SIGNED.

Dated: March 05, 2009

JAMES M. MARLAR
U.S. Bankruptcy Judge

IN THE UNITED STATES BANKRUPTCY COURT

FOR THE DISTRICT OF ARIZONA

In re:	)	Chapter 11
	)	
TEMPE LAND COMPANY, LLC,	)	No. 2:08-bk-17587-JMM
	)	
Debtor.	)	**MEMORANDUM DECISION**

On February 26 and 27 and March 4, 2009, this court heard argument and took evidence on the U.S. Trustee's motion to appoint a trustee (Dkt. #83). After consideration of the matters submitted, the court rules.

JURISDICTION

This is a core proceeding, 28 U.S.C. § 157(b)(2)(A), over which this court has jurisdiction.

FACTS

A. General Background

This case presents several facets of a domino effect caused by an earlier bankruptcy filing by Mortgages Ltd. ("ML").

An involuntary chapter 7 bankruptcy was filed against ML on June 20, 2008, Case No. 2:08-bk-07465-RJH. The case was converted to chapter 11 on June 24, 2008. ML had been the principal lender to this Debtor, Tempe Land Company, LLC ("TLC"), and had lent it approximately $133 million, with commitments to lend an additional $45 million. Suddenly, ML found itself unable to do so and, along with many other financial problems, filed its bankruptcy case. ML had a lien on the TLC project known as Centerpoint. At that time, this Debtor, TLC, had used the funds advanced by ML to partially construct two residential-living towers in Tempe, Arizona, near University and Mill Avenues. One of the towers is approximately 90% complete, and the second is about 75% complete.

ML's filing left TLC in a precarious financial condition, and without a secondary lending source ready to fill the gap left by ML's collapse, TLC was itself forced to seek bankruptcy protection. The entire scenario, as if not bad enough, became additionally complicated by the crisis in the financial markets, a slowdown in the United States (and international) economies, and the drop in values of real estate, both nationally and in the greater Phoenix area.

B. ML'S Bankruptcy Loan to TLC

As noted, ML obtained chapter 11 relief on June 24, 2008 (ML Dkt. #36). Because this event contributed to TLC's difficulties in being able to move forward on its project, certain critical and urgent needs arose for TLC's project.

On August 19, 2008, TLC and ML petitioned the ML bankruptcy court for an interim loan, in order for TLC to "button up" the buildings and pay urgent needs to preserve and protect ML's collateral and TLC's property (ML Dkt. #408). The court approved an immediate loan from ML to TLC (ML Dkt. #483), which ML itself borrowed from Stratera Portfolio Advisors, LLC on a DIP loan basis. (Ex. 8.)

The loan from ML to TLC was split into two segments: (1) a critical need segment of $1.8 million (Ex. 4.3); and (2) a secondary segment for less immediate and essential needs. The total loan added up to about $4.8 million. (Ex. 4.2.) TLC used the majority of such funds for

authorized purposes, but created problems for itself by using $568,706 to reimburse one of its affiliates, Avenue Communities, for advances made for what had been included in, and used for TLC's critical needs budget, and by using another $142,177 (which was in the less critical second segment funding for certain "soft costs") principally for attorneys' fees. (Ex. 85.)

C. Motion to Appoint a Trustee

Primarily because of the unauthorized uses of the ML loan, the U.S. Trustee and two other interested parties (Radical Bunny and the ML Investors' Committee) filed and/or joined in the U.S. Trustee's motion in this case. In addition, ML also filed a contempt motion in its case, based upon the same grounds (ML Dkt. #1076).

On January 23, 2009, the U.S. Trustee filed a motion to appoint a trustee (Dkt. #83) or alternatively a motion to convert the case to chapter 7 or dismiss it. On February 2, 2009, ML joined in the U.S. Trustee's motion (Dkt. #105) (later withdrawn by Dkt. #176); on February 3, 2009, the ML Investors' Committee joined (Dkt. #122); and on February 4, 2009, the Radical Bunny chapter 11 trustee also joined the U.S. Trustee (Dkt. #133).

ML is the owner of 70% of the current loan from ML to TLC, while the ML Investors own the other 30%. Radical Bunny's interest is more indirect, as it holds a collateral assignment in "ML's notes and deeds of trust," which include the TLC obligation.

Along with TLC, approximately 17 creditors have opposed the relief sought by the U.S. Trustee, and have urged the court to allow the chapter 11 debtor to have an opportunity to reorganize and propose a plan which has the possibility of paying them what is due (Dkts. ## 97, 101, 104, 106, 107, 109, 110, 111, 112, 113, 116, 117, 119, 125, 128, 131 and 179).

As for the ML contempt motion, which arises out of the same facts, ML has now entered into a settlement agreement with TLC (Ex. 91), and has withdrawn from the present skirmish, leaving the U.S. Trustee, Radical Bunny and the ML Investors' Committee to go it alone. ML has now filed a pleading expressing its satisfaction with the repayment terms agreed to with

TLC, and is also placated by TLC's commitment to hire a "Financial Compliance Officer," in the person of Robert P. Abele, a longtime member of the private trustee panel (Ex. 90).

D. Grounds for Appointment

The U.S. Trustee, in its initiating pleading, set forth several grounds for its requested relief, alleging that the Debtor:

(1) has no equity in the assets it holds as evidenced by its Statement of Financial Affairs and accompanying schedules it has filed;

(2) has no source of liquidity to pay its ongoing expenses;

(3) has had to seek funds from its creditors to pay for a short term extension of its builder's risk insurance policy;

(4) has no employees;

(5) has no current operating business;

(6) has no confirmed source of takeout financing by a third party after over five (5) months of searching;

(7) has lost the confidence of the majority of its creditor body by the actions it has taken with regard to the expenditure of the Mortgages Limited Loan proceeds;

(8) is currently facing an Order to Show Cause hearing for potentially violating the terms of the Interim Order and improperly using the Mortgages Limited Loan proceeds;

(9) had to obtain either an equity infusion, or loan, from an affiliate company to pay for its bankruptcy counsel's retainer in this case;

(10) has failed to seek an employment application for the firm that it has retained to bring the Adversary Action; and

(11) has failed to timely file its first monthly operating report in this case.

Each area will be discussed by the court.

1. Improper Use of the ML Emergency Loan Funds

The bulk of the evidence presented in this case involved the Debtor's unauthorized use of some of the emergency ML loan funds, approved by ML's bankruptcy judge on September 3, 2008 (Ex. 8). Of the $2.8 million authorized in the first draw, the TLC Debtor ended up with about $1.8 million in hand. (Ex. 43.) With that cash, TLC allowed the following sums to be paid out, or deducted, which had not been part of the approved budget (Ex. 4.2; 4.3; 85):

$568,706.00	Reimbursement to Avenue Communities for windows
142,177.16	"Soft costs" (principally attorneys' fees)
82,814.27	Overdrafts repaid
$793,697.43	Total

(Ex. 85.)

As for the Avenue Communities' reimbursement and the money paid to the TLC attorneys, the Debtor admits that it did so, but argues that Avenue had already advanced such sums to pay for the needed--and approved--repairs, and thus the approved amounts were "paid," but in a slightly different fashion than set forth in the critical budget.

The U.S. Trustee argues that such money would not have had to have been drawn down at all, because an emergency no longer existed. Thus, the "critical need" had evaporated, making that aspect of the ML borrowing unnecessary.

As for the payment of the attorneys' fees, TLC notes that it believed it had permission to use "Tranche 2"monies in the "Tranche 1" draw. There is support for TLC's position on this point, and correspondence indicates that such perception was plausible. (*See* Ex. 4.11; 26; 61; 75.)

The automatic deduction for the bank's overdraft fees appears to be the more minor issue, due to its relatively small size and the fact that such event was not foreseen.

The most serious breach of the spirit, if not the letter of the "Tranche 1" funding and understandings, was Avenue's reimbursement. On this point, the court concludes that TLC's

management knowingly exceeded its authority, and is now simply rationalizing a weak excuse. (*See, e.g.*, 81; 32; 33.) The real issue, though, is whether this dereliction of duty rises to the level of requiring a trustee in this case, or dismissing or converting it.

And, as events have now unfolded, the party who was most injured thereby, ML, has withdrawn its joinder in the U.S. Trustee's motion, because it has entered into a settlement of its dispute with TLC. (*See* Ex. 91.) As ML has a 70% stake in that part of the controversy, its withdrawal of its opposition to TLC has taken a large amount of air from the U.S. Trustee's motion, but not enough to cause the motion to fully stall. Nevertheless, 70% of the current controversy has suddenly been mooted out.

2. No Liquidity

The U.S. Trustee presented no affirmative evidence on its argument that the Debtor has no liquidity with which to continue its building projects. However, the Debtor has been resourceful, finding interim funding and even potential long-term financing. It thus continues to move forward, feeling its way along through a difficult financial maze.

Thus, it appears that the Debtor may be able to complete its building projects. How it survives past the completion point, in this market, remains a feasibility issue once TLC presents a reorganization plan.

For now, however, it appears that the U.S. Trustee's concerns on this issue have been allayed.

3. Operating Report

The U.S. Trustee argued that the Debtor had failed to file its first monthly operating report in the case. However, on February 4, 2009, the December report was filed (Dkt. #132). Thus, this concern has been mooted out. And, in addition, January's report has now also been filed (Dkt. #174).

4. No Equity

In its schedules, the Debtor showed its current real property value to be $152,398,371, and its personalty to be worth at least $380,750. In its secured creditor column, between materialmens' and mechanics' liens, and consensual liens, the Debtor reflected $152,398,371 of secured claims (Dkt. #49), and $46,640,862 of unsecured claims.

While, facially, the U.S. Trustee's position may be accurate (liabilities exceed assets), this is not necessarily a reason to convert the case to a chapter 7 proceeding, or to dismiss it. It is still possible to reorganize, even if creditors are only paid a percentage of their total debt. Ultimately, it is the creditors who will vote to approve or disapprove the Debtor's plan, and they may voluntarily agree to accept only half a loaf, in lieu of nothing at all.

Therefore, this "no equity" fact, standing alone, is insufficient to appoint a trustee, or to convert or dismiss the case.

5. DIP Loan for Builders Risk Insurance

The immediate need to borrow, in order to keep insurance protection active, is an insufficient reason to grant any part of the U.S. Trustee's motion. And, with the approval of an interim loan on March 3, 2009, partially for this purpose, this issue has now been rendered moot.

6. No Employees and No Current Operating Business

The Debtor clearly has an operating business, and the evidence showed that it is competent in managing it. But for ML's failure, this Debtor may have been able to not only survive, but to make a profit. That the Debtor has other affiliates and associated businesses that each handle specialized or related parts of the entire project does not mean that this Debtor is incapable of proposing a feasible plan. The Debtor is very much operating, and so far, appears to be making steady progress.

On this ground, the U.S. Trustee's motion must be denied.

7. No Confidence of the Majority of Its Creditor Body

Events since the filing of the U.S. Trustee's motion have tended to moot out this argument. ML, which holds a $133 million lien, according to the schedules, in addition to the instant $2.8 million emergency loan, has withdrawn its voice on the trustee / conversion / dismissal issue. In addition, 17 other creditors have joined with TLC in resisting the U.S. Trustee's motion. It appears now that the majority of the interested creditors, in both number and dollar amount, support the Debtor's efforts to reorganize, and to keep it as a debtor-in-possession.[1]

Creditor confidence tends to support, rather than oppose the Debtor.

8. Takeout Financing

Now waiting in the wings may be a motion to approve much of the remaining amount necessary for construction financing (Ex. 87, 89). Taking the case one step at a time, this is an important step, because eventually a permanent lender will only commit to long-term takeout financing when it is assured that the project it lends to is both finished and capable of repaying the loan. The Debtor is showing the necessary progress to reach that final goal. Thus, that the Debtor cannot today show a firm, takeout lender is not a ground for conversion, dismissal or the appointment of a chapter 11 trustee.

[1] Two of the subcontractors, Mr. Randy Bafus of Heritage Interiors and Mr. Don Martin of Danko Plumbing have opined that they work well with the Debtor and its managers, who they feel are ethical and professional, and foresee that the appointment of a trustee would set back the progress made to date.

Similarly, one of the ultimate condominium purchasers, Mike Willard, agrees and trusts this Debtor's principals to move forward. (*See* Ex. 94.)

9. Bankruptcy Counsel Retainer Payment

That a third-party has either contributed to bankruptcy counsel's fees, or has committed to do so, is neither novel nor egregious. So long as proper disclosures are made, and the source of payment does not create inherent conflicts of interest, there is no impropriety in such practice.

These grounds for relief are therefore overruled.

10. Employment Application for Adversary Counsel

The adversary proceeding commenced by the Debtor was filed on December 8, 2008. But, all parties were dismissed without prejudice (before filing answers) by December 11, 2008 (Adversary No. 2-08-ap-00912-JMM). No answers were filed, nor does it appear from the docket that service was ever attempted. That adversary is closed. To date, such special counsel have not sought fees. Thus, it appears that whatever sound and fury was associated with that adversary proceeding has now vaporized, and what was once an issue is now moot. These facts do not present a basis to grant the U.S. Trustee's motion.

THE LAW

The request to appoint a trustee calls for a basic assessment of the Debtor's ability to control its affairs, in a chapter 11 case, as a "fiduciary." If management is grossly incompetent or dishonest, they should be replaced by an independent trustee in whom all parties and the court have confidence. 11 U.S.C. § 1104. The test is not strictly legal, but mostly factual, and grounded in common sense. *In re Klein/Ray Broadcasting*, 100 B.R. 509, 511 (9th Cir. BAP 1987). In other words, the court has broad discretion to determine whether the Debtor's conduct, even if improper, rises to the level of "cause" for appointment of a chapter 11 trustee, considering the "wide spectrum"

of conduct and the various interests involved in the bankruptcy proceeding. *See, e.g., Committee of Dalkon Shield Claimants v. A.H. Robins Co., Inc.*, 828 F.2d 239, 241 (4th Cir. 1987).

It is clear that TLC knew exactly what it was doing when it used $568,000 to reimburse Avenue Communities, and another $142,000 to pay its attorneys and other "essential soft costs" from the first draw. But did those decisions harm the project? The court believes not. Should the Debtor have been more forthcoming? Yes. Were these expenses justified under all of the circumstances of the case? Perhaps. Has there been irreparable injury? That has not been shown up to this time. Have feelings been hurt? No doubt. Do people feel as if they've been misled? Of course. But can the Debtor move forward, with its current management, toward a plan of reorganization that will pay creditors? The answer to that ultimate question is that it appears that it can, and probably with more dispatch than educating a trustee to the issues (along with a trustee's attorney and attendant costs).

The events complained of occurred pre-petition and arose out of a desperate situation. TLC's management acted partially in panic to events that had sent TLC's business formula spinning down a different track. But, if given a chance, this management team may be able to ride out the storm and succeed.

The court clearly has concerns that Judge Haines' emergency order was misconstrued, or violated. But Judge Haines can deal with that issue in the ML case. As far as this case is concerned, the Debtor created additional unnecessary debt which was then paid to an insider as a preferential payment. But the record shows that that damage is being resolved by the settlement with ML.

As for this court's decision, while it in no way condones the TLC decision to pay Avenue Communities from the ML loan without approval of the ML court, upon notice and hearing, the evidence showed that this was an isolated incident, born out of the desperation of the moment. Had there been a proven pattern of the same type, the court would be more inclined to appoint a trustee.

But, taking the broader view, it does not appear that the best interests of the creditors of the TLC bankruptcy would be better off with a trustee. With the ongoing tight scrutiny of the

court, creditors, U.S. Trustee, the Debtor's bankruptcy counsel and a financial compliance officer, this court finds that this case, for now, can proceed more expeditiously and fruitfully as a debtor-in-possession.

The court will, however, appoint Robert P. Abele as the Financial Compliance Officer, to oversee the Debtor's future use and expenditure of funds. If any party objects, they should file those objections within ten days, and a hearing will be set. In addition, Mr. Abele shall be granted independent legal standing to bring to the court's attention, on his own motion, any improprieties which he cannot himself cure, and any such hearing will be heard on an accelerated basis.[2]

ANALYSIS

The U.S. Trustee's strongest argument has to do with the unauthorized use of the ML funds. But, looking at the issue in a larger sense, the Avenues' reimbursement did not reimburse costs that were used for purposes besides the project. In other words, the money previously paid by Avenue Communities did go toward preserving the TLC project, and thus benefitted ML.

As for the "soft cost" attorneys' fees, the second leg of the ML DIP loan did have a line item for those sums. This payment was perhaps premature, but was nonetheless authorized in draw no. 2. ML's bankruptcy filing cannot be looked at in a vacuum--its filing and defaults affected TLC, and no doubt many others. TLC had to protect itself, and bankruptcy attorneys are one very important way of doing that in commercial bankruptcy proceedings. Moreover, such attorneys' fees are an administrative priority in this bankruptcy, and a method for paying them would likely have been approved early in this case. As for the reasonableness issues, those can be addressed, if necessary, at a later time.

Had the ML "unauthorized use" funds been used for something unrelated to the TLC project, then the arguments for a trustee would hold more water. But, because the funds were used

[2] The U.S. Trustee, counsel for the Debtor or the creditors should endeavor to craft a separate form of order which meets these, and any other important criteria.

for TLC's direct benefit, and also because ML has now settled with TLC, the initial bang has been reduced to a whimper.

While the court appreciates the argument, and notes that the Debtor may have played fast and loose with the ML loan, the court was not left with a sense that it has been dishonest or that it has incompetent managers for this chapter 11 proceeding. With the strict control and oversight that a chapter 11 proceeding brings, the creditor body can keep a tighter rein on the Debtor's activities, and TLC's activities must of necessity become transparent.

On the record before the court, then, the court cannot find that the U.S. Trustee has carried its burden by clear and convincing evidence. The Debtor may remain as a debtor-in-possession.

RULING

A separate order will be entered which DENIES the U.S. Trustee's motion to appoint a trustee, or convert or dismiss this case. The order will also appoint Robert P. Abele as the Debtor's Financial Compliance Officer.

DATED AND SIGNED ABOVE.

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