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DEC 9 2004

UNITED STATES
BANKRUPTCY COURT
FOR THE DISTRICT OF ARIZONA

UNITED STATES BANKRUPTCY COURT
IN AND FOR THE DISTRICT OF ARIZONA

In Re)
THE LEES CHILDREN L.L.C.)
Debtor.)

Chapter 11 Proceedings
Case No. 02-04-BK-12039-PHX-CGC
UNDER ADVISEMENT DECISION
RE: DEBTOR'S MOTION FOR
POST-PETITION FINANCING

I. INTRODUCTION

Debtor Lees Children LLC ("Debtor") has filed a motion seeking authority to borrow up to \$500,000.00 secured by a priming first lien on the Paradise Valley home that is Debtor's sole asset. Barbara Lees objects. On November 29, 2004, the Court held an evidentiary hearing and took the matter under advisement. For the reasons stated below, the Court denies the motion.

II. BACKGROUND

Debtor is an Arizona limited liability company. Its managing member is a trust of which two children of Nicholas and Barbara Lees are the beneficiaries. Nicholas Lees is a debtor in another currently pending bankruptcy proceeding; Nicholas and Barbara Lees are divorced.

Barbara Lees was the original trustee of the trust and the manager of the LLC. The Superior Court of Arizona, in probate proceedings, removed Ms. Lees from both of those positions and appointed Marlene Appel, a lawyer experienced in probate and guardianship matters, in her stead. Ms. Appel caused this bankruptcy to be filed.

Debtor owns one asset of value, a 2.35 acre lot and house located on Solano Drive on the north side of Camelback Mountain in Paradise Valley, Arizona. All parties agree that the current value of the house is at least \$2.1 million. It is currently encumbered by a first lien in favor of Washington Mutual for approximately \$600,000.00. The present motion seeks to prime Washington Mutual with a new loan of up to \$500,000.00. Washington Mutual has consented to

1 having its secured position primed conditioned upon it receiving adequate protection in a form
2 and manner it has negotiated with Debtor.

3 Debtor initially sought post-petition financing in the amount of \$250,000.00. At a
4 previous hearing, the Court found that inadequate notice had been given to Washington Mutual
5 and directed the Debtor to give such notice promptly. Once Washington Mutual became
6 engaged in the process, terms and conditions of adequate protection were negotiated. The
7 proposed use of the proceeds is as follows:

- 8 1) \$100,000.00 to bring Washington Mutual current and to establish a payment
9 reserve for approximately 6 months;
- 10 2) \$90,000.00 to establish a reserve for the post-petition lender and to pay loan
11 expenses;
- 12 3) \$120,000.00 in additional reserves (for unknown or unexpected expenses);
- 13 4) \$25,000.00 for insurance;
- 14 5) \$125,000.00 for legal accounting and appraisal expenses;
- 15 6) \$35,000.00 to address the property's violations of the Town of Paradise Valley
16 codes and to hire consultants needed to complete due diligence and evaluation
17 with respect to the alternatives available for the property;
- 18 7) \$2,000.00 for United States Trustee's fees.

19 As originally requested and noticed, Debtor sought only \$250,000.00; that was changed
20 through a "supplement" that was subsequently filed. As originally presented at the hearing, the
21 terms of the loan would be as follows:

- 22 1) Interest rate prime plus 10%, compounded daily;
- 23 2) Facility fees – 4% of the loan amount (\$20,000.00);
- 24 3) Prepayment penalty equal to interest on loan amount for full term;
- 25 4) Extension fees – 1% for 30 day period after term
- 26 5) Default rate prime plus 19%;
- 27 6) Reimbursement of all expenses.

1 Thus, the cost of the funds, as originally presented, would be \$20,000.00 in commitment
2 fees, approximately \$75,000.00 in committed interest payments and legal fees. These amounts
3 total roughly \$100,000.00. Therefore, under the loan as originally presented, \$100,000.00 of the
4 \$500,000.00 proceeds would be used to pay fees, interest, and expenses back to the lender.

5 After questions were raised at the hearing as to the high cost of the money, Debtor
6 negotiated with the lender during a court break for concessions on the fixed fee amount. As a
7 result of those negotiations, Debtor represented on the record that the lender had agreed to reduce
8 the pre-payment penalty to 90 days of interest on \$250,000.00 or the amount actually borrowed,
9 whichever is greater. This would reduce the committed interest to approximately \$10,000.00
10 from \$75,000.00. Of course, if the full \$500,000.00 were borrowed for the full term, the interest
11 due would be approximately \$75,000.00.¹

12 Everyone agrees that the house is in poor condition and is currently uninhabitable. There
13 have been numerous violations cited against the property by the Town of Paradise Valley that
14 need to be addressed quickly. No more than \$35,000.00 has been set aside for this purpose,
15 however.

16 According to Ms. Appel, the loan is needed because the estate is totally without funds.
17 She alleges that this has resulted from the "looting" of the LLC by Ms. Lees when she was
18 manager. As a result, although Ms. Appel has been in control of Debtor for nearly a year, she
19 argues that she has been unable to do the kind of due diligence necessary for her to decide how
20 best to maximize the value of the property for the benefit of the estate. Out of the fees for legal
21 and other expenses, she proposes to pay approximately \$25,000.00 to a general contractor,
22 architect, engineer and other specialists to advise on how best to maximize the value.

23 At the hearing, Ms. Lees presented testimony from a developer who specializes in
24 building custom homes in the high end market as well as a realtor who has specialized for the last
25 thirty years in the same market niche.

26 All parties seem to agree that Ms. Appel is faced with a limited number of choices. She

27 ¹These are rough calculations based upon prime rate at approximately 5%.
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1 could sell the property as is, yielding basically the land value of approximately \$2 million. She
2 could tear down the house and "scrape" the land, preparing it for sale as a lot, thereby controlling
3 the cost of the demolition and removal. She could remodel the house to improve its overall
4 value. Finally, she could build a new house up to current luxury home standards on the property,
5 thereby potentially raising the value significantly.

6 As Ms. Appel puts it, her dilemma is that she does not know which of these alternatives is
7 best until she can engage the experts to advise her, and she cannot engage the experts to advise
8 her until she has the funds to do so. As a result, this case has stalled for approximately one year.
9 In addition, Ms. Lees has claimed a leasehold interest in the property that has clouded the title.
10 This has been the subject of separate litigation in probate court where currently a preliminary
11 injunction is in place barring Ms. Lees access to the property. At the hearing, Ms. Lees agreed
12 that the house could be sold free and clear of liens and other interests and that her lease claims
13 would attach to the proceeds. Thus, the existence or nonexistence of the lease is no longer a bar
14 to the sale of the property.

15 Ms. Lees filed a motion to compel the trustee to sell the property. She has produced a
16 buyer who has offered to pay 94% of the average of three appraisals of the property in "as is"
17 condition. Previously, Ms. Lees stated that she would consent to such a sale free and clear of her
18 lease interest only if the purchaser were Mr. Gray; at the hearing, she removed that condition.
19 Mr. Gray consented to the property being sold at auction so long as the time period was limited
20 to 30 or 45 days.²

21 Both of the witnesses testified that construction costs for a new house on the lot would be
22 no less than \$250.00 a foot and that the expected return would be in the vicinity of \$500.00 a foot.
23 However, Mr. Davis, the real estate agent, testified that the market for houses in excess of \$5
24 million in Paradise Valley is very thin at the moment and that only 4 or 5 houses have sold in the
25 last year. Of 45 houses listed at \$4 million or above, only 14 have sold. In order to build a

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27 ²Mr. Gray has agreed that Ms. Lees and her two girls could continue to rent the house
28 until they finish school.

1 house up to current standards, the estate would have to borrow a substantial amount of money –
2 probably around \$2.5 million – against the possibility that the house could be sold in a
3 reasonable period of time after completion to justify the additional return to the estate. This
4 scenario is further complicated by the strict procedures in place in the town of Paradise Valley
5 for obtaining the necessary approvals and permits, including the fact that the lot is subject to the
6 hillside ordinance and review process.

7 Ms. Appel testified that she was advised that renovations could be made to the house with
8 an approximate budget of \$750,000.00. However, there was no evidence directly from a witness
9 with knowledge on this subject.

10 In summary, therefore, the situation is as follows. Ms. Appel wants to borrow
11 \$500,000.00, of which a maximum of \$35,000.00 would be spent actually improving the
12 property. Those improvements would be limited to what is necessary to satisfy the inspectors of
13 Paradise Valley. The primary focus of the borrowing is to obtain the \$25,000.00 needed to hire
14 the necessary consulting experts. Ms. Appel asserts that she is unable to make an informed
15 decision on what to do in the absence of hiring the experts but that she expects she could get a
16 response from them within 30 days.

17 As a general rule, the Court will defer to the trustee or debtor-in-possession on matters
18 involving business judgment where that judgment has been exercised within reasonable bounds.
19 Based on the record in this case, the Court concludes that borrowing this amount of money on
20 these terms for these uses is not a reasonable exercise of the business judgment of the debtor-in-
21 possession. The Court is not convinced that there are not less expensive alternatives available to
22 achieve the results requested. Even at the lower numbers, the fees and expenses to be incurred
23 for this loan are substantial and significantly exceed the amount of money that would be actually
24 used for the purpose stated – obtaining the due diligence. The Court fully acknowledges the
25 “chicken and egg” problem that exists here but cannot find that a loan of this size for these
26 purposes can be justified. This conclusion is based upon three things:

- 27 1) The amount, price and terms of the loan;

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- 2) The unlikelihood that a remodel solution at a reasonable price would produce a significantly large enough incremental return to the estate to be a reasonable alternative; and
- 3) The fact that the “tear down and rebuild” scenario would, even under the best of circumstances, involve enormous risks for the estate, could be subject to substantial delays, would always be subject to market risk on the resale of the property, and would put the estate at unreasonable risk.

Therefore, the motion will be denied without prejudice. Ms. Appel has 30 days within which to present a new scenario for performing the due diligence she believes is necessary. If such a scenario cannot be presented within 30 days, the Court will hold a continued hearing to determine if the motion to compel sale of the property should be granted. The Court notes that, in the absence of substantial new facts to the contrary, the Court would be inclined at that point to grant such a motion.

So ordered.

DATED: Dec. 9, 2004


 CHARLES G. CASE II
 UNITED STATES BANKRUPTCY JUDGE

APM
 COPY of the foregoing sent via facsimile and/or mailed this 9th day of December, 2004, to:

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