Honorable Karen A. Overstreet
Chapter 11
Hearing Date: July 12, 2013
Hearing Time: 9:30 a.m.
Location: 700 Stewart Street
Seattle WA
Response Date: July 5, 2013

UNITED STATES BANKRUPTCY COURT

WESTERN DISTRICT OF WASHINGTON

In re: J AND Y INVESTMENT, LLC, Debtor.	Bankruptcy No. 13-10218-KAO Chapter 11 BACM 2004-1 320TH STREET SOUTH, LLC'S OBJECTIONS TO DEBTOR'S SECOND AMENDED PLAN OF REORGANIZATION

BACM 2004-1 320TH STREET SOUTH, LLC ("BACM")[1] hereby objects to Debtor's Second Amended Plan of Reorganization (the "**Plan**") on the grounds that (a) no impaired class will vote in favor of the Plan, as required by § 1129(a)(10); (b) the Plan is not proposed in good faith, as required by § 1129(a)(3); (c) the Plan is not fair and equitable as required by § 1129(b); and (d) the Plan is not feasible as required by § 1129(a)(11). For these reasons, which are discussed in detail below, and for the reasons set forth in BACM's Motion for Relief from Stay (Dkt. 150, the "**RFS Motion**"), which is hereby incorporated by reference, the Court should deny approval of the Plan, and grant the RFS Motion.

I. FACTS

Although the Plan purports to provide for payments based on a 30-year amortization, analysis of the Plan projections attached to the Second Amended Disclosure Statement (Dkt.

[1] Unless otherwise noted herein, all capitalized terms not otherwise defined herein have the same meanings as in the RFS Motion.

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146) reveals that they project payments based on an amortization period of 502 months (41.8 years). *See* the amortization table attached to the Declaration of Howard J. Aaronson, filed herewith (the "**Aronson Decl.**") at Exh. A. This alone is unfair to BACM. But to make matters worse, after making interest-only payments at the unreasonably low rate of only 4.75% for two years and very modest principal payments in Plan years 3 through 7, the obligation at the end of the Plan period would exceed $9,950,000 (a reduction of only 4.25% of the overall obligation) *even if Debtor were to make every payment as promised*.[2]

II. THE PLAN CANNOT BE CONFIRMED

A. Debtor Does Not Have an Impaired Class of Creditors to Vote in Favor of the Plan.

1. Classes 1, 2, and 3 Have Not Voted In Favor of the Plan.

Section 1129(a)(10) requires, as a condition of plan confirmation, that "at least one class of claims that is impaired under the plan has accepted the plan, determined without including the acceptance of the plan by any insider." In turn, 11 U.S.C. § 1126(c) provides that, "A class of claims has accepted a plan if such plan has been accepted by creditors, other than any entity designated under subsection (e) of this section, that hold at least two-thirds in amount and more than one-half in number of the allowed claims of such class held by creditors, other than any entity designated under subsection (e) of this section, that have accepted or rejected the plan."

The simple fact is that there are no legally recognizable classes of real creditors that have voted in favor of the Debtor's Plan. As a result, the Plan cannot be confirmed.

2. Debtor's Effort to Manufacture Two New Classes of Purported Claims is Impermissible.

Unlike Debtor's first plan filed on March 26, 2013, the Plan purports to classify claims of "Guarantors" and "Transferees" as new classes of creditors in a transparent attempt to manufacture one or more impaired classes. BACM has objected to each of these purported

[2] The Aaronson Decl. contains a detailed analysis of the Plan and concludes that, even if Debtor were to make its budget as projected over the next seven years, the Plan has no chance of succeeding when the appropriate interest rate of 10.05% is applied.

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claims, for reasons detailed in Dkt. Nos. 173 through 182 ("**BACM's Claims Objections**"). All of the facts, authorities, and arguments asserted in BACM's Claims Objections are hereby incorporated into these Objections and restated here.

Case law is clear that manufacturing an impaired class will not be tolerated. The creation of an artificially impaired class can be deemed either a violation of the requirement of an accepting impaired class or a violation of the requirement that the plan be proposed in good faith, or both. *In re Daly*, 167 B.R. 734, 737 (Bankr. D. Mass. 1994). Although plan proponents are afforded substantial flexibility in the classification and treatment of claims, "they go too far when a class of claims is plainly contrived and engineered solely to create an accepting impaired class." *In re Orchards Vill. Invs., LLC*, No. 09-30893-RLDLL, 2010 WL 143706, at *13 (Bankr. D. Or. Jan. 8, 2010) (internal quotation marks omitted) (citing *In re Daly*, 167 B.R. at 737).

Here, the Transferees are not listed as creditors in Debtor's chapter 11 schedules nor have they ever filed a proof of claim. The Transferees have not disgorged the funds received that are subject to avoidance, and they haven't even entered an appearance in this case. Despite all this, Debtor has included them as a separate class.

Similarly, the Guarantors are not listed as creditors in the schedules. Three of the Guarantors have not filed any proof of claim or entered an appearance in this case. Two of them filed claims only after the claims bar date, and none of the Guarantors has paid BACM the sums due under their respective guaranties.

All of these claims must be disallowed pursuant to 11 US. C. §502(b)(9) as not having been filed timely (or at all).

In addition to disallowance due to nonfiling or tardy filing, 11 U.S.C §§502(d) and 502(e) require that all of the purported Guarantor and Transferee claims be disallowed. If any of the Guarantors hereafter pays BACM's claim in full, the Guarantor(s) so paying would not have an independent claim that is separately classifiable for plan purposes; the paying Guarantor(s) would simply be subrogated to BACM's Class 1 claim.

Thus, if Debtor were acting in good faith as a fiduciary of the bankruptcy estate—and not seeking merely to meet voting requirements—it would protect the estate by challenging these claims for being untimely filed. Instead, Debtor has created these claims out of thin air, while at the same time challenging every aspect of BACM's claim. Under these facts, Debtor's attempt to create these classes of claims "is plainly contrived and engineered solely to create an accepting impaired class." This is not allowable under the Code. *In re Orchards Vill. Invs., LLC, supra.*

3. All of the Transferees are Insiders, Whose Votes Do Not Count.

Debtor's counsel suggested at the hearing on the RFS Motion that one or more of the Transferees might decide to disgorge the avoidable transfers received from Debtor prepetition in an effort to overcome BACM's Claims Objections. Even if the Debtor were to orchestrate such a maneuver, any vote that theoretically might be cast by any of the Transferees could not be counted for confirmation purposes because, as noted above, 11 U.S.C. §1129(a)(10) provides that the acceptance of a plan must be "determined without including the acceptance of the plan by any insider." Here, each of the Transferees is either a current or former shareholder of Debtor's sole member, East of Cascade, Inc. ("**EOC**"). At the time of each avoidable transfer, there was a close relationship between Debtor and the transferee who received the funds, and the transfer was made at a time when Debtor was in default under its obligations to BACM. As explained in detail in BACM's objections to Debtor's motion to temporarily allow the claims of the Transferees and Guarantors, each of the Transferees is an insider whose vote cannot be counted for plan confirmation purposes in any event. For all of the foregoing reasons, Debtor will not and does not have sufficient votes to obtain Plan confirmation.

B. <u>The Plan is Not Proposed in Good Faith</u>.

Under § 1129(a)(3), Debtor must show that its Plan has been proposed in good faith. The term "good faith" means that there exists "a reasonable likelihood that the plan will achieve a result consistent with the objectives and purposes of the Bankruptcy Code" and must be viewed

in light of the totality of the circumstances. *In re Madison Hotel Assocs.*, 749 F.2d 410, 415 (7th Cir. 1984). Debtor cannot carry its burden here.

As noted above, Debtor has attempted to create two classes of claims that must be disallowed as a matter of law, under Bankruptcy Code §§502(d) and (e). This gerrymandering is bad faith in its own right. But the Debtor adds insult to injury by proposing to assign certain avoidance claims to BACM in a manner intended to ensure pursuit of these claims is economically infeasible—specifically, requiring BACM to subtract any recovery from the amount of its claim, but none of the legal fees and costs incurred in such pursuit. Effectively, BACM would lose ground with every successful avoidance action. This is a blatant attempt to protect the Transferees from ever having to disgorge the substantial sums they received prepetition, and a breach of Debtor's fiduciary duties to the estate and its creditors. It is also noteworthy that the Plan proposes not to assign claims under 11 U.S.C. §549, so any post-petition transfers to Transferees would not be part of the claims assigned.

The terms of Debtor's loan repayment proposal also evidence bad faith, in that they provide for payment of no interest for two years, a pay-down of less than 5% of the principal balance over seven years, and an evisceration of the loan covenants. These all evidence an intent to impose unfair and uneconomic terms on BACM, and to pursue an aggressive refinance of a maturing note through the bankruptcy court.

C. <u>The Plan is Not Fair and Equitable</u>.

1. <u>The Plan is Not Fair and Equitable Because it Fails to Meet the Cramdown Requirements</u>.

The Plan fails to meet any of the three alternative requirements of S 1129(b)(2)(a).[3] In short, the Plan proposes to use BACM's cash collateral to pay unsecured creditors—and presumably, administrative expenses—without BACM retaining any lien in the funds paid. This

[3] BACM incorporates the arguments contained in its RFS Motion and in its Reply (Dkt. 219) as part of these Objections to the Plan.

Plan feature does not satisfy § 1129(b)(2)(A)(i), because BACM is not retaining its lien on the cash, and does not satisfy § 1129(b)(2)(A)(iii), because BACM will not realize the indubitable equivalent of its claim.[4] *See In re Arnold & Baker Farms*, 85 F.3d 1415, 1422 (9th Cir. 1996) ("[T]o the extent a debtor seeks to alter the collateral securing a creditor's loan, providing the 'indubitable equivalent' requires that the substitute collateral not increase the creditor's risk exposure."); *In re Am. Mariner Indus., Inc.*, 734 F.2d 426, 433 (9th Cir. 1984) (stating that two components of the indubitable equivalent standard are that it (i) "compensate for present value," and (ii) "insure the safety of the principal"); *In re Souza*, Case No. 12-13341 (Bankr. E.D. Cal. 2012, LEXIS 6169 (a copy of which is attached hereto as Exh. A) ("The use of a secured creditor's collateral post-confirmation to pay lower priority creditors as a means of reorganizing is not fair and equitable within the meaning of § 1129(b)(2)(A)(i)"); *In re Griswold Bldg, LLC*, 420 B.R. 666, 705-06 (Bankr. E.D. Mich. 2009) ("Debtors propose to use the Lender's cash collateral to pay claims that have a lower priority . . ., without providing any replacement collateral for the Lender. It is hard to see how that is fair and equitable.")

Debtor seeks to pay BACM's collateral over to unsecured creditors and to pay its administrative expenses free of BACM's lien. It provides no substitute collateral to compensate BACM for such use other than rents in the three new leases and one month-to-month tenancy that it has produced postpetition. Debtor has not proved that the present value of these agreements can even come close to the $68,000-plus of unsecured claims listed in Debtor's schedules plus administrative expenses that will be substantial. In fact, Debtor has absolutely no unencumbered assets, so it cannot provide BACM with adequate substitute security not already subject to BACM's lien. If Debtor is allowed to use BACM's cash collateral to pay its unsecured creditors and administrative expenses, Debtor will have less cash available to make payments on BACM's claim, and BACM will have less collateral to secure the amount owed.

[4] Because the Plan proposes no sale of collateral, 11 U.S.C. §1129(b)(2)(A)(ii) is not applicable here.

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As reflected in the authorities cited above, use of collateral in a manner that leaves a creditor with more risk is the opposite of the indubitable equivalent, and does not satisfy the cramdown requirements.

2. The Plan is Not Fair and Equitable Because the Proposed Interest Rate is Too Low.

For the Plan to be fair and equitable, it must include an interest rate that is appropriate, considering the market and the risks inherent in the Property and the Debtor. *See Till v. SCS Credit Corp.*, 301 F.3d 583 (2004); *In re Boulders on the River*, 164 B.R. 99, 105 (9th Cir. B.A.P. 1994); *In re Orchards Vill. Invs., LLC*, No. 09-30893-rld11, 2010 Bankr. LEXIS 48, at *53-57 (Bankr. D. Or. Jan. 8, 2010) (holding cramdown rate was "too low" when less risky loans were available at higher rates). The 4.75% rate proposed in the Plan does not account for the risks BACM must bear, including (i) an effective seven year extension of a nearly matured loan; (ii) no principal payments for the first two years; (iii) a pay-down of only 4.25% of principal over seven years, with payments based on a 41-year amortization period, leaving almost $10 million in principal due in 2020; (iv) no certainty regarding Debtor's ability to sell or refinance to pay that very large balloon payment at that time; (v) a greater than 100% loan-to-value ratio ; and (vi) an inadequate debt service coverage ratio;. *See* Aaronson Decl. Although the Plan and the Disclosure Statement do not identify any reason for selecting the 4.75% rate, it is obvious that Debtor has not considered what rate would be required to obtain a market-priced loan with these features. As reflected in the Aaronson Decl., the rate proposed by Debtor is unreasonably low, and the appropriate rate is 10.05% per annum.

3. The Plan is Not Fair and Equitable Because it Fails to Consider the Unsecured Portion of BACM's Claim and will Violate the Absolute PriorityRule.

Debtor claims that it will pay all unsecured creditors in full and thus it does not have to be concerned about the absolute priority rule, embodied in 11 U.S.C. §1129(b)(2)(B), or its inability to comply with the "new value" exception. The Plan does not account in any way for

the unsecured portion of BACM's claim.[5] Instead, the Plan allocates BACM's entire claim as "secured," regardless of the fact that the evidence will show that the Property's value is substantially lower than BACM's claim.

a. Debtor may not allocate BACM's entire Claim as a Secured Claim.

The option to make a Bankruptcy Code §1111(b) election belongs solely to the creditor, not the debtor. Bankruptcy Rule 3014 outlines the procedure for making an 1111(b) election, and clearly states "An election of application of § 1111(b)(2) of the Code ***by a class of secured creditors*** in a chapter 9 or 11 case may be made at any time prior to the conclusion of the hearing on the disclosure statement . . . the election ***shall be in writing and signed*** unless made at the hearing on the disclosure statement." (Emphasis added.)

There is no provision for a debtor to elect this treatment for an undersecured creditor's claim, nor should there be. Courts have repeatedly and explicitly stated that the right to elect fully secured claim status belongs solely to creditors, not to debtors. *See In re Channel Realty Associates Ltd. P'ship*, 142 B.R. 597, 600 (Bankr. D. Mass. 1992) ("A debtor who is proposing a plan cannot on its own initiative make the section 1111(b)(2) election and place an undersecured creditor into a single secured class."); *Matter of Coventry Commons Associates*, 155 B.R. 446, 500 (E.D. Mich. 1993) ("The choice of whether a secured claim will be treated as fully secured under section 1111(b)(2) belongs solely to the creditor."); *In re 266 Washington Associates*, 141 B.R. 275, 285 (Bankr. E.D.N.Y. 1992) *aff'd sub nom. In re Washington Associates*, 147 B.R. 827 (E.D.N.Y. 1992) (stating debtor's choice to classify an undersecured creditor's claim as fully secured is "in direct violation of 11 U.S.C. 506(a) and 1111(b)."); *In re B & B W. 164th St. Corp.*, 147 B.R. 832, 838 (Bankr. E.D.N.Y. 1992) ("It is abundantly clear that it is the Debtor who is making the

[5] The Plan also does not appear to provide for full payment of the purported Guarantors' claims. See Art. III.B.5.b. of the Plan. As explained above, those claims must be disallowed, per 11 U.S.C. §502(e), and Class 5 should be eliminated from the Plan, without prejudice to the Guarantors becoming subrogated to BACM's Class 1 claim if any of the Guarantors pays BACM in full.

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election to treat FNB's claims as fully secured. The law is equally abundantly clear that such a choice belongs only to the creditor."). Simply put, Debtor's proposed treatment of BACM's claim is impermissible and runs contrary to the Bankruptcy Code.

b. Debtor's Failure to Classify BACM's Deficiency Claim Cannot Satisfy the Absolute Priority Rule.

Section 1129(b)(2)(B) requires either that an unsecured creditor receive "property of a value, as of the effective date of the plan, equal to the allowed amount of [its] claim," or that no junior creditor receives any property. The inclusion of the phrase "as of the effective date" means, in the case of § 1129(b)(2)(A)(i), that the payments must have a discounted value equal to the amount of the claim.

Here, Debtor fails to provide for the treatment of BACM's deficiency claim, and therefore fails to carry its burden that the Plan complies with § 1129(b)(2)(B). It is unclear whether Debtor even proposes to pay interest on general unsecured claims. *See* Plan § 2(b) (providing for general unsecured claims to be paid "in full," and providing for interest to be paid only on Class 4 claims (i.e., Allowed Guarantor Claims).) Simply put, Debtor seeks to avoid the absolute priority rule, but has utterly failed to provide for the claim treatment that this would require.

4. The Plan is Not Fair and Equitable Because of the Proposed Changes in the Loan Terms and Documents.

Plans that seek to impose loan terms unavailable in the marketplace, as well as terms substantially different from those originally bargained for, are unfair and inequitable and therefore unconfirmable. *See In re D & F Constr. Inc.*, 865 F.2d 673 (5th Cir. 1989) (rejecting as unfair and inequitable proposal to convert one-year construction loan into 12-year financing for debtor); *In re Tri-Growth Ctr. City, Ltd.*, 136 B.R. 848, 852 (Bankr. S.D. Cal. 1992) (refusing to convert short-term loan into seven-year financing as invalid attempt by debtor to "shift the risks associated with a declining motel business on a secured creditor who did not bargain for those risks when it initially lent the funds").

Here, Debtor proposes to extend the term of the Loan, which matures in four months, for an additional *seven years*, to make no principal payments for two years, thereby substantially reducing the monthly loan payments, and to eliminate an entire, carefully drafted and negotiated 82-page loan agreement and replace it with four bare-bone, watered-down covenants, resulting in substantial impairment of the value of BACM's collateral. Then, after dragging out the Loan term, Debtor provides for payment of the remaining Loan balance via a speculative refinancing or a sale, neither of which alternatives is based on anything more than wishful thinking.

The Plan is also not fair and equitable because it would terminate all of the Loan documents except the Deed of Trust, thereby using the Code to defeat the perfection of all security interests governed by the Uniform Commercial Code and releasing the Guarantors. The Plan would eliminate a number of provisions included in the Loan documents designed for BACM's collateral protection, including, without limitation, the following:

(a) requiring rents to be paid directly into a lock-box account and to be distributed from a cash management account;

(b) establishing various reserve accounts to ensure sufficient funds are retained for payment of insurance, property taxes, tenant improvements, leasing commissions, replacement reserves, capital improvements, etc.;

(c) restricting transfer or alteration of the Property;

(d) requiring periodic inspections; and

(e) providing for other remedies.

All of the above provisions are meant and designed to protect BACM and its collateral. In view of Debtor's substantial diversion of rents and improper payments to insiders *in the face of such provisions*, the prospect of Debtor actually retaining funds to cover property-related expenses if the covenants were eliminated and otherwise performing responsibly is remote at best. Elimination of these protections that were expressly agreed to by the Debtor would impair BACM's legitimate interests in ensuring that rents are used for Property-related payments and

that the Property is protected and preserved, and would put both its cash collateral and the Property at risk of dissipation and loss.

There is simply no legal basis to eliminate these collateral protections in the Loan Documents. This is yet another reason that the Plan does not provide the indubitable equivalent of BACM's collateral position required under 11 U.S.C. §1129(b)(2)(A)(iii).

5. The Plan Unfairly and Unreasonably Shifts Business Risks to Lender.

The Plan proposes to replace the Loan, which matures in four months, with a new loan that provides for interest only payments for the first 24 months, and only small principal payments over the next five years. It appears that less than 5% of the principal balance will be paid during the entire seven year term, with approximately $10 million of principal remaining. (*See* Aaronson Decl., Exh. A.) In effect, BACM will be forced to hope for a substantial increase in the value of the Property—a property that is today worth at most $9.2 million—if it is to have any chance of being paid what it is promised. This is the epitome of a speculative plan and amounts to little more than a bet on the market. This is especially egregious where Debtor and its principals are adding no new value to apportion the risk.

6. The Plan is Not Fair and Equitable Because it Purports to Assign Avoidance Actions to BACM on Uneconomic Terms Designed to Protect the Transferees.

BACM incorporates all of the points in Section II.B above as though set forth in full here.

D. <u>The Plan is Not Feasible</u>.

Debtor has provided no explanation or detail regarding the underlying assumptions, nor any historical facts upon which it bases its budget and income projections. Yet, Debtor looks seven years into the future and boldly predicts that it will lease up the Property and either sell it or obtain a refinancing loan to make a balloon payment to pay the substantial Loan balance that will remain in seven years. Debtor does this while it knows that the Property as of today is worth no more than $9.2 million, and where it seeks to pay an interest rate that dramatically undercompensates BACM for the risks it faces. Even in the absence of any supporting detail, it

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is clear from the projections themselves that Debtor has not factored in the prospect that some very common problems may occur.

First, Debtor will simply be unable to sell or refinance the Property with sufficient funds available to make the necessary balloon payment unless the Property increases substantially in value. Debtor may hope this occurs, but any such hope—in the complete absence of evidence of market appreciation, a signed sale agreement at the hoped-for pricing, or a refinancing commitment at today's loan-to-value ratio—is little more than speculation.

Second, the Plan does not consider the costs of maintaining and increasing occupancy—in particular, the costs of renewing leases of existing tenants, including payment of commissions, rent concessions, and tenant improvement costs.

Third, the Plan fails to consider the prospect that one or more of the existing tenants may default and vacate, or that they may choose not to renew their leases when the terms expire. The projections also include no reserves for vacancy, maintenance, or unusual or unexpected capital expenses.

Fourth, and perhaps most telling, the Aaronson Decl. evidences that, once the appropriate interest rate of 10.05% is applied, Debtor simply does not have the cash flow to make its projected payments.

IV. CONCLUSION

For the foregoing reasons and others explained in the Aaronson Decl., BACM respectfully asks the Court to rule that the Plan fails to meet the Code's requirements for confirmation, and to grant the RFS Motion.

RESPECTFULLY SUBMITTED this 5th day of July, 2013

STOEL RIVES LLP

/s/ Andrew A. Guy
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CERTIFICATE OF SERVICE

I hereby certify that I caused copies of the foregoing document to be served on the following parties by CM/ECF on the date set forth below:

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DATED: July 5, 2013

/s/ Andrew A. Guy
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