In the United States Bankruptcy Court

for the Northern District of Iowa

Western Division

DESAI PROPERTIES, INC.	Bankruptcy No. 93-50509XS
DESAI CORPORATION	Bankruptcy No. 93-50508XS
Debtors.	Chapter 11

DECISION RE: JOINT PLAN OF REORGANIZATION

The debtors' joint plan of reorganization is before the court for confirmation. Debtors filed their chapter 11 cases on March 25, 1993. Joint First Amended and Substituted Plan of Reorganization was filed September 14, 1993. Amendments to the plan were filed December 29, 1993. The amended plan drew objections from only First Federal Savings Bank of Siouxland. Trial was held February 16, 1994 in Sioux City.

The court has considered the plan, the objections of First Federal and the testimony, exhibits and arguments. The court now issues its ruling including findings and conclusions as required by Fed.R.Bankr.P. 7052 as it incorporates Fed.R.Civ.P. 52(a).

The objections raised by First Federal are as follows:

- Debtors' plan is not fair and equitable within the meaning of 11 U.S.C. § 1129(b)(2)(A) in two respects: first, the Bank's lien retention is not adequately protected because the value of the real estate securing the Bank's claim is less than the amount of the secured claim as treated in the plan, and second the interest rate is inadequate to provide fair and equitable treatment to Bank.
- Treatment of First Federal's claim amounts to an impermissible gerrymandering to prevent Bank's invocation of the absolute priority rule to forestall cram down.
- The plan is not feasible as required by 11 U.S.C. § 1129(a)(11).

Desai Corporation is record titleholder of certain real estate in downtown Sioux City where Desai Properties, Inc. operates an Imperial 400 motel. Mahesh Desai is the sole shareholder of the corporations. He works hard, spending many hours a day and week at the motel, which he has been operating since 1981. There are 64 rooms in the motel, but not all are presently used for guests. The 1994 projection of the debtors shows the availability of approximately 60 rooms, or 22,000 room days per year.

Implementation of the plan contemplates debtor obtaining a Friendship Inn franchise from Choice Hotels International. The franchising would enable debtor to take advantage of marketing aids, technical advice, and a nationwide reservation system. The reservation service would, in addition to local Friendship Inn reservations, provide reservations for the motel when other motels in the franchise hierarchy are filled or do not exist in this geographical area.

Other benefits of franchising would be the purchasing of supplies at discount rates, name brand recognition, and franchisor advertising including the distribution of motel directories. The cost for this is a 3% royalty on income, plus advertising and reservation fees. Total fees may be as much as 6 to 7 per cent of room revenues.

There are two Friendship Inns in Iowa, one in Minnesota, and two in Wisconsin. The next brand higher in the hierarchy of Choice Hotels franchises is Econolodge. There are 10 in Iowa, and several others in adjoining states.

To obtain a franchise, the debtors would have to pay up to $10,000.00 in an initial franchise fee. This figure is somewhat negotiable, but there is no evidence that it would be significantly less than $10,000.00.

Also, debtors would have to make certain repairs and cosmetic alterations to the motel. These, based on a punch list provided by Choice Hotels, and based on Washington, D.C. construction rates, are estimated to cost approximately $40,000. Debtors' president thinks the work could be done for less, and the court finds this likely, although the evidence is insufficient as to how much less.

Once the franchise is granted, debtors expect an increase in the occupancy rate and an increase in room rates. In 1992, the average occupancy rate was 56.48% with average room rate of $28.35. Total room revenue in 1992 was $340,956.

In 1993, the occupancy rate was 51.20% with an average room rate of $28.43. Total room revenue in 1993 was $360,061.

For 1994, debtors project total room revenue of $378,064 with additional revenues of $18,723, for total gross revenues of $444,863. It is expected annual room revenues would rise five per cent in 1994 over 1993 levels. The 1994 occupancy rate is projected at 62.5% with an average room rate of $31.00, an increase of less than $2.00 per room over 1993.

Debtors project that between 1994 through 1998, the motel would have average room rates ranging from $32 to $40 and average occupancy from 61.43% in 1994 to 59.74% in 1998.

In addition to the franchising, the debtors base their income projections on the construction of a cancer hospital within walking distance of the motel and the recent construction of a Perkins restaurant across the street. The exact commercial benefit of the hospital to debtors is as yet unknown as no one could testify regarding the hospital's geographical drawing power for patients whose families would need to stay overnight in Sioux City. It is reasonable to find that there would be some benefit to the motel by the construction of the hospital as anyone desiring to stay overnight would likely be rate sensitive.

Another aid to the motel is that it would be the only "hard budget" motel or hotel located in downtown Sioux City. It would provide lodging to customers who are interested in obtaining a clean, comfortable, inexpensive room. Such travelers are salesmen paying their own expenses, families visiting Sioux City, and travelers passing through on Interstate 29.

Although not argued, other nearby attractions which reasonably could be thought to beneficially affect room revenues are the motel's close proximity to the Sioux City Auditorium, the City Convention Center and the downtown riverfront park which at present houses riverboat gambling and a city dance pavillion. Construction of a new city art center is also planned for nearby.

The expenses projected by debtors are reasonable, even in the opinion of Kurt Smith, Bank's expert. Debtors have on hand $22,000.00 in cash and have escrowed approximately $27,000.00 for post-petition real estate taxes as part of an adequate protection agreement with Bank.

The first issue to be addressed is whether the interest rate afforded to First Federal in the plan provides fair and equitable treatment. The plan treats First Federal's claim as fully secured. The claim was filed in the amount of $617,758.21. In the claims report, debtors objected to that amount and asserted that the amount of the claim was $610,937.77. In December, debtors withdrew their objections to the claim as filed. It was allowed in the amount filed as a secured claim. First Federal voted its claim as secured in the amount of $617,758.21.

The plan proposes to amortize the debt over a 20-year period at 7.75 per cent interest per year, with a balloon payment at the end of ten years. Payments of $5,000.00 would be made monthly.

First Federal introduced into evidence copies of pages from the Wall Street Journal showing interest rates for U. S. Treasury bonds for varying dates of maturity (exhibit B). Bank points out that the interest rate on government bonds maturing in February 2004, is 5.89 per cent. By adding a 2 per cent risk factor, First Federal argues it is entitled to at least a 7.89 per cent rate. Debtors say they are willing to pay that rate if it is correct.

In In re Noe, 76 B.R. 675 (Bankr. N.D. Iowa 1987), the court adopted Iowa Southern District methodology for determining the base rate of interest before addition of a risk factor. The case cited with approval was Matter of Doud, 74 B.R. 865, 868 (Bankr. S.D. Iowa 1987) aff'd by United States v. Doud, 869 F.2d 1144 (8th Cir. 1989). In re Noe at 678.

Doud does not, as First Federal argues, establish a base rate by finding the interest rate for a government bond maturing at the same time as the payoff of the plan debt to the secured creditor. At page 868, the Doud court explains its methodology of determining the "percentage of the average amount outstanding during the repayment period and then matching the percentage to a government security with an equal maturity." This method was not used by First Federal or probably the debtors in determining the maturity rate applicable in this instance. Because the debtors would be reducing the principal balance before the final payout at the end of 10 years, the applicable maturity date would be less than 10 years, not 10 years.

From exhibit B, the Wall Street Journal pages, it can be seen that there are bonds which mature in less than 10 years which have rates somewhat higher than 5.75%, while others are somewhat lower. Given debtors' testimony and an examination of the rates, and without the court's making the Doud calculation, the court determines that the 7.75 per cent annual rate is fair and equitable.

The next issue is whether the plan fails to adequately protect First Federal's lien during the period of the payout to First Federal. If adequate protection is not provided, the treatment of First Federal would not meet the requirement that the plan be fair and equitable under 11 U.S.C. § 1129(b)(2)(A)(i)(I). Abbott Bank-Thedford v. Hanna (In re Hanna), 912 F.2d 945, 950-51 (8th Cir. 1990) (so holding under chapter 12).

In arguing that the plan fails to protect its lien, Bank asserts that the value of the real estate is less than the amount of its claim at the time of filing. The filed and allowed amount of its claim, at filing, was as previously noted, $617.758.21. First Federal is being treated as fully secured so that post-petition interest on the date of the confirmation hearing was estimated to be $27,498.22 for a total secured claim at the time of the confirmation hearing of $645,256.43.

First Federal argues that if debtor defaults in its plan payments, the value of the real estate will not be sufficient to pay the claim in full. This issue involves a dispute over the value of the real estate collateral. First Federal offered an appraisal of the property showing an appraised value of the motel and grounds of $600,000.00 as of July, 1993. Debtors' president, Mahesh Desai, testified that in his opinion, the value is much greater and in support of his estimate, he testified he had received a cash offer of $816,000.00 for the motel property, including personalty, in November of 1993 (exhibit 5). The offer has not been accepted because in Desai's view, the amount is not sufficient to pay all of the corporations' debts including any income tax incurred by the sale.

Bank's appraiser determined the present fair market value of the motel property by using the income capitalization approach. The methodology is shown at pages 69 through 91 of the appraisal (exhibit 10). The present value of the property was estimated by LeGrand & Company of Sioux City (appraiser) by considering the present value of future income and the present value of the resale of the property in six years.

The appraiser devised first a five-year cash flow for the business using both historical and estimated income and expense figures. The appraiser assumed a $210,000.00 renovation in 1994. After considering occupancy, likely room rates and expenses, the appraiser determined not only a five-year cash flow but also net operating income for the sixth year of operation. This latter figure was $127,000.00, to which the appraiser applied a capitalization rate of 14 per cent to achieve a $900,000.00 resale value during the sixth year of operation. From this, the appraiser subtracted selling costs of $36,000.00, leaving net proceeds from the sale of the motel in 1999 of $865,000.00. The present value of this figure was determined to be $430,078.00. To this, the appraiser added the present value of the net income stream from the five years of operation--1994 to 1998. The discount factor was 15 per cent, and it was applied to monthly net operating income before depreciation or debt service. The calculation resulted in a present value figure for the operating net income over five years of $162,232.00. Added to the present value of the resale price, the appraisal showed a total present value of $592,310.00 rounded to $600,000.00. Because the appraiser believed the income approach to be of the most value, no estimate of value was made on market or replacement cost approaches.

The greatest single impact on value as shown in the appraisal is the $210,000.00 expenditure for renovation projected by the appraiser for 1994. This is shown as a cash infusion which has the effect of substantially reducing the first year cash flow, so that it is a negative monthly net figure for the first year. Because of this, there is no positive monthly net operating income until sometime in year three of the appraiser's projection. The appraisal finds the infusion necessary to achieve room and occupancy rates projected for the six years, the sixth year being the resale year.

The appraiser's projected room rates range from $28 in year one to $32.47 in the sixth year. Average occupancy rates range from 48 per cent in year one to 58 per cent in year six.

The court, having heard all testimony regarding room rates, occupancy rates, other income, and expenses, finds that the debtors' projections as to income and expense are reasonable. Moreover, the court does not find that a $200,000.00 expenditure is necessary to achieve room rates projected by the appraiser. The early projections are essentially being achieved at present. The 1993 actual occupancy rate was 56.48 per cent, a point not projected by the appraiser until 1996.

The debtors propose to achieve their projections by affiliating with Friendship Inns and by doing a more basic renovation. The court finds that even this lesser proposal would be of great benefit in achieving the projections of the appraiser, which also are not unreasonable.

It is the testimony of Mahesh Desai and the professional statement of debtors' counsel, A. Frank Baron, that the borrowing necessary to pay the franchise fee and to do the debtors' proposed renovation (approximately as much as $40,000) would be subordinated to payments to unsecured creditors so that no repayment would be required during the first three years of the plan. If this is so, the appraiser's "five year discounted cash flow estimate," shown on page 88 of the appraisal could be adjusted as follows. The renovation expenditure would be omitted. This would create a positive net operating income for year one of $70,300.00 and a per month net operating income of $5,858.00. The present value of this first year's monthly cash flow would be $64,902.00. When added to the appraiser's remaining positive annual present values, the total cumulative present value for the five-year period would be $356,119.00 (instead of $162,232). When added to the present value of the resale value, which is $430,078.00, the total present value estimate, not rounded off, is $786,197.00. The value, then if the plan is confirmed, would be roughly $790,000.00, not $600,000.00. Thus even if Bank is correct and the plan fails, under Bank's theory of valuation, it is adequately protected. The foregoing adjustment assumes no detrimental effect on cash flow by repayment of the family loan.

Bank argues also that debtors have misclassified Bank to exclude it from the unsecured class. If its alleged deficiency were in the unsecured class, Bank contends, Bank would have voted its unsecured claim as rejecting the plan, and the unsecured class would thus have dissented, and the absolute priority rule would have prevented confirmation.

The court has mathematically tested this argument. If Bank were correct that the value of the property is $600,000.00, then the unsecured component of its claim would be $17,758.21. If the Bank voted its unsecured claim to reject, debtor would still have more than one-half of the unsecured creditors who voted, voting for the plan. However, it would fall just short of obtaining accepting ballots from creditors holding at least two-thirds of the amount of claims voted. Bank's rejection would increase the amount of claims rejecting to $20,572.31. Accepting votes totaled $39,785.20 or 65.9 per cent, just short of that sufficient for the class to accept. 11 U.S.C. § 1126(d).

But inasmuch as the court has found Bank to be fully secured for purposes of this plan, this objection must also be overruled. Even if Bank were not fully secured, the court would overrule this objection because Bank waived it when Bank filed its claim as secured. Bank neither filed or voted an unsecured claim nor did it seek valuation of its secured claim by motion. These options were open, but instead Bank's claim was filed and treated as secured.

The third and final objection is that the plan is not feasible. If a plan is to be confirmed, the court must find that confirmation is not likely to be followed by liquidation or the need for further financial reorganization. 11 U.S.C. § 1129(a)(11). To be feasible, the plan must offer a reasonable prospect of success and be workable. United Properties Inc. v. Emporium Department Stores, Inc., 379 F.2d 55, 64 (8th Cir. 1967). The test is whether the things to be accomplished after confirmation can, as a practical matter, be accomplished. Clarkson v. Cooke Sales & Service Co. (In re Clarkson), 767 F.2d 417, 420 (8th Cir. 1985). Predictions must be based on objective fact. Id. However, the proponent does not have to guarantee success.

There is no question that, as proposed, the plan is feasible only if debtors obtain the franchise and are able to increase the motel's occupancy rate and average room rate as projected. To do this, debtors must pay for a $40,000.00 renovation and a $10,000.00 initial fee to Choice Hotels.

The ability of debtors to do this is based on an oral commitment of two persons who are friends and/or family of Mahesh Desai. They are Raju Patel and Kishore Desai; they reside overseas. He says they have promised to lend the money if the plan is confirmed and also that they do not demand

repayment immediately. Indeed there is nothing in the debtors' five-year cash flow projection which shows the loan or its repayment terms.

Without firm commitments for necessary financing, similar plans have been denied confirmation on feasibility grounds. For a very similar example, see Matter of Holiday Associates Ltd. Partnership, 139 B.R. 711, 716-17 (Bankr. S.D. Iowa 1992). Also see In re Stratford Associates Ltd. Partnership, 145 B.R. 689, 699 (Bankr. D. Kan. 1992).

Desai testified and his counsel argued that the culture of the lenders and debtors' president, Mr. Mahesh Desai, is significantly different from United States culture in that the promise of a loan such as the one in question is relied on and honored without the necessity of a formal written commitment. Debtors ask the court to also rely on the ability and willingness of the two lenders to make the money available. Mr. Desai, the lenders, and Mr. Baron must understand that although the court may respect and admire such other cultures, it is bound by the Rules of Evidence and the necesssary burdens of proof. The court is asked to find that two people who have not appeared are ready, willing and able to lend approximately $50,000.00 to the debtors or to Mr. Desai to make this plan work. This is so although the Bank is denied the opportunity to cross-examine the lenders on their ability to make the loan and on their understanding of the plan and their own repayment requirements. This the court cannot do.

This is of great concern to the court because it would find that the plan is otherwise feasible. The debtors' projections of income and expense are rooted in historic fact and are based on reasonable estimates. The feasibility, if the loan is made and the franchise granted, is not without risk. It is a close question. But the court believes that debtors should have the opportunity to reorganize through confirmation of this plan. One important factor to the court is that debtors have set aside substantial monies to pay taxes, and the debtors propose monthly, not annual, payments to the Bank upon confirmation. This is an important factor in protecting the Bank's interests.

Then what is the court to do about this failure of proof? It does not make sense to the court to deny confirmation and start over. If the very same plan were proposed, the Bank might argue that a previous denial is res judicata on the issue of feasibility. On the other hand, the court will not confirm this plan without the certainty of the loan.

The court believes that at least this one time some accommodation should be made. An order of confirmation will enter only upon deposit of $50,000.00 of loan proceeds from the proposed lenders in a Sioux City bank account in the name of the debtors and upon the filing of a written agreement, memorandum or letter of understanding as to the identity of the lenders, the identity of the borrower or borrowers, the permitted use of the funds and the terms of repayment.

Debtors are cautioned that the testimony provided to the court by the debtors as to the nature of the loan was understood by the court to show the existence of an understanding that friends and relatives of Mahesh Desai were ready, willing, and able to lend the money to the corporations or to Desai so that the renovations would be accomplished and the franchise obtained. There was no testimony which indicated repayment requirements which would affect feasibility. As proposed, the lenders could not demand repayment before all payments to the unsecured creditors have been made.

Therefore, the court does not expect to see in the loan document equivocal language and qualifying agreements which in other ways call into question the feasibility of the plan. Debtors sought confirmation based firmly on a generous commitment from Mr. Desai's friends and family to provide

debtors or Mr. Desai with the needed money. If that is not shown in writing along with the simultaneous availability of the funds, confirmation will be denied.

Debtors have 30 days to submit proof of the deposit and availability of the funds and to submit the required agreement or commitment document.

The court recognizes that debtors and Mr. Desai may believe the renovations and fee can be handled for less than $50,000.00, but the court finds that the evidence of how much less is insufficient for the court to confirm on any basis other than the availability of a loan in that amount.

The court finds and concludes that debtors as proponents have complied with the applicable requirements of Title 11. The plan complies with the applicable provisions of Title 11; the plan has been proposed in good faith and not by any means forbidden by law. Further, the court finds and concludes that the identify of continuing officers and directors has been disclosed, and all payments relating to costs and expenses of the case are subject to approval by the court. There is no regulation of rates by a governmental agency. With regard to each impaired class, each holder of a claim within the class has either accepted the plan or will receive under it what it would receive in a chapter 7 liquidation. An impaired class, not counting the vote of any insider, has accepted the plan. The plan provides that priority claims will be paid in accordance with 11 U.S.C. § 1129(a)(9). Required fees have been paid or the plan provides for payment. As to "cram down," under § 1129(b)(2) and the claim of First Federal Savings Bank of Siouxland, the court finds and concludes that the Bank is being treated fairly and equitably and that the plan does not discriminate unfairly.

The court withholds its finding on feasibility for 30 days. Accordingly,

IT IS ORDERED that debtors shall have 30 days to submit to the court proof of the loan commitment of $50,000.00 and proof of the deposit of the funds in a United States bank in the name of the debtors. The funds will not become property of the estate until the Order of Confirmation enters. The funds will become property of the estate if a confirmation order enters, even if appealed, unless a stay pending appeal is granted.

SO ORDERED ON THIS 29th DAY OF APRIL, 1994.

William L. Edmonds
Chief Bankruptcy Judge

I certify that on ___________ I mailed a copy of this order by U. S. mail to: