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An [In]Subordinate Lender: Delaware Bankruptcy Court Dismisses Mezzanine Borrower's Chapter 11 Case for Bad Faith

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In an opinion that has wide-ranging implications for the structured finance industry, the Delaware bankruptcy court recently dismissed a mezzanine borrower's chapter 11 case as a bad faith filing pursuant to section 1112(b) of the Bankruptcy Code. *In re JER/Jameson Mezz Borrower II, LLC*, No. 11-13338, 2011 WL 6749058 (Bankr. D. Del. Dec. 22, 2011). At the core of the motion to dismiss were allegations that the debtor had filed for bankruptcy in bad faith, solely to benefit the lender to a parent entity, and to the detriment of the debtor's lender. The opinion stands in contrast to *In re General Growth Properties, Inc.*, 409 B.R. 43 (Bankr. S.D.N.Y. 2009) ("GGP"), and may leave structurally senior lenders breathing a sigh of relief.

Facts and Procedural History

In 2006, JER/Jameson Mezz Borrower II, LLC ("Mezz II") and certain of its affiliates borrowed approximately \$400M to acquire the hotel chain Jameson Inns and Signature Inns (the "Jameson Hotels"). The loan was structured as a multi-tiered facility made up of five different tranches of debt. Operating companies, which owned or leased and operated the Jameson Hotels (the "Operating Companies"), borrowed \$175M, secured by the hotel properties. Four mezzanine borrowers, which were formed for the sole purpose of the financing (referred to herein as "Mezz I," "Mezz II," "Mezz III," and "Mezz IV"), each borrowed \$40M. Mezz IV's loan was secured by its 100% equity interest in Mezz III, Mezz III's loan was secured by its 100% equity interest in Mezz II, Mezz II's loan was secured by its 100% equity interest in Mezz I, and Mezz I's loan was secured by its 100% equity interest in the Operating Companies. The Operating Companies provided the sole source of revenue for the Jameson Hotel enterprise.

On August 9, 2011, all of the loans matured and the Operating Companies and mezzanine borrowers defaulted. Lenders at each level commenced enforcement actions. The lender at the Mezz II level ("Colony") provided notice of its intent to conduct an auction under Article 9 of the

Uniform Commercial Code (the “UCC Auction”) of Mezz II’s equity interests in Mezz I, and also exercised its right to buy the secured debt at the Mezz I level. The Mezz III and Mezz IV loans were held by a collateralized debt obligation managed by an affiliate of Gramercy Loan Services LLC (“Gramercy Loan”) and JER Investors Trust, Inc. (“JER”) or its affiliate. Gramercy Loan exercised its right to replace non-independent directors for Mezz II, Mezz III, and Mezz IV and ultimately installed its own director at each of the mezzanine borrowers and at the Operating Companies. On the eve of the UCC Auction, Mezz II filed for bankruptcy.

Colony moved to dismiss Mezz II’s chapter 11 petition for bad faith (the “Motion to Dismiss”), arguing that the bankruptcy case served no legitimate purpose, and was filed solely to thwart Colony from foreclosing on Mezz II’s indirect equity interest in the Operating Companies. Colony’s argument was based, in part, on the fact that Mezz II had no unsecured creditors, Mezz II’s only secured creditor was Colony, and it was the only entity in the capital structure that had filed for bankruptcy. A few days later, Mezz I and the Operating Companies (together with Mezz II, the “Debtors”) filed chapter 11 petitions. The Debtors opposed the Motion to Dismiss, contending that the bankruptcy filing should be read in the context of the filings of Mezz I and the Operating Companies. The Debtors asserted that the valid reorganization purpose was to preserve the value of the enterprise and restructure the entire capital stack, or conduct a sale of the Jameson Hotels.

Delaware Bankruptcy Court Ruling

The court first recognized that good faith is a “predicate to the right to file a petition in bankruptcy” The burden is on the debtor to show good faith based on a totality of the circumstances. The court distinguished case law from the Second Circuit, which considers both objective futility and subjective intent. The court observed that the test in the Third Circuit 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.” In making the bad faith determination, the *JER/Jameson* court cited the factors set forth in *In re Primestone Inv. Partners, L.P.*, 272 B.R. 554, 557 (D. Del. 2002), and found that nearly all the so-called *Primestone* factors were present: Mezz II had only one asset (the membership interest in Mezz I), there were few if any unsecured creditors, Mezz II has no ongoing business operations or employees, the petition was filed on the eve of foreclosure solely to obtain the benefit of the automatic stay, and Mezz II had no cash or income and no possibility of reorganization because Colony would oppose any reorganization plan. In addition, the case involved a two-party dispute between Colony and the lender at the Mezz III and IV levels. Finally, litigation in state court was already pending.

The court further reasoned that even absent analysis of the Primestone factors, evidence that Mezz II's bankruptcy petition had been filed as a mere litigation tactic was compelling, given the timing of the filing, the role of the non-independent director installed by Gramercy Loan in the filing, and Gramercy Loan's payment of the independent directors' fees. In addition, the court concluded that the filing could not serve a valid reorganizational purpose as Colony, Mezz II's only creditor, would not vote to accept a plan of reorganization. Accordingly, the court dismissed Mezz II's bankruptcy case.

The court also granted Colony relief from the automatic stay pursuant to sections 362(d)(1) and (d)(2) of the Bankruptcy Code to foreclose on Mezz II's ownership interest in Mezz I. The decision effectively removed the enterprise's revenue stream from the parent entities, and the reach of the lender at the Mezz III and Mezz IV's levels.

Conclusion

In the wake of GGP, this opinion may provide structurally senior lenders comfort that, at least in Delaware, bankruptcy proofing a single asset borrower within a larger capital structure may succeed. However, it also leaves the type of mezzanine financing used in this case suspect, as the structurally subordinated lender was left high and dry, with the enterprise's revenue stream snatched out from underneath it. Had the Mezz III and Mezz IV lender made a junior loan at the Mezz II level (or lower down the chain), rather than a structurally subordinate loan at the Mezz III and Mezz IV levels, it would have had some skin in the game in Mezz II's bankruptcy case, making a potential consenting impaired class and, thus, plan confirmation theoretically possible. It is unclear, however, whether the result would have been different if the structure of the Jameson Hotel enterprise had the complexity of GGP. In addition, a simultaneous bankruptcy filing of all the entities in the capital stack would have looked less like a mere litigation tactic, and more like a good faith attempt to restructure the enterprise as a whole. Thus, while the opinion provides some assurance to finance professionals, its scope and application remain to be seen.

[1] The implication was that Gramercy Loan had acted in bad faith by appointing its own director and directing him to file Mezz II for bankruptcy the day before the UCC Auction.

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