

DOLLARS FOR DIRT: CREATIVE FINANCING OPTION FOUND IN DEVELOPER BANKRUPTCY



BY CANDANCE C. CARLYON, ESQ.

Nevada has been hard-hit by the recent economic downturn. The number of Chapter 7 and 11 bankruptcy cases filed in Nevada doubled in the first quarter of 2008 compared to 2007, and such filings for the first two months of 2009 are double that of the same period in 2008! The tumble in real property sales has been at the forefront of the economic decline.

While Bankruptcy Chapter 11, “reorganization,” implies some type of ongoing operations or development, declining prices and tight credit markets have created a surge of real property (or “dirt”) cases involving overleveraged assets with no source of funding for such a reorganization effort. Recently, the Nevada Bankruptcy Court approved an unusual financing tool brought together by a savvy bankruptcy trustee, an innovative, newly-opened financial institution and a cast of supportive creditors and professionals.

In *In re Tower Homes, LLC*, BK-S-07-13208-BAM, a trustee, W.A. “Biff” Leonard, Jr., was appointed to manage the Chapter 11 reorganization effort.¹ The case involved a partially constructed condominium development, listing claims in excess of \$100 million. Leonard immediately saw that funding was needed

in order to maintain entitlements, pay for needed permits, secure and insure the property and provide for payment of the expenses of administering the bankruptcy case. While the secured creditors agreed that such funding was necessary, the existing lienholders were unwilling or unable to make additional advances.

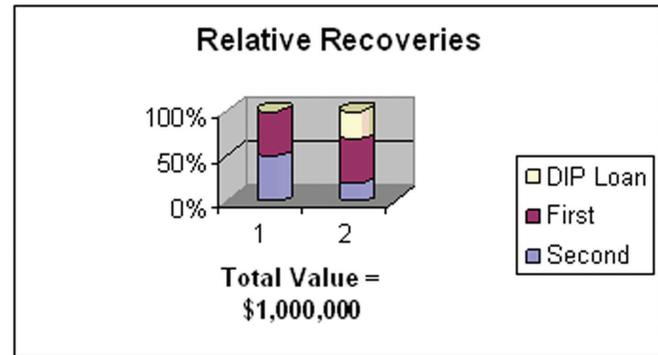
The Bankruptcy Code provides for the possibility of approving financing with a variety of potential lender protections. These include, in appropriate circumstances:

1. Granting a “superpriority” administrative expense, such that the loan is paid prior to all other creditors from any unencumbered assets of the bankruptcy estate;²
2. Granting a lien on unencumbered assets;
3. Granting a junior lien on encumbered assets; and
4. Granting a senior (“priming”) lien with priority over existing liens.

Of these protections, the fourth is both most valuable and most problematic. The general standards for approving a priming lien include a showing that existing secured creditors will be “adequately protected,” and that the financing is not available

without the requested protections. Where the estate assets are overencumbered (*i.e.* the value of the property is less than the liens against it), adequate protection is virtually impossible to provide.³ In such a situation, junior lienholders already expect to receive less than full recovery; thus, as a general matter, every dollar advanced with a higher priority decreases the value of the junior lien. This concept is illustrated in the chart below, which assumes property worth \$1 million, with a first deed of trust securing a debt of \$600,000; a second deed of trust securing a debt in the amount of \$500,000; and a proposed “priming lien” of \$300,000.

In the *Tower Homes* case, the secured creditors consented to the priming lien. However, the trustee faced the hurdle of obtaining a source of funding. While Chapter 11 Debtor-in-Possession (DIP) loans are the subject of a national market, generally such loans involve millions of dollars and carry transactional costs in the six figures. Leonard reached out to the recently-opened Bank of George (as in Washington). Diane Fearon,⁴ President and CEO of Bank of George, agreed to consider the request.



Fearon first identified the comfort level, on a conceptual basis, with the bank's loan committee. In order to proceed, it would be necessary for the bank to obtain a current appraisal, as well as input from counsel with regard to the structure of the proposal. Finally, significant time would be required on the part of bank employees, due to the unusual nature of the request. The trustee obtained emergency approval to grant a priority for the appraisal fees, legal

CONTINUED ON PAGE 18 ►

DOLLARS FOR DIRT

CONTINUED FROM PAGE 17

fees and the bank's 2-percent loan origination fee, so that the bank would not suffer "out-of-pocket" losses if the loan was ultimately not approved by the bankruptcy court. Ultimately, the bankruptcy court approved the full funding request of \$550,000 (inclusive of loan costs and interest reserve).

The *Tower Homes* case illustrates both the flexibility of the bankruptcy code to facilitate practical business oriented solutions to financial problems, and the ability of seasoned professionals to achieve such results. [NL](#)

-
- 1 Generally, there is no trustee appointed in a Chapter 11 case; rather, the owner (or "debtor") remains in possession and control of the assets and management, thus the term "Debtor-in-Possession."
 - 2 Such a priority is of little value if, as is increasingly common, there are no "unencumbered assets" of the bankruptcy estate.
 - 3 The "classic" form of adequate protection is an "equity cushion" in the real property – that is, where the value of the real property is sufficiently in excess of the amount of the secured debt that existing lienholders are clearly expected to receive payment in full, even after payment of the new loan. Of course, if such equity actually existed, it would likely be unnecessary to provide for "priming" existing creditors, since the new lender would be adequately secured by a junior position. In today's market, demonstrating a true and sufficient "equity cushion" is challenging, to say the least.
 - 4 DFearon@BankofGeorge.com.

CANDACE CARLYON is a shareholder at Shea & Carlyon, Ltd. in Las Vegas. A graduate of Pepperdine University School of Law and former law clerk to Nevada Supreme Court Justice Cliff Young, Carlyon represents numerous financial institutions and secured creditors, as well as representing selected debtors, committees and trustees in commercial cases. She is a frequent author and lecturer, and has been certified by the American Board of Certification in the area of commercial bankruptcy since 1994. Carlyon also serves as a Nevada Supreme Court Settlement Judge; Short Trial Judge; and is an officer and member of numerous professional organizations. She can be reached via e-mail at ccarlyon@sheacarlyon.com.