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## **Litigation: A single-asset entity can't file bankruptcy and stop foreclosure** *In Mezz II, a precedent was set to dismiss bad faith bankruptcy filings*

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On Oct. 18, 2011, JER/Jameson Mezz Borrower II LLC (Mezz II), a mezzanine borrower for the Jameson Inns Inc. hotels, filed a Chapter 11 petition just hours before a scheduled UCC foreclosure sale of Mezz II's sole asset consisting of its membership interest in JER/Jameson Mezz Borrower I, LLC (Mezz I). *In re JER/Jameson Mezz Borrower II, LLCAs* a result of the Chapter 11 filing, the foreclosure sale was stayed.

Mezz II was formed in 2006 as part of a capital structure to acquire the Jameson Inns and Signature Inns hotel chains. As part of the capital structure, Mezz II and Mezz I (along with two other mezzanine borrower affiliates) were formed for the sole purpose of borrowing additional funds. Mezz II is the sole member of Mezz I.

The mezzanine debt's original maturity date was in August, 2008. Three available extensions were exercised and the maturity date was extended to Aug. 9, 2011. Mezz II and Mezz I were unable to repay the mezzanine debt obligations on the maturity date and the lender commenced enforcement actions by issuing a notice of intention to auction Mezz II's membership interest in Mezz I. The auction sale was scheduled for Oct. 19, 2011. The Mezz II lender also exercised an option to acquire the Mezz I secured debt.

Soon after the Mezz II bankruptcy filing, the lender filed motions to dismiss and for relief from the automatic stay to proceed with their foreclosure sale. The lender asserted that the bankruptcy filing was in bad faith under Bankruptcy Code section 1112(b) solely to avoid the foreclosure sale. Consequently, the lender sought dismissal with prejudice under Bankruptcy Code section 349(a). Mezz II argued that its intent was to reorganize and maximize value for all constituents. The hearing on the motions was set for Nov. 22, 2011.

Before the motions were heard, Mezz I and other affiliated mezzanine borrowers as well as the operating entities for the Jameson hotel chain each filed their own Chapter 11 bankruptcies.

In analyzing the lender's assertion that the case should be dismissed because it was filed in bad faith solely as a litigation tactic, the Bankruptcy Court began with the 3rd Circuit's "totality of facts and circumstances" test to determine whether the petition was filed for a valid reorganizational purpose.

According to the 3rd Circuit, the good faith inquiry is "based more on an objective analysis of whether the debtor sought to step outside the equitable limitations of Chapter 11 than the subjective intent of the debtor."

Rejecting the debtor's argument citing 2nd Circuit case law not adopted by the 3rd Circuit, the Bankruptcy Court held that it is the debtor's burden to establish that its petition was filed in good faith to preserve the debtor's going concern value rather than as a litigation tactic.

Citing *Primestone Partners, L.P.*, the Bankruptcy Court noted the following factors (amongst others) and found all to be present:

- Single asset case
- Few unsecured creditors
- No ongoing business and employees
- Petition filed on eve of foreclosure
- No cash or income
- Case was a two party dispute
- No pressure from non-moving creditors
- No possibility of reorganization
- Debtor filed solely to create automatic stay
- Subjective intent of the debtor

In discussing the two-party dispute nature of the case, the court specifically referenced testimony of Mezz II's sole non-independent director who admitted Mezz II filed bankruptcy to stop the lender's foreclosure sale and that the primary beneficiaries of the bankruptcy were affiliated mezzanine borrowers of the debtor.

The court next turned to whether the filing was for a valid reorganization purpose. While agreeing with the debtor that the court must consider the good of the entire enterprise—Mezz II's filing in relation to the other affiliated companies cases—the court found that “in the absence of substantive consolidation, Mezz II does not have any chance of confirming a plan.”

Finding that Mezz II's petition was filed in bad faith and for no legitimate bankruptcy purpose, the Bankruptcy Court found cause under Bankruptcy Code section 349(a) and dismissed with prejudice.

In deciding the motion for relief from stay and without delving too deeply into the value of the enterprise, the court concluded that there was an insufficient equity cushion to provide adequate protection to the lender and granted relief from stay under Bankruptcy Code section 362(d)(1). The court also granted relief from stay under Bankruptcy Code section 362(d)(2) holding that lender's collateral was not necessary to an effective reorganization. The bankruptcy case was dismissed on Dec. 22, 2011, a mere two months from the petition date. A motion for a stay pending appeal was denied on Dec. 23, 2011 and the lender was scheduled to foreclose the same day.

Jameson should be a cautionary tale to all debtors with little or no business operations who seek to file bankruptcy solely to forestall foreclosure without any ability to reorganize. Those debtors shouldn't assume they'll buy time and remain under the protections of bankruptcy for long.

#### About the Author



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