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HOMEBUILDER BANKRUPTCY CASES

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I. GENERAL OBSERVATIONS.

- The homebuilding industry is going through dramatic slowdown after years of record growth. Large publicly traded homebuilders are reducing workforces, selling land at steep discounts against face value and trying to raise cash any way they can. While the larger industry players tend to have the balance sheet strength to stave of debilitating financial distress, smaller competitors are often not so fortunate. All over the county homebuilders have filed for bankruptcy protection in recent months. All appear to be plagued by similar factors:

    - Slowing pace of home sales;
    - Spiking existing home inventory;
    - Decreasing home values;
    - Rapid increases in foreclosures;
    - Credit crunch that prevents buyers from obtaining financing;
    - Mounting debt and interest payment due to lenders;
    - Credit agreement defaults; and
    - Lender fatigue.

- Privately owned homebuilders typically own multiple projects in separate subsidiaries, maintain a central marketing/sales and construction management operation, and utilize regional/local construction lenders for project specific construction finance and bank or finance company lines of credit at the parent level for general working capital purposes. The principal/controlling shareholder often is a guarantor under the project specific construction loans. Projects are in various phases of development when sales fail to meet projections, causing liquidity problems that, in turn, impede completion of projects. Other causes of financial distress include overexpansion that outstrips management's ability to

oversee development, mismanagement of resources at the G&A level, and customer dissatisfaction/local regulatory intervention caused by product defects.

- In cases where recapitalization/restructuring is not accomplished outside of an insolvency proceeding, the bankruptcy case usually does not involve a reorganization of the business that involves development of new projects, but rather an orderly liquidation of the debtor by completion of projects in progress to the extent the debtor holds equity in excess of project specific debt and arranging for section 363 sales of unprofitable projects to the project lenders or others, subject to higher or better bids.

- The constituencies in the bankruptcy case:

    - The Debtor (or chapter 11 trustee, if appointed)
    - Principals/Controlling Shareholders
    - Chief Restructuring Officer
    - Creditors' Committee
    - Project Specific Mortgage Lenders (these loans are often sold to capital market/distressed debt funds)
    - Line of Credit/Mezzanine Lender
    - Construction/Mechanics' Lien Claimants
    - General Unsecured Trade Creditors
    - Bonding Companies/Sureties/Issuers of Letters of Credit
    - Consumer Purchasers with Unit Purchase Agreements
    - Homeowner Associations/State Attorneys' General/State Department of Consumer Affairs (DCA)

- Status of business at the time of filing - At the time of the filing, construction has been suspended due to defaults under construction loans, contractors have walked off jobs and taken action to perfect mechanics'/materialmens' liens, customer deposits have been commingled with operating funds, and the debtor has reduced management personnel due to liquidity constraints. Foreclosure actions may have been commenced or threatened, together with actions on loan guarantees.

- These cases involve issues that arise in all chapter 11 proceedings, and also involve matters that were prevalent during the era of the real estate bankruptcy cases of the late 1980's and early 1990's.

II. <u>CASE ADMINISTRATION</u>.

A. <u>Who Is in Charge</u>.

- <u>Debtor</u> – By the time the case is filed, the lenders have lost confidence in the debtor's management. Often, unless either a Chief Restructuring Officer or new outside construction management firm and Financial Advisor is in place, the lenders and/or the Office of the United States

Trustee file a motion to appoint a chapter 11 trustee in the initial weeks of the case. Debtor's principals agree to step aside from day-to-day management, but may contend that there is equity in many projects, and demand some role.

- Creditors' Committee – Creditors' Committee is appointed for all debtor entities. However, the Committee is confronted with inherent conflict of representing interests of creditors in multiple single project debtors. The Committee often treats the jointly administered cases as if substantially consolidated even though no motion is filed for such relief. Allocation of professional fee administration claims and debtor-in-possession financing debt among debtors is an issue. The Committee is often in conflict with positions of project specific lenders.

- Project Specific Lenders – Many bank lenders sell their positions to capital market distressed funds prior to and/or subsequent to the bankruptcy filing. Many of these funds do not have in-house construction loan administration capabilities, which delays recommencement of project construction.

- Contractors/Construction Lien Claimants – This constituency is often prepared to cooperate in the chapter 11 case regarding treatment of their pre-petition claims if they receive assurance that they will be retained for further work on the jobs. Legal review of mechanics'/construction lien claims reveals that many claimants fail to follow state law perfection requirements, and adversary proceedings are filed naming most of these claimants to avoid their liens. Middle-market contractors usually are reluctant to incur substantial legal costs in these matters.

B. Financing the Bankruptcy Case.

- Debtor-in-Possession Financing – Issues Presented:

    - Priming Liens - Is there a substantial equity cushion in excess of first mortgage debt that is available to secure DIP financing for case administration costs and G&A costs, or will third party extend DIP financing secured by subordinate liens on projects? Loan to own? See Swedeland Development Group, Inc., 16 F.3d 552 (3d Cir. 1994)(cautioning that in most situations where the existing lender's interest is diminished by being "primed", additional collateral or new third-party guarantees are necessary to satisfy the adequate protection requirement).

    - Factors disfavoring priming liens:

        - loan sought for soft – operational costs as opposed to construction costs;
        - success of project depends upon contingencies outside of debtor's control (e.g. land use approvals);
        - ratio between proposed loan and pre-exiting loan as well as total value of the collateral is low;
        - business cannot demonstrate that it can operate profitably; and
        - unpaid property taxes are diminishing the value of the secured lender's protection based upon the collateral.

    - Factor favoring priming liens:

        - significant equity cushion;
        - good prospect of successful reorganization; and
        - presence of a well reasoned financial analysis.

    - Allocations of DIP Loan – Are all debtors jointly liable for DIP even if there is no substantive consolidation, or there is no clear benefit of DIP Loan to certain debtors?

    - Approval Rights/DIP Loan Covenants – DIP loan agreements often provide DIP Lender approval rights for project budgets, sales agreements, individual debtor plans of reorganization – project lenders are in conflict with DIP loan terms because they effect a *de facto* substantive consolidation, conflict with project construction loan terms, and make it difficult to sever project from the rest of the cases.

    - Adequate Protection – Other parties requiring adequate protection are construction lien claimants and parties to purchase agreements (*e.g.* possible lien claim for deposit in event of rejection).

- Project Specific Financing – Issues Presented:

    - To what extent the pre-petition construction loan terms remain in effect (interest rate, unit release prices, etc.), or does project lender obtain more favorable terms that are provided to conventional DIP lender (rate, fees, etc.).

    - Application of unit sale proceeds to pre- or post-petition debt; negotiation of section 506(c) carve out; interplay with overall parent DIP lender; and negotiated cap on bankruptcy professional fees allocated to project debtor subsidiary.

- Negotiation of allocation of overall case G&A (marketing/sales, construction management, and CRO staff) to project debtor DIP budget.

- Maturity Date – When is the DIP due and payable?

- Adequate protection for construction lien claimants (as units sold) and purchaser deposit lien claims.

C. SARE Status – Stay Relief Issues – BAPCPA Amendments.

- Before BAPCPA, Single Asset Real Estate ("SARE") cases were not common or significant because the $4 million cap imposed by the definition of SARE excluded most projects owned and operated by special purpose entities. BAPCPA has now eliminated the cap by the following revised language:

> (51B) "single asset real estate" means real property constituting a single property or project, other than residential real property with fewer than 4 residential units, which generates substantially all of the gross income of a debtor who is not a family farmer and on which no substantial business is being conducted by a debtor other than the business of operating the real property and activities incidental.

11 U.S.C. §101(51B)(as amended).

- The definition of Section 362(d)(3) was also modified by BAPCPA to read:

> (3) with respect to a stay of an act against single asset real estate under subsection (a), by a creditor whose claim is secured by an interest in such real estate, unless, not later than the date that is 90 days after the entry of the order for relief (or such later date as the court may determine for cause by order entered within that 90-day period) or 30 days after the court determines that the debtor is subject to this paragraph, whichever is later –
>
> (A) the debtor has filed a plan of reorganization that has a reasonable possibility of being confirmed within a reasonable time; or
>
> (B) the debtor has commenced monthly payments that –
>
> (i) may, in the debtor's sole discretion, notwithstanding section 363(c)(2), be made from rents or other income generated before, on, or after the date of the commencement of the case by or from the property to each creditor whose claim is

secured by such real estate (other than a claim secured by a judgment lien or by an unmatured statutory lien); and
(ii) are in an amount equal to interest at the then applicable non default contract rate of interest on the value of the creditor's interest in the real estate; …

11 U.S.C § 362(d)(3) (as amended). See In re Khemko, Inc., 181 B.R. 47, 50-51 (Bankr. S.D. Ohio 1995) for a discussion of the origin and meaning of the term "single asset bankruptcy case" as understood before the 1994 enactment of § 362(d)(3).

- If a homebuilder is determined to be a SARE, cash flow problems are exacerbated by the challenges created by the requirement to pay regular monthly interest within 90 days of the petition date, as many SARE debtors do not have the revenue from business operations from which to make those payments.

- Four recent cases are instructive on efforts to avoid the onerous SARE payment provisions enacted by BAPCPA. Although three of these debtors fail in their efforts, a detailed review of these cases and the relevant principles may provide some helpful insight on how a potential SARE debtor may succeed where they have failed.

  - In re Kara Homes, Inc., 363 B.R. 399 (Bankr. D. N.J. March 28, 2007).

    - after initially declaring itself a SARE, the debtor and its affiliates sought to be excluded from the statutory definition of SARE and the lenders objected.

    - the bankruptcy court held that because the debtor and its affiliates did not generate income from other activities not incidental to owning and developing the real estate, they were single asset real estate debtors.

  - In re Heather Apartments Limited Partnership, 366 B.R. 45 (Bankr. D. Minn. 2007).

    - after admitting that the debtor owned apartment complex was a SARE, the debtor sought to extend the 90 day deadline imposed by §362(d)(3) for "cause" until the sale of the primary asset could be concluded.

    - the bankruptcy court denied the debtor's motion stating that the focus is entirely on an in hand realization of cash by the

creditor, during the pendency of the case, while the property remains in the debtor's hands, and if a debtor is to be excused from having to surrender that cash right away, it must demonstrate a very substantial likelihood that the creditor would receive an equivalent value from another source, quickly enough to minimize its risks of recovering the time value of money.

- the Court observed that the statutory scheme gives "very special deference" to the mortgagees of single-asset real estate cases, requiring payments after 90 days unless the debtor-owner has filed a plan that is at least "arguably confirmable."

- query whether the prospect for a § 363 sale or other cause exists to justify relief from the payment requirements of § 362(d)(3). See In re Planet 10, L.C., 213 B.R. 478, 481 (Bankr. E.D. Va. 1997)(unconditional lifting of the stay is not mandatory where Chapter 7 Trustee has Bankruptcy Court approval of a post conversion agreement of sale) and In re Archway Apartments, Ltd., 206 B.R. 463, 465 (Bankr. M.D. Tenn. 1997)(Congress did not completely abrogate the bankruptcy court's discretion to taylor the appropriate relief for failure to strictly comply with the requirements of § 362(d)(3)). See also In re Heather Apartments Limited Partnership, 366 B.R. 45, 50 (Bankr. D. Minn. 2007)(prospective sale might "qualify as a concrete substitution for the ongoing realization in money via payment of interest" where the debtor can show "the likelihood that a sale will close promptly, and that there would be enough proceeds to serve the needs honored by the statute" – where sale agreement has been executed, financing is not in question, there are no material contingencies, and substantial progress has been made towards satisfying the ministerial closing requirements).

- In re Land Preserve, LLC, 2007 Bankr. LEXIS 2288 (Bankr. D. Conn. July 2, 2007).

  - after admitting SARE status the debtor failed to make payments or file a plan of reorganization prior to the 90 day limit and when the secured creditor sought relief from stay the debtor argued that the equity in the property is sufficient to defeat relief from the automatic stay.

  - the bankruptcy court granted relief from the stay to the secured creditor approximately 9 months after the case was filed.

- In re Club Golf Partners, L.P., 2007 WL 1176010 (E.D. Tex. April 20, 2007).

  - on the petition date, the debtor that owns and operates a golf club with tennis courts, driving range and casual club house filed a motion for a determination that it was not a SARE.

  - the bankruptcy court determined that the debtor was not a SARE stating that real property that, for the generation of revenues, requires the active, day-to-day employment of workers and managers other than or additional to the principals of the debtor, and that would not generate substantial revenue without such labor and efforts, should not be regarded as single asset real estate.

- Although Section 362(d)(3) appears to mandate some relief where the debtor fails to satisfy the "plan or payment" requirements, at least one court has held that the unconditional lifting of the stay is not mandatory when ruling upon a motion pursuant to Section 362(d)(3), In re Archway Apartments, Ltd., 206 B.R. 463, 465 (Bankr. M.D. Tenn.1997).

  - In Archway, the Chapter 11 debtor had failed to file a plan within the 90 day period by "simple, honest error" with no attempt by the debtor to deliberately delay the rights of the creditor. Id. Judge Lundin felt compelled by Section 362(d)(3) to grant relief to the creditor but he did so in the form of conditioning the stay upon a drop dead date for confirmation of the plan, rather than unconditional relief from the automatic stay. In doing so, he reasoned "[w]hile Congress may have enacted Section 362(d)(3) to protect the interests of secured creditors in single asset real estate cases, it did not completely abrogate the bankruptcy court's discretion to tailor the appropriate relief for failure to strictly comply with the requirements of Section 362(d)(3)." Id.

D. Contractor and Mechanics Lien Issues.

- Under the Bankruptcy Code, a mechanics lien is a statutory lien governed by Section 545. Any defects in the perfection of a mechanics lien can therefore be attacked and possibly avoided pursuant to Section 545(2).

- With certain exceptions, section 546(b)(1) of the Bankruptcy Code permits the perfection of a mechanics lien after the commencement of a bankruptcy case. A mechanics lien recorded after the filing of the petition

does not violate the automatic stay, Section 362(b)(3). See In re Kara Homes, Inc., 374 B.R. 542, 554 (Bankr. N.J. 2007) ("[t]he net effect of these two provisions is to authorize an entity to perfect an 'interest in property' after the filing of a petition to the extent state law provides for perfection to relate back to the pre-petition interest.") See also Schoonover Electric Co., Inc. v. Enron Corp, et al., 294 B.R. 232, 239 (Bankr. S.D.N.Y. 2003)(discusses the relation back principal with respect to an interest in property arising pre-petition under the NJ Construction Lien Law).

- This same section also permits any additional perfection to be made by notice pursuant to Section 546(b)(2), such as the filing of a notice in lieu of commencing the lien foreclosure action.
- Mechanics lien claimants frequently assert that their liens are superior to a senior secured creditor of the debtor.
- In light of current economic and market conditions, mechanics lien issues will continue to arise in homebuilder bankruptcy cases, and although most often determined by the state court in the prepetition mechanics lien litigation, they are sometimes addressed in the bankruptcy court as well.

E. Disposition of Projects – Death by Thousand Slits.

- Unprofitable Projects – Disposed of by consent to relief from automatic stay/section 363 sales. Issue presented: As more projects are not part of the bankruptcy case, the costs of administration (*e.g.* professional fees, parent G&A) are spread among fewer projects. In the event a DIP loan has been obtained, project specific lenders are confronted with constituencies that have incentive to retain and build out projects and oppose the lender taking back the project absent a substantial contribution to avoid administrative insolvency. In the event projects cannot be completed, status of surety bonds issued for site improvements must be assessed.
- Profitable Projects – Determination of whether debtor marketing/construction management staff can remain in place or whether new third-party project sale/management should be retained for remaining projects and whether revised cost estimates yield substantial equity at conclusion.

F. Other Case Administration Issues.

- Joint Administration vs. Substantive Consolidation – Single Asset Real Estate case (SARE) status. See Kara Homes, Inc., Case No. 06-9626 (D. N.J., March 12, 2007)
- Disposition of construction lien avoidance actions.
- Application of payments made pursuant to 11 U.S.C. § 362(d)(3) – principal or interest?
- Section 105 injunction proceedings to enjoin actions on guarantees.
- Purchaser Contracts – Motions to compel assumption/rejection by purchasers who want to get out of their unit purchase contracts.
- Exclusivity – Depends on SARE ruling.

III. THE HOMEBUILDER CHAPTER 11 PLAN OF REORGANIZATION.

A. Treatment of Creditor Classes.

- DIP Lender – Conversion to exit financing. DIP lender in this situation usually enters the credit with intention to convert the DIP to exit facility and/or acquire other project-specific debt.
- Project Specific Lenders – Either cashed out at a discount with exit loan proceeds or continue to provide construction loans on negotiated terms and complete projects. Alternatively, projects are sold under plan or the loans cured and reinstated pursuant to 11 U.S.C. § 1124(2).
- Construction Lien Claimants – Valid liens must be addressed; unperfected liens are avoided and treated as unsecured claims, either as separate class or same class as general trade creditors.
- Surety/Bond Claimants – Treated as contingent and unliquidated claims.
- Trade Creditors – Liquidation trust model funded by chapter 5 causes of action and lump sum payment by plan proponent or paid over time from unit sales proceeds (*e.g.* $5,000 per unit).
- Equity Security Holders – Cancelled; but if principal holds a position in certain project debtors with equity, this issue may need to be addressed.

B. Means for Implementation.

1. Plan proponent(s) can be the DIP lender and others who desire to be involved in build-out of remaining projects.

2. Construction and Sales Management – Must be identified – usually new player with experience in the region.

3. Liquidation Trust – Same as other liquidating chapter 11 cases.

4. Discharge – The plan usually provides for a discharge based on attempt to position the surviving debtor projects as a reorganization with equity issued to the DIP lender/exit financing entity and others.

5. Projects that are to be retained are built-out; other projects are transitioned to lenders through sales.

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