Continued Recession Not "Extraordinary Circumstance" Justifying Modification of Confirmed Chapter 11 Plan

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Affirming the bankruptcy court below in a case of first impression, in *In re Caviata Attached Homes, LLC*, 481 B.R. 34 (B.A.P. 9th Cir. 2012), a Ninth Circuit bankruptcy appellate panel held that a relapse into economic recession following a chapter 11 debtor's emergence from bankruptcy was not an "extraordinary circumstance" that would justify the filing of a new chapter 11 case for the purpose of modifying the debtor's previously confirmed plan of reorganization.

Modification of a Confirmed Chapter 11 Plan

Section 1141(a) of the Bankruptcy Code provides that the terms of a confirmed chapter 11 plan are binding on all parties. Section 1127(b) provides that a confirmed chapter 11 plan may be modified only before the plan has been substantially consummated. Under section 1101(2), "substantial consummation" occurs when: (i) substantially all of the property to be transferred under the plan has been transferred; (ii) the debtor or its successor has assumed the business or management of substantially all of the property dealt with by the plan; and (iii) distributions under the plan have commenced. Taken together, sections 1127(b) and 1141(a) impose an important element of finality in chapter 11 cases that allows stakeholders to rely on the provisions of a confirmed chapter 11 plan.

Although section 1127(b) prohibits modification of a substantially consummated plan, some courts have ruled that "serial" (successive) chapter 11 filings are not per se impermissible and that a second plan may modify the first plan if there has been an unforeseeable or unanticipated

change in circumstances. *See Elmwood Dev. Co. v. Gen. Electric Pension Trust (In re Elmwood Dev. Co.)*, 964 F.2d 508 (5th Cir. 1992); *In re 1633 Broadway Mars Rest. Corp.*, 388 B.R. 490 (Bankr. S.D.N.Y. 2008). However, as noted by the court in *In re Adams*, 218 B.R. 597 (Bankr. D. Kan. 1998), "[e]ven extraordinary and unforeseeable changes will not support a new Chapter 11, if these changes do not substantially impair the debtor's performance under the confirmed plan." Examples of unforeseen changed circumstances justifying a second chapter 11 filing and modification of a previous plan have included federal-law changes affecting tenancy of an apartment building, termination of service by major airlines that had provided vital customers for an airport hotel, crops or livestock lost due to weather or natural disaster, and substantial adverse judgments. The bankruptcy appellate panel considered this question in *Caviata Attached Homes*.

Caviata Attached Homes

In 2005, Caviata Attached Homes, LLC ("Caviata") obtained a $40.7 million recourse loan from California National Bank ("CNB") to develop a 184-apartment housing complex. In exchange, Caviata executed a promissory note and deed of trust, which assigned Caviata's right, title, and interest in the apartment complex to CNB. Caviata soon defaulted on the loan. In response, the parties entered into a series of forbearance agreements. Caviata, however, defaulted yet again. This time, CNB sued in state court to foreclose. CNB subsequently sold the loan to U.S. Bank, N.A. ("U.S. Bank").

In 2009, before the scheduled foreclosure trial, Caviata filed for chapter 11 protection in Nevada. The company filed a chapter 11 plan proposing to make payments on U.S. Bank's $27.5 million secured claim at a reduced rate of interest for three years, by the end of which Caviata would either sell the apartment complex or refinance the loan.

In its approved disclosure statement, Caviata expressly warned of the risks posed by a continued downturn in the economy on the value of the property and on Caviata's ability either to refinance the U.S. Bank loan or to realize sufficient value from a sale in three years to pay the secured claim of U.S. Bank in full.

U.S. Bank objected to confirmation, arguing that the plan was not feasible, because of, among other things, the declining value of the apartment complex and continued uncertainty in the real estate market. The bankruptcy court overruled U.S. Bank's objections and confirmed the plan. In so ruling, the court agreed with Caviata's witnesses that the apartment complex could be sold for at least $34 million within three years, "when the cycle of downturn would improve."

Caviata filed a second chapter 11 petition in Nevada 15 months later, in August 2011. Although it had not yet defaulted under its confirmed chapter 11 plan, Caviata contended that it would soon be unable to perform, due to an "unexpected" relapse into recession, particularly in the real estate market. At the time of Caviata's second chapter 11 filing, the value of the apartment complex was appraised at $21 million to $23 million.

U.S. Bank sought dismissal of the second chapter 11 case, arguing that the filing was a bad-faith attempt to circumvent the prohibition in section 1127 against modifications to a substantially consummated plan. Caviata countered that section 1127's prohibition does not apply where "extraordinary circumstances" substantially impair a debtor's ability to perform under its confirmed plan.

The bankruptcy court dismissed the case for "cause" under section 1112(b) of the Bankruptcy Code. The court ruled that, although Caviata did not act in bad faith by filing a second chapter 11 case, section 1127 barred the modifications that Caviata sought to make to its confirmed plan. According to the court, "[T]he fact that the economy changes doesn't relieve people from their contractual obligations." It added that "in 2010 there were certainly inklings that the economy was very bad" and that "just being wrong that the economy is worse than [Caviata] thought it was going to be is [not] a basis for filing a new plan." Caviata appealed the dismissal order.

The Bankruptcy Appellate Panel's Decision

The bankruptcy appellate panel affirmed, holding that changed market conditions cannot justify a second chapter 11 filing unless the changes were both unforeseeable and fundamental to the market itself. In Caviata's case, the court explained, the risk that the real estate and lending markets would not improve as expected was specifically identified by both Caviata in its disclosure statement and U.S. Bank in its objection to confirmation. It could not be said, therefore, that those conditions were unforeseeable. According to the appellate panel, Caviata did nothing wrong by using its "best guess" for an economic recovery when formulating its chapter 11 plan. Guessing wrong, however, was not an excuse to undo the plan once it was confirmed.

Outlook

From a creditor's perspective, *Caviata Attached Homes* underscores the importance of testing a plan proponent's assumptions in a proposed chapter 11 plan with a view toward blocking confirmation if the plan is unfeasible for whatever reason. Building a strong evidentiary record in connection with plan confirmation can forestall subsequent assertion in a serial chapter 11 filing that an eventuality was unanticipated or unforeseeable.

As in other contexts (e.g., orders approving asset sales), the finality of an order confirming a chapter 11 plan is an important part of U.S. bankruptcy jurisprudence. *Caviata Attached Homes* indicates that such finality is not easily skirted (regardless of how the subsequent challenge is formally framed), and stakeholders seldom receive another bite at the apple absent compliance with the Bankruptcy Code's strict requirements or, in some cases, a showing of extraordinary circumstances.