

1 PAUL B. SNYDER
United States Bankruptcy Judge
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5 **March 16, 2009**

6 MARK L. HATCHER
CLERK U.S. BANKRUPTCY COURT
WESTERN DISTRICT OF WASHINGTON
7 AT TACOMA
DEPUTY

8 **UNITED STATES BANKRUPTCY COURT
WESTERN DISTRICT OF WASHINGTON AT TACOMA**

9 In re:
10 PACIFIC LIFESTYLE HOMES, INC.,
11 Debtor.

Case No. 08-45328

**MEMORANDUM DECISION
NOT FOR PUBLICATION**

12
13 THIS MATTER came on for an evidentiary hearing on February 17, 18 and 20, 2009, on Pacific
14 Lifestyle Homes, Inc.'s (Debtor) Motions Seeking Entry of An Order Under Sections 361 and 363¹ of
15 the Bankruptcy Code, Authorizing Debtor's Use of Cash Collateral and Granting Adequate Protection
16 for Bank of America, N.A. (BofA) and KeyBank, National Association (KeyBank) (collectively the
17 Lenders and Motions).² Both Lenders filed an objection to the Debtor's Motions, as did the Official
18 Committee of Unsecured Creditors (Committee). At the conclusion of the hearing, the Court took the
19 matter under advisement. At the parties' request, post-hearing briefs were filed on March 5, 2009, to
20 provide additional legal authority on cash collateral. This Memorandum Decision shall constitute
21 Findings of Fact and Conclusions of Law as required by Fed. R. Bankr. P. 7052. This is a core
22 proceeding under 28 U.S.C. § 157(b)(2). Based on the pleadings, testimony, and evidence presented,
23 the Court's findings of fact and conclusions of law are as follows.

24 ¹Unless otherwise indicated, all "Code," Chapter and Section references are to the Federal Bankruptcy Code,
25 11 U.S.C. §§ 101-1532, as amended by BAPCPA, Pub. L. 109-8, 119 Stat. 23, as this case was filed after
October 17, 2005, the effective date of most BAPCPA provisions.

² The Debtor also sought use of West Coast Bank's cash collateral, but prior to the hearing, the Debtor and West
Coast Bank reached a contingent agreement.

I

FINDINGS OF FACT

There was conflicting information regarding some of the basic facts of this case among the pleadings, testimony, and hearing exhibits. The Court's Findings attempt to reconcile these conflicts.

On October 16, 2008 (Petition Date), the Debtor filed a voluntary petition for relief pursuant to Chapter 11. The Debtor continues to operate its business and manage its property as a debtor in possession.

The Debtor is a Washington corporation headquartered in Vancouver, Washington. One of the largest homebuilders in Southwestern Washington and Northern Oregon, the Debtor develops and sells real estate for residential purposes. The Debtor's core business is to acquire real estate, obtain the necessary government permits and approvals required for the property to be platted, either as a single family home or legal subdivision, construct the infrastructure, and construct the residential dwellings on each lot. The Debtor also constructs homes for owners on land owned by the owners. The Debtor offers design services to its customers to help customize their new homes. The Debtor has won numerous awards for its homes and design plans.

In years prior to 2008, the Debtor was constructing approximately 250-300 homes per year. The Debtor suspended the majority of its construction activities on its property in August, 2008, because its lenders stopped making advances under the Debtor's existing credit facilities. Testimony establishes that the Debtor is experiencing its current financial difficulties primarily because of the general financial and housing collapse. As of the Petition Date, the Debtor had approximately 9 communities under construction.

A. Bank of America

Commencing in 2006, BofA made a series of loans (BofA Loans) to the Debtor and its former subsidiaries and affiliates evidenced by promissory notes and secured by deeds of trust (collectively the BofA Loan Documents) on real estate located in both Washington and Oregon. The BofA Loans

1 were made on the following projects currently held by the Debtor's bankruptcy estate³: Songbird,
2 Osprey Pointe, Banner Properties (acreage properties that were not part of a specific development),
3 and Cassini View.⁴ The Debtor is seeking to use cash collateral as defined in § 363(a) (Cash
4 Collateral) from all of these projects except Cassini View (BofA Projects).

5 As of the Petition Date, it appears the BofA Projects were comprised of 22 completed homes,
6 three partially constructed homes and 34 finished lots.⁵ BofA and the Debtor stipulated that as of
7 October 16, 2008, the Debtor owed BofA \$21,973,689.36 in principal and interest.⁶ Debtor's Exhibit 1
8 establishes that as of January, 2009, the Debtor held a total of \$4,300,665 in Net Cash Proceeds from
9 BofA Projects. BofA's post-hearing brief indicates that there is Cash Collateral in the amount of
10 \$4,300,300.

11 1. Songbird

12 Songbird is a subdivision with a total of 39 lots, located in Vancouver, Clark County,
13 Washington. BofA and the Debtor stipulated that as of February 12, 2009, there were 26 lots and
14 three homes unsold (one home in closing, one partially completed, one model home). Debtor's Exhibit
15 9 provides a comparison of the values of the unsold lots as determined by Debtor's appraiser The Zell
16 Company d/b/a Zell & Associates (Zell) and by BofA's appraiser PGP Valuation, Inc. (PGP):

	<u>Debtor</u>	<u>BofA</u>
17 Retail Lot Value	\$100,000	\$110,000
18 Bulk Lot Value	\$ 67,307	\$ 85,000
19 Liquidation Lot Value	\$ 40,384	\$ 68,077

20
21 The Per Lot Adequate Protection Payment is listed as \$57,000, which is 85% of the Debtor's bulk sale
22 appraisal. This is a decrease from the amount of \$82,000 originally proposed in the Motions.

23
24 ³ Not listed as estate property are projects that are owned by separate entities or that were transferred to a
25 different entity or a "liquidating trust" prior to bankruptcy.

⁴ Evidence was unclear as to the status of Cassini View.

⁵ Finished lots, or just "lots," are lots ready for home building.

⁶ This debt includes loans made on property not part of the estate.

1 The modeling prepared by Clyde A. Hamstreet & Associates, LLC, at Debtor's Exhibit 1,
2 indicates that the Debtor proposes to start construction of one new house per month at Songbird for
3 four months. With a four-month construction period, the Debtor shows a sale in June, two in
4 September, and a final sale in December, 2009. The gross sales price for each home is projected to
5 be between approximately \$323,462 and \$326,423. BofA's Exhibit 78 indicates that after the \$57,000
6 release price is paid, the actual net for the estate is \$809.00.

7 2. Osprey Pointe

8 Osprey Pointe is a subdivision with a total of 54 lots located in Ridgefield, Clark County,
9 Washington. BofA and the Debtor stipulated that as of February 12, 2009, there were three lots
10 unsold. Debtor's Exhibit 9 provides the following values determined by Zell and PGP:

	<u>Debtor</u>	<u>BofA</u>
11 Retail Lot Value	\$125,000	\$105,000
12 Bulk Lot Value	\$ 75,000	\$ 95,000
13 Liquidation Lot Value	\$ 75,000	\$ 95,000 ⁷

14 The Per Lot Adequate Protection Payment is listed as \$86,000.⁸

15 3. Banner Properties

16 Banner Properties consists of Garrette Custom Homes, which are spec homes built on acreage
17 parcels. Testimony indicates that these are located in several areas, including Kalama, Washougal,
18 Gresham, Battle Ground, and Bush Prairie, Washington. BofA and the Debtor stipulated that as of
19 February 12, 2009, remaining unsold in Banner Properties were five lots, three completed homes, and
20 two partially completed homes. Neither the Debtor nor BofA completed appraisals on these
21 properties.
22

23
24 ⁷ Debtor's Exhibit 7, which is Zell's appraisal of Osprey Pointe, only indicates a liquidation value; there is no bulk
25 value provided. BofA's Exhibit 75, which is BofA's appraisal of Osprey Pointe, only indicates a bulk value; there is
no liquidation value provided.

⁸ This amount appears to be a variance from the other Lender Project lot release amounts, which testimony
establishes are 85% of the Debtor's bulk sale appraisal.

1 **B. KeyBank**

2 Commencing in 2006, KeyBank made a series of loans (KeyBank Loans) to the Debtor and its
3 former subsidiaries and affiliates evidenced by promissory notes and secured by deeds of trust
4 (collectively the KeyBank Loan Documents) on real estate located in both Washington and Oregon.
5 The KeyBank Loans were made on the following projects: Meriwether-Discovery and Meriwether-
6 Hillshire Manor, Morgan's Vineyard, Ponte Cino Homes and Ponte Cino Townhomes, and Taverner
7 Ridge (KeyBank Projects). The Debtor is seeking to use Cash Collateral from the KeyBank Projects.

8 As of the Petition Date, the KeyBank Projects were comprised of approximately 35 completed
9 homes, eight partially constructed homes and 124 finished lots. The Debtor and KeyBank stipulated
10 that the outstanding principal amount under the KeyBank Loans as of the Petition Date was
11 \$18,950,800 (which includes debt that is secured by deeds of trust on property that is no longer owned
12 by Debtor). Debtor's Exhibit 2 establishes that as of January, 2009, the Debtor held a total of
13 \$4,577,760 in Net Cash Proceeds from KeyBank Projects. The pleadings and testimony, however,
14 indicate that KeyBank has approximately \$3.6 million in Cash Collateral. For the sake of consistency,
15 the amount of KeyBank's Cash Collateral will be referred to as approximately 4 million dollars.

16 1. Taverner Ridge

17 Taverner Ridge is a planned community that currently consists of 44 single-family residential
18 lots, four unfinished homes, and approximately four completed homes located in Ridgefield, Clark
19 County, Washington. The evidence establishes that this subdivision is substantially uncompleted. At
20 the current rate of sales, it would take approximately three to four years to build out this project.

21 Debtor's Exhibit 9 provides a comparison of the values of the unsold lots as determined by
22 Debtor's appraiser Zell and by KeyBank's appraiser PGP:

	<u>Debtor</u>	<u>KeyBank</u>
23 Retail Lot Value	\$102,614	\$115,500
24 Bulk Lot Value	\$ 65,909	\$ 87,000
25 Liquidation Lot Value	\$ 39,545	\$ 70,125

1 The Per Lot Adequate Protection Payment is listed as \$56,000, which is 85% of the Debtor's bulk sale
2 appraisal. This is a decrease from the amount of \$86,000 originally proposed in the Motions, which
3 was based on an estimate bulk sale price rather than an actual appraisal. The Debtor has increased
4 the average price per home by approximately \$46,000 due to a proposed increase in square footage
5 and additional options. KeyBank's Exhibit 12 indicates that the proposed unit proceeds available for
6 payment on the KeyBank debt is \$73,596.

7 Craig Zell, President of Zell, the Debtor's expert appraiser, testified that Clark County is in an
8 over-supply situation. He testified that Taverner Ridge is a better, more desirable and higher demand
9 project.

10 2. Meriwether

11 This project consisting of two sections—Hillshire Manor and Discovery—is located in
12 Woodland, Cowlitz County, Washington. The evidence establishes that this subdivision is
13 substantially uncompleted. There are a total of 66 lots, seven completed homes, and a few homes
14 under construction. At the current rate of sales, it would take approximately four to five years to build
15 out this project.

16 Debtor's Exhibit 7 provides that "Woodland is suffering through what can only be described as
17 a market collapse. According to RMLS Market Action, the Woodland area has seen a 31.6% decrease
18 in pending sales and a 30.6% decrease in median price, year to date." Kent Mordy, financial advisor
19 to BofA and KeyBank, believes there will be a decline in value at this subdivision. Since filing
20 bankruptcy, the Debtor has reduced the house prices in this project by an average of 20%. Due to the
21 outlying location of this project, Meriwether is in a more price-sensitive market.

22 a. Hillshire Manor

23 Hillshire Manor consists of 11 single-family residential lots within a 45 lot recorded phase of a
24 larger multi-phase subdivision. Debtor's Exhibit 9 provides a comparison of the values of the unsold
25 lots as determined by Debtor's appraiser Zell and by KeyBank's appraiser PGP:

	<u>Debtor</u>	<u>KeyBank</u>
1		
2	Retail Lot Value	\$ 60,000 \$ 75,000
3	Bulk Lot Value	\$ 49,200 \$ 60,909
4	Liquidation Lot Value	\$ 29,520 \$ 51,818

5 The Per Lot Adequate Protection Payment is listed as \$42,000, which is 85% of the Debtor's bulk sale
6 appraisal. This is a decrease from the amount of \$56,000 originally proposed in the Motions. The
7 Debtor has increased the average price per home from \$230,000 to \$268,000 due to a proposed
8 increase in square footage and additional options. KeyBank's Exhibit 12 indicates that the proposed
9 unit proceeds available for payment on the KeyBank debt is \$51,392.

10 b. Discovery

11 Meriwether Discovery consists of 55 single-family building lots and two unfinished homes within
12 a 68 lot recorded phase of a larger multi-phase subdivision. Debtor's Exhibit 9 provides a comparison
13 of the values of the unsold lots as determined by Debtor's appraiser Zell and by KeyBank's appraiser
14 PGP:

	<u>Debtor</u>	<u>KeyBank</u>
15		
16	Retail Lot Value	\$ 60,000 \$ 75,000
17	Bulk Lot Value	\$ 40,363 \$ 53,455
18	Liquidation Lot Value	\$ 24,000 \$ 42,727

19 The Per Lot Adequate Protection Payment is listed as \$34,000, which is 85% of the Debtor's bulk sale
20 appraisal. Testimony establishes that the lot release value was reduced from \$66,000. The Debtor
21 has increased the average price per home by \$57,000 due to a proposed increase in square footage
22 and additional options. KeyBank's Exhibit 12 indicates that the proposed unit proceeds available for
23 payment on the KeyBank debt is \$37,662.

24 3. Banner Properties

25 This consists of one stand-alone home in Clark County, that is projected to be sold in April,
2009. The Debtor expects to receive \$420,000 in net proceeds. The Debtor will turn this over to

1 KeyBank when this last Garrette Custom Homes home is completed.

2 4. Morgan's Vineyard

3 Morgan's Vineyard is a subdivision that consists of approximately six lots and nine homes
4 located in Lafayette, Yamhill County, Oregon, which is in the Portland metropolitan area. Build out of
5 the project is near the end. Debtor's Exhibit 9 provides a comparison of the values of the unsold lots
6 as determined by Debtor's appraiser Zell and by KeyBank's appraiser Moscato, Ofner & Henningsen,
7 Inc. (M, O & H):

	<u>Debtor</u>	<u>KeyBank</u>
8 Retail Lot Value	\$ 75,000	\$ 95,000
9 Bulk Lot Value	\$ 61,666	\$ 79,167
10 Liquidation Lot Value	\$ 36,666	\$ 66,667

11
12 The Per Lot Adequate Protection Payment is listed as \$52,000. This is an increase from the amount
13 of \$42,000 originally proposed in the Motions. KeyBank's Exhibit 12 indicates that the proposed unit
14 proceeds available for payment on the KeyBank debt is \$48,358.

15 5. Ponte Cino

16 This project consists of single-family homes and townhomes located in Happy Valley,
17 Clackamas County, Oregon. There are approximately 10 lots⁹, seven homes, and a few homes under
18 construction. This project is substantially more developed than the Woodland and Ridgefield projects
19 (Meriwether and Taverner).

20 Kevin Wann (Wann), President of the Debtor, testified that although the housing market has
21 softened in all areas, the closer-in projects like Ponte Cino and Morgan's Vineyard have maintained
22 their pricing level better than the Woodland and Ridgefield projects (Meriwether and Taverner). For
23

24 _____
25 ⁹ The Court recognizes that this total number of lots is inconsistent with the number of lots specified under the homes and townhomes sections. This discrepancy is due to the inconsistency among the pleadings, testimony, and exhibits.

1 the outlying projects, a lower price point is a more important factor for buyers due to a longer
2 commute.

3 a. Homes

4 Ponte Cino Homes consists of approximately one single-family residential lot. Debtor's Exhibit
5 9 provides a comparison of the values of the unsold lots as determined by Debtor's appraiser Zell and
6 by KeyBank's appraiser M, O & H:

	<u>Debtor</u>	<u>KeyBank</u>
8 Retail Lot Value	\$120,000	\$ 90,000
9 Bulk Lot Value	\$100,000	\$ 73,000
10 Liquidation Lot Value	\$ 60,000	\$ 62,800

11 The Per Lot Adequate Protection Payment is listed as \$85,000. This is an increase from the amount
12 of \$76,000 originally proposed in the Motions. KeyBank's Exhibit 12 indicates that the proposed unit
13 proceeds available for payment on the KeyBank debt is \$102,210.

14 b. Townhomes

15 Ponte Cino Townhomes consist of approximately six lots for attached units. Debtor's Exhibit 9
16 provides a comparison of the values of the unsold lots as determined by Debtor's appraiser Zell and by
17 KeyBank's appraiser M, O & H:

	<u>Debtor</u>	<u>KeyBank</u>
19 Retail Lot Value	\$ 90,000	\$ 60,000
20 Bulk Lot Value	\$ 73,333	\$ 48,600
21 Liquidation Lot Value	\$ 45,000	\$ 41,800

22 The Per Lot Adequate Protection Payment is listed as \$62,000. This is a decrease from the amount of
23 \$76,000 originally proposed in the Motions. KeyBank's Exhibit 12 indicates that the proposed unit
24 proceeds available for payment on the KeyBank debt is \$7,396.

1 **C. The Debtor**

2 The Debtor is a volume home builder, which builds track homes in a period of approximately 90
3 days from start to finish. The Debtor has long-term relationships with its subcontractors. Additionally,
4 it employs specialists, which include people in sales, builders, warranty personnel for servicing
5 customers, administrative employees for handling financing and closing, and accounting staff. The
6 Debtor has reduced its employees from 115 to 24. Wann testified that he has trimmed his staff as far
7 as possible. He testified that in order to support the Debtor's overhead, he needs use of the Cash
8 Collateral from both Lenders and West Coast Bank. Wann testified that the Debtor needs \$5.7 million
9 to continue in business as is.

10 **D. Market and Sales Projections**

11 Gerald Johnson (Johnson), the Debtor's real estate and economic expert, testified that demand
12 for houses is down by one-third. He testified that it is difficult to forecast the housing market. He
13 compared today's economic situation to a 100-year flood. He testified that generally, areas are looking
14 at a decline of 7-10% in 2009, although a leveling off should occur in 2010.

15 Johnson testified that people prefer a more developed community to one with more unfinished
16 lots and less completed homes. Wann testified that building in a project near completion is less risky
17 than building in a project not as complete.

18 **E. Cash Collateral**

19 Clyde Hamstreet (Hamstreet), President of Clyde A. Hamstreet & Associates, LLC, has been
20 working with the Debtor since 2008 on the proposed cash collateral plan. He testified that selling
21 vacant lots would yield the least amount of money to the Lenders. He testified that the collateral value
22 in the hands of the Debtor is higher than in the hands of the Lenders. Because payments are made to
23 the Lender when homes are sold, loan balances decrease as inventory decreases.

24 The cash collateral plan proposes a lot release price in excess of the liquidation price of the
25 lots. He stated in his declaration, however, that "[h]ome prices have fallen so dramatically that it is

1 impossible for Debtor to sell its existing inventory of homes at prices sufficient to pay the historical lot
2 release prices and have cash left over to stay in business.”

3 Hamstreet testified that in normal times, builders expect a profit of 17-22%. Today, 10% is a
4 reasonable margin. Spring is the time to start building as it is when people buy homes. The Debtor
5 proposes to use Cash Collateral through December, 2009, which will be all of the Debtor’s working
6 capital except for a loan from Wann for \$1.7 million.

7 Wann testified that under conventional financing outside of bankruptcy, the risk of decreased
8 sales or sale prices is on the builder, or Debtor. But under the current cash collateral model, an error
9 in projections of house values still permits the Debtor to receive 10% off the top and payment of the
10 professionals in the case.

11 **F. Kevin Wann**

12 Wann personally guaranteed a number of the Debtor’s obligations, including two million dollars
13 unsecured personal guaranty to KeyBank and one million dollars unsecured personal guaranty to
14 BofA. On December 9, 2008, the Court approved a stipulated order authorizing the estate to obtain
15 post-petition financing pursuant to § 364 from Kevin and Nicki Wann. The Wanns committed \$1.7
16 million of their personal funds from a tax refund in order to cover current and future operating costs of
17 the estate. As of the hearing date, the Debtor had borrowed approximately \$500,000 of this amount.

18 Wann testified that he intends to commit his 2008 tax refund, estimated to be around four
19 million dollars, in order to fund confirmation of a Plan of Reorganization (Plan). He is unwilling to do
20 so, however, unless he believes the Debtor will be able to confirm a Plan. Wann expects to receive
21 the tax refund between September and October, 2009. Wann currently receives an income of
22 approximately \$26,000 per month from the Debtor, which was his salary prepetition.

23 **G. Procedural History**

24 Shortly after filing bankruptcy, the Debtor moved for limited use of Cash Collateral as to
25 KeyBank and West Coast Bank for purposes of weatherizing several houses in various states of
construction to prevent damage. On December 9, 2008, the Court approved two stipulated orders

1 authorizing limited use of Cash Collateral and granting adequate protection for KeyBank and West
2 Coast Bank.

3 On December 30, 2008, the Debtor filed the Motions, seeking use of BofA's and KeyBank's
4 Cash Collateral in the ordinary course of business consistent with the Budgets for each BofA Project
5 and KeyBank Project (Lender Projects) set forth in Exhibit A to each respective Motion. In support
6 thereof, the Debtor filed the declarations of Wann and Hamstreet. According to the Debtor's
7 December 2008 Monthly Financial Report, the Debtor reported a net loss of \$1,377,571 for the post-
8 petition period from October 17, 2008, to December 31, 2008.

9 For each Lender, the Debtor needs use of the Cash Collateral primarily to: (1) complete
10 construction of the partially constructed homes; (2) build new homes; (3) pay expenses related to the
11 Lender Projects, including payment of assessments owed to homeowner associations, insurance
12 premiums, accrued and accruing ad valorem property taxes, fulfillment of government conditions under
13 existing permits, and marketing and advertising costs; and (4) contribute to Debtor's general and
14 administrative expense of its business and this Chapter 11 case.

15 For each Lender, the Debtor proposes to use the Cash Collateral in the following manner:

16 (1) Ten percent of all gross proceeds from sales of homes in each Lender Project and ten
17 percent of the existing balance in the Segregated DIP Accounts determined at the time an order
18 approving the Motions are entered, will be retained by the Debtor for working capital and other general
19 corporate expenses. These funds will be used for general corporate purposes before applying the
20 funds from the DIP Financing.

21 (2) Except as specifically provided, the Debtor will use the Net Cash Proceeds from home
22 sales to fund expenses incurred after January 1, 2009, that are necessary to preserve each Lender
23 Project. These costs include costs to complete construction and to commence new construction, costs
24 to market and sell completed homes, including the costs of providing home warranties, and costs to
25 maintain the existing homes.

1 The Lenders will not receive payment of any profits earned on the individual homes within a
2 Lender Project until that Lender Project is completed.

3 Pursuant to § 363(e), the Debtor proposes to make adequate protection payments to the
4 Lenders for use of their Cash Collateral, equal to the interest payment on their debts.

5 **II**

6 **CONCLUSIONS OF LAW**

7 The Debtor argues that to fully implement its business plan, three factors must be met: (1)
8 achieve a level of sales that will support its general overhead requirements and provide sufficient
9 funding to restart construction activities; (2) replenish its inventory of completed homes in order to
10 maintain its operations on a going forward basis; (3) obtain the use of Cash Collateral from both
11 Lenders and West Coast Bank in order to fund ongoing operations and building expenses. The Debtor
12 and West Coast Bank have entered into a contingent agreement allowing the Debtor use of West
13 Coast Bank's Cash Collateral, but BofA and KeyBank oppose the use of their Cash Collateral.

14 Under § 363(c)(2), a debtor may not use cash collateral unless consented to by the entity that
15 has an interest in the cash collateral or with court authorization. Section 363(e) provides that on
16 request of an entity that has an interest in property to be used by the debtor, the court shall prohibit or
17 condition the use "as is necessary to provide adequate protection of such interest." The debtor has
18 the burden of proof on the issue of adequate protection. § 363(p)(1).

19 The Code does not define adequate protection but sets forth three alternative non-exclusive
20 methods by which adequate protection may be provided when required under § 363: (1) periodic cash
21 payments; (2) additional or replacement liens; or (3) other relief resulting in the "indubitable equivalent"
22 of the secured creditor's interest in such property. § 361. The determination of adequate protection is
23 a question of fact for the trial court. In re Bear River Orchards, 56 B.R. 976, 979 (Bankr. E.D. Calif.
24 1986).

25 Courts have recognized the breadth of adequate protection. "The goal of adequate protection
is to safeguard the secured creditor from diminution in the value of its interest during the Chapter 11

1 reorganization.” In re Mosello, 195 B.R. 277, 288 (Bankr. S.D. N.Y. 1996) (quoting In re 495 Central
2 Park Avenue Corp., 136 B.R. 626, 631 (Bankr. S.D. N.Y. 1992)). “The concept of adequate protection
3 was designed to ‘insure that the secured creditor receives the *value* for which he bargained.” In re
4 Martin, 761 F.2d 472, 474 (8th Cir. 1985) (quoting S. Rep. No. 989, 95th Cong., 2d Sess. 53, reprinted
5 in 1978 U.S. Code Cong. & Ad.News 5787, 5839 (emphasis added)). “Secured creditors should not
6 be deprived of the benefit of their bargain.” In re Am. Mariner Indus., Inc., 734 F.2d 426, 431 (9th Cir.
7 1984), effectively overruled on other grounds by United Sav. Ass’n of Tex. v. Timbers of Inwood Forest
8 Assocs., Ltd., 484 U.S. 365, 368 (1988). As the Ninth Circuit Court of Appeals set forth from the
9 House Report,

10 There may be situations in bankruptcy where giving a secured creditor an absolute
11 right to his bargain may be impossible or seriously detrimental to the bankruptcy laws.
12 Thus, this section recognizes the availability of alternate means of protecting a secured
13 creditor’s interest. Though the creditor might not receive his bargain in kind, the
14 purpose of the section is to insure that the secured creditor receives in value
15 essentially what he bargained for.

16 American Mariner, 734 F.2d at 431 (quoting H.R. Rep. No. 595 at 339, 1978 U.S. Code Cong. &
17 Ad.News at 6295).

18 “Whether protection is adequate depends directly on how effectively it compensates the
19 secured creditor for loss of value.” American Mariner, 734 F.2d at 432. While sections 361(1) and (2)
20 by their own terms compensate for a decrease in value, the “compensatory nature of adequate
21 protection is even more apparent from the catch-all alternative of section 361(3).” American Mariner,
22 734 F.2d at 432.

23 The phrase “indubitable equivalent” as used in § 361(3) was coined by Judge Learned Hand in
24 In re Murel Holding Corp., 75 F.2d 941, 942 (2nd Cir. 1935), as follows:

25 It is plain that “adequate protection” must be completely compensatory; and that
payment ten years hence is not generally the equivalent of payment now. Interest is
indeed the common measure of the difference, but a creditor who fears the safety of his
principal will scarcely be content with that; he wishes to get his money or at least the
property. We see no reason to suppose that the statute was intended to deprive him of
that in the interest of junior holders, unless by a substitute of the most indubitable
equivalence.

1 “‘Indubitable’ means ‘too evident to be doubted.’” In re Arnold & Baker Farms, 85 F.3d 1415, 1421
2 (9th Cir. 1996) (quoting In re Arnold & Baker Farms, 177 B.R. 648, 661-62 (9th Cir. BAP 1994)
3 (citation omitted)). “[T]o the extent a debtor seeks to alter the collateral securing a creditor’s loan,
4 providing the ‘indubitable equivalent’ requires that the substitute collateral not increase the creditor’s
5 risk exposure.” In re Keller, 157 B.R. 680, 683-84 (Bankr. E.D. Wash. 1993).

6 The use of indubitable equivalent “at least encourages if not requires a present value analysis
7 under section 361,” so that the present value of the secured creditor’s interest is protected. American
8 Mariner, 734 F.2d at 432. As explained by the Ninth Circuit Court of Appeals,

9 In its context, Judge Hand’s interpretation of adequate protection emphasizes
10 two factors. First, it suggests that to be “completely compensatory” adequate
11 protection must compensate for present value, “that payment ten years hence is not
12 generally the equivalent of payment now.” . . . Second, adequate protection must
13 insure the safety of the principal. . . . Judge Hand concluded that the creditor’s right “to
get his money or at least the property” may be denied under a plan for reorganization
only if the debtor provides “a substitute of the most indubitable equivalence.” Such a
substitute clearly must both compensate for present value and insure the safety of the
principal.

14 American Mariner, 734 F.2d at 433.

15 The Debtor contends that the Lenders are adequately protected because use of the Lenders’
16 Cash Collateral will increase the value of the Lender Projects, rather than decrease the value. It
17 contends that if the Lender Projects are not completed, given the current market conditions, their
18 values will decline significantly. Even so, the Debtor proposes to make adequate protection payments
19 as follows: (1) monthly payments equal to the non-default interest under the applicable note, made
20 from the Lenders’ Cash Collateral; and (2) lot release amounts determined by the Debtor for each
21 Lender Project. As further adequate protection, the Debtor also proposes to each Lender (1) a
22 replacement lien on the Net Cash Proceeds from future sales; (2) a lien on all improvements made to
23 existing and new homes; (3) limiting use of Cash Collateral as determined by the Court; (4) limiting
24 construction of spec homes based on the current inventory of spec homes for each Lender Project, as
25 determined by the Debtor; (5) limiting construction of new homes based on the balance of the

1 Segregated DIP Accounts; (6) regular reporting to the Lenders and Committee; (7) maintaining
2 insurance; and (8) reasonably managing home construction.

3 In assessing the Debtor's request for the use of Cash Collateral, like other courts examining
4 cash collateral, this Court is mindful of the purposes of a business reorganization under Chapter 11:
5 "[T]o initially relieve the debtor of its prepetition debts, to free cash flow to meet current operating
6 expenses, and ultimately to permit the debtor 'to restructure a business's finances so that it may
7 continue to operate, provide its employees with jobs, pay its creditors, and produce a return for its
8 stockholders.'" American Mariner, 734 F.2d at 431 (quoting H.R. Rep. No. 595 at 220, 1978 U.S.
9 Code Cong. & Ad.News at 6179). The Court's concern for these purposes is particularly pronounced
10 given today's economic situation and the federal government's goal to stimulate the economy through
11 job growth, a housing bailout, and other financial measures.

12 In evaluating adequate protection in the context of a cash collateral request, the Eight Circuit
13 Court of Appeals applied a three-step approach to determine whether the proposed adequate
14 protection provided the creditor with the value of his bargained for rights.

15 In order to encourage reorganization, the courts must be flexible in applying the
16 adequate protection standard. This flexibility, however, must not operate to the
17 detriment of the secured creditor's interest. In any given case, the bankruptcy court
18 must necessarily (1) establish the value of the secured creditor's interest, (2) identify the
19 risks to the secured creditor's value resulting from the debtor's request for use of cash
20 collateral, and (3) determine whether the debtor's adequate protection proposal protects
21 value as nearly as possible against risks to that value consistent with the concept of
22 indubitable equivalence.

23 In re Martin, 761 F.2d at 476-77 (citation omitted).

24 In this case, the value at issue is the present value of the use of the Net Cash Proceeds which
25 comprises the Cash Collateral for the Lenders. The evidence establishes that as of the pending
26 Motions, the Debtor held approximately \$4.3 million in Cash Collateral for BofA, and approximately
27 four million dollars for KeyBank. Thus, the Debtor must "as nearly as possible under the
28 circumstances of the case provide the creditor with the value of his bargained for rights," American
29 Mariner, 724 F.2d at 435, which is the present use of cash totaling approximately eight million dollars.

1 The Lenders argue that the “adequate protection” offered by the Debtor is not adequate to
2 protect them from erosion in the value of their collateral. First, although the Debtor promises to pay
3 interest at the contract non-default rate, it would pay the interest amount from the sales proceeds it is
4 already withholding from the Lenders and in which the Lenders already have a secured interest.
5 Second, while the Debtor promises a replacement lien on the proceeds of future sales or
6 improvements of new homes constructed, the Lenders’ deeds of trust already extend to the sale
7 proceeds of its collateral and improvements on the real estates securing its deeds of trust.

8 The Court primarily agrees with the Lenders’ position. The Debtor has pointed to no possible
9 additional source from which it could make cash payments, other than from the sales proceeds upon
10 which the Lenders already hold first liens. Nor has the Debtor offered other unencumbered property
11 that could be used to provide “an additional or replacement lien” to the Lenders. In In re Swedeland
12 Dev. Group, Inc., 16 F.3d 552, 565-67 (3rd Cir. 1994), the Third Circuit Court of Appeals rejected as
13 adequate protection similar offers—continued personal guarantees and liens on sales proceeds—
14 where the creditor in that case was entitled to these offers anyway. Furthermore, this Court concludes
15 that as to the lot release payments, these cannot be “periodic cash payments” under § 361(2) because
16 the Lenders will receive these if and only if a house sells. These are not recurring payments proposed
17 to be made at fixed intervals, as Black’s defines “periodic.” Black’s Law Dictionary 1138 (6th ed.
18 1990). Thus, subsections (1) and (2) of § 361 are not a basis for adequate protection in this case.
19 See Mosello, 195 B.R. at 288 (where court analyzed adequate protection under the “indubitable
20 equivalent” standard when debtor had no separate source from which to make periodic cash payments
21 and no unencumbered property to provide an additional or replacement lien).

22 The question then is whether the Debtor can offer additional adequate protection that is the
23 indubitable equivalent of the value of the present use of the Lenders’ Cash Collateral. The primary
24 adequate protection offered by the Debtor is the increase in value of the Lenders’ collateral (distinct
25 and different from Cash Collateral) that is projected to occur with continued construction of the Lender
Projects. In order to answer this question, the Court must determine whether the proposed continued

1 construction compensates the Lenders for the present value of their Cash Collateral, and whether the
2 proposed continued construction protects the safety of their Cash Collateral.

3 Central to the Debtor's argument is that allowing its business to continue will result in an
4 increase in value to the Lender Projects greater than would be realized if the Debtor ceased operating.
5 The Lenders disagree, however, contending that there is no guarantee of success and that under this
6 proposal they will assume the risk of future nonprofitability at the expense of approximately eight
7 million dollars in cash available to them now.

8 In Swedeland, the appellate court considered whether the debtor in possession offered
9 adequate protection to a pre-petition lender for purposes of obtaining credit pursuant to § 364(d)(1),
10 and thereby creating a superpriority lien in the post-petition lender. Swedeland, 16 F.3d at 556-57.
11 The debtor in that case was developing a 508-acre golf course and residential project. Among other
12 incentives, the debtor offered the pre-petition lender as adequate protection increased value of the
13 property due to the continued construction. The Third Circuit Court of Appeals thoroughly reviewed
14 and rejected this contention:

15 In the first place, continued construction based on projections and improvements to the
16 property does not alone constitute adequate protection. See Town of Wesport v. Inn at
17 Longshore, 32 B.R. 942, 946 (Bankr. D. Conn. 1983). Those cases which have
18 considered improvements to be adequate protection have done so only when the
19 improvements were made in conjunction with the debtor's providing additional collateral
20 beyond the contemplated improvements. See, e.g., In re O'Connor, 808 F.2d at 1396
21 (grant of additional, unencumbered collateral); In re 495 Central Park Avenue Corp.,
22 136 B.R. 626 (Bankr. S.D. N.Y. 1992) (projected property improvements constituted
23 adequate protection where annual rental income of \$180,000 from an existing lease
24 conditioned on improvements would increase value of real estate securing pre-petition
25 loan by at least \$800,000, and superpriority post-petition loan financing the projected
improvements amounted to only \$650,000). 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.

Swedeland, 16 F.3d at 566.

Similar to the debtor in Swedeland, the Debtor contends that if it is permitted to complete
existing unfinished houses and build new houses, it can sell these houses and successfully continue
its business. It urges that continued construction will result in the Lenders getting paid more than if

1 construction is halted. Yet a preponderance of the evidence establishes the rate of house sales is
2 down sharply, house prices are continuing to decline, unemployment rates are rapidly rising, financing
3 for home purchases is difficult, and foreclosure rates are climbing. There is speculation by the
4 Debtor's experts as to when and to what degree the housing market will recover. Given the testimony
5 of the Debtor's and Lenders' experts, however, the evidence establishes that use of historical data
6 cannot accurately project future market conditions and real estate values due to the unparalleled
7 economic crisis this country is experiencing. As Debtor's counsel stated at BofA's Exhibit 77, "The
8 impact of the subprime mortgage crises and other financial crises on the real estate sector is
9 unparalleled in recent history. It is impossible at this time to predict whether housing prices will
10 continue to fall and for how long, let alone when they will start to level off and rebound."

11 Through its proposed adequate protection, the Debtor has offered little, if anything, of
12 additional value to the Lenders in exchange for the use of their Cash Collateral. Instead, the Debtor
13 relies on its hopes and projections of future profitability, and does so during a period of financial crisis
14 unprecedented in recent history. The Court concludes that this speculation does not compensate the
15 Lenders for the present value of the use of their Cash Collateral. Even though the Debtor historically
16 ran a successful business and operated at a comfortable profit margin, today's market may no longer
17 support this model. If the Debtor continues to conduct business as usual and construct homes across
18 the board—in Lender Projects both close to and far from completion—there is no guaranty that the
19 homes will sell, or will sell in a timely manner, sufficient to compensate the Lenders for the loss of
20 approximately eight million dollars in cash that is available to them today.

21 Furthermore, the Debtor's proposal does not protect the safety of the Lender's Cash
22 Collateral. The Debtor and Wann propose to assume little risk for the use of the Lenders' Cash
23 Collateral. Notably, Wann testified that he will not unconditionally commit his four million dollar tax
24 refund; rather, he will commit it only if he is certain the Debtor can reorganize. Furthermore, it is
25 uncontested that when a house sells, the Debtor will receive the first 10% distribution for operating
expenses, which includes payment to Wann of his salary at the prepetition rate of some \$26,000 per

1 month; next the subcontractors will receive payments for their services on that particular house; and
2 finally the Lenders will receive only the lot release amount. A preponderance of the credible evidence
3 establishes that the lot release prices to be paid to the Lenders have and may continue to substantially
4 decrease. Additionally, if any funds are received in excess of these amounts, these will be available to
5 the Lenders only when the respective project is completed.

6 Should the Debtor's reorganization fail, Wann will be paid on his \$1.7 million postpetition loan
7 pursuant to § 364(a) prior to payment of the Lenders. The professionals employed in this case will be
8 paid pursuant to a carve-out. Only then will the Lenders will receive their collateral, or value of their
9 collateral. Their collateral, however, will include unsold houses. Thus, the Lenders could be left with
10 the additional cost of maintaining the unsold houses until the housing market rebounds. These costs
11 clearly exceed the costs of maintaining unimproved lots.

12 The Debtor has presented this Court, as well as BofA and KeyBank, with an "all or nothing"
13 approach. It contends that it needs to use all of the Cash Collateral of both Lenders and West Coast
14 Bank in order to reorganize. It makes these demands even though the objecting Lenders indicated at
15 the hearing that they may be willing to negotiate with the Debtor regarding its use of Cash Collateral
16 on a more limited scale.

17 The Court acknowledges that the evidence indicates that if the Debtor is unable to reorganize,
18 the Lenders will be left with the finished lots, which testimony establishes is likely worth less than lots
19 containing homes (assuming that these homes could be sold quickly for the asking price). It is also
20 undisputed that currently there is virtually no market for bulk sale lots. Yet the Court must evaluate the
21 value and security of the Lenders' Cash Collateral, which is approximately eight million dollars cash
22 available to the Lenders today; that the homes may not sell, or sell for less than expected; and that the
23 Lenders could be left with maintaining unsold homes, which is far more expensive than lots. There
24 also can be no question that the Lenders are aware of the losses that will occur if they are forced to
25 foreclose on the lots.

1 The Court and creditors, secured and unsecured, would like nothing more than for the Debtor
2 to succeed in a reorganization. The Debtor has an excellent reputation, appears to be well managed,
3 and has provided a quality product. A successful reorganization would not only maintain a historically
4 successful business, it would save numerous jobs during a tumultuous economic time. The Debtor,
5 however, has not met its burden of proof in establishing that the proposed adequate protection for the
6 use of all of the Lenders' Cash Collateral adequately protects the Lenders' interest under the "all or
7 nothing" approach.

8 Accordingly, the Debtor's requests to use the Cash Collateral of BofA and KeyBank are denied.

9 DATED: March 16, 2009

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11 _____
Paul B. Snyder
U.S. Bankruptcy Judge