Client Advisory

Katten
Katten Muchin Rosenman LLP

Bankruptcy and Creditors' Rights/Real Estate

January 24, 2012

Delaware Bankruptcy Court Dismisses Chapter 11 Petition of Mezzanine Borrower as Filed in Bad Faith

The United States Bankruptcy Court for the District of Delaware (the Court) recently granted a motion to dismiss a mezzanine borrower's chapter 11 bankruptcy petition at the outset of the debtor's case.[1] In *In re JER/Jameson Mezz Borrower II, LLC*, the Court found that the debtor's petition had been filed in bad faith because, among other things, a junior mezzanine lender had directed the sole non-independent director of the debtor to file the petition with the intent of hindering a senior mezzanine lender's foreclosure efforts and without any valid reorganization purpose. The *Jameson* decision is significant because it may limit the ability of both mezzanine borrowers and mezzanine lenders to utilize the threat of bankruptcy as a negotiation tactic when dealing with other parties in a capital structure. Ultimately, however, whether the *Jameson* decision will be limited to intercreditor disputes has yet to be determined.

Background

Mezzanine loans are common in large commercial real estate financings. Mezzanine loans are similar to second mortgages, with the major difference being that a mezzanine loan is secured by a pledge of the equity in the entity that owns the real property, instead of a subordinate mortgage or deed of trust encumbering the actual real estate. Upon a default by the borrower, the mezzanine lender can foreclose on the pledged ownership interests in a matter of a few weeks, as opposed to the months or even years it can take to foreclose a mortgage (depending on the state in which the property is located). In more complicated financings, there can be multiple levels of mezzanine loans, with each successive loan secured by a pledge of interests in successive levels of holding companies.

In re JER/Jameson Mezz Borrower II, LLC

In *Jameson*, the debtor was (1) the direct parent of the most senior mezzanine borrower and the indirect parent of two mortgage borrowers (which were also the operating companies) and (2) the direct subsidiary of another mezzanine borrower and the indirect subsidiary of the most junior mezzanine borrower. That is, the debtor was the borrower under a second level mezzanine loan. Two affiliates of Colony Capital owned the debt of the debtor, while a CDO managed by Gramercy Loan Services held the third and fourth level mezzanine loans. The mortgage lender and the various mezzanine lenders had entered into an intercreditor agreement among themselves.

The mortgage borrowers and each of the mezzanine borrowers defaulted at the common maturity of their respective loans. Following these maturity defaults, each lender commenced enforcement proceedings under the respective agreements, with (1) Colony (which also held the first level mezzanine loan) issuing a notice of intention to auction the debtor's assets pursuant to Article 9 of the U.C.C., and (2) Gramercy replacing the non-independent directors of each of the mezzanine borrowers with a Gramercy-appointed director. This new director then objected to the Colony U.C.C. auction. Colony responded by filing suit in New York seeking a declaratory judgment that (1) the U.C.C. notice was commercially reasonable, and (2) Gramercy improperly replaced the directors. While the case was still pending, Colony scheduled the U.C.C. auction.

---

[1] *In re JER/Jameson Mezz Borrower II, LLC,* No. 11-13338 (MFW) (Bankr. D. Del. Dec. 22, 2011).

At 11:00 p.m. the night before the U.C.C. auction was scheduled to take place, the debtor filed a chapter 11 petition in Delaware. The other borrowers filed chapter 11 petitions over the next week. Shortly after the filing, Colony moved to dismiss the debtor's petition, claiming that it was filed in bad faith.[2]

The Decision

The Bankruptcy Court ultimately dismissed the case with prejudice after the Court concluded that the debtor had filed in bad faith because (1) virtually all of the factors to be considered when determining whether a petition has been filed in bad faith, as articulated by the District Court in *In re Primestone Investment Partners, L.P.*,[3] were present, (2) Gramercy used the filing solely as a litigation tactic and (3) the debtor filed without a valid reorganization purpose. Importantly, when analyzing the issue of bad faith, the Court refused to adopt the Second Circuit's test (as advocated by the debtor), which emphasizes a debtor's subjective good faith, because "[t]he Third Circuit has not adopted that test." In the Third Circuit, the inquiry of good faith is "based more on an objective analysis of whether the debtor has sought to step outside the equitable limitations of Chapter 11 than the subjective intent of the debtor."

The Bankruptcy Court began its bad-faith analysis by considering the 13 *Primestone* factors:

1. Single asset case
2. Few unsecured creditors
3. No ongoing business or employees
4. Petition filed on eve of foreclosure
5. Two-party dispute that can be resolved in pending state court action
6. No cash or income
7. No pressure from non-moving creditors
8. Previous bankruptcy petition
9. Prepetition conduct was improper
10. No possibility of reorganization
11. Debtor formed immediately prepetition
12. Debtor filed solely to create automatic stay
13. Subjective intent of the debtor

The Court noted that virtually all of the *Primestone* factors were present,[4] and, accordingly, reasoned that the case should be dismissed as a bad faith filing.

The Court found "compelling" evidence that the debtor's filing was merely an impermissible litigation tactic designed to forestall Colony's foreclosure efforts, without a valid reorganization purpose. Specifically, the Court noted that (1) Gramercy replaced the non-independent director of the debtor in order to "get Colony's attention" because negotiations between Gramercy and Colony were not going well, (2) Gramercy advanced funds to pay the debtor's professional fees prior to the filing, and (3) the non-independent director admitted that the debtor filed the petition to stop the U.C.C. auction, which would primarily benefit the lenders for which Gramercy was acting as servicer.

The Court also found that, absent the substantive consolidation of the borrowers, the debtor only had one creditor (i.e., Colony), and thus would be unable to obtain the consent of an impaired class of creditors over Colony's objection in order to confirm a "cramdown" plan.[5] Accordingly, the debtor would not be able to reorganize through a bankruptcy.

[2] Colony also moved for relief from the automatic stay, which then was granted by the Bankruptcy Court. See id. at *23-33.

[3] *In re Primestone Inv. Partners, L.P.*, 272 B.R. 554, 557 (D. Del. 2002) (noting that no one particular factor is determinative).

[4] The factors not present were (8) (i.e., no previous bankruptcy petition) and (11) (i.e., debtor was not formed immediately before the filing).

[5] In order to confirm a plan over Colony's objection, the debtor would need one class of impaired creditors to vote in favor of confirming the debtor's plan of reorganization. See 11 U.S.C. § 1129(a)(10).

The Court found that the debtor's petition was filed in bad faith and for no legitimate bankruptcy purpose and dismissed the petition with prejudice.[6]

Implications of *Jameson*

Jameson could have significant implications for real estate lenders in multi-tranched financings. Bankruptcies have been avoided for the most part in the downturn of the past few years because lenders required that credit-worthy owners of real estate borrowers execute guaranties that would make those owners liable (either for the entire loan or losses suffered) if the applicable borrower filed for bankruptcy. In multi-tranched financings, however, a concern remained that a junior mezzanine lender would foreclose on its collateral, take ownership of the next entity in the chain of ownership and file that entity to thwart foreclosure efforts by more senior mezzanine lenders. The Jameson decision could reduce this risk. Many of the factors present in the Jameson case—few unsecured creditors, no ongoing business or employees, no cash or income—would be present in most real estate multi-tranched financings. Moreover, the Court acknowledged that the "enterprise" was actually larger than the SPE debtor (including multiple properties and entities) but nonetheless held that absent substantive consolidation, each case is separate and each debtor must be able show that it has a chance of confirming a plan.

6 A dismissal with prejudice bars a debtor from refiling a petition for relief. See 11 U.S.C. § 349(a).

For more information, please contact your Katten Muchin Rosenman LLP attorney, or any of the following members of our **Bankruptcy and Creditors' Rights**, **Distressed Debt and Claims Trading** or **Real Estate** practices.

Bankruptcy and Creditors' Rights

Kevin M. Baum	212.940.6325	kevin.baum@kattenlaw.com
Karin H. Berg	312.902.5523	karin.berg@kattenlaw.com
Dustin P. Branch	310.788.4420	dustin.branch@kattenlaw.com
Jeff J. Friedman	212.940.7035	jeff.friedman@kattenlaw.com
Brian D. Huben	310.788.4771	brian.huben@kattenlaw.com
Thomas J. Leanse	310.788.4475	thomas.leanse@kattenlaw.com
Kenneth E. Noble	212.940.6419	kenneth.noble@kattenlaw.com
Matthew W. Olsen	212.940.6472	matthew.olsen@kattenlaw.com
Kenneth J. Ottaviano	312.902.5366	kenneth.ottaviano@kattenlaw.com
George J. Pagano	212.940.6566	george.pagano@kattenlaw.com
Bradley E. Pearce	704.344.3095	brad.pearce@kattenlaw.com
Peter A. Siddiqui	312.902.5455	peter.siddiqui@kattenlaw.com
John P. Sieger	312.902.5294	john.sieger@kattenlaw.com
Joshua Wayser	310.788.4715	joshua.wayser@kattenlaw.com
Kristin C. Wigness	212.940.6547	kristin.wigness@kattenlaw.com

Distressed Debt and Claims Trading

Noah Heller	212.940.6539	noah.heller@kattenlaw.com

Real Estate

David J. Bryant	312.902.5380	david.bryant@kattenlaw.com
David R. Dlugie	312.902.5274	david.dlugie@kattenlaw.com
Wendy L. Fields	202.625.3800	wendy.fields@kattenlaw.com
Daniel S. Huffenus	704.444.2011	dan.huffenus@kattenlaw.com
Andrew L. Jagoda	212.940.8520	andrew.jagoda@kattenlaw.com
Bruce E. Kosub	972.868.9058	bruce.kosub@kattenlaw.com
Timothy G. Little	212.940.8594	tim.little@kattenlaw.com
Benzion J. Westreich	310.788.4409	benny.westreich@kattenlaw.com

Katten
Katten Muchin Rosenman LLP

www.kattenlaw.com

CHARLOTTE CHICAGO IRVING LONDON LOS ANGELES NEW YORK OAKLAND WASHINGTON, DC