UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF NEBRASKA

IN THE MATTER OF:	)	
	)	
TC PROPERTIES, LLC,	)	CASE NO. BK01-82345
	)	
Debtor(s)	)	CH. 11

MEMORANDUM

Hearing was held in Omaha, Nebraska, on March 22, 2002, on Debtor's Motion for Authorization to Incur Debt Secured by Senior Lien on Property of the Estate/to Borrow $800,000 (Fil. #16); and Objection by Avalanche Funding, LLC (Fil. #26). Marion Pruss appeared for the debtor, Michael Washburn appeared for Avalanche Funding, and Deborah Gilg and George Zeilinger appeared for Keith County. This memorandum contains findings of fact and conclusions of law required by Fed. R. Bankr. P. 7052 and Fed. R. Civ. P. 52. This is a core proceeding as defined by 28 U.S.C. § 157(b)(2)(D).

Facts and Analysis

This debtor owns more than 1,300 acres of unimproved land abutting the south edge of Lake McConaughy, a large reservoir located in Keith County, Nebraska, near Ogallala, Nebraska, which reservoir is used for agricultural irrigation, power generation, and recreation. The debtor has, prior to the bankruptcy filing, proposed a mixed-use residential and commercial development for the site which would include a marina on the lake, two 18-hole golf courses, a hotel and other commercial amenities, and approximately 1,700 residential lots with a variety of configurations permitting different sizes and types of housing. The plan proposes a long-term development process which will be initiated by the construction of basic infrastructure, including a water line connected to the City of Ogallala water system; a sewer line with appropriate equipment to catch effluent which would then be hauled to the City of Ogallala sewage treatment facility for proper treatment; and initial gravel-type surface road from the current county road which is some distance from the property, into and through the property and almost to the edge of the property which abuts the reservoir.

Since the purchase of this property in the year 2000, the debtor has spent a considerable amount of money preparing a marketing plan which includes conceptual drawings of the space at various times during completion of the project. Additionally, sums have been expended for legal and engineering services to obtain permission of the County of Keith to proceed with the development in compliance with the subdivision ordinances of the County. Preparation of the marketing plan, and accomplishment of the engineering and legal matters which are preliminary to the opportunity for actually marketing the lots, has taken considerably longer than was originally anticipated by the developer. Additionally, the developer has had a delay in obtaining significant financing which is necessary for proceeding with construction of the infrastructure.

The property was purchased in the year 2000 for a little more than $2 million. The purchase price was financed by the execution of notes and the granting of deeds of trust against the property. The first lienholder, after property taxes owed to the County of Keith, is Avalanche Funding, LLC, which is owed more than $1.6 million at the time of the hearing.

The debtor now wants to “prime” all of the liens represented by the deeds of trust, by borrowing $800,000 from an entity called Hard Money Funding, Inc. (“Hard Money”) and giving such lender a first lien status superior to that of all prior lenders. The net proceeds of the loan would be used to immediately begin construction of the road referred to above in order to provide access to the property for potential purchasers. In addition, some of the net proceeds would be used for development of the on-site marketing program and development of advertising, direct mail, and website marketing. Finally, some of the net proceeds would be used for surveying the initial lots and some of the money would be used to begin dealing with the items required by the County of Keith to enable the debtor to maintain its status as having obtained approval of its preliminary plat.

Of the $800,000, the debtor would actually have available only approximately $562,000. According to the term sheet itemizing the source and use of such funds, the debtor would be limited to using $250,000 for development of the road and approximately $300,000 for the marketing program.

The terms of the loan, although apparently legal, are not "good." As mentioned, the debtor will net only $560,000. According to the term sheet, the interest rate is 14% on an $800,000 loan. However, since the debtor will not net $800,000, but will pay 14% on the $800,000 number, the interest rate far exceeds the purported 14%.

The loan is for one year with no absolute right to renew. The term sheet provides that if lots in the development are sold, the lender participates in such sales by receiving a significant portion of the lot sale price.

Although the debtor takes the position that the property is worth somewhere between $7 and $15 million, the debtor has been unable to convince any lenders, other than Hard Money, to provide any money to initiate construction of the necessary infrastructure to market the project. Hard Money, apparently, insists that it must have a first lien position, no matter what the debtor's representatives believe the value of the property to be.

The holder of the first deed of trust, Avalanche Funding, LLC ("Avalanche"), objects to being placed in the subordinate position to Hard Money. Avalanche is owed approximately $1.6 million which was loaned against the $2 million asserted value at the time of its financing. It had a one-year loan, none of which has been paid and which is now more than a year delinquent. It is the position of Avalanche that its interest in the collateral, that is, the land, will be put in jeopardy and not adequately protected by equity in the property if the debtor is permitted to borrow $800,000 from Hard Money and give Hard Money a first lien on the property.

Three appraisals are in evidence. The debtor originally obtained an appraisal dated January 28, 2000, which valued the property at $2,734,000 or approximately $2,000 per acre. That appraisal was prepared by Thomas Luhrs, a general certified appraiser. Mr. Luhrs updated his appraisal on December 19, 2001. In that updated appraisal, he considered proposed improvements, rezoning of the real estate, scheduled approval of two subdivisions, and the possibility of public water availability from the City of Ogallala, Nebraska. His updated valuation is $7,335,000.

The debtor then obtained an appraisal from Frank Wilson, also a certified general real property appraiser in the State of Nebraska. He estimates the value of the property at $14,900,000.

Avalanche obtained an appraisal dated December 13, 2001, by Brandt Appraisal Company, Inc., Gary Brandt, Nebraska Certified General Appraiser. His opinion of value is $2,420,000.

Although each of the appraisers did a commendable job of obtaining information about the area and attempting to place a value on the property as if it were an ongoing development, none of them apparently had the benefit of considering the actual manner in which the developer proposes to develop the property. The marketing plan, or business plan, as referred to by one of the principals of the developer, suggests that lots, although of various sizes for residential purposes, would generally be significantly less than an acre in size and many, if not most of such lots, would sell for $40,000 or $50,000, if the roads, water and sewer were in place. None of the appraisals mentioned lots of such a small size or lot prices in such a range.

Both appraisals submitted by the debtor suggest that the valuation of the property as expressed by the appraiser is based upon the assumption of having the infrastructure in place. However, there is no infrastructure and, other than the proposal to put in an access road, there is no money available to put in any part of the infrastructure. In the deposition of one of the principals, he admits that in order to complete those items which are required by the Keith County Planning Board, and which must be completed before sales can begin, additional loans will be necessary. For example, detailed engineering drawings must be completed and financing arranged to activate the water contract with the City of Ogallala and install the water system. Although the debtor has a contract with the City of Ogallala with regard to a supply of water, the contract requires an initial net payment of $185,000, which the debtor does not have, plus construction of the water line, plus an annual fee for usage or access to the water.

There is no money available to the debtor to set up the sanitary improvement district which would control the sewer system. There is no money available to build the sewer system. There is no money available to upgrade the county road or to complete the interior roads which are necessary to provide access to the development after the initial road grading which will be paid for from funds to be made available by Hard Money.

The reality, as of today, does not support the valuation placed on the property by the appraisers for the debtor. There is no money to complete the improvements which would increase the value of the property from plain dirt to property which could be sold for residential use. Both appraisers for the debtor estimated the value of the property based upon significantly different assumptions from those which the developer proposes. There is no appraisal evidence based upon what the developer actually proposes for this property.

Representatives of the debtor and the appraisers for the debtor suggests that the value of the property has been increased because of the “sunken costs” which have already been expended to prepare the marketing plan and obtain approval of the Keith County Planning Board with regard to zoning and platting. However, such sunken costs provide no value unless there is evidence that the project has sufficient additional financing to enable it to get off the ground. The Hard Money loan does not provide sufficient funding to enable the project to get off the ground. It only provides funding to allow some grading, minimal surveying of lots, and an expenditure of funds for marketing. No infrastructure can be built with the Hard Money fund.

The value of the real estate today, for the purpose of determining whether there is sufficient equity over and above the Avalanche debt to permit the imposition of an $800,000 loan in first position, is determined to be that which is suggested by Mr. Brandt, $2,420,000. That value recognizes the current status of the property as undeveloped.

Even if it could be found that the value of the property is far in excess of $2,400,000, such supposed "equity" over and above the interest of the first lienholder, does not necessarily provide adequate protection for the interest of the first lienholder. The actual terms of the Hard Money loan may not be before the court. The term sheet that is in evidence at Exhibit 1A is not signed by a representative of Hard Money. Those terms which are included on Exhibit 1A do not itemize closing costs, attorney fees, approvals, title reports and "costs of the loan" which are to be paid by the borrower. On the other hand, a significant term is contained in the last paragraph on page 2 of Exhibit 1A. That paragraph states,

> In the event TC Properties, LLC, successfully discharges the bankruptcy, and moves forward with either a PUD development or land sales program and in acknowledgment of Hard Money's contributions, a "Success Fee" of $260,000 is due and payable; plus, 3% of lot sales prices on lots/land reserved, sold and/or conveyed during the 12-months from the closing of this loan within the Trails Crossing Resort project.

Although the meaning of that paragraph is not exactly clear, one could infer that the first lien to be granted Hard Money supports an additional obligation of the debtor to pay $260,000 and an amount equal to 3% of lot sale prices for each lot reserved during the next twelve months. In other words, even if the sale of lots did not close during the twelve months following the closing of the loan, for each lot on which the developer/debtor obtains a tentative commitment from a potential buyer, 3% of the "sale price" on such committed lots would be due and payable. If not paid, such amounts would increase the amount of the debt which would "prime" the position of Avalanche.

The factual issue before the court is not whether the property will someday be improved to such an extent that its value will be $7 to $15 million. The factual issue is whether Avalanche may remain adequately protected by a significant equity cushion if the Hard Money loan is given lien priority over Avalanche and no other funds become available to the debtor to take out Avalanche during the one-year term of the Hard Money loan. At the end of that one-year term, Hard Money would have the legal right to foreclose. If the condition of the property at that time is similar to the condition of the property at this time, that is, undeveloped, interest will have continued to accrue on the Avalanche debt and there is a likelihood that, after costs of foreclosure and payment of the Hard Money debt, there will be insufficient equity left to permit full payment of the Avalanche obligation.

Law

A debtor may “prime” the lien of a senior creditor under 11 U.S.C. § 364(d) in order to obtain secured post-petition financing, if certain conditions are met.

Section 364(d) provides:

> (1) The court, after notice and a hearing, may authorize the obtaining of credit or the incurring of debt secured by a senior or equal lien on property of the estate that is subject to a lien only if –
>
> > (A) the trustee is unable to obtain such credit otherwise; and
> >
> > (B) there is adequate protection of the interest of the holder of the lien on the property of the estate on which such senior or equal lien is proposed to be granted.
>
> (2) In any hearing under this subsection, the trustee has the burden of proof on the issue of adequate protection.

The issue of adequate protection is governed by § 361: the debtor may provide adequate protection of the creditor’s interest by making cash payments, offering an additional or replacement lien, or by otherwise fashioning a method of providing the creditor with the indubitable equivalent of its interest in the property.

The underlying purpose of the adequate protection requirement of § 364(d) is to ensure that secured creditors are not deprived of the benefit of their bargain. The debtor should make certain that the pre-petition creditor receives the same level of protection it would have had absent post-petition super-priority financing. In re Swedeland Dev. Group, Inc., 16 F.3d 552, 564 (3d Cir. 1994) (en banc).

The existence of adequate protection is a fact-specific inquiry, but "its focus is protection of the secured creditor from diminution in the value of its collateral during the reorganization process." In re Beker Indus. Corp., 58 B.R. 725, 736 (Bankr. S.D.N.Y. 1986).

Because super-priority financing displaces liens on which creditors have relied, courts contemplating authorization of such financing "must be particularly cautious when assessing whether the creditors so displaced are adequately protected." In re First South Sav. Ass'n, 820 F.2d 700, 710 (5th Cir. 1987).

In In re Mosello, 195 B.R. 277 (Bankr. S.D.N.Y. 1996), the debtors' motion to borrow was denied because the debtors did not meet their burden of proof on adequate protection, given the debtors' lack of equity in the property, the speculative nature of their real estate development project, the uncertainty of their future income stream, and the clear diminution of the value of the first lienholder's interest in the property in the meantime.

The Mosellos owned two pieces of undeveloped property in Mount Pleasant, NY. They used the property as collateral to secure a $1 million loan. The debtors eventually defaulted, and filed their Chapter 11 case to forestall a foreclosure sale. The value of the property was disputed, but the parties agreed that the first mortgage exceeded whatever value was placed on the real estate, so the debtors had no equity in the property. There was also a second mortgage of $600,000, in addition to the $350,000 the debtors sought to borrow post-petition.

The debtors ultimately filed a liquidating plan under which they would sell all the lots, but they first needed financing in order to develop the property with roads, sewer lines, and other infrastructure to put the property in salable condition. The debtors proposed borrowing $350,000 from Monetary Advisory

Corp. to develop 20 residential lots, sell the lots, pay the first mortgage holder (an entity called Acquvest), and “provide a modest recovery for the unsecured creditors” as well as some profit for themselves.

The “funding agreement” between the debtors and the Monetary Advisory Corp. contained the “substance of the proposed funding” and contemplated the execution of financing statements, security agreements, mortgages and mortgage notes, and other necessary documents. The funding agreement purported to be a proposal to lend up to $350,000 to the debtors, but the agreement did not constitute a binding commitment by the lender to provide any amount of financing. The terms of the agreement indicated the loan, if any, would be at the sole discretion of the Monetary Advisory Corp. The loan would be for one year, with no commitment by the lender to renew or refinance the loan.

The funding agreement provided that Monetary Advisory Corp. would be given a senior secured super-priority lien on the real estate which could not be primed or equaled by any future lien on the property.

The interest rate on the loan would be 16 percent, paid monthly. The lender required an “initial fee” of 6 percent of the loan amount. All expenses and costs, including attorneys’ fees, incurred by the lender were to be paid by the debtors. Renewal or refinancing would require an additional fee of 3 percent, to be paid at or before renewal.

The funding agreement also contained specific provisions regarding the debtors’ use of proceeds from the lot sales: 10 percent for debtors’ operating overhead; $40,000 from the sale of each lot for the release of Acquvest’s lien; and up to 7.5 percent of the sales price of the first 15 lots and up to 10 percent of the sales price of the next 5 lots for unsecured creditors.

However, notwithstanding these distributions, the Monetary Advisory Corp. was to receive $25,000 per lot from the sale of the first two lots, and $50,000 per lot from the sale of the next six lots.

Finally, the loan would terminate and all amounts advanced by the lender would immediately become due and owing when the property was transferred or otherwise disposed of, a trustee was appointed, the case was converted to Chapter 7, a motion for relief was granted, or a lien senior or equal to the lender's was granted.

After an evidentiary hearing on Acquvest's objection to this proposed financing, the court reached the following conclusions:

< of the competing appraisals offered as evidence, the valuation determinations of Acquvest's appraiser were more reliable. The debtors had experienced neighborhood opposition to their proposed development and were having difficulty getting the necessary zoning and planning approvals. Therefore, the appraisal based on a smaller number of salable lots was probably more credible. Likewise, the purchase offers that debtor had received for lots prior to bankruptcy were in line with the sales figures used by Acquvest's appraiser, while the debtors' sales figures were inflated;

< the debtors met their burden of establishing an inability to obtain other financing;

< on the issue of adequate protection, the debtors had no source of cash to make cash payments, nor did they have any unencumbered property on which to offer a replacement lien;

< the evidence failed to support the debtors' proposition that using the proceeds from the Monetary Advisory Corp. would result in an increase in the value of the real estate greater than the amount of the loan, and that the increase would constitute adequate protection against diminution of Acquvest's interest in the property. For further discussion of that proposition, see <u>In re Swedeland Dev. Group</u>, 16 F.3d 552 (3d Cir. 1994) (en banc):

> [C]ontinued construction based on projections and improvements to the property

> does not alone constitute adequate protection. Those cases which have considered improvements to be adequate protection have done so only when the improvements were made in conjunction with the debtor’s providing additional collateral beyond the contemplated improvements. We reject the notion that development property is increased in value simply because a debtor may continue with construction which might or might not prove to be profitable.

16 F.3d at 566 (internal citations omitted).

< the development project was simply too uncertain and risky to find that adequate protection exists:

- the funding agreement was “illusory,” because the debtors would require more money, according to their own calculations, than the lender was willing to provide (assuming, of course, that it was actually willing to provide any money, given the lack of commitment on that point), and because the required repayments from lot sales were more than would be available from such sales;

- the number of lots was unclear, because the planning board had not approved the debtors’ proposal;

- there was no credible evidence as to what price lots would sell for, when and if they were ever developed;

- the development costs were not reliable. The debtors used engineering estimates rather than contractor bids for the budgeted drainage, road, sewer, and utility costs, and some expenses had been left out altogether, such as the services of a project manager, professional fees for obtaining planning board approval, and so forth.

- the timing of approval and development was unclear. Despite the debtors' optimism, the court favored the presumably more realistic estimates of Acquvest's witness that final approval for the second part of the subdivision may take up to two years.

- potential for additional delays in building the road, sewer, and utility facilities, and in marketing the lots. The court said that too many variables outside the debtors' control existed in this regard (weather, local economy, and so forth);

- increased costs associated with any delay; and

- lack of working capital. The debtors' three-year projections showed a loss after the first year, which would be compounded over the following two years. The debtor would have to spend more than the Monetary Advisory Corp. intended to lend to make up the deficit. Moreover, lots would have to sell faster and at a better price than anticipated, <u>and</u> the debtors would have to forego the proposed set-asides for unsecured creditors as well as any principal payment to Acquvest, in order for the budget to work. The court found that to be simply impossible.

In coming to this conclusion, the court distinguished two cases relied on by the debtors. The first case was <u>In re Dunes Casino Hotel</u>, 69 B.R. 784 (Bankr. D.N.J. 1986). The <u>Mosello</u> court pointed out that in the <u>Dunes</u> case, the parties had an equity cushion of at least $8 million. Moreover, the proposed super-priority financing was only a fraction (approximately 4 percent) of the total indebtedness. In contrast, the Monetary Advisory Corp. money (loan plus interest plus legal fees plus percentage points) sought by the Mosellos amounted to a significant portion of the total indebtedness in the case.

The second case distinguished by the Mosello court was In re 495 Central Park Ave. Corp., 136 B.R. 626 (Bankr. S.D.N.Y. 1992). In that case, super-priority post-petition financing was approved because the debtor owned an established office building and sought a loan to renovate part of the building to attract higher-paying tenants. The evidence showed that the renovation would immediately increase the value of the building by more than the amount of the post-petition loan. In addition, the debtor identified its prospective tenants and the rent they were willing to pay for the renovated space. The speculative and uncertain elements of the Mosello case did not exist in the 495 Central Park case.

When determining whether adequate protection exists, the amount of debtor's equity in the property exceeding the claims against the property must be considered. There is a line of cases, following In re Aqua Associates, 123 B.R. 192 (Bankr. E.D. Pa. 1991), which says that the presence of an equity cushion is a relevant factor, but should not be the defining factor, in an adequate protection analysis.

> An equity cushion analysis contains certain inherent pitfalls. It must first be determined whether "going concern" or "liquidated" value is in issue. Then, a determination highly dependent on the forensic skills of "dueling appraisers" must be made. Conceptually, making such an analysis determinative may permit a debtor who can establish an equity cushion to foolishly "let the air out" of an equity cushion, while, on the other hand, it may direct the denial of permission to a debtor who lacks an equity cushion to enter into a transaction which is demonstrably wise and resourceful.
>
> Therefore, we believe that, while the presence of an equity cushion should be a relevant factor, it should not be a determinative factor in any "adequate protection" analysis, and particularly one relating to § 364(d)(1)(B). The

> important question, in determination of whether the protection to a creditor's secured interest is adequate, is whether that interest, whatever it is, is being unjustifiably jeopardized.

123 B.R. at 196 (internal citations omitted).

Decision

The motion is denied. The proposed financing and "priming" of the lien position of Avalanche will not permit the interest of Avalanche to be adequately protected, because the value of the property in its present condition and in the condition that it will probably be in approximately one year from today, is no more than the total debt of Avalanche, plus interest, plus the total loan of Hard Money. Therefore, the likelihood of injury to the interest of Avalanche is significant. The debtor has no other assets, at this time, and no other financing which would permit the debtor to provide adequate protection to Avalanche in another form.

Separate judgment to be filed.

DATED: April 8, 2002.

BY THE COURT:
s/Timothy J. Mahoney
Timothy J. Mahoney
Chief Judge

Notice given by the Court to:
*Marion Pruss
Michael Washburn
Deborah Gilg & George Zeilinger
United States Trustee

Movant (*) is responsible for giving notice of this order to all other parties not listed above if required by rule or statute.

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Debtor(s)	)	CH. 11

JUDGMENT

The motion for authorization to incur debt secured by senior lien on property of the estate/to borrow $800,000 (Fil. #16) is denied. The proposed financing and "priming" of the lien position of Avalanche does not adequately protect the interest of Avalanche and cannot be permitted. See Memorandum filed this date.

DATED: April 8, 2002

BY THE COURT:
s/Timothy J. Mahoney
Timothy J. Mahoney
Chief Judge

Notice given by the Court to:
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Deborah Gilg & George Zeilinger
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