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Simultaneous Distress of Residential Developers and Their Secured Lenders An Analysis of Bankruptcy & Bank Regulation

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SIMULTANEOUS DISTRESS OF RESIDENTIAL DEVELOPERS AND THEIR SECURED LENDERS: AN ANALYSIS OF BANKRUPTCY & BANK REGULATION

Sarah Pei Woo[†]

ABSTRACT

With falling home prices and foreclosures acknowledged as a severe problem in the U.S., more attention should be paid to the contributing phenomenon of residential developers undergoing liquidation, leaving a trail of partially-completed or abandoned properties. This Article presents a study of 222 residential developers that filed for Chapter 11 bankruptcy in 2007-8. A key finding is that very few developers, as compared to previous studies, confirmed a reorganization plan. Most were dismissed or converted to Chapter 7, culminating in foreclosure or liquidation.

An investigation of this liquidation preference reveals that, during a severe recession, banks may prefer liquidation owing to a capital shortfall and procyclical regulatory pressure to reduce portfolio concentrations in real estate lending. This is inconsistent with existing theories that secured lenders choose economically optimal outcomes within a bankruptcy case itself. Supporting this hypothesis is the fact that about half of the secured lenders in this data sample are themselves failed or undercapitalized banks. Furthermore, multivariate regression analyses show that a bank's financial distress has a statistically significant impact on whether it would file a lift-stay motion to pursue foreclosure. Overall, this constitutes strong evidence that the standard theory of creditor behavior in bankruptcy is incomplete without consideration of the regulatory environment and procyclicality in capital requirements.

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I. INTRODUCTION

The United States is in the middle of a “perfect foreclosure storm.” According to the U.S. Congress Joint Economic Committee, an estimated \$736,160,105,369 of housing wealth was lost from record numbers of foreclosures and falling home prices in 2007, and an estimated \$1,144,177,880,280 in 2008.¹ Between 2005 and 2008, the decline in housing’s contribution to annual Gross Domestic Product was more than \$300 billion.²

Amidst the constant bombardment of news and studies lamenting the problem of home owners defaulting on their mortgages and being foreclosed upon, more attention needs to be paid to the problem of residential developers declaring bankruptcy. In normal times, the liquidation of a bankrupt residential developer might represent an efficient redeployment of assets, as property prices remain buoyant and other developers are standing by with the financing and resources to continue the development. This is no longer true in the current crisis, however, which has been marked by pervasive market failure. As financially distressed residential developers and builders go into liquidation or foreclosure, communities are now being abandoned half-built, to the great detriment of those already moved in, warranties are lapsing, and developments are left with potholed roads, open sewers, and other hazards.³

Half-completed or fire-sale properties can also have a negative effect on the property values of wider communities and exacerbate serious problems in housing markets. The following excerpt from the March 2009 Oversight Report by the Congressional Oversight Panel shows how foreclosures on developers and homeowners alike can have

1. U.S. CONG. JOINT ECON. COMM., COAST TO COAST, HOME PRICES ARE DOWN AND FAMILIES HAVE LOST WEALTH FROM 2007-2009 (2008), http://jec.senate.gov/index.cfm?FuseAction=Files.View&FileStore_id=1b2660a6-c009-471f-ac56-7e537380f68f.

2. NAT’L ASS’N OF HOME BUILDERS, HOUSING’S CONTRIBUTION TO GROSS DOMESTIC PRODUCT, <http://www.nahb.com/generic.aspx?sectionID=784&genericContentID=66226> (last visited Mar. 21, 2010).

3. See, e.g., Lisa Osburn, *Unfinished Subdivisions Are Victims of Faltering Economy: Lots Crumble and Mud Flows*, BIRMINGHAM NEWS, Mar. 15, 2009, at 1A; Lorraine Mirabella & Melissa Harris, *Unfinished Homes and Stolen Dreams: A Columbia Builder Leaves Maryland Buyers Fuming*, BALTIMORE SUN, June 7, 2009, at 1A.

devastating effects:⁴

Foreclosures depress housing and commercial real estate prices throughout neighborhoods, imposing serious costs on third parties. Each of the eighty closest neighbors of a foreclosed property can suffer a nearly \$5,000 property value decline as a result of a single foreclosure. Communities with high foreclosure rates suffer increased urban blight and crime rates. When families have to relocate, community ties are cut, affecting friendships, religious congregations, schooling, transportation[,] and medical care. Numerous foreclosures flood the market with excess inventory that depress other sale prices. Thus, foreclosures can harm other homeowners both by encouraging additional foreclosures and by reducing home sale prices, while decreased property values hurt local businesses and reduce state and local tax revenues.

With so many residential developers entering bankruptcy, the question of whether the U.S. bankruptcy and debtor/creditor regime has shaped the current situation for the worse is urgent. Looking for answers to address this issue, a review of the bankruptcy literature revealed a gap: there is little past empirical work focusing specifically on bankruptcies occurring during a severe downturn. This is also true in relation to studies on bankruptcies in the residential development industry.

In response, this Article offers a systematic empirical inquiry into the bankruptcies of 222 residential developers and home builders which filed for Chapter 11 bankruptcy during the current housing crisis. Only 4.6% of the developers that filed for Chapter 11 in this study had a confirmed plan of reorganization by the end of the sample period. Such results are consistent with anecdotal observations. The majority of these cases were dismissed or converted to Chapter 7 and as a result, the real estate was either foreclosed upon by the secured lenders or liquidated in forced sales.

This study also revealed that secured lender control of bankruptcy proceedings was a major driver of these outcomes. This conclusion was supported by observations from the bankruptcy dockets, which showed that an overwhelming proportion of the motions filed by secured lenders

4. CONG. OVERSIGHT PANEL, FORECLOSURE CRISIS: WORKING TOWARD A SOLUTION: MARCH OVERSIGHT REPORT 2 (Mar. 6, 2009), *available at* <http://cop.senate.gov/documents/cop-030609-report.pdf>.

to obtain relief from the automatic stay, known as ‘lift-stay motions,’ prevailed, allowing the secured lenders to pursue foreclosures. 72.5% of the cases showed at least one instance where a secured lender sought a lift-stay motion to pursue foreclosure; 92.2% of these motions were successful.

The rise of secured creditor control in bankruptcy proceedings and their preference for liquidations and asset sales has been much discussed in the literature, and there is disagreement as to whether it is desirable.⁵ Douglas Baird and Robert Rasmussen argue that higher secured creditor control leads to more efficiency in resolving the fate of distressed companies.⁶ According to their view, companies fail because their resources have not been efficiently managed and reorganizations may delay better utilization of such resources elsewhere in the market.⁷

On the other hand, Elizabeth Warren, Jay Westbrook, Lynn LoPucki, and others argue that creditor control may result in the destruction of viable firms and opine that Chapter 11 has a variety of important roles to play in terms of societal utility through maximizing the going concern value of a bankrupt firm.⁸ This Article’s contribution to this debate, through an analysis of developer bankruptcies, lies in providing perspectives as to how secured creditor control, as embodied by the single-minded pursuit of foreclosure and liquidation, does not

5. See generally Barry Adler, *Bankruptcy Primitives*, 12 AM. BANKR. INST. L. REV. 219, 235 (2004); Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751, 751-52 (2002); David A. Skeel, Jr., *Creditors’ Ball: The “New” New Corporate Governance in Chapter 11*, 152 U. PA. L. REV. 917, 918 (2003); Elizabeth Warren & Jay Lawrence Westbrook, *Secured Party in Possession*, 22 AM. BANKR. INST. J. 12, 12 (2003); .

6. See, e.g., Douglas G. Baird & Robert K. Rasmussen, *Chapter 11 at Twilight*, 56 STAN. L. REV. 673, 675 (2003).

7. See, e.g., Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. PA. L. REV. 1209, 1231-32 (2006); James J. White, *Death and Resurrection of Secured Credit*, 12 AM. BANKR. INST. L. REV. 139, 162-64 (2004).

8. See, e.g., Lynn M. LoPucki & Joseph W. Doherty, *Bankruptcy Fire Sales*, 106 MICH. L. REV. 1, 30-31 (2007); Lynn M. LoPucki, *The Nature of the Bankrupt Firm: A Response to Baird and Rasmussen’s The End of Bankruptcy*, 56 STAN. L. REV. 645, 653 (2003); Warren & Westbrook, *supra* note 5, at 12-13; Jay Lawrence Westbrook, *The Control of Wealth in Bankruptcy*, 82 TEX. L. REV. 795, 826 (2004); Harvey R. Miller & Shai Y. Waisman, *Is Chapter 11 Bankrupt?*, 47 B.C. L. REV. 129, 170-72 (2005); Harvey R. Miller & Shai Y. Waisman, *Does Chapter 11 Reorganization Remain a Viable Option for Distressed Businesses for the Twenty-First Century?*, 78 AM. BANKR. L.J. 153, 198-99 (2004) [hereinafter Miller & Waisman, *Reorganization*].

necessarily lead to an optimal utilization of assets during this economic downturn.

Baird and Rasmussen have argued that “businesses in Chapter 11 have little going-concern value and sales are usually the best way to preserve whatever value exists.”⁹ Some may also argue, as did the counsel for the senior secured creditors in the bankruptcy of large residential developer LandSource Communities Development (“LandSource”) that secured lenders need to act quickly to preserve the value of the assets through swift liquidations when asset prices or values are falling. Counsel for Barclays Bank, Bruce R. Zirinsky, articulated this view:

[T]his is a wasting asset. This is a depreciating asset. Values are declining. This is not about controlling the case; this is about providing lenders who are willing to accommodate a debtor and the other financial constituents a reasonable time to come up with a plan, a consensual plan. At the same time, we have to be very cognizant about protecting interests of the lenders whose assets are at risk here We have—and it doesn’t take an expert. One just has to read the newspapers every day. We have assets that are declining in value. They have declined dramatically in value since the time the loan was made, and they are continuing to decline in value.¹⁰

However, in this specific set of cases in the highly-distressed residential development industry, liquidations are not necessarily the most optimal outcome during a severe economic downturn. Under downturn conditions, prices are unlikely to reflect the true economic value of the assets—for instance, new rules enacted by the Financial Standards Accounting Board during the downturn in 2009 allow institutions to not use mark-to-market accounting for certain long-lived assets.¹¹ In the LandSource case, the judge responded to this line of reasoning as follows:

(Bankruptcy Judge, Hon. Kevin J. Carey): Here it’s a real estate case . . . [a]nd I understand the atmosphere in which your client is now

9. Douglas G. Baird & Robert K. Rasmussen, *Boyd’s Legacy and Blackstone’s Ghost*, 1999 S. CT. REV. 393, 402-06 (1999).

10. June 25, 2008 Hearing Transcript at 17, *In re LandSource Communities Dev., LLC*, No. 08-11111 (Bankr. D. Del. June 8, 2008).

11. Kara Scannell, *FASB Eases Mark-to-Market Rules*, WALL ST. J., Apr. 2, 2009, at C1.

trying to survive, but you know, in my experience eventually the value comes back. The question is how fast, and how much, and what are the liquidity needs in the meantime.¹²

Next, we shift gears from analyzing bankruptcy dockets to focus on the key actor of these bankruptcy proceedings—the secured lender which, according to this data on residential developers, is typically a commercial bank. The central picture that emerges is that banks are highly-constrained profit-maximizing entities. The banking regulatory environment is a significant constraint in the current context. It is unclear if optimal solutions are produced by a bankruptcy regime which allows a high degree of secured lender control at a time when many banks are fighting for their own survival. It is easy to see how banks might forgo restructuring of the debts for long-term gain, and instead liquidate the assets as soon as possible in a bid to raise more capital.

This Article ties together the threads of this discussion through an empirical analysis of the banks in our data sample and their state of financial distress. Using a series of probit regression models, we show that a bank's financial distress has a statistically significant effect on the probability that it will file a lift-stay motion, after controlling for firm size, capital structure, housing market prices and region.

This Article is organized as follows: Section II describes the methodology for the empirical data analysis, covering topics such as data sources, sample selection, and the descriptive statistics of the sample. Section III documents our findings regarding the distribution of outcomes in the data sample. Section IV presents observations from an in-depth investigation of the bankruptcy dockets, analyzing the actions of secured lenders in moving debtors towards liquidation. Section V completes the discussion with insights regarding the capital adequacy issues of banks and other regulatory issues which help explain their preference for liquidation.

II. METHODOLOGY

A. Data on Residential Development Bankruptcies

This study revolves around the cases of residential developers and home builders across the United States which filed Chapter 11 bank-

12. June 10, 2008 Hearing Transcript at 20, *In re LandSource Communities Dev., LLC*, No. 08-11111 (Bankr. D. Del. June 8, 2008).

ruptcy petitions between November 1, 2007 and December 31, 2008.¹³ The target group is defined as companies which, at the time of the bankruptcy filing, were involved in the development and building of new single-family homes, condominium developments, developed lots and raw land. The target group excludes contractors and custom builders working exclusively on existing homes. The defining characteristic is that target companies own and develop residential real estate, the collateral underlying the acquisition, development and construction loans. This can be verified through a perusal of the Schedules of Assets and Liabilities (“Schedules”) and the Statements of Financial Affairs filed in Chapter 11 proceedings.

The first step involves identifying residential developers and home builders which filed for Chapter 11 bankruptcy in United States bankruptcy courts across all districts during the specified time period, using a collection of sources such as The Troubled Company Reporter, Bankruptcy Datasource, government agency databases, publications from industry associations such as the National Association of Home Builders, press releases from the news archives, reports on developer bankruptcies, and searches of Bloomberg data. Then, data is collected on these cases from bankruptcy dockets on the PACER (Public Access to Court Electronic Records) system. From PACER, court records comprising the bankruptcy petition, the Schedules, the Statements of Financial Affairs, relevant motions filed by debtors and creditors, orders entered by the court, the disclosure statement, and the plan of reorganization are extracted. For each case, the data extraction and coding is verified by hand.

Chapter 7 bankruptcies are beyond this Article’s scope and are not included in this sample. The key reason why Chapter 7 bankruptcies do not fall within the ambit of this research is that bankruptcy relief under this Chapter expressly provides for liquidation, whereas this research is primarily concerned with why residential developers, with an opportunity to reorganize in bankruptcy, are going into liquidation. The exclusion of this segment of cases does not affect the findings in this

13. The recession technically began in December 2007. See NAT’L BUREAU OF ECON. RESEARCH, DETERMINATION OF THE DECEMBER 2007 PEAK IN ECONOMIC ACTIVITY 1 (Dec. 11, 2008), available at <http://www.nber.org/dec2008.pdf>. However, we found in our archival searches that the flurry of residential development defaults started in November 2007, so we set the sample selection period to start on November 1, 2007.

Article for two main reasons.

First, in assessing the procedural and economic outcomes of these bankruptcy cases (discussed further in Sections 3 and 4 of this Article), we have benchmarked the cases against prior literature dealing only with Chapter 11. Second, being cognizant of the possibility that Chapter 7 cases can be converted to Chapter 11, especially those commenced by an involuntary petition, a random sampling of fifty cases of Chapter 7 developer bankruptcies was undertaken to test whether this is material to the research in terms of affecting the liquidation or reorganization rate. Of these 50 cases, there was only one case where the debtor moved to convert proceedings to Chapter 11. In less than two months, however, a motion was filed to convert the case back to Chapter 7 and the case was dismissed prior to the hearing of this conversion motion.¹⁴ There were five cases involving involuntary Chapter 7 petitions but these were not converted to Chapter 11.

Next, where there are cases of several companies belonging to a single holding company, these are considered as separate cases, unless the court allowed substantive consolidation, under which the related companies could pool assets and liabilities.¹⁵ While joint administration is very common for corporate groups, courts have considered substantive consolidation an extraordinary measure.¹⁶ We believe that, absent substantive consolidation (in such cases, the lead case designated in bankruptcy is tracked in the data collection process), subsidiaries and affiliates in a corporate group should be considered separate legal entities for data reporting purposes.

B. Research Design

The first part of this research is designed to rigorously study the resolution outcomes of Chapter 11 bankruptcy proceedings and verify the phenomena observed in the residential development industry during this economic downturn. The second thread of this examination is the type and extent of secured lender control in these developer bankruptcies.

Since this Article is primarily concerned with the Chapter 11

14. See generally Docket Report, *In re Kyle James Wheatley*, No. 08-61092 (Bankr. W. D. Tex. Oct. 24, 2000).

15. Where substantive consolidation is recorded for a set of cases, only the lead case (designated by the bankruptcy court) is analyzed for the purposes of this Article.

16. See, e.g., *In re Gandy*, 229 F.3d 489, 499 (5th Cir. 2002).

process, the procedural outcomes captured are categorized as follows:

- Confirmation of a reorganization plan;
- Confirmation of a liquidation plan;
- Sale of substantially all assets free and clear of liens under Section 363;
- Conversion to Chapter 7; and
- Dismissal of bankruptcy proceedings.

The economic outcomes are categorized as follows:

- Continuation of the business with a new capital structure (reorganization);
- Shutdown of the business (foreclosure or liquidation); and
- Going-concern sale.

A limitation of this study is that a number of cases in the sample are currently unresolved in terms of the outcomes listed above.¹⁷ In trying to be as timely as possible in documenting and analyzing fairly unfamiliar phenomena with important consequences relating to the housing crisis, the implication is that since the cases are filed in 2007-2008, a number of them will still be unresolved. A balance must be struck, however, between the importance of analyzing a recent phenomenon at the core of the current recession, and the need for “methodological purity” in terms of using cases which meet a strict definition of resolution.

The reasoning for this is twofold. First, a key objective of this study is to examine secured lender control and their actions in moving a bankruptcy case in one way or another. In the volatile environment of the sample period, with declining real property values, secured lenders acted quickly to safeguard their collateral. This study documents the kind of actions taken in that respect. Furthermore, the limitation on exclusivity periods introduced by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (“BAPCPA”) facilitates a much faster resolution.

Second, Warren and Westbrook showed in their empirical study of Chapter 11 business cases that “substantial screening” occurs early in

17. The cut-off date adopted for assessing case resolution in this sample is July 31, 2009.

the case.¹⁸ Of all the cases that were eventually pushed out of Chapter 11 without a plan being filed, more than half were gone in less than six months, 70% were gone by nine months, and more than 80% were gone within a year.¹⁹ One can argue, however, that weak cases are pushed out earlier in proceedings and that cases culminating in plan confirmations will take longer.

Warren and Westbrook found that the median time to resolution in their sample was 264 to 274 days, while the median time to plan confirmation was close to one year.²⁰ On the other hand, a study of 1,096 public companies filing for Chapter 11 between 1979 and 1990 found the median time to resolution by economic outcomes to be as follows: 1.1 years (merged/acquired); 1.2 years (liquidated); 1.4 years (emerged as a public company); and 1.3 years (emerged as a private company).²¹

Thus, to avoid sampling bias, the sample includes cases which are “substantially resolved,” as compared to the above categorization of procedural outcomes for cases which are “strictly resolved.” “Substantial resolution” includes major milestones towards resolution such as the filing of a Chapter 11 plan, the filing of a motion for a section 363 sale of substantially all assets, and successful lift-stay motions.

The metric for plan filing is inspired by Warren and Westbrook’s empirical study.²² It is thought to be a useful indicator for sorting cases which are “Dead-on-Arrivals” (“DOAs”) from those which are plausible candidates for reorganization. The filing of a section 363 sale motion is a corollary for plausible candidates for bankruptcy sale. On the other hand, lift-stay motions pursuant to foreclosure and their ensuing orders are important in the residential development context. Cases where the core real estate has been foreclosed upon are likely to result in conversion or dismissal, even if proceedings subsequent to the order might be moving along slowly.

As such, six categories of “substantial resolution” outcomes are differentiated as follows:

18. Elizabeth Warren & Jay Lawrence Westbrook, *The Success of Chapter 11: A Challenge to the Critics*, 107 MICH. L. REV. 603, 630-32 (2009).

19. *Id.*

20. *Id.*

21. EDWARD I. ALTMAN, *BANKRUPTCY, CREDIT RISK, AND HIGH YIELD JUNK BONDS* 492 (2002).

22. Warren & Westbrook, *supra* note 18, at 614-15.

1. The Court has ordered relief from stay for substantially all assets for the secured lenders(s) to pursue foreclosure;
2. The Court has ordered relief from stay for certain assets for the secured lenders(s) to pursue foreclosure;
3. The Debtor has filed a plan and no lift-stay motions have been filed by secured lenders yet;
4. The Debtor has filed a plan and at least one lift-stay motion has been filed by a secured lender;
5. The Debtor has filed a plan and the court has entered at least one order for relief from stay for a secured lender to pursue foreclosure; and
6. A motion for a sale of substantially all assets under section 363 has been filed, pending hearing.

Based on the above sample selection and research design, 235 Chapter 11 developer bankruptcy cases were identified. Thirteen cases which were filed too close to the data cut-off date to reach a major milestone were eliminated.²³

The other set of information tracked under the bankruptcy docket analysis are the types of actions taken by secured lenders. These include significant motions and court rulings during Chapter 11 proceedings such as the following:²⁴

- Lift-stay motions to pursue foreclosure;
- Dismissal of the case;
- Appointment of a trustee;
- Termination of exclusivity or the filing of a competing plan; and
- Conversion of the case from Chapter 11 to Chapter 7.

The literature suggests that in every instance where the Bankruptcy Code provides the Chapter 11 debtor with substantial power, it checks

23. Note that, of these thirteen cases, six of them were filed in December 2008.

24. See generally Tom Chang & Antoinette Schoar, The Effect of Judicial Bias in Chapter 11 Reorganizations (Sept. 11, 2006) (unpublished manuscript), available at http://www.rsm.nl/portal/page/portal/ERIM/Content_Area/Documents/5. In this empirical study, the authors consider the most important creditor-filed motions in the Chapter 11 process to be the motions for case dismissal, conversion to Chapter 7, relief from stay, and objection to the reorganization plan. We have considered all of these, apart from the last motion type which is typically filed in almost every instance where a reorganization plan is filed.

that power with avenues for creditor action.²⁵ The primary elements of a debtor's power include initiation of the procedure and the trigger of an automatic stay and exclusivity (the exclusive right to file a plan during the first 120 days). The correlative creditors' powers thus include conversion, dismissal, relief from stay, the termination of exclusivity, and the appointment of a trustee.

C. Descriptive Statistics of the Sample

The final sample consists of 153 "strictly resolved" cases, 58 "substantially resolved" cases, and 11 "mega" cases. Figure 1, below, describes the distribution of cases in the sample by total assets and total liabilities at the time of the bankruptcy filing, excluding the "mega" cases.²⁶

Figure 1

Distribution of Total Assets and Total Liabilities

Share of Sample	\$500K or less								Median	Mean
	\$1M	\$5M	\$10M	\$25M	\$50M	\$100M	\$100M+			
Tot. Assets	2%	4%	26%	19%	27%	11%	6%	3%	\$7.44M	\$18.32M
Tot. Liab.	1%	4%	30%	19%	26%	11%	7%	2%	\$8.86M	\$19.80M

These "mega" cases, where total assets exceed \$250 million, are separately analyzed to avoid sampling issues. These were designated as complex cases in bankruptcy proceedings, owing to the multiple subsidiaries and affiliates. Based on the methodology outlined in subsection A, each entity is treated as a separate case as long as no substantive consolidation has been ordered yet. Since these cases take longer to resolve and their resolution outcomes may be similar across the same corporate group, these "mega" cases are segregated from the rest of the sample for analysis to avoid any distortion of the overall results..

Based on the descriptive statistics, the data points in the sample are

25. See, e.g., Stephen J. Lubben, *Credit Derivatives and the Future of Chapter 11*, 81 AM. BANKR. L.J. 405, 418 (2007).

26. While the Schedules require debtors to report the "current value," i.e., market value, most debtors either use book value or the value from the last appraisal. There are also a few missing values where the debtor entered "TBD" in the Schedules.

reasonably well-distributed across the board, in terms of size.²⁷ Figure 2 presents the geographical distribution of 211 cases by the state of the bankruptcy filing; it shows a reasonable distribution across states, with natural concentrations in states worst hit by the housing crisis. As for the “mega” cases, three are filed in Delaware, four in California, two in Florida, and two in Illinois.

Figure 2

Geographical Distribution of Cases

Distribution of Cases by State			
State	Count	State	Count
Alabama	2	Minnesota	2
Arizona	31	Mississippi	3
Arkansas	2	Missouri	2
California	16	Nevada	7
Colorado	6	New York	3
District of Columbia	1	North Carolina	27
Florida	23	Ohio	2
Georgia	13	Oregon	4
Idaho	2	Pennsylvania	1
Illinois	1	South Carolina	4
Indiana	1	Tennessee	5
Iowa	1	Texas	14
Kansas	1	Utah	4
Maryland	18	Virginia	5
Massachusetts	2	Washington	2
Michigan	5	Wisconsin	1

Looking at the geographical distribution, the large number of cases in relation to North Carolina is partly due to sixteen residential development entities, each managed by Landcraft Management LLC, but which are not substantively consolidated, and have different resolution outcomes.

27. There are relatively less companies with total assets or total liabilities under \$5 million. This is expected—even small residential developer bankruptcies are generally bigger than small business bankruptcies due to the substantial real estate holdings.

Second, the number of cases in relation to California may seem a tad low, given that the Californian housing market is considered to be one of the worst-hit in the country. Part of this is due to the large proportion of bankrupt residential developments in California that are represented in four mega cases—LandSource, Dunmore Homes, the SunCal companies, and Empire Land. For example, at the time of bankruptcy, Dunmore Homes alone had 26 communities in California, and the SunCal companies constituted one of the largest private residential developers in California, with more than 250,000 residential lots and ten million square feet of real estate valued at \$300 to \$600 million in bankruptcy proceedings.²⁸

Another reason is that large companies have a disproportionately huge market share in California. To illustrate, the ten largest residential developers and builders in the United States (including non-defaulted companies) occupied 52.3% of the Southern California market and 56.4% of the Central California market in 2007, compared to 28.8% of the North Carolina region.²⁹

Nevada and Florida are also states with badly-hit housing markets where the proportion of cases in our sample may look relatively low. Besides the fact that two of the mega cases are in Florida, it should be noted that in 2007, the ten largest residential developers and builders in the United States occupied 72.1% of the Miami/Miami Beach/Kendall area and 63.2% of the Cape Coral/Fort Myers area.³⁰ As for Nevada, we omitted from the sample bankrupt residential developers in Las Vegas which were also hotel and resort developers.³¹

To reiterate, we believe that these figures show that the data points in the sample are reasonably well-distributed across the board.

28. *In re Dunmore Homes, Inc.*, No. 07-13533, slip op. at 5 (Bankr. S.D.N.Y. Jan. 14, 2008), http://www.nysb.uscourts.gov/opinions/mg/162320_210_opinion.pdf. See Disclosure Statement filed by Lehman Brothers at 17-22, *In re Palmdale Hills Prop., LLC*, No. 08-17206 (lead case) (Bankr. C.D. Cal. Nov. 6, 2008).

29. FITCH RATINGS, US HOMEBUILDING/CONSTRUCTION: THE CHALK LINE—QUARTERLY UPDATE: SPRING 2009.

30. *Id.*

31. For example, one case omitted is Lake at Las Vegas Joint Venture, LLC—the developer of a 3,592 acre resort destination which also comprises of two luxury hotels (including a Ritz-Carlton), a casino, and golf courses. See Voluntary Petition of Debtor at 4, *In re Lake at Las Vegas Joint Venture, LLC*, No. 08-17814 (Bankr. D. Nev. July 17, 2008).

III. CHAPTER 11 BANKRUPTCY OUTCOMES OF RESIDENTIAL DEVELOPERS

The key results of our data collection exercise are summarized in the table below, showing the distribution of outcomes from the sample (excluding the 11 “mega” cases). Figure 3 lays out the distribution for the main dataset, where the cases have been resolved using a strict definition of resolution, as well as the augmented dataset containing cases that we consider to be substantively resolved.

Figure 3

Distribution of Procedural Outcomes in the Dataset

Procedural Resolution of Cases			
	#	Sub-Total	% of Subtotal
Strict Resolution			
Converted to Chapter 7	34		22.2%
Dismissal	85		55.6%
Section 363 Sale	17		11.1%
Plan Confirmed	17	153	11.1%
Substantive Resolution			
Order for relief from stay for substantially all assets	26		44.8%
Order for relief from stay for certain assets	9		15.5%
Plan filed by debtor and at least 1 order for relief from stay	6		10.3%
Plan filed by debtor and at least 1 lift-stay motion	4		6.9%
Plan filed by debtor; no lift-stay motions	9		15.5%
Sale motion filed and pending hearing	4	58	6.9%
Total	211		

The quick overview presented by Figure 3 provides two main insights. First, Chapter 11 cases in the residential development industry in this time period are least likely to be resolved through a confirmed plan and are more frequently dismissed or converted to Chapter 7 bankruptcy. Moreover, upon examining the cases with plan confirmation, only seven of these plans involve reorganization. Therefore, the actual reorganization rate is only 4.6% of the overall sample. Second, of

the cases which are substantively resolved, the majority of them have experienced relief from stay pursuant to foreclosure, with 44.8% having almost no assets left to support viable prospects of reorganization. These key findings will be discussed in detail throughout this Section.

A. General Findings

The most striking point of the empirical findings is that an overwhelming majority of the Chapter 11 cases ended in dismissals and conversions. Furthermore, plan confirmation rates stood at a low level of 11.1%. This distribution is based on the 153 cases (excluding 11 “mega” cases) where there has been “strict resolution”, i.e., plan confirmation, consummation of a section 363 sale, conversion to Chapter 7, and dismissal.

There is a stark contrast between this distribution of bankruptcy outcomes and those calculated from LoPucki’s Bankruptcy Research Database (“BRD”)—see Figure 4 for a benchmarking analysis of these findings against those based on the full data sample from the BRD for 1980 through 2008 and a sub-sample for a prior downturn of 2001 through 2002.³²

Figure 4

Comparison of Bankruptcies in the Residential Development Industry (2007-08) with Large Public Bankruptcies

Data Sample	Dismissal	Conversion	363 Sale	Plan Confirmation
153 Residential Developers and Builders (2007-08)	55.6%	22.2%	11.1%	11.1%
733 Large Public Companies from BRD (1980-2007)*	0.8%	4.1%	10.0%	85.1%
176 Large Public Companies from BRD (2001-02)*	1.7%	2.8%	19.3%	76.1%

*Source: Lynn M. LoPucki, Bankruptcy Research Database

32. There was insufficient data to come up with the distributions for prior downturns such as 1980-81 (8 observations) and 1990-91 (70 observations).

It is unsurprising that the rate of plan confirmation in this data sample would be lower than that in the BRD, or that the dismissal and conversion rates would be higher, since the former consists of smaller companies in a particularly distressed industry (as opposed to a wide range of large public companies). The disparity in rates is extremely wide, however.

Drilling into the rate of dismissals and conversions, there is less attention in prior studies to the proportion of dismissal rates in bankruptcy proceedings, except for the following papers which provided indicative levels for these procedural outcomes (see Figure 5).

Figure 5

**Empirical Findings on Dismissal and
Conversion Rates from Prior Literature**

Literature	Findings on Dismissals and Conversions	Data Sample
Ayotte and Morrison (2008) ³³	Conversion rate: 14% Dismissal rate: 9%	153 cases, consisting of large corporate cases listed in the <i>Bankruptcy Datasource</i> "Public and Major Company Database" during the latter half of 2001, with median assets of \$151M.
Morrison (2006) ³⁴	Northern District of Illinois cases: 23.2% conversion rate and 43.6% dismissal rate; All districts: 39.4% conversion rate and 29.9% dismissal rate	Northern District of Illinois cases (1998-99): 470 cases (median assets of \$114,160); All districts (from Survey of Small Business Finance) (1998-99): 13,457 cases (median

33. Kenneth Ayotte & Edward R. Morrison, *Creditor Control and Conflict in Chapter 11* 30 (Columbia L. & Econ. Research Paper No. 321, 2008), available at <http://ssrn.com/abstract=1081661>.

34. See Edward R. Morrison, *Bankruptcy Decisionmaking: An Empirical Study of Continuing Bias in Small Business Bankruptcies* 51 (Columbia L. & Econ. Working Paper No. 239, 2006), available at <http://ssrn.com/abstract=880101>.

		assets of \$320,971)
Bernant and Flynn (1998) ³⁵	Conversion rate: 35.4% Dismissal rate: 35.3%	131,089 cases filed between 1989 and 1995 in different districts

Compared to the ranges in prior studies, the conversion rate in this data sample is comparable but the dismissal rate at 55.6% seems very high. On the other hand, the combined conversion and dismissal rates in this data sample of 77.7% seems comparable to those in the Morrison (2006) and Bernant and Flynn (1998) studies. Note, however, that these two studies include small business bankruptcies. The ensuing implication is that bankrupt residential developers in this downturn are being dismissed and converted at similar rates to small business bankruptcies. This is disturbing because these developers are much larger companies, (median assets of \$7.44 million, liabilities of \$8.86 million), with substantial real estate holdings.³⁶

Warren and Westbrook's study found relatively high dismissal rates, over 60%, suggesting that weaker cases were culled early in bankruptcy proceedings.³⁷ In that study, of all the cases eventually pushed out of Chapter 11 without a filed plan, more than half were gone by six months, 70% by nine months, and more than 80% within one year.³⁸ Examining our sample, these developer bankruptcies, although considerably larger in size, were pushed out faster: 67% were gone by six months, 90% by nine months, and more than 95% within one year.³⁹

As for plan confirmation rates, the 11.1% in our study is low compared to the findings in other studies. A 1997 report by the National Bankruptcy Review Commission cited a report by the Administrative

35. See Gordon Bernant & Ed Flynn, *Bankruptcy by the Numbers, Outcomes of Chapter 11 Cases: U.S. Trustee Database Sheds New Light on Old Questions*, 2 AM. BANKR. INST. J. 8 (1998).

36. See Douglas G. Baird et al., *The Dynamics of Large and Small Chapter 11 Cases: An Empirical Study* 32 (Yale ICF Working Paper No. 05-29, 2007), available at <http://ssrn.com/abstract=866865> (finding that most small business bankruptcies "never confirm a plan of reorganization but they are converted or dismissed . . .").

37. Warren & Westbrook, *supra* note 18, at 630-31.

38. *Id.*

39. *Id.* Note that Warren and Westbrook's sample had a median total debt load of about \$643,490 (1994 sub-sample) and \$1.8 million (2002 sub-sample), compared to our sample with a median total debt load of \$8.9 million.

Office of the U.S. Courts that found a 17% confirmation rate.⁴⁰ In more recent empirical studies, the confirmation rate hovered between 30% and 75% (see Figure 6).

Figure 6

**Empirical Findings on Plan Confirmation Rates
from Prior Literature**

Literature	Findings on Plan Confirmation	Data Sample
Warren & Westbrook ⁴¹	1994: 30.3% confirmation rate; 2002: 33.4% confirmation rate	1994: 437 cases; 2002: 197 cases (Smaller cases, with only 2.62% (1994) and 25.19% (2002) over \$5 million in total assets). ⁴²
Ayotte & Morrison (2008) ⁴³	2001: 75% confirmation rate	153 cases, consisting of large corporate cases listed in the <i>Bankruptcy Datasource</i> "Public and Major Company Database" during the latter half of 2001, with median assets of \$151M.
Morrison (2006) ⁴⁴	Northern District of Illinois cases (1998-99): 33.2% confirmation rate; All districts (1998-99):	Northern District of Illinois cases: 470 cases; All districts: 13,457 cases; Mainly small cases with 81.1% under \$1 million in total assets.

40. NAT'L BANKR. REVIEW COMM'N, REPORT OF THE NATIONAL BANKRUPTCY REVIEW COMMISSION ch. 2, nn.781-82 (Oct. 20, 1997), available at <http://govinfo.library.unt.edu/nbrc/report/09amass.html>.

41. Warren & Westbrook, *supra* note 18, at 632-33. Warren and Westbrook also discussed a screening effect, finding that the confirmation rate for cases that survived six months was much higher—41% in 1994 and 47% in 2002. To check how this "screening effect" affected the findings in this paper, we checked the confirmation rate for cases surviving six months. The result budged slightly upwards, showing a 12.5% confirmation rate.

42. See Elizabeth Warren & Jay Lawrence Westbrook, *Financial Characteristics of Businesses in Bankruptcy*, 73 AM. BANKR. L.J. 499, 568 (1999); Warren & Westbrook, *supra* note 18, at 641.

43. Ayotte & Morrison, *supra* note 33, at 26.

44. Morrison, *supra* note 34, at 51.

	30.7% confirmation rate	
Ancel & Markell (1999) ⁴⁵	1990-96: 39% confirmation rate	2393 Chapter 11 cases filed between 1990 and 1996 (around 340 cases a year), in Region 10 of the United States Trustee's Office, including Indiana and the Southern and Central Districts of Illinois.
LoPucki (1983) ⁴⁶	47% confirmation rate	48 public company cases over twelve months in the Western District of Missouri, 1979-80.

This study seeks to look beyond the procedural outcomes of these developer bankruptcy cases to the economic outcomes, as discussed in the research methodology. The more important part of the inquiry is the extent to which liquidations of the bankrupt developers are observed. This is addressed in the following Sections where we dig deeper into bankruptcy dockets to investigate the actual resolution in these cases.

B. Do Dismissals and Conversions Necessarily Mean Liquidations?

This Section presents findings that the cases resolved through dismissals and conversions to Chapter 7 were essentially liquidated and ceased to operate as going concerns, in terms of economic outcomes. While the economic outcomes revolving around dismissals can be fairly ambiguous, such that we have to investigate the reasons for dismissal, the economic outcomes in Chapter 7 conversion cases are fairly clear-cut. This is because the mainstay of Chapter 7 bankruptcy proceedings involves a trustee taking over and conducting a piecemeal liquidation of the assets for distribution to creditors.

There is a hybrid form of conversion cases in which a going concern sale under section 363 is first undertaken, followed by a

45. Steven H. Ancel & Bruce A. Markell, *Hope in the Heartland: Chapter 11 Dispositions in Indiana and Southern Illinois*, 50 S.C. L. REV. 343, 349 (1999).

46. Lynn M. LoPucki, *The Debtor in Full Control—Systems Failure under Chapter 11 of the Bankruptcy Code?* (pt. 2), 57 AM. BANKR. L.J. 247, 272-73 (1983).

conversion to Chapter 7.⁴⁷ Since such cases would be considered sales, rather than liquidation, a review of the sample is necessary to identify whether any of the Chapter 7 conversions were preceded by section 363 sales.

All of the conversion cases in this study were preceded by at least one order granting a secured lender relief from stay to pursue foreclosure, except for eight cases. The latter were converted to Chapter 7 by the U.S. Trustee, citing reasons such as the debtors' failure to proceed with reorganization in timely fashion, an absence of reasonable likelihood of rehabilitation, and debtors' failure to file reports or pay fees. None of these involved section 363 sales.

Moving on to case dismissals, prior studies have stated that dismissals can sometimes follow a successful accommodation between a debtor and its creditors without the need for a court-approved Chapter 11 plan.⁴⁸ A 1994 study cited anecdotal evidence from bankruptcy lawyers and judges that a fair number of cases were dismissed because parties have worked out a settlement that they were not able to achieve prior to the Chapter 11 filing.⁴⁹ In contrast, Morrison's empirical study on 103 business bankruptcies in the Northern District of Illinois showed that 83.4% of the dismissal cases ended in the shutdown of the business.⁵⁰

While these studies refer to older data, they show that the economic outcomes in dismissal cases can be idiosyncratic, and there was no systematic factual inquiry regarding the circumstances behind the dismissal of these cases. Bearing this in mind, and conjecturing that the data available today may be of better quality, we investigated the filings documenting the reasons for the dismissals of these cases.

Of the 85 dismissal cases in our sample, the main reason for dismissal was that the bankruptcy estate had minimal valuable assets remaining available for liquidation or distribution, and that a plan was

47. Occasionally, Chapter 11 cases convert to Chapter 7 after having first confirmed a plan of reorganization. See Richard C. Friedman, *Issues in Chapter 7 Cases Converted from Chapter 11, 12 or 13*, J. NAT'L ASS'N BANKR. TRUSTEES, June 2000, available at http://www.justice.gov/ust/eo/public_affairs/articles/docs/nabtalk072000.pdf.

48. Bermant & Flynn, *supra* note 35, at 8.

49. See Samuel L. Bufford, *What Is Right About Bankruptcy Law and Wrong About Its Critics*, 72 WASH. U. L.Q. 829, 833 (1994).

50. Morrison, *supra* note 34, at 52.

no longer feasible. Further investigation showed that about 94% of the dismissals (81 cases) involved some form of foreclosure or liquidation as an economic outcome. This is illustrated in the first three rows of Figure 7.

In 55 of these cases (the first row of Figure 7) the motion for dismissal was preceded by orders granting secured lenders relief from stay to foreclose on substantially all real property of the developer, or orders granting relief on certain core assets (typically accompanied by the debtors' motions to abandon interests in the remaining assets to creditors). Dismissal is a logical step in such cases since the expense of Chapter 11 proceedings can no longer be justified where successful lift-stay motions meant that there were no more assets of significant value available for distribution to the general creditor body.

In eight of these cases (the second row of Figure 7), there were successful lift-stay motions by some, but not all, secured lenders, and certain assets remained with the estate. However, the debtors or the U.S. Trustee moved to dismiss the case by citing, *inter alia*, that there was no reasonable likelihood of reorganization and that Chapter 11 proceedings would not benefit the rest of the creditors.⁵¹ Such dismissals without restructuring of the capital structure typically exposed the firms to potential liquidation under state law, according to Morrison's 2006 study which showed that the probability of shutdown was very high in cases which exited without new capital structures.⁵²

Figure 7

Breakdown of Dismissals in the Dataset

Dismissals (from Strict Resolution)		Count	Subtotal	% of Total
Foreclosure or Liquidation as an economic outcome	Estate has minimal valuable Assets - dismissal preceded by lift-stay order on all assets	55		64.7%
	Estate has minimal valuable Assets -	8		9.4%

51. Note that where the case was dismissed by motion filed by the U.S. Trustee, the motion will usually include reasons such as the failure to file reports and schedules, quarterly pay fees, and so forth.

52. Morrison, *supra* note 34, at 52.

	dismissal preceded by lift-stay order on certain assets			
	Reasons related to sale or foreclosure after bankruptcy	18	81	21.2%
Otherwise	Settlement of claims between creditor and debtor for continued operations	4	4	4.7%
TOTAL		85		

Of the remaining 21.2% of dismissals (18 out of 81) which did not fall under the above category, the reasons for dismissal are summarized as follows:

- Motions by creditors to dismiss the case (in order to pursue state law remedies such as foreclosure) have been approved by the court;
- Voluntary motions to dismiss by the debtors following contentious hearings on lift-stay motions or court determinations of Single Asset Real Estate (“SARE”) status;⁵³ and
- Proposed sale of substantially all real property (outside of the section 363 sale provisions) to a junior creditor which would continue negotiations with the senior secured lender.⁵⁴

53. See 11 U.S.C. § 362(d) (2008). A SARE determination affects the deadline date for submission of a confirmable plan or the commencement of monthly interest payments. See, e.g., Joint Statement Regarding Chapter 11 Conference at 2, *In re Valle Grande Props. LLC*, No. 08-11016 (Bankr. E.D. Cal. Feb. 28, 2008) (the debtor stated in a filing some time after determination of its SARE status that it “believes that the Court now has sufficient jurisdiction to enter an order in relief”).

54. See, e.g., Motion to Dismiss by Debtor at 2, *In re SMG Land Dev. LLC*, No. 08-40902 (Bankr. D. Mass. Mar. 24, 2008). The proposed acquirer of the real property, the holder of a junior lien, had entered into negotiations with Sovereign Bank; thereafter, the debtor dismissed the case since the estate would have no remaining assets available for distribution.

Only four of these cases actually involved settlements of the claims between the developers and its creditors, and in one case, a third party entity purchased the claim of the secured lender and agreed to allow the debtor to continue in operation.

Therefore, with 95.3% of the dismissal cases found to have culminated in foreclosure or liquidation and 100.0% of the Chapter 7 cases being liquidation cases, the results from this empirical analysis at this point reflect the high rate of liquidation in the residential development industry during this time period.

C. To What Extent Were Cases with Confirmed Plans Reorganizations?

While Chapter 7 is the prevailing method of business liquidation, Chapter 11 expressly contemplates liquidation through a plan.⁵⁵ A liquidating plan may contemplate piecemeal liquidation not much different from a typical Chapter 7 proceeding, but its key distinguishing features are that the debtor's management can control the plan process, creditors can vote on the plan, and the plan may include deviations from the absolute priority rule.⁵⁶

In identifying the nature of the Chapter 11 plans in our sample, we went beyond the label affixed to the plans and examined the post-confirmation arrangement proposed by the debtor.⁵⁷ For example, in the case of Landing Development, the debtor proposed a "Reorganization Plan" which laid out what was substantially a liquidation scheme. The plan provided for repayment of the secured lenders by compelling a liquidation sale of the existing residential development and restricted the debtor to an inventory of no more than sixteen homes.⁵⁸

55. See 11 U.S.C. § 1123(b)(4) (2008). It has been said that it is a "false dichotomy that paints chapter 11 as the tool of reorganization with chapter 7 as the sole means of liquidation." See, e.g., OLIVER HART, FIRMS, CONTRACTS AND FINANCIAL STRUCTURE 156 (1995).

56. See generally Lynn M. LoPucki & William C. Whitford, *Bargaining over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 139 U. PA. L. REV. 125, 141-43 (1990).

57. Baird & Rasmussen, *supra* note 6, at 676 (observed that many cases coded as "emerged" might actually be sales of some sort, ranging from a sale where the business did not emerge intact as an independent entity to a sale of substantial level of assets while maintaining the business as a discrete legal entity). In undertaking this study, we took pains to guard against this issue.

58. See generally First Amended Disclosure Statement, *In re Landing Dev. Inc.*, No. 08-31686 (Bankr. D. Or. Apr. 14, 2008). At the time of plan confirmation, the

Of the seventeen cases where a plan was confirmed, only seven involved reorganization plans, and the remaining were plans for liquidation. A typical liquidation plan in our sample essentially affords the developer the opportunity for an orderly sale process. To illustrate, in the plan confirmed for Heritage Homes, the debtor would be allowed to market its properties for a period of six months from the date of confirmation. In the event that these properties were not sold within the agreed-upon time frame, the estate would abandon its interests and allow secured lenders to pursue foreclosure. If the sales were to generate net proceeds in excess of the secured claims, the proceeds would be held in a disbursement trust account for the benefit of unsecured creditors.⁵⁹

As for the seven cases with reorganization plans, one of them, First Dartmouth, would restructure the claims with its remaining creditors, even though substantially all of its real property had already been foreclosed upon.⁶⁰ This appears to fall within the gray area between reorganization and liquidation.

An interesting observation developed from those cases with a confirmed reorganization plan is that more than half involved recently-completed developments which have either started to generate rental income or are potentially income-producing.⁶¹ This is unsurprising, as developers of income-producing real estate are likelier to make regular payments to secured lenders and therefore provide more comfort to the

development consisted of 26 townhouses and 89 lots. *Id.* at 4. The plan stated that “[a]t no time shall the standing inventory or townhome units exceed 16 (including any that are *under construction*), excluding the 4 model townhome units” *Id.* at 6 (emphasis added).

59. See Joint Disclosure Statement and Plan of Liquidation at 3, *In re* Heritage Homes Inc., No. 08-13285 (Bankr. W.D. Wash. May 29, 2008).

60. See Schedules of First Dartmouth Homes at 2, *In re* First Dartmouth Homes, No. 07-12927 (Bankr. M.D. Fla. Dec. 29, 2007) (noting that the company owned two lots of real property, both of which are collateral securing the claims of Regions Bank); see also Disclosure Statement of First Dartmouth Homes at 6, *In re* First Dartmouth Homes, No. 07-12927 (W.D. Wash. May 29, 2008) (stating that “Regions Bank shall conclude the foreclosure of the [above-referenced] two lots”).

61. See, e.g., Schedules and Statement of Financial Affairs at 67, *In re* North Park Village LLC, No. 07-06618 (Bankr. D. Ariz. Dec. 7, 2007); 7/31/2008 Transmittal of Financial Reports and Certification of Compliance at 6, *In re* Northpoint Village of Utica LLC, No. 08-53097 (Bankr. E.D. Mich. May 29, 2008); 2/22/2008 Motion for the Authorization of Rental at 5, *In re* The Towers of Channelside LLC, No. 08-00939 (Bankr. M.D. Fla. Jan. 25, 2008).

lenders in terms of a lower probability of default on restructured claims. It should be noted, however, that the broader socioeconomic impact of the liquidation and foreclosure of unfinished homes is far more severe than that of completed and income-producing properties.

D. Are the “Mega” Cases on the Track to Reorganization?

Of the eleven “mega” developer bankruptcies, five cases have been resolved and only one case, LandSource Communities, had confirmed a reorganization plan.⁶² One of the cases, Empire Land, had been converted to Chapter 7, after multiple lift-stay motions in pursuit of foreclosure by secured lenders were approved by the court.⁶³ Kimball Hill, Dunmore Homes, and Levitt & Sons all had confirmed liquidation plans.

In these three cases, a portion of the real estate assets were sold or foreclosed upon by the time of confirmation. Dunmore Homes occupied the most “extreme” end of the spectrum—at the time when the plan was confirmed, secured lenders had already foreclosed upon substantially all residential developments, leaving the developer’s assets consisting of land options, deferred compensation funds, receivables, deposit accounts, and litigation claims.⁶⁴

At the time of writing, four out of the eleven “mega” cases saw debtors filing a plan: Touse and DBSI proposed liquidating plans, while Woodside Group and WCI Communities proposed reorganization plans.⁶⁵ The remaining cases—the SunCal group and Neumann

62. See June 2, 2009 Disclosure Statement of Debtor at 5, *In re LandSource Communities Dev., LLC*, No. 08-11111 (Bankr. D. Del. June 8, 2008).

63. See generally Docket Report, *In re Empire Land, LLC*, No. 08-14592 (Bankr. C.D. Cal. Apr. 25, 2008).

64. See, e.g., Second Amended Disclosure Statement at 44-49, *In re Levitt and Sons, LLC*, No. 07-19845 (Bankr. S.D. Fla. Nov. 9, 2007) (noting that relief from stay had been granted for certain creditors); Disclosure Statement of Debtor at 32-33, *In re Kimball Hill, Inc.*, No. 08-10095 (Bankr. N.D. Ill. Apr. 23, 2008); Disclosure Statement at 28-32, *In re Dunmore Homes, Inc.*, No. 08-20569 (Bankr. E.D. Cal. Nov. 8, 2007) (listing the various assets left at the time of confirmation).

65. See, e.g., Disclosure Statement for Chapter 11 Plan at 57, *In re TOUSA Inc.*, No. 08-10928 (Bankr. S.D. Fla. Jan. 29, 2008); Disclosure Statement in Support of Joint Plan of Reorganization at 15-16, *In re Woodside Group, LLC*, No. 08-20682 (Bankr. C.D. Cal. Aug. 20, 2008); Disclosure Statement for Reorganization Plan at 1, *In re WCI Communities Inc.*, No. 08-11643 (Bankr. D. Del. Aug. 4, 2008); Disclosure Statement of Debtor at 6, *In re DBSI Inc.*, No. 08-12687 (Bankr. D. Del. Nov. 10, 2008). Note that Woodside Group’s proposed reorganization plan must be put into context—the bankruptcy petition was filed on behalf of the 30 major banks and 5 insurance

Homes—had not filed a plan yet, but their progress in bankruptcy proceedings suggests that liquidation or sale would be a likely outcome.

Neumann Homes was confronted with multiple successful lift-stay motions and, as it filed for bankruptcy on November 1, 2007, its exclusivity period to file a reorganization plan, a statutory maximum of 18 months under the BAPCPA, had expired at the time of writing.⁶⁶ It should be noted that distressed lenders (IndyMac, Guaranty Bank, and GMAC) held more than 70% of the \$115 million bank debt. Similarly, the SunCal group had as their primary secured lenders subsidiaries of the bankrupt Lehman Brothers, and the trustee has since condemned their role in burdening the estate with liabilities of at least \$100 million. This raises the issue of the simultaneous distress of both developer and secured creditor which we will discuss further in Section V.⁶⁷

E. Benchmarking Economic Outcomes against Other Studies

Based on the foregoing analyses, the actual rate of liquidation in the “strict resolution” sample of 153 cases is 81.7%, being a composite of the following:

- 52.9% from dismissals (81 cases with liquidation or foreclosure as an outcome);
- 22.2% from Chapter 7 conversions (all of the 34 cases which were converted); and
- 6.5% from confirmed plans of liquidation (10 cases).

The economic outcomes in this study are benchmarked against those of prior empirical studies—Edith Hotchkiss and Robert Mooradian’s 2004 study on Chapter 11 cases for 1,400 public companies from 1979 to 2002, Sreedhar Bharath’s 2007 study on public companies’ Chapter 11 filings for the period of 1980 through 2005, which showed a liquidation rate of 18.8%, and the Ayotte & Morrison (2008) and Morrison (2006) studies (discussed above in Section 4.1).⁶⁸

companies against 185 affiliated borrower/guarantor entities that had borrowed in excess of \$600 million on an *unsecured* basis.

66. See Disclosure Statement of Debtor at 1, *In re Neumann Homes, Inc.*, No. 07-20412 (Bankr. N.D. Ill. Nov. 1, 2007) (noting that the plan was filed on Aug. 26, 2009).

67. See, e.g., *In re Palmdale Hills Prop., LLC*, No. 08-17206 (Bankr. C.D. Cal. Nov. 6, 2008) (lead case).

68. See generally Ayotte & Morrison, *supra* note 33; Morrison, *supra* note 34;

Figure 8 summarizes the results of this benchmarking exercise.

Figure 8

Benchmarking Economic Outcomes against Prior Studies

Literature/Data	Liquidations	363 Sale	Reorganization	Others*
This Study (2009)	81.7%	11.1%	4.6%	2.6%
Bharath, Panchapegesan and Werner (2007)	18.8%	11.3%	59.3%	10.5%
Hotchkiss and Mooradian (2004)	21.5%	7.6%	70.6%	N/A
Morrison (2006)	62.1%	5.3%	24.2%	8.4%
Ayotte and Morrison (2008)	66.0%		32.0%	N/A

The liquidation rate for bankrupt developers in our study, at 81.7%, is high compared to these studies. A possible explanation is that the liquidation rates for the studies by Hotchkiss and Mooradian (2004) and Bharath et al (2007) relate to large companies, while our sample covers residential developers, which are mostly middle-market. On the other hand, even the most optimistic estimate of reorganization rates in the “mega” cases at 45.4% (assuming the two cases with proposed reorganization plans and the two pending cases will culminate in reorganizations, i.e., five out of eleven) is not near the levels in these two prior studies. Furthermore, the 81.7% liquidation rate is still much higher than the rate found in Morrison’s 2006 study on small business bankruptcies, not to mention the low 4.6% reorganization rate in our main sample of 153 cases against Morrison’s 24.2%.

One way to interpret these results is that these prior studies cover an entire economic cycle, while this sample is drawn from one of the most distressed sectors of the economy amidst a severe downturn. If this does

Sreedhar T. Bharath et al., *The Changing Nature of Chapter 11* (Fisher Coll. of Bus. Working Paper No. 2008-03-003, 2007), available at <http://ssrn.com/abstract=1102366>; Edith S. Hotchkiss et al., *Bankruptcy and the Resolution of Financial Distress* (Jan. 2008) (unpublished manuscript), available at <http://ssrn.com/abstract=1086942>.

turn out to be an important explanation for the difference in our results, then it raises a critical question: should bankruptcy policy be shaped by data averaged across the economic cycle? After all, large changes in the U.S. bankruptcy regime have occurred during previous severe downturns when, presumably, society found the existing regime, established during more prosperous periods, to be unsatisfactory.⁶⁹ It is apparent that the causes of bankruptcy, and the socio-economic outcomes, differ greatly depending on the economic cycle. Perhaps the remedies should vary accordingly.

F. Focusing on Cases with a Plan Filed

A possible criticism of the above analysis is that the data should be filtered for dead-on-arrival (“DOA”) cases, those where the debtor arrived at Chapter 11 in such a precarious state that the debtor had no realistic chance of survival. In Warren and Westbrook’s study, this is proxied by the situation where the debtor did not file a plan throughout the case.⁷⁰ It has been asserted that any Chapter 11 case that could be derailed before a plan could be filed was likely to be in so much trouble that reorganization was unlikely in the first place.

Applying this logic, the data is re-analyzed after identifying the cases where the debtor had filed a plan. The results are presented in Figures 9 and 10. Each figure shows the distribution of outcomes in cases where a plan was filed, compared to the proportion of outcomes in cases where no plan was filed.

Figure 9

Procedural Outcomes				
	Debtor-Filed Plan		No Debtor-Filed Plan	
	Count	%	Count	%
Converted Ch. 7	16	24.6%	18	20.5%
Dismissal	26	40.0%	59	67.0%

69. See Charles Jordan Tabb, *The History of Bankruptcy Law in the United States*, 3 AM. BANKR. INST. L. REV. 5, 32 (1995) (documenting that bankruptcy legislation has often been enacted on the heels of domestic economic turmoil).

70. Specifically, cases where the debtor did not file a plan of reorganization throughout the life of the case. Warren & Westbrook, *supra* note 18, at 614.

Sale (363)	6	9.2%	11	12.5%
Plan Confirmed	17	26.2%	N/A	N/A

Predictably, the rate at which any reorganization plan was confirmed increased, to 26.2% in the sub-sample of cases where the debtor proposed at least one plan. The plan confirmation rate remains very low compared to Warren and Westbrook's findings in relation to cases with a debtor-filed plan - 65.5% in 1994 and 71.6% in 2002.⁷¹ Moreover, in terms of economic outcomes, in Figure 10 below, the level of reorganization is still low at 10.8%.

Figure 10

Economic Outcomes

	Debtor-Filed Plan		No Debtor-Filed Plan	
	Count	%	Count	%
Liquidation	51	78.5%	74	84.1%
Reorganization	7	10.8%	N/A	N/A
Going Concern Sale	6	9.2%	11	12.5%
Others	1	1.5%	3	3.4%

The use of a debtor-filed plan as a proxy for DOA incidences is problematic because it places an excessive emphasis on the debtors' actions. Warren and Westbrook explained their approach by likening the bankruptcy court to an emergency room. They argued that if an emergency room attracts a large number of DOAs, even the best-run emergency room would score badly in a system that simply counted the number of people who die in the emergency room.⁷² If the DOAs were excluded, they reasoned, patient outcomes drawn from a pool within their control would more accurately measure the skill of the emergency room staff. This analogy does not work as well in the bankruptcy context, where the actions of other stakeholders, in particular secured lenders, are likely to affect the debtor's ability to file a plan. Under the Warren and Westbrook analogy, this is akin to an emergency room where actors besides the doctors and patients decide whether or not to pursue life-saving treatments.

71. *Id.*

72. *Id.*

As Miller and Waisman have remarked, the bankrupt debtor must, while “in its most fragile state, either challenge the lender’s liens and security interests or seek to use the lender’s cash collateral over the lender’s objection, which if they are options at all, involve lengthy and resource-draining proceedings, or accede to the lender’s demands.”⁷³ Furthermore, as this Article discusses in the next Section, many of these developer bankruptcies were fraught with lift-stay motions. A developer kept busy fending off multiple lift-stay motions may not have the time and resources to file a plan. As the Official Committee of the Unsecured Creditors of Village Homes, a case discussed further in the next Section, stated in a response to a lift-stay motion by the lender, “the Debtor has been constantly forced into litigation with its secured creditors . . . rather than focused on a re-organization The Motion [for relief from stay] continues this unfortunate trend.”⁷⁴

G. Casting a Wider Net with “Substantially Resolved” Cases

Another possible criticism of this Article’s findings is the potential for sample selection issues. Since this sample is comprised of recent cases, between November 1, 2007 and December 31, 2008, it is conceivable that the cases which may result in plan confirmation are still in a pending stage and that reorganization cases may take a longer time to reach resolution.

To address this issue, we have collected docket information on cases which are “substantially resolved” in doing so, we consider successful lift-stay motions, the filing of a Chapter 11 plan, and the filing of a motion for a section 363 sale of substantially all assets as major milestones towards resolution. Figure 11 summarizes the resolution status of these cases.

73. Miller & Waisman, *Reorganization*, *supra* note 8, at 185.

74. See Official Unsecured Creditor’s Committee Response to Motion for Relief from Stay at 1, *In re Village Homes of Colo. Inc.*, No. 08-27714 (Bankr. D. Colo. Nov. 6, 2008).

Figure 11

Status of Substantially Resolved Cases

Cat.	Status	#	%
1	Order for relief from stay for substantially all assets*	26	44.8%
2	Order for relief from stay for certain assets*	9	15.5%
3	Plan filed by debtor and at least 1 order for relief from stay	6	10.3%
4	Plan filed by debtor and at least 1 lift-stay motion	4	6.9%
5	Plan filed by debtor; no lift-stay motions	9	15.5%
6	Sale motion filed and pending hearing	4	6.9%

*Cases where no plan has been filed by the debtor yet.

The most optimistic scenario regarding the substantially resolved cases involves an expectation that all of the cases in Categories 2-5 in Figure 11 will result in a confirmed plan. These cases do have some probability of reaching plan confirmation: a plan has been filed but not yet confirmed for cases in Categories 3-5; and while an order for relief has been granted regarding certain assets for cases in Category 2, it is still possible for the debtor to file a plan. In this scenario, we have excluded cases in Categories 1 and 6. While it is possible that Category 1 cases can still culminate in plan confirmation,⁷⁵ these cases are more likely to move towards dismissal or conversion, given the loss of substantially all assets.

Based on this optimistic scenario, 28 cases from Categories 2-5 can be added to the 15 cases with a plan confirmed (in the “strictly resolved” sample). This means that the estimated plan confirmation rate can be increased from 11.1% to 20.4%, but it is still lower than the range in prior empirical studies cited above.

It is easy to see that very optimistic assumptions are required before the debtors in our sample achieve a plan confirmation rate closer to the range in previous studies. As gleaned from the findings in subsection F, only 26.2% of the cases where a plan was filed ended in confirmation. Further analysis of the “strict resolution” sample also shows that cases with a plan filed and at least one order for relief from stay (i.e., Category 3 cases) have a 17.8% chance of confirmation. Besides, we should also

75. Note that in the case of First Dartmouth, the debtor managed to confirm a restructuring plan with the other creditors in relation to remaining assets, even though substantially all real estate has been foreclosed upon. *See supra* note 60.

consider the fact that 33.3% of the cases in Category 2 (where a plan is not filed yet) were filed more than twelve months ago. Given the statutory maximum on plan filing exclusivity of eighteen months and solicitation exclusivity of twenty months, these cases face a rushed timeframe and the probability that all of these cases would reach plan confirmation is not that high.

Furthermore, as discussed above, it is not merely plan confirmation which is important, but the confirmation of a reorganization plan. At first glance, eleven of the plans filed were liquidation plans and eight were reorganization plans. As such, even if we assume that the remaining cases will culminate in reorganization, the addition of these cases to the overall sample will only bring the reorganization rate to 7.1%.

This Section shows evidence that residential developers are going into liquidation and foreclosure at an unprecedented rate. The next Section presents details on exactly how secured lenders are exerting their influence to bring about such liquidation or foreclosure outcomes.

IV. THE ROAD FROM BANKRUPTCY TO FORECLOSURE AND LIQUIDATION

The foregoing analysis of this relatively comprehensive dataset has demonstrated that the outcomes of bankruptcy cases that we have studied are very different from those of prior studies. The main finding is that only a small minority of developers reorganize in Chapter 11, with the vast majority ending up in liquidation or foreclosure. This is unsurprising because secured lenders often prefer a swift sale or liquidation of the debtor, as opposed to a Chapter 11 reorganization process fraught with uncertainty and delay. In fact, the gradual move toward greater control of Chapter 11 proceedings by secured lenders has allowed fuller expression of the lenders' incentives for swift resolution of financial distress.⁷⁶

This appears to be the situation in the residential development industry, at least as evidenced by the low reorganization rate tracked in the last section. This Section sheds light on the variety of methods employed by secured lenders in moving bankrupt debtors down the path to liquidation or foreclosure.

76. See generally Adler, *supra* note 5; Todd J. Zywicki, *The Past, Present, and Future of Bankruptcy Law in America*, 101 MICH. L. REV. 2016 (2003).

A. The Prevalence of Lift-Stay Motions

As discussed in the previous section, many of the dismissal and conversion cases in developer bankruptcies were preceded by the following orders:

- Orders granting secured lenders relief from stay to foreclose on substantially all real property of the developer, or
- Orders granting relief on certain core assets followed by the debtors' motions to abandon interests in the remaining assets to creditors.

The high combined rate of dismissals and conversions indicates a prevalence of lift-stay motions pursuant to foreclosure - a key finding in relation to secured lenders' actions. Indeed, this is the main finding borne out in bankruptcy docket analysis of secured lender actions. In the overall sample of 211 developer bankruptcies, there are 153 cases (72.5%) where at least one lift-stay motion in pursuit of foreclosure was filed by a secured lender. In contrast, data gathered on such bankruptcies between 2004 and 2006 revealed a rate closer to 50%. While the sample size is small (i.e., data on 35 residential development bankruptcies was collected during this time period owing to relatively fewer defaults), a 95% confidence interval ranges from 31% to 66%, considerably lower than the 72% level experienced in cases occurring during the current crisis.⁷⁷ More importantly, in 92.2% of these 153 cases, an order granting the motions was entered.⁷⁸

In relation to other actions observed, at least one secured lender moved to dismiss proceedings in twenty cases (9.5%); moved to convert the case to Chapter 7 in fifteen cases (7.1%); moved to appoint a trustee in ten cases (4.7%); and moved to terminate exclusivity or file a

77. The 95% confidence interval extends from 33.0% to 64.4% (based on the adjusted Wald method) and 31.4% to 66.0% (based on the Clopper & Pearson method).

78. Note that there is a dearth of literature regarding the proportion of lift-stay motions and their approval in bankruptcy proceedings, but we did find one study finding that creditors filed lift-stay motions in 68% of all shutdowns and the court granted them 42% of the time. Morrison, *supra* note 34, at 54. Note that these relate to small business bankruptcies filed in 1989-90 and the numbers are based on shutdowns only, not the entire sample (i.e., the proportion of lift-stay motions is much lower than the levels found in our sample).

competing plan in three cases (1.4%). These actions are not mutually exclusive; it is relatively common for lenders to file a motion for dismissal and conversion, in the alternative.⁷⁹

The prevalence of these successful lift-stay motions suggests an issue meriting further investigation. After all, part of bankruptcy policy is based on the principle that there should be a moratorium on asset grabs. The following subsections analyze the rationale for these lift-stay motions, the grounds asserted by secured lenders in these motions, the extent to which the phenomenon is legislative or market-driven, and the incentives of the insiders such as guarantors.

B. Relief under 11 U.S.C. § 362

The filing of a bankruptcy petition triggers an automatic stay under section 362 of the Bankruptcy Code.⁸⁰ Part of the fundamental protections afforded to debtors, the automatic stay is meant to provide debtors with breathing space from their creditors during which they can attempt to structure a plan to repay their debts or arrange for relief from the financial pressures that drove them into bankruptcy.⁸¹

There are two main grounds typically advanced in support of lift-stay motions:

- Cause, including the lack of adequate protection (section 362(d)(1)); or
- The debtor's lack of equity in the property and that such property is not necessary to an effective reorganization (section 362(d)(2)).

This Article next illustrates how secured lenders use sections 362(d)(1) and 362(d)(2) in Chapter 11 bankruptcy proceedings of residential developers. Village Homes of Colorado ("Village Homes") represents a classic case. One of Colorado's largest residential developers with around \$200 million in annual revenues, Village Homes filed for bankruptcy on November 6, 2008. Before the recession began in 2007, Village Homes would have hardly seemed like a candidate for lift-

79. See, e.g., Docket Report at 40, *In re Le Jardin, LLC*, No. 08-77019 (Bankr. N. D. Ga. Aug. 9, 2008).

80. See 11 U.S.C. § 362(d) (2008).

81. See H.R. REP. NO. 95-595, at 340 (1977).

stay motions pursuant to foreclosure. Its profile appeared to be in line with a plausible candidate for debt restructuring and reorganization, with a reasonable chance of success.

Since its founding in 1984, Village Homes built nearly 10,000 homes in Colorado.⁸² It developed active communities in seven locations throughout the Denver metropolitan area, two locations in northern Colorado (Fort Collins and Longmont), and two locations in the Colorado mountains (Granby and New Castle). It has developed communities ranging from small residential infill to large-scale, mixed-use master plans, and offers a variety of home types and price ranges. In fact, some of the communities developed by Village Homes had received numerous local, state, and national awards, including “Community of the Year” from the Home Builders Association of Metropolitan Denver every year from 2002 through 2007.

Nonetheless, like many residential developers, Village Homes’ Chapter 11 filing was precipitated by the onset of severe housing market downturn conditions as well as the credit crisis, which caused a significant constriction of credit and reduced the funds that the developer had available to continue normal operations. At the time of bankruptcy, the company had 142 finished, but unsold, homes in inventory, comprised of 11 completed homes under contract with a buyer, 79 completed homes not under contract, and properties under construction with projected costs of completion estimated at \$5.9 million.

Four days after the bankruptcy filing, Guaranty Bank, the administrative agent for the lender group, initiated the first volley, a motion objecting to the use of cash collateral. A highly contentious dispute ensued. While the secured lenders took the position that the cash Village Homes had on hand constituted their cash collateral, the developer argued that the lenders had limited security interests on personal property and that part of the cash belonged to home buyers who put down deposits.⁸³

In the midst of this dispute, the secured lenders also launched lift-stay motions in pursuit of foreclosure against Village Homes.⁸⁴ Note

82. See Debtor’s Brief in Support of Motion for Expedited Entry of Order and Notice of Impending Hearing Thereon at 1, *In re Village Homes of Colo. Inc.*, No. 08-27714 (Bankr. D. Colo. Nov. 6, 2008).

83. *Id.*

84. On January 21, 2009, Guaranty Bank, as agent for the Lender Group, filed its motion for relief from stay. See generally Motion for Relief From Stay, *In re Village*

that the relief was sought very early in the case, when Village Homes was barely in Chapter 11 for two months and had had no chance to focus on reorganization. First, under the ground of “cause” in the lift-stay motions, the secured lenders argued that there was a “lack of adequate protection.” “Lack of adequate protection,” a term of art defined only by example in the Bankruptcy Code, is generally considered the most common basis for finding cause to grant relief in bankruptcy proceedings.⁸⁵ Generally speaking, a secured creditor’s interest is adequately protected when provisions that the court considers adequate has been made to protect the secured creditor from loss from a decline in the value of the secured creditor’s collateral during the imposition of the automatic stay.⁸⁶

In particular, the lenders cited the decline of residential real estate values and the lack of adequate protection payments as sufficient showing that they, the secured lenders, were not protected from any deterioration in the value of their collateral. Moreover, they argued that the debtor had not closed any sales of houses under the terms of the Ordinary Course Order entered by the Court and had only closed five “short sales” by the time of the lift-stay motion.⁸⁷

Based on the cases in our sample, it is relatively rare to find cases where the cash-strapped bankrupt developers were able to furnish adequate protection payments in cash. Indeed Village Homes argued that it was providing adequate protection of the secured lenders’ interests by continuing with the construction and development of its housing projects, citing cases that post-petition improvement of real property is sufficient to constitute adequate protection.

This argument is quite weak. On the issue of “adequate protection” in the bankruptcy of Den-Mark Construction on April 7, 2009, the district court rejected a similar argument, citing the Court of Appeals for the Third Circuit.⁸⁸

Homes of Colo. Inc., No. 08- 27714 (Bankr. D. Colo. Nov. 6, 2008).

85. See generally *Relief from the Stay*, 1-362 COLLIER BANKRUPTCY MANUAL P 362.07 (3d ed. rev. 2008)

86. LYNN M. LOPUCKI & ELIZABETH WARREN, SECURED CREDIT: A SYSTEMS APPROACH 103 (5th ed. 2005).

87. In this context, short sales mean sales of real estate in which the proceeds from the sale fall short of the balance owed on a loan secured by the property sold.

88. See *In re Swedeland Dev. Group, Inc.*, 16 F.3d 552, 567 (3d Cir. 1994).

[C]ontinued construction based on projections and improvements to the property does not alone constitute adequate protection . . . Those cases which have considered improvements to be adequate protection have done so only when the improvements were made in conjunction with the debtor's providing additional collateral beyond the contemplated improvements . . . We reject the notion that development property is increased in value simply because a debtor may continue with construction which might or might not prove to be profitable.

It should be noted that this case is premised on the policy that "Congress did not contemplate that a secured creditor could find its position eroded and, as compensation for the erosion, be offered an opportunity to recoup dependent upon the success of a business with inherently risky prospects."⁸⁹ The question is whether legislators continue to adhere to this policy in the significant nationwide decline in housing prices starting in 2007, where almost all distressed real estate businesses can plausibly be considered to have inherently risky prospects.

Next, the secured lenders argued that the debtor had no equity in the property and that the property was not necessary for an effective reorganization. They were quickly able to show that Village Homes had no equity in the real estate.⁹⁰ In the course of the creditors' meetings, the debtor acknowledged that the deficiency for creditors might be higher than the \$35 million shown by values reported in its Schedules of Assets & Liabilities, owing to the depressed values of uncompleted properties.⁹¹ Village Homes reported in its Schedules total liabilities of \$138.4 million, of which the bulk was owed to senior secured lenders, and total assets of \$103.9 million.

The secured lenders then proceeded to assert that there was no prospect of a successful reorganization. Citing precedents, they argued that the mere indispensability of the property to the debtor's survival and

89. *Id.*

90. Note that in many cases, this issue is not as clear-cut for several other developers and, in those instances, the litigation would center on the different appraisal values of the real estate, including issues such as whether the "as is" or "upon completion" values should be used. In some of these cases, if the court had assigned a different value, the outcome might have been different.

91. This is unsurprising, given the low market value of the uncompleted properties. In fact, it is a common phenomenon in developer bankruptcies, given the high loan-to-value ratios in loans extended to developers, and the sharp negative correction in real estate prices since 2007.

the debtor's hopes of reorganization were insufficient to justify continuation of the stay when reorganization is not reasonably possible.⁹² The central argument was that without post-petition financing, Village Homes had no feasible way to continue its business, and that terms for financing the developer could not be agreed upon.

Since the secured lenders were thought to have a strong legal case during hearings, Village Homes eventually agreed to compromise and settle with its secured lenders on March 13, 2009.⁹³ While not a case which culminated in an order for relief and foreclosure, the developer agreed to a forced sale of "Non-Core Assets," which included most of the residential lots under construction and a portion of finished homes.⁹⁴ In the agreed stipulation, Village Homes acknowledged that it had no equity in these "Non-Core Assets" and that they were not necessary to an effective reorganization such that relief from stay was appropriate under § 362(d)(2) of the Bankruptcy Code.

The three main arguments marshaled by these secured lenders in asking bankruptcy courts for relief from the automatic stay in order to foreclose are:

1. The developer no longer has any equity in the collateral because its value has plunged with the sharp decline in residential real estate values and the developer was highly-leveraged at origination;
2. No lender has offered to refinance the project, so reorganization is impossible; and
3. There have been no or very few offers to purchase homes (or the project itself) as a result of the housing market crisis.

Judging from the high proportion of cases where relief from stay was ordered, it appears that the current bankruptcy regime and bankruptcy judges are sympathetic to such arguments. To some extent, this might be a carry-over from times when many bankruptcies were a

92. See, e.g., *In re Coones v. Mut. Life Ins. Co.*, 168 B.R. 247, 259 (D. Wyo. 1994).

93. Docket Report at 376, *In re Village Homes of Colo. Inc.*, No. 08-27714 (Bankr. D. Colo. Nov. 6, 2008). Note that the compromise happened after the initial exclusivity period expired. This case is also an example as to why companies which are not DOAs may not file a plan in time, given that the resources were tied up fighting lift-stay motions.

94. *Id.*

result of poor management. Finance scholars call this idiosyncratic risk. This reasoning is less applicable in the current environment, where the entire residential development industry is collapsing along with housing prices nationwide, with many large and small firms alike entering bankruptcy.⁹⁵ These factors, coupled with illiquidity in the financing markets, reflect systematic risk. Under these circumstances, the argument that the aggressive liquidation preferred by senior lenders is simply separating the wheat from the chaff falls apart. When the entire sector, if not the entire economy, is suffering, there are unlikely to be sales and transfers which amount to a “better” utilization of those assets.

Perhaps the bankruptcy case of Grusaf LLC, a middle-market developer of condominiums in Florida, elucidates more clearly the single-mindedness of many secured lenders on repossessing the property and pursuing foreclosure at all costs. Grusaf proposed a plan providing for the sale and marketing of the property within six months from the entry of the confirmation order. If the sale was not consummated, the property would be surrendered to the bank.⁹⁶ Nonetheless, the secured lender vehemently objected to the developer’s proposed plan. First, the lender characterized the plan as unfeasible, arguing that the developer had “no reasonable prospect of being able to sell its property.” The lender also said the plan was unfair and inequitable because it did not “propose to make any payments to the Bank during the six month period within which the Debtor propose[d] to sell the Bank’s collateral.”⁹⁷

As in the Village Homes’ bankruptcy, there was a lack of buyers for the residential real estate in Grusaf’s case. It is unclear what resources the creditors were supposed to “capture” and reinvest when the assets of the business were properties under construction. Indeed, another bankrupt developer remarked in a court filing in relation to their properties where the common area and certain infrastructure were still

95. In an empirical study on highly leveraged transactions of the 1980s, which subsequently became financially distressed and filed for bankruptcy, it was found that high leverage, not poor firm or industry performance, was the primary cause of financial distress. Gregor Andrade & Steven Kaplan, *How Costly Is Financial (Not Economic) Distress? Evidence from Highly Leveraged Transactions That Became Distressed*, 53 J. FIN. 1443, 1444-45 (1998).

96. Chapter 11 Plan of Liquidation at 2, *In re Grusaf, LLC*, No. 07-bk-12701(Bankr. M.D. Fla. Dec. 21, 2007).

97. *Id.* Note that, at the time of this objection, the developer had just begun renting out some condominium units, and the process would have taken a while before it could make adequate protection payments to the bank.

under construction, “[w]ithout amenities and competing with sellers in the market who provide for infrastructure costs in sale contracts, a liquidation of the Debtors’ assets is unlikely to attract any but the most opportunistic buyer.”⁹⁸

This brings to the forefront a set of policy questions which are not adequately addressed by the current bankruptcy regime. In a period of severe market correction, should the legal framework allow developers to retain and complete the properties, instead of allowing creditors to seize the properties? Which party is in a better position to be responsible for the properties, since a forced sale is likely to result in a lose-lose situation? In fact, a motion filed by the debtor, Village Homes, highlights this policy puzzle:

There is a fundamental inconsistency in the position RFC [the secured lender] has taken regarding their assertion of a housing market decline in the RFS Motion versus their position on the Debtor’s Sale Motion. RFC objected to the Debtor’s proposal to sell homes quickly and resolve disputes over the proceeds at a later time. Apparently RFC was not worried about a declining market in that context, but now contend that the court should grant it relief from stay because of its fears about a declining market. *Does RFC really expect that the Short Sales it objected to will somehow turn into higher priced sales if it is given relief from stay, and do so quickly enough to overcome the feared market decline?* If RFC really fears that home prices are going to decline, wouldn’t it be more logical to consent to all of the sales the Debtor currently has under contract, get them closed as quickly as possible, and then assert their interest in the proceeds?⁹⁹

Finally, it should be noted that construction loans make up a very large proportion of total bank lending, and unloading developers’ real estate assets en masse could have negative ramifications for the property values of many communities and people. It would even indirectly hurt the value of the overall portfolios of banks themselves, as they have

98. April 3, 2009 Disclosure Statement of Debtor at 9, *In re* 2W Homestead LP, No. 08-12195 (Bankr. W.D. Tex. Nov. 3, 2008).

99. Debtor’s Objection to Relief From the Automatic Stay of RFC Construction Funding, LLC at 4, *In re* Village Homes of Colo. Inc., No. 08-27714 (Bankr. D. Colo. Nov. 6, 2008) (emphasis added). The secured lender, RFC, or Residential Funding Corporation, is part of the GMAC group and has been financially-distressed itself during the bankruptcy proceedings—an issue which we will discuss in Section V.

other real-estate related assets which have to be marked to market.¹⁰⁰

C. Consent Orders and Agreed Stipulated Relief

As illustrated by the Village Homes proceeding, the lift-stay motions can be resolved by a stipulated relief agreed between parties; in that case, the secured lenders and the developer agreed to a liquidation of non-core assets. Examining the information collected from the bankruptcy dockets, of the 141 cases where the lender obtained relief from stay, only 68 (48.2%) of these involved consent orders or agreed stipulations between the developer and secured lenders. This proportion is much lower than the finding in Charles Shafer's 1990 empirical study, which found that 87% of the lift-stay motions were settled before the court rendered its decision.¹⁰¹ This metric may be a reliable indicator of contentiousness between developers and secured lenders in bankruptcy proceedings.

This begs the question: in cases with consent orders, why would a developer consent to relief from stay when doing so leads to foreclosure and, particularly in cases of smaller developers, the possible dissolution of the firm? The most common reason cited in these consent orders or stipulated relief is the developer's desire to avoid contested proceedings. For instance, in the stipulation entered into by Village Homes the developer stated their compromise benefited the estate by "avoiding the costs of litigating the relief from stay motion, providing certainty to the Debtor of the lots it will be entitled to build on in the future."¹⁰² In addition, these consent orders often embody a compromise in which the secured lender agrees to foreclose on only a limited portion of the debtor's assets, or postpone foreclosure proceedings with "drop dead" provisions if certain milestones are not reached within a specified time period. In exchange, the developer typically agrees to make certain pay-

100. *The Looming Foreclosure Crisis: How to Help Families Save Their Homes: Hearing on H.R. 1106 Before the S. Comm. on the Judiciary*, 111st Cong., 1st Sess. (2009) (testimony of Mark Zandi, Chief Economist, Moody's) (stating that "[g]iven that the total cost of foreclosure to lenders is much greater than that associated with Chapter 13 bankruptcy, there is no reason to believe that the cost of mortgage credit across all mortgage loan products should rise").

101. Charles Shafer, *Determining Whether Property Is Necessary for an Effective Reorganization: A Proposal for the Use of Empirical Research*, ANN. SURV. BANKR. L. 79, 79-81 (1990).

102. Debtor's Motion to Approve Settlement at 10, *In re Village Homes of Colo. Inc.*, No. 08-27714 (Bankr. D. Colo. Nov. 6, 2008).

ments or cede a degree of control over its operations to the lender.

The Village Homes case remains illustrative of the concessions likely to be required of a developer in exchange for the ability to retain some of their core assets. First, the Village Homes stipulated relief called for the appointment of a Chief Restructuring Officer (“CRO”). The developer agreed to select one of two candidates presented by the secured lenders. Amongst other things, the CRO would control the sales of homes and the payment of lenders and other creditors from the net proceeds.¹⁰³ Second, while the lenders agreed to allow Village Homes to use its cash collateral according to an approved budget, the settlement provided contingent adequate protection to the secured lenders in the form of a lien on receivables from an insurance premium refund of \$1.5 million and a trust fund refund of \$0.4 million. Furthermore, the parties executed mutual releases, including the release by the developer of preference claims exceeding \$10 million against the secured lenders.¹⁰⁴

A genre of lift-stay consent orders involves a “negotiated truce” between the developer and secured lenders. Under this scenario, a developer is given a specified time period to sell its property outside foreclosure. The case of Maryland Homes Palisades PA is illustrative. The terms of the stipulation terminating automatic stay included the following:¹⁰⁵

- The automatic stay in relation to the property would be terminated immediately with respect to the bank's rights and remedies under its financing agreements;
- The bank would forbear from exercising its rights to foreclose provided the developer complied with the terms of the consent order;
- The developer was given nearly 15 months to market and sell the remaining finished properties, with a possibility of obtaining a 6-month extension.

At first glance, such arrangements may seem to have provided the developer a window of opportunity to work towards an orderly sale or reorganization. However, where the specified sales targets are overly

103. *Id.*

104. *Id.*

105. Motion for Approval of Stipulation and Consent Order at 4, *In re Md. Homes Palisades PA, LLC*, No. 08-18286 (Bankr. D. Md. June 23, 2008) (filed on Jan. 20, 2008).

ambitious given the housing crisis, the developer can easily fall into non-compliance, allowing the lender to proceed with foreclosure. This occurred in a number of cases.¹⁰⁶ Part of the consent order in the case of Maryland Homes Palisades PA carried darker overtones, complicated by the incentives of guarantors to be released from personal guarantees. In one of the provisions, the secured lender agreed that the principal could pay a fixed sum of \$325,000 in full and final satisfaction of his personal guarantee of the company's debt, regardless of the status of the sales of homes.

A prior study suggested that the capital structure below the level of the senior secured debt may affect the outcome of cases where the debtor's owner-manager has personally guaranteed the firm's debt.¹⁰⁷ If the firm's assets at the outset of bankruptcy are sufficient to cover guaranteed debt to lenders, the owner-manager may favor early shut-down to avoid personal liability, at the expense of unsecured creditors. This is consistent with a line of literature criticizing Chapter 11's manager-controlled process, particularly the conflict of interest problem.¹⁰⁸

The analysis of the bankruptcy docket data in this study found that 39.7% of the consent orders contained some form of agreement by the secured lender to waive its deficiency claim and release insiders from their liabilities as guarantors.

In the case of Crosswinds at Lone Star Ranch 1000, Ltd., the secured lender agreed, *inter alia*, to drop a lawsuit filed in a state court

106. See, e.g., Motion for Approval of Settlement Agreement at 7, *In re Tucson Copper Hills Estates LLC*, No. 08-02557 (Bankr. D. Ariz. Mar. 13, 2008) (noting that if the debtor does not sell the property in question and make the payment, the lender may immediately foreclose). In this case, a settlement was reached between the secured lender and the debtor but the developer did not manage to sell the property by the deadline set in the stipulated relief and the case was dismissed with the lender proceeding to foreclosure. January 12, 2009 Minute Entry at 1, *In re Tucson Copper Hills Estates LLC*, No. 08-02557 (Bankr. D. Ariz. Mar. 13, 2008).

107. Morrison, *supra* note 34, at 28.

108. See generally A. Mechele Dickerson, *Privatizing Ethics in Corporate Reorganizations*, 93 MINN. L. REV. 875 (2009) (arguing that the fiduciary duties of managers during bankruptcy cases are ill-defined, and conflict of interest often occur, though this problem can extend to situations where a private trustee is appointed and controlled by one of the secured creditors). See also Barry E. Adler, *A Theory of Corporate Insolvency*, 72 N.Y.U. L. REV. 343, 362-63 (1997) (a critique of Chapter 11's manager-controlled model); Douglas G. Baird, *Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren*, 54 U. CHI. L. REV. 815, 822-24 (1987).

enforcing guarantee obligations against the principal in exchange for the termination of the automatic stay to proceed with foreclosure.¹⁰⁹ There are also cases which played out like the case of Maryland Homes Palisades PA, discussed above, where the consent order fixed the guarantors' obligations at a relatively low level.¹¹⁰ For example, in the case of Namwest LLC, part of the settlement involved the cancelation of all the outstanding debt owed by the guarantors (save for a \$37,500 note executed by the guarantors in favor of the lender) in exchange for the conveyance of real estate with a scheduled value of \$28 million, and additional ownership interests in undeveloped land.¹¹¹

It should be noted that the data may under-represent the frequency of such arrangements, which might take the form of unfiled side agreements.¹¹² While it falls to bankruptcy judges to take into account the interests of junior creditors when scrutinizing these deals, these findings also introduce nuances to the role of creditors as positive agents of corporate governance.

*D. BAPCPA Amendments of the
Single Asset Real Estate ("SARE") Proviso*

A question often asked in post-BAPCPA days is whether the 2005 legislative changes have made the bankruptcy regime even more biased towards creditors. The original intention of the BAPCPA was to make it

109. In exchange for lifting the automatic stay to permit PCR to foreclose and withdraw the plan, PCR would pay \$450,000 into the bankruptcy estate, dismiss the lawsuit enforcing guarantees and exchange mutual releases. The docket showed no objections filed by unsecured creditors, but the rushed timeframe should be taken into account as well—merely 10 days elapsed between the filing of the motion to court approval. *See* Debtor's Motion to Approve Settlement at 6, *In re* Crosswinds at Lone Star Ranch 1000, Inc., No. 08-40262 (Bankr. E.D. Tex. Feb. 4, 2008).

110. *See generally* Motion for Approval of Consent Order, *In re* Maryland Homes Palisades PA, LLC, No. 08-18286 (Bankr. D. Md. June 23, 2008).

111. *See* Emergency Motion to Approve Settlement at 6, *In re* Namwest, LLC, No. 08-13935 (Bankr. D. Ariz. Oct. 10, 2008).

112. *See generally* February 2, 2009 Emergency Motion to Stay Sale, *In re* Bysynergy LLC, No. 08-7680 (Bankr. D. Ariz. June 25, 2008). Under-the-table arrangements between the secured lender and the developer came to light after the parties fell out. According to the motion, a party, on behalf of the secured lender, allegedly told the principal that he would "lose personally everything" if he did not support their position and, in return, the latter would "receive some kind of an interest 'on the back end.'" *Id.*

more difficult for serial and abusive filings to stand. Significant changes include the introduction of a statutory presumption of bad faith for certain repeat filers and restrictions on the automatic stay for repeat filers within 12 months. The change with the most significant impact on developer bankruptcies, however, is the change to the SARE provision.

Under section 362(d)(3) of the Bankruptcy Code, a secured lender is entitled to relief from the automatic stay in a SARE case unless the debtor has:

- Filed a plan of reorganization that has a reasonable possibility of being confirmed within a reasonable time; or
- Commenced making monthly payments to the secured creditor in an amount equal to the non-default contract rate of interest accruing under the loan documents on the value of the creditor's interest in the real property collateral.

A debtor must perform one of these actions within 90 days of the petition date, or 30 days after the court determines that the debtor is subject to SARE provisions, whichever is later.

Before BAPCPA went into effect, the Bankruptcy Code defined a SARE case as one involving "real property constituting a single property or project . . . , which generates substantially all of the gross income of a debtor . . . and on which no substantial business is being conducted by a debtor other than the business of operating the real property and activities incidental thereto."¹¹³ Also, the debtor's aggregate, non-contingent, liquidated, secured debts must be less than \$4 million. Larger real estate projects did not fall within SARE ambit.

BAPCPA eliminated the \$4 million cap. With the distressed housing market, this has resulted in an increase in the number of developers who fell under SARE's provisions.

Prior to this BAPCPA amendment, Le Jardin, which owned a luxury real estate project consisting of 1,100 partially developed acres and aggregate assets and liabilities of approximately \$53 million at the end of 2006, would have fallen outside the scope of the SARE provisions.¹¹⁴ Similarly, Crosswinds at Lone Star Ranch 1000, a 944-acre development with a February 2007 appraisal value of \$162 million,

113. See 11 U.S.C. § 101(51B) (2002).

114. See generally October 16, 2008 Order, *In re Le Jardin LLC*, No. 08-77019 (Bankr. N.D. Ga. Aug. 9, 2008).

and secured claims over property of about \$61 million¹¹⁵ was also considered a SARE case.¹¹⁶ In light of the BAPCPA changes, these cases fell within the SARE's provisions for expedited creditor relief, which the secured lenders obtained.

It is unreasonable to expect cases involving such huge properties and dollar value amounts of real estate to have their time for plan filing limited to a very short time frame. With the compressed deadline, and a secured lender who indicated its skepticism of the developer's reorganization prospects through the filing of the lift-stay motion, it might be unrealistic to expect a bankrupt developer to fulfill section 362(d)(3)'s requirement that a debtor present a reorganization plan with a reasonable chance of being confirmed. A cursory review of the cases showed many debtors were also unable to satisfy the statute's alternative requirements and make monthly payments as well, given slow home sales in the distressed housing market. The monthly payments requirement presents a natural bias against developers with unfinished properties. Developers which are still in the process of construction are unlikely to be holding income-producing properties which generate revenue sufficient to make monthly payments. While income-producing properties are more likely to be the subject of reorganizations, the glut of foreclosed unfinished properties is more problematic from a socioeconomic perspective than the foreclosure of income-producing properties. The implementation of the new law tilts the field in favor of secured creditors.

It may be that the BAPCPA amendments introduced changes to bankruptcy law that legislators, homeowners, and homebuilders alike may come to regret. Many of the amendments were clearly aimed at preventing the costs and delays owing to abuses of the bankruptcy process. However, the provisions may have been shown to be over-inclusive in scope such that it prevents certain cases, which do deserve bankruptcy protection, from obtaining appropriate relief.

Having discussed the impact of secured lender actions on the bankruptcies of residential developers, the following Section analyzes how the downturn has also created pressure on banks, and argues that

115. Debtor's First Amended Disclosure Statement for Debtor's First Amended Plan at 10, 13, *In re Crosswinds at Lone Star Ranch 1000, Inc.*, No. 08-40262 (Bankr. E.D. Tex. Feb. 4, 2008).

116. *Id.* at 16.

banks were influenced by factors beyond the simple economics of the bankruptcy case itself.

V. REGULATORY PRESSURE, BANK REGULATION, AND THE PREFERENCE FOR LIQUIDATION

The foregoing Sections discuss secured lenders' preference for foreclosures and liquidations and the significant degree of control these lenders exercised over bankruptcy proceedings in the current legal regime. In this Section, instead of focusing on the position of the debtors, we shift the viewpoint to the position of the lenders, most of which are banks.¹¹⁷

Banks make up most of the secured lenders in the residential development industry, according to FDIC statistics. As of the end of 2007, the total dollar amount of construction and development loans in the U.S. provided by banks was more than \$559 billion.¹¹⁸ The composition of the data sample in this study is consistent with this observation: at least one bank is involved as a senior secured lender in 92.3% of the cases.¹¹⁹

Much of bankruptcy literature, in the discussion of the role and actions of banks, proceeds on the premise of banks as rational, profit-maximizing actors, with little reference to the actual regulatory environment in which banks function.¹²⁰ One of the assumptions underlying the rise of secured creditor control is that a secured creditor choosing to exert their dominant control in bankruptcy to force

117. The discussion in this Section is partly based on interviews with more than 50 banks and risk managers, as well as the author's own experience in consulting for banks in risk management practices.

118. See generally FDIC, Statistics on Depository Institutions, Net Loans and Leases: Construction and Land Development (Dec. 31, 2007), at <http://www2.fdic.gov/sdi/main.asp> (select "Retrieve Predefined Reports;" then under "Standard Report #1," select "Run Report;" then select "Net Loans and Leases" and change the "Report Date" in each column to "12/31/2007;" then select "Update Report").

119. A small proportion of the senior secured lenders comprised of hedge funds. The sample also shows that hedge funds and finance companies involved in construction lending tend to take second lien positions, presumably due to the higher rates of return offered by such tranches (without discounting for default risk).

120. See generally Charles Tabb, *Of Contractarians and Bankruptcy Reform: A Skeptical View*, 12 AM. BANKR. INST. L. REV. 259 (2004) (argued against the central assumption of contractualists that parties are rational, pointing to behavioral economic studies that show people acting in systematically irrational ways).

liquidation of a firm will do so only because it maximizes return on that investment and when that happens, the value of the assets will be maximized through sale and reinvestment by third parties. However, a nuanced understanding of the financial regulatory environment of banks can help explain how banks are motivated to pursue liquidations by factors extraneous to the bankruptcy case itself. This exposes potentially troubling implications for the theoretical underpinnings of our current bankruptcy regime. After all, it is questionable as to whether failed or failing banks should be in a position to hold the reins of bankruptcy proceedings.

This Section presents three main perspectives explaining how the preference for liquidation of many banks during the downturn may arise from factors extraneous to the bankruptcy case and the individual characteristics and asset value of the bankrupt borrower. These perspectives include cost of capital considerations, regulatory pressures to reduce concentrations in commercial real estate loans, and procyclicality issues.

A. Cost of Capital Considerations

The cost of capital, or any other risk-based allocation of cost, is an integral component of a bank's lending decisions. Capital can be thought of as the equity cushion regulators require a bank to maintain to absorb large *unexpected* losses.¹²¹ Such capital is above and beyond provisions for expected losses, formally known as the Allowance for Loan and Lease Losses, against which loan losses are charged off and replenished constantly by more provisions from net income. To prove to regulators that it is well-capitalized, a bank needs to show, among other

121. In risk management, there are two kinds of capital—economic and regulatory. Regulatory capital is an accounting-based measure of the capital regulators expect a bank to have and is used widely, and can be regarded as a minimum level. Economic capital is a measure of a bank's cushion of solvency calculated using economic models, and can be thought of as the capital required to reach a certain standard of solvency. Regulators are also very interested in economic capital levels. In calculating economic capital, a bank would measure probabilities of default, the loss on the loan if it does default, the size of its exposure at default, and an estimate of how likely its loans are to default at the same time, or how correlated its exposures are to one another. See generally FDIC, ECONOMIC CAPITAL AND THE ASSESSMENT OF CAPITAL ADEQUACY (2004), http://www.fdic.gov/regulations/examinations/supervisory/insights/siwin04/economic_capital.html.

things, how its capital allocation to each sector of its portfolio compares to that sector's potential for large losses.

Capital requirements are higher than simply the sum of average losses across all loans because of what finance academics call systematic risk. Lack of diversification on the part of the bank poses a layer of risk, invisible to the individual debtors, yet potentially having a large impact on how the bank will treat a distressed debtor. Essentially, regulators want banks to be well-diversified so as to not be in danger of collapsing due to losses in any one part of its portfolio, which can be driven by correlated, or systematic, events that manifest as higher-than-expected losses in that sub-portfolio. A well-diversified bank will see increasing losses in some parts of its portfolio generally offset by decreasing losses in another parts.¹²²

Undiversified portfolios, on the other hand, are more vulnerable to sudden shocks. To be considered well-capitalized, a bank has to maintain a level of capital at over 10% of risk-weighted assets for unexpected losses.¹²³ Regulators have assessed that if a bank is diversified in its exposures, the probability of capital exhaustion falls even further. The implication is that if a bank is not diversified, or excessively concentrated, the chance of capital-exhausting events grows unacceptably large. A bank must then either raise capital or reduce concentrations. Since raising capital is very expensive, and even more so in 2007 to 2008, any method of capital relief will be appealing, including the liquidation of assets.

If a bank has a large concentration in real estate, it needs to keep a disproportionately large amount of capital to cover sudden spikes in real-estate losses. For example, if real-estate loans represented 30% of a bank's loan book, and every other sector was relatively small in comparison, a bank would need to carry more than 3% capital against real estate loans. This is because each other sector's gains and losses can be generally expected to offset each other, but they are unlikely to offset in sum extreme losses on real estate loans if that sector went south, because it is so large. The 10% number is essentially an average across the whole book, so higher-than-average sub-portfolio risks (balanced by the lower-than-average ones) attract higher than 10%

122. See generally Harry M. Markowitz, *Foundations of Portfolio Theory*, 46 J. FIN. 469 (1991).

123. See 12 U.S.C. § 93(a) (2003). See also FED. RES. BANK OF KANSAS CITY, *BASICS FOR BANK DIRECTORS* 30 (5th ed. 2010), available at <http://www.kansascityfed.org/Publicat/BasicsforBankDirectors/BasicsforBankDirectors.pdf>.

capital. If a bank is especially concentrated, regulators might order it to carry more than 10% capital.

Exactly how disproportionate a share of capital the real estate book has to attract due to concentration risk is an exercise that consumes large resources at banks and depends very much on the result of financial analysis and portfolio modeling. In general, a bank's estimate of how correlated the defaults of its debtors are by category is a primary driver of rising capital. This is a particularly important issue during a downturn where there is often a clustering of real estate-related defaults.¹²⁴

The disproportionate (at least, disproportionate relative to the book value of debt, and not to risk) allocation of capital to real estate loans means that a disproportionate share of the cost of capital has to be allocated to real estate. This causes the bank's internal cost, per dollar amount of real estate loans, to go up. This increased internal cost has nothing to do with a change in the debtor's ability to cover his debts, or an "entrepreneur's mismanagement" of his company, and more to do with the bank's internal portfolio management efforts.

The cost of capital and provisions is thus part of the overall cost-benefit analysis that a bank performs when making business decisions, including making loans. For banks, it is no longer enough to speak of Return on Assets, because this ignores risk. Instead, they use Risk-Adjusted Return on Capital, which incorporates the cost of capital, concentration risk, and other kinds of portfolio-wide risk.¹²⁵ As an illustration of how cost of capital affects the decision-making process of banks, we have included in Appendix I an example provided by a regional bank showing a wide disparity in loan spreads depending on the capital ratio levels.

Next, in order to meet the shareholder-mandated return on risk-weighted assets and justify the risk-adjusted revenue relative to the risk-adjusted cost, banks must find a way to extract more value out of their debtors, particularly those that consume relatively more capital, which are, in this example, real estate loans. They can do this by either increasing fees and interest rates in the short term (and thereby increasing default risk in the midterm) or reducing what they perceive to be causes of default risk in the short term by imposing ever more

124. See, e.g., Adrian M. Cowan & Charles D. Cowan, *Default Correlation: An Empirical Investigation of a Subprime Lender*, 28 J. BANKING FIN. 753, 754-55 (2004).

125. See CHARLES SMITHSON, CREDIT PORTFOLIO MANAGEMENT 262-65 (2003).

covenants and conditions on their debtors. The fastest solution to reduce concentrations in a portfolio, of course, is to liquidate the debt entirely. The best solution would be to sell the debt.

However attractive the notion of selling the debt to another financial institution, this option may not be possible during a liquidity crunch. In a downturn, liquidity will be scarce and prices low. The next best option for the bank dealing with concentration risk in its portfolio would be to end the relationship with the debtor somehow. The withdrawal of financing can contribute to liquidity problems of residential developers and, in some cases, precipitate loan defaults, and thus facilitate foreclosure or liquidation in bankruptcy.¹²⁶ This would relieve the bank of its exposure to the debtor, even if it takes a short-term loss on its principal, because of the “invisible” cost of capital.

As the definition of capital is very close to the definition of equity, its cost would be close to the cost of equity for a bank. Being able to cheaply raise extra capital in a downturn, when the cost of equity will be very high, is very desirable. If a bank were to relieve itself of a chunk of its capital requirement by getting rid of real estate loans, it would be another chunk of capital it would not have to pay through the nose for in the capital markets. The cost-of-capital explanation helps shed light on why banks may choose liquidation over reorganization. It is a flawed assumption that a bank makes its decision to support liquidation purely because the economic value of the bankrupt debtor is higher in liquidation than in reorganization, essentially confusing the difference between the market price of the assets and its economic utility to a specific party.

A bank, when liquidating a bankrupt firm, will not only receive the market price of the liquidated asset but also save the cost of raising capital equivalent to that asset’s price. Under normal conditions, this price is usually negligible as the credit risk of banks as counterparties themselves is negligible. In a credit crunch, however, this price becomes extraordinarily high.¹²⁷

The savings on this “capital injection” through liquidating debtors’ assets instead of borrowing money may be higher than the discounted present value of the marginal increase in the value of the debtor in

126. Disclosure Statement at 5-6, *In re Denmark Constr. Inc.*, No. 08-02764 (Bankr. E.D.N.C. Apr. 24, 2008).

127. Erik Holm, *For Buffett, Goldman Deal Looks like a Pot of Gold*, WASH. POST, July 26, 2009, at G4.

reorganization over liquidation. Yet, this capital cost is entirely dependent on the health of the bank. A very healthy and well-capitalized bank with a low cost of capital would have less pressure to liquidate its distressed debtors in search of liquidity. Another way of looking at it is that banks are analyzing the return on assets for these transactions, conditional on their own survival. This issue is essentially encapsulated in the following quote from a paper on bank real estate lending and the New England capital crunch in the 1980s.¹²⁸

Banks below minimum capital standards had only two options: increase equity with retained earnings or new capital, or shrink their assets. New England banks with large loan losses had little possibility of quickly restoring capital with retained earnings and did not raise additional equity . . . they can shrink their loan portfolios by tightening credit standards and, in some cases, calling or refusing to roll over loans. Because poorly capitalized banks feel more pressure to shrink their asset portfolios, their customers may find their loan conditions or loan availability altered, primarily because of the financial condition of their banks.

B. Regulatory Pressure to Reduce Concentration Risk

Pressure to exit the real estate lending market comes not only from a bank's own perceived need to raise capital but also regulatory action from outside the bank, which depends on the regulator's perception of the bank's capital adequacy. Regulatory pressure, however, is a larger issue and begins even before capital reaches inadequate levels. There is evidence, from the official correspondence and Congressional testimony as well as findings from our interviews, that right before and during the current downturn, regulators encouraged banks to reduce their exposure to real estate-linked loans, especially construction loans.¹²⁹ From our empirical observations, this pressure exceeded what one would expect

128. To illustrate, Goldman Sachs, in September 2008, right after the collapse of Lehman Brothers, sold \$5 billion of preferred stock to Warren Buffett yielding a 10% dividend per year, a rate more typically found in junk securities during the boom. See, e.g., Joe Peek & Eric S. Rosengren, *Bank Real Estate Lending and the New England Capital Crunch*, J. AM. REAL EST. & URBAN ECON. ASS'N 33 (1994).

129. The author of this article, at the 2008 Risk Management Association Annual Conference in Baltimore, where regulators were present, observed that many sessions were peppered with comments from regulators and bankers regarding concentration risk in relation to commercial real estate lending, including construction lending.

from normal supervision and created a high amount of pressure on banks to exit exposures to the residential development market, in any way possible.

This creates a high likelihood that banks, to avoid receiving regulatory sanctions, responded to the pressure by reducing commercial real estate concentrations through such solutions as liquidating debtors (i.e., getting them off the bank's books), instead of reorganizing debtors (i.e., keeping them on the books). Whether or not the end-result was counter-productive to the regulators' objectives is beyond this Article's scope, but the fact remains that banking industry regulatory action is a factor that cannot be ignored in the analytical framework of bankruptcy scholars.

Congressional comment about regulatory interference is a reliable indication that regulators are being active. Before the official start of the recession, Congressman Spencer Bachus, addressing the House Subcommittee on Financial Institutions and Consumer Credit on regulatory guidance on commercial real estate,¹³⁰ remarked that the way the committee sought to address high and increasing concentrations of commercial real estate loans at some banks was "too much of a 'one size fits all' formulation and effectively a cap on commercial real estate lending."¹³¹

In a recent Capitol Hill testimony hearing, Michael Menzies, the Chairman of the Independent Community Bankers of America, testified

130. See FDIC, Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices, 71 Fed. Reg. 74,580 (Dec. 12, 2006). This was subsequently updated in 2008. FDIC, Managing Commercial Real Estate Concentrations in a Challenging Environment, FDIC Financial Institution Letter FIL-22-2008 (Mar. 17, 2008), <http://www.fdic.gov/news/news/financial/2008/fil08022.pdf>. Note the supervisory limits on the Loan-To-Value ratios in construction lending in these FDIC Financial Institution Letters. An institution may "lend up to 65 percent of the value for raw land, 75 percent for land development or finished lots, 80 percent for multifamily residential construction, and 85 percent for 1- to 4-family residential construction . . . the institution should ensure that the borrower maintains appropriate levels of hard equity throughout the term of the loan." FDIC, Frequently Asked Questions on Residential Tract Development Lending 3 (Sept. 8, 2005), available at <http://www.fdic.gov/news/news/financial/2005/fil9005a.pdf>.

131. *A Review of Regulatory Proposals on Basel Capital and Commercial Real Estate: Hearings Before the H. Subcomm. on Financial Institutions and Consumer Credit of the H. Comm. on Financial Services*, 108th Cong. 7 (2006) (opening statement of Rep. Spencer Bachus (R-AL), Chairperson, H. Subcomm. on Financial Institutions and Consumer Credit).

in Congress that “field examiners are overzealous and unduly overreaching and are, in some cases, second guessing bankers and professional independent appraisers and demanding overly aggressive write-downs and reclassifications of viable commercial real estate loans and other assets.”¹³²

He also cited reports from various community bankers about examiners requiring write-downs or classification of performing loans based on the value of collateral irrespective of the income or cash flow of the borrowers, placing loans on non-accrual even though the borrower was current on payments, and downgrading of solid loans simply because they are located in a state with a high mortgage foreclosure rate.¹³³ He ended his speech with a plea that “examiners should take a longer-term view of real estate held by banks as collateral and should not demand aggressive write-downs and reclassifications of loans based on forced sales of real estate that occur during illiquid or dysfunctional markets.”¹³⁴

When Sheila Bair, the Chair of FDIC, says that she wanted to “send a message that regulators were concerned about growing CRE concentrations” and that banks should “manage concentrations according to an acceptable level of risk tolerance,” banks listen.¹³⁵ After all, FDIC has the authority to close banks that it deems to be risky and under-capitalized and did so regularly throughout 2008 and 2009.¹³⁶ In line with this regulatory focus on reducing concentration risk, the Office of Comptroller of Currency, which supervises a separate segment of commercial banks, reported in a survey of credit underwriting standards that 49% of its bank respondents reported tightening standards in commercial construction loan portfolios in 2008, as compared to 13% in 2007.¹³⁷

132. *Exploring the Balance between Increased Credit Availability and Prudent Lending Standards: Hearings Before the H. Comm. on Financial Services*, 111st Cong. 49-51 (2009) (testimony of Michael Menzies, Chairperson, Independent Community Bankers of America).

133. *Id.*

134. *Id.*

135. Sheila C. Bair, FDIC Chairman, Remarks to the Independent Community Bankers Association, Orlando, Florida (Mar. 5, 2008) (transcript available at <http://www.fdic.gov/news/news/speeches/archives/2008/chairman/spmar0508.html>).

136. FDIC, Failed Bank List, <http://www.fdic.gov/bank/individual/failed/banklist.html> (last visited Mar. 29, 2010).

137. OFFICE OF THE COMPTROLLER OF THE CURRENCY, SURVEY OF CREDIT

Subsequently, in August 2008, Senator Ron Wyden wrote a letter to Sheila Bair, citing that “the recent FDIC directive to member institutions to reassess the valuations of collateral underlying outstanding commercial homebuilding debt may actually be forcing financially stable borrowers into default.”¹³⁸ He decried the practice, which he claimed to be driven by regulatory pressure, where borrowers, whose newly-assessed construction loans failed to meet certain loan-to-valuation ratios (“LTV”), were forced to pay the financial institutions an amount necessary to bring the loans into compliance with the original LTV ratios.¹³⁹ Many borrowers are unable to meet these new financial requirements owing to the severe recession and may be forced into insolvency.

Approximately 1,020 comment letters were sent in response to the regulatory guidance on “Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices,” of which the majority were protests by community banks that the prescribed capital limitations would lead to a significant reduction in commercial real estate lending, especially construction lending.¹⁴⁰ The guidance remained, however, and the evidence thus far suggests that banks may choose to exit the construction loan market under regulatory pressure, and one of the swiftest ways includes liquidating bankrupt companies (regardless of firm viability) so as to present a “cleaner”-looking balance sheet. This upsets a major line of reasoning underlying giving banks dominant control over the bankruptcy process, since the economics and concerns underlying their decisions in a bankruptcy are not purely predicated on the merits of the case.

UNDERWRITING PRACTICES 2008 4 (2008), available at <http://www.occ.treas.gov/cusurvey/2008UnderwritingSurvey.pdf>. See also FED. RES. BD., THE JULY 2008 SENIOR LOAN OFFICER OPINION SURVEY ON BANK LENDING PRACTICES 3 (2008), available at <http://www.federalreserve.gov/boarddocs/snloansurvey/200808/fullreport.pdf> (citing similar findings).

138. See Letter from Ron Wyden, U.S. Senator, to Sheila Bair, FDIC Chairman (Aug. 27, 2008) (on file with Fordham Journal of Corporate and Financial Law) (addressing the potential consequences certain FDIC policies were poised to inflict upon Oregon’s home building industry and small financial institutions and requesting consideration of alternative approaches that may lessen these impacts).

139. *Id.*

140. FDIC, FDIC Federal Register Citations, <http://www.fdic.gov/regulations/laws/federal/2006/06comcrelending.html> (last visited Mar. 29, 2010).

C. Procyclicality in Bank Behavior

Existing bankruptcy literature appears to neglect the different implications of bankruptcy policy, particularly on the issue of secured creditor control, in different parts of the economic cycle. This is a glaring omission, especially given how lenders' incentives and behavior tend to differ in a downturn and under stress as opposed to a more "normal" part of the economic cycle, when they are closer to the hypothetical rational long-term profit maximizing entity found in bankruptcy literature.

In general, banks are highly procyclical.¹⁴¹ During good times, banks incur more risks than they reasonably should through, for example, excessive lending with poor standards. In bad times, banks make drastic corrections and pull back their lending, which incidentally exacerbates the wider downturn when all the banks do so simultaneously.¹⁴² Quite independently of the merits of the bankruptcy case, and somewhat independently of whether a bank is highly distressed and in need of capital or under regulatory pressure as well, banks will in general tighten lending standards during a recession and loosen lending standards in an expansion. The following two charts illustrate this phenomenon.¹⁴³

Figure 12

**Changes in Underwriting Standards in
Commercial Construction Loan Portfolios (Percent of Responses)**

	Eased	Unchanged	Tightened
2003	2	61	37
2004	10	75	15
2005	29	63	8
2006	32	56	12

141. Miguel Fernández Ordóñez, Governor, Bank of Spain, Speech at the Conference on Procyclicality and the Role of Financial Regulation: Procyclicality in the Banking Activity (May 4, 2009).

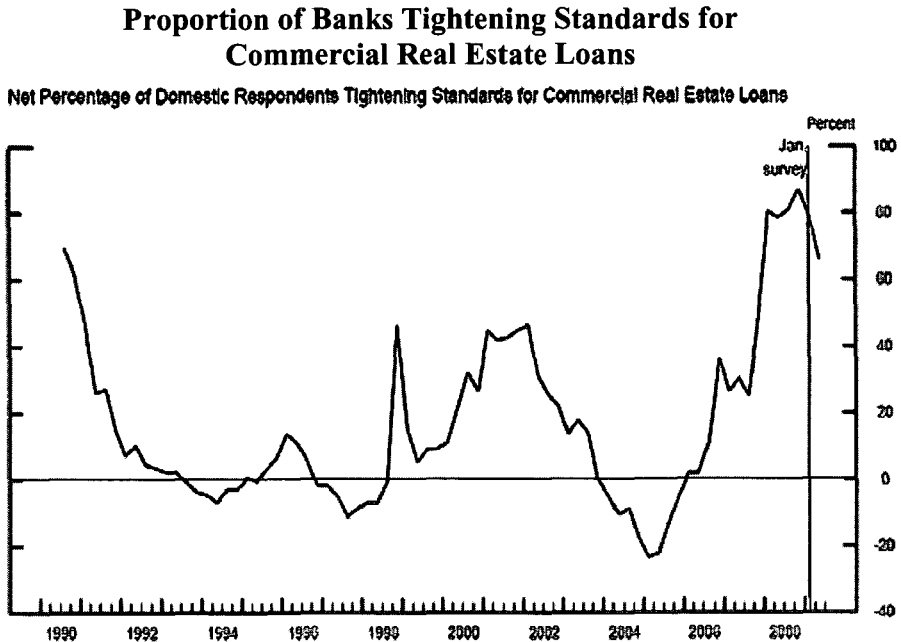
142. *Id.*

143. See generally Michael B. Gordy & Bradley Howells, *Procyclicality in Basel II: Can We Treat the Disease without Killing the Patient?* (May 12, 2004) (unpublished manuscript), available at http://www.bis.org/bcbs/events/rtf04gordy_howells.pdf.

2007	28	59	13
2008	8	43	49

Source: 2008 Survey of Credit Underwriting Practices by the Office of the Comptroller of Currency.

Figure 13



Source: Federal Reserve, April 2009 Senior Loan Officer Opinion Survey on Bank Lending Practices

A 2003 study focusing on a behavioral view of lending practices found evidence for a “memory hypothesis” under which the ability to differentiate accurately between high-risk and low-risk debtors deteriorate over time as loan officers forget the lessons of the last recession with large credit losses. When the bank again experiences large losses, standards tighten drastically, and the cycle begins again.¹⁴⁴ The implication is that banks have an implicit “risk premium” that varies through the cycle. Their price of risk (or for risk) determines whether they think long term or short term (through differential discount rates for

144. Allen N. Berger & Gregory F. Udell, *The Institutional Memory Hypothesis and the Procyclicality of Bank Lending Behavior* 15 (Bank of Int’l Settlement Working Paper No. 125, 2003), available at <http://www.bis.org/publ/work125.pdf>.

future cash flows), and this drives whether they choose to support liquidation or reorganization.

This is encouraged by banking regulation, which is generally procyclical in nature. It pressures banks to respond to increasing systemic risk by becoming far more conservative, on both expected losses as well as unexpected losses. Procyclicality has been one of the most controversial issues during the discussion of Basel II regulatory proposals.¹⁴⁵ Basel II, in its original conception, represents a more risk-sensitive capital framework whereby, as credit conditions change, minimum requirements change correspondingly.

Specifically, under the Basel II Advanced Internal Ratings-Based approach, capital requirements constitute an increasing function of the primary credit risk drivers (namely, probability of default, loss given default, and exposure at default). During the downturn, these risk drivers deteriorate, leading to greater capital requirements. The converse is true during upswings; banks keep less capital during good times. It has been argued in finance literature that another material source of financial procyclicality is the inappropriate responses by financial market participants to changes in risk over time.¹⁴⁶

For example, Zions Bank stated in a 2006 letter to bank regulators stating that Basel II capital requirements “will be updated continuously as new default, exposure, and loss given default data are incorporated into the quantitative analysis. In times of low losses, the capital required by Basel II banks will drift lower [I]n good times large banks will operate at an increasing competitive advantage in various types of lending compared to community and regional banks, and will squeeze them out of the market or into lower quality credits.”¹⁴⁷

A key item on the Basel II agenda among regulators now is how to

145. See, e.g., Claudio Borio et al., *Procyclicality of the Financial System and Financial Stability: Issues and Policy Options 1* (Bank of Int'l Settlement Working Paper No. 1, 2001), available at <http://www.bis.org/publ/bppdf/bispap01a.pdf>; William R. White, *Procyclicality in the Financial System: Do We Need a New Macrofinancial Stabilisation Framework?* (Bank of Int'l Settlements Working Paper No. 193, 2006), available at <http://ssrn.com/abstract=891765>.

146. Claudio Borio et al., *supra* note 145, at 1.

147. Letter from Doyle L. Arnold, Chairman, Zions Bancorporation, to Jennifer J. Johnson, Secretary, Board of Governors; Robert E. Feldman, Executive Secretary, FDIC; Office of Comptroller of Currency; and Office of Thrift Supervision (Jan. 18, 2006) [hereinafter Arnold Letter], available at <http://www.fdic.gov/regulations/laws/federal/2005/05c37basel1a.pdf>.

regulate capital in a counter-cyclical way, and force banks not to underprice credit during times of economic expansion.¹⁴⁸ Unfortunately, the eventual result of under-pricing credit is the urge to overprice it afterwards when a chain of defaults starts to occur. This implies that the outcomes of bankruptcy cases can depend on the economic cycle.

As large numbers of distressed banks, seeking liquidity, foreclose on homeowners and force properties onto the market, increasing supply and depressing prices, the net result is actually that the marked-to-market value of many bank assets will fall correspondingly¹⁴⁹—a precursor to bank failure (which was limited by the 2009 changes to accounting rules to allow banks to not have to mark-to-market their assets). In a way, this posits a social dilemma, in which individuals acting independently in their own self-interests cause a problem that cannot be self-corrected by action of a market, because the damage is shared mainly among those which act later.

A possible solution, to be explored by further research, is government action that can incorporate the positive externality of slowing foreclosures and liquidations through legal reforms, although it is possible that privately, banks might come together to negotiate a cooperative solution, but this is not likely as they will suffer from free-rider problems and are also unwilling to reveal too much information on their individual situations to their competitors.

The above perspectives provide a more complete picture of banking behavior than contemporary bankruptcy literature, which often assumes that the returns and costs of the secured lender come primarily from the terms of a credit transaction and that changes in those terms primarily stem from changes in the debtor profile and financial position.

148. *Regulators and the Cycle*, ECONOMIST, May 15, 2008, available at http://www.economist.com/displayStory.cfm?story_id=11325492. The article also has some observations on the relationship between regulators and banks: “‘What you have to do every so often,’ says a former regulator, ‘is pick a performance measure of some kind, line the banks up and shoot the dog. The rest will quickly cower at the other end of the row.’” *Id.*

149. Note that FDIC data shows that, as of December 31, 2008, commercial banks have an average of 44% concentration in real estate loans. See generally FDIC, FDIC Quarterly Banking Profile (Dec. 31, 2008), available at <http://www2.fdic.gov/qbp/2008dec/qbp.pdf>.

D. Financially-Distressed Banks in the Data Sample

The threads discussed so far in this Section come together in the analysis of the banks that are secured lenders to the residential developers analyzed for this Article. If the secured lenders in this data sample are in financial distress then they would suffer acutely from a high cost of capital. They would also be under severe regulatory scrutiny and pressure to reduce their risk concentrations in real estate, and as a result, they would pull back their financial support for the developers, whether ordered to do so by the regulator or not. All of this would translate into the liquidation preference observed in this Article.

This Article analyzed the actual proportion of banks in the data sample which were in financial distress while they participated in the bankruptcy proceedings of their debtors. In measuring financial distress of a bank in this Article, the following metrics were used:

- Has the bank failed and been seized by FDIC or another regulator?
- Has the bank failed, even though FDIC has not been appointed its receiver? Examples include Wachovia (FDIC-arranged rescue) and Lehman Brothers (Chapter 11 bankruptcy).
- Has the bank received at least one cease-and-desist order from a banking regulator for operating with an inadequate level of capital for its risk profile?¹⁵⁰
- Has the bank been under-capitalized according to Prompt Corrective Action (“PCA”) directives?

Under the PCA directives, a bank is under-capitalized when its total risk-based capital ratio is less than 8%, its Tier 1 risk-based capital ratio is less than 4%, or its Tier 1 leverage ratio is less than 4%. A bank is significantly under-capitalized when its total risk-based capital ratio is less than 6%, its Tier 1 risk-based capital ratio is less than 3%, or its Tier

150. Note that empirical studies on bank capital and commercial real estate lending have found that, although poorly capitalized banks shrank their assets more than better capitalized institutions, the reduction was more dramatic if regulators imposed formal actions. See generally Joe Peek & Eric S. Rosengren, *Bank Regulatory Agreements in New England*, 15 FED. RES. BANK BOSTON NEW ENG. ECON. REV. 24 (1995); Joe Peek et al., *The Impact of Greater Bank Disclosure Amidst a Banking Crisis* (Fed. Res. Bank of Boston Working Paper Series no. 99-1, 1999), available at <http://ideas.repec.org/s/fip/fedbw.html>.

1 leverage ratio is less than 3%.¹⁵¹

Based on these metrics, 45.4% of the banks in the sample fell within these categories of financial distress between November 2007 and December 2008.¹⁵²

Figure 14

Proportion of Financially-Distressed Banks in the Data Sample

Financial Distress	No.	%
Failed Banks	58	26.1%
Banks with Cease-and-Desist Orders	31	14.0%
Under-Capitalized Banks	7	3.2%
Significantly Under-Capitalized Banks	5	2.3%

It is problematic that almost half of the banks participating and exercising secured creditor control in developer bankruptcies were in financial distress themselves. More disturbingly, these results may have under-estimated the proportion of financially-distressed banks. The FDIC maintains a “Problem Bank” list which comprised 252 banks by the fourth quarter of 2008.¹⁵³ In addition, these results may not have captured financially-distressed banks which have been raising capital, including those participating in the U.S. Treasury Department’s Troubled Asset Relief Program.¹⁵⁴ As such, a failure to analyze the environment in which banks function is a glaring omission.

Investigating this point further, this Article undertakes a quick analysis of the effect of a bank’s financial distress on the probability of the filing of a lift-stay motion pursuant to foreclosure using a probit

151. See 12 U.S.C. § 93(a) (2003).

152. Note that, in categorizing the banks into categories of financial distress, a bank which failed or received a cease-and-desist order, though under-capitalized as well, is only counted once in the former categories.

153. David Ellis, *Problem Banks List Top 300*, CNN MONEY NEWS, May 27, 2009, http://money.cnn.com/2009/05/27/news/companies/fdic_profile/index.htm?postversion=2009052711. Note that regulators never disclose the names on the list out of fear that depositors at those institutions may prompt a “run on the bank.” *Id.*

154. FDIC, Quarterly Banking Profile 3 (Mar. 2009), available at <http://www2.fdic.gov/qbp/2009mar/qbp.pdf> (stating that most of the aggregate increase in capital came from participation in TARP).

regression model.¹⁵⁵ The dependent variable equals one when a lift-stay motion was filed by a bank in the bankruptcy case and equals zero when no lift-stay motions were filed in the case. Appendix II presents the variants of the model specifications and results.

Column (1) displays a simple model in which the filing of a lift-stay motion is a function of the “Bank Distress” variable (a dummy variable equal to one where a bank is financially distressed, as defined above, and zero for others) and the size of the developer, as measured by the total assets. Column (2) controls for price levels in the housing market through the use of Housing Price Index released by the Office of Federal Housing Enterprise Oversight in the month that the developer filed the bankruptcy petition. Columns (3) and (4) expand this model to include variables reflecting the capital structure of the developer—the leverage ratio and the ratio of secured debt to total liabilities. Column (5) introduces dummy variables based on the geographic region—Pacific, Mountain, Midwest, Northeast, Southeast, South and Mid-Atlantic (the base category). Finally, Column (6) presents the “kitchen sink” model where all variables are tested in the regression.

Regardless of the specification, the primary result is the same: the “Bank Distress” variable is statistically significant at the 1% confidence level. Calculating the marginal effects, we find that this varies between 24.9% and 28.6%, i.e., there is a percentage change of 24.9% to 28.6% in the probability of a lift-stay motion being filed by a bank associated with a discrete change in that variable. This effect is economically large and statistically significant, even after controlling for firm size, capital structure, housing market prices, and region.

This provides strong support for the hypothesis that the financial distress of banks is correlated with their liquidation preference in debtors’ bankruptcy proceedings. These findings ought to trouble those who argue in favor of stronger secured creditor control. It demonstrates that during times of stress secured lenders may just be as desperate as their debtors and driven to understate the long-term economic value of the bankrupt estate to raise cash quickly. In such a scenario, they ought not to be given the driver’s seat in bankruptcy.

Two examples illustrate the possible negative impact of secured

155. In undertaking the multivariate regression, only the cases where there is at least one bank involved are used; the result is 190 observations are used in each specification (after excluding cases with missing independent variables).

lender control over distressed residential development properties where the lender is itself in financial distress. The first example involves the SunCal companies, where the bankruptcy trustee, upon undertaking due diligence of the real estate, condemned the role of Lehman Brothers affiliates in their role as secured lenders:¹⁵⁶

Lehman's funding practices, dictatorial control over the Projects' operations, and breach of its funding obligations created a common layer of unpaid unsecured debt that now burdens all of the Debtors' estates in the estimated amount of \$100 million. Furthermore, human lives and property are being put at risk from situations as diverse as: (a) potential levee failures, (b) airborne friable asbestos, (c) failure to provide dust and erosion control measures, (d) possible brush fires in densely populated areas during peak periods of the California fire season due to the failure to fund brush control, and (e) failure to provide adequate storm water control. In addition, the condition and value of the assets are wasting; fines have been assessed or threatened to be assessed due to the Projects' violation of governmental permits; entitlements are at risk; availability of resources such as water are at risk; governmental bonds are being called; and taxes and insurance are going unpaid.¹⁵⁷

The second example relates to the demolition of mostly-finished single-family homes and completed model homes in Victorville, California, after foreclosure. Guaranty Bank, the secured lender, subsequently failed in August 2009. City officials stated that Guaranty Bank had told them it would cost \$100,000 to tear these down, but a lot more to finish the project, on top of which there would be escalating city fines should vandals and squatters take over the homes.¹⁵⁸ While one may argue that these represent extreme examples, they highlight the importance of placing boundaries and restraints on secured lender control in certain circumstances to avoid situations which essentially result in a destruction of value.

156. *In re Palmdale Hills Prop., LLC*, No. 08-17206 (Bankr. C.D. Cal. Nov. 6, 2008) (lead case).

157. There are other news reports about local authorities, across the country, facing a rise in complaints about environmental and safety hazards from construction sites where work has been frozen. See, e.g., Jim Carlton, *Deserted Building Sites Add to Property Bust's Toll*, WALL ST. J., May 7, 2009, at A4.

158. Michael Corkery, *No Sale: Bank Wrecks New Houses*, WALL ST. J., May 5, 2009, at A3. Note the fact that squatters could have been living in the homes in this case suggest that some of these homes were probably close to completion.

VI. CONCLUSION

We are in the midst of a major foreclosure crisis, extending beyond residential mortgage defaults to the bankruptcies of residential developers. The foreclosures or fire sales of new homes and unfinished residential developments not only have a domino effect on housing prices, but also affect home owners in a myriad other ways.

This Article takes the first few steps to bridging the chasm between an understanding of the regulatory context in which banks function and the bankruptcy regime by analyzing the banks' regulatory environment and their sensitivity to the economic cycle and the cost of capital. Banks can be viewed as highly-constrained profit-maximizing entities, and their actions can be significantly driven by factors apart from the individual risk profiles of debtors. Furthermore, when banks are struggling for their own survival, issues involving liquidity, capital and regulatory pressure may contribute to them preferring liquidation over reorganization.

These issues are especially relevant in today's environment, where the government provides financial support to banks through the Troubled Asset Relief Program. It is sometimes argued that a capital infusion into either banks or their debtor firms should make both sectors better off. However, a cash infusion can increase the bargaining power of the sector receiving aid with regards to the other. Douglas Diamond and Raghuram Rajan have argued that an infusion into banks large enough to prevent bank runs, but not large enough to extend the risk-taking horizon, may simply lead to debtors coming under more pressure than before by their banks.¹⁵⁹ This is because banks are usually recapitalized only up to the point where they still have to struggle with profitability, whereas if distressed banks were closed and their loans sold to healthy institutions, these new creditors are more able to take a long-term view of the case. Diamond and Rajan, in conjunction with this Article's conclusion, make a powerful argument for greater oversight of how banks taking government money treat their financially distressed debtors.

159. Douglas W. Diamond & Raghuram G. Rajan, *A Theory of Bank Capital*, 55 J. FIN. 2431, 2456-57 (2000).

Finally, let us hope that the current economic crisis comes to an end soon, but not without bringing about changes which can help mitigate the severity and duration of future next crises are implemented.

APPENDIX I

Example: How Cost of Capital Affects Bank Lending

This example is derived from a 2007 letter from Zions Bank to banking regulators:¹⁶⁰

As a simple illustration of the powerful market effects of the Basel proposals, we provide a simple loan pricing example. Suppose that five banks, all with 5% or higher total bank leverage ratios, allocate five different capital ratio levels to a conventional commercial loan For all banks, we assume that the required return on capital is 12%, the marginal tax rate is 40%, and the average expense rate for originating and servicing loans is 1.0%. We have adopted these simple assumptions to spotlight the effects of differing capital allocations on required loan spreads. There is a wide disparity in loan spreads over cost of funds required to provide a 12% return on capital from a low of 1.50% to a high of 2.60%. Such differences would logically provide significant competitive advantages for the banks at the low end of the capital range.

Loan Pricing Example:	
Cost of Capital:	12%
Tax rate:	40%
Expense rate:	1.00%

Capital ratio:	Required Breakeven Spread ¹ :
2.5%	1.50%
4.0%	1.80%
5.0%	2.00%
6.0%	2.20%
8.0%	2.60%

¹Pricing Spread which covers Cost of Capital

160. Arnold Letter, *supra* note 147.

APPENDIX II

Probit Regression Model: Effect of Bank Distress on
Probability of Lift-Stay Motion Filing

	(1)	(2)	(3)	(4)	(5)	(6)
Constant	0.4886 (0.0001)***	8.1513 (0.0322)**	8.1478 (0.0323)**	7.7928 (0.0424)**	7.3472 (0.066)*	6.791 (0.093)*
Bank Distress	0.8012 (0.0007)***	0.8708 (0.0003)***	0.872 (0.0003)***	0.8566 (0.0004)***	0.7789 (0.002)***	0.7507 (0.0032)***
Total Assets (millions)	-0.00699 (0.0311)**	-0.00619 (0.0567)*	-0.00617 (0.0594)*	-0.0123 (0.083)*	-0.00635 (0.063)*	-0.0159 (0.0317)**
Housing Price Index		-0.0369 (0.0438)**	-0.0368 (0.0442)**	-0.0352 (0.0561)*	-0.0344 (0.0739)*	-0.0321 (0.0995)*
Leverage Ratio			-0.00462 (0.9353)			0.0279 (0.6815)
Secured Debt/Total Liabilities				9.72E-09 (0.3338)		1.48E-08 (0.2285)
Region = Pacific					0.0644 (0.8763)	0.0942 (0.8212)
Region = Mountain					0.3798 (0.2754)	0.3452 (0.3314)
Region = Midwest					0.2218 (0.6317)	0.2233 (0.6296)
Region = South					1.1068 (0.0128)***	1.1577 (0.0101)***
Region = Northeast					0.1762 (0.7717)	0.2109 (0.729)
Region = Southeast					0.2563 (0.4249)	0.2987 (0.357)