In the United States Bankruptcy Court

for the Northern District of Iowa

MAX L. BARTLETT
Debtor.

Bankruptcy No. 96-10707KC
Chapter 11

ORDER RE DEBTOR'S MOTION FOR AUTHORITY TO LEASE PROPERTY WITH OPTION TO PURCHASE

On January 7, 1997, the above-captioned matter came on for hearing on Debtor's Motion for Authority to Lease Property With Option to Purchase. Objections have been filed. Debtor Max L. Bartlett appeared in person with his attorney, Dan Childers. Mercantile Bank of Eastern Iowa appeared by Greg Epping. Kenneth Magina appeared by H. Raymond Terpstra II. National Travelers Life Co. and The Center Owners Association also filed objections of record, however, neither objector appeared at the time of hearing. Based upon comments made at the time of hearing, the Court feels that the objections of National Travelers Life and The Center Owners Association have been adequately resolved and need not be further addressed in this ruling.

Debtor Max L. Bartlett filed this Chapter 11 Petition on March 27, 1996. As of the time of hearing, no Plan of Reorganization has been filed. A major asset of Debtor's estate consists of the Fourth Floor of the Ground Transportation Center which Debtor has owned since the time of the construction of the building. At or about the time that Debtor filed his Petition, two tenants occupied this floor, New York Life and KHAK Radio. New York Life has now constructed its own building and terminated its lease with Debtor.

In September, 1996, Debtor entered into a lease agreement with APAC to lease the available space and, ultimately, the entire floor. The lease term commenced in October of 1996. It was not until November 7, 1996, however, that Debtor filed a Motion for Authority to Lease Property With Option to Purchase. Debtor took the position that while the lease was within the ordinary course of Debtor's business, the option to purchase requires Court approval. The Motion was noticed to all parties and the objections previously noted were filed.

The lease contains an option to purchase the property for $710,000 at any time during the course of the lease. Debtor seeks approval of this transaction. He states that after New York Life vacated the premises, he was not able to service the outstanding indebtedness on the property based solely on the KHAK lease. With the rental payments from New York Life, he was able to service the debts on both mortgages and actually pay something toward principal.

Valuation testimony was presented at the hearing. Mr. Robert Scott is a professional appraiser and has, on several occasions, appraised property in the Ground Transportation Center. Mr. Scott appraised Debtor's Fourth Floor as of November, 1996 between $725,000 and $750,000. He testified that he feels an offer of $710,000 is somewhat low.

Mr. Don Grooms is the building manager and also acts as an agent for APAC in leasing and purchasing. He testified that the Twelfth Floor of the APAC Building was purchased in 1993 for $837,000; the First and Second Floors together were sold in 1994 for $1.4 million; and the Seventh Floor was sold in 1995 for $717,500. Additionally, APAC has entered into a lease for half of the Tenth Floor, with an option to purchase at a price of $365,000. Based upon the valuation testimony, it appears that the option price is lower than possible fair market value though the difference is not extreme.

Mary Quass, owner of Quass Broadcasting Company, which owns KHAK Radio, also testified. She has a lease on a portion of the Fourth Floor which is to expire in March of 1997. She has contacted a lender concerning financing for the purchase of this floor and would be willing to pay more than $710,000 based upon her knowledge of the circumstances

as they presently exist. She states that if she purchased the property, Mr. Don Grooms, the purchasing agent for APAC, would not receive a commission and more money would be available to creditors.

National Travelers Life objects to the lease asserting that Grooms & Associates was not approved as a broker or shown to be disinterested. Additionally, it questioned whether Debtor plans to pay the commission over the life of the lease or in advance payment. The Court understands this objection is now resolved. The Center Owners Association asserted an assessment lien for condominium fees. It sought adequate protection concerning monthly association fees for the Fourth Floor and for any arrearages since April of 1995. The Court understands this objection is also now resolved. Mercantile Bank is a creditor holding a second mortgage on the property. It objects that the Motion does not disclose how secured creditors would be paid from the rents received. It also points out that Debtor has yet to file a Plan of Reorganization. At the close of all of the testimony, Mercantile Bank withdrew its objection.

Kenneth Magina is a creditor who asserts rights in the property as a result of a 1980 settlement agreement. He argues that his rights are being prejudiced by the lease and sale. He asserts that the lease with option to purchase of Debtor's largest asset outside a confirmed Plan is inappropriate. He also argues that the option price is inadequate. He points out that Debtor had not submitted an appraisal or projections of net revenue from the property at the time of the filing of the Motion.

In summary, the issue for determination is whether the Court should allow Debtor to sell his most significant asset before proceeding through the Chapter 11 confirmation process. Two Code provisions intersect in this determination. Section 363(b) provides that the debtor-in-possession may sell property of the estate before confirmation and after notice and hearing. Section 1123(b)(4) states that a Chapter 11 plan may provide for the sale of all or substantially all of the property of the estate. A controversy exists as to whether the debtor-in-possession may sell substantially all of its assets without first complying with the provisions for confirmation of a plan. See Collier on Bankruptcy 1129.01[2] (15th ed. 1996). This led to the evolution of the so called "creeping", "sub rosa" or "piecemeal" plan doctrine. In re Work Recovery, Inc., 202 B.R. 301, 304 (Bankr. D. Ariz. 1996).

In response to this question, In re Lionel Corp., 722 F.2d 1063, 1065 (2d Cir. 1983), now represents the prevailing view. Id. It holds that the bankruptcy court must expressly find from the evidence "a good business reason" to grant a 363(b) application to sell an important asset of a debtor. Lionel Corp., 722 F.2d at 1071; see In Re Equity Management Sys., 149 B.R. 120, 124 (Bankr. S.D. Iowa 1993) (scrutinizing lease and ultimate sale of principal assets of debtors, determined to be within ordinary course of business, for sound business reasons). Following Lionel, the Fifth Circuit noted factors to consider in this situation, among them:

1. has the debtor articulated a business justification for the request;

2. is it good business judgment for the debtor to enter into the proposed transaction;

3. will the proposed transaction further the diverse interests of the debtor, creditors and equity holders alike;

4. is the asset increasing or decreasing in value;

5. does the proposed transaction specify terms for adoption of the reorganization plan; and

6. will approval of the proposed transaction effectuate a de facto reorganization in such a

"fundamental fashion" as to render creditors' rights under the other provisions of chapter 11 meaningless.

In re Continental Air Lines, Inc., 780 F.2d 1223, 1226-27 (5th Cir. 1986); Work Recovery, 202 B.R. at 304.

Courts have developed a four-element "sound business purpose" test. In re Taylor, 198 B.R. 142, 157 (Bankr. D.S.C. 1996). The debtor-in-possession or trustee has the burden of proving that

(1) a sound business reason or emergency justifies a pre-confirmation sale; (2) the sale has been proposed in good faith; (3) adequate and reasonable notice of the sale has been provided to interested parties; and (4) the purchase price is fair

and reasonable.

Id. The element of good faith can require that the sale not unfairly benefit insiders or the prospective purchasers, or unfairly favor a creditor or class of creditors. In re Channel One Communications, 117 B.R. 493, 496 (Bankr. E.D. Mo. 1990).

Based on the record, the Court concludes that approval of the lease with option to purchase would be premature at this time. Debtor's articulated reason in entering into the lease with option was to be able to service the mortgages. The lease, without the option to purchase, accomplishes this goal. The asset does not appear to be decreasing in value. There is no showing that an emergency situation exists.

No specific terms for adoption of a reorganization plan have been proffered to the Court. The purchase price is somewhat below market value and may unfairly benefit APAC as purchaser. The property has not been listed for sale on the open market. Creditors may be prejudiced by what may appear to be a sub rosa transaction. Based on these factors, Debtor has failed to satisfy the requirement that the sale satisfy the sound business purpose test under 363(b).

WHEREFORE, while the Court expresses no opinion on whether the terms of the contract are divisible, the Court does conclude that the lease portion of the agreement between Debtor and APAC is in the ordinary course of business and is APPROVED.

FURTHER, for the reasons set forth in this opinion, the Court concludes that the option to purchase between Debtor and APAC is not in the ordinary course of business and does not satisfy the sound business purpose test under 363(b) and is, therefore, DENIED.

FURTHER, the denial of approval of the option to sell is denied without prejudice against resubmitting the same or similar terms within a Plan of Reorganization.

SO ORDERED this 13th day of January, 1997.

Paul J. Kilburg
U.S. Bankruptcy Judge