Delaware Bankruptcy Court Dismisses Single-Asset Real Estate Mezz Debtor's Bankruptcy Case for Bad Faith

January 26, 2012

On December 22, 2011, the United States Bankruptcy Court for the District of Delaware in *In re JER/Jameson Mezz Borrower II LLC* [1] dismissed with prejudice a mezzanine borrower's bankruptcy case for bad faith under Section 1112(b) of the Bankruptcy Code. In doing so, the court clarified that the standard in the Third Circuit to evaluate the good faith of a debtor seeking shelter under the umbrella of Chapter 11 of the Bankruptcy Code is an objective one and does not consider the subjective good faith of a debtor as do courts within the Second Circuit.

Facts

To understand the basis for the court's dismissal of the petition, one must understand JER/Jameson's capital structure. In 2006, JER/Jameson Mezz Borrower II LLC (Mezz II Borrower) was formed as part of a capital structure to acquire a chain of 103 economy hotels known as the Jameson Inns and Signature Inns for approximately $400 million. JER/Jameson Properties LLC and JER/Jameson NC Properties LP (the Operating Debtors) borrowed $175 million under a CMBS loan. Four affiliates, including Mezz II Borrower, (the Mezzanine Borrowers) were formed for the sole purpose of borrowing additional funds.

As shown below, Mezz I Borrower was the sole member of the Operating Debtors; Mezz II Borrower was the sole member of Mezz I Borrower; Mezz III Borrower was the sole member of Mezz II Borrower; and so forth. The Operating Debtors owned the real estate and hotels. Each mezzanine borrower incurred approximately $40 million in debt to several other lenders. Specifically, CDCF JIH Funding LLC and ColFin JIH Funding (Colony) loaned approximately $80 million to Mezz I and Mezz II Borrower, respectively, and the debt at Mezz III Borrower and Mezz IV Borrower were held by collateralized debt obligations serviced by an affiliate of Gramercy Loan Services LLC (Gramercy).

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1 No. 11–13338 (MFW), 2011 WL 6749058 (Bankr. D. Del. Dec. 22, 2011).

Mezz IV Borrower
• Gramercy loaned $40MM to Mezz IV Borrower
Mezz III Borrower
• Gramercy loaned $40MM to Mezz III Borrower
Mezz II Borrower
• Colony loaned $40MM to Mezz II Borrower
Mezz I Borrower
• Colony loaned $40MM to Mezz I Borrower
Operating Debtors
• $175MM CMBS Loan

All the debt matured in August 2011, and the lenders at both the Operating Debtor level and the mezzanine level began enforcing remedies. Colony issued a notice of intention to auction the assets of Mezz II Borrower under Article 9 of the Uniform Commercial Code (UCC), which was scheduled for October 19, 2011. Thereafter, on October 18, 2011, Mezz II Borrower filed its bankruptcy petition to prevent Colony from foreclosing under the UCC on its sole asset—the membership units in Mezz I Borrower. That filing was followed by the bankruptcy filings of Mezz I Borrower and the Operating Debtors on October 26, 2011.

Immediately following its filing, Colony filed an emergency motion to dismiss Mezz II Borrower's bankruptcy case for bad faith and for relief from stay, contending that because the debtor is not an operating company, has no ongoing operations, no employees and was a special purpose entity established solely to hold one asset—100 percent of the membership interests in Mezz I Borrower—there was no legitimate reorganization purpose. According to Colony, Mezz II Borrower was invoking the automatic stay as a litigation tactic.

Court's Ruling

After hearing four full days of evidence, the court agreed with Colony, granting the motion to dismiss for bad faith under Section 1112(b) of the Bankruptcy Code. At the outset, the court made clear that it is the debtor's burden to prove it filed its petition in good faith—not the movant's burden, as the debtor contended. The court also held that the debtor's reliance on Second Circuit authority, which permits a court to consider the subjective good faith of a debtor, was misplaced because the standard in Third Circuit is based more on an objective analysis.

Then, the court examined whether there existed the typical indicia of bad faith under the *Primestone*[2] factors and held that virtually all the *Primestone* factors were supported by the evidence. Specifically, the court held that Mezz II Borrower had but one asset (the membership interests in Mezz I Borrower);

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[2] *In re Primestone Inv. Partners, L.P.*, 272 B.R. 554, 557 (D. Del. 2002). These factors (or some amalgamation thereof) are considered in other circuits as well. *See*, e.g., *In re Phoenix Piccadilly, Ltd.*, 849 F.2d 1393 (11th Cir. 1988).

had few, if any, unsecured creditors; no ongoing business operations or employees; no cash or income; no possibility of reorganization because Colony asserted it would block confirmation; and had filed bankruptcy on the eve of foreclosure solely to benefit from the protections of the automatic stay.

The court dismissed the debtor's petition for two additional, independent reasons: (1) because the case involved only a two-party dispute, and there was another forum in which the parties could assert their rights; and (2) because the prepetition conduct of the debtor unmasked the fact that it filed bankruptcy solely to gain a tactical advantage in bankruptcy, which is an impermissible use of the Bankruptcy Code. Perhaps the most harmful piece of evidence to the debtor was testimony by its non-independent director, who admitted that the petition was designed to "get Colony's attention" and also that the primary beneficiary of Mezz II Borrower's bankruptcy filing was Gramercy—lenders to Mezz II Borrower and Mezz IV Borrower.

The debtor and its affiliated debtor alleged that Mezz II Borrower's petition was filed in good faith with an aim toward preserving enterprise value for all the debtors' constituents. According to the debtors, the court should not take a myopic view of Mezz II Borrower's bankruptcy, but should consider the filing in conjunction with the holistic nature of the entire enterprise. The court agreed that it should look at the enterprise holistically to determine whether there was a realistic possibility of reorganization for Mezz II Borrower, but nonetheless held that no such possibility exists in light of the confirmation requirements in Section 1129 of the Bankruptcy Code.

Notably, the court held, citing Judge Carey's decision in *In re Tribune*,[3] that absent substantive consolidation, there must be a consenting class for each individual debtor before a joint plan can be confirmed. Thus, because Colony was Mezz II Borrower's only creditor and had indicated it would not affirmatively vote for the plan, reorganization was not possible, as Colony was in a blocking position. The debtor also failed to present any evidence that the bankruptcy filing would preserve value that would otherwise be available to creditors outside of bankruptcy. Because, in the view of the court, the debtor's bad faith permeated the entire bankruptcy filing, the court dismissed the case with prejudice under Section 349(a) of the Bankruptcy Code and, alternatively, found that cause existed to grant relief from the automatic stay because Colony was not adequately protected.

Take-Away

Motions to dismiss for bad faith are highly fact-intensive. The implications of the *JER/Jameson Mezz Borrower II LLC* decision are probably most pronounced in the structured finance context. When junior lenders in a mezz structure seek to place the mezzanine borrower into bankruptcy, given the limited and special-purpose nature of those entities and absent a basis for substantive consolidation, it appears it will be more difficult to convince a bankruptcy court that there is a reasonable prospect for reorganization. As Delaware bankruptcy courts continue to reinforce corporate separateness—for instance, requiring that each debtor obtain an impaired accepting class

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[3] No. 08-13141, 2011 WL 5142420, at *37-*41 (Bankr. D. Del. Oct. 31, 2011).

even in a joint plan—the sole creditors of these entities will be in a blocking position, which ties into a basis for dismissal under Section 1112(b) for bad faith. In fact, a review of case law on Section 1112(b) indicates that the "possibility of reorganization" might be one of the factors that receive more weight by bankruptcy courts. It appears to have received substantial weight in *JER/Jameson Mezz Borrower II LLC*.

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