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6 UNITED STATES BANKRUPTCY COURT
7 NORTHERN DISTRICT OF CALIFORNIA
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9 In re:) Bankr. No. 01-31936-TC
10) Chapter 11
11)
12 HAWTHORNE PLAZA, LTD.,)
13 a California Limited Partnership,)
14)
15 Debtor.)
16 _____)

17 MEMORANDUM RE RELIEF FROM STAY AND STAY PENDING APPEAL

18 On April 26, 2002, this court held a hearing regarding an
19 order to show cause why relief from stay should not granted to
20 permit a secured creditor to foreclose upon Debtor's real
21 property. John Poppin and Matthew J. Shier appeared for Debtor.
22 Terrence V. Ponsford and Craig Stuppi appeared for Secured
23 Creditors ITW Mortgage Investments II, Inc. and GE Capital
24 Realty Group, Inc. (ITW).

25 In response to ITW's motion for relief from stay, the court
26 had previously held a hearing to determine the value of the
27 property. The court later held a hearing at which the court
28 denied confirmation of Debtor's First Amended Plan of
Reorganization. I now determine that ITW should be granted

1 relief from stay, and that neither the denial of confirmation
2 nor the relief from stay should be stayed pending appeal.

3 **FACTS**

4 Debtor's only significant asset is a large office building
5 in San Francisco known as Hawthorn Plaza (the Property). The
6 Property is encumbered by a loan from ITW secured by a deed of
7 trust. Debtor was initially unable to rent all of the space in
8 the building, and was consequently unable to make debt service
9 payments. The loan was modified six times to add unpaid
10 interest to principal. Debtor finally achieved complete
11 occupancy and thereafter timely paid the debt service.

12 Debtor filed the present bankruptcy because the ITW loan
13 matured and Debtor was unable to find replacement financing.
14 The original maturity date on the loan was September 1, 1992,
15 but was extended to December 31, 2000 through the loan
16 modifications noted above. Two factors made it difficult for
17 Debtor to obtain a new loan. First, the addition of unpaid
18 interest to the loan balance increased the loan-to-value ratio.
19 This meant financing on conventional terms could be obtained
20 only if the building maintained a high appraised value and
21 produced a large net operating income. Second, at about the
22 time Debtor filed this chapter 11 case, the market for San
23 Francisco office buildings collapsed, especially for properties
24 in the South of Market area where Debtor's building is located.
25 This meant that the Property did not have the a high enough
26 appraised value to qualify for conventional financing. Debtor

1 filed a chapter 11 petition on July 24, 2001 to stop ITW's
2 scheduled foreclosure.

3 ITW filed a motion for relief from the automatic stay. The
4 court held an evidentiary hearing at which it determined the
5 value of the building to be \$97 million and the balance on the
6 ITW loan to be approximately \$99.5 million. Having determined
7 that Debtor has no equity in the Property, the court conditioned
8 the continuation of the automatic stay on Debtor confirming a
9 plan promptly.

10 Debtor filed a plan that called for ITW to retain its lien,
11 for ITW to be paid interest at 8.35 percent, and for the
12 maturity date of the loan to be extended for five years. ITW
13 objected to confirmation, contending, inter alia, that the
14 interest rate was not sufficient.

15 At the confirmation hearing, both parties introduced expert
16 testimony regarding interest rates. ITW's expert, Richard
17 Ferrell, testified that the appropriate blended rate of interest
18 should be 11.27 percent, calculated as follows.

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<u>Tranche</u>	<u>L-T-V Ratio</u>	<u>Interest Rate</u>
20 First	Up to 70%	6.98%
21 Second	70-85%	17.5%
22 Third	85-100%	25%

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24 Debtor's counsel did not cross examine Mr. Ferrell. The court
25 found that the three-tranche approach was appropriate, but that
26 the appropriated blended rate of interest was "at least" 10
27 percent, calculated as follows.

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<u>Tranche</u>	<u>L-T-V Ratio</u>	<u>Interest Rate</u>
First	Up to 70%	7%
Second	70-85%	15%
Third	85-100%	20%

The court denied confirmation of the plan. Using the Debtor's own projections regarding net operating income before debt service, the court found that the Property did not have sufficient cash flow to pay ITW interest at 10 percent. The court then issued the present order to show cause why relief from stay should not be granted.

RELIEF FROM STAY

This court previously determined that Debtor has no equity in the Property. Under section 362(d)(2) of the Bankruptcy Code, where a debtor has no equity in property, relief from stay should be granted unless the property is "necessary to an effective reorganization." Under section 362(g), the debtor bears the burden of showing that necessity. Moreover, the debtor must show not only that the property is necessary if there is to be a reorganization, but also that the debtor can confirm a plan within a reasonable period of time. Bonner Mall Partnership v. U.S. Bancorp Mortgage Co. (In re Bonner Mall Partnership) 2 F.3d 899, 902 (9th Cir. 1993), cert. granted, 510 U.S. 1039 (1994), motion to vacate denied, case dismissed, 513 U.S. 18 (1994). In the present case, there is no doubt that Debtor needs to keep the Property to reorganize, the question is whether Debtor can actually confirm a plan.

1 I find that Debtor is not likely to confirm a plan within a
2 reasonable period of time.

3 Confirmation of Debtor's first plan was denied because
4 Debtor did not have sufficient cash flow to pay interest on
5 ITW's claim at the rate necessary to confirm the plan over ITW's
6 objection.

7 Debtor now proffers an alternate plan under which it will
8 repay part of the ITW loan immediately and repay the remainder
9 over five years. Under one option, Debtor will obtain a new
10 first loan in the amount of \$75 million at 5.4 percent interest.
11 Debtor states that it would then be able to pay the remaining
12 two tranches of the ITW loan at the rates previously determined
13 by the court. Under a second option, Debtor would obtain a new
14 junior loan of \$14.5 million for 9 percent interest plus an
15 unspecified equity participation. This would enable Debtor to
16 pay the first two tranches of the ITW loan at the rate
17 previously determined by the court and still have enough cash
18 flow to pay the new junior loan.

19 I find that it is unlikely that Debtor can obtain the new
20 first loan necessary to implement the first option under
21 Debtor's alternative plan. Debtor has been searching without
22 success for new financing since well before the ITW loan matured
23 on December 31, 2000. Debtor does not represent that Debtor has
24 a commitment for the new first loan. Moreover, the court found
25 that the appropriate rate of interest on a conforming first loan
26 is 7 percent, not the 5.4 percent Debtor hopes to get. Thus,
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1 there is no reason to believe it is likely Debtor will be able
2 to secure such financing within a reasonable period of time.

3 I find that it is also unlikely that Debtor can obtain the
4 new junior loan necessary to implement the second option under
5 Debtor's alternative plan. Debtor does not represent that it
6 has secured a commitment for the new junior loan. Under the
7 proposed new loan, the lender would receive interest at 9
8 percent per annum. This rate is lower than the 20-percent rate
9 the court found Debtor must pay ITW on the third tranche, while
10 the new lender would be subject to a greater risk of loss than
11 ITW. This is so because the new junior lender, unlike ITW,
12 would be subject to a senior deed of trust held by a different
13 entity. The new junior lender would thus suffer the risk that
14 its collateral could be lost in a foreclosure sale conducted by
15 the senior lender. Thus, there is no reason to believe it
16 likely that Debtor will be able to secure this very unusual new
17 junior financing within a reasonable period of time.

18 Debtor has been afforded a reasonable period of time to
19 confirm a plan. Debtor filed this chapter 11 case ten months
20 ago. The ITW loan matured eight months before the petition
21 date. Because the Debtor has no equity in the Property and has
22 been unable to confirm a plan or refinance the property after
23 an extended period of time, it is appropriate to grant ITW
24 relief from stay to permit foreclosure.

25 **STAY PENDING APPEAL**

26 At the hearing on the order to show cause, Debtor submitted
27 a request for stay pending appeal of this order denying

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1 confirmation of Debtor's plan. This court construes that motion
2 as also requesting stay pending appeal of the order granting
3 relief from stay.

4 In determining whether to grant a stay pending appeal, this
5 court should consider the following four factors: (1) the
6 likelihood of success on appeal; (2) irreparable injury if a
7 stay is not granted; (3) the absence of substantial harm to
8 interested persons; and (4) the absence of harm to the public
9 interest. In re Wymer, 5 B.R. 802, 806 (9th Cir. B.A.P. 1980).
10 Although a stay pending appeal should generally be granted only
11 if the appellant demonstrates a significant likelihood of
12 prevailing on appeal, the court may grant a stay if the
13 appellant demonstrates that the appeal raises a serious issue
14 and that the balance of hardships tips sharply in favor of
15 appellant. In re Zaleha, 162 B.R. 309, 317-18 (Bankr. D. Idaho
16 1993).

17 **A. Merits of Appeal**

18 **1. Denial of confirmation.** I determine that Debtor has
19 little likelihood of prevailing on appeal regarding the denial
20 of confirmation of Debtor's First Amended Plan of
21 Reorganization.

22 Setting aside the denial of confirmation will require the
23 reversal of findings of fact. Debtor's plan was not confirmed
24 because Debtor cannot pay ITW an appropriate rate of interest.
25 The determination of the interest rate that Debtor must pay is a
26 question of fact that will be set aside on appeal only if
27 clearly erroneous. Connecticut Gen. Life Ins. Co. v. Hotel
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1 Associates of Tucson (In re Hotel Associates of Tucson), 165
2 B.R. 470, 473 (9th Cir. B.A.P. 1994) (cramdown interest rate).
3 It is worthy of note that ITW's expert testified that the
4 appropriate interest rate was more than 11 percent, and that
5 Debtor's counsel did not cross-examine him regarding that
6 testimony.

7 Debtor's main argument is that the court should have
8 considered various equitable factors, in addition to evidence
9 regarding market rate, in determining the interest rate ITW must
10 be paid. Debtor argues that in determining the interest rate to
11 be paid on the ITW claim, the court should have considered the
12 following factors even though they would not be considered by a
13 lender in a market transaction: (a) the partner's original
14 investment; (b) the tax consequences of foreclosure to the
15 partners; (c) the original interest rate on the ITW loan (fixed
16 when it was a conforming loan); and (d) the fact that net rental
17 income would decline after foreclosure because property taxes
18 would rise but could not be passed through to the tenants (and
19 thus that ITW would really not benefit by foreclosing). Nothing
20 in the Bankruptcy Code or caselaw supports this approach.

21 Because ITW did not accept the plan, the plan may be
22 confirmed over its objection only if the plan is "fair and
23 equitable." 11 U.S.C. § 1129(b). To be fair and equitable, the
24 plan must provide ITW payments "of a value, as of the effective
25 date of the plan" equal to the amount of its claim. Id. That
26 is, if ITW's claim is not paid off on the effective date, it
27 must be paid with interest.

1 The Ninth Circuit has stated that the bankruptcy court
2 should determine the appropriate rate of interest by determining
3 what a market rate of interest would be for a similar loan, and
4 that the bankruptcy judge is to be afforded considerable
5 deference in making such determinations. Hotel Associates of
6 Tucson, 165 B.R. at 476.

7 Nothing in the caselaw authorizes the court to abandon use
8 of a market rate of interest on the basis of the type of
9 equitable considerations urged by Debtor. Debtor's argument
10 actually stands the caselaw interpreting the "fair and
11 equitable" language in section 1129(b) on its head. The courts
12 have held that payment of the claim in full with interest is the
13 minimum requirement for a plan to be considered fair and
14 equitable. In re D&F Constr., Inc., 865 F.2d 673, 675 (5th Cir.
15 1989); In re Dollar Associates, 172 B.R. 945, 948 (Bankr. N.D.
16 Cal. 1994).

17 **2. Relief from stay.** I determine that Debtor has little
18 likelihood of prevailing on appeal regarding the order granting
19 relief from stay.

20 A bankruptcy judge's decision to grant relief from stay is
21 reviewed for abuse of discretion. Moldo v. Matsco, Inc. (In re
22 Cybernetic Services, Inc.), 239 B.R. 917, 918 (9th Cir. B.A.P.
23 1999), aff'd, 252 F.3d 1039 (9th Cir. 2001), cert. denied, 122
24 S.Ct. 1069 (2002). Underlying findings of fact are reviewed for
25 clear error. U.S. v. Wyle (In re Pacific Far East Lines, Inc.),
26 889 F.2d 242, 245 (9th Cir. 1989). Underlying conclusions of
27 law are reviewed de novo. Id.

1 The determination that Debtor has no equity is purely one of
2 fact. As noted previously, the court heard expert testimony
3 regarding the value of the property. There was no significant
4 dispute between the parties regarding the balance on the ITW
5 loan.

6 The determination that Debtor is not likely to obtain the
7 financing necessary to confirm its alternate plan of
8 reorganization is not only a question of fact, it is an issue
9 on which the Debtor bears the burden of proof in the relief from
10 stay proceeding. 11 U.S.C. § 362(g).

11 **B. Balance of Hardships**

12 I determine that the balance of hardships does not tip
13 sharply in favor of Debtor.

14 The direct hardship on the Debtor from denying a stay
15 pending appeal is that ITW will be able to foreclose, and Debtor
16 will thus lose its only significant asset. The effect of this
17 hardship is attenuated by the fact that Debtor currently has no
18 equity in the Property, and thus stands to lose only the
19 opportunity to reap future appreciation in the Property.

20 The indirect hardship on Debtor is that a foreclosure will
21 constitute a sale or exchange of the Property for tax purposes.
22 Upon such a sale, Debtor will be deemed to realize a sale price
23 equal to the balance on the ITW loan, even though Debtor
24 receives no cash. Because Debtor's tax basis is lower than the
25 balance on the ITW loan, Debtor will recognize a large capital
26 gain. Debtor has introduced evidence that the partners will
27 incur a tax liability of approximately \$13.8 million. ITW does
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1 not dispute this calculation. For the purpose of weighing
2 hardship on the Debtor, however, this hardship must be
3 discounted to some extent, because it is Debtor's partners
4 rather than Debtor that will bear the tax burden.

5 Granting a stay pending appeal would cause harm to ITW,
6 because ITW would be forced to bear the economic risks of
7 ownership without enjoying all of the economic benefits of
8 ownership. The fair market value of the Property is \$97 million
9 and the balance on the ITW loan is \$99.5 million. Thus, it is
10 ITW rather than Debtor that will bear the risk of any decline in
11 the value of the property from the present time until ITW is
12 paid off or is permitted to foreclose. ITW will not, however,
13 reap all the benefit of any appreciation in value during that
14 period. If, for instance, the Property appreciates by \$5
15 million, ITW would reap one-half of that appreciation by having
16 its loan paid in full, and Debtor would retain the remainder of
17 the appreciation.

18 There are three ways in which this pernicious asymmetry in
19 the allocation of economic risk and benefit can be eliminated.
20 First, economic ownership could be transferred to ITW by
21 allowing ITW to foreclose. Second, the ITW loan could be paid
22 down to a conventional loan-to-value ratio. If the loan
23 represented only 75-80 percent of the value of the Property,
24 Debtor would bear the major risk of decline at the same time
25 that it enjoyed the benefits of appreciation. As noted earlier,
26 the evidence indicates that Debtor is not able to pay down the
27 ITW loan in this manner. Third, ITW could be given an

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1 enforceable right to recover a rate of interest sufficient to
2 compensate ITW for the high degree of risk that it is being
3 forced to bear. At the confirmation hearing, I determined that
4 this rate was "at least 10 percent" per annum. Debtor has
5 offered to pay ITW 10 percent during the pendency of the appeal.
6 For the reasons set forth below, however, I determine that this
7 offer does not provide ITW sufficient protection.

8 The problem with Debtor's proposal to make up any shortfall
9 in monthly payments is that it does not provide ITW an
10 enforceable right to receive 10 percent interest over a
11 sufficient period of time. The Property does not create income
12 sufficient to pay 10 percent interest. Debtor's partners
13 propose to make up the shortfall from their personal funds each
14 month. This proposal is an option, not an enforceable promise
15 by Debtor or its partners. If at any time the partners come to
16 believe that the Property is declining in value, they can simply
17 stop funding the shortfall and walk away. ITW would then
18 receive property that has declined in value and have no recourse
19 to any fund to make up that loss. This is a very real risk.
20 The evidence at the valuation hearing showed that the real
21 estate market in the area in which the Property is located is
22 very distressed. The market may be still declining, it may be
23 stabilizing. There is no evidence that rental rates or sale
24 prices have started to recover. Another weakness in Debtor's
25 proposal is that it will give Debtor a strong incentive to cut
26 corners regarding maintenance. Every dollar saved on

1 maintenance will lower the amount of the shortfall that the
2 partners have to make good.

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4 **CONCLUSION**

5 Relief from stay should be granted, because Debtor has no
6 equity in the Property, because Debtor was unable to confirm its
7 initial plan of reorganization, and because it is unlikely
8 Debtor will be able to obtain the financing necessary to confirm
9 its alternate plan. Stay pending appeal of the order granting
10 relief from stay and of the order denying confirmation is
11 denied, because Debtor has little likelihood of prevailing on
12 appeal, and because the balance of hardships does not tip
13 sharply in favor of Debtor.

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17 The court will stay the order granting relief from stay for 20
18 days to allow Debtor to seek a stay pending appeal from an
19 appellate court in an orderly manner.

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24 Dated: MAY 30, 2002

Thomas E. Carlson
United States Bankruptcy Judge

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