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The Sunwest Cases[1]: An Assault on SPE Structure

A. Radical Rulings from the Left Coast

Although the *GGP/General Growth* case garnered headlines and numerous articles on the impact to the SPE structure—the foundation of modern real estate finance—recent rulings by the U.S. District Court of Oregon and the Ninth Circuit Court of Appeals could also have far-reaching impact on SPE financing. While *Sunwest* is a procedural thicket, the central decisions in the case undermine the core principles behind "bankruptcy remote" SPEs and market expectations regarding SPEs.

B. Sunwest Management, Inc. and related Special Purpose Entities

During the last decade, an individual named Jon Harder developed an assisted living empire headquartered in Salem, Oregon. This empire was built using numerous special or single purpose entities (SPEs), each of which owned a separate assisted living facility. These assisted living facilities were managed by an affiliate, Sunwest Management, Inc. The individual assisted living facilities were financed by more than 100 secured lenders holding approximately $1.8 billion in secured debt. Each secured lender received a deed of trust on the real property and improvements owned by the individual SPE, and a security interest or assignment of rents on the revenues generated by the particular facility. Harder also obtained additional funds from investors, either through tenant in common (TIC) transactions or through LLC private

[1] The author represented a number of secured lenders in the Sunwest cases which together had loans totaling approximately $452 million.

placements. The Sunwest-related SPE properties reached their peak at just over 250 assisted living facilities.

In the summer of 2008, a number of Sunwest-related SPEs defaulted on their loans. In response, secured lenders began foreclosure and receivership proceedings. On December 31, 2008, Jon Harder filed a petition for relief under chapter 11 of the Bankruptcy Code in U.S. Bankruptcy Court in Portland, Oregon. Harder simultaneously commenced an adversary proceeding in the Bankruptcy Court against approximately 100 secured lenders, seeking a preliminary injunction under Section 105 of the Bankruptcy Code to prevent the exercise of foreclosure rights and the secured lenders' right to terminate Sunwest as manager of the assisted living facilities.

Efforts to implement that strategy in the Bankruptcy Court proved unsuccessful. On February 13, 2009, after a three-day evidentiary hearing, United States Bankruptcy Judge Trish M. Brown denied Harder's motion for injunctive relief. *Harder v. Premierwest Bank (In re Harder)*, 413 B.R. 827, 843 (Bankr. D. Or. 2009) ("The property owned by the LLCs is not property of Mr. Harder's bankruptcy estate."). Bankruptcy Judge Brown stressed that the only debtor in the Chapter 11 proceedings at issue was Harder and that Harder's ownership interests in the SPEs did not make those SPEs a part of the bankruptcy estate. (*Id.*) She further noted that the secured lenders would "face significant harm" by the issuance of the injunction sought, which failed to provide "any mechanism for obtaining adequate protection." (*Id.* at 839.)

C. The SEC District Court Action

On March 2, 2009, the Securities and Exchange Commission (the "SEC" or "Commission") filed a complaint against Harder, Sunwest Management, certain Sunwest affiliated broker-dealer companies, Sunwest insiders, and others in U.S. District Court in

Eugene, Oregon (U.S. District Court, District of Oregon Case No. 09-6056). The SEC alleged that the defendants were for several years engaged in a fraudulent scheme involving the sale of TIC interests in various assisted living facilities. The complaint alleged that "unless restrained and enjoined," the defendants would continue to violate the securities laws.

In the U.S. District Court case, the SEC sought a temporary restraining order and preliminary injunction pursuant to Rule 65 of the Federal Rules of Civil Procedure and Section 20(b) of the Securities Act of 1933 ("Securities Act") and Section 21(d) of the Securities Exchange Act of 1934 ("Exchange Act"), which provide that:

> Whenever it shall appear to the Commission that any person is engaged or about to engage in any acts or practices which constitute or will constitute a violation of the provisions of this subchapter . . . the Commission, may, in its discretion, bring an action . . . to enjoin such acts or practices . . .

15 U.S.C. § 77t; see also 15 U.S.C. § 78u(d)(1).

At the outset of the March 2, 2009 hearing on the SEC's TRO application, U.S. District Court Judge Michael Hogan expressed doubt that the SEC had demonstrated any risk of future securities law violations or any need for oversight by an SEC Receiver:

> I don't know that there are risks of commingling now, or of defrauding new investors. I'm not certain that having a receiver to handle the bank accounts is any better than the process that's set up.

Ruling from the bench, Judge Hogan denied the TRO sought by the SEC:

> With regard to – generally speaking as far as the scope of the TRO sought by the government today, I find that there has not been a significant showing of likelihood to further securities law violations or dissipation or commingling of assets.
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> * * *
>
> I'm not going to appoint a receiver at this time. I don't see the need for that given my finding a moment ago.

Despite these findings, later that same day Judge Hogan granted a TRO—agreed upon by all defendants—against secured lenders to the hundreds of Sunwest-related SPE entities (the same lenders Bankruptcy Judge Brown said two weeks earlier could not be enjoined). Secured lenders were not named in the complaint, and the SEC did not contend that lenders engaged in any improper conduct, or that they received any "ill-gotten gains" or funds to which they were not entitled. The March 2, 2009 TRO was entered without notice to secured lenders.

In the TRO, Judge Hogan found "good cause" to enter an injunction to "(i) preserve the status quo; (ii) prevent further dissipation of the property and assets of the Defendants and all entities they control or in which they have an ownership interest (the "Assets"); (iii) prevent the encumbrance or disposal of Assets; and (iv) protect investors' assets." The Court then ordered that "no creditor or claimant against any of the Defendants . . . shall take any action to interfere with the taking control, possession, or management of the Assets, including but not limited to the, the filing of any lawsuits, liens or encumbrances or involuntary bankruptcy cases to impact the Assets subject to this order or the seeking of the appointment of receivers to take control of the Assets . . ." The TRO also provided that "no person or entity . . . shall take any action to terminate any management contract between Sunwest Management, Inc. and any affiliate, including any entity that Defendant Harder controls or in which he has an ownership interest."

D. The March 10 Preliminary Injunction Hearing in the SEC Case

Eight days later, on March 10, 2009, Judge Hogan issued a Preliminary Injunction and Order Appointing Receiver (the "March 10 Order").

The March 10 Order provides among other things that:

> IT IS FURTHER ORDERED that no creditor of or claimant against any of the Receivership Entities, or any person acting on behalf of such creditor or claimant, shall take any action to

> interfere with the Receiver's or CRO's control, possession, or management of the Receivership Entities or any of their assets, including, but not limited to, the filing of any lawsuits, liens or encumbrances or bankruptcy cases to impact the Receivership Entities or any of their assets without further order of this Court. Without limiting the scope of the preceding sentence, no person or entity, including any creditor or claimant against any of the Defendants, or any person acting on behalf of such creditor or claimant, shall take any action to terminate any management contract between Sunwest and any of the Receivership Entities. This Order shall not be construed to stay or enjoin actions in pending bankruptcy cases, or state or federal receivership actions.

The March 10 Order also appointed a federal receiver for the Sunwest SPEs (the "SEC Receiver"). The secured lenders objected to the proposed relief and immediately appealed the injunction to the Ninth Circuit Court of Appeals.

E. Withdrawal of the Jon Harder and SPE Chapter 11's from Bankruptcy Court to District Court

Following his appointment, the SEC Receiver filed motions in the District Court to withdraw the reference[2] of the Jon Harder individual chapter 11 and another twenty-three pending Sunwest-related SPE chapter 11 bankruptcy cases in order to move those cases out of Bankruptcy Court and into District Court. The SEC Receiver invoked 28 U.S.C. § 157(d) and the purported conflict between the federal securities laws and the Bankruptcy Code in support of the withdrawal. The Harder case and the SPE chapter 11 cases were pending before Bankruptcy Judge Brown.

[2] To comply with the U.S. Supreme Court's ruling in *Northern Pipeline Co. v. Marathon Pipeline Co.*, 458 U.S. 50 (1982), Congress vested original jurisdiction of bankruptcy cases in Article III District Courts. The District Courts, as permitted by Congress, automatically "refer" all bankruptcy cases to the Bankruptcy Court. But when certain events and conditions exist, the District Court will "withdraw the reference" to the Bankruptcy Court and reassert jurisdiction over a bankruptcy case. (28 U.S.C. § 157(d))

Judge Hogan granted all of those motions in April 2009 and assumed control over the Harder and Sunwest-related SPE chapter 11 cases, while continuing to preside over the Sunwest/SPE receivership case. The pending Sunwest-related SPE chapter 11 cases included the case of *In re Stayton SW Assisted Living LLC*, which was the lead case in jointly administered chapter 11 cases involving 20 SPEs which were joint and several borrowers to a single secured lender.

F. The Plan of Distribution in the SEC Receivership Case: Equitable Consolidation Into a "Unitary Enterprise"

In late August 2009, the SEC Receiver and the CRO of the Sunwest receivership SPEs filed a "Plan of Distribution" in the SEC receivership case.

The central feature of the Plan of Distribution was a request for a judicial determination to "equitably consolidate" the assets and liabilities of the individual SPEs and Sunwest Management. The Plan of Distribution dubbed this "equitably consolidated" creature the Sunwest "Unitary Enterprise." The Plan of Distribution also provided that upon approval the SPEs would be transported into a pre-existing pending chapter 11 bankruptcy case (the *In re Stayton SW Assisted Living* chapter 11 case) without the filing of separate bankruptcy petitions by each SPE.

Secured lenders who were still subject to the pending injunction under the March 10 Order opposed the Plan of Distribution. A number of investors who held ownership positions in SPEs which held valuable properties with equity over the secured debt also objected. The District Court held a one-day hearing on the Plan of Distribution in late September 2009. On October 2, 2009, the District Court entered its findings of fact and an order approving the Plan of Distribution over all objections (the "October 2 Order").

In its findings, the Court stated that "a substantial body of case law . . . supports equitable pooling of the assets of receivership entities in order to enable pro rata distributions to investors in cases like this one . . . The Court is not bound in this Federal Receivership Case to apply the bankruptcy law concept of substantive consolidation or to follow bankruptcy case law regarding this separate and distinct concept." (Findings of Fact, ¶ 8)

The Court also found that "the Distribution Plan presents adequate means for the realization of the highest and best value of the Sunwest Enterprise for the benefit of all stakeholders, including through the recognition of the unitary enterprise and its reorganization through the Reorganization Plan [referring to a Chapter 11 plan of reorganization to be filed in the ensuing global consolidated Chapter 11 case]."

The Court's October 2, 2009 Order approving the Plan of Distribution provides that "the Receiver and the CRO are authorized to reorganize the unitary enterprise recognized by the Approved Plan through the pending chapter 11 case of *In re Stayton SW Assisted Living, LLC*, Bankruptcy Case No. 08-36637 pending before this court, as set forth in the Approved Plan."

G. The "Unitary Enterprise" Parachutes Into Bankruptcy

The October 2 Order approving the Plan of Distribution propelled hundreds of SPEs into the existing *Stayton SW* bankruptcy case. That same day, the "Unitary Enterprise" filed a number of "first day" pleadings to effectuate bankruptcy relief related to the assisted living facility assets held by the SPEs, including requests for the use of lenders' cash collateral and to displace previously appointed state court receivers.

The U.S. Trustee and certain secured lenders moved to dismiss the resulting chapter 11 case of the "Unitary Enterprise" on grounds that (1) the entity was not a legal entity, (2) the Unitary Enterprise was not a debtor eligible for bankruptcy relief, and (3) absent legitimate

bankruptcy petitions filed by the SPEs, the Court had no jurisdiction. In response, the Sunwest "Unitary Enterprise" filed a "precautionary" motion to substantively consolidate the SPEs. In December 2009, Judge Hogan entered an order substantively consolidating all of the SPEs and denying the motion to dismiss as moot.

H. Sunwest Rulings Issued by the Ninth Circuit Court of Appeals

1. The Preliminary Injunction Appeal

The Ninth Circuit issued a ruling on December 29, 2009 affirming in part, reversing in part and remanding the March 10 Order granting a preliminary injunction and appointing a receiver.

The panel, in an unpublished decision (Ninth Circuit Case No. 09-35250), stated that

> District courts have authority to issue injunctions such as this one. We have previously upheld the appointment of a receiver in a securities fraud case brought by the SEC. *See SEC v. Wenke*, 622 F.2d 1363, 1365 (9th Cir. 1980). We have also upheld the authority of the district court to bar all actions against receivership entities (including actions brought by non-parties). *See id.* at 1369; *accord SEC v. Hickey*, 322 F.3d 1123, 1131 (9th Cir. 2003). This authority stems from the district court's broad *in rem* jurisdiction over receivership assets. *Wencke*, 622 F.2d at 1369, 1370 n.11. Finally, district courts may stay foreclosure proceedings in an SEC enforcement action, *SEC v. Universal Fin.*, 760 F.2d 1034, 1037–39 (9th Cir. 1985), enjoin bankruptcy proceedings, *SEC v. Lincoln Thrift Ass'n*, 577 F.2d 600 (9th Cir. 1978), and sell receivership assets outside of bankruptcy proceedings, *See SEC v. Ross*, 504 F.3d 1130, 1145 (9th Cir. 2007).

The Ninth Circuit then held that "the district court abused its discretion in granting the preliminary injunction because it entered the preliminary injunction without findings and conclusions that support its action." The Ninth Circuit remanded to the District Court to make adequate findings and further stayed its own order for 60 days to allow the District Court sufficient time to make new findings. In other words, assuming that the District Court makes

findings on remand that are adequate to support the preliminary injunction and are grounded on proper evidence, it appears that the Ninth Circuit will not overturn the preliminary injunction.

2. Appeal of Approval of Plan of Distribution

A number of secured lenders also filed an appeal of the October 2, 2009 Order approving the Plan of Distribution and also sought a stay pending appeal. The Ninth Circuit summarily denied the motion for stay pending appeal, and issued an order to show cause why the Court should not dismiss the lenders' appeal of the order as interlocutory. The secured lenders, the Sunwest "Unitary Enterprise," the SEC, and the SEC Receiver all filed briefs arguing that the Order approving the Plan of Distribution was a final order subject to appeal. Nonetheless, in December 2009, the Ninth Circuit entered an order dismissing the appeal on grounds that it "did not resolve all claims as to all parties."

3. Appeal of Substantive Consolidation Order

Many secured lenders also appealed the District Court's December 22, 2009 order granting the motion to substantively consolidate the SPEs entered in the *Stayton SW* chapter 11 case. Those appeals are pending.

I. Impact of Sunwest Cases on SPE Structure

1. "Super Injunctions" in SEC Receivership Cases

The SPE structure is designed to make it more difficult for a borrower to avail itself of chapter 11 and thereby invoke an automatic stay against the enforcement of lender remedies. This "bankruptcy remote" structure (which factors into loan pricing) assumes that certain corporate authorizations and acts must be done, all in accordance with the borrower's organizational documents, before a bankruptcy petition can be filed and a case commenced (with the resulting stay of lender enforcement). SPE organization documents typically limit a solvent

SPE from filing a bankruptcy petition without the authorization of an independent director (for a corporation) or manager (for an LLC).

In the Sunwest case, SPEs were drawn into a giant bankruptcy-like collective proceeding with a de facto automatic stay (tantamount to an automatic stay under section 362 of the Bankruptcy Code) without the checks and balances established by Congress which arise upon the filing of a legitimate bankruptcy petition. In the Sunwest case, the Court (under color of the Securities Act, the Exchange Act, and enhancing investor recovery) issued a temporary restraining order and then a preliminary injunction of unlimited duration in an SEC Receivership to prevent lenders from foreclosing upon real property collateral, from obtaining appointment of a receiver, from taking control of project rents and revenues, from terminating the manager, or from enforcing any other rights and remedies.

The SEC in seeking this injunction did not allege any wrongdoing on the part of the lenders. Rather, the jurisdictional premise for the injunction was that once an SEC Receiver is appointed, a receivership *res* is created, and the Court, acting as a Court of equity, has jurisdiction and power to protect the *res* for the benefit of defrauded equity security investors. And in the Sunwest case, the defendants and the SEC contended that the exercise by secured lenders of their rights and remedies would harm the *res* through foreclosure. The following colloquy by counsel for defendant Jon Harder (the alleged fraudster) and the counsel for the SEC at the ex-parte March 2, 2009 TRO hearing gives color to this concept:

> MR ENGLISH (Harder attorney): "The---one of the powers that the receiver has in conjunction with the district court is the power to stop foreclosures. The receiver will cooperate with the disposition committee and the bankruptcy lawyers to use those powers to stop foreclosures as necessary to expand the equity interest of the estate.

> MR FICKES (SEC attorney): Agreed. And to effectuate that, the LLCs will be part of the Receivership"

The Ninth Circuit, in its unpublished ruling, appears to hold that a District Court has jurisdiction to enjoin innocent non-party secured lenders from foreclosing on their collateral once an SEC Receivership is created based on the *in rem* jurisdiction of the District Court over receivership property. Under the Ninth Circuit decision in Sunwest, there seems to be no showing required for the issuance of an injunction other than the need for protection of the receivership *res*. The Sunwest decision suggests that an SEC injunction against secured lenders is at least as broad as the automatic stay provided by the Bankruptcy Code, and that the inherent power of a District Court to enjoin secured lenders springs into being upon the mere creation of a receivership *res*.

2. "No Cash For You, Lender!"

A fundamental tenet of SPE finance is that an SPE is adequately insulated from the consequences of any related party's insolvency. Based on this insulation, a lender expects that its cash collateral and payment streams will continue to be used to service the SPEs obligations to its specific lender. In the Sunwest case, the cash collateral of hundreds of separate and distinct SPEs (again, without a bankruptcy petition) was drawn into a collective insolvency proceeding. The SEC Receiver and the CRO of the SPEs asserted dominion and control over all cash collateral. Payments to secured lenders were limited to monthly, non-default, contract rate interest. SPEs whose cash flow was inadequate to make those payments did not make any payments. No payments were made on past due interest, amortization, late fees, attorneys' fees or other charges.

3. "Equitable Consolidation"

Lenders which extend non-recourse SPE financing do so with the understanding that a bankruptcy court may, under certain and express circumstances, pool the assets and liabilities of the lender's SPE borrower with a parent entity or other affiliates and bring those assets into bankruptcy under the stringent "substantive consolidation" test. Under established case law, there is a two-pronged test for substantive consolidation: "(1) whether creditors dealt with the entities as a single economic unit and did not rely on their separate identity in extending credit; or (2) whether the affairs of the debtor are so entangled that consolidation will benefit all creditors." *In re Augie/Restivo Banking Co.*, 860 F.2d 515, 518 (2d Cir. 1986) (adopted by the Ninth Circuit in *In re Bonham,* 229 F3d 750 (9th Cir. 2000) (Internal citations omitted). The first factor is based on whether lenders "structure[d] their loans according to their expectations regarding the borrower and d[id] not anticipate either having the assets of a more sound company available in the case of an insolvency or having the creditors of a less sound debtor compete for the borrower's assets." 860 F.2d at 518-519. Consolidation under the second factor is justified only where "the time and expense necessary even to attempt to unscramble them [is] so substantial as to threaten the realization of any net assets for all creditors," *Id* at 519, or where no accurate identification and allocation of assets is possible.[3]

Lenders try to mitigate substantive consolidation risk by requiring "separateness covenants" in their borrower's loan documents as well as by insisting on a "non-consolidation" legal opinion from borrower's counsel. Such separateness covenants and non-consolidation opinions are designed taking into account the decisional law of substantive consolidation as

[3] The Third Circuit Court of Appeals has adopted a even stricter test for substantive consolidation in *In re Owens Corning*, 419 F.3d 195 (3d Cir. 2005).

developed over the last 70 years (going back to the Supreme Court case of *Sampsell v. Imperial Paper & Color Corp.*, 313 U.S. 215 (1941)).

In the Sunwest case, through the mechanism of the Sunwest Plan of Distribution, the SEC Receiver and the CRO asked the District Court to pool the assets—i.e., real property assisted living facilities—and liabilities of hundreds of distinct and separate SPE entities (each of which had separate lenders and investors) using its broad equitable powers under the Securities Act and the Exchange Act and as a "court of equity."

The District Court agreed that it had the inherent equitable power to order such relief. Significantly, District Judge Hogan stated that:

> A substantial body of case law concerning distributions through federal equity receiverships supports equitable pooling of the assets of receivership entities in order to enable pro rata distributions to investors in cases like this one. *Eustace*, 2008 WL 471574, at *6 (citing *CFTC v. Topworth Int'l, Ltd.*, 205 F.3d 1107 (9th Cir.1999); *Forex Asset Management*, 242 F.3d 325; *Elliot*, 953 F.2d 1560. The Court is not bound in this Federal Receivership Case to apply the bankruptcy law concept of substantive consolidation or to follow bankruptcy case law regarding that separate and distinct concept.

The cases relied upon by the District Court to "equitably consolidate" the Sunwest SPEs involved investors and circumstances from which it was impossible to identify cash or securities assets located in accounts. None of those cases involved secured lenders with recorded mortgages/deeds of trust in property titled in the name of different and distinct SPE entities. None involved secured lenders who made loans in reliance on the separateness of their SPE borrower entity. The District Court in Sunwest dramatically expanded the remedies in an SEC Receivership to the detriment of lenders' expectations.

The District Court's equitable consolidation in the SEC Receivership case lumped all of the SPE assets and liabilities together in one giant pool as a "Unitary Enterprise." Then, in the same Order, the Court transported the assets and liabilities of the "Unitary Enterprise" into a chapter 11 case for the express purpose of restructuring secured lender indebtedness under the Bankruptcy Code and reorganizing the fictitious "Unitary Enterprise" entity. In so doing, the Sunwest decision raises the specter of broad-stroke judicial pooling of affiliated but distinct SPEs under ambiguous and sweeping standards of equity, and irrespective of the long established doctrine of substantive consolidation.