

Bankruptcy's Impact on Real Estate

Sun Valley, Idaho

July 17, 2009

Honorable R. Kimball Mosier  
United States Bankruptcy Judge  
Frank E. Moss United States Courthouse  
Salt Lake City, Utah 84101

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**I. The Woeful Tale of Jackalope Estates**

You've heard of Jackalope Estates, even if you never have. Situated on the outskirts of Grantsville, Utah, Jackalope Estates was the brainchild of real estate mogul Rex Rogers. Rex's good friend and sometimes business partner, Freddy Stonewall, is a general contractor and his company handled the construction of Jackalope Estates.

In early 2006, Rex acquired the 25 acres that became Jackalope Estates using a newly formed Utah limited liability company—Jackalope Estates LLC. Rex conceived of converting the 25 acres of sagebrush and sand into a bedroom community of 60 single family residences priced from \$220,000 when complete. Rex bought the raw land for \$2 million, financed using \$1.5 million from Texas American Republic People's Bank (aka TARP Bank). Rex used \$500,000 of his own money to complete the purchase.

In 2006, Rex was able to subdivide and entitle the development. Freddy Stonewall's company installed necessary water and sewer connections and paved streets and sidewalks. Freddy obtained the asphalt and cement necessary to complete the paving

from his long-time supplier, Paul's Paving Products. Because of their long-standing relationship, Paul's Paving was willing to extend credit to Freddy in a greater amount and with longer terms than Paul's Paving would provide to its ordinary customers. Freddy Stonewall's construction company began building homes in late 2006.

Paul's Paving completed its contract to supply asphalt and cement in March 2007. It was owed approximately \$500,000 for the asphalt and cement it supplied to the development. To protect its position, Paul's Paving filed a notice of mechanics' lien in July 2007, although Paul's Paving was always confident that it would be paid by its long-time customer Freddy Stonewall. Unfortunately, Freddy Stonewall and his companies filed Chapter 7 bankruptcy petitions in October 2007. In November 2007, Paul's Paving filed a lawsuit in Utah state court to enforce its mechanics' lien.

Rex Rogers was forced to find a replacement contractor after Freddy Stonewall's bankruptcy. Rex decided that he had enough experience to finish the job himself, and so he obtained a general contractor's license and worked to complete the development. By July 2008, about half of the homes planned for Jackalope Estates had been constructed. Although sales were quite slow, Rex had every reason for optimism because his homes were priced to meet the one area of the real estate market where buyers existed—homes under \$250,000. Unfortunately, Rex ran out of money in mid 2008.

Desperate for capital to complete the development, Rex resorted to hard money. The Darth Family Fund's terms were harsh, but better than the bankruptcy alternative. The Darth Family loaned Rex \$3.5 million he needed to complete the development, backed by an appraised value (as of July 2008) of \$6 million. The Darth Family knew it was in second position on the Jackalope Estates property, behind TARP Bank's \$1.5 million loan. But the Darths did not check for mechanics' liens filed against Jackalope Estates, and therefore the Darths did not realize that Paul's Paving had filed a \$500,000 mechanics' lien for material it supplied to the development.

Despite an aggressive marketing plan, sales of Jackalope Estates homes slowed through 2008 and early 2009. Although 40 homes had been constructed, only 15 had been sold. Jackalope Estates could no longer afford to make required interest payments

to the Darth Family, and the Darths commenced a non-judicial foreclosure process. On June 15, 2009, on the eve of the Darths' scheduled foreclosure sale, Jackalope Estates, LLC filed a voluntary Chapter 11 bankruptcy petition.

Jackalope Estates' bankruptcy schedules listed real estate having a value of \$6 million. It listed the following claims as secured by its real estate: TARP Bank (\$1.5 million), Darth Family Fund (\$3.5 million), and Paul's Paving (\$500,000). Jackalope Estates also listed \$750,000 in unsecured debt in its bankruptcy schedules. The bankruptcy case was assigned to Judge R. Kimball Mosier.

A flurry of activity followed. The Darth Family Fund immediately filed a motion for relief from the automatic stay to foreclose its lien on Jackalope Estates. The Darth Family Fund obtained an updated appraisal of Jackalope Estates immediately after the bankruptcy filing showing that the development was now worth only \$5 million—less than the combined secured debt of TARP Bank and the Darth Family Fund.

Just one week after the Darth Family Fund filed its for relief from the automatic stay, the debtor Jackalope Estates LLC filed an emergency motion to approve the sale of the Jackalope Estates development to the Vulture Real Estate Fund for a total price of \$5.5 million. The debtor proposed that the sale would be free and clear of liens under Bankruptcy Code § 363(f), with any valid liens to attach to the proceeds of the sale.

Paul's Paving filed an objection to the sale, arguing that it holds a valid mechanics' lien against Jackalope Estates, and that it did not consent to the sale under Bankruptcy Code § 363(f)(2), and because the debtor's proposed sale is for less than the face amount of the liens against the property, the debtor cannot sell the property free and clear of liens under Bankruptcy Code § 363(f)(3). Paul's Paving gave notice in its objection to the sale of its offer to purchase Jackalope Estates for \$6 million. The competing bid is a credit bid of Paul Paving's \$500,000 mechanics' lien, coupled with \$5.5 million in cash, although the offer was contingent upon Paul Paving's obtaining financing for \$3 million of the purchase price.

Judge Mosier scheduled an evidentiary hearing to consider all of the pending motions on July 17, 2009.