UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF NEW YORK

IN RE:

FRANCIS M. LOBELLO III	CASE NO. 03-61012
Debtor	Chapter 13

APPEARANCES:

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Hon. Stephen D. Gerling, Chief U.S. Bankruptcy Judge

**MEMORANDUM-DECISION, FINDINGS OF FACT,
CONCLUSIONS OF LAW AND ORDER**

Presently before the Court is an objection filed on April 15, 2003 by the United States Small Business Administration ("SBA") to the confirmation of the chapter 13 plan filed by Francis M. LoBello, III ("LoBello" or the "Debtor") on February 21, 2003 (the "Plan"). The

Plan was amended on November 5, 2003.

SBA specifically objects to the valuation, as provided in the Plan, of the Debtor's real property located at 5196-5198 Route 11, Pulaski, New York (the "Subject Property"), on which the SBA holds a mortgage position. The Court convened an evidentiary hearing on November 5, 2003 in Utica, New York, after which the Court provided an opportunity for the parties to file a posthearing statement. The matter was submitted for decision on December 5, 2003.

JURISDICTIONAL STATEMENT

The Court has jurisdiction over the parties and the subject matter of this contested pursuant to 28 U.S.C. §§ 1334, 157(a), 157(b)(1), and (b)(2)(A), (B), and (O).

FACTS

I. The Subject Property and its financing

The Subject Property consists of nearly 2½ acres of improved real property in the Vvillage of Pulaski in the Town of Richland in Oswego County, New York. The Subject Property consists of a single-family residence and a 4,800 square foot retail-wholesale produce sales facility. The commercial facility was built in 1999 and contains a loading dock, a sales area, an office, and two rooms refrigerated by wall-mounted evaporators and remote-mounted compressors. The commercial portion of the Subject Property consists of .76 acres of land.

The Debtor financed the purchase and development of the Subject Property with loans from Oswego County National Bank and SBA. According to the Debtor's Plan, the current combined balance of these obligations is over $200,000. Plan, filed Nov. 5, 2003, ¶¶ 4(c)(1), 6.

II. The appraisals

The parties submitted appraisals of the Subject Property at the valuation hearing. The Debtor submitted the appraisal report of Harlan La Vine ("La Vine"), while SBA submitted the appraisal of Marlin J. Nohle ("Nohle"). La Vine and Nohle were both qualified at the valuation hearing as expert witnesses. The reports submitted by La Vine and Nohle both valued the residential portion of the Subject Property at $60,000. At the hearing, their testimony was limited to their valuations of the commercial portion of the Subject Property.

1. LaVine's appraisal

La Vine based his valuation of the commercial portion of the Subject Property on the market-comparison and the capitalization of income methods, arriving at a figure of $145,000, to which he added the agreed upon value of the residential portion ($60,000), fixing the total valuation of the Subject Property at $205,000. La Vine used the following properties as commercial comparables:

Sale #4 5501 N. Jefferson Street Village of Pulaski, Town of Richland	Sold for $75,000 on December 5, 2001 3,500 square foot commercial building on 1.14 acres

Located .1 miles from the Subject Property

Sale #5
3952 Port Street
Village of Pulaski, Town of Richland
Sold for $105,000 on February 24, 2003
Two commercial buildings of 6,832 and 1,240 square feet, respectively, on .87 acres
Located 1.5 miles from the Subject Property

Sale #6
3957 Port Street
Village of Pulaski, Town of Richland
Sold for $40,000 on February 13, 2003
4,200 square foot commercial building on 1.3 acres
Located 1.5 miles from the Subject Property

Sale #7
333-337 State Route 104B
Town of Mexico
Sold for $76,500 on August 21, 2002
Two commercial buildings of 1,588 and 1,200 square feet, respectively, on 4.7 acres
Located 8.8 miles from the Subject Property

LaVine acknowledged that none of the comparables had refrigerated rooms. La Vine adjusted the comparables' selling price per square foot upward between twenty and fifty percent to reflect the Subject Property's comparatively superior condition. Sale #6 was adjusted upward a further twenty percent to account for its unusual lot shape. The adjusted price per square foot ranged from $16.18 to $32.93. La Vine set the Subject Property's price per square foot at $30, which when multiplied by 4,800 square feet produces a value of the commercial portion of $144,000 under the market-comparison approach.

La Vine also performed an income-based valuation, applying a capitalization rate, that utilized a band of investment component, of 10.24 percent. La Vine arrived at a total annual revenue figure for the Subject Property of $25,080 after assuming an annual rent of $26,400 (based on $5.50 per square foot), less $1,320 for vacancy and credit loss. La Vine based his price per square foot on four comparable rental properties ranging from $1.99 to $6.62 per square foot. La Vine assumed a semi-gross lease, which would require the owner to pay taxes, insurance, and maintenance. La Vine attributed $7,218 in the expense column to taxes. According to La Vine, the local tax assessor considers 72% of the total annual taxes on the Subject Property of $10,026.13 attributable to the commercial parcel. La Vine calculated the total annual expenses, including taxes, at $10,193. The capitalization rate was constructed as follows:

> 75% of a 9.25% 20-year mortgage rate (10.99% constant rate) and
> 25% of a 8% return on equity.

The annual net income was then divided by the capitalization rate to produce a rounded valuation figure for the commercial portion of the Subject Property of $145,400.

In his testimony at the evidentiary hearing, La Vine dismissed the cost method as the "most unreliable method of valuation," and did not employ it specifically because he contended that reliable depreciation rates were difficult to determine and because the Subject Property was not a special use property. La Vine considered the Subject Property "readily adaptable for other uses."

In a posthearing submission filed with the Court on December 5, 2003, Nohle argued that La Vine misstated the Subject Property's highest and best use by failing to mention the Subject Property's refrigerated rooms, heated loading docks, and dock-height receiving floors. Nohle Letter dated Nov. 25, 2003, filed Dec. 5, 2003. At the hearing, Nohle also opined that La Vine's comparable properties relate poorly to the Subject Property and would require "subjective and extreme adjustments." Nohle noted that Sales #4 and #7 were designed for different uses. Nohle claims that Sale #4 is over sixty years old and in inferior condition. He portrayed the sale prices of Sales #5 and #6 as sub-market distress values because they were sold by Agway, Inc., during its chapter 11 case pending before this Court.

2. Nohle's appraisal

Regarding the valuation of the Subject Property's commercial facility, Nohle rejected the market-comparison method in his appraisal report and did not utilize any comparable sales. Nohle appraised the Subject Property utilizing the cost method, with support from the capitalization of income method, arriving at a total value of $230,000.

Nohle used a valuation reference published by Marshall & Swift as the source for his replacement cost figures. Nohle estimated $210,278 as the replacement cost of the commercial facility. He then provided economic lives of forty-five years for the facility and twenty years for the refrigeration equipment. Nohle set the annual depreciation percentages for the facility and the refrigeration equipment at three and fourteen percent, respectively. Four years of depreciation was calculated as $7,353. Nohle added $30,000 for the rounded value of the land, which was the product of the entire acreage of the Subject Property multiplied by thirty cents per square foot. To arrive at this figure, Nohle provided four vacant lot comparables, ranging from seventeen cents to $5.50 per square foot. Nohle arrived at a rounded cost-based valuation figure of $233,000 for the commercial portion of the Subject Property.

Nohle estimated, utilizing the capitalization of income method, that the Subject Property's value was $205,000. Annual gross income under Nohle's model was $27,360, which was based on a $6 per square foot rental figure and a five percent vacancy and loss deduction. Expenses included, *inter alia*, management, insurance, and maintenance costs and totaled $5,307. Net operating income was $22,053, which when divided by Nohle's capitalization rate of 11.25 percent led to a valuation figure of $205,137. Nohle's capitalization rate was constructed as follows:

> 70% of a 12.3% constant mortgage rate and
> 30% of an 8.5% return on equity.

Nohle's final conclusion after adding the agreed upon value of the residential portion ($60,000) was to value the Subject Property at $290,000.

After the Court inquired at the evidentiary hearing whether Nohle thought cold storage facilities in North Syracuse would be comparable to the Subject Property, he said that they would. Nohle testified, however, that he had not investigated such comparables for the purposes of devising a market-comparison analysis with respect to the commercial portion of the Subject Property. He added that statewide sales of such cold storage facilities ranged from $150,000 to $200,000.

DISCUSSION

This valuation determination is authorized by Code § 506(a), which provides in pertinent part that a property's "value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing . . . on a plan affecting such creditor's interest." Congress further explained that courts should determine value under Code § 506(a) "on a case-by-case basis, taking into account the facts of each case and the competing interests in the case." H.R. Rep. No. 595, 95th Cong., 1st Sess. 356 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5787, 6312. Here, the parties have requested the Court to value the Subject Property in order to establish, pursuant to Code § 1325(a)(2)(B)(ii), the amount of SBA's secured claim, which will be payable by the Debtor pursuant to the Plan.

The parties agree upon $60,000 as the value of the residential portion of the Subject Property. However, they dispute the value of the commercial portion. Nohle's valuation of $230,000 for the commercial parcel is primarily based on a cost analysis and supported by a capitalization of income analysis, while La Vine's valuation of $145,000 is primarily based on a capitalization of income analysis and supported by a market-comparison analysis.

Nohle relies on the cost method and rejects the market-comparison method because he considers the use of the Subject Property, by virtue of its two refrigerated rooms, so unique that it cannot be compared to other properties on the market. The cost method is more appropriate for valuing depreciating assets that are unique in nature and generally not susceptible to finding comparable sales in the marketplace. More problematic is that Nohle's depreciation percentages and land cost figures are refuted by simple math. Straight-line depreciation over forty-five and twenty years for the facility and the refrigeration equipment require annual deductions of $4,462.18 and $385, respectively.[1] Four years of depreciation would result in total deductions of $17,848.71 for the facility and $1,540 for the refrigeration equipment, not $6,026 and $1,327, as Nohle estimated. Additionally, Nohle did not limit his land valuation to the acreage on which the commercial portion is located. When Nohle's market value of thirty cents per square foot is multiplied by the Subject Property's commercial acreage of .76 acres, the sum is $9,931.68, more than two-thirds less than his figure of $30,000. Using the correct depreciation and land cost figures, Nohle's valuation would be $193,467.97, or $193,000 after rounding—a whole $40,000, or seventeen percent, less than his original estimate of $233,000. These errors merely illustrate the Court's finding that the cost method is unreliable. Moreover, the Subject Property is not so unique that it cannot be compared to similar properties in the region. By

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[1] The Court arrived at the figure of $385 after assuming the cost of the refrigeration equipment as $9,200 and the salvage value as $1,500, which are the figures Nohle cited at the hearing. A salvage value for the facility was assumed as zero because a figure was not provided in the documentary and testimonial evidence. However, the Court believes this is an underestimated figure and would have requested further information from the parties had it found reason to ultimately rely on the cost method. These depreciation figures represent adjusted annual deductions of 4.18% for the refrigeration equipment and 2.2% for the facility, not 14% and 3% as proposed by Nohle.

Nohle's own testimony, recent statewide sales of cold storage facilities have ranged between $150,000 and $200,000. Accordingly, the Court will accord Nohle's cost-based valuation no weight in its determination of the value of the Subject Property.

The Court also questions the reliability of Nohle's income-based methodology in view of the fact that he did not provide for property taxes in his expense stream. Nohle stated that he assumed the Subject Property would be subject to a net lease, which would require the tenant to pay taxes owed on the Subject Property. Accounting for real estate taxes in Nohle's analysis leads to a capitalization of income valuation approaching LaVine's result of $145,000. Nohle also did not provide rental comparables in his report to substantiate his finding that the Subject Property's fair rental value is $6 per square foot, exclusive of the aforementioned taxes.

Nonetheless, the Court also finds that the income approach is not the most reliable methodology in this case. The Court believes this approach is more appropriate for the appraisal of pure investment properties. *See, e.g., In re Vanderveer Estates Holdings, LLC,* 293 B.R. 560, 563-64 (Bankr. E.D.N.Y. 2003); *Nextwave Personal Communications, Inc. v. FCC (In re Nextwave Personal Communications, Inc.)*, 235 B.R. 277, 295 (Bankr. S.D.N.Y. 1999); *In re Garsal Realty, Inc.*, 98 B.R. 140, 153 (Bankr. N.D.N.Y. 1989). Nothing adduced at the hearing or in the parties' papers indicates that LoBello has either used the Subject Property for rental income in the past or intends to in the future. Moreover, the highest and best use of the Subject Property is its current use as a retail-wholesale produce sales facility, not as an investment property.

Hence, the Court will rely on the market-comparison approach. *See, e.g., In re Leonard*, 151 B.R. 639, 642 (Bankr. N.D.N.Y. 1992). The *Nextwave* court discussed the appropriateness of using the market-comparison method, stating the following:

> The necessary predicates for employing the market comparable method of valuation are the existence of arm's length, marketplace transactions within a reasonably proximate time frame involving the same or basically comparable assets. The assets involved in the transactions to be compared need not be identical to the property to be valued. The test is whether the properties to be compared are sufficiently similar in nature and interchangeable in function that any differences can rationally be reflected by appropriate adjustments.

Nextwave, 235 B.R. at 294.

SBA challenged La Vine’s comparables, citing Sales #5 and #6 as distressed sales and Sales #4 and #7 as designed for different uses than the commercial facility on the Subject Property. Initially, the Court does not deem the commercial facility an incomparable special use structure simply by virtue of its refrigerated rooms. Many businesses in the region require such a feature and, in any event, considering that the rooms can be adapted for other uses, the Court does not believe that the buyers who do not need such a feature would be repelled from purchasing the site solely on the basis of the refrigeration. Secondly, La Vine’s Sales #5 and #6, which were sold by Agway, Inc., a debtor before this Court, were not distressed or liquidation sales, as SBA contends. The Court entered Orders approving the bid procedures and sale of those properties, pursuant to which Agway, Inc. retained a broker to solicit and obtain offers in an open market.

The Court finds La Vine’s market-comparison reasonable and most applicable. He used data from properties of similar functionality and location and adjusted their values, where appropriate. Because SBA did not provide any alternative comparables, the Court must base its valuation on La Vine’s market-comparison approach. However, to account for the refrigeration equipment, the Court will add $7,660, which is the value of the units less depreciation, to La Vine's market comparison-based valuation of $144,000. Thus, the Court finds that the total rounded value of the commercial portion of the Subject Property is $152,000, which when added to the agreed upon value of the residential portion of the Subject Property produces a total value of the Subject Property of $212,000.

Based upon the foregoing, it is,

ORDERED, that Debtor's Amended Plan filed herein on November 5, 2003, shall be returned to the Chapter 13 Confirmation Calender of this Court to be held at the U.S. Courthouse, 100 S. Clinton St., Syracuse, New York, on April 20, 2004, at 2:00 P.M., for further proceedings consistent with this Memorandum-Decision and Order.

Dated at Utica, New York

this 26th day of March 2004

STEPHEN D. GERLING
Chief U.S. Bankruptcy Judge