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You Can't Play Hide-And-Go-Seek in Chapter 11

Written By **Lance P. Martin** (lpm@wardandsmith.com)
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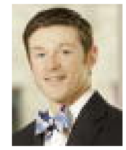

In a Chapter 11 bankruptcy, the debtor attempts to reorganize its affairs in a Chapter 11 Plan.

When the debtor files its proposed Plan, it must also file a Disclosure Statement providing creditors and claimants with "adequate information" about the Plan. Creditors rely on the Disclosure Statement to learn how, and it what amount, the debtor will re-pay them under the Plan, and what risks they will face under the Plan. Armed with this information, creditors and claimants can support or oppose the Plan, and the Court can determine if the debtor may proceed to a confirmation hearing.

In a recent case involving a real estate developer in Chapter 11, the United States Bankruptcy Court for the Eastern District of North Carolina discussed the importance of the Disclosure Statement as a prerequisite to a debtor's ability to move forward with a plan of reorganization. In In re CHL, the debtor's primary operations involved developing property in a multi-phase subdivision called Scotts Hill Village in Wilmington, North Carolina. The Debtor owned 52 developed lots and 57 acres of undeveloped land when it filed bankruptcy.

The Bankruptcy Code requires a disclosure statement to contain "adequate information" -- meaning information of a kind, and in sufficient detail, as far as reasonably practicable, given the nature and history of the debtor and the condition of the debtor's books and records, to enable a hypothetical investor to make an informed judgment about the plan. The disclosure required will depend on the particular case. The Bankruptcy Code prohibits a court from issuing final approval of a disclosure statement without finding that the statement contains adequate information under the circumstances.

The Status of the Property and the Debtor's Plan

In In re CHL, the Disclosure Statement outlined the status of the seven phases of development of the property. It also outlined the primary intention of the Plan -- to sell lots to a residential builder named Level Carolina Homes, LLC ("LCH").

According to the Disclosure Statement, the Debtor initially planned to sell 52 lots in Phases 1 and 2 to LCH for $85,000.00 each, for a total of $4,420,000.00. Although a construction budget attached to the Disclosure Statement stated those phases were 100% complete, the Debtor was responsible under a contract with LCH for preparing the lots for a sewer connection. According to the Court, those phases were "far from being completed."

The Disclosure Statement also stated that the Debtor's contract with LCH required the Debtor to meet certain development benchmarks, including the completion of an amenity center within Phase 7 of the subdivision, within twelve months of the sale. The Debtor attached a site plan to the Disclosure Statement, but the delineation of the phase locations was unclear due to the small scale of the site plan.

The Construction Reserve

The Disclosure Statement called for a "Construction Reserve" of $500,000.00 (then reduced to $100,000.00) as a development cost to be withheld from creditor distribution. The Debtor did not explain why a reserve of this amount was necessary, other than a perfunctory mention of use for "change orders, increases in material prices, contingencies, or unexpected costs." The Court found that a line item of this amount demanded more explanation.

The Critical Role of the Builder

The Plan contemplated the future purchase by LCH of lots in Phases 3 through 7 after they were developed to LCH's specifications. Because the Plan relied extensively on the Debtor's relationship with LCH and LCH's ability to perform, the Court found that the Disclosure Statement should have provided information about LCH in these areas: its history as a residential builder; other similar projects; its ownership; its licensing; any pending legal action; its prior relationship with the Debtor and its principals; and its capitalization.

The Value of the Property

The Disclosure Statement did not explain why the Debtor valued the Property at $8,000,000.00 in its current condition. The Debtor obtained this figure from a foreclosure credit bid by one of its creditors. But the Debtor provided no other estimate of value from any other source, even though, as the Court pointed out, it should have known the foreclosing creditor would not use a going concern value in its bid at a foreclosure sale.

Closing Costs, Commissions, and Management Fees

The Disclosure Statement projected closing costs associated with the sale of the Debtor's lots to LCH, including a 4% fee to the Debtor "for general administrative costs of continuing to manage the subdivision and its development" and a 6% commission to JEF Management, LLC ("JEF") for brokerage fees. The Disclosure Statement did not detail the management services the Debtor would performing to warrant those fees. Ernest Woodrow Davis Jr., the Debtor's principal, intended to retain his 100% interest in the Debtor, so management fees paid to the Debtor would presumably go to him.

As for JEF, the Disclosure Statement was vague about the anticipated 6% commission for the sale of the 52 lots. And evidence suggested that JEF shared the same office address as Davis and that JEF's managing member may qualify as an insider of the Debtor due to her close relationship with Davis. The Disclosure Statement contained no information about JEF's relationship to the Debtor. The Court pointed out that, upon the initial sale of the 52 lots, JEF could earn over $265,000.00 in commissions from the initial sale of 52 lots to LCH and the Debtor could earn management fees of as much as $331,500.00. The Court found that the Debtor had to be transparent about its relationship to JEF and the anticipated brokerage and management work under the Plan.

In conclusion, the Court held that the Debtor's Disclosure Statement did not contain adequate information under the circumstances. If the Debtor wanted to proceed with a plan of reorganization, it would have to file an amended disclosure statement.

Creditors and claimants in Chapter 11 proceedings, whether involving real estate developers or otherwise, can use this decision as a guide for evaluating and objecting, when necessary, to disclosure statements. As the decision highlights, adequate disclosure requires all pertinent information about valuation of the debtor's property, high-value carve-outs, the method and means of implementation of the plan, any clear inaccuracies in the plan, payments to the debtor or its principals and insiders, and the role of third parties and their relationship to the debtor. Creditors are entitled to this information before deciding to support or oppose a Chapter 11 plan.

Ward and Smith represented the lead creditor in this case.

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