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STRATEGY AND FORCE IN THE LIQUIDATION OF SECURED DEBT

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The question of why parties use secured debt is one of the most fundamental questions in commercial finance. The commonplace answer focuses on force: A grant of collateral to a lender enhances the lender's ability to collect its debt by enhancing the lender's ability to take possession of the collateral by force and sell it to satisfy the debt. That perspective draws considerable support from the design of the major legal institutions that support secured debt: Article 9 of the Uniform Commercial Code and the less uniform state laws regarding real estate mortgages.

Both of those institutions are designed solely to support the liquidation process. Each has four major elements: statutory rules describing the actions a borrower and lender must take to create a lien or security interest in a particular asset, statutory and contractual rules describing the occurrences that entitle the lender to take possession of the collateral, statutory and contractual regulations of the mechanics by which the lender can sell the collateral, and statutory rules allocating priority among various claimants to the asset or its proceeds.[1] All of those rules reflect an implicit assumption that the central focus of the transaction is the ability of the lender to liquidate the collateral. Legal and contractual institutions foster that ability both by enhancing the practicability of reliable and cost-effective liquidation and by tempering the potential for inequities in the process of liquidation.

The most general problem with that arrangement is that forced liquidation has little to do with the system as it actually operates. In practice, the important element is not force, but strategy. The most important effects arise from the capacity of a grant of collateral to influence the actions the parties take short of forced liquidation of collateral. Although that perspective is contrarian, it is not entirely novel. Bob Scott suggested the limited importance of forced liquidation in a passing comment more than a decade ago.[2] More

1. *See infra* notes 301-05 and accompanying text (summarizing those rules).

2. *See* Robert E. Scott, *A Relational Theory of Secured Financing,* 86 COLUM. L. REV. 901, 950 (1986) [hereinafter Scott, *Relational Theory*]. Scott notes:

> [T]he function of secured credit is conceived within the industry as enabling the creditor to influence debtor actions prior to the onset of business failure. This conception is markedly different in effect from the traditional vision of collateral as a residual asset claim upon default and insolvency. Security is taken for its active rather than its passive properties.

Id. Scott develops a similar point in greater detail in Robert E. Scott, *Rethinking the Regulation of Coercive Creditor Remedies,* 89 COLUM. L. REV. 730 (1989) [hereinafter Scott, *Coercive Creditor Remedies*] (arguing that the principal effect of creditor remedies is to give the creditors leverage rather than to enhance the ability to obtain payment coercively). My point here is quite similar, but focuses on the particular way in which remedies work when the creditor has collateral.

recently, my anecdotal research has presented a general explanation of the reasons for the use of secured credit in which there is little place for forced liquidation.[3] Rather, I have argued that the most important justifications for the use of collateral are its indirect effects: enhancing the credibility of limits on future borrowing and repairing the loan-induced incentives of the borrower toward excessive risk.[4]

But neither Bob Scott nor I has done anything to explore the perception that liquidation is relatively unimportant in the practice of secured debt. Liquidation certainly occurs: a trip to the steps of any county courthouse in Texas on the first Tuesday of any month will prove that.[5] But we know little or nothing about just how frequently it does occur. More fundamentally, if it is relatively infrequent — as I have argued in my prior work — why? Given the existence of valuable collateral, why would any competent lender faced with a borrower that is unwilling or unable to pay refrain from taking the collateral and selling it?

Those questions raise a related point that is just as central to the academic discourse on debtor-creditor relations: if liquidation is a marginal element of the practice of secured credit, just how important is bankruptcy to the system for disposing of failed businesses? The recent academic literature on debtor-creditor issues has expended considerable effort to analyze the ex ante effects of bankruptcy on the credit market. In that literature, the basic question is how various rules for the treatment of businesses in bankruptcy affect two aspects of the world before bankruptcy. First, at the time the loan is issued the decisions of borrowers and lenders might be affected by the possibility that a later bankruptcy

3. *See* Ronald J. Mann, *Explaining the Pattern of Secured Credit,* 110 HARV. L. REV. 625, 639-40 (1997) [hereinafter Mann, *Pattern of Secured Credit*] (suggesting that the tendency of collateral to enhance forced liquidation is less important than its indirect effects); Ronald J. Mann, *The Role of Secured Credit in Small-Business Lending,* 86 GEO. L.J. (forthcoming Nov. 1997) [hereinafter Mann, *Small-Business Secured Credit*] (arguing that the ability of lenders to liquidate collateral is generally not relevant to small-business secured debt).

4. *See* Mann, *Pattern of Secured Credit, supra* note 3, at 639-58; Mann, *Small-Business Secured Credit, supra* note 3.

5. As I have discovered firsthand in efforts to conduct some direct empirical research about real estate foreclosures, it is not easy to observe the frequency of foreclosure in most states, because foreclosures generally are scheduled on a case-by-case basis — either by a public official, in the case of a judicial sale, or by the lender's attorney, in the case of a nonjudicial sale. *See, e.g.,* CAL. CIV. CODE § 2924f (West 1993) (providing for a notice designating the time and date of a foreclosure sale); MASS. GEN. LAWS ch. 244, § 14 (1994) (same). Texas's situation is different because real estate foreclosures in Texas must be conducted during normal business hours on the first Tuesday of the month. *See* TEX. PROP. CODE ANN. § 51.002(a) (West 1995) (requiring foreclosures sales to occur "between 10 a.m. and 4 p.m. of the first Tuesday of a month").

would alter the borrower's obligation to repay the loan.[6] Second, during a period of distress the decisions of borrowers and their lenders might be affected by the way the loan would be treated in a potential bankruptcy proceeding.[7] But those questions have less direct significance if the ordinary process for the liquidation of distressed loans proceeds without recourse to bankruptcy.

Surprisingly, no substantial empirical research has investigated those questions. A number of widely recognized studies by legal academics have investigated the last part of the credit process — what happens when firms enter bankruptcy.[8] Similarly, a number of finance scholars have studied the characteristics of loans that go into default.[9] But there has been no general study of the crucial period in the middle, when loans have fallen into distress but the business has not yet failed completely.[10]

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6. The classic treatment appears in William H. Meckling, *Financial Markets, Default, and Bankruptcy: The Role of the State,* LAW & CONTEMP. PROBS., Autumn 1977, at 13, 19-24. For a recent treatment, see Ronald J. Mann, *Bankruptcy and the Entitlements of the Government: Whose Money Is It Anyway?,* 70 N.Y.U. L. REV. 993, 1057 n.231 (1995).

7. The most exhaustive treatment is Robert K. Rasmussen, *The Ex Ante Effects of Bankruptcy Reform on Investment Incentives,* 72 WASH. U. L.Q. 1159, 1176-206 (1994). *See also* Mann, *supra* note 6, at 1046 n.188 (offering a more recent discussion of that topic).

8. The most prominent studies to date are a study of small-firm reorganizations by Lynn LoPucki, *see* Lynn M. LoPucki, *The Debtor in Full Control — Systems Failure Under Chapter 11 of the Bankruptcy Code?* (pts. 1 & 2), 57 AM. BANKR. L.J. 99, 247 (1983), and a study of large-firm reorganizations by Lynn LoPucki and Bill Whitford that resulted in a series of articles in the early 1990s, *see* 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 (1990); Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies,* 141 U. PA. L. REV. 669 (1993); Lynn M. LoPucki & William C. Whitford, *Patterns in the Bankruptcy Reorganization of Large, Publicly Held Companies,* 78 CORNELL L. REV. 597 (1993); Lynn M. LoPucki & William C. Whitford, *Venue Choice and Forum Shopping in the Bankruptcy Reorganization of Large, Publicly Held Companies,* 1991 WIS. L. REV. 11. Teresa Sullivan, Jay Westbrook, and Elizabeth Warren are in the process of completing a more complete study of business bankruptcies, but the results of that study will not be available for several years. *See* Elizabeth Warren & Jay Westbrook, *Searching for Reorganization Realities,* 72 WASH. U. L.Q. 1257 (1994).

9. *See, e.g.,* GEORGE M. VON FURSTENBERG, TECHNICAL STUDIES OF MORTGAGE DEFAULT RISK: AN ANALYSIS OF THE EXPERIENCE WITH FHA AND VA HOME LOANS DURING THE DECADE 1957-66 (1971); JOHN P. HERZOG & JAMES S. EARLEY, HOME MORTGAGE DELINQUENCY AND FORECLOSURE (1970); Tim S. Campbell & J. Kimball Dietrich, *The Determinants of Default on Insured Conventional Residential Mortgage Loans,* 38 J. FIN. 1569 (1983).

10. The only major empirical studies of troubled loans of which I am aware are two studies by Stuart Gilson. *See* Stuart C. Gilson, *Transaction Costs and Capital Structure Choice: Evidence from Financially Distressed Firms,* 52 J. FIN. 161 (1997); Stuart C. Gilson et al., *Troubled Debt Restructurings: An Empirical Study of Private Reorganization of Firms in Default,* 27 J. FIN. ECON. 315 (1990). Those studies have limited value for the questions that I address because they look only at reorganizations by large firms of publicly traded debt securities in which collateral is quite rare. Accordingly, although interesting in their own right, those studies shed no light whatsoever on the role of collateral in the liquidation of distressed loans.

To fill that gap, I undertook a series of three case studies designed to provide a picture of what actually happens when secured loans to businesses[11] fall into distress. Each case study was designed to collect as random a group as practicable of problem secured loans in the portfolio of an institutional lender and to study what happened to those loans. To enhance the admittedly limited robustness of the study, I conducted case studies at three separate kinds of lenders: an insurance company, a bank, and a commercial-finance company.[12] At each lender I reviewed files covering between twenty-one and twenty-eight problem loans.[13] For each loan, I reviewed all of the files that the lender was able to retrieve and interviewed one or more loan officers responsible for dealing with the loan during its time of distress. I then completed a standardized profile consisting of about twenty questions regarding the initial lending transaction, the event that caused the loan to be identified as a problem loan, how the lender responded to the distress, and what ultimately happened to the collateral and to the lender's investment.[14] To put the problem loans in context, I also conducted general exit interviews with each of the loan officers designed to collect information about the lender's general lending practices.

Although my work does not involve anything approaching a random sample of all distressed loans, the profiles do provide a rich picture of secured credit in action, with information of far more general interest than the specific questions that motivated the study. On those questions, however, the profiles reveal a world in which the occurrence of liquidation is surprisingly rare. The pursuit of collateral was rare not only in the smaller loans typical of the finance-company study but also in the somewhat larger bank loans and even in the much larger loans I examined at the insurance

11. As with my prior work about secured credit, I generally steer clear of the difficult issues associated with consumer credit. *See, e.g.*, Mann, *Pattern of Secured Credit*, *supra* note 3, at 635 n.38 (discussing the difficulty of understanding the pattern of secured credit in consumer finance). The theoretical portion of this study, however, does attempt to explain why foreclosure is much more common in consumer loans than it is in the business loans that I studied. *See infra* section II.A.3.b.

12. To obtain unlimited access to the files of the lenders, I agreed not to disclose the specific identities of the lenders or identifying information about any of the debtors whose loans I examined.

13. I collected a total of 74 profiles at the three lenders. Two of the profiles involved forced liquidations that were not randomly selected. Accordingly, the sample that I use to evaluate general practices is based on 72 profiles.

14. Copies of the 74 profiles are available upon request, either in hard copy or on computer diskette. For the sake of confidentiality, I have numbered the profiles and refer to them by those numbers rather than by the names of the debtors.

company. Officers at all three institutions exhibited a firm predisposition to treat repossession of collateral as a last resort, to be pursued only when all else fails.

More importantly for theoretical purposes, the profiles provide a persuasive and coherent explanation for the limited significance of liquidation. The answer has two parts — the relatively high transaction costs of liquidation and the relatively effective alternative ways for debtors to repay their loans — but the effect is much more pervasive than I anticipated. At bottom, all three case studies indicate a consistent belief by loan officers that a decision to repossess collateral and liquidate was tantamount to accepting a loss on the loan. Those officers generally believed that they could not hope to liquidate collateral at a value that would be sufficient to pay off the nominal loan balance and, more importantly, to cover the costs of repossession and liquidation, including the risks of litigation associated with any adversarial response.

Moreover, the substantive results of my profiles offer strong reasons for accepting the perspective of those loan officers. Most important is the direct results those lenders received from liquidation. Although all three of those lenders are highly sophisticated entities that use careful underwriting standards designed to ensure that collateral is adequate to protect their investments, not a single one of my profiles involved a liquidation of collateral in which the lender recovered the entire balance of its loan. Indeed, even though the overwhelming majority of the profiles revealed full payment of the loans — particularly at the bank and finance company[15] — not a single one of the cases of full payment involved repossession or foreclosure. Rather, full payment almost invariably came either from continued operations of the distressed business, often for months or years during which the loan continued in a serious state of default; from a sale by the debtor of all or part of the underlying collateral; or from a successful refinancing, where another lender paid off the loan I was studying. Taken together, those results provide evidence of a relatively thick and well-functioning market in which distressed debtors have a real ability to obtain funds to protect their business assets even while their lending relationship is in the process of termination. Those results are particularly valuable given the

15. In the aggregate, the lenders obtained full payment in 64% of the profiles, including a surprising 84% of the bank and finance company profiles. Full payment was uncommon in my insurance company profiles (only 14% of the profiles). For a discussion of possible reasons for that distinction, see *infra* note 201.

general assumption of previous scholarship that distressed debtors face pervasive liquidity problems.[16]

My analysis proceeds in two steps. Part I presents the empirical part of my study —the data from the three case studies. For each lender, I outline the types of transactions in which it engages, the mechanisms the lender uses for identifying problem loans, the way in which it responds to problem loans, and the ultimate outcomes those responses produce.

Part II assesses two separate theoretical implications of my evidence. The first part of the theoretical discussion addresses the direct implications of my evidence for the economics of distressed debt. In particular, I show how the mechanisms evidenced in my case studies generally allow debtors to protect any equity they have in assets that they have given as collateral. From that perspective, the poor prices at foreclosure sales reveal not abuse by creditors, but the end result of a sorting process in which the only loans that proceed to the end-game of foreclosure are those in which the assets have deteriorated to values far below the original loan amount. Having explained why foreclosure is so rare in my studies, I close that section by explaining the comparatively high rate of foreclosures that seem to occur in consumer loans for motor vehicles and homes. Building on work by Art Leff and Bill Whitford, I attribute the relatively high rate of foreclosure in those areas to a combination of two factors: the unusually high liquidity of motor vehicles and homes as collateral and systemic obstacles to consensual resolution of consumer collection disputes.

The second part of the theoretical discussion addresses broader questions about the relation between the market for distressed debt and the larger market for the initial issuance of debt. First, based on the very low frequency of liquidation and the extremely poor results that lenders obtain on liquidation, I argue that the principal

16. I am as guilty of that assumption as anyone. *See, e.g.,* Mann, *Pattern of Secured Credit, supra* note 3, at 646 n.74. Steven Schwarcz is the most notable exception to that perception, arguing that one of the principal benefits of the institution of secured debt is its ability to provide financing to distressed companies. Indeed, Schwarcz seems to believe that a large portion of the secured debt market is debt issued by distressed firms. *See* Steven L. Schwarcz, The Easy Case for the Priority of Secured Claims in Bankruptcy: A Response to Professors Bebchuk and Fried 22-28 (Feb. 24, 1997) (unpublished manuscript, on file with author). Although that type of lending certainly exists — and plays an important role in the market for distressed debt (discussed *infra* in section II.A.1) — I do not believe that it is a significant part of the institutional lending in this country, largely because I have not observed that phenomenon as a significant share of the market for secured debt in any of the markets that I have examined in this article or in any of the related work I have done on the pattern of secured credit. Schwarcz presents no empirical evidence to undermine my perspective on that point.

reason that lenders take collateral in business loans is the strategic advantage that it gives them; the enhancement of their power to liquidate collateral by force is of so little value that it cannot plausibly be viewed as a general justification for those transactions. Accordingly, legal reforms of the secured-credit system should focus more on the serious policy issues raised by those strategic advantages than on perceived difficulties in obtaining a reliable right to liquidate.

That discussion closes by addressing the long-standing concern that rules hindering creditors' collection efforts will affect the willingness of lenders to issue new loans. My evidence of the low frequency of business failure and bankruptcy strongly suggests that the concern is for the most part unfounded, at least in the context of commercial finance.

I. Liquidating Problem Loans

A. *The Finance Company*

The first of the three case studies involves a finance company. Although it is difficult to tell how representative my particular company is of the universe of all finance companies, its size places it comfortably within the mid-range of American finance companies. Specifically, its $4 to 5 billion portfolio makes it one of the thirty largest finance companies in this country.

1. *The Finance Company's Lending Transactions*

Because the finance company's treatment of distressed loans is so dependent on the highly specialized nature of its lending transactions, I start by outlining the mechanisms the finance company uses to make loans. Although different companies specialize in different areas, inventory lending is a dominant line of business for many, if not most, finance companies. One of the most common transactions — and the subject of most of the loans in my sample — is a "floorplan" transaction that involves agreements among three parties: the lender, the inventory manufacturer, and the retailer. The arrangement starts with a floorplan agreement between the lender and the manufacturer.[17] That agreement establishes the general price that the lender charges retailers to fund purchases from the manufacturer. For example, in the Consumer Electronics and Ap-

17. I speak here of manufacturers only for convenience, because in many cases the entity supplying the inventory is not a manufacturer but a middle man such as a wholesaler.

pliances area (CE&A) at my finance company, a typical agreement provides for a 2 to 4% "discount": when a retailer purchases a covered appliance, the lender funds to the manufacturer only 96 to 98% of the purchase price. The 2 to 4% spread between the nominal sales price (owed to the lender by the retailer) and the discounted price (paid to the manufacturer by the lender) compensates the lender for a sixty- to ninety-day period during which no interest accrues on the loan. The provision obligating the retailer to pay the full price even though the lender only advances the discounted price to the manufacturer thus provides the lender a return for the time value of that interest-free period.[18] The amount of the discount and the length of time before interest starts to accrue are negotiated on a manufacturer-by-manufacturer basis, generally determined by the parties' respective negotiating strengths.[19] Those terms then apply generally to most retailers that purchase under the agreement, without regard to the specific credit strength of the individual retailer.[20]

The floorplan agreement also contains a repurchase commitment by the manufacturer. If the lender finances inventory under the agreement and ends up repossessing the inventory from the retailer, the manufacturer in specified cases is obligated to purchase the inventory from the lender at the original sales price.[21] At least theoretically, that arrangement gives the lender a substantial protection against losses from defaults by its debtors, because it purports to ensure that the lender can liquidate the collateral at an amount equal to the amount the lender advanced against the collat-

18. *See* Interview with Account Manager (Aug. 1, 1996) [hereinafter Account Manager Interview]. Throughout this article I have declined to indicate the location of the interviews and the names and employers of the interviewees in order to preserve the anonymity of the companies.

19. *See* Interview with Branch Operations Manager (July 26, 1996) [hereinafter Branch Operations Manager Interview].

20. *See* Account Manager Interview, *supra* note 18; Branch Operations Manager Interview, *supra* note 19. Retailers face higher credit terms only in unusual cases in which the financial strength of the retailer is marginal. The finance company's need to preserve a positive relationship with the manufacturer gives the finance company a strong incentive not to quibble about the financial strength of individual retailers.

21. *See* Floorplan Agreement § 3, at 1 (on file with author). The agreement provides:

> Whenever [the lender] deems it necessary in its sole discretion to repossess or if [the lender] otherwise comes into possession, actual or constructive, of any Merchandise in which it has a security interest or other lien, Vendor will purchase such Merchandise from [the lender] at the time of its repossession or other acquisition or possession . . . [at] an amount equal to (i) the total unpaid balance (being principal and finance charges) owed to [the lender] with respect to such Merchandise, or Vendor's original invoice price for such Merchandise, whichever is greater, and (ii) all costs and expenses (including, without limitation, reasonable attorneys' fees) paid or incurred by [the lender] in connection with the repossession of such Merchandise.

Id.

eral. For a variety of practical reasons discussed below, however, the repurchase obligation turns out to be significantly less valuable than it appears on first impression.[22]

The second leg of the financing arrangement is an agreement between the lender and a retailer that purchases inventory from a covered manufacturer. Several provisions of that agreement have the effect of making the lender's financing "at-will." First, it imposes no binding obligation that the lender advance funds for any particular item of collateral.[23] Moreover, the agreement specifically allows the lender to terminate the entire relationship without cause on thirty-days' notice.[24] As discussed above, the terms on which the lender advances funds for inventory purchases normally are standardized on a manufacturer-by-manufacturer basis, not a debtor-by-debtor basis. Accordingly, the individual debtor agreements do not set forth a specific discount percentage and interest-free period to govern the retailer's purchases. Rather, each purchase is governed by the terms applicable to the manufacturer from whom the retailer purchased that particular item. Then, when a debtor purchases inventory from a covered manufacturer, the lender remits the agreed-upon percentage of the nominal sales price to the manufacturer and accepts an obligation from the retailer for the gross (undiscounted) amount of that price. As mentioned above, the discount off the nominal price thus compensates the lender for allowing the retailer to defer payment interest-free for an agreed-upon period — usually at least thirty days. At that point, interest begins to accrue at an agreed-upon floating rate, usually in the range of prime plus 4-8% per annum. If the debtor fails to make a scheduled payment, the late amount accrues interest at 18% per annum.[25]

The lender has two common types of payment schedules, which are established on a debtor-by-debtor basis. The most common is a scheduled payment plan ("SPP"), in which the time of payment is

22. *See infra* text accompanying notes 77-81.

23. Agreement for Wholesale Financing § 1, at 1 (on file with author) ("[The lender] may extend credit to Dealer from time to time to purchase inventory .... [The lender's] decision to advance funds will not be binding until the funds are actually advanced.").

24. Agreement for Wholesale Financing, *supra* note 23, § 17, at 4. The agreement stipulated:

> Either party may terminate this Agreement at any time by written notice received by the other party. If [the lender] terminates this Agreement, Dealer agrees that if Dealer ... is not in default hereunder, 30 days notice of termination is reasonable and sufficient (although this provision shall not be construed to mean that shorter periods may not, in particular circumstances, also be reasonable and sufficient).

25. *See* Account Manager Interview, *supra* note 18.

established without regard to the actual date on which the debtor resells the inventory. For example, a typical arrangement might call for "4 Pay 120": four payments of one-fourth of the purchase price at 30 days, 60 days, 90 days, and 120 days after the financing.[26] By establishing a payment schedule that makes the time of resale irrelevant, the arrangement substantially diminishes the need for the lender to monitor the retailer's sales and allows the lender to dispense with frequent inventory audits and the attendant costs.

At the same time, the rigid payment schedule imposes substantial risks on the parties. The debtor faces a problem if the inventory turns more slowly than the payment schedule suggests: if the debtor does not sell the inventory for five months, it will have to pay the lender for the inventory out of its own pocket before it obtains funds from the ultimate customer. Conversely, the lender is at risk if the inventory turns too quickly: the inventory — the lender's collateral — will disappear while the debt remains. The lender attempts to minimize those risks by designing a payment schedule that accurately reflects the rate at which each debtor turns over its inventory.[27] But the impracticability of designing schedules that match the turnover rates precisely[28] necessarily leaves one or the other, if not both, of the parties exposed to substantial risks.

The riskiness of that arrangement is aggravated by a relatively obscure quirk of U.C.C. § 9-312.[29] By complying with U.C.C. § 9-312(3), the lender can obtain a first-priority security interest in the

26. *See* Telephone Interview with Branch Operations Manager (Mar. 19, 1997) [hereinafter Supplemental Branch Operations Manager Interview].

27. *See id.*

28. This can be true not only because the lender and the debtor might agree to a schedule that is shorter or longer than the debtor's customary inventory turnover, but also because the actual turnover might vary from time to time depending on the season of the year or other market conditions.

29. U.C.C. § 9-312(3) reads:

> (3) A perfected purchase money security interest in inventory has priority over a conflicting security interest in the same inventory and also has priority in identifiable cash proceeds received on or before the delivery of the inventory to a buyer if
>
> (a) the purchase money security interest is perfected at the time the debtor receives possession of the inventory; and
>
> (b) the purchase money secured party gives notification in writing to the holder of the conflicting security interest if the holder has filed a financing statement covering the same type of inventory (i) before the date of the filing made by the purchase money secured party, or (ii) before the beginning of the 21 day period where the purchase money security interest is temporarily perfected without filing or possession (subsection (5) of Section 9–304); and
>
> (c) the holder of the conflicting security interest receives the notification within five years before the debtor receives possession of the inventory; and
>
> (d) the notification states that the person giving the notice has or expects to acquire a purchase money security interest in inventory of the debtor, describing such inventory by item or type.

U.C.C. § 9-312(3) (1987).

inventory that it finances even if other lenders have financing statements on file against the debtor at the time the lender starts lending to the retailer.[30] Unlike most rights under Article 9, however, that priority does not extend to accounts receivable that the debtor receives as proceeds of the inventory: U.C.C. § 9-312(3) limits the purchase-money priority to "identifiable cash proceeds." Because a sale of inventory by the retailer is in the ordinary course of business, as well as "authorized" by the retailer's agreement with the lender,[31] the sale by the retailer strips the lien from the inventory.[32] Because U.C.C. § 9-312(3) prevents the lender's lien from attaching in first priority to the account received for the inventory, the lender is left empty-handed at the time of the sale. That problem is aggravated by the reality that for SPP loans of modest size it is not practical for the lender to do periodic inventory audits.[33]

30. That rule is significant because, as I note below, the finance company's debtors almost always have other financing statements on file against them at the time that the finance company initiates its relationship. *See infra* note 47 and accompanying text. As it happens, the lender generally is not willing to rely on the U.C.C. § 9-312 priority in SPP transactions. *See* Telephone Interview with General Counsel (Feb. 12, 1997) [hereinafter General Counsel Interview]. Accordingly, on loans that exceed $250,000, the lender normally insists on obtaining subordinations from lenders with prior filings, even if those filings would be subordinate to the lender under Article 9. *See* Account Manager Interview, *supra* note 18. The lender treats SPP transactions differently because of two problems that make it difficult to maintain purchase-money status in SPP transactions. First, most SPP collateral has no serial number; accordingly, it is hard for the lender to match up the individual items in the debtor's stock with the particular loan advances by the lender. Also, because the SPP program calls for payments at arbitrary dates that will not necessarily correspond to the date of the sale, the debtor at any time is likely to have substantial amounts of collateral for which the lender has been partially paid and substantial amounts of debt remaining for which the matching collateral has already been sold. In many jurisdictions, that circumstance could call into question the purchase-money status of the loan. *See* General Counsel Interview, *supra* (explaining the lender's concerns); *see also* DOUGLAS G. BAIRD & THOMAS H. JACKSON, CASES, PROBLEMS, AND MATERIALS ON SECURITY INTERESTS IN PERSONAL PROPERTY 402-05 (1987) (discussing the "strict tracing requirement" imposed by Article 9); JOHN O. HONNOLD ET AL., SECURITY INTERESTS IN PERSONAL PROPERTY 329 (1992) (discussing difficulties in determining which items of collateral secure which obligations); LYNN M. LOPUCKI & ELIZABETH WARREN, SECURED CREDIT: A SYSTEMS APPROACH 682-83 (1995) (discussing problems in retaining purchase-money status in cross-collateralized loan transactions). Proposed revisions to Article 9 would eliminate this problem. *See* U.C.C. § 9-107(e) (Reporter's Interim Draft 1997).

31. The lender cannot practicably forbid sales of the retailer's inventory because those sales are the very point of the retailer's business.

32. *See* U.C.C. § 9-306(2) (1987) (providing that a security interest does not continue in collateral sold by the debtor if the sale is "authorized" by the lender); U.C.C. § 9-307(1) (1987) (providing that a security interest does not continue in collateral sold in the ordinary course of the debtor's business).

33. *See* Branch Operations Manager Interview, *supra* note 19. The branch manager explained that cost effectiveness is the overriding concern in the frequency of audits and that the lender is working steadily to conduct more and more audits: "[We c]an't afford to go every month. It's not worth it. But going out every year? We're really working toward that." She explained further that the increasing number of audits is a function not only of the lender's trend toward larger loans, but also "a function of the false reports we've gotten.

The other major type of payment arrangement is a pay-as-sold ("PAS") arrangement. Under that arrangement, the debtor is obligated to make payments to the lender promptly upon the sale of each item of collateral. The lender enforces that schedule by regularly scheduled, on-site inventory audits that compare the items of inventory on hand with the lender's records of the inventory it has financed. Although such audits ordinarily discover some amount of inventory that has been sold but not yet paid for — items that are sold and unpaid ("SAU") — that is not necessarily a cause for concern. Given the typical practice of making one payment to the lender each week,[34] it would be no surprise if an audit revealed a shortfall of twenty-five percent of a month's normal sales. Accordingly, the branch operations manager explained that the lender is not troubled by persistent SAU shortfalls as long as they do not exceed thirty percent of a month's sales. When I commented to him that the arrangement leaves the lender chronically short of collateral, he responded without concern, "That's just the way that program works."[35]

The other significant lending product covered by my case study was a line of business that the lender terms "asset-based lending" ("ABL"). Although an outside observer might characterize all of the lender's lending as asset-based, the lender limits the term ABL to loans on which the lender does not have repurchase agreements to protect itself. The finance company enters into those transactions either because the loan covers inventory for which the lender does not have a repurchase arrangement or because the loan covers accounts receivable and other noninventory collateral. Because there is no repurchase agreement, those loans would be structured with significantly lower advance rates, typically in the range of fifty to sixty-five percent of the wholesale value of the collateral.[36]

To protect itself on the ABL transactions, the lender requires its debtors to have the account debtors — that is, the ultimate consum-

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Every time we have a loan go bad we try to find out what we can do to prevent that from happening again." Interview with Branch Manager (Aug. 1, 1996).

34. *See* Branch Operations Manager Interview, *supra* note 19. The applicable agreement states without elaboration that the debtor is obligated to pay for PAS collateral "when such Collateral is sold, transferred, rented, leased, otherwise disposed of or matured." Agreement for Wholesale Financing, *supra* note 23, § 9, at 2.

35. Branch Operations Manager Interview, *supra* note 19. The results of my profiles suggest that this quirk does not appear to impose a huge risk on the lender when compared to the practical difficulties of eradicating that risk, especially for retailers that sell relatively inexpensive items.

36. *See, e.g.*, Profile 17 (advancing 60% on carpets); Profile 18 (advancing 65% on guns, 35% on ammunition, and 50% on accounts receivable).

ers who purchase on credit — make payments directly to a "lockbox," a post-office address for a bank account under the lender's control.[37] The lender's lockbox program appears to be relatively successful. After a "growing period" to "retrain" customers to have payments sent to lockboxes, eighty-five to ninety percent of accounts receivable typically are paid to lockboxes.[38] The lender monitors the payment situation closely so that it can take action promptly if it observes a decline in the percentage of payments being made into the lockbox.[39]

2. *Selecting Loans for Study*

After some introductory interviews attempting to get a sense of the lender's business, the next task was to decide how to select a group of files to examine. Because the lender does not organize its records in a way that would allow me to sample all of the distressed loans over a certain period of time, I was unable to draw a direct sample of all of the loans in which debtors had defaulted during a particular time period. Moreover, because the lender's right to terminate without cause allows it to terminate relationships before the debtors commit a default, a sample that included only the loans on which debtors defaulted would not accurately represent the universe of distressed debtors. Accordingly, I asked each of three different account executives to allow me to review the files on the nine loans that they had "liquidated"[40] most recently. That term was slightly overinclusive because in the lender's usage it includes files in which the debtor voluntarily terminated the relationship. After excluding four of the twenty-seven files because the debtors voluntarily terminated the relationship, I was left with a group of twenty-three files: nine from asset-based lending and fourteen from floor-plan arrangements — seven of those from management information systems and seven from consumer electronics and appliances. Because the sample included so few cases of adversarial liquidation, I also examined two older files — not part of my random sample — one of which involved a bankruptcy and one of which involved forced liquidation of the collateral.[41]

37. *See* Branch Operations Manager Interview, *supra* note 19 (stating that all accounts-receivable lending in his branch requires payments to a lockbox).

38. *See id.*

39. *See id.*

40. "Liquidation" is the term that the lender uses for the process of terminating a financing relationship.

41. In the bankruptcy case, the lender was paid in full with interest within five months after the bankruptcy filing. *See* Profile 24. In the forcible liquidation case, the debtor con-

The biggest problem with the selection of files at the finance company is the possibility that the process was skewed by the need for me to take files from the three officers mentioned above. As it happens, the product lines for which those officers are responsible appear to include some of the smaller items of collateral on which the lender makes loans: office equipment, home appliances, and the like. It is possible that the results would have been different if I had reviewed files in which loans against larger assets, like boats or farm equipment, had been liquidated. I doubt, however, that the skewing is substantial because the general trend of the profiles from the finance company closely resembles the general trend of the profiles from the bank, which tended to make loans on more substantial assets.

3. *Results of the Profiles*

a. The Debtors. The lender's standard loan review forms provide a considerable amount of standardized information about the debtors. Accordingly, I start by outlining some of this information about the twenty-three distressed debtors covered by my profiles. At the time of the distress, all twenty-three debtors were corporations.[42] In each case, without exception, the lender had a guaranty from at least one of the principals of the business, and in most of the cases had a guaranty from each individual that owned stock in the debtor,[43] along with the spouses of those individuals.[44] The median debtor had one location,[45] had annual sales of $2.4 million,[46]

ducted a liquidation sale that reduced the loan balance from about $190,000 to $80,000; a year later, the lender is still pursuing the guarantors for the remainder. *See* Profile 25.

42. One account executive explained: "[One hundred percent] of those entities may be owned by one guy, but they tend to be organized as corporations. It's not that we're looking to finance corporations, it's more that the size of the borrower that we're looking for tends to be a corporation." Account Manager Interview, *supra* note 18.

43. All stockholders signed guaranties in 21 of the 23 profiles. In one of the remaining cases, the lender had guaranties from individuals owning only 56% of the shares, *see* Profile 10, and in the other from individuals owning only 65% of the shares, *see* Profile 12.

44. The interest in the guaranty was evidenced on the form for evaluating each loan by a specific place to indicate whether all guaranties had been signed not only by the principals but also by their spouses. It appears that the desire to obtain signatures from the spouses of the stockholders was not motivated by any interest in marital status, but more out of a desire to avoid marital-property defenses to enforcement of the guaranty. *See* Telephone Interview with General Counsel (Nov. 6, 1996).

45. Eight of the debtors had multiple locations. *See* Profile 3; Profile 6; Profile 16; Profile 17; Profile 18; Profile 19; Profile 20; Profile 22. The high was about 20, *see* Profile 17, with an average of 2.6 locations overall.

46. The number for annual sales requires some judgment, because use of the final figure (at the time of liquidation) — in most cases quite a small figure — would not reflect accurately the previous scope of the business. The figure in the text is based on the last full year reported before the year in which the debtor's distress became an issue for the lender.

and had been in business for fourteen years. U.C.C. searches at the time the lender extended its loan indicate that the lender advanced funds in the face of a large number of secured lenders of record.[47] At the time the lender decided to terminate the relationship, the median debtor had been borrowing money from the lender for three years, with a range from less than one year to seventeen years; had a credit line of $300,000, with a range from $15,000 to $6,000,000; and had an outstanding balance of $82,000, with a range from $700 to $4,000,000. Interestingly, twenty-one of the twenty-three debtors had funds available under their credit line at the time the lender decided to terminate the relationship.[48]

b. Selecting Debtors for Termination. Some of the most enlightening information that I obtained related to the circumstances that motivate the lender to terminate its lending relationships.[49] Most striking was the lender's relative lack of concern for late payments.[50] Of the twenty-three profiles, fifteen noted late payments in the last periodic review before termination, but the late payments were the basis for termination in only five cases.[51] In eight of the other ten late-payment profiles, the basis for termination was general concern about the financial strength[52] of the debtor or its

47. The lender was the exclusive lender in only 3 of the 23 cases. *See* Profile 5; Profile 16; Profile 17. The average number of secured lenders of record at the time of the lender's loan was 3.9. My evidence is not direct evidence of the number of secured lenders from whom a typical borrower will obtain funds, because of the possibility that distressed debtors do not accurately represent the universe of all debtors; distressed debtors might have more secured lenders than nondistressed debtors. I do find, however, some probative value in the surprisingly large number of lenders outstanding at the time when the lender initially made the loan — that is, at a time when the debtor appeared to be healthy.

48. Of the other two, one debtor was at its $2 million limit, *see* Profile 17, and a second was $100,000 over its $500,000 credit line, *see* Profile 21.

49. Determining the basis for termination of a loan that is in default and also is a demand relationship is relatively subjective. I base my assessments on my review in each profile of a memorandum written by the responsible account officer recommending a course of action. The course of action becomes effective only upon approval by a number of higher executives. In the cases where those executives selected a different course of action, the reasons for their decisions were evidenced by handwritten notes on the memorandum prepared by the responsible account officer.

50. The relative insignificance of late payments as a basis for termination flies in the face of the traditional academic perspective that late payments are the focus of lender decision-making on termination decisions. *See, e.g.*, LoPucki & Warren, *supra* note 30, at 257 ("Most defaults actually acted upon by secured creditors are defaults in payment.").

51. *See* Profile 3; Profile 4; Profile 12; Profile 13; Profile 15. In one of those cases, the payment default was aggravated by the debtor's failure to deliver a letter of credit required under the debtor's agreement with the lender. *See* Profile 13.

52. The principal indicators of financial strength that the lender follows are the debtor's gross revenues and tangible net worth, as well as the ratio of the debtor's leverage (debt to tangible net worth). The lender calculates those indicators based on its own records of inventory sales and information provided by the debtors.

guarantor.[53] In another profile, the termination was based on the debtor's refusal to provide a financial statement, notwithstanding *seventeen* separate requests over a period of about ten months! That debtor's two late payments during the period of the financial-statement problem were not significant to the lender's decisionmaking process.[54] Finally, in the last profile, the basis for the termination was an apparent fraud by the debtor: at an on-site inventory inspection, the debtor attempted to pass off empty containers as containing unsold inventory.[55]

The relative lack of concern with payment defaults is also evidenced by the fact that eight of the relationships were terminated even in the absence of a payment default. In three cases the relationships were terminated because of general concern about the debtor's financial strength, which was accompanied in each case by violation of a financial covenant.[56] The other five relationships terminated without a payment default were terminated because of inadequate use of the credit facility.[57] Although that might seem like a strange reason for termination in the abstract, it justifies termination for two separate reasons. First, a decline in usage of the credit facility often is associated with a general decline in sales, which the lender understandably views as a significant leading indicator of financial distress. Second, even if the debtor is not in financial distress, its failure to make frequent use of the credit line limits the income that the lender earns from the relationship. Because the lender incurs substantial fixed costs in reviewing and monitoring each credit line, a credit line becomes unprofitable if it is used infrequently.

In sum, concern about financial strength was the leading basis for termination (11 profiles, 48%), followed by the related problem

53. If the late payments alone had been enough to justify termination, the debtors would have been terminated in response to those payments; the lender would not have waited to terminate the debtor until a regularly scheduled periodic review of the loan. The relevant financial concern focused on problems with the debtor itself in several profiles. *See* Profile 1; Profile 2; Profile 10; Profile 18; Profile 19; Profile 21. In Profile 6, the principal of the debtor suffered a foreclosure on an unrelated judgment. The lender terminated the relationship with the debtor when the principal was not able to offer a satisfactory explanation. In Profile 16, a manufacturer had guarantied the loan. The lender terminated the relationship when the manufacturer refused to extend the guaranty.

54. *See* Profile 5.

55. *See* Profile 7. Because that debtor was on a pay-as-sold program, the absence of the inventory without prior payment constituted a payment default. It is clear from the file that the fraud at the inspection was the basis for termination, not simply the late payment.

56. *See* Profile 17 (reporting debtor's violation of tangible net worth and leverage covenants); Profile 20 (reporting debtor's violation of tangible net worth covenant); Profile 23 (reporting debtor's violation of tangible net worth and leverage covenants).

57. *See* Profile 8; Profile 9; Profile 11; Profile 14; Profile 22.

of limited use of the credit line (5 profiles, 22%), payment defaults (5 profiles, 22%), and one case each of refusal to deliver financial statements and fraud (4% each). Those statistics significantly undermine any image of the lender waiting by its mailbox eager to seize on a technical payment default to justify termination. On the contrary, the facts suggest a lender motivated to continue every relationship, even in the face of fairly frequent default, as long as the lender has any reason to believe that the relationship will be profitable.[58]

The at-will nature of the lender's program is central to its ability to rely so heavily on financial strength in selecting loans for termination. Because the lender can terminate relationships on thirty-days' notice without cause, it does not have to substantiate to the debtor the basis for its decision to terminate the relationship. In a more traditional term-loan context, a lender could terminate based on financial considerations only if it could identify and substantiate a specific event of default. In the at-will context, by contrast, the lender's own decision that the debtor's financial strength is unsatisfactory is enough to justify termination. The at-will nature of the relationship thus gives the lender the ability to terminate the relationship before the occurrence of a serious payment default.

Another interesting fact is that the presence or absence of an adequate collateral cushion rarely seems to be of significance. Although a few of the debtors were short on collateral at the time the lender decided to terminate the relationship, in the overwhelming majority of the cases the lender believed that it was fully collateralized at the time that it decided to terminate the relationship.[59] In one case, for example, although the debtor had failed to satisfy leverage and tangible net worth covenants for quite some time, the lender ultimately decided to terminate the relationship because of its perception that the debtor's principal was focusing his attention on a new and unrelated business. At the time of the termination,

58. The lender's incentive to continue relationships rests not only on its desire to continue individual relationships as long as there is a possibility of future profits, but also on its need to maintain a good relationship with its manufacturers. If the lender cuts off the manufacturer's retailers too quickly, the manufacturer might decide to shift its lending arrangements to a different finance company.

59. The lender believed that there were significant shortages on three profiles. *See* Profile 15; Profile 16; Profile 21. It was concerned about possible shortages on three additional profiles. *See* Profile 1; Profile 5; Profile 19. In the other 17 profiles, the lender believed that it had adequate collateral. As I explain *infra* at note 326, it is difficult to tell whether that assessment indicates that an actual liquidation would make the lender whole. The relevant point, though, is that the lender was not motivated to take action by concern about the value of the collateral.

the lender was wildly oversecured, with funds outstanding equal to about thirty percent of the repurchase value of its collateral.[60]

That approach seems to me to tie into the previous discussion of financial strength. The at-will nature of the relationship allows the lender to terminate debtors soon after they become shaky, allowing liquidation of the loan generally to occur at a time when the lender still can obtain full payment.[61] A relationship that required a more objective justification for termination of the relationship would be likely to result in considerably larger losses for the lender.[62]

c. The Process of Termination. As the previous section suggested, the process of termination of loans by the lender is more proactive than reactive. The process in the great majority of cases occurs as a result of a scheduled periodic review rather than in response to a specific default.[63] Perhaps the most surprising effect of that proactive approach is that it makes it possible for the lender to exit its relationships in a relatively nonadversarial manner. The overwhelming majority of the cases are terminated by allowing the debtors to liquidate the loan in the ordinary course of business through sale of the collateral or refinancing with another lender. Thus, although the legal rights of the parties under Article 9 and the Bankruptcy Code always remain as a background against which the parties bargain, the ordinary course of liquidation results in complete payment of the lender without any use of the Article 9 remedies and with only limited reliance by the debtor on rights under the Bankruptcy Code.[64]

Contrary to the traditional academic perspective, not a single time in my twenty-three profiles did the lender exercise its Article 9 rights to repossess collateral and sell it in satisfaction of the debt.[65]

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60. *See* Profile 17.

61. That perspective is evidenced by the frequency with which reviewing executives call for termination of a relationship on the theory that the early signs of distress indicate that it is "time to get out." *See, e.g.*, Profile 12 (offering that rationale for termination of an adequately collateralized loan).

62. That would be true whether the need for an objective justification arose from a contractual agreement between the parties or from the interposition of a mandatory legal requirement through lender-liability rules. *See infra* note 244 and accompanying text (criticizing legal rules that limit parties' ability to create flexible termination provisions).

63. Of the 23 profiles, only 3 (13%) were liquidated outside the course of scheduled periodic reviews. *See* Profile 3 (special mid-year review in response to persistent payment defaults); Profile 5 (failure to supply financial statement for ten months, despite 17 separate requests from the lender); Profile 7 (fraudulent passing off of inventory).

64. The debtors filed bankruptcy in one case, *see* Profile 23, and threatened a filing in another, *see* Profile 12.

65. During their entire time at the lender, which covered the liquidation of a total of about 100 accounts, none of the three account executives had ever repossessed collateral and removed it from the debtor's possession. *See* Branch Operations Manager Interview, *supra*

Rather, in each transaction the lender left the collateral in the debtor's control, allowing the debtor to sell the collateral in the ordinary course of business or obtain substitute financing to repay the loan.[66] When questioned about their reticence to repossess collateral, the account executives uniformly pointed to the general success of allowing the debtor to sell the collateral: the executives ordinarily expect to get full repayment if they leave collateral in the debtor's possession and rarely expect to get full repayment if they do not. Surprisingly, that perception seems to be well justified. In only one of the twenty-three cases did the lender fail to recover the entire amount of its principal and interest.[67] That was the only case in my twenty-three profiles in which the debtor was not able to liquidate the collateral in the ordinary course of its business: the debtor filed for bankruptcy and the bulk of the collateral was sold at an auction conducted under order of the bankruptcy court.[68]

When I started the study, I wanted to investigate the hypothesis that the reason that the lender could trust its debtors to liquidate the collateral was the idea that it could pursue the guarantors if the business did not repay the debt. Although that hypothesis might be true in some cases, the results of the study suggest that it is not generally accurate: the lender frequently leaves debtors in possession to liquidate even in cases where the guarantors have little or no net worth. For example, the account executive in one case acknowledged that the guarantor "had no net worth," but left him in possession to liquidate because "he wanted to stay in business" and "he was sending constant payments."[69]

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note 19 (about 30 accounts); Interview with Account Executive (Aug. 6, 1996) (17 accounts); Account Manager Interview, *supra* note 18 (about 50 accounts). The closest incidents involved two situations in which the lender allowed debtors to conduct liquidation sales with lender personnel on site to monitor the sale. *See* Branch Operations Manager Interview, *supra* note 19. Profile 25 is a nonrandom review of one of those files, which I do not include in my sample.

66. One arguable exception is Profile 15, in which the lender and the debtor agreed to "transfer" some of the collateral to another one of the lender's debtors. The manufacturer issued a credit to the distressed debtor for the collateral, and the lender was repaid for that collateral when it was sold by the second, healthy retailer. Even in that case, however, the lender did not force the debtor to relinquish the collateral and never took possession of the collateral itself.

67. *See* Profile 23. That is not to say that none of the lender's loans ever go bad. Although its chargeoffs are impressively low, they are not invisible: 1995 chargeoffs came to about 20 basis points of the lender's net loan volume for that year. *See* Interview with Finance Company Credit Executive (April 1996) [hereinafter Finance Company Credit Executive Interview].

68. *See* Profile 23. In that case, the lender eventually charged off about $150,000 of a loan that had about $1,200,000 outstanding when the debtor went into default.

69. Profile 1. For other cases where the principals of the debtor had negligible net worth but were still allowed to control disposition of the collateral, see Profile 3 (reporting that a

The fundamental reason for the lender's willingness to allow its debtors to control liquidation of collateral was the prevailing pessimism of account executives as to the results that they could expect to obtain through more adversarial approaches to liquidation. The general perception was that the lender could never hope to get paid in full if it repossessed the collateral and sold it in satisfaction of the debt. The dominating basis for that perception was a belief that the debtors almost universally could sell the collateral for more than the lender. As one executive stated in connection with a troubled firearms debtor: "If he couldn't sell [some obsolete hunting equipment], we certainly couldn't."[70] Even in the profile mentioned above where the lender eventually wrote off about $150,000, the lender consciously decided to leave the collateral in the possession of the debtor on the theory that the debtor ultimately could complete manufacturing its inventory and sell the resulting goods for an amount far greater than any amount that the lender could have obtained from a sale of the raw materials and work in process.[71] Of course, that approach leaves lenders exposed to the risk that the indigent principals of their borrowers might abscond with the assets. But the cases I reviewed suggest that the poor results expected on repossession were adequate in most cases to motivate lenders to trust their borrowers to retain the collateral.

Transaction costs are another common problem that make repossession impractical for small or remotely located debtors. For example, in one case the executive justified his decision not to repossess collateral from a video dealer in South Dakota as follows:

> "For fifteen thousand dollars [the outstanding loan balance], to go up to South Dakota, to try to repossess him, to take whatever inventory was left and try to send it back to the manufacturer probably would

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wife of one of the stockholders had significant assets, but never signed a guaranty); Profile 22 (reporting "no tangible net worth" of guarantors); Profile 24 (nonrandom file examined because it involved a rare bankruptcy filing) (reporting that the debtor was left in possession despite a negative net worth). I do not mean to suggest that the guaranty itself is irrelevant. On the contrary, the lender's periodic reports highlight information regarding the absence of a guaranty from any shareholder or the spouse of any shareholder. In one of the rare cases in which the lender did not have a guaranty from all of the owners, the absence of a guaranty from one of the owners was one of the factors motivating the lender's termination of the relationship, even though the existing guarantor had a tangible net worth that exceeded the balance of the loan. *See* Profile 10.

70. Profile 18.

71. *See* Profile 23; *see also* Profile 25 (nonrandom file selected because it involved a liquidation sale) (reporting that the debtor was allowed to conduct a liquidation sale on the view that "[e]ven if it was a liquidation sale, it clearly was better than the liquidation sale [the lender] could have conducted").

> cost us five thousand dollars." Had we repossessed him it probably would have been a break even, so we tried to collect it by phone.[72]

The legal costs associated with repossession posed a similar problem. For example, in one case the lender's decision not to repossess was motivated in part by the concern that the lender might be held liable for repossession because it had allowed the debtor to continue operating for several years notwithstanding persistent defaults.[73] In another case, the lender accepted a debtor's commitment to repay a loan in almost a year's worth of weekly payments rather than test the debtor's threat that it would file for bankruptcy if the lender attempted to repossess the collateral.[74] Concerns about the costs of the legal system slowed the push for repossession even in one profile that involved blatant fraud by the debtor.[75] As the branch operations manager explained: "'If we go after him, we'll have to sue him, so it's better to save the money you'd have to give to attorneys by collecting internally yourself (through letting him pay you voluntarily).'"[76]

I also was surprised at the limited use by the lender of its repurchase option. When I first learned of the lender's repurchase arrangement, my natural focus on legal rights and remedies led me to assume that the repurchase arrangement would enhance the lender's incentive to repossess collateral because of the high likelihood that the lender would be able to resell the collateral at cost to the manufacturer. In fact, however, the lender makes only limited use of the repurchase option.

Two general problems motivate the lender's reluctance to exercise the repurchase option. The first is the legal and practical costs of repossession. Despite the general pride that legal academics take in the creation of Article 9 as an ostensibly efficient system for liquidating collateral,[77] the transactions that the statute is supposed to facilitate remain relatively impractical. Essentially, the problem

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72. Profile 22. That loan eventually was repaid in full out of the business's ordinary cash flow. Similar concerns about the cost effectiveness of using repossession for small loans were mentioned as significant factors in two profiles. *See* Profile 8; Profile 14.

73. *See* Profile 17.

74. *See* Profile 12. It is not clear how significant that threat was, because it appears from the lender's practices in other cases that the lender probably would have accepted the debtor's workout proposal even without the threat.

75. *See* Profile 7. The characterization of the fraud as blatant is mine, based on my review of the documents in the file. The debtor denied any fraudulent activity.

76. Profile 7. As discussed below, that debtor repaid its loan in full a few months later.

77. For a typical example of the highly laudatory perspective that legal academics have on Article 9's procedures, see LoPucki & Warren, *supra* note 30, at 110-11 (offering a functional analysis of the improvements of Article 9 as compared to real estate procedures).

is that the lender is highly unlikely to get paid 100% if it exercises its repurchase option, of only because of the legal exposure.[78] Just as significant as the transaction costs and legal risks associated with taking possession of the collateral is the difficulty of forcing the manufacturer to repurchase the collateral. As it happens, much of the collateral left in the possession of a debtor whose business is having trouble tends to be old, and thus perhaps obsolete, or damaged, and thus not subject to repurchase.[79] For example, in one profile where the debtor was terminated for committing fraud in connection with an inventory audit, the lender nevertheless allowed the debtor to continue operating and selling the remaining collateral in the ordinary course of business.[80] The outstanding balance of the loan — after a prompt payment made in response to the inspection — was $20,000, and the lender thought it could get only $2,000 for the collateral against which it had advanced the $20,000. The debtor ultimately repaid the entire amount outstanding on the loan without litigation.[81]

One of the most important factors in fending off repossession is the debtor's ability to persuade the lender that the debtor can be trusted to "do the right thing" and pay off its obligation. Surprisingly, the lender's evaluation of the debtor's character usually proceeds with little or no personal interaction; in only four of the cases did the account executive ever have any significant personal knowledge about the principal of the debtor.[82] Much more crucial to the situation was the debtor's pattern of payments when faced with distress. When the debtor could convince the lender that it was mak-

78. To be sure, the applicable provisions of the standard floorplan agreement, quoted at *supra* note 21, require the manufacturer to reimburse the lender for the costs of repossession. That contractual assurance, however, is not sufficient to assuage the concerns of the decisionmakers faced with problem debtors. Among other things, it is doubtful that it covers the lender's exposure to a tort judgment for a misstep in the repossession process. Another plausible reason, suggested to me by Paul Shupack although not raised in my discussions with the account executives, is the need to maintain good relationships with the manufacturers, which would tend to limit the desire of the lender to call the manufacturer on its repurchase obligation.

79. That is a particular problem in the computer industry, where products become obsolete in a matter of months. *See* Telephone Interview with Andrea J. Dunn, Worldwide Credit Manager, Corporate Treasury, Hewlett-Packard Company (Jan. 4, 1996) (discussing Hewlett-Packard's reluctance to agree to repurchase obsolete computer equipment). The lender monitors that situation closely; its standard report forms include information about the amount of collateral that is "out of" repurchase.

80. *See* Profile 7.

81. For a similar situation, see Profile 19, which refers to a "very weak" repurchase agreement as a basis for refraining from repossession.

82. *See* Profile 12; Profile 17; Profile 18; Profile 23. In one other case, the lender was influenced by a positive impression of the professional reputation of a newly hired comptroller. *See* Profile 19.

ing payments as it sold the collateral, the lender generally would be comfortable allowing the situation to continue undisturbed.[83] Similarly, a debtor that responded to termination by making a commitment to pay off the outstanding balance over a specified period of time ordinarily was given an opportunity to meet that payment schedule, even in cases where the schedule proposed by the debtor was quite prolonged.[84]

One final reason for leaving the debtor in possession is that it enhances the likelihood that the debtor can obtain refinancing. Legal scholars generally assume that a decision by a lender to terminate a line of credit exerts tremendous leverage on a debtor because of the debtor's inability to obtain financing from a new lender in the face of one lender's decision to terminate a relationship.[85] As it happens, however, debtors in at least four of the twenty-three cases (17%) paid off the balance that they owed to the lender through funds obtained from a new lender.[86] In two of the twenty-three cases, the lender's decision to put off repossession was explicitly motivated in part by a desire to enhance the debtor's opportu-

83. *See, e.g.*, Profile 10 (explaining that the lender was not worried that payments regularly came in late during liquidation of the loan because they were no later than they had been before the relationship was terminated).

84. *See* Profile 1 (stating that the lender "trusted" the debtor because he was sending constant payments); Profile 2 (stating that there was "no reason [for the lender] to do anything" because the debtor was making the payments it had promised); Profile 5 (reporting a decision not to repossess that was motivated by the debtor's current payment status and the small size of loan); Profile 6 (reporting a decision not to repossess because the debtor was "basically current or close to it"); Profile 12 (reporting that the debtor's "[c]onsistent payment performance" as promised gave the lender "a lot of faith and confidence" in the debtor and that the lender accepted a 46-week payment schedule proposed by the debtor).

85. The following recent explanation is illustrative:

> [I]n most situations in which loans are made payable on demand, the parties know full well that if the bank calls the loan without warning, the debtor would not be able to pay and would go into default. One might expect that debtors would be reluctant to agree to repayment terms they know they cannot meet. That appears, however, not to be the case.

LoPucki & Warren, *supra* note 30, at 258; *see also* David G. Epstein & Steve H. Nickles, Debt: Bankruptcy, Article 9 and Related Laws, Modern Cases and Materials 207 (1994) (offering a similar discussion of the difficulties of a borrower obtaining funds in the face of acceleration by the primary existing lender); Mann, *Pattern of Secured Credit*, *supra* note 3, at 646 n.74 (discussing the reasons distressed debtors might have difficulty attracting new financing and citing other scholars adopting the same perspective).

86. *See* Profile 13; Profile 18; Profile 20; Profile 21. Four other profiles involved miscellaneous sources of payment other than liquidation of the collateral. *See* Profile 3 (lender drew on a letter of credit); Profile 6 (loan paid off with funds from a one-time sale of intellectual property); Profile 7 (debtor completed its repayments with a lump-sum payment from an unknown source that could have been a new lender); Profile 17 (loan paid off with a new capital contribution). Excluding the single failed business, *see* Profile 23, the remaining situations (14 of 23, 61%) apparently were paid off through the sale of the collateral in the ordinary course of business.

nity to obtain a new lender to pay off the lender.[87] For example, in one case the executive explained that a "very weak" repurchase agreement made "[g]iving them a chance to find a new lender . . . the best way to get paid."[88] In another case, the lender decided to let the debtor operate through the Christmas season, on the view that if the lender "[l]eft them in to do their best sales [and] get a [fiscal year end] statement," the debtor could "try to get a new lender."[89]

The overall picture of the termination process shows a process much more leisurely, and much less destructive, than academics have assumed. The classic picture of liquidation of a secured loan shows a lender calling in the loan in response to default and destroying the debtor's business immediately.[90] That scenario did not occur in a single one of the finance company profiles. Indeed, only one debtor's business failed during the course of liquidation of the debt, and in that case the failure was not precipitated by the lender's actions against the debtor. On the contrary, the debtor in that case filed for bankruptcy with the approval of the lender out of a desire to fend off unsecured trade creditors.[91]

In sum, the lender's decision to terminate its relationship with the debtor was much more an incident of ongoing business than a watershed event. As mentioned above, several of the debtors simply replaced the lender with another institutional lender. Others might have shifted the focus of their businesses, no longer selling inventory from the manufacturer whose sales the lender financed, substituting inventory from other manufacturers from whom financing was available. Still others, of course, ultimately might have failed for lack of adequate financing. But a slow death of that sort is far different from the immediate termination assumed in the scholarly literature.[92]

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87. *See* Profile 19; Profile 21.

88. Profile 19.

89. Profile 21. That strategy paid off when Chase Manhattan paid the loan in full the following February.

90. *See, e.g.*, EPSTEIN & NICKLES, *supra* note 85, at 207; ROBERT L. JORDAN & WILLIAM D. WARREN, SECURED TRANSACTIONS IN PERSONAL PROPERTY 262 (3d ed. 1992); LOPUCKI & WARREN, *supra* note 30, at 275; Scott, *Relational Theory, supra* note 2, at 926-27 (discussing the leverage arising from a creditor's ability "both to seize the debtor's assets . . . and to terminate the financing necessary for the operation of the business"); *see also* Mann, *Pattern of Secured Credit, supra* note 3, at 645-49 (discussing that leverage).

91. *See* Profile 23.

92. I should add that the picture might be different at a finance company less dependent on repurchase agreements. That type of finance company might be more likely to finance all of a debtor's inventory, wherever purchased. In that case, a decision by the lender to terminate might have a more catastrophic effect on the debtor. I doubt, however, that it would be

d. The Costs of Termination. A final topic is the costs of termination: To what extent do lenders profit from financial distress through fees imposed on debtors at the time a loan is selected for termination? In the case of the finance company that I studied, the answer is simple: not much. Ordinarily, the only fee imposed by the lender is a default interest rate, substantially higher than the normal contract interest rate, which is assessed only on amounts that a debtor does not pay in accordance with its regular payment schedule. Because the lender ordinarily does not accelerate the entire amount of the indebtedness when it sends a notice of termination,[93] debtors ordinarily have a substantial opportunity to avoid that charge. The only profile in which the lender actually charged any other fees was the profile in which the debtor filed for bankruptcy. In that transaction the lender charged a modest amount of about $25,000 in attorney's fees on a debt of $1.2 million (about 2% of the debt).[94] Surprisingly, the "no-fees" policy was applied even in profiles in which the lender incurred out-of-pocket expenses for audits and the like.[95] As the branch operations manager explained in discussion of one transaction, there is

> "[n]o point in pissing the dealer off if you can get him to cooperate in a downside situation. It's better to keep on a good working relationship with the dealer so you can collect your money. If you get a dealer mad by charging him $2,000 for an audit fee, he can do little things that make your life a lot harder (like paying somebody else before he pays you)."[96]

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much different, because several of the profiles that I examined in the asset-based lending area — where the lender does not have repurchase agreements — appeared to involve financing of all, or substantially all, of the debtor's inventory. Those profiles, however, showed the same pattern of termination practices as the repurchase-based lending in the other product lines offered by the lender.

93. In all but 3 of the 23 profiles (13%), the lender gave at least 60-days' notice of termination before declaring the entire balance due and payable, and in 2 of the 3 exceptions the lender gave 30-days' notice. *See* Profile 7 (40-days' notice of termination in response to fraud at an inventory audit); Profile 12 (debt accelerated 30 days after 60-day letter based on debtor's failure to make payments during the intervening 30 days). The sole case of immediate acceleration involved an odd case in which a manufacturer unilaterally terminated its guaranty of the debtor's obligations. *See* Profile 16.

94. *See* Profile 23. My characterization of those fees as modest is based on the evidence in Robert M. Lawless et al., *A Glimpse at Professional Fees and Other Direct Costs in Small Firm Bankruptcies*, 1994 U. ILL. L. REV. 847, 868 (suggesting that the average professional fees in a small-business chapter 11 proceeding amounted to 8.66% percent of all assets).

95. *See* Profile 12 (reporting that audit expenses were not passed on to the debtor).

96. Profile 1.

B. *The Bank*

The second of the three case studies involves a bank. The bank is the largest operating subsidiary of a midwestern bank holding company that at the time of my study was about the fiftieth largest banking company in the country, with a 1996 market capitalization of about $3 billion.

1. *The Bank's Lending Transactions*

The bank's lending transactions are much less routine — and thus much more individualized — than the lending transactions of the finance company. Nevertheless, it is reasonably accurate to say that all of the transactions I examined fell into four general types of loans. The first group are amortizing working-capital loans. Those loans provide a one-time infusion of cash, usually either to fund a debtor that is purchasing or establishing a business; occasionally those loans refinance similar existing loans. The second group of loans are standard commercial real estate loans. Those loans ordinarily are relatively long-term amortizing loans, secured by a mortgage on one or more parcels of real estate. The third group of loans are revolving working-capital lines of credit. Those loans typically require relatively small monthly payments and have relatively short terms, allowing the bank to decide on a fairly frequent — usually annual — basis whether it wishes to continue the relationship. The final group of loans are purchase-money loans, specifically, amortizing term loans usually in the three to five year range, used to fund the purchase of specific items of personal property.

2. *Selecting Loans for Study*

As with the finance company, I started my work at the bank with a number of introductory interviews designed to ascertain the most practicable way to collect the information I wanted without undue interference with the lender's daily operations. Ultimately, I decided to review all of the distressed loans that were liquidated by a single bank officer during 1996. The bank provided me a tracking report that listed the file numbers for all such loans and gave me free access to the portions of the files for those loans located in the division at the bank that handles distressed loans, a total of fifteen to twenty feet of files. The printout showed a total of forty-five files. I ultimately excluded seventeen of the forty-five files, either because the information available in the files was insufficient to complete my profile or because the liquidation process had not yet

been completed. I thus ended up collecting profiles on a total of twenty-eight bank loans.[97]

The biggest problem with the selection process at the bank is the possibility that the process was skewed because it represented the portfolio of files assigned to the particular bank officer who was assisting me. The officer in charge of the Special Assets Division does not assign files randomly, but rather based on the skills and workload of the officers in his division. That officer assured me, however, that the sample would not be skewed toward any particular group among the bank's debtors. If anything, he suggested, the loans assigned to this officer might be slightly larger than the average loans that came to his division. Given the wide variety of the loans I reviewed, as discussed below, I do not believe that the problem is critical.

3. *Results of the Profiles*

a. The Debtors. Although the bank's files do not reveal nearly so much information about its debtors as do the finance company's files, it is useful to start by outlining some basic information about the twenty-eight debtors covered by my bank profiles. Thirteen of the debtors were organized as for-profit corporations, fourteen were individuals or sole proprietorships, and one was a benevolent corporation (a church). In each of the cases involving the for-profit corporations, the bank held guaranties from all of the shareholders of the debtor entity.[98] As with the finance company's debtors, the great majority of the debtors had a single location.[99] Finally, at the time of the distress, the median debtor had been borrowing money from the lender for seven years, with a range from one year to twenty-eight years, and had an outstanding balance of between $65,000 and $70,000, with a range from $10,000 to $2.3 million.[100] Of the six profiles in which the bank had outstanding lines of credit,

97. *See* Profiles 26-53.

98. In one of the profiles involving a for-profit corporation, one of the shareholders did not accept complete responsibility. *See* Profile 32. That debtor had two shareholders; one shareholder's guaranty was limited to 25% of the debt. In the profile involving the benevolent corporation, there was no guaranty on the loan. *See* Profile 29. As for the rest of the profiles, the bank's records do not make it clear whether all spouses of the shareholders signed the guaranties.

99. Only eight debtors had multiple locations, *see* Profile 31; Profile 32; Profile 37; Profile 38; Profile 40; Profile 43; Profile 49; Profile 50, and three of those were real estate developers that were not operating retail businesses at the locations, *see* Profile 40; Profile 49; Profile 50. The greatest number of locations was nine. *See* Profile 38. Excluding the three multiple-location real estate loans, the average number of locations was 1.5.

100. Although the median problem loan for the bank is only slightly smaller than the median problem loan for the finance company ($82,000), that obscures the generally larger

three of the debtors had funds remaining available under the line.[101]

b. Selecting Debtors for Termination. The bank's process for selecting loans for termination has two steps.[102] First, when a loan is identified as a serious problem, the loan is transferred from the originating loan officer into a separate group in the bank called, somewhat euphemistically, the Special Assets Division. The most objective occurrence that would result in such a transfer would be the debtor's failure to make two consecutive monthly payments. If a loan becomes ninety days past due, the bank places the loan on "nonaccrual" status: for internal purposes, the bank ceases to regard the asset as accruing interest on an ongoing basis.[103] Because it would reflect poorly on the vigilance of the originating officer if the loan went onto nonaccrual while it still remained in his control, the originating officer ordinarily transfers the loan to the Special Assets Division before the debtor has been delinquent ninety days.[104] In addition to payment defaults, loans might be transferred into the Special Assets Division for more subjective reasons, including a perception that the value of the collateral is insufficient to repay the debt, or concern that the debtor will be unable to repay the loan at its scheduled maturity date.[105]

When the loan is transferred to the Special Assets Division, the officer to whom the loan is assigned promptly reviews the file and constructs an exit strategy for the bank, reflecting the officer's best assessment as to how the bank can maximize its recovery from the loan.[106] Because the strategy in many cases will be to do nothing but wait and hope for the best,[107] the factors that go into the deter-

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nature of the finance company's problem loans: the finance company's average problem loan was in the amount of $484,000, while the bank's average problem loan was "only" $244,000.

101. Three profiles had funds still available, *see* Profile 26; Profile 47; Profile 53, and three did not, *see* Profile 27; Profile 31; Profile 42. Those figures appear to contrast with the finance company data, in which 21 of the 23 debtors had funds available at the time the finance company decided to terminate the relationship. The small number of the bank credit lines, however, dissuades me from placing any significant weight on the difference.

102. The description of the bank's process for selecting loans for termination is based on an informal interview with the loan officer who handled the loans that I studied. *See* Interview with Bank Officer (Nov. 1, 1996) [hereinafter Bank Officer Interview].

103. Nonaccrual status is a wholly internal device, designed to aid the bank in maintaining a conservative estimate of the value of its loans. It does not affect the liability of the debtor. The bank's records include a second balance — the "borrower's balance" — that continues to accrue interest even after the loan is placed on nonaccrual status. *See id.*

104. *See id.*

105. *See id.*

106. *See id.*

107. Because my work is based on loans that actually were liquidated, it is not a random sample of the loans transferred to the Special Assets Division. That is, it does not include

mination of that strategy are the factors relevant to my study: the factors that motivate the lender to terminate its relationship with a debtor.

On that point, the results are in some ways similar to the results of the profiles from the finance company.[108] For example, the debtor's failure to make one or more monthly payments was a significant basis for termination in only three of the twenty-eight profiles (11%),[109] although there were payment defaults in thirteen of the twenty-eight files (46%).[110] Put another way, even in cases where a debtor that had failed to make monthly payments was terminated, the payment default was the basis for termination less than a quarter of the time (3 of 13 profiles, 23%). In the other ten payment-default cases, the most common justification (7 of 10 profiles, 70%) was general concern about the ongoing financial stability of the debtor or its assets.[111] The remaining three cases involved financial distress as well, but more immediate: in two of the profiles the debtor voluntarily closed its business,[112] in the third the debtor advised the bank that it could not successfully pay off the loan and believed that foreclosure was the best alternative.[113]

The relative insignificance of payment defaults also is evidenced by the surprisingly high percentage of the loans that were termi-

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loans where the bank left the loan in place and received payment as agreed in the ordinary course of business. I chose loans the way I did because my goal was to study loans that lenders wish to terminate, not loans that concern them at some lower level insufficient to justify termination. I doubt, however, that the distinction is important; my impression is that very few loans are transferred to the Special Assets Division and left in place without further action.

108. Determining the precise basis of termination is more difficult for the bank than it was for the finance company, because some of the bank's files did not contain specific memoranda addressing the appropriate course of action. In those cases, I relied upon oral statements from the responsible loan officer regarding his motivation at the time he decided to terminate the relationship. The justifications that he offered do not appear to reflect any attempt to portray the bank's actions in an unduly positive manner. As explained below, the principal conclusion of note that I draw from his explanation of those motivations is that the bank frequently terminates loans for reasons not related to payment defaults.

109. *See* Profile 30; Profile 40; Profile 46. The 11% figure arguably overstates the significance of the monthly-payment defaults, because one of those cases was justified by a combination of persistent payment defaults and a serious shortage of collateral.

110. In 8 of the 13 cases noting monthly-payment defaults, the loan reached its scheduled maturity date before the bank terminated the relationship. As I explain below, maturity alone was never a basis for termination.

111. *See* Profile 28 (failure to pay withholding taxes); Profile 34 (inadequate cash flow to service debt); Profile 38 (chronic inability to maintain property); Profile 41 (deterioration in value of barge that served as collateral); Profile 44 (general lack of confidence in the business's future); Profile 47 (obsolescence of the business's main product lines); Profile 50 (negative cash flow).

112. *See* Profile 35; Profile 52.

113. *See* Profile 43.

nated even in the absence of a failure to make a monthly payment (15 of 28 profiles, 53%). In those cases, general concern about financial strength again was the most common motivating factor (7 of 15 profiles, 47%).[114] Another significant group of files (5 of 15 non-late payment profiles, 33%) involved situations where the debtor voluntarily "surrendered": two cases where the debtor voluntarily closed its business,[115] two cases where the debtor advised the bank that it was unable to satisfy its financial obligations,[116] and one case where the debtor filed bankruptcy for reasons unrelated to the creditor's pursuit of its remedies.[117] The last three non-late payment profiles (20% of that group) involved assorted character-related problems serious enough to motivate the lender to take action: one case in which the debtor fraudulently failed to report sales of several automobiles in which the lender had a lien;[118] one case in which the debtor refused to provide inventory reports and financial statements;[119] and one case in which the debtor was a physician convicted of felony sexual abuse of his patients.[120]

In sum, like the finance company, the bank's principal justification for deciding to terminate its relationships was concern about financial strength (14 profiles, 50%). Indeed, to give adequate weight to financial strength as a motivating factor, those profiles should be aggregated with the substantial group of profiles in which the debtor voluntarily determined that it could not satisfy its financial obligations, as evidenced either by a direct communication to the bank or a decision to close its business (8 profiles, 29%). Taken together, those two groups constitute more than seventy-five percent of the bank profiles. Payment default is much less significant, being the stated reason for termination in only three of the bank profiles (11%), the same as the character-problem terminations.

The last significant piece of the bank's process for termination is the role of the maturity date. Each of the bank loans that I studied called for monthly payments that included both principal and inter-

114. *See* Profile 26 (filing of state tax liens against a related party that provided supplies to the debtor); Profile 27 (precipitous decline in sales); Profile 32 (negative cash flow); Profile 45 (poor credit reports on debtor); Profile 49 (inadequate debt-service coverage); Profile 51 (rapid decline in value of securities pledged as collateral); Profile 53 (poor financial results that left debtor overextended on its line of credit).

115. *See* Profile 39; Profile 42.

116. *See* Profile 29; Profile 37.

117. *See* Profile 48 (reporting that the debtor filed for bankruptcy without committing any default whatsoever on the loan).

118. *See* Profile 31.

119. *See* Profile 33.

120. *See* Profile 36.

est; thus, a continued schedule of those payments eventually would pay off the loan. In only a few cases, however (7 profiles, 25%), was the term long enough to allow the payments to amortize the loan completely. In the other twenty-one profiles, the loan was scheduled to mature with a significant balance still outstanding. The nature of the bank's business — primarily the incentive to continue lending relationships as long as they appear to be profitable — leads the bank to renew loans at maturity as a matter of course just as it leads the finance company to continue lending relationships that technically are at-will. Maturity alone rarely would be a reason for termination, absent some underlying concern about the continued profitability of the transaction. The maturity date does, however, give the bank a free opportunity to terminate loan relationships without pointing to a particular default.

My profiles suggest that the relatively short maturity dates play a functional role similar to the role of the "at-will" feature of the finance company's arrangement. They allow the bank to use the maturity date as a clear and objective justification for terminations based on subjective concerns about financial strength, obviating any need for requiring the bank to justify those concerns to the debtor. Thus, of the fourteen profiles where financial strength was the lender's primary reason for terminating the relationship, the loans had matured in eleven. Because one of the other three cases involved a persistent payment default,[121] the lender had to rely on financial problems as a basis for termination in only two of the fourteen cases in which that was the actual reason.[122]

c. The Process of Termination. The next step is to examine what happened after the bank decided to terminate the loans. The general picture at the bank resembles the picture at the finance company in two ways. First, even in cases in which the bank decides that it wants to terminate the lending relationship, it is quite unusual for the bank forcibly to repossess and liquidate its collateral. Second, as with the finance company profiles, the bank's demand for payment or refusal to extend a maturing loan is not at all likely to lead to a business failure or bankruptcy; it is much more likely that the debtor will repay the bank by selling the property or refinancing the loan with another institutional lender. Indeed, all but

121. *See* Profile 50 (reporting the termination of a loan where the debtor's business was failing to make payments because of negative cash flow).

122. *See* Profile 51 (reporting the termination of a loan when a precipitous decline in the value of pledged securities left the bank undersecured); Profile 53 (reporting that poor financial results left the debtor overextended on its line of credit).

one of the business failures in my bank profiles arose from a voluntary decision of the debtor that was made *before* the bank decided to take action.

First the repossession point. Like the finance company profiles, not a single one of my twenty-eight bank profiles revealed a forced repossession and liquidation of collateral. Only one profile even reached the first step: a forced repossession.[123] The bank was motivated to act in that case by a combination of several circumstances. The bank decided that it wanted to terminate the relationship in response to a report from an affiliated bank of a serious default on a loan to the debtor's main supplier, an entity under common ownership with the debtor. The bank met with the debtor several times over the course of seventy-five days but eventually decided to pursue repossession when it was unable to obtain either a payment to reduce the loan balance or current financial statements for the debtor. Interestingly, even in that case the bank did not liquidate the collateral after repossession. Rather, it held the collateral for about a month and then released the collateral to the debtor when the bank's loan was paid off through refinancing by another bank.

The reason for the reluctance to repossess was put most succinctly by the officer in charge of the Special Assets Division, who explained his general perception on repossession: "[A] decision to go out and get the collateral is a decision not to get paid in full."[124] As long as the bank does not go out and get the collateral, the bank has a substantial chance of being paid in full through one of several reasonably likely courses of events: a sale of the business, a refinancing of the loan by another lender, or continued operation of the business long enough to defray the outstanding balance of the debt.

By contrast, a decision to repossess collateral ordinarily ends the possibility that payment will come from any of those three alternatives and leaves the lender only with the possibility that payment can be obtained from liquidation of the collateral and pursuit of the debtor's principal for any deficiency. On that point, the files I reviewed are replete with evidence of frustration at the limited likelihood that the bank could obtain full repayment through liquidation. For example, even in the profile where the bank did repossess collateral forcibly, it determined that the collateral could be sold for at most $50,000, hardly a positive outcome for a loan with an out-

123. *See* Profile 26.

124. Interview with Bank Division Manager (Nov. 14, 1996) [hereinafter Bank Division Manager Interview].

standing balance of about $295,000. The bank waited thirty days and it was paid in full when another bank refinanced the loan.[125]

That perspective appeared in cases governing a wide variety of collateral, including used automobile-repair equipment,[126] obsolete data-processing equipment,[127] street-construction equipment,[128] and commercial real estate.[129] The problem was exacerbated when the collateral was located out of state because the bank would have to hire third parties to act at a distance or incur the expenses of sending an officer to the remote location.[130]

The fear of repossession governed the bank's actions even when the collateral included highly liquid items like motor vehicles. For example, in a profile involving loans to an automobile dealership, the officer indicated that the most he could have received upon repossession would have been a net of ninety-seven percent of the original invoiced cost. Because the debtor was out of balance on the line of credit, that would not have been enough to repay the loan. By allowing the business to continue to operate, the bank made it possible for the entire business to be sold in place at a significantly higher price.[131] Similarly, in a loan in which the collateral was a single automobile, the officer indicated that he decided not to repossess the car because the owner had moved to another town — which elevated the cost of repossession — and because he had personal knowledge that the car was in poor condition. In that case the debtor eventually repaid the loan in full, with interest and late charges, through small monthly payments.[132]

Again, as with the finance company, the strategy of leaving the debtor in control of the collateral worked surprisingly well. The bank took a loss in only seven of my twenty-eight bank profiles (25%). Of those seven, four were profiles in which the debtor closed its business *before* the lender took any action and one was a

125. *See* Profile 26.

126. *See* Profile 34; Profile 44.

127. *See* Profile 32.

128. *See* Profile 28.

129. *See* Profile 40.

130. *See* Profile 33 (inventory of out-of-state discount store); Profile 46 (out-of-state travel agent).

131. *See* Profile 31. The bank still took a loss of about $100,000 on a loan of $1,000,000. The deficiency after the sale of the business was about $160,000. The bank released one of the two guarantors — the one that the bank considered less culpable — for a payment of $60,000. It was unable to collect from the second guarantor because that guarantor had a stroke shortly after the sale of the business, became insolvent, and ultimately filed for bankruptcy.

132. *See* Profile 30.

profile where the debtor asked for a foreclosure based on its own determination that it would not be able to repay the loan. In all, the bank took a loss in only two of the twenty-one profiles in which it left the debtor in control of the collateral even after the bank decided to terminate the relationship. To put that number in perspective, note that five of the seven profiles in which the bank took a loss came in the six profiles in which the debtor itself decided that the assets should be liquidated.[133] The bank lost money in five of six profiles (83%) in which the debtor decided that the assets should be liquidated, but in only two of twenty-one profiles (10%) in which the bank refrained from repossession.[134]

The profiles offer two related explanations for the general success of the bank's strategy of leaving the debtor in control. First, even after their finances had deteriorated to the point that the bank no longer wanted them as customers, the debtors were able to obtain refinancing from other institutional lenders with a frequency that I found astonishing. In nine of the twenty-eight profiles (32%) the bank was paid in full through a straight refinancing by another financial institution, with six of the refinancings coming from other banks.[135] In another three profiles, which involved real estate collateral (11% of all the bank profiles), the debtor paid the loan in full by selling the collateral to a third party at a sales price that exceeded the amount of the bank's debt.[136] Those numbers are even more impressive when I remove the two profiles in which

133. The bank took a loss in the profile where the debtor asked for foreclosure, *see* Profile 43, and in four profiles where the debtor voluntarily closed the business, *see* Profile 35; Profile 39; Profile 42; Profile 48. The bank did not take a loss in Profile 52, even though the business failed.

134. Those two profiles included the profile involving the automobile dealership, *see supra* note 131 and accompanying text, and the one significant bankruptcy proceeding, *see infra* notes 139-141 and accompanying text. The two groups of profiles — 21 in which the bank did not repossess and 6 in which the debtor voluntarily gave up — do not add up to 28 because there is one additional profile, which presented the odd situation where the bank repossessed the collateral but did not liquidate it. *See* Profile 26. That strategy resulted in full payment.

135. *See* Profile 26; Profile 27; Profile 34; Profile 36; Profile 40; Profile 41; Profile 44; Profile 45; Profile 50. That figure is conservative because it includes only the cases where the bank knew that the debtor repaid the loan through refinancing. In one case the bank did not know the source of the funds the debtor used for repayment. *See* Profile 46.

136. *See* Profile 29; Profile 37; Profile 49. In one of those cases, the new financing came from the bank itself, impressed with a personal guaranty from the purchaser that made the collateral safer than it was in the hands of the existing debtor. *See* Profile 29. In two other profiles, the bank consented to sales at amounts inadequate to satisfy the debt. It ended up taking a modest loss on one of those transactions, *see* Profile 31, but was paid in full in the other, *see* Profile 47.

there was no operating business[137] and the six profiles in which the debtors themselves decided that the assets should be liquidated.[138] The debtors used a sale or refinancing to repay their obligations in full in twelve of twenty profiles (60%) in which the debtor was still in operation at the time the bank decided to terminate the relationship.

The second reason that the bank's strategy was successful relates closely to the wide availability of refinancing: businesses survived. It was quite unusual for the bank's decision to terminate the loan to result in a failure of the debtor's business. Indeed, of the twenty profiles in which a business was operating at the time the bank decided to terminate the loan, nineteen of the businesses still were operating at the time of my research.

The only exception was a profile in which a manufacturing business filed bankruptcy after the bank decided to stop making advances under the business's line of credit.[139] Even in that case, the bank did not intend to force the debtor into bankruptcy when it stopped making advances under the line of credit. The bank stopped making advances because the debtor's deteriorating sales had allowed the amount outstanding on the line of credit to move beyond the authorized amount and — more troubling to the bank — apparently quite far beyond the value of the existing collateral. At the time, the bank believed that the debtor had sufficient raw materials on hand to continue operations for quite some time. The bank also thought that negotiations toward resolving the problem by altering the scope of the debtor's operations were going well when the debtor unexpectedly sought relief under Chapter 11 of the Bankruptcy Code. The officer viewed the bankruptcy filing as a mistake from the debtor's perspective,[140] which he attributed to the inexperience of the debtor's attorney:

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137. Profile 30 involved a note secured by an automobile without any operating business. Profile 51 involved a note secured by securities that had been given in satisfaction of a previous real estate loan.

138. *See supra* note 133 (listing those six profiles).

139. *See* Profile 53. There was one other debtor bankruptcy, *see* Profile 48, but the debtor on that loan filed for bankruptcy even before the bank became aware of the business's financial distress. *See infra* text accompanying note 142.

140. After about two years in bankruptcy, the bankruptcy court approved a plan of reorganization under which the business was liquidated and all of the proceeds of the sale were distributed to the bank. The liquidation of the tangible collateral and most of the accounts produced enough to repay with interest all but about $130,000 of the $1.1 million that had been outstanding at the time of the bankruptcy. The bank then entered into a settlement agreement under which it agreed to release the guarantors in return for a share of payments from future collections on the remaining accounts. Under that arrangement, the bank ended up being repaid all of the debt, including costs and attorney fees, except for about $50,000.

> It was a puzzle to us because nobody really expected it. One week we had a meeting saying, 'hey, you're not performing, we're concerned,' and the next week they filed bankruptcy. . . . They could have made it. If they had the right help, they could have made it. The only reason they filed bankruptcy is that they thought we were coming to get them. They overreacted. We could have worked it out. If they had [an attorney] who had been through this situation before, they could have gotten through it: gotten rid of the [relatively incompetent son-in-law of the original operator], worked through it.

It is possible of course that the bank officer's explanation paints his actions as more accommodating than they appeared to the debtor at the time. On the other hand, the bank's actions in the other profiles I reviewed convince me of the plausibility of the officer's perspective. Among other things, it is clear that the bank had not moved decisively to collect the loan. When the debtor filed for bankruptcy the bank had taken no steps to obtain possession of the collateral. Specifically, the bank had not sought to repossess the tangible collateral or taken steps to collect any of the debtor's accounts receivable. It is understandable that the debtor would expect the hammer to fall at any moment, but the fact remains that the bank was not in the habit of taking that kind of decisive action, and an attorney experienced in such matters would have known that.[141]

Related to the general ability of the debtors to survive is the relative infrequency of bankruptcy. In addition to the case discussed above, only one other debtor filed for bankruptcy.[142] In that transaction, the debtor took its business straight into a Chapter 7 liquidation even before the bank was aware of the debtor's financial distress. That profile offers a good example of the general destructiveness of liquidation. The bank's loan balance at the time of the bankruptcy was $64,000. The collateral was liquidated for $15,800 at a cost of $4,300, twenty-seven percent of the sales price. The bank then recovered ninety percent of the loan balance by exercising its rights under a guaranty from the Small Business Administration.

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141. Given the relative rarity with which lawyers are involved in the disposition of distressed debt, it is understandable that a practicing attorney would not have a good understanding of the likelihood that a bank would respond forcibly in such a situation. As mentioned below, the lender retained legal counsel in only 2 of the 28 profiles. *See infra* note 153. That occurrence is similar to the results of the finance company profiles, in which the lender incurred attorney's fees in only 1 of the 23 profiles. *See supra* notes 93-96 and accompanying text (discussing costs incurred in finance company profiles). I should add that in-house counsel did not appear to have spent any significant time on any of the cases in which outside legal counsel was not retained.

142. *See* Profile 48.

The only other incidents of bankruptcy were three cases in which individual principals of debtor corporations filed bankruptcy after liquidation of the loan to the corporation. In one of those cases, the bank recovered the rest of its outstanding debt from the proceeds of a foreclosure on a deed of trust securing the bank's guaranty.[143] In the other two cases, where the guaranties were unsecured, the bank did not participate in the bankruptcy and did not receive any recovery.[144]

d. The Costs of Termination. The bank's response to recovering costs in financial distress is much more difficult to assess than that of the finance company. As discussed above, the finance company did not often charge fees on distressed loans, largely because of a desire to keep the debtor's principals motivated to work the problem out successfully. The bank, by contrast, does appear in at least a few cases to profit from the distressed state of its debtors.

The first point to note about the bank's response to recovering costs is that the Special Assets Division at the bank is a separate division responsible for its own profitability.[145] Accordingly, the division has a substantial direct incentive to maximize the income from its portfolio. Under current conditions the division actually earns a profit, even though the only assets under its control are the bank's most distressed loans.[146] Of course that does not mean that the division is earning as high a return as the divisions that hold performing assets, but it does indicate some success at collecting revenues from the distressed debtors for which it is responsible.

The second point is that both the division manager and the loan officer who had handled the loans in my sample responded to my question about their ability to profit from the distress of their debtors with the same general answer. As a general matter, they explained, one of their most common responses to distress is to

143. *See* Profile 47.

144. *See* Profile 31; Profile 42. In Profile 31, the bank considered filing a motion seeking to except the debt from discharge on the theory that the individual debtor had committed fraud. The individual had sold several automobiles on which the bank had a lien without reporting the sales to the bank. The bank ultimately decided that it was not worth the effort of filing the motion. Instead, it referred the matter to the FBI for investigation. That investigation terminated when the individual suffered a stroke.

145. The profitability of the division is determined as the difference between (1) the income the division earns from payments on the loans for which it is responsible, and (2) the sum of the amounts written off as unrecoverable and an imputed interest expense based on the bank's current cost of funds.

146. In order to ensure that the separate loan-originating divisions of the bank have an adequate incentive not to originate problem loans, the profit or loss of the Special Assets Division is allocated in pro rata shares back to the various divisions from which its loans came.

require an increase in the interest rate as a condition of any extension beyond the stated maturity date of the loan.[147] The reason for the increase is simple: it gives the debtor the most direct incentive to deal with the problem by refinancing or selling the underlying collateral.

My profiles confirmed the use of that strategy but indicated that it may not be quite as uniform a practice as they suggested. In the eleven profiles in which the lender granted a formal extension of the date of maturity, the lender raised the interest rate in six profiles (55%).[148] In three (27%),[149] the lender did not change the interest rate at all, and in three (27%),[150] the lender in fact dropped the interest rate. In the few cases where the bank dropped the rate, the motivation appeared to parallel the finance company's philosophy: a gesture of good faith to enhance the likelihood that the debtor would pay something.[151]

Given the low rate of losses on any of the loans, it is difficult to assess the success of the strategy; a direct evaluation of the strategy would require a process in which lenders tried both foreclosure and extension on loans that appeared to them to be identical in relevant respects. It is worth pointing out, however, that the bank did not lose money on any of the loans in which it agreed to an extension. That might reflect the skewing of the group of loans in which the bank agreed to an extension. One explanation would be that the bank agreed to an extension only in cases in which it believed the debtor was highly likely to succeed in paying off the loan at a later date; the results then would mean only that the bank was correct in all eleven of the profiles in which it made that determination.

The bank officer's explanation, however, does have considerable plausibility. It is easy to see that the increased interest rate can be an effective device for motivating the debtor to seek refinancing. If a savvy debtor understands the limited likelihood that the bank

147. Both officers indicated that the bank's desire to raise interest rates in that situation was not tied to a need to adjust rates to reflect changes in prevailing market rates. Instead, as the text suggests, the motivating factor was the desire to induce the debtor to respond to the problem.

148. *See* Profile 34; Profile 36; Profile 37; Profile 38; Profile 45; Profile 50.

149. *See* Profile 32; Profile 44; Profile 49.

150. *See* Profile 29; Profile 38; Profile 40. The number of profiles does not add up to 11 because in one case, Profile 38, the lender did both: it raised the interest rate in connection with one extension and subsequently dropped the interest rate in connection with a later extension.

151. The textual explanation is not particularly valuable as a general explanation of the bank's policies because of the small number of cases and because the officer to whom I spoke strongly disagreed with the decision to lower the interest rate in Profile 38. It is, however, the best explanation I have to offer.

actually will repossess, the bank has few significant levers to encourage the debtor to go to the trouble to find a new lender. By adjusting the cost of continuing to do business with the terminating bank to a rate that reflects the elevated risk of the distressed loan, the bank can put the debtor in a situation where it can save money by refinancing and switching to another lender — presumably a lender that specializes in loans that are riskier than those that the bank prefers to hold and presumably at an interest rate higher than the rate the bank initially was charging yet lower than the elevated rate the bank is charging after the extension.[152]

Aside from the increased interest rate, the incidence of charges connected with default was relatively small and unlikely to be profitable for the bank. In nineteen of the profiles, the bank charged no fees whatsoever — excluding from consideration any of the interest-rate increases described above. In four profiles, the bank sought reimbursement for various expenses.[153] In only six of the profiles did the bank assess charges that did not clearly reflect actual expenses that it had incurred: late charges in five profiles[154] and a $250 extension fee in one profile.[155] Although the files did not contain information sufficient for me to determine the precise amount of those charges, the officer characterized them as nominal in most of the cases. The only profiles in which the officer thought the charges were significant were two profiles in which the officer deliberately was attempting to put as much pressure as possible on the debtor.[156]

152. For a more general discussion of the way in which the market for distressed debtors responds to distressed debtors by moving them to more risk-tolerant lenders, see *infra* section II.A.1.a.

153. *See* Profile 26 (legal fees and liquidator's fees associated with repossession); Profile 27 (cost of third-party inventory audit); Profile 48 (liquidator's fees); Profile 53 (payment from Chapter 11 estate of accountant fees of debtor and attorney's fees incurred by lender). Because the bank ordinarily charged its debtors fees to compensate for the time of its in-house counsel, I can determine that the bank did not retain in-house or external counsel in any cases other than those listed above.

154. *See* Profile 26; Profile 30; Profile 31; Profile 38; Profile 47.

155. *See* Profile 49.

156. *See* Profile 26 (reporting that the bank repossessed collateral in response to a perception that the debtor was not negotiating with the bank in good faith); Profile 38 (reporting that the bank officer assessed all possible late charges as part of a concerted effort to motivate the debtor to refinance the loan).

C. *The Insurance Company*

The third of the three case studies involves a large national life insurance company with a portfolio that consists almost exclusively of commercial real estate loans.[157]

1. *Selecting Loans for Study*

The process of obtaining files of distressed loans at the insurance company was considerably more difficult than at the finance company and the bank. For reasons that should become clear from the results discussed below, the process of liquidating distressed loans at the insurance company is much more protracted than it is at the bank and the finance company. Accordingly, the need to find a group of files in which liquidation had been completed forced me to draw my distressed loans from a historical portfolio of distressed loans at some time several years in the past. Not surprisingly, it was clear from my first conversations with personnel in the real estate investment division of the insurance company that efforts to review files from older loans would be hampered both by turnover of personnel during the intervening years and by the difficulty of locating complete files.

Ultimately, my contact at the insurance company provided me a list of all of the loans in the insurance company's portfolio as of May 1992, when she began to work at the insurance company. The list assigned a rating to each loan ranging from one to five, in which one is the highest rating, three is the standard rating, and five is the lowest rating. Based on discussion with my contact, I decided that loans rated four and five would be the best loans for my project. Because loans rated one, two, and three are either normal or above normal, it was clear that they should be excluded. It was clearly appropriate to include loans rated five because those are loans for which the insurance company expects to take a loss of all or a portion of its principal. I decided that I also would include loans rated four, based on a description of that rating as covering loans "with some hair on them," normally with debt-service coverage dropping down to 1.0, or some other basis for believing that default is imminent.[158] The portfolio included 117 loans with those two ratings,

157. *See, e.g.*, MICHAEL T. MADISON & ROBERT M. ZINMAN, MODERN REAL ESTATE FINANCING: A TRANSACTIONAL APPROACH 360-64 (1991) (reporting statistics indicating that insurance companies tend to invest in long-term real estate loans and offering reasons for that tendency).

158. By debt-service coverage, I refer to the extent to which cash flow "covers" debt service — the ratio of cash flow to debt service. My description of the rating system is drawn

from which I randomly selected sixty.[159] The insurance company then collected all of the files that it could locate for those sixty loans and brought them to a central location, a total of about 150 boxes of files.[160]

My review of the loans consisted of examination of the relevant files and discussions with several executives at the insurance company, including officers with legal and business responsibility for distressed loans during the time that the insurance company dealt with the loans in my sample. Because of the difficulty of locating complete files several years after the distressed loans I wanted to study, and because of the turnover of personnel at the insurance company, I was able to gather sufficient information to complete a usable profile on only twenty-one of the sixty loans.

In some ways, the process of selection at the insurance company is superior to the process I used at the bank and finance company. In particular, because the sample was drawn randomly from the insurance company's entire portfolio, the risk that the group is unrepresentative because of selection bias is much less than it is at the finance company and the bank, where I worked from problem loans of particular officers at particular times. The small yield of my selection process (21 of 60, 35%) does not strike me as a serious problem because I see no reason to expect a connection between the company's ability to locate complete files on the transaction several years after the event and the results I would have found for the transaction.[161]

2. *Results of the Profiles*

a. The Debtors. The insurance company's files revealed nothing surprising about the composition of the debtors that fell into distress. The most common form of entity for the twenty-one debtors was a limited partnership (7 debtors, 33%), followed by trusts (6

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from Interview with Insurance Company Executive (Dec. 20, 1996) [hereinafter Insurance Company Executive Interview].

159. I took every second loan rated four and every second loan rated five. To get my sample up to 60 loans, I then took the loan located at the center of the remaining unselected loans.

160. It should be obvious that this process reflected the insurance company's commitment of a substantial amount of resources to my project.

161. One reader suggested that incomplete files might correlate with the complexity or difficulty of the cases. That certainly is possible but seems unlikely. If anything, complex cases seemed more likely to leave a significant enough paper trail for me to reconstruct the transaction sufficiently for my purposes even when a large portion of the file was missing.

debtors, 29%),[162] general partnerships (5 debtors, 24%), corporations (2 debtors, 10%), and one sole proprietorship (5%). The great majority of the projects (15, 71%) were office buildings, with the remaining six projects including two hotels (10%), one luxury condominium building, one enclosed mall, one community shopping center, and one apartment project (5% each). The debtors were concentrated in the northeast, with five each from New York — four of which were from Manhattan — and New Jersey, four from Massachusetts, two from Virginia — both of which were from suburban Washington, D.C. — and one each from New Hampshire, Rhode Island, Pennsylvania, Maryland, and South Carolina.

In two important respects, the loans were quite different from the bank and finance company loans. First, all of the loans were nonrecourse, with the insurance company's sole avenue for repayment being recourse to the collateral; the insurance company had guaranties in none of the transactions.[163] Second, the loans were much larger. The median outstanding loan amount was $12 million, with a range from $1.65 million to $91 million; the average amount was $20.9 million.

b. The Process of Termination. The process by which the insurance company responds to troubled loans is significantly different from the processes at the bank and finance company. In particular, the decisions to terminate the relationship and to remove the debtor from possession of the collateral are much more closely related than they are at the bank and the finance company. In the insurance company context, a decision that the relationship cannot be salvaged ordinarily is associated with relatively prompt action to remove the debtor from possession of the collateral.[164] Accord-

162. The high incidence of trusts is explained by the volume of Massachusetts loans in the lender's portfolio. The four Massachusetts loans provided four of the six trust profiles in my sample. The Massachusetts business trust has long been a traditional vehicle for operating businesses, which has never really caught on elsewhere.

163. Two of the profiles had guaranties ensuring financial stability at the beginning of the transaction. One guaranteed that the project would be leased up. *See* Profile 70. The other guaranteed that debt-service coverage would reach a specified level. *See* Profile 72. In each case, the guaranty had lapsed before the loan fell into the distress that led to its low rating.

164. Although it is a bit beyond my purpose here to explain the difference in approach, I tentatively would attribute the difference to some fundamental differences in the loan transactions. The transactions of the bank and finance company frequently involved operating businesses that could generate funds to reduce the loan amount through the ordinary process of selling individual items of inventory or services. The insurance company's transactions, by contrast, almost always involved single-asset transactions where the loan was likely to be paid off only through a one-time sale of the entire collateral. Furthermore, although the results of the insurance company profiles indicate that the borrowers frequently are the highest-valuing users of the assets that they have pledged as collateral, I do not think that real estate suffers nearly as precipitous a decline in value upon a transfer of possession as the operating personal-property businesses I examined at the finance company and the bank.

ingly, the appropriate inquiry is to determine exactly what it takes to motivate an insurance company to remove its debtor from possession.

The basic answer to that inquiry resonates with the results of the bank and finance company profiles. The debtor's inability to conform to the agreed payment schedule is rarely an adequate reason for the insurance company to remove a debtor from possession. The key question for the insurance company is whether the debtor is contributing value to the asset to justify allowing the debtor to remain in possession with the concomitant opportunity to recover value from future appreciation of the asset.[165] The contribution could take the form of cash contributed to cover cash-flow shortages or it could take the form of expertise or management services that support the value of the asset more cheaply than the insurance company could if it took possession itself. But as long as the insurance company believes that the debtor is making such a contribution, the insurance company is likely to leave the debtor in possession.[166]

The first piece of evidence supporting that thesis is the insurance company's response to payment defaults in my sample profiles. Every one of those profiles involved a serious failure to adhere to the payment schedule. Twelve of the twenty-one profiles (57%) involved complete financial collapse: the debtor either stopped making payments entirely or advised the lender that it was unable to make payments.[167]

Although the other nine profiles did not involve a complete cessation of payments, they did involve two types of payment problems that justifiably put the lender in a position of serious concern. The bulk (7 profiles, 33% of the insurance-company sample) involved the debtor's failure to refinance the loan at its maturity.[168] Unlike the bank and finance company, the insurance company is

165. As I see it, that question is structurally similar to the implicit question the bank and finance company executives ask in determining whether to leave their debtors in possession. In those contexts, the debtor's contribution is clear: operating the business allows the collateral to be sold at retail value instead of being liquidated for almost nothing. Steve Harris has suggested to me that one way to explain the different results in the insurance company profiles is to acknowledge that the answer to that question is much less uniform for real estate collateral because it often requires considerably less specialized skill to operate.

166. The general discussion in the foregoing paragraph is based on the Insurance Company Executive Interview, *supra* note 158.

167. *See* Profile 56; Profile 57; Profile 58; Profile 59; Profile 60; Profile 62; Profile 64; Profile 65; Profile 66; Profile 67; Profile 69; Profile 72. In Profiles 73 and 74, the debtor advised the lender that it would not be able to make payments before it actually stopped making the payments.

168. *See* Profile 54; Profile 55; Profile 61; Profile 63; Profile 68; Profile 70; Profile 71.

deeply troubled when one of its debtors fails to arrange for repayment of one of the insurance company's loans before the scheduled date of maturity. The basic reason for the insurance company's perspective is that the insurance company, unlike the bank and finance company, does not operate on the assumption that it will renew its lending relationships indefinitely: the baseline response to maturity is an unwillingness to extend rather than a desire to extend. Among other things, a voluntary decision to extend a loan past the originally scheduled maturity date would require an evaluation of the loan commensurate with the evaluation that was made at the time the loan originally was issued. Because the insurance company's portfolio managers constantly shift their investment criteria to enhance the balance and diversification of the insurance company's portfolio,[169] it is quite ordinary for the insurance company to prefer that a loan be repaid at the stated date of maturity. That could be true even if the debtor had performed as agreed during the term of the agreement and even if the debtor exhibited no objective signs of serious financial distress; termination of such a loan would be quite an unusual response for the bank or finance company. To be sure, I note below the insurance company's decision to extend several of the loans in my sample; those extensions, however, were viewed as the most prudent response to distress — making the best of a bad situation — not as affirmatively positive extensions of credit.

In the final two profiles (10%),[170] the debtor had not defaulted on payments owed to the insurance company, but instead had failed to make a property-tax payment. Given the serious consequences of a debtor's failure to maintain tax payments, which include the prospect that a tax lien will gain priority over the insurance company's mortgage,[171] the insurance company justifiably views that type of default as a basis for immediate action.

Notwithstanding those serious defaults, the first response of the insurance company was not to move unilaterally to take possession of the collateral at the first opportunity. Rather, the most common response (12 profiles, 57%) was for the lender to agree to a formal arrangement accepting less onerous payment terms than those to

169. *See, e.g.*, MARCIA STIGUM, THE MONEY MARKET 106-09 (3d ed. 1990) (summarizing the need for portfolio managers to match the duration of assets and liabilities).

170. *See* Profile 57; Profile 69.

171. *See, e.g.*, BAIRD & JACKSON, *supra* note 30, at 636; LOPUCKI & WARREN, *supra* note 30, at 748.

which the debtor originally had agreed.[172] In each of those twelve loans, the arrangement involved a diminution of the scheduled monthly payment; in most (10 of those 12 profiles) the arrangement also involved an extension of the date of maturity.[173]

The key question for my purposes is what debtors had to offer to convince the lender to agree to such a modification. The easiest situations were those where the principals of the debtor agreed to make present or future cash contributions to support the property. In eight of the twelve profiles in which the lender agreed to formal payment concessions, the debtor agreed to make significant cash contributions of one form or another.[174] Those contributions included one-time cash infusions,[175] unspecified contributions to fund chronic cash-flow deficits,[176] funds needed for tenant improvements[177] or to resolve environmental hazards,[178] and agreements to increase the rate at which interest accrued on the loan.[179]

In a few profiles (2 of the 12 in which the lender granted formal payment concessions), the lender's principal motivation was the less objective determination that particular expertise or management skills on the part of the debtor would provide the lender a significant benefit that justified leaving the distressed asset in the debtor's control.[180] In one case involving a property in Maryland near Washington, D.C., the lender left the debtor in control based on its perspective that the debtor was unusually able and active in its efforts to maintain value in the face of a significant decline in the

172. *See* Profile 54; Profile 56; Profile 57; Profile 61; Profile 62; Profile 63; Profile 64; Profile 65; Profile 66; Profile 67; Profile 73; Profile 74.

173. The lender did not extend the maturity date in Profile 64 (shortening the maturity date by one year) or Profile 66 (retaining the same maturity date).

174. *See* Profile 54; Profile 57; Profile 62; Profile 65; Profile 66; Profile 67; Profile 73; Profile 74.

175. *See* Profile 73 (reporting an infusion of a total of $25 million on a group of distressed properties, including $6 million to reduce the balance on the loan I studied by about 30%); Profile 74 (reporting an infusion of $200,000 to reduce the balance on the loan I studied by about 2.5%).

176. *See* Profile 54.

177. *See* Profile 57; Profile 67. In Profile 67, the debtor agreed to contribute those funds after the lender had obtained a receiver; in return for that contribution the lender had the receiver removed and allowed the debtor to go back into possession of the collateral.

178. *See* Profile 65.

179. *See* Profile 62; Profile 66. Even though those modifications increased the rate at which interest accrued (from 9.625% to 9.875% in Profile 62 and from 13.25% to 16% in Profile 66), they lowered the current payment obligations by establishing a significantly lower "pay rate" (8% in Profile 62; 7% in Profile 66).

180. *See* Profile 56; Profile 63.

local property market.[181] In the other case, the lender was motivated less by an unusual level of managerial skill than by a specific determination that it would not be able to resell the property. In that case, the lender allowed the debtor to remain in control, but at the same time obtained a right to eighty percent of future appreciation of the value of the property. As the officer responsible for the file put it, "[b]asically we're getting him to manage for free for a hope certificate."[182]

Managerial expertise was also significant in several of the cases in which a cash contribution contributed to the lender's willingness to leave the debtor in control.[183] For example, in one case, the main source of distress was the imminent expiration of a major lease in a Manhattan office building by a tenant with whom the debtor had a longstanding relationship; the lender believed that "the borrower has the best shot at getting [the tenant] to renew its lease."[184] That ability, together with a willingness to increase the rate at which interest accrued on the loan, was enough to convince the lender to leave the debtor in control of the property.[185] A similar concern motivated the lender in one case in which the property was part of a large development controlled by the same developer: the lender feared it would face significant leasing difficulties if it took the project back and was forced to compete against the developer's other nearby projects.[186]

The last two of the twelve profiles in which the lender granted formal payment concessions involved specially tailored arrangements. In one case, the lender was compensated for its agreement to lower the rate of interest by a one-year reduction in the term of the loan and a twenty-five percent participation in future appreciation of the property.[187] In the other case, the lender agreed to an

181. *See* Profile 63. In that case, the debtor also made a nominal capital contribution to pay the legal costs of the restructuring. It was also relevant that the debtor had performed as agreed on four previous loans from the lender.

182. Profile 56.

183. That motivation is similar to the motivation a bank or finance company lender would have in determining that its debtor could sell inventory at a higher price than the lender. As I mentioned above, that determination would not be as uniformly clear for real estate as it would be for most kinds of personal property held for sale. *See supra* note 165.

184. Profile 66.

185. In a similar situation, the lender allowed a debtor that agreed to fund cash-flow deficits to remain in control of a condominium building based on particular skill at selling off individual condominium units. That situation, Profile 54, was one of only three insurance company profiles in which the lender did not take a loss.

186. *See* Profile 57 (reporting that the debtor agreed to contribute future funds for tenant improvements).

187. *See* Profile 64.

extension of three years, during which it would obtain all cash flow from the project, in return for execution by the principal of the debtor of an unusual agreement that included a complete guaranty of the outstanding indebtedness that would terminate only if the debtor voluntarily conveyed the property to the lender.[188]

In addition to the twelve profiles in which the lender granted formal payment concessions, the lender and the debtor disposed of the property by agreement in an additional six profiles (29%).[189] In three cases, the debtor agreed to turn the property over to the lender.[190] In the other three, the lender released its lien at substantial discounts, accepting payments in those transactions of about 20%, 29%, and 75% of the outstanding balances.[191]

At the other end of the spectrum from the twelve profiles in which the parties agreed upon a resolution of the dispute — either through a grant of formal payment concessions or through immediate liquidation of the debt — were three profiles (15%) in which the lender proceeded against the collateral without the consent of the debtor. The basic motivation in those cases was the flip-side of the motivation in the loans discussed above: the debtor's unwillingness to contribute funds to the property or to establish some other basis for retaining control of the property. The results of those transactions help explain the lender's general willingness to avoid action against collateral. In two of those three cases, the debtor responded by instituting litigation. One involved a lender liability action that the debtor litigated all the way to the federal court of appeals; after a year and a half of litigation (in which the lender prevailed), the lender released its lien for a discounted payment of about sixty-seven percent of the loan amount.[192] The other involved a Chapter 11 bankruptcy proceeding that ultimately was dis-

188. *See* Profile 61.

189. *See* Profile 55; Profile 58; Profile 59; Profile 60; Profile 71; Profile 72.

190. *See* Profile 55 (deed in lieu of foreclosure); Profile 60 (consent foreclosure); Profile 71 (deed in lieu of foreclosure). In all three of those transactions, the lender ultimately sold the properties for considerably less than the debt. *See* Profile 55 (reporting that, taking account of environmental cleanup costs, lender sold property at a loss of $6 million on an original $6 million loan); Profile 60 (reporting that property with original loan of $26 million, which increased to about $34 million by the time of foreclosure, ultimately was sold for $13.23 million); Profile 71 (reporting that property with original loan amount of $8.5 million ultimately was sold for $5 million).

191. *See* Profile 58 (reporting that the lender released its lien in return for payment from separate assets of 20% of the loan amount, $20 million on an outstanding balance of about $100 million); Profile 59 (reporting that the lender released its $2.4 million lien to permit a sale to a tenant for a price of $1.8 million, 75% of the loan amount); Profile 72 (reporting that the lender released its $42 million lien in return for proceeds of refinancing of about $12 million, 29% of the loan amount).

192. *See* Profile 68.

missed as a bad-faith filing. The lender succeeded in foreclosing only after a delay of twenty-two months.[193] The only case in which the debtor did not respond by instituting litigation was one in which the debtor was a trust that apparently was not eligible for relief under the Bankruptcy Code.[194]

One final point about the lender's response in cases of disagreement relates to its use of a receiver. The conventional wisdom is that many lenders refrain from seeking a receiver in connection with a distressed real estate loan based on concerns about the cost of that procedure and the relative ineffectiveness of a receiver's management.[195] Although the small number of profiles involving adversarial disposition of collateral makes any conclusions tentative, my findings are in some tension with that conventional wisdom. My profiles include a total of seven cases in which the lender moved against collateral without the consent of its debtor.[196] The lender sought and obtained a receiver in three of those transactions (43%).[197] When I questioned the responsible loan officer about the decision to seek a receiver, he acknowledged the force of conventional wisdom but explained that the lender nevertheless seeks a receiver in states where the foreclosure process is unusually pro-

193. *See* Profile 69.

194. *See* Profile 70 (noting the problem that the only form of trust that can file for bankruptcy relief is a "business trust"); *see also* 11 U.S.C. § 109(b) (1994) (permitting bankruptcies by a "person"); 11 U.S.C. § 101(41) (defining "person" to include corporations); 11 U.S.C. § 101(9)(A)(v) (defining "corporation" to include business trusts). A trust that does not operate an active business is not a business trust and accordingly is not eligible for relief under the Bankruptcy Code. *See, e.g.*, Shawmut Bank Connecticut v. First Fidelity Bank (*In re* Secured Equipment Trust of Eastern Air Lines, Inc.), 38 F.3d 86, 89-91 (2d Cir. 1994) (holding that a trust with title to an airplane was ineligible for bankruptcy relief); Mosby v. Boatmen's Bank (*In re* Mosby), 791 F.2d 628, 628 (8th Cir. 1986) (holding that a personal or spendthrift trust was ineligible for bankruptcy relief); *In re* Treasure Island Land Trust, 2 B.R. 332, 333-36 (Bankr. M.D. Fla. 1980) (dismissing a bankruptcy petition by an Illinois land trust based on the determination that the debtor was not a business trust for purposes of the Bankruptcy Code).

195. *See, e.g.*, GRANT S. NELSON & DALE A. WHITMAN, REAL ESTATE TRANSFER, FINANCE, AND DEVELOPMENT: CASES AND MATERIALS 389-91 (4th ed. 1992).

196. In addition to the three profiles in which adversarial disposition was the principal response, there were three profiles in which the lender first proceeded against the property without the consent of the debtor and then reached an agreement with the debtor before completing foreclosure proceedings, *see* Profile 59; Profile 67; Profile 72, and one profile in which the lender initially agreed to a workout but then sought foreclosure when the debtor was unable to comply with the terms of the workout, *see* Profile 66.

197. *See* Profile 67; Profile 68; Profile 72. Those limited figures are similar to the only other empirical evidence of which I am aware — although, as I discuss in *infra* section II.A, the other evidence appears to involve loans much smaller than those that I studied. *See* Steven Wechsler, *Through the Looking Glass: Foreclosure By Sale as De Facto Strict Foreclosure — An Empirical Study of Mortgage Foreclosure and Subsequent Resale*, 70 CORNELL L. REV. 850, 872-73 (1985) (finding that receivers were appointed in 7 of the 21 commercial foreclosures conducted in 1979 in Onondaga County, New York).

tracted, offering New Jersey and Massachusetts as examples.[198] I thus was not surprised that two of the three receivers were appointed in New Jersey transactions.[199] The third receiver was appointed in a Virginia transaction in response to frustration by the lender that the debtor was diverting cash flow from the project to personal uses.[200]

c. The Results of Termination. The insurance company profiles reflect losses that are much more frequent than the finance-company and bank profiles. The insurance company suffered losses in eighteen of the twenty-one profiles (86%); in many cases the losses approached or even exceeded the original loan amount.[201] All three of the successful profiles appeared in transactions in which the debtor made a substantial cash infusion in connection with a workout. In one of them, the debtor subsequently paid the loan in full through sales of individual units in the property, a luxury Manhattan condominium project.[202] In the other two, the properties stabilized after the workouts and now are generating revenues at amounts that appear likely to repay the loans in full through regular amortization.[203]

Removing two profiles in which the lender sold the loans to third parties,[204] my sample includes nineteen profiles in which I can identify the ultimate disposition of the collateral. The most common disposition (11 profiles, 58%) was for the debtor to retain control of the property. In two of the profiles, as mentioned above, that occurred when a workout allowed the debtor to stabilize the collateral at a value that exceeded the loan amount.[205] In the other

198. The two New Jersey foreclosure proceedings in my sample were settled after 20 months, *see* Profile 67, and 17 months, *see* Profile 68. The only Massachusetts foreclosure proceeding was completed in 21 months. *See* Profile 70.

199. *See* Profile 67; Profile 68.

200. *See* Profile 72.

201. I have no firm explanation for the difference in results. I doubt that it is attributable to the lack of personal guaranties in the insurance company profiles because the bank and finance company profiles revealed few instances of collection based on pursuit of the guarantors. My best explanation is a combination of the generally riskier nature of real estate lending and the fact that the loans I examined appeared to reflect conditions at the low point of a business cycle for real estate lending. *See infra* note 327 (reporting statistics indicating a systemically higher rate of default on insurance company real estate loans and suggesting that default rates reached a half-century peak in the early 1990s).

202. *See* Profile 54.

203. *See* Profile 73 (northern Virginia hotel); Profile 74 (South Carolina apartment project).

204. The prices the lender obtained on those sales were quite favorable: approximately 80% of the loan amount in one case, *see* Profile 56, and approximately 55% in the other, *see* Profile 64.

205. *See* Profile 73; Profile 74.

nine of those eleven,[206] the lender accepted a discounted payoff of the loan from the debtor, often recognizing a loss of staggering magnitude.[207] Although the lender did not have information as to the source of funds for the payoff in all of the cases, the records did indicate that the source was refinancing from another lender in three of the nineteen profiles (16%) for which I know the ultimate disposition.[208]

Even after my research at the finance company and the bank, I was surprised at the frequency with which debtors maintained control of the collateral. I would not have expected it to have been a common occurrence for the lender to accept a substantial loss and still leave the debtor in possession of the asset with complete control over future appreciation of the collateral. As a matter of the underlying economics, however, that outcome should not be surprising. Given the debtor's longstanding relationship with the project, frequently as the original developer, it would not be at all surprising if the developer was the highest-valuing user of the property and thus willing to pay more for the project than any third party would be willing to pay. That could be true both because of the information costs that a third party would have to incur to evaluate the project — which the already-informed debtor would not need to incur — and because of special expertise and skills related to the project that many third parties might not have.[209] For example, an executive at the insurance company described to me a transaction in Portland, Maine — not one of my profiles — in which the lender was reluctant to take possession of the collateral. The lender explained that the debtor controlled such a significant share of the Portland real estate market that the lender, or any third party,

206. *See* Profile 57; Profile 58; Profile 61; Profile 62; Profile 63; Profile 65; Profile 67; Profile 68; Profile 72.

207. *See, e.g.*, Profile 57 (accepting a 60% discount on a $20 million balance); Profile 72 (accepting a 70% discount on a $40 million balance); Profile 58 (accepting an 80% discount on a $100 million balance). I cannot present complete information about the discounted payoffs because I was unable to locate the precise numbers in several of the profiles in which the lender accepted payoffs. But the smallest discount for which I was able to get reliable information was over 25% of the loan amount ($1.5 million on a $6 million balance). *See* Profile 68.

208. *See* Profile 57 (mezzanine financing); Profile 68 (loan from Bank of New York); Profile 72 (mezzanine financing). In five of the other profiles in which the loan was paid off at a discount, the lender's records did not indicate the source of the funds used to pay off the loan. *See* Profile 61; Profile 62; Profile 63; Profile 65; Profile 67. Given the large sums involved, it is likely that several of those transactions involved refinancing.

209. Jim Bowers has explored in great detail the reasons why debtors might be best placed to deal with their assets upon financial distress. *See* James W. Bowers, *Groping and Coping in the Shadow of Murphy's Law: Bankruptcy Theory and the Elementary Economics of Failure*, 88 MICH. L. REV. 2097, 2113-41 (1990).

would have had great difficulty leasing the property if it forcibly took control of the project from the debtor.[210] Accordingly, if the lender was unable to work out a "sale" of the project to the debtor, the lender ultimately would be faced with the prospects of a sale to the highest-valuing third-party user, which, by hypothesis, would bring a lower return than a sale to the debtor.

In the remaining eight profiles, the debtor lost control of the collateral. In two profiles (11%), the lender released the lien upon a sale of assets by the debtor, one of which resulted in full payment[211] and one of which resulted in a loss of about 35% of the loan amount.[212]

In the last six profiles (32%), the lender took control of the collateral, three times with the consent of the debtor,[213] and three times through an adversarial foreclosure proceeding.[214] The disappointing results of those transactions suggest that the lender's frequent willingness to compromise its loan and allow the debtor to retain ownership of the property is prudent.[215] In each of those cases the lender subsequently sold the property at an amount significantly lower than the original loan amount.[216] The *best* outcome, which happened in the second smallest transaction, involved a loss of forty-two percent of the loan amount. The *average* percentage of loss in those profiles was seventy-two percent of the loan amount. Because the larger loans tended to have worse outcomes, the average loss rises even higher when I weight the losses to account for

210. *See* Insurance Company Executive Interview, *supra* note 158. The executive pointed out that a prudent lender would focus on the "thinness" of that market before entering into the transaction and take account of any concern in setting the initial terms of the transaction. For a similar problem, see Profile 57 (accepting a 60% discounted payoff on a property that was part of a single large development controlled by the debtor).

211. *See* Profile 54.

212. *See* Profile 59.

213. *See* Profile 55 (deed in lieu of foreclosure); Profile 60 (consent foreclosure); Profile 71 (deed in lieu of foreclosure).

214. *See* Profile 66; Profile 69; Profile 70.

215. Of course, those results do not prove that compromise is always prudent. Direct evidence of the value of the strategy would come only from a test in which the lender tried both strategies on substantially similar loans.

216. Including interest or maintenance expenses or both that were not covered by cash flow from the properties, the lender's records reflect losses of the following percentages of the original loan amount: Profile 55 (sold for a 100% loss, $6 million on an original loan amount of $6 million); Profile 60 (sold for an 81% loss, $21 million on an original loan amount of $26 million); Profile 66 (sold for an 82% loss, $75 million on an original loan amount of $91 million); Profile 69 (sold for a 71% loss, $17 million on an original loan amount of $24 million); Profile 70 (sold for a 57% loss, $11 million on an original loan amount of $17.5 million); Profile 71 (sold for a 42% loss, $3.5 million on an original loan amount of $8.5 million).

the amount of the loans: an average loss of seventy-seven percent of the loan amount.[217]

The last piece of the puzzle is the frequency of bankruptcy. In the nineteen profiles in which I know the ultimate disposition, the debtors sought relief in bankruptcy in four cases (21%).[218] The cases do not conform to any one pattern, but two of them reflect the situation that I would have anticipated based on my experience: a debtor filing for bankruptcy to delay the lender's exercise of its remedies. In the first of those cases, the lender responded to a $900,000 tax default by pressing promptly for foreclosure.[219] The debtor in turn responded by filing for bankruptcy under Chapter 11. The bankruptcy court dismissed the filing for bad faith two months later, which led to an immediate foreclosure by the lender. In the second case, the property became distressed when the Resolution Trust Corporation announced plans to repudiate a lease of a portion of the property that a failed bank had used for office space.[220] When the debtor completely stopped making payments despite positive cash flow from the property, the lender obtained a receiver. The debtor then responded by filing for bankruptcy. At that point, the parties agreed to a workout under which the debtor made a substantial payment against the note, in return for which the lender forgave a substantial amount of the remaining debt and agreed to allow the debtor to remain in possession. The lender ultimately accepted a deeply discounted payoff of the note.

The other two bankruptcies reflected problems that are less easily categorized. In one case, the debtor filed for bankruptcy after a personal bankruptcy by the debtor's principal removed any possibility that the debtor could make future contributions to the project.[221] The lender's view at the time was that the bankruptcy was filed not because of concerns related to this particular project, but as part of the general strategy in the personal bankruptcy of the principal. When the debtor was unable to confirm a plan over the lender's opposition, the lender sold the project at a consensual sale[222] about eighteen months after the bankruptcy filing.

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217. The lender lost $133.5 million on the $173 million it invested in those six loans. The percentage lost on the three cases of forced foreclosure (78%) was only slightly higher than the percentage lost on the three cases of consensual foreclosure and reconveyance (75%).

218. *See* Profile 60; Profile 69; Profile 72; Profile 74.

219. *See* Profile 69.

220. *See* Profile 72.

221. *See* Profile 60.

222. The sale was held pursuant to 11 U.S.C. § 363(f) (allowing the sale of property "free and clear of any interest in such property of [a lender] . . . if . . . [the lender] consents").

In the last case, a limited-partnership debtor that owned an apartment project filed for bankruptcy fairly soon after a market downturn reduced net cash flow on the project below the level necessary to keep the note current.[223] It appeared that the bankruptcy was a protective measure to avoid the serious adverse tax consequences a foreclosure would have for the limited partners of the debtor; apparently even the debtor recognized that a foreclosure was not likely. The lender readily agreed to a plan of reorganization in which the limited partners of the debtor contributed additional funds to stabilize the property. The loan remains in the lender's portfolio, one of only three insurance company profiles in which the lender did not take a loss in connection with the distress.[224]

II. Implications

The case studies summarized in Part I do not provide definitive empirical evidence of the ways in which lenders respond to distress in their secured loans. Indeed, they do not even provide definitive evidence of the ways in which particular kinds of lenders respond to distress. For example, even though the evidence that I present of finance company responses to distressed debt is more detailed than anything in the existing literature, the conclusions I would draw from that evidence could be erroneous because of the possibility that the finance company that I examined is not representative of finance companies in general. I thus would have been more confident that I had obtained a representative picture of finance company practices if I had done case studies at three separate finance companies instead of case studies at three different types of lenders.

My goal, however, is not to demonstrate the details of the practices of finance companies — or banks or insurance companies, for that matter. Rather, the purpose of this project is to provide an empirical foundation for a general theory of the mechanisms that commercial lenders and their business debtors use to respond to distress. The best evidence on which to base such a theory is not a complete picture of the practices of any one type of lender, but rather evidence from as many sectors of the secured-lending marketplace as possible. Notwithstanding the limited value of my evidence as proof of practices in any single area, the variety of the case

223. *See* Profile 74.

224. I do not discuss the costs of termination in the insurance company profiles because I was unable to gather adequate information on that point from the files available to me.

studies in fact enhances the probative value of my findings in areas where all three case studies agree: it seems quite unlikely that I would observe similar practices at three lenders from three completely different markets unless those practices are at least reasonably representative of a substantial portion of the entire market for secured lending.

Approaching the evidence in that spirit, the remainder of this article assesses the implications of my case studies for theories about debtor-creditor relationships. Section II.A addresses the most direct implications of my study: the nature and effectiveness of the mechanisms of the financial market that face distressed debtors. Section II.B turns to a more indirect topic: the implications that my view of the market for distressed debt has on the market for lending in general.

A. *The Economics of Distressed Debt*

When academics discuss the process by which secured creditors liquidate secured debt, they ordinarily telescope the entire process into a single moment: the foreclosure sale. Starting from a focus on that moment, the predominant commentary — which relates for the most part to real estate foreclosures — understandably highlights the obvious ways in which the foreclosure sale differs from an arms-length voluntary sale, and then concludes that the foreclosure sale frequently allows creditors to obtain property from their debtors even though the value of the property, as evidenced by resale after the foreclosure sale, substantially exceeds the amount of the debt.[225] Moreover, some commentators argue, creditors frequently

225. *See, e.g.*, LoPucki & Warren, *supra* note 30, at 71-87 (offering a discussion of problems with foreclosure sale procedures, generally supporting the conclusion that "the sale process does a poor job of valuing the collateral," and suggesting that "[t]hreatening to blow the property to bits would accomplish as much, and the explosives might be less expensive"); 1 Grant S. Nelson & Dale A. Whitman, Real Estate Finance Law § 8.8 (3d ed. 1993) (discussing "abuses of the foreclosure sale process" and urging "fundamental reform of the foreclosure sale system" that would require foreclosing lenders to employ "customary commercial methods . . . including the use of real estate brokers and normal commercial descriptive and pictorial advertising"); Elizabeth Warren & Jay Lawrence Westbrook, The Law of Debtors and Creditors 82 (3d ed. 1996) ("Judicial sales are notorious for bringing low prices for the items sold."); Patrick B. Bauer, *Statutory Redemption Reconsidered: The Operation of Iowa's Redemption Statute in Two Counties Between 1881 and 1980*, 70 Iowa L. Rev. 343 (1985) (relying on empirical evidence of redemption after foreclosure as evidence of frequent inadequacy of price at foreclosure sales); Alex M. Johnson, Jr., *Critiquing the Foreclosure Process: An Economic Approach Based on the Paradigmatic Norms of Bankruptcy*, 79 Va. L. Rev. 959, 959 (1993) (providing an economic analysis of foreclosure sales starting from the premise that "[i]n the vast majority of cases, the sale price realized at such a foreclosure sale will be so inadequate that not only will the mortgagor lose her home but she will also lose any equity she owns in the property"); Wechsler, *supra* note 197, at 870 (report-

resell the foreclosed collateral at large profits.[226] As a related point often made in the context of loans secured by personal property, academics often express concern about the ability of the secured lender to exercise its rights against personal property to destroy a valuable business.[227]

My empirical evidence supports a completely different perspective on the situation: it suggests that the concerns expressed in the existing literature are seriously overstated, at least in the commercial context.[228] The key problem with the existing analysis of the foreclosure process is that it focuses on the last step of the process — the foreclosure sale — without giving adequate attention to the earlier stages of the system of which that sale is but one small part. My empirical evidence suggests a group of related conclusions that work together to convince me that it is extremely unusual for debtors that have equity in their businesses to be subjected to forced repossession of collateral. I explain my perspective in two steps, first by direct exposition of the mechanisms that allow debtors to protect their equity, and then by indirect inference, by discussing the evidence regarding the financial results lenders obtain from foreclosure and repossession of collateral.

1. *The Mechanisms of Market Efficiency*

Distressed debtors have three major ways of obtaining funds to protect any equity in their business: refinancing of their debt, cash flow from operations, or sale of the business. My case studies sug-

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ing evidence that lenders resold foreclosed properties at prices that exceeded the unpaid debt).

226. *See, e.g.*, LoPucki & Warren, *supra* note 30, at 87 ("The . . . lien holder . . . gets the property for the amount of the lien and resells it for a price approaching market value, thereby capturing the debtor's equity."); Johnson, *supra* note 225, at 960 (discussing "hue and cry" about situations in which foreclosed homes are resold at prices exceeding the amount of the unpaid debt); Wechsler, *supra* note 197, at 870 (reporting an empirical study concluding that "[m]ortgagees made profits in about half of the cases in which they purchased and quickly resold the foreclosed properties"); *see also* 1 Nelson & Whitman, *supra* note 225, § 8.8 (suggesting reforms that would produce surpluses at foreclosure sales).

227. *See, e.g., supra* note 90 and accompanying text.

228. Discussion of consumer real estate lending is generally beyond the scope of this study. A variety of circumstances make the residential process considerably different, most obviously the fact that consumer real estate is not ordinarily an income-producing asset in the way that business collateral is. My economic analysis hinges on my belief that the financial markets function sufficiently well to allow even distressed debtors to capture a large part of the value of their income-producing assets. I do suggest below that lenders that take possession of homes on which they have loaned money are generally successful at recovering a substantial portion of their loans through disposition of the collateral. *See infra* notes 287-89 and accompanying text. But I have no confidence, or even reason to believe, that the markets for the sale of residential real estate function to protect their borrowers nearly so well as the analogous markets available to commercial real estate borrowers.

gest that each of those alternatives provides a realistic and frequently successful avenue for solving the problems of debtors faced with dissatisfied secured creditors.

a. Refinancing. The most surprising single result that I found in my studies is the frequency with which distressed debtors in all three of my case studies successfully obtained third-party refinancing in the face of a decision by their existing lender to terminate their relationship. In my seventy-two profiles,[229] debtors responded to distress by taking their business to another lender in at least sixteen cases (22%).[230] Even that figure probably understates the incidence of refinancing significantly, given the substantial number of profiles (7 cases, 10%) in which loans were paid off in lump sums without the lender knowing the source of the money.[231] Anecdotal evidence from an interview with another banker supports the idea that my evidence provides a conservative estimate of the frequency with which debtors successfully refinance troubled loans.[232]

The natural question is why a second lender would agree to extend a loan to a business that is in such serious financial distress that the business's current lender is attempting to terminate the relationship. After all, the potential for asymmetric information is striking. Among other things, the lender that wants to terminate the existing relationship is highly likely to have a more thorough understanding of the financial prospects of the existing business than the new refinancing lender that has not yet had a lending relationship with the business.[233]

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229. Throughout this part of the article I report aggregate statistics based on a total of 72 profiles, including the two profiles in which the insurance company liquidated its position by selling its loan to a third-party investor. *See supra* note 204 and accompanying text. My rationale is that sale of the loan to a third party is one of the dispositions that a lender can choose to obtain payment, a disposition just as realistic as forced liquidation or strategic restraint. Of course, some more substantive liquidation strategy might well occur after the sale — a circumstance that ultimately would put the loan into one of the other categories. In any event, removing those two profiles would raise the percentages calculated in this Part only slightly, by lowering the universe of profiles from 72 to 70.

230. The share of refinancing outcomes is relatively balanced across the three case studies: 4 of the 23 finance company profiles (17%), 9 of the 28 bank profiles (32%), and 3 of the 21 insurance company profiles (14%). The lowest of those shares occurs in the study in which I had the largest number of unidentified payments, *see infra* note 231 and accompanying text, so the shares might be more closely aligned if I had more complete information.

231. *See supra* note 86 (one profile in the finance company study); *supra* note 135 (one profile in the bank study); *supra* note 208 (five profiles in the insurance company study).

232. *See* Telephone Interview with Michael R. James, Executive Vice President, Wells Fargo Bank, transcript at 14 (Mar. 5, 1997) (transcript on file with author) [hereinafter James Interview] (containing a statement by the supervisor of workouts for small-business loans that "a very high percentage" — at a minimum "over 50[%]" — of the loans his bank terminates are paid off through refinancing with another lender).

233. *But cf.* Mitchell A. Petersen & Raghuram G. Rajan, *The Benefits of Lending Relationships: Evidence from Small Business Data,* 49 J. FIN. 3, 14 (1994) (reporting a statistical

The most plausible consideration that could overcome the inherent informational difficulties would be a difference in risk preferences. For example, consider the possibility that the refinancing lender specializes in slightly more risky businesses than the terminating lender, presumably charging slightly higher interest rates for accepting that risk. If so, the refinancing lender might be interested in obtaining the soon-to-be-terminated debtor as a customer even if the terminating bank does not wish to continue its existing relationship.

Not surprisingly, given the reticence of lenders to suggest that they specialize in risky loans, it is difficult to get any direct support for that hypothesis. Several scattered items, however, convince me that the "differential-risk" explanation best explains the phenomenon.[234] The nature of the refinancing lenders, which tend to specialize in riskier transactions, provides the most persuasive evidence. For example, in my insurance-company profiles, two of the three profiles in which I could identify a refinancing lender involved funds from a mezzanine financier,[235] which typically[236] would be involved in transactions much riskier than those that would interest an insurance company.[237] Similarly, an executive vice president who supervises commercial-loan workouts for a large west-coast bank explained to me that most of the lenders that refinance his loans are nonbank lenders that tend to charge higher interest rates to reflect the higher risks of their transactions.[238]

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study of small-business lending finding no significant connection between the price of credit and the length of the lender's relationship with the debtor).

234. The other most obvious explanation would be misjudgment of risk by either the first or the second lender: the first lender in overestimating the risk or the second lender in underestimating it. Although such errors undoubtedly occur, I am reluctant to attribute such a significant feature of the marketplace to human error. Moreover, such an explanation would be particularly hard to credit when the second lender would be motivated to evaluate the risk carefully, given the great likelihood that it would be aware of the negative assessment of the first lender.

235. *See supra* note 208.

236. *See, e.g.*, Beth Randolph, *New Private Fund Intends To Invest in Amex Listings*, WALL ST. J., Feb. 20, 1996, at A11 (describing mezzanine financing as "a layer of capital that sits between equity and debt both in terms of risk and returns"); Richard Wright, *Taking Lending to the Next Level*, PROFIT, Sept. 1, 1996, at 62, *available in* 1996 WL 9559655 ("Mezzanine financing . . . falls between conventional debt secured against property, and unsecured debt or pure equity financing, both in terms of the degree of security expected against the loan, and in terms of cost.").

237. The third refinancing lender was a bank that obtained a personal guaranty from the debtor. *See* Profile 68.

238. *See* James Interview, *supra* note 232. My sense is that those lenders are lenders for whom the primary source of repayment on which their underwriting relies is liquidation, as opposed to cash flow. Given the losses that are inherent in forced liquidation, that kind of underwriting focus should result in higher interest costs — because of the likely losses in the event of liquidation — but it also should result in better protection against the downside

The more difficult problem for my explanation is the frequency with which other banks refinance distressed bank loans.[239] To explain that part of the pattern I have to posit not only a spectrum of different types of lenders with different risk preferences, but a spectrum internal to the banking industry, in which different banks specialize in bank loans of differing levels of risk. I received precisely that explanation when I raised that problem with the manager of the Special Assets Division at the conclusion of my examination of the files at the bank. He readily agreed with my suggestion that different banks might be willing to make loans to different debtors. He explained that the most common basis for the differential underwriting standards is probably the length of amortization different banks expect on their commercial loans. He suggested that the heavy takeover pressures in his market give his bank a strong incentive to require relatively high current payments on its loans; accordingly, the loans in his bank's portfolio amortize more quickly, allowing a shorter time during which the bank would be exposed to a risk of loss from business reverses. A different bank more willing to take risks might accept lower current payments, and a correspondingly longer amortization period, extending the time during which the second bank would be exposed to a risk of loss.[240] Because the loan offered by the second bank would have lower payments than the loan offered by the bank that I studied, a debtor unable to produce cash flow to repay a loan from my bank might have adequate cash flow to satisfy the second bank's lower current-payment standards. Of course, the refinancing bank might charge a higher interest rate for its more slowly amortizing product, but that reflects only the fact that it has made a riskier investment than the terminating bank.[241]

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losses that cash-flow reliant underwriters face in the event of liquidation. *See* Mann, *Small-Business Secured Credit*, *supra* note 3 (discussing that problem for small-business bank lenders). That focus also might explain the apparent fact — pointed out to me by Lynn LoPucki in comments on an earlier draft of this article — that almost all businesses enter bankruptcy with all of their assets encumbered by secured debt of one kind or another.

239. Six of my 28 bank profiles (21%) were paid off with refinancing proceeds from another bank. *See supra* note 135.

240. *See* Bank Division Manager Interview, *supra* note 124.

241. I received a similar perspective in a telephone interview with a loan officer that recently had moved from one major national bank, NationsBank, to another relatively large midwestern bank, ComericA. He explained that the differing cultures of the two banks — with NationsBank focused much more on cash flow and ComericA focused more on recoverable collateral — resulted in quite different evaluations of the same business. Indeed, he stated that after he moved to ComericA, his division at ComericA approved a number of loans to debtors that he personally had rejected while working at NationsBank! *See* Telephone Interview with James R. McNutt, Vice President and Commercial Banking Officer, ComericA Bank, Texas (Oct. 10, 1996).

The evidence of persistent refinancing would make little sense in a world with only two classes of debtors — good and bad — and only a single class of lenders, which make loans to good debtors and decline loans to bad debtors. A better view contemplates a continuous spectrum of debtors ranging from the most credit-worthy all the way to the financially moribund, and an analogous, though admittedly less populated, spectrum of lenders that specialize in accepting different levels of risk.[242]

The market for refinancing distressed debt operates to align the riskiness of each particular debtor with a lender that specializes in bearing the particular level of risk presented by that debtor at any given time. When the riskiness of a debtor's business changes, the market moves the debtor to a more appropriate lender. If the debtor's risk profile improves, the debtor pays off its loan and moves to a lender that specializes in higher quality debtors. If the debtor's risk profile deteriorates, the lender terminates the relationship and forces the debtor to seek financing from a more risk-tolerant lender.[243]

That perspective suggests that the operation of the market is enhanced considerably by mechanisms — for example, the at-will and short-term features that dominated the finance company and bank profiles — that allow a lender to move a debtor promptly after determining that the debtor's risk has become unacceptably high. The sooner the debtor is moved, the sooner the debtor must pay a price for the risk it imposes on its lender. In that way, the lender can lower the amount of the premium that it must charge its portfolio to account for the costs of bearing risks that it views to be unacceptably high. The importance of those mechanisms to the market as a whole makes me skeptical of the propriety of recent litigation and academic proposals to limit the ability of lenders to use those mechanisms to terminate their lending relationships.[244]

In sum, when distressed debtors attempt to find new financing to protect the equity in their existing business, they face a relatively robust and well-developed market that frequently allows them to

242. The text simplifies by suggesting that lenders specialize along lines of greater or lower risk. They certainly specialize their risks in other dimensions as well — for example, line of business, expected duration of the credit, and exposure to interest-rate fluctuation.

243. Of course, at some point the debtor will reach the most risk-tolerant available lender. At that point, refinancing may no longer be a serious possibility.

244. The leading case is *KMC Co. v. Irving Trust Co.*, 757 F.2d 752, 766 (6th Cir. 1985) (affirming a $7.5 million verdict against a lender for failing to use good faith in terminating a demand line of credit). *See* LoPucki & Warren, *supra* note 30, at 268-73 (providing a sympathetic discussion of *KMC* and criticism of judicial decisions limiting the reach of the *KMC* rationale).

protect themselves from financial collapse by transferring their business from a lender for whom they are a problem loan to be eradicated to a lender for whom they are a welcome addition to the portfolio.

b. Cash Flow from Operations. The second significant way in which debtors can protect the equity in their businesses is by keeping their businesses operating long enough to repay their loans through cash flow from continued operations. Although lenders obviously could prevent their debtors from taking advantage of that opportunity, the normal consequence would be the destruction of the business, which would leave the lenders no source of repayment other than forced liquidation of collateral. As my case studies suggest, there are good reasons for believing that lenders rarely come out whole in transactions in which they liquidate collateral. If that is true, I would expect lenders to show great flexibility in allowing their debtors an opportunity to repay loans through continued operations. In fact, that course of action occurred successfully in my profiles with about the same frequency as refinancing, an aggregate of sixteen profiles (22%).[245] That percentage, however, seriously understates the feasibility of that response, because my data include thirty profiles[246] in which the debtor either was not an operating business or had closed the business before the lender decided to respond to the distress. Those sixteen profiles are more than a third (38%) of the profiles in which the debtor had an ongoing business at the time the lender responded to the distress.

Because the success of the cash-flow-from-operations strategy hinges on the lender's willingness to refrain from action, the debtor's ability to use cash flow from operations to avert a loss through foreclosure is much less direct than its ability to use funds from refinancing. But in a universe where lenders correctly view repossession as equivalent to loss, the lender's legal right to shut down its debtor's businesses is largely hypothetical. Thus, the cash-flow-from-operations strategy in fact appears to be every bit as practical as the refinancing strategy. Indeed, in the context of loans to operating businesses — like the loans in my finance-company study — it appears to be the most common solution.

245. *See supra* note 86 (14 of the finance company profiles); Profile 28 (bank profile); Profile 32 (bank profile).

246. That group consisted of all 21 of the insurance company profiles, *see* Profiles 54-74, the one failed business in the finance company profiles, *see* Profile 23, and the eight bank profiles in which there was no ongoing business at the relevant time, *see supra* notes 133 & 137.

c. Sale of Collateral. The final way in which debtors can protect their equity is by selling all or a portion of the collateral.[247] Going into my research, I was not sure how frequently that strategy would work. On the one hand, the assets of such a debtor by definition are distressed, which should limit their marketability considerably. On the other hand, given their inherent informational advantage, debtors often are in a better position than lenders to obtain the best possible price for the collateral.[248] Balancing those expectations, I was not surprised to find that debtors used that alternative in a fair, but not large, number of my profiles: eight out of seventy-two (11%).[249]

One major reason for the lower frequency of that alternative, compared with the use of refinancing or cash flow from operations, is undoubtedly the consequences of a sale: the debtor must give up control of the business, something it need not do if it can satisfy the lender with refinancing proceeds or cash flow from operations. In many cases — especially with smaller, closely held businesses — loss of the business is a highly unpalatable alternative to be avoided if at all possible. On the other hand, using sale proceeds to "cash in" any equity makes a great deal of sense in cases involving collateral held for investment purposes. In my three case studies, that description applies best to commercial real estate loans. Accordingly, it is not surprising to see that seven of the eight profiles in which debtors took that course involved commercial real estate loans.[250] Of the twenty-eight commercial real estate loans[251] in all three studies, the cases of repayment with sales proceeds are a more significant twenty-five percent.

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247. Lynn LoPucki and Elizabeth Warren note the possibility that debtors can protect equity in their assets by selling collateral before foreclosure, but the tone of their discussion suggests that they do not view it as a practical alternative. *See* LoPucki & Warren, *supra* note 30, at 87 (suggesting that relying on foreclosure procedures to motivate debtors to sell their property is tantamount to "[t]hreatening to blow the property to bits").

248. For a thorough theoretical explanation of the debtor's potential advantages, see Bowers, *supra* note 209, at 2113-41.

249. *See* Profile 6 (paying off finance company loan with proceeds of a one-time sale of intellectual property); Profile 29 (selling of collateral by debtor to satisfy bank loan); Profile 31 (same); Profile 37 (same); Profile 47 (same); Profile 48 (same); Profile 54 (settling of insurance company loan for sales proceeds); Profile 59 (same). Stuart Gilson has shown that asset sales are a common strategy in the restructuring of the debt of large, publicly traded companies. *See* Gilson, *supra* note 10, at 167, 172 (presenting evidence that large, publicly traded firms that restructured their debt out of court experienced a median asset decline of 37.6% during the time around that restructuring).

250. The one exception is a finance company loan that was paid off through a one-time sale of intellectual property. *See* Profile 6.

251. This group consists of all 21 of the insurance company profiles, as well as seven profiles from the bank case study. *See* Profiles 29; Profile 36; Profile 37; Profile 40; Profile 45; Profile 49; Profile 50.

Like the cash-flow-from-operations strategy, the sales-proceeds strategy has inherent limitations to its general applicability. Nevertheless, at least in loans involving investment collateral, the strategy appears to be practical. Debtors' ability to sell assets thus does not appear to be substantially hindered by the distressed nature of their existing financing.[252]

* * *

The market institutions that are available to distressed debtors are not perfect, or even close to those that appear in classic markets like the New York Stock Exchange. But they do appear to function better than the market that would face even the most sophisticated lender in its attempts to dispose of the distressed assets on its own account. However imperfect, the markets that the debtors face thus appear to be "good enough," in the sense that they present debtors of all types with a variety of realistically practicable strategies that enable them generally to protect valuable assets from their secured creditors.

2. *The Unprofitability of Foreclosure and Repossession*

In the end, the most important evidence relates to what actually happens when the lender obtains control of the collateral. Although the considerations outlined above suggest that debtors have practical mechanisms for preventing lenders from taking control of collateral in which they have equity, the best evidence on that point must come from the actual outcomes: What happens in the cases in which lenders in fact take possession of the collateral?

Interestingly, my case studies do not provide much direct evidence on that question because the lenders whom I studied *believe* that the results will be so bad that they almost never do it. Only once in my bank and finance-company studies did the lender forcibly repossess collateral, and in that case the lender released it to the debtor when the debtor successfully refinanced the loan a few months later.[253] Thus, out of my seventy-two profiles, the lender ultimately took over the collateral only six times (8%), all of which involved the insurance company.[254]

252. Recent empirical inquiry bolsters my view that the sale option is valuable by demonstrating the strength of the market for so-called "vulture" investments in distressed firms. *See* Edith S. Hotchkiss & Robert M. Mooradian, *Vulture Investors and the Market for Control of Distressed Firms*, 43 J. FIN. ECON. 401, 401-04 (1997).

253. *See* Profile 26.

254. *See supra* notes 213 & 214 (listing those six profiles).

As summarized above, it is fair to characterize the results in those six profiles as disastrous: the lender's proceeds on resale of the properties left the lender losing more than seventy-five percent of the original loan amounts in those profiles.[255] Given the limited number of cases in my sample in which lenders took possession of the collateral, those figures standing alone would not be particularly probative, especially in the personal-property area, where my profiles found no foreclosures whatsoever. Nevertheless, I find the results to be powerfully suggestive, given their general consistency with the bulk of the preexisting evidence of which I am aware[256] and with the analysis that the various lending executives used to support their aversion to taking over collateral.

To be sure, my conclusions differ starkly from the conclusions of the only other published study on the profitability to lenders of repossession and foreclosure, Steven Wechsler's 1985 study of foreclosures in Onondaga County, New York.[257] Wechsler used public records to analyze the outcomes of the 118 foreclosure sales conducted in Onondaga County in 1979. One goal of his study was to "measure the frequency and profitability of resales of properties purchased at foreclosure sales by mortgagees . . . ."[258] Although most of his sample involved residential loans, it did include twenty-one commercial loans.[259] Based on his analysis, he concluded that lenders resold the collateral at a price exceeding their debt in almost half of the cases — thirty-five of the seventy-two resales for which he obtained a sales price.[260] Most important for my purposes are his conclusions about the commercial properties. On that point, he did not present data in the text, but did state that "the likelihood of profit or loss on resale did not hinge on the type of property involved . . . ."[261]

255. *See supra* notes 213-17 and accompanying text (summarizing the outcomes of those profiles).

256. For anecdotal evidence bolstering the view of the lenders from my case studies that liquidation of personal property can be as ineffective as liquidation of real property, see Mann, *Small-Business Secured Credit, supra* note 3. For another, unpublished study of the effect of foreclosures on a lender's portfolio, see Brief for Amici Curiae Federal Home Loan Mortgage Corporation at 23, *BFP v. Resolution Trust Corp.*, 511 U.S. 531 (1994) (No. 92-1370) (reporting statistics indicating that the Federal Home Loan Mortgage Corporation lost an average of $792,110 on each of the 156 apartment complexes that it resold after foreclosure in 1992).

257. *See* Wechsler, *supra* note 197.

258. *Id.* at 851.

259. *See id.* at 872.

260. *See id.* at 880.

261. *Id.* at 882.

For several reasons, however, Wechsler's actual data do not support the conclusion that the lenders in his study frequently managed to resell foreclosed collateral at values sufficient to recoup their investments in the commercial properties.[262] First, as Wechsler acknowledges, the method of his study makes it impossible for him to determine the lender's ultimate profit or loss.[263] His conclusions depend on a simple comparison of the price at the foreclosure sale to the price on which the lender paid real estate transfer taxes at the time it resold the property.[264] He thus cannot account for carrying costs or expenditures to improve the property or remedy hazardous conditions on the property. The problems with that approach are evident from one transaction where his methodology indicated a profit of $648,953 on resale after foreclosure of a loan for only $189,743. As Wechsler explains, that transaction involved a construction project on which the lender apparently foreclosed early in construction; the higher resale price apparently reflected the difference between the value of the completed, project and the value of the uncompleted distressed project.[265] As that example suggests and as my profiles indicate, it is not at all uncommon for lenders to incur extraordinary expenditures to stabilize properties after foreclosure.[266] As Wechsler acknowledges, his calculations overstate the lender's recoveries on resale to the extent that they ignore those expenditures.[267]

Moreover, even taken on its own terms, Wechsler's foreclosures did not produce results nearly so sanguine as the text of his article suggests. Excluding the construction-loan transaction mentioned

262. Even if Wechsler's data did support that conclusion for his sample, I would have some concerns about his sample, which appears to involve unusually small commercial real estate loans: an average loan amount on the 16 loans of about $276,000, with a median loan amount below $90,000. My calculations are derived from Appendix A to Wechsler's article, *id.* at 899-900. I base my calculations on 16 of the 21 loans that he lists as commercial loans. I excluded four loans for which he could not determine the disposition because the resale was exempt from tax (his loan numbers 191, 1611, 1612, and 3088). I also excluded one construction loan (his loan number 5182) for which his methodology was inappropriate because of its inability to determine the amount the lender invested in completing construction of the building. *See infra* note 265 and accompanying text (discussing that transaction.)

263. *See id.* at 880 n.170 (noting the inaccuracies of his methodology as applied to a construction-loan transaction).

264. *See id.* at 867 (discussing calculation of sale price).

265. *See id.* at 880 n.170 (discussing that transaction); *id.* app. at 900.

266. *See, e.g.,* Profile 55 (reporting that expenditures to cure environmental hazards on the property were obtained through the deed in lieu of foreclosure).

267. *See* Wechsler, *supra* note 197, at 886. Wechsler's calculations also do not take account of the lender's carrying costs: the interest that would have accrued on the investment during the period of time between the foreclosure and the date of resale. My calculations also ignore these costs, because the insurance company did not record accruals of interest after the date on which it obtained possession of collateral.

above, Wechsler's lenders made small profits[268] in four of the sixteen transactions, averaging fourteen percent of the original loan amount[269] — eleven percent if the transactions are weighted by amount.[270] To get a sense for the profits in question, the total profit on the four transactions was only $21,700, less than $6,000 per transaction. To put those "profits" in perspective, an expenditure by the lender of a modest ten percent of the loan amount in each case — to cover brokerage commissions, title-insurance policies, repairs, and other closing costs — would have converted two of those four transactions to losses and reduced the average profit on the four transactions as a whole to a minuscule $630, about 1.3% of the total loan amount.[271]

By contrast, the losses tended to be much more significant. The average loss on the eleven losing transactions was thirty-five percent[272] — forty-eight percent if the transactions are weighted by amount.[273] Thus, the average loss on the losing transactions was more than $180,000[274] — more than thirty times the size of the average profit Wechsler records on the transactions that he treats as profitable. To put it in perspective, even under Wechsler's method the average outcome on all sixteen transactions[275] was a loss of

268. My method for determining the lender's profit (or loss) depends on whether the lender purchased the property at the foreclosure sale. For transactions in which the lender purchased at the sale and subsequently resold the property, I use Wechsler's Profit or Loss (–) on Resale Column (which equals the difference between the Resale Price and the Total Due Mortgagee at Foreclosure). For transactions in which a third party purchased the property at the foreclosure sale, the lender can only break even or sustain a loss; the lender cannot profit. *See infra* note 275. For the lender's loss, I use Wechsler's Deficiency (–) or Surplus column (which equals the difference between the Foreclosure Sale Price and the Total Due Mortgage at Foreclosure.) There are no loans involving commercial transactions in which the lender purchased at the foreclosure sale and failed to resell the property before the date that Wechsler collected his data.

269. Mean computed by dividing sum of percentages (56%) by number of transactions (4).

270. Profits of $21,700 on loans totaling $191,800.

271. A recent article offers anecdotal evidence that carrying costs during a residential foreclosure proceeding average about 14% of the loan amount. *See* Debra Pogrund Stark, *Facing the Facts: An Empirical Study of the Fairness and Efficiency of Foreclosures and a Proposal for Reform*, 30 U. MICH. J.L. REFORM 639, 675-77 (1997). $21,700 minus $19,180 is $2,520, 1.3% of the total loan amount in those transactions ($191,800).

272. Mean computed by dividing sum of percentages (389.5%) by number of transactions (11).

273. Losses of $2,004,453 on loans totaling $4,217,991.

274. Losses of $2,004,453 on eleven transactions.

275. Wechsler treats four transactions as profitable, eleven as losses, and one (his loan number 3898) he treats as if the lender broke even — a transaction in which a third party purchased the property at foreclosure for an amount that exceeded the lender's debt. The lender in that last transaction received the precise amount of its outstanding debt, with the surplus going to the mortgagor, or inferior lienholders, if appropriate. *See* 1 NELSON &

about $124,000, forty-five percent of the average loan amount.[276] To be sure, that forty-five percent figure is significantly better than the seventy-seven percent average loss that I found in my case study,[277] but it is severe enough to support my view that the rational business lender expects to lose quite a bit of its loan whenever it presses a transaction to foreclosure.

* * *

The simplest interpretation of those findings would be the starkest: lenders hardly ever can hope to liquidate collateral at a value that would approach the amount of their debt. But that conclusion by itself ignores the sorting accomplished by the mechanisms discussed in the first section of this subpart. From my perspective, the disastrous losses that lenders face in foreclosed transactions are to be expected, because they underscore the effectiveness of the mechanisms that allow debtors to protect any equity they might have in their businesses.

The basis for that view is easy to see if we assume that the universe of distressed debtors with secured debt includes debtors whose businesses have values ranging from amounts that substantially exceed the amount of their debts to amounts that are substantially less than the amount of their debts. Two logically separate effects deter the lender from responding immediately with forced liquidation. The first affects the lender directly: the transaction costs of liquidation, which need not be expended if the debtor responds to the distress by satisfying the lender. The second affects the lender indirectly, by providing the debtor opportunities to satisfy the lender if it chooses to do so. Those opportunities are likely to remove debtors at the upper end of the spectrum from the pool: they protect themselves by refinancing, using cash flow from operations, or selling all or a portion of the collateral. The debtors that remain after those possibilities have run their course are likely to be the worst of the pool, those whose assets are worth much less than the debt. When the lender forecloses on the collateral of those few remaining debtors, the natural result — that is to say, the result in my few foreclosure profiles and in Wechsler's somewhat larger uni-

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WHITMAN, *supra* note 225, § 7.31, at 669 (explaining the applicable rules for distribution of proceeds of a foreclosure sale).

276. A net loss of $1,982,753 on 16 transactions involving a total loan amount of $4,417,673.

277. That difference is to be expected, given the inability of Wechsler's methodology to capture the lender's entire costs.

verse of foreclosures — is for the lender to lose quite a large portion of its loan.

My case studies present only a limited amount of direct evidence of the results of foreclosures, and that evidence is limited to real estate foreclosures.[278] But that evidence fits so well with the more general analysis of the market options available to distressed debtors in both real- and personal-property contexts that it lends plausibility to the whole framework. If that framework is correct, the problem of abuses in the foreclosure process is much less important than previously supposed. However logical the theoretical basis for the concern that lenders can use foreclosure to capture valuable assets from their debtors, the market in practice leaves little opportunity for that to occur. Because the debtor ordinarily has a unique ability to obtain the highest possible value for its business assets, even a distressed debtor has considerably more leverage than conventional wisdom would suggest.[279]

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278. The only direct evidence of personal-property liquidation comes from two finance company profiles in which collateral was liquidated by the borrower, under the supervision of the lender in one case and a bankruptcy court in the other. In the first case, the finance company allowed the debtor to conduct a liquidation sale. The sale produced $80,000 against a debt of $190,000, leaving 58% of the debt unpaid. *See* Profile 24. In the second, liquidation produced $1,050,000 against a debt of $1,200,000, leaving 13% of the debt unpaid. *See* Profile 23. In two other cases, my lenders refrained from liquidation in the face of considerable provocation based on specific estimates as to the losses that they would suffer from liquidation. *See* Profile 7 (decision by the finance company not to repossess inventory in the face of fraudulent inventory reports from the debtor based on a determination that the collateral could be sold for $2,000 against a debt of $20,000); Profile 26 (decision by the bank not to liquidate repossessed inventory and equipment based on a determination that a liquidation sale would bring only $50,000 against a debt of $295,000). Restraint turned out to be effective: in both of those profiles the debtors promptly repaid the entire balance of their debts.

279. Throughout this portion of the article I have ignored the possibility that a lender could recoup a portion of its loss by obtaining a deficiency judgment against the debtor, largely because of the limited likelihood that a lender could obtain and collect such a judgment in a commercial transaction. There was only one such judgment in all of Wechsler's loans — he does not say whether it was obtained in a residential or commercial transaction — and that judgment was not satisfied. *See* Wechsler, *supra* note 197, at 877-78. As Jim White and Steve Harris have pointed out to me, there is good reason to believe that some consumer lenders, specifically General Motors Acceptance Corporation, operate on the assumption that deficiency judgments are important to their transactions. Existing evidence, however, makes it difficult to ascertain whether they actually succeed in obtaining and collecting such judgments with any significant frequency.

In the profiles of mine that involved foreclosure, all of the loans were nonrecourse transactions in which the lender contractually waived its right to seek a deficiency judgment. Relying on a contractual exception to that waiver — which allowed the lender to pursue a personal judgment for fraud — the lender in one of my profiles sought, obtained, and collected a judgment of about $1 million against the principal of one of the debtors based on a claim of fraud. *See* Profile 70. Based on a right to withhold funds from the property's income to pay bona fide management fees, the debtor had withheld more than $1 million that in fact was not attributable to management expenses; much of the money was used to pay legal fees supporting the debtor's resistance to the lender's foreclosure action. My description of the loss on that loan, *see supra* note 216, credits the recovery on the fraud judgment against the loan balance; without that recovery the loss would have been even larger.

3. *The Incidence of Foreclosure and Repossession*

Perhaps the most obvious question raised by my study is why I observed so few instances of the exercise of remedies by the lender. As mentioned above, not a single one of my forty-four personal-property profiles involved a repossession and sale of collateral. Although the frequency with which the lender took possession of the collateral was much higher in my real estate profiles (6 of 28 profiles, 21%), even there the incidence of repossession struck me as surprisingly small. The low frequency of repossession is particularly troubling given the strong anecdotal evidence of at least two types of loans in which lenders frequently do take possession of their borrowers' collateral: home mortgages and automobile loans.[280] The apparent frequency of repossession and foreclosure in those markets suggests that my analysis is not complete without some explanation as to why repossession is so rare in the markets I studied and so common in those markets.

Because I have not studied those markets directly, any explanation I offer is largely speculative. Nevertheless, building on the work of Bill Whitford and Art Leff in the consumer-credit area,[281] I can offer a plausible explanation of the differing frequencies of repossession. My explanation starts from a premise familiar from Leff's work: Because coercive collection is a destructive process, a borrower and lender normally can increase their joint wealth by reaching a negotiated solution to the collection problem.[282] That

280. I have no statistical evidence to support my perspective that forced repossession of collateral is common in those two markets. Accordingly, it is at least theoretically possible that I am wrong in worrying about this point: perhaps there are no markets left in our economy in which lenders repossess collateral. For example, I cannot prove that homeowners do not generally avert foreclosure by selling their homes to raise money to pay the debt. My sense, however, is that homeowners avert foreclosure, if at all, by filing for bankruptcy. *See, e.g.*, Rake v. Wade, 508 U.S. 464 (1993); Nobelman v. American Sav. Bank, 508 U.S. 324 (1993); Johnson v. Home State Bank, 501 U.S. 78 (1991). My impression that repossession is a frequent incident in the automobile lending market is based not only on the plausibility of such popular cultural phenomena as the film *Repo Man* (Universal Studios 1983), but also on conversations with Jim White and Steve Harris — both of whom assure me that the major automobile finance companies care deeply about the relevant rules governing the consequences of repossession and sale of their collateral — and on a persuasive, albeit dated, empirical study of that market, *see* Robert W. Johnson, *Denial of Self-Help Repossession: An Economic Analysis*, 47 S. CAL. L. REV. 82, 90 (1973) (presenting statistics indicating that California automobile lenders in the early 1970s repossessed 8.7% of the new cars against which they loaned money).

281. *See* Arthur Allen Leff, *Injury, Ignorance and Spite — The Dynamics of Coercive Collection*, 80 YALE L.J. 1 (1970); William C. Whitford, *A Critique of the Consumer Credit Collection System*, 1979 WIS. L. REV. 1047.

282. *See* Leff, *supra* note 281, at 5-6 (presenting a graph demonstrating why it is rational in the presence of positive costs of coercive collection for the parties to reach an agreed solution to the dispute); *id.* at 12 (summarizing the reasons why coercive collection is costly and destructive); *id.* at 38-39 (attributing failure to settle to "market breakdown [that] stems

analysis is consistent with the results I found in my studies. The harder problem is to identify precisely why the markets I studied differ from the markets in which those negotiations fail. I offer two separate justifications for the failure of negotiations and frequency of foreclosure in the home and motor-vehicle markets. First, those are markets in which the assets are so liquid that the losses from coercive collection are relatively small — often smaller than the transaction costs of negotiating a solution. Second, because those markets involve predominantly unsophisticated consumer borrowers and relatively small loans, the transaction costs of negotiating a solution are likely to be relatively high, limiting the attractiveness of attempts at negotiated solutions.[283]

a. Liquidity of the Collateral. The first point is the most obvious one. It is easy to see that the incidence of repossession and foreclosure should increase with the liquidity of the assets that a lender takes as collateral. For relatively liquid assets that regularly are sold in an organized market, the lender can determine quite reliably what its net return will be after it incurs the costs of repossessing, holding, and selling the assets. To some degree, increased liquidity is reflected in a higher price for the assets.[284] But even for two assets that have the same market value — that is, two assets that would be expected to sell at the same price in an ordinary market

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from an institutional insufficiency which blocks the efficient exchange of information"); Whitford, *supra* note 281, at 1053 ("[T]here is . . . a range of possible settlements, consisting of consensual debtor payments, that will simultaneously benefit the creditor more and hurt the debtor less than coercive execution."); *id.* at 1129 (discussing the "'lost value' phenomenon that characterizes all property execution"). *But see* Alan Schwartz, *The Enforceability of Security Interests in Consumer Goods*, 26 J.L. & ECON. 117, 139-48 (1983) (arguing that Whitford (and implicitly Leff) err in postulating the "lost value" phenomenon, based on Schwartz's view that debtors would not rationally grant security interests if those interests would result in greater losses to the debtors than gain to the creditors).

283. A third factor affecting the likelihood of a negotiated solution would be the number of creditors. As Stuart Gilson has argued, firms that face a greater number of creditors should have more difficulty reducing their debt because of the possibility of individual creditor holdouts. Accordingly, Gilson predicts a connection between greater dispersion of debt and reliance on judicial restructuring through Chapter 11 proceedings. *See* Gilson, *supra* note 10, at 169 (making the argument); *id.* at 185 (reporting evidence to support it); *cf.* MARCEL KAHAN & BRUCE TUCKMAN, PRIVATE VS. PUBLIC LENDING: EVIDENCE FROM COVENANTS 6-15 (Harvard Law Sch. Program in Law and Econs. Discussion Paper No. 151, 1995) (presenting empirical evidence to support the argument that holdout problems cause debt covenants in publicly traded debt to be less onerous than debt covenants in privately placed debt). My impression, however, is that holdout problems should not be as significant in the resolution of troubled secured debt, because the creditor's lien on the assets limits the significance of holdout problems. *Cf.* Mann, *Pattern of Secured Credit*, *supra* note 3, at 651-54 (arguing that secured credit enhances the value of loan covenants because it protects for the creditor the benefits of covenants associated with specific assets).

284. *See, e.g.*, Ronald J. Mann, *Searching for Negotiability in Payment and Credit Systems*, 44 UCLA L. REV. 951, 957-58 (1997) (explaining how liquidity can increase the value of otherwise similar assets).

transaction, taking into account any market premium paid for liquidity — it seems likely that a lender would be more apt to pursue repossession and foreclosure on the more liquid asset.

The most obvious reason that liquidity of collateral would enhance the attractiveness of repossession and foreclosure is that liquidity lowers the dead-weight losses associated with forced collection.[285] That is so because the price that a lender receives upon sale of an asset that is more liquid should be closer to the "market" price that the borrower could have received in an ordinary-course sale of the asset. By definition, the more liquid the asset, the less the price should depend on the particular marketing skills and expertise of its seller.

To be sure, the parties should recognize the enhanced liquidity at the time they are negotiating over consensual solutions, and thus theoretically should be just as able to reach consensual solutions in the high-liquidity context as they are in any other context. Arguably, the only difference would be that the likely consensual solution would be more favorable to the lender, reflecting the greater value of the lender's foreclosure option. The problem with that theory, however, is that it ignores the transaction costs of negotiating a solution. The lender's net recovery from a negotiated solution is unlikely to exceed the value of the collateral to the debtor.[286] In cases where the collateral is highly liquid, the lender can sell the collateral for a net return as high, or almost as high, as the value that the debtor places on the collateral. Accordingly, the lender has little to gain from attempting to negotiate a solution. To put it more starkly, it would not be rational for the lender to pursue a negotiated solution in cases where the transaction costs of negotiating a solution would exceed the difference between the liquidation value of the collateral and the value of the collateral to the debtor.

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285. Another less definitive reason would be the lower variability of recoveries from liquid collateral. If the lender is risk averse, a decrease in the variability of expected recoveries from foreclosure would enhance the attractiveness of the foreclosure option. Although I think that reason has some explanatory force, I do not rely on it heavily, given the difficulty of obtaining solid evidence about the risk aversion of institutions and the officers that make decisions about workouts. For what it is worth, my impression is that any explanation based on risk aversion will decline in significance as information technology enhances the sophistication, uniformity, and objectivity with which institutions make the relevant decisions. *See, e.g.*, Mann, *Small-Business Secured Credit*, *supra* note 3 (explaining how credit-scoring systems can improve the accuracy of underwriting decisions).

286. If the lender insisted on a greater recovery, the borrower would be better off stepping aside and letting the lender take the collateral. I assume, of course, that the parties give no weight to the possibility of a deficiency judgment against the borrower. *See supra* note 279 (justifying that assumption as a general working hypothesis).

Viewed from that perspective, it is easy to understand the relative attractiveness of foreclosure in the markets for motor vehicles and single-family homes as compared to the markets for most business assets. The market for used automobiles in particular appears to be extremely predictable.[287] Lenders should be confident that they can dispose of repossessed cars within a matter of days or weeks at a price that bears a predictable relation to the price for which the vehicle sold at retail.[288] Similarly, although a considerably greater element of unpredictability is present in sales of single-family homes,[289] it is fair to expect that a lender could sell a home fairly quickly for a large portion of the home's "market" value.

By contrast, in the contexts that I studied lenders would be much less likely to dispose of collateral so easily. As Part I of this article chronicles, many, if not most, general business assets degrade in value substantially upon repossession. Even in what must be close to the best of all possible worlds — the repurchase-agreement-backed lending discussed in my finance company study — lenders generally are confident that they cannot sell the collateral for anything approaching the value for which the debtor could sell it. The substantial losses my lenders see coming upon repossession pose a powerful deterrent to repossession as a common strategy. Conversely, the only market in which I saw any forced transfers of possession was the market in which the borrower's ability to bring value to the asset was the most uncertain — the commercial real estate market.[290]

b. Consumer and Business Borrowers. Just as liquidity enhances the frequency of coercive collection by lowering the transaction costs of collection, the presence of consumer borrowers

287. *See* William C. Whitford, *The Appropriate Role of Security Interests in Consumer Transactions,* 7 CARDOZO L. REV. 959, 994 (1986) (discussing typical results obtained on resale of repossessed motor vehicles); Whitford, *supra* note 281, at 1125 ("[A] secured creditor whose collateral is a motor vehicle . . . regularly uses coercive execution as a direct means of collection, partly because there is a well established market in used motor vehicles.").

288. *See* Profile 30 (relating the statement of a bank officer that he "without a doubt" could resell cars repossessed from a dealer's lot at 97% of the wholesale price paid by the dealer for the car, reduced only by the expenses of moving the cars).

289. I speak from the personal experience of two difficult home sales forced by past relocations.

290. I emphasize that my argument is only that repossessed homes and automobiles are *relatively* liquid compared to business collateral. I recognize that there is good reason to believe that even for those assets a substantial amount of value is lost upon repossession and sale. *See* Leff, *supra* note 281, at 42-46; Scott, *Coercive Creditor Remedies, supra* note 2, at 734-35 (summarizing the literature about the lost-value hypothesis, particularly in the automobile lending market). My point is only that the value lost upon repossession seems likely to be even higher in loans involving business assets that ordinarily are not susceptible to resale in an organized market.

enhances the frequency of coercive collection by increasing the transaction costs of a negotiated solution.

In the business context, there is every reason to expect the result my studies suggest. Sophisticated repeat players should do the rational thing and reach an agreement that allows them to avoid the losses inherent in any coercive collection effort. Art Leff put it well: "When . . . transactions [between businessmen] lead to dispute, businessmen avoid the judicial-coercive system, that very flower of Western common law, like some rare Asiatic plague."[291]

As Bill Whitford has explained most thoroughly, however, several factors come together to limit significantly the likelihood of a fully rational disposition of collection disputes in the consumer arena.[292] Among other things, consumers are relatively unlikely to understand their legal rights, much less the practical leverage those rights give them.[293] Moreover, even the rare consumer that does understand the significance of its position will have a hard time convincing the creditor to credit the consumer with a potential for an informed and rational response to the problem.[294] Businesses in dispute frequently will have effective channels of communication, prior relationships, and reputational interests that make it easy for them to provide their counterparts credible commitments of forthcoming actions.[295] Consumers, by contrast, will not have access to similar opportunities. Their relationships with their creditors are much more likely to be one-shot affairs, with limited past opportunities for trust-building communications, and a limited likelihood of future transactions.[296] The rational creditor would do better assuming that consumers generally will not understand their rights and will not act rationally in pursuing their interests whether or not they understand those interests.[297]

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291. Leff, *supra* note 281, at 24.

292. *See* Whitford, *supra* note 281, at 1106-09 (explaining why consumer credit collection involves "too little bargaining and informal settlement, and too much litigation and coercive execution").

293. *See id.* at 1060-66.

294. *See id.* at 1064-66 (suggesting that debtors will not be able to negotiate successfully with creditors unless the debtors hire attorneys).

295. *See* Leff, *supra* note 281, at 24-30.

296. *See id.* at 41; Scott, *Coercive Creditor Remedies, supra* note 2, at 746 (suggesting that "trust is often achieved by the continuity of the relationship between the parties" and that in consumer transactions "the future casts an insufficient shadow over the present to discipline reliably the current behavior of the parties").

297. *See* Whitford, *supra* note 281, at 1107 (suggesting that one "important cause of unnecessary execution is failure of a debtor who can pay to believe a creditor's execution threat, or failure to appreciate the serious consequences of execution"); *id.* at 1108 ("I be-

Thus, in the end, the rational creditor would be likely to adopt a harsh stance that does not allow for case-by-case assessment of the rationality and intelligence of the particular consumer. As Leff states:

> [I]t is too expensive, given the current institutional framework, for [consumer] collection transactions as currently designed to be handled individually on the basis of the peculiar needs of particular parties in particular instances. . . . [O]ne cannot easily customize dispute resolution any more than one can customize manufacture or distribution for a mass market.[298]

If the lender is to adopt one standard approach, the most sensible course certainly would be to wait until the debtor's lack of payment becomes serious, and then proceed with foreclosure as promptly as possible.[299] Indeed, there is a ring of sad reality in Bob Scott's analysis of the reputational incentives forcing the lender to the sternest possible responses: little likelihood of a negative effect on the lender's reputation with potential future borrowers, coupled with a strong likelihood of a positive effect on the lender's reputation for toughness with future defaulters.[300]

B. *Distressed Debt in Context*

The process for terminating distressed debt is not a free-standing economic institution. It is the last step in a lengthy process that starts with the transactions in which debt originates. A complete understanding of the mechanisms of distress thus must evaluate the interplay between what happens in the end-game of distress and what happens up front — at the time of the initial debt contract — when the players establish the rules for the relationship. Turning to that topic, my evidence is directly relevant to two of the most

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lieve debtors make [rational settlement] offers less often than they should from a perspective of personal wealth maximization.").

298. Leff, *supra* note 281, at 38.

299. *See id.* at 42 ("It is no accident that much current collection practice is handled in a relatively rigid, stylized and automatic manner, based on stereotypes and game-like statistical strategies."). My perspective on the reactions of an institutional lender faced with an intelligent consumer is informed by a transaction in which a senior credit officer at a Houston life insurance company, a frequent client of mine, attempted without success to reach a negotiated solution regarding her personal liability on a mortgage on an Austin condominium that was worth substantially less than the outstanding balance on the mortgage. The lender's internal procedures did not permit it to accept any proposal short of complete payment. That procedure can be rational only if it is based on a perspective that there is such a small likelihood of a consumer debtor offering or accepting a value-increasing workout proposal that the lender cannot justify the costs of evaluating such proposals.

300. *See* Scott, *Coercive Creditor Remedies, supra* note 2, at 749-51, 773; *see also* Whitford, *supra* note 287, at 964 (discussing the incentive for creditors "always [to] be concerned about how their actions in a particular case will affect judgments that others, particularly debtors, make about their behavior in future cases").

fundamental issues of commercial law: the reasons for the use of secured credit; and the effect of distress, and the legal rules that govern it, on the willingness of creditors to issue debt in the first instance.

1. *Why Secured Credit: Strategy or Force?*

Secured credit is an economic institution founded on a set of legal rules that are designed to enhance the lender's ability to collect its debt through force, specifically through the forced repossession and sale of the collateral.[301] Legal rules regulate every aspect of the exercise of that force: the types of arrangements that create an opportunity for the use of that force,[302] the events that must occur before a lender is entitled to exercise that force,[303] what the lender can do with the collateral after repossession,[304] and who will have priority over any proceeds produced by the lender's disposition of the collateral.[305]

I have argued in previous articles that the possible benefits of force (liquidation) are much less important than the benefits of strategy. Essentially, my argument has been that the possible returns from liquidation are less important to the potential secured creditor than the various ways in which secured credit indirectly allows the debtor to precommit to actions that enhance the likelihood of repayment.[306] All that I have been able to do in my previous articles, however, is present anecdotal evidence that individual debtors and creditors believe that strategy is important in some circumstances. Because it is clear that liquidation occurs in some

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301. *See, e.g.*, BAIRD & JACKSON, *supra* note 30, at 1 (describing the archetypal secured transaction as one in which "[o]ne person extends credit to another and, as a condition of the loan, both parties agree that in the event of default, the extender of credit can take possession of personal property of the other and sell it to satisfy the debt"); Steven L. Harris & Charles W. Mooney, Jr., *A Property-Based Theory of Security Interests: Taking Debtors' Choices Seriously*, 80 VA. L. REV. 2021, 2051 n.83 (1994) (containing statement by reporters for revised Article 9 that the "essence" of a security interest is the lender's right to possess, dispose of, exclude others from, and sell collateral).

302. *See, e.g.*, U.C.C. § 9-203 (1987); RESTATEMENT (THIRD) OF PROPERTY-SEC. (MORTGAGES) §§ 1.1-1.5 (Tentative Draft No. 1, 1991).

303. *See, e.g.*, U.C.C. §§ 9-502 to -503 (1987); RESTATEMENT (THIRD) OF PROPERTY-SEC. (MORTGAGES) § 8.1 (Tentative Draft No. 5, 1996).

304. *See, e.g.*, U.C.C. §§ 9-504 to -505 (1987); RESTATEMENT (THIRD) OF PROPERTY-SEC. (MORTGAGES) §§ 8.2-8.6 (Tentative Draft No. 5, 1996).

305. *See, e.g.*, U.C.C. §§ 9-301 to -316 (1987); RESTATEMENT (THIRD) OF PROPERTY-SEC. (MORTGAGES) §§ 2.1-2.4 (Tentative Draft No. 1, 1991); RESTATEMENT (THIRD) OF PROPERTY-SEC. (MORTGAGES) §§ 7.1-7.8 (Tentative Draft No. 4, 1995).

306. *See* Mann, *Pattern of Secured Credit*, *supra* note 3, at 639-58; Mann, *Small-Business Secured Credit*, *supra* note 3; *see also* Scott, *Relational Theory*, *supra* note 2, at 950 (suggesting a similar perception "within the [lending] industry").

cases, I have not been able in my past work to provide a clear picture of the relative importance of force and strategy.

The case studies presented here, however, speak to that topic directly, with a much broader empirical foundation than any of my prior work. The message of those case studies is clear: At least in the contexts that I studied, forced liquidation of collateral is quite rare. My lenders forced liquidation of collateral in only four percent (three cases) of my entire universe of seventy-two profiles. To be sure, that figure understates the significance of liquidation to some degree because it does not take into account the secondary effects of liquidation — cases in which the debtor was motivated to act by concern over what would have happened if the creditor had resorted to forced liquidation. Be that as it may, the fact remains that compared to the much higher frequencies of disposition by refinancing, cash flow from operations, and sale,[307] liquidation comes off as a relatively unusual result. That is especially true in the fifty-one profiles from my finance-company and bank studies, where there were no cases of forced liquidation at all.[308]

Given the infrequency with which forced liquidation occurs, it is difficult to contest the view that, at least in some contexts, the major motivations for secured credit must be the indirect effects that play a role in all transactions by affecting the debtor's behavior during the period *before* the loan becomes distressed: limiting the debtor's ability to obtain excessive subsequent financing and repairing the debtor's risk-preferent incentives.[309]

That conclusion suggests an odd dissonance in the organization of the secured-credit system. The legal system provides commercial actors a detailed set of legal rules designed to facilitate forced transfer of collateral, but commercial actors use those rules almost entirely for other purposes. A view of the system in light of the uses that commercial actors actually make of it suggests some hard questions about the propriety of the current path of legal developments in this area. As I write, both of the major institutions that provide legal frameworks for secured lending — Article 9 of the Uniform Commercial Code and the *Restatement of Mortgages* — are in the final stages of projects generally designed to enhance the ease with

307. *See supra* section II.A.1.

308. For a similar anecdotal assessment, see James Interview, *supra* note 232, at 14-15 (stating that Wells Fargo Bank forcibly liquidates collateral in less than 10% of the transactions in which the borrower's business fails).

309. For a general explanation of those effects, see Mann, *Pattern of Secured Credit*, *supra* note 3, at 639-57.

which parties can engage in secured lending.[310] The general rationale for those developments starts from the premise that secured lending provides a cheap and effective credit source and reasons from that premise to the conclusion that the lending market as a whole would work better if we made it easier for parties to use that source by extending the system to cover all conceivable assets: letting the creditors "plow the corners of the field."[311]

In my view, the propriety of that reasoning is linked inextricably with the implicit assumption that forced liquidation is the focal point of the enterprise of secured lending. Thus, I understand why the policymakers who are the ultimate constituencies of those projects can look benignly on a project that is designed simply to lower the transaction costs of forcing nonpaying debtors to hand over the promised collateral in the event of default. Similarly, I see no substantial policy problems with the spread of a system whose principal practical effect is to provide an effective limit on future borrowings.[312] As Douglas Baird has noted,[313] however, it is not nearly so obvious that we should be unconcerned about the spread of a device that operates to enhance the leverage the creditor has over the debtor — holding the debtor hostage, if you will.[314]

Although this article certainly is not the place to work out the details of an alternative set of financial legal institutions, the policy concerns associated with the hostage-related effects of secured credit pose an obvious question: Could we develop a more radically revised financing system that both eliminated the potential for leverage and incentive-alteration that comes with the current liquidation-based system and provided the enforceable mechanism for preventing excessive future borrowing that is missing from the

310. *See* Ronald J. Mann, *The First Shall Be Last: A Contextual Argument for Abandoning Temporal Rules of Lien Priority,* 75 TEXAS L. REV. 11, 11-12 (1996) (summarizing those developments).

311. Memorandum from Elizabeth Warren to Council of the American Law Institute 1 (Apr. 25, 1996) [hereinafter Warren Reform Proposal] (on file with author) (describing "the operative metaphor" of proposed revisions to Article 9). Although the wide variety of assets that will remain outside Article 9 even if the revisions are adopted suggests that Warren's perspective is a bit overstated, it is fair to say that the reporters "think the transfer of an effective security interest ought to be as easy, inexpensive, and reliable as possible." Harris & Mooney, *supra* note 301, at 2021.

312. *See* Mann, *Small-Business Secured Credit, supra* note 3 (arguing that the principal reason for taking collateral from small businesses is to limit future borrowing).

313. *See* Douglas G. Baird, *Security Interests Reconsidered,* 80 VA. L. REV. 2249, 2263-66 (1994).

314. *See, e.g.,* Mann, *Pattern of Secured Credit, supra* note 3, at 646 (analogizing the grant of collateral to the general theory of hostages as a contracting device).

current legal framework?[315] If one of the main reasons that parties use secured credit is to provide a credible limitation on future borrowings, is it not possible that it would be a significant advance to move to a system that preserved that advantage and yet — by limiting the creditor's ability to force liquidation — eliminated, or at least truncated, the less palatable hostage- and leverage-related elements of the current system?[316]

Of course, erection of a new system that eliminated some of the potential benefits of the current system might raise the costs of credit by eliminating the benefits that parties currently derive from the incentive-altering effects of secured credit. But it is highly likely that there are some identifiable contexts in which those effects are not a significant positive factor, so that the loss of them would cause little harm.[317] Moreover, some policymakers might choose to limit those transactions even if they prohibited some value-increasing transactions in the process; that is the kind of moral choice policymakers make all the time.

The problem in the secured-credit context is that the treatment of liquidation as the focal point of the system has obscured the policy issues raised by the actual uses to which the system is put. By abandoning the focus on secured credit as a tool for enhancing creditors' ability to liquidate collateral, scholars could turn their efforts to more relevant inquiries: identifying areas in which secured credit serves unambiguously benign functions, evaluating the policy ramifications of the less benign functions of secured credit, and designing systems that enhance the efficacy of the more benign functions while limiting the use of the less benign functions.[318]

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315. *See id.* at 643-45 (explaining why the current system does not provide a practical mechanism for offering a credible commitment to refrain from excessive future borrowing); Mann, *Small-Business Secured Credit, supra* note 3 (presenting empirical evidence of the acute significance of that problem in small-business lending).

316. Alan Schwartz presents a related proposal in Alan Schwartz, *Priority Contracts and Priority in Bankruptcy*, 82 CORNELL L. REV. (forthcoming 1997). His proposal, however, would merely enhance the ability of creditors to obtain credible commitments against future borrowing, by creating a cause of action enhancing the enforceability of negative-pledge and negative-debt covenants. He would not go on to limit the liquidation-forcing rights of the secured creditor — as I suggest here.

317. *See* Mann, *Small-Business Secured Credit, supra* note 3 (arguing that limiting future borrowing is the only significant benefit of secured credit in the market for bank-issued lines of credit to small businesses).

318. Any serious examination of those questions is beyond the scope of this project. My point here is just to suggest the kinds of issues that are relevant to the situations distressed debtors face in practice.

2. *Distress and the Market for the Origination of Debt*

Most of the highly controversial topics for commercial-law scholars in the last decade have focused on the perceived inefficiencies of the legal system's rules for dealing with financial distress. In the bankruptcy area, a swarm of commentators, generally writing from a law and economics perspective, has castigated the inefficiencies of the bankruptcy processes for distressed businesses.[319] One of the central issues to be faced in evaluating their concerns is the ex ante question: Do aspects of the bankruptcy process that hinder creditors' rights to collect their debts adversely affect the market for the origination of debt? For example, if the bankruptcy process makes it harder to collect debts, then, the argument goes, the supply of credit should contract, raising the price of loans in the first instance.[320]

A similar problem arises in the secured-credit literature, where academics are engaged in an ongoing policy debate about priority among secured and unsecured creditors. The dominant perspective on the topic is that one of the principal effects of secured credit is to shift the risk of financial loss to unsuspecting creditors that either are too unsophisticated to protect themselves by taking collateral or obtain their claims in ways that do not give them an opportunity to take collateral, such as a tortious act by the debtor.[321] Responding to that concern, Elizabeth Warren has offered a controversial proposal that would "carve out" a twenty percent share of the value of collateral held by distressed debtors and set it aside for unsecured creditors.[322] Others have argued that the remedy for that problem is to give tort creditors priority over consensual secured creditors.[323] As with provisions of the Bankruptcy Code that are per-

319. *See, e.g.*, Barry E. Adler, *Bankruptcy and Risk Allocation*, 77 CORNELL L. REV. 439, 440-42 (1992); Lucian Arye Bebchuk, *A New Approach to Corporate Reorganizations*, 101 HARV. L. REV. 775 (1988); Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 YALE L.J. 1043 (1992); Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Bankruptcy*, 71 TEXAS L. REV. 51 (1992).

320. *See* Alan Schwartz, *The Absolute Priority Rule and the Firm's Investment Policy*, 72 WASH. U. L.Q. 1213, 1218-22 (1994) (presenting a formal mathematical analysis of that problem).

321. The leading exponents of that perspective are Lucian Arye Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857 (1996), and Lynn M. LoPucki, *The Unsecured Creditor's Bargain*, 80 VA. L. REV. 1887 (1994).

322. *See* Warren Reform Proposal, *supra* note 311. That proposal, together with the articles by Bebchuk, Fried, and LoPucki, *supra* note 321, were the subject of a February 1997 conference at the Harvard Law School, the proceedings of which are forthcoming in the *Cornell Law Review*.

323. *See, e.g.*, David W. Leebron, *Limited Liability, Tort Victims, and Creditors*, 91 COLUM. L. REV. 1565, 1649, 1646-49 (1991) ("Subordinating all lenders to tort claimants would eliminate the advantage of leverage, and would remove the ability of corporate or-

ceived to delay secured creditors in the exercise of their rights,[324] a fundamental concern with those proposals is the possibility that they will have an adverse effect on the market for the origination of credit. If secured creditors will be able to collect only a portion of their collateral when their debtors face distress, then, the argument goes, secured creditors will constrict the supply of credit; that constriction in turn will slow the pace of investment and thus harm the economy as a whole.[325]

The concern for the origination market is natural for observers that start with the classic presupposition that the function of secured credit is to enhance the creditor's ability to liquidate collateral. But the evidence I present here suggests that the link between the creditor's ability to liquidate collateral and the origination of a secured loan is much looser than traditional analysis would suggest. Although lenders ordinarily set their loan amounts by reference to a posited liquidation value of the collateral, their experience teaches them that in many cases they will be unable to sell the col-

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ganizers to unilaterally determine an artificial level of exposure to tort judgments."); LoPucki, *supra* note 321, at 1893, 1897-98 (discussing how the priority of secured creditors allows firms to externalize tort risk); Robert K. Rasmussen & David A. Skeel, Jr., *The Economic Analysis of Corporate Bankruptcy Law*, 3 AM. BANKR. INST. L. REV. 85, 87 (1995) ("[C]ompensating tort claimants injured by the firm ahead of contractual creditors . . . forces corporations to take into account the injuries their behavior imposes on third parties."); Robert K. Rasmussen, *An Essay on Optimal Bankruptcy Rules and Social Justice*, 1994 U. ILL. L. REV. 1, 31-35 (cataloging the "ills caused by the current regime" of according secured creditors priority over tort creditors).

324. The most useful explanation of the delay imposed by chapter 11 is Lynn M. LoPucki, *The Trouble with Chapter 11*, 1993 WIS. L. REV. 729, 732-45.

325. For analysis of the proposal starting from the assumption that secured creditors in fact will constrict their lending to about 80% of the amounts they currently are willing to lend, see Steven L. Harris & Charles W. Mooney, Jr., *Measuring the Social Costs and Benefits and Identifying the Victims of Subordinating Security Interests in Bankruptcy*, 82 CORNELL L. REV. (forthcoming 1997); Lynn M. LoPucki, *Should the Secured Credit Carve-Out Apply only in Bankruptcy? A Systems/Strategic Analysis*, 82 CORNELL L. REV. (forthcoming 1997). Professor Steven L. Schwarcz provides a similarly negative assessment:

> One therefore would expect, and this has been corroborated with leading finance and bankruptcy lawyers, that a partial priority rule would create an economic disincentive that would cause many potential lenders simply to refuse to make loans to debtors. . . . [T]his Article will assume that a 75% partial priority rule would cause between 10-25% of debtors that need liquidity to be unable to find willing lenders. That assumption has been corroborated as being reasonable and perhaps even conservative.

Steven L. Schwarcz, *The Easy Case for the Priority of Secured Claims in Bankruptcy: A Response to Professors Bebchuk & Fried* 51-52 (Feb. 24, 1997) (unpublished manuscript, on file with author) (citations omitted); *see also id.* at 3 & nn.6-7 (quoting letters from attorneys that support that perspective). Although the practitioners to whom Professor Schwarcz spoke and with whom he corresponded — such notables as Ken Klee, Howard Ruda, and Edwin Smith — have, like Professor Schwarcz himself, impressive practice experience as attorneys, they differ from the subjects of my interviews because they are not themselves lending professionals.

lateral for anything approaching that value.[326] Moreover, in practice both involuntary liquidation of collateral and bankruptcy are quite unusual, even within the relatively small universe of loans that fall into distress.[327] As I have explained above, the creditors in my sample of distressed loans forcibly liquidated the collateral of their debtors in only three profiles (four percent of the entire sample), all of which were in the insurance company study. Not a single one of the forty-four personal-property secured loans in my sample[328] resulted in a forced liquidation of collateral. Furthermore, the values obtained on the insurance company's liquidations were so low — averaging less than twenty-five percent of the unpaid debt — that a twenty percent deduction from those values would have a relatively

326. At first glance, the widespread use of loan-to-value ratios in underwriting significantly undermines my argument, because it suggests that lenders carefully assess the liquidation value of collateral in deciding whether to make secured loans. My tentative view, however, is that, at least in institutional lending by banks and insurance companies, the use of loan-to-value ratios does not really reflect a serious concern about liquidation value. In the insurance company context, my impression, based on several years representing an insurance company in dealing with its distressed loans and on my review of files for this project, is that the asset value described in insurance company credit documentation is derived almost entirely from projections of the cash flow of the asset rather than independent assessment of likely sale proceeds. Essentially, the lender determines how much cash flow the project will produce and then capitalizes the cash flow to produce a value; I think it is almost unheard of for that capitalization to result in denial of a loan application for which the cash flow suggests adequate coverage of the anticipated debt service. Admittedly, capitalizing cash flow is not an unreasonable approach to determining valuation, but it does suggest that cash flow, rather than liquidation, is the point of central significance. Similarly, in a recent study of small-business lending by banks, the lenders to whom I spoke generally stated that cash flow sufficient to cover the anticipated debt service was much more significant to their underwriting decisions than any direct assessment of the value of any available collateral. Indeed, several of the lenders admitted that they readily would make loans that failed to satisfy loan-to-value guidelines provided they were comfortable with the cash flow of the business. *See* Mann, *Small-Business Secured Credit, supra* note 3, at n.68.

327. The universe of distressed loans that I studied is itself only a tiny part of the entire lending market, given the likelihood that well over 95% of loans will be repaid as agreed without incident. *See, e.g.*, Finance Company Credit Executive Interview, *supra* note 67 (stating that less than one-half of one percent of the finance company's loans are in default at any given time); *see also* Gordon Matthews, *Declining Loan Reserves Stir Analysts' Concern*, AM. BANKER, June 20, 1996, at 1, *available in* 1996 WL 5562586 (reporting FDIC statistics indicating that net chargeoffs on business loans made by banks throughout an entire business cycle are in the range of 0.60%, with the worst year ever (1991) recording chargeoffs of 1.63%); Kerry D. Vandell, *Predicting Commercial Mortgage Foreclosure Experience*, 20 J. AM. REAL EST. & URB. ECON. ASSN. 55, 56 (1992) (reporting insurance company industry statistics from 1981-1988 indicating that the total of loans that were delinquent, in the process of foreclosure, or actually foreclosed ranged during the 1980s from a low of about two percent to a high of almost five percent). Although the five percent figure would be conservative under normal economic conditions, delinquencies at insurance companies can rise significantly above that level in periods of pervasive real estate distress. *See* Kerry D. Vandell et al., *Commercial Mortgage Defaults: Proportional Hazards Estimation Using Individual Loan Histories*, 21 J. AM. REAL EST. & URB. ECON. ASSN. 451, 451 (1993) (reporting delinquency and foreclosure statistics for 1992 that totaled 9.78% of insurance company portfolios, and characterizing those statistics as "at their highest levels since the Depression").

328. The 44 personal property profiles are all of the 72 profiles other than the 28 real estate profiles identified at *supra* note 251.

small effect on the lender's recovery even in those cases.[329] Of course, the effects of the carveout would be felt not only in the cases in which liquidation occurred, but also in cases in which the parties negotiate a solution predicated on what would happen if liquidation did occur. But the limited direct significance of liquidation casts doubt on any theory that gives it a weighty role.

The incidence of bankruptcy as a response to a distressed loan is similarly uncommon. In my seventy-two profiles, the debtors sought relief in bankruptcy in only seven cases, ten percent of the entire sample,[330] and two of those cases were filed without opposition from the secured lender.[331] Indeed, even if I look only to the profiles that involved failed businesses, the incidence of bankruptcy remains surprisingly modest (6 of 15, 40%).[332]

Given the relative infrequency of bankruptcy and liquidation even in the universe of distressed loans, it seems most unlikely that either the problems with the bankruptcy system or Warren's carveout proposal would have the kinds of direct deleterious effects on the market for origination that a focus on liquidation might suggest. For something that happens so rarely to have a long-term cognizable effect on the willingness of lenders to issue new debt, the change of result in the rare case of liquidation or bankruptcy would have to be quite striking, and the changes in question do not seem

329. *See supra* note 217 and accompanying text (discussing the losses that the insurance company realized in cases in which it foreclosed).

330. *See* Profile 23; Profile 48; Profile 53; Profile 60; Profile 69; Profile 72; Profile 74. That number does not include the three profiles in which principals of bank debtors filed for bankruptcy, *see supra* notes 142-44 and accompanying text, because those bankruptcies were motivated not by the lender's pursuit of the collateral, but by its pursuit of an unsecured claim against the principal.

331. *See* Profile 53; Profile 74.

332. I count only six bankruptcies in that class because one of my seven bankruptcy profiles involved a tax-motivated bankruptcy with the lender's consent that did not result in severe distress for the property. *See* Profile 74. For the 15 profiles of business failure, see Profile 23; Profile 35; Profile 39; Profile 42; Profile 43; Profile 48; Profile 52; Profile 53; Profile 55; Profile 60; Profile 66; Profile 69; Profile 70; Profile 71; Profile 72.

significant enough to have serious effects in the massive universe of cases in the market[333] for loan origination.[334]

To test that intuition, I discussed Elizabeth Warren's carveout proposal with lending executives at each of the three companies whose loans I examine in Part I of this article. Given the direct purpose of the proposal — to lower their recoveries in loan transactions in which their borrowers fail — it did not surprise me that none of the lenders received the proposal sympathetically.[335] For example, the executive at the finance company stated firmly that his firm would constrict its lending if the proposal were enacted.[336]

But the overall reactions to the proposal suggest that the long-term reactions to that proposal might be relatively small. For example, given the higher frequency of liquidation in his type of lending than in the other types of lending that I studied,[337] I expected the insurance company executive to respond most negatively to the proposal.[338] I thus was not surprised at his view that his institution would react to the proposal by declining to make some loans that it otherwise might have made and by reducing the loan amount in

333. My argument must be limited to the markets that I investigated. There probably are heavily collateral-based areas of lending in which the proposal would have a more direct effect. My main point, however, is that I think it unlikely that the proposal will have the kind of serious, direct, across-the-board impact that critics suggest. Serious effects are likely to be limited to particular markets in which collateral has unusual significance. For example, Paul Shupack tells me that securities clearinghouses retain large amounts of collateral to ensure that entities that use them to clear trades will be able to satisfy their obligations. He reasons that the Warren proposal would upset their operations by significantly increasing the amount of collateral necessary to maintain their operations. He is in the early stages of a project attempting to obtain some empirical support for his view.

334. For empirical evidence supporting an analogous argument, see Michael H. Schill, *An Economic Analysis of Mortgagor Protection Laws*, 77 VA. L. REV. 489, 500-15 (1991) (concluding that differences in mortgagor-protection laws do not have a statistically significant effect on the market for the origination of loans); *see also* Whitford, *supra* note 281, at 1077-78 (outlining reasons why restrictions on creditor's remedies would not directly affect the availability of credit). To get a sense for the tremendous difficulties in careful empirical investigation of such a question, see the frankly ambiguous results reported in William C. Whitford & Harold Laufer, *The Impact of Denying Self-Help Repossession of Automobiles: A Case Study of the Wisconsin Consumer Act*, 1975 WIS. L. REV. 607.

335. *Cf.* Whitford & Laufer, *supra* note 334, at 634 (noting a similar problem with response bias in a survey of automobile lenders regarding their perspective on legal reforms limiting their right to repossess automobiles from defaulting borrowers).

336. *See* Supplemental Branch Operations Manager Interview, *supra* note 26.

337. All of the cases of forced liquidation that I studied were in the insurance company profiles.

338. I should point out that my discussion of the proposal with the insurance company executive was purely hypothetical because the existing proposal would not apply to real estate loans. Warren contemplates only an amendment to Article 9, not the Bankruptcy Code or any other body of law applicable to real property. *See* Warren Reform Proposal, *supra* note 311, at 1 (summarizing the proposal); *cf.* LoPucki, *supra* note 325 (discussing criticism of the proposal based on the exclusion of real estate loans).

others.[339] I was a bit surprised, however, by his subsequent comments expressing doubt that the response would reflect a permanent change in lending practices. First, because his institution suffered considerable losses on its real estate portfolio during the last decade, he believes that his institution is considerably more cautious than many of the institutions against which it competes for business.[340] Accordingly, he thought it at least possible that other institutions would continue to advance funds on the terms that currently are customary, with the end result being less a reduction in lending and more a shift in business from his institution to less cautious institutions.[341] Second, he thought that even at his institution a contraction of lending would dissipate if experience of the industry indicated that the carveout rule did not impose substantial losses on lenders. As he put it: "I think there would be a general slowdown, but my guess is that after people gulp a little bit — the engines might get geared up again — especially if we work through a cycle and see how it works."[342] Thus, even the insurance company executive — whose institution lost tens of millions of dollars just on the loans I studied — was not confident that the carveout rule would have a significant long-run impact.

Finally, the banking executive firmly believed that the proposal would have no effect whatsoever on bank lending. As he put it, loan officers responsible for origination "don't think or give one hoot about bankruptcy/workout scenarios. They hope to hell it won't happen. . . . [I]t won't affect one iota how the banks initiate loans."[343] He initially attributed that result to the imperfect incentives that confront bank loan officers. From his perspective, those officers are institutionally unlikely to be adequately concerned about the risk of loss in their loan transactions, both because of their responsibility to "get money out the door" and because the effects on them of failed loans are much more indirect: "[T]hey are there to make loans — that's how they are compensated and that's how they are rewarded and anything that potentially will happen is way down the road and they will probably be gone or moved

339. *See* Telephone Interview with Insurance Company Executive (Mar. 6, 1997) [hereinafter Supplemental Insurance Company Executive Interview].

340. *See id.* at 5 (suggesting that his institution is "more on the conservative side" and "more willing to walk away . . . from a deal that wouldn't work").

341. *See id.* at 5 (stating that his institution's conservatism distinguishes it from competitors for whom "that's the job, there's the money, you've got to put it out").

342. *Id.* at 2.

343. Telephone Interview with Bank Division Manager (Mar. 6, 1997) [hereinafter Supplemental Bank Division Manager Interview].

on."[344] He maintained that opinion even when I pressed him to consider what would happen if the compensation incentives for loan officers were altered to remove that problem. Even then, he stated, the effects would not be enough to alter underwriting patterns: "[A]n officer by his . . . job is an optimist that things are never going to go wrong and I'm a good underwriter and those are things that don't happen to me, it always happens to the other person. So [the proposal] would have no bearing at all."[345]

Together with the numerical evidence from my case studies, those interviews support my thesis that adoption of current proposals to limit secured-creditor priority in liquidation or insolvency would not have nearly so serious an effect on lending as a liquidation-focused analysis would suggest. Analysis of those proposals thus should not be diverted by concerns that they would have a substantial effect on the lending market.[346] Rather, those proposals should be evaluated based on their effects in the situations in which they are more directly relevant: the transactions in which they directly alter liquidation allocations and the transactions in which liquidation is sufficiently likely for the proposals to alter the parties' strategies in responding to distress.

CONCLUSION

Secured credit is a complex institution that appears in many forms in many different parts of our economy. Given the wide variety of contexts in which it is used, I would not have been surprised if my three case studies produced widely varying perspectives. But as it happened, they produced evidence of striking homogeneity. All three case studies suggest that, even on distressed loans, it is unusual for secured creditors to take possession of their collateral, that it is common for secured creditors to be repaid through refinancing or sale of their collateral, and that the great majority of their debtors' businesses survive unscathed in the face of the distress that causes the secured creditor to terminate its relationship

344. *Id.* at 2. The bank division manager's perspective that loan officers are insufficiently sensitive to risk is not universally shared. *See, e.g.*, James J. White, *Efficiency Justifications for Personal Property Security*, 37 VAND. L. REV. 473, 494-502 (1984) (arguing that bank officers seek collateral because they are excessively sensitive to risk).

345. *See* Supplemental Bank Division Manager Interview, *supra* note 343, at 2.

346. My perspective might be different if I were convinced by the suggestion, *see, e.g.*, Schwarcz, *supra* note 325, at 3 (quoting letters from concerned attorneys), that negative effects would be concentrated in particular sectors such as small businesses, which play a disproportionately important role in overall economic development. Given my general belief that secured credit is disappearing from the small-business market, *see* Mann, *Small-Business Secured Credit*, *supra* note 3, that concern strikes me as misplaced.

with the debtor. To be sure, those observations might be untrue in some contexts — in other markets that I did not examine or in particularly distressed portions of the business cycle. But the consistency of the picture in the widely disparate environments that I did examine strongly suggests that the findings noted above are important parts of the overall picture.

Those findings, in turn, suggest two global conclusions about the world of distressed debt. First, creditors and debtors, acting with relatively limited assistance from positive law, have developed mechanisms that allow creditors to identify and respond to distress at a surprisingly early stage, long before businesses become terminally ill. Second, distressed debtors can turn to a strikingly well-functioning market to respond to the concerns of their creditors. Taken together, those conclusions present a world in which — with little thanks due to the products of the legislative process — the plight of the distressed debtor is surprisingly sanguine.