating to bankruptcy and as problems with the property presented themselves, the operating partner no longer has any control over the borrower and, therefore, is in no position to prevent a bankruptcy filing from occurring. In such circumstances, a bankruptcy filing by the borrower remains a significant threat to the lender. This threat has materialized in connection with at least two defaulted real estate loans and has been threatened in connection with a number of other loans. As the crisis deepens, lenders need to be on their guard against this threat especially in circumstances where a "springing" guarantee relating to bankruptcy is non-existent or otherwise is likely to be an ineffective deterrent.

First Steps

If a real estate borrower files for bankruptcy, the lender should consider filing an immediate motion to dismiss on several grounds. First, the lender should examine whether the bankruptcy filing was properly authorized by the borrower. Since the late 1990s, many commercial real estate borrowers were formed as special purpose bankruptcy remote entities ("SPEs"). The SPEs were structured to require that one or more independent directors, managers or members vote in favor of a voluntary bankruptcy proceeding. Real estate owners and operators, in haste to file, or without knowledge or disregard of the organizational documents, might cause their borrowers to file for bankruptcy without getting the consent of these directors, managers or members. In such event, the lender holding the debt should make a motion to dismiss the bankruptcy case on the basis that it was not properly authorized. Further, if the borrower's equity is significantly "under water" (i.e., the amount of the debt far exceeds the value of the prop-

erty), the lender should consider bringing a motion to dismiss the bankruptcy case on the basis that the case was commenced in bad faith since there is no realistic possibility that a plan of reorganization will be able to be confirmed and that the true purpose behind the filing was merely to delay the exercise of remedies by the lender.

Timing of Confirmation

If the lender is unsuccessful in getting the bankruptcy case dismissed, the debtor-borrower will, in commercial single asset real estate cases, have the exclusive right for 90 days to (i) file a plan of reorganization which has a reasonable possibility of being confirmed in a reasonable period of time and (ii) begin to make payments to the lender in an amount equal to the current market rate of interest on the value of the lender's interest in the real estate. (Lenders should be aware, however, that there is an opportunity for debtor-borrower gamesmanship to delay these deadlines in a case where a small operating business operated by the debtor-borrower on the premises can be claimed to remove the project from the category of a "single asset real estate case.") If a reasonable plan is filed by the debtor-borrower, it would have an additional 60 days to solicit acceptances of the plan. These time periods can be extended for cause. Further, the Code includes a "hell or high water provision" requiring that the plan exclusivity period may not be extended beyond 18 months after the filing date and the acceptance of the plan by a majority of the creditors may not be extended beyond 20 months after the filing date.

The Cramdown

The biggest threat to a lender in a commercial real estate reorganization is a "cramdown." However, the confirmation and other requirements that a debtor must satisfy in order to "cramdown" either a secured or an unsecured claim in the case of a single asset real estate bankruptcy impose such burdens on a debtor that few Chapter 11 debtors are likely to achieve successfully a reorganization by cramming down the lender.

If all the requirements of a plan of reorganization are satisfied, with the exception of a successful vote by creditors, the plan of reorganization may still be confirmed over the objection of a dissenting class. This is known as a "cramdown." In a "cramdown," the debtor may do any one or more of the following:

- reduce the principal amount of the secured claim to the value of the collateral;
- reduce the interest rate;
- extend the maturity date; or
- alter the repayment schedule.

Also, the debtor may make a minimal payment on the unsecured claim. In order for a cramdown to occur the debtor must satisfy the following requirements:

- At least one impaired class must have accepted the plan (without counting the votes of insiders holding claims);
- A class with a higher priority under the plan must be paid in full before any junior class can receive anything, unless (i) such senior class consents to lesser treatment or (ii) a creditor or equity holder in a junior class provides "new value" to the debtor to assist it in its reorganization;
- The debtor must show that the plan is

"fair and equitable" and "does not unfairly discriminate" with respect to each class of claims and interests that is impaired and has not accepted the plan; and

- The debtor must show that the plan will probably not be followed by a liquidation or a need for a further financial reorganization as a result of a subsequent loan default or otherwise (the "Feasibility Test").

Lender Responses to a Debtor Proposed Cramdown Plan

In a single asset real estate bankruptcy, each of the requirements to a confirmation of a cramdown plan create either burdens for debtors/borrowers or opportunities for lenders that make a successful confirmation of such a plan remote.

Voting or Claims to Block Confirmation

Because the lender's claim is likely to be deemed undersecured it will be divided into two claims: (i) a secured claim equal to the value of its collateral and (ii) an unsecured deficiency claim for the balance. For an impaired class to accept the plan creditors holding at least two-thirds of the allowed claims in the class, including more than one-half of the actual number of allowed claims that vote, must vote for acceptance. Because the undersecured claim of the lender usually is large enough to control the unsecured creditor class, the lender is often able to block confirmation of a cramdown plan. This scenario applies in most single asset real estate cases, as the only other creditors are trade creditors who are owed relatively small amounts. However, there is an increased risk of cramdown if there are other subordinate lenders in the capital stack of the same borrower. (This would be the case if there were second mortgage debt on a property but should not be the case if there is mezzanine debt incurred by a separate borrower and secured by a direct or indirect equity interest in the property owner.)

If the lender's claim is not large enough to control the class vote, or if the lender's deficiency claim has been classified separately from the other unsecured claims, the lender may seek to purchase sufficient claims from other class members to force a negative vote by the class or to control one-third of the amount of each non-insider (i.e., non-affiliates, officers, directors and other control persons of the debtor) impaired class in order to block confirmation.

Because the bankruptcy court may disallow claims purchased by a creditor not acting in good faith,[3] the question arises as to whether purchasing claims for the purpose of preventing confirmation constitutes bad faith. Since the Code provides no guidance on what constitutes bad faith, it was left to the courts to develop a standard. While there is little U.S. Supreme Court or circuit court guidance on the subject, a general framework is emerging for the types of motives that will lead to a finding of acting in bad faith. The emerging test is whether the creditor acted pursuant to an ulterior motive unrelated to the protection of the secured creditor's claims in the case, such as malice, blackmail, intent to destroy the debtor's business in order to advance the interests of a competing business, intent to profit from the purchase or from information obtained thereby, intent to obtain control of the debtor, intent to block confirmation of a plan, or intent to obtain an unfair advantage in shaping the bankruptcy proceedings. Findings of bad faith should be

"the exception, not the rule" however, and the party seeking to designate another's vote bears the burden of proving that it was not cast in good faith.[4] Additionally, it is important to note that purchasing claims to promote the creditor's self interest is permissible and does not amount to an ulterior motive which constitutes acting in bad faith.[5]

In re Kovalchik, an unreported bankruptcy court decision in Pennsylvania, upheld the purchase of blocking claims by a subsidiary created by the secured lender for the purpose of blocking confirmation. The court ruled that the purchase of the claims was permissible and that the claims could be voted because:

- all impaired non-insider claims in the class were offered the same opportunity to sell;
- the price offered was 100% of each claim with immediate payment in full;
- the purchasing entity identified itself as the secured creditor;
- there was no duplicity in dealing with the creditors; and
- the offer of purchase treated the unsecured creditors equally and fairly.

The court stated that no formal solicitation process was required because no discount was requested by the purchasing creditor and noted that a creditor's self-interest in purchasing claims was not bad faith. Accordingly, if the lender pays 100% for the claims, it is not likely that the lender will be found to be acting in bad faith. Therefore, if it is willing to invest in purchased claims, the lender can prevent an impaired class from voting in favor of a cramdown plan.

Absolute Priority Rule

A plan can be crammed down on a dissenting class of creditors only if each class with the higher priority is paid in full before any junior class receives anything (the "Absolute Priority Rule"). Accordingly, the partners in the debtor (i.e., the equity) cannot retain their equity interests in the debtor unless all the senior creditors are paid in full. The question of whether a creditor has been paid in full is inherently subjective question that can entail the use of prediction, particularly when distributing equity in the reorganized debtor under the plan. As such, if the equity tries to impose an unreasonable cramdown plan or the lender (i.e., a plan that maintains for the equity a significant ownership stake in the reorganized debtor), the lender has the right to challenge the plan in court by utilizing expert testimony from real estate valuation experts that it is not being paid in full. If the lender demonstrates that it is willing to defend aggressively its Absolute Priority Rule rights, the equity will be motivated to act more reasonably or face the reality that it will retain nothing under the reorganization plan.

It should be noted, however, that there exists an exception to the Absolute Priority Rule known as the "new value exception." This exception allows equity holders to keep their ownership interests even though unsecured creditors do not receive full payment of their claims, provided that such equity holders contribute new capital to the reorganized debtor in an amount reasonably equivalent to their retained interest in the debtor. The new value exception requires that the equity holders' infusion of capital be:

- substantial;
- new;

- reasonably equivalent to the interest being retained;
- in the form of "money or money's worth" that constitutes more than a promise by the equity holders to make future payments; and
- necessary to a reorganization.

The bankruptcy court must determine whether the equity holders' contribution is sufficient to permit them to retain their interests, particularly while senior claims are not being paid in full. Generally, the court determines whether the contribution is reasonably equivalent to the value of the retained equity interests, whether the junior impaired classes are better off with the new value, and whether the new value makes the plan feasible. The new value exception to the Absolute Priority Rule is often not a significant risk to lenders, since if the equity holder or a junior lender is willing to put more "skin in the game" by investing a substantial sum in the debtor which can then be utilized to de-lever the lender's position in the property, this equity can create the basis for the adoption of a consensual plan.

The Plan Is Fair and Equitable

Under the Code, the fair and equitable standard mandates that the debtor cannot confirm a plan of reorganization over the objection of a class of secured creditors unless the plan provides for distributions of property that are equal in value to the allowed amount of their claims. In order to accomplish this, the plan would have to permit the secured creditor to retain its lien and receive deferred cash payments equal to the present value of the collateral securing the loan. A second alternative for satisfying this standard in a cramdown plan can be accomplished if the secured lender receives the "indubitable equivalent" of its claim. A secured creditor receives the indubitable equivalent of the claim when, for example, the secured creditor receives a return of part of its collateral while the remainder of its secured claim continues to be secured by the remaining collateral, and when the debtor proposes to pay the present value of the remaining secured claim over a period of time. Given the capitalization rate expansion that has occurred in this most recent commercial real estate cycle, debtors will most likely not be able to prove that a secured lender has received the distribution of the property having a present value equal to the allowed amount of its claim. In such event, the equity in the debtor will be left with only one viable alternative—to relinquish any interests in the property or request that the senior lender consent to a plan that leaves the equity with only a minor subordinated interest in the property often referred to as a "hope certificate."

Feasibility Requirements of a Cramdown Plan

Before a court confirms a cramdown plan, the bankruptcy court must, among other things, determine whether the plan is feasible. In other words, the bankruptcy court must find that the plan is unlikely to be followed by a liquidation or a need for further financial reorganization. Although the feasibility requirement does not guarantee the success of the reorganized debtor, it does require that the plan enable the reorganized debtor to emerge solvent and with reasonable prospects of financial stability and success. The burden is on the debtor to prove that the plan is feasible.

Generally, the factors that the bankruptcy court considers in determining feasibility include:

- the earning power of the business (i.e., cash flow from the property);
- the sufficiency of the capital structure;
- the condition of the collateral and any deterioration that may have occurred throughout the bankruptcy process;
- economic conditions;
- management efficiency;
- the availability of credit, if needed; and
- the debtor's ability to meet capital expenditures.

The bankruptcy court is obligated to evaluate past earnings (i.e., net operating income) to determine if they are a reliable criterion of future performance, and, if not, to make an estimate of future performance by inquiring into foreseeable factors that may affect future prospects. To enable the court to evaluate past earnings and to estimate future earnings, the debtor must present competent, concrete, and reliable evidence.

Therefore, although debtors may make a proposal to restructure their debts, debtors carry a significant burden to establish that they will be able to satisfy the payments proposed in their plans. In a single asset real estate bankruptcy case, the court will deny confirmation if the debtor cannot prove the plan's feasibility based upon realistic and verifiable projections establishing the existence of cash flow adequate to operate the property and pay all the debtor's debt service. In the current environment for commercial real estate that would be a significant burden for any debtor.

Final Conclusions

Although a cramdown remains the single biggest workout and bankruptcy threat to lenders, this threat is more fiction than fact.

- Although the provisions regarding cramdown are among the most complicated in the Code, lenders have numerous weapons in their arsenal to avoid getting crammed down over their objections.
- In order to effectuate a cramdown, all debtors must satisfy numerous interrelated requirements, including a significant requirement that the plan is feasible.
- Because most jurisdictions do not allow the debtor to isolate the lender's deficiency claim and treat it differently from other unsecured claims, the lender should be able to block confirmation of a cramdown plan. Even if a valid reason is found for classifying the unsecured claims of other creditors (i.e., trade creditors) differently from the unsecured claims of the lender, the lender can purchase the unsecured claims of other creditors in order to successfully block confirmation of a cramdown plan.
- Ultimately, in single asset real estate bankruptcy cases, it will be very difficult for a debtor to satisfy all the requirements necessary in order to affect a cramdown of a lender.

NOTES:

[1]*Bank of America, N.A. v. Lightstone Holdings, LLC*, 2011 WL 4357491 (N.Y. Sup 2011).

[2]*UBS Commercial Mortg. Trust 2007-FL1 v. Garrison Special Opportunities Fund L.P.*, 2011 WL 900949 (N.Y. Sup 2011).

[3]11 U.S.C.A. §§ 1126(e).

[4]*In re Adelphia Communications Corp.*, 359 B.R. 54, 47 Bankr. Ct. Dec. (CRR) 125 (Bankr. S.D. N.Y. 2006).

[5]*In re Figter Ltd.*, 118 F.3d 635, 31 Bankr. Ct. Dec. (CRR) 17, Bankr. L. Rep. (CCH) P 77470 (9th Cir. 1997).