

A BLIGHTED LAND: AN EMPIRICAL STUDY OF RESIDENTIAL DEVELOPER BANKRUPTCIES IN THE UNITED STATES 2007-2008

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Abstract

With falling home prices and home foreclosures currently acknowledged as a severe problem in the U.S., more attention needs to be paid to the contributing phenomenon of residential developers undergoing liquidation, which has left behind a trail of partially-completed or abandoned properties. In order to understand this phenomenon, we investigated the following questions: How have the Chapter 11 bankruptcy cases of residential developers and home builders during this downturn been resolved? How did the actions taken by secured lenders in the course of bankruptcy proceedings shape the resolution outcome? To what extent was bank behavior during these bankruptcies affected and constrained by the banking regulatory framework and culture?

We analyzed more than 200 residential developers that filed Chapter 11 bankruptcy petitions between November 2007 and December 2008. Our finding was that only a small minority of these developers confirmed a reorganization plan. The majority of the cases were dismissed or converted to Chapter 7, culminating in foreclosure or liquidation sales. In the sample, over 70% of the cases showed at least one instance where a secured lender sought lift-stay motions to pursue foreclosure. Among such cases, orders granting the lift-stay motions were granted most of the time.

Investigating this insistence on quick foreclosure, we explore more nuanced views of banks' lending functions, risk management and their regulatory environment. We find that during a recession, banks may have a preference for liquidation in bankruptcy because of capital shortfalls and procyclical regulatory pressure to reduce portfolio concentrations, particularly in real estate lending. This would be inconsistent with theories that secured lenders will choose economically optimal outcomes within a bankruptcy case, as they may choose outcomes that are sub-optimal within a bankruptcy to maximize an exogenous urgent need for capital.

Finally, a study of FDIC data and banks' comment letters suggests that in the period prior to the current crisis, the riskiness of debtors was only weakly linked to increased pricing for riskier debtors, because of competitive markets, increased securitization, and inadequate risk management and risk-based pricing systems. We find evidence that a general weakening of secured creditor control does not necessarily lead to specific changes in the cost and availability of credit.

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Chapter 1: Introduction

1.1 Background and Overview

“There's a cement slab on Ridge Lane, topped with a few pipes, an electrical box and a porta-john. Nearby, an empty house, a large sign in the driveway declaring “inventory home.” Around the corner, a few muddy lots, rimmed with construction fences ... ‘If [the developer] is gone,’ [Kathy] Koss [a resident in the neighborhood] said, ‘what is going to happen to these houses?’”¹

Snippets describing unfinished residential developments, such as this one, are increasingly seen in the news since the recession started in 2007. Amidst the constant bombardment of news and industry studies regarding the severity of the foreclosure problem for home owners defaulting on their mortgages in the United States, less attention has been paid to the problem of bankrupt residential developers and their relationship with unfinished, abandoned, or empty developments and a glut in the housing industry.

As financially distressed residential developers and home builders are forced into liquidation or foreclosure and leaving behind communities under construction, the impact is not limited to home owners living in those neighborhoods. Unfinished or fire-sale properties can have a domino effect on housing prices and exacerbate the serious problems we have seen in housing markets. It has been said in Congress, in support of the Helping Families Save Their Homes Act Of

¹ Kristen Valle, *Unfinished Homes Worry Neighbors*, Charlotte Observer, Mar. 15, 2009, at http://wotnews.com/like/unfinished_homes_worry_neighbors/1234705/.

2009 (H.R. 1106) that “[u]ntil the housing sector is stabilized, there will simply be no recovery in America”.²

The media spotlight has mainly been on individual home owners, rather than residential developers, yet the fact that so many residential developers have entered bankruptcy forces the question of whether the bankruptcy process in some way shapes the situation described above. It is thus important to ask, how have the bankruptcies of these residential developers been resolved, and are these outcomes a necessary result of the bankruptcy process?

Looking for answers to address this issue, we reviewed academic papers and found a gap in the literature – there is little past empirical work focusing specifically on bankruptcies occurring during a severe downturn,³ let alone studies on the residential development industry. Nonetheless, a survey of contemporary bankruptcy literature turned up key starting points for our investigation: the rise of secured lender control in bankruptcy proceedings, and their preference for sales and liquidations.⁴

² H.R. Rep. No. 1106, 111st Congress, 1st Sess. (2009) (speech of House Speaker, Nancy Pelosi, in support of the Helping Families Save Their Homes Act of 2009).

³ See, for example, Cheol S. Eun & H. Jonathan Jang, *Investor Recognition of Bankruptcy Costs: Evidence from the 1987 Market Crash*, 4 *Multinational Finance Journal*, 221 (2000).

⁴ See, generally, Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 *Stan. L. Rev.* 751 (2002), [hereinafter Baird & Rasmussen, *End*], David A. Skeel, Jr., *Creditors' Ball: The "New" New Corporate Governance in Chapter 11*, 152 *U. Pa. L. Rev.* 917 (2003), Elizabeth Warren & Jay Lawrence Westbrook, *Secured Party in Possession*, 22 *Am. Bankr. Inst. J.* 12 (2003) [hereinafter Warren & Westbrook, *Possession*], Barry Adler, *Bankruptcy Primitives*, 12 *Am. Bankr. Inst. L. Rev.* 219 (2004) [hereinafter Adler, *Primitives*]. These works focusing on secured creditor control of the bankruptcy process are in contrast to earlier works that focused on the debtor and management control of the process, reflecting a change in the balance of power. Examples of the older work include: Lucian Arye Bebchuk & Howard F. Chang, *Bargaining and the Division of Value in Corporate Reorganizations*, 8 *J. L. Econ. & Org.* 253 (1992), Alan Schwartz, *A Contract Theory Approach to Business Bankruptcy*, 107 *Yale L.J.* 1807 (1998) (“It is widely believed that debtor firms use their power to run their businesses and to control the reorganization agendas to capture portions of the value that creditors are legally entitled to receive.”), and Barry E. Adler, *Financial and Political Theories of American Corporate Bankruptcy*, 45 *Stan. L. Rev.* 311, 315-16 (1993) [hereinafter Adler, *Theories*] (“Typically, the firm’s prebankruptcy managers—agents of the equity investors and often equity investors themselves—control both the firm and the reorganization process.”)

1.2 Research Questions and Design

To fill the gap in the literature, we embarked on an empirical inquiry into the bankruptcy proceedings and outcomes of 222 residential developers and home builders which have filed for Chapter 11 bankruptcy from November 2007 till the end of 2008, using the data to answer the following questions:

1. How have the Chapter 11 bankruptcy cases of residential developers and home builders during this downturn been resolved?
2. How did the actions taken by secured lenders in the course of bankruptcy proceedings shape the resolution outcome? Where there were key actions taken by secured lenders which contributed significantly to the outcome, what have we observed from bankruptcy proceedings that explain the secured lenders' ability to push through its objectives?
3. To what extent might the outcomes of these bankruptcy cases be affected by the lack of availability of DIP financing from lenders? What really happened inside the bankruptcy proceedings of developers which managed to obtain DIP financing from lenders?
4. Why did the banks act the way they did in these bankruptcy proceedings? To what extent was bank behavior affected and constrained by the banking regulatory framework and culture?

In the research design, we choose to focus on cases of residential developers and home builders which filed for Chapter 11 bankruptcy from November 2007 (near the official start of the recession) till the end of 2008. Chapter 7 bankruptcy cases are not within the scope of this paper,

since these cases are already earmarked for liquidation, i.e., auction sale or foreclosure, from the outset (see further details in the methodology discussion in Chapter 3 of this paper).

In defining another key resolution outcome, “reorganization”, we take our cue from the bankruptcy literature where the milestone studied is the confirmation of a reorganization plan where the entity continues as a going concern with a new capital structure.⁵ In the context of developers, this means that the entity will be able to proceed with the residential construction and development process, and continue to honor obligations to customers such as home owners (e.g., under home warranty programs) and home buyers (e.g., where they have placed a deposit for presold homes).

Questions 1 and 2 are mainly addressed through an analysis of the data collected on 222 cases from Chapter 11 bankruptcy dockets, where we tracked the resolution outcomes of the bankruptcy cases and the major actions taken by secured lenders during proceedings. Note that we seek to look beyond the procedural outcomes of these bankruptcy cases to the economic outcomes, e.g., whether a case dismissal involves a subsequent foreclosure by the lender, or whether it is the result of an amicable settlement by parties. In dealing with a potential criticism that there may be sample selection issues owing to the recentness of the cases, we look beyond strict resolution outcomes such as plan confirmation to include cases with substantial resolution, as explained in further detail in the methodology and findings sections, Chapters 3 and 4. It should be noted that a balance has to be struck between the importance of studying a recent phenomenon at the heart of the current recession and the need for “methodological purity” in terms of analyzing data.

Next, a case study approach is utilized to answer Question 3. Given the small number of cases where DIP financing was available to the bankrupt developers and the need to provide a rich description of what happened in such cases, the use of case studies may be the most appropriate

⁵ See, for example, Elizabeth Warren & Jay Lawrence Westbrook, *The Success of Chapter 11: A Challenge to the Critics*, 107 Mich. L. Rev. 603 (2009) [hereinafter Warren & Westbrook, *Challenge*] and also Elizabeth Warren & Jay Lawrence Westbrook, *Contracting Out of Bankruptcy: An Empirical Intervention*, 118 Harv. L. Rev. 1197 (2005) [hereinafter Warren & Westbrook, *Intervention*].

research technique. As briefly discussed above, we selected one case from each of two main sub-sectors of residential development – single-family homes construction and condominium development, Suncrest and Shores of Panama, respectively.

Additionally, to understand how the interplay of issues may be different in the case of a larger developer with a more complicated capital structure (i.e., second lien lenders), we selected LandSource for analysis. As an aside, one of the most interesting insights from examining LandSource is how easily the resolution outcome could change depending on the secured lender's preferences – the secured lender first pushed for a piecemeal liquidation of the developer, and subsequently supported reorganization in light of changed circumstances.

As for Question 4, we relied on findings from interviews with over 30 participants from the banking industry, bank comment letters and personal observations obtained in the course of work with the risk management departments of banks, as well as some banking regulation manuals, finance literature and Congressional testimonies about banking practices.

1.3 Summary of Findings

The findings from this investigation are in line with anecdotal observations from the news – only around 5.3% of the developers which filed for Chapter 11 in our study had confirmed a plan of reorganization. The majority of the cases was actually dismissed or converted to Chapter 7, whereby the real estate was either foreclosed upon by the secured lenders or liquidated in forced sales.

Digging deeper into the dockets to investigate the role of secured lender actions in the bankruptcies of the residential developers, we confirmed that secured lender control of bankruptcy proceedings shaped these outcomes. This conclusion was supported by observations from the bankruptcy dockets which showed an overwhelming proportion of motions filed by secured

lenders to obtain relief from the automatic stay imposed by bankruptcy in order to pursue foreclosures, i.e., lift-stay motions. In our data sample, 72.0% of the cases showed at least one instance where a secured lender sought lift-stay motions to pursue foreclosure and, among such cases, an order granting the lift-stay motions was granted 90.1% of the time.

We then delved into these cases to understand the grounds underlying the secured lenders' ability to succeed in these motions. What are the reasons raised by the secured lenders in support of the motions? To what extent are these motions granted due to the 2005 changes in bankruptcy legislation, or settlements struck with the developer and its insiders? We also took a look at sales of substantially all assets of these developers free and clear of liens under section 363 of the Bankruptcy Code which seem to be used by secured lenders as an alternative to foreclosures. There, we uncovered a pattern of winning credit bids where secured lenders acquired the properties of bankrupt developers put on auctions at low prices.

Next, we turned to the question of post-petition financing, and must confront the fact that the significant declines in earnings and assets for many financial institutions originating from the subprime mortgage meltdown might have adversely affected the developers' access to financing to fund ongoing construction.

Would the bankrupt developers have fared differently if they were able to obtain post-petition financing? At first glance, our data appears consistent with this line of argument – very few developers were indeed getting funding in bankruptcy proceedings (i.e., debtor-in-possession (“DIP”) financing) from lenders. However, what is more striking is that most of the cases where DIP financing was provided by lenders were either liquidated or packaged for sale.

In an attempt to understand what happened in these developer bankruptcies where DIP financing was available, we selected 3 cases for detailed analysis: that of a condominium developer,

Shores of Panama, Inc. (“Shores of Panama”),⁶ that of a mid-sized developer of single-family homes, Suncrest LLC (“Suncrest”),⁷ and that of a “mega” developer, LandSource Communities Development LLC (“Landsource”),⁸ with over a billion in total assets. Using these case studies, we investigated and have here documented how secured lenders, also the DIP lenders, used the DIP financing arrangements to set the course and shape the outcomes of these bankruptcy proceedings, often culminating in sales and liquidations.

We also found illustrative examples of the problem of ceding control to a party with interests that are not necessarily aligned with those of other stakeholders. While our analysis showed that the DIP financing did provide marginal benefit in keeping these developers afloat pending resolution, it came at a cost which other stakeholders might consider to be “extraordinary”. Furthermore, in two of the case studies, we looked beyond the bankruptcy proceedings to the aftermath of the real property sale. In one case, the bank which repossessed the property not only had trouble with the remaining development process but also found itself in a position where it could not sell the property as a going concern – further evidence that secured lender control might not necessarily produce optimal results. In the other case, the bank which repossessed the property was seized by regulators 2 months later for being insufficiently capitalized, raising the issue of the extent to which a bank’s own financial problems might have contributed to its preference for liquidation during bankruptcy proceedings.

Finally, we examined the key actors of these bankruptcy proceedings – the secured lenders, which, according to our data on residential developers, are typically commercial banks. The objectives of this exercise were two-fold: (i) provide a further understanding of the reasons underlying the liquidation preference of secured lenders; and (ii) address a gap in the literature regarding how banks actually function. Perspectives from this exercise are important, adding color

⁶ See *In re Shores of Panama*, No. 08-50066 (Bankr. N. D. Fla. February 26, 2008).

⁷ See *In re Suncrest LLC*, No. 08-22302 (Bankr. D. Utah April 11, 2008).

⁸ See *In re LandSource Communities Development, LLC*, No. 08-11111 (Bankr. D. Del. June 8, 2008).

to the empirical evidence in this study and its plausible use as support for legislative interventions relating to the bankruptcy regime.

Much of contemporary bankruptcy literature is premised on banks being rational, single-mindedly profit-maximizing actors. This assumption typically underlines the resistance to legal reforms which may undermine secured lender control and alter lenders' rights, arguing that these will increase borrowing costs and reduce the availability of credit. Using findings from interviews with participants in the banking industry, information in comment letters from banks to bank regulators and personal observations from a 2.5-year stint consulting for bank risk management departments, the central picture that emerged was that banks are highly-constrained profit-maximizing entities, with the banking regulatory framework and culture being a significant constraint. Furthermore, we should consider whether socially optimal solutions are produced by a bankruptcy regime which allows secured lender control at a time when many banks are fighting for their own survival – would these banks restructure the debts owed by debtors, or simply try to liquidate the assets as soon as possible in a bid to raise more capital?

1.4 Contributions and Chapter Summary

This study is a contribution to the literature for the following reasons:

- Being the first comprehensive empirical study on bankruptcies occurring in one of the worst-hit sectors during a severe downturn, it addresses a current phenomenon related to residential developer foreclosures and the housing crisis, which has been relatively overlooked, despite its significant implications on homes and communities;

- It is an inter-disciplinary work infusing the understanding of bankruptcy policy with the banking regulatory and risk management context. The objective is to elucidate the inner workings and regulation-infused culture of banks, which are typically portrayed in bankruptcy literature as rational, profit-maximizing actors, and how this understanding helps explain bank decision-making in bankruptcy.

The rest of this study will proceed as follows. Chapter 2 lays out the research context by describing the societal impact of foreclosures and liquidations of residential developers. It also contains a review of the literature on the rise of secured creditor. Chapter 3 provides a detailed description of the methodology for the empirical data analysis, covering topics like sample selection, the methods used for extracting data from bankruptcy dockets and a description of the sample collected for analysis.

This is followed by Chapter 4 which documents our findings from the docket analysis regarding the distribution of outcomes in the data sample. Chapter 5 comprises of observations from an in-depth investigation of the bankruptcy dockets, where we describe the actions of secured lenders to move developers down the path of liquidation, forced sale or foreclosure. In analyzing the mainstay of Chapter 5, the prevalence of lift-stay motions, we not only looked at the grounds underlying contentious lift-stay motions but also cases where the developers compromised and consented to the relief from stay for foreclosure. Chapter 6 presents the three case studies of bankrupt developers with DIP financing from lenders, while Chapter 7 caps off the discussion with insights regarding the inner workings and regulation-infused culture of banks.

Chapter 2: Research Context

The current economic crisis that began with a recession in December 2007 has been punctuated by soaring unemployment, the failure of numerous banks, and more firms declaring bankruptcy than ever before. In this backdrop, this study has chosen to focus on the workings on the bankruptcy process in one of the most financial distressed sectors during the severe recession – the residential development and homebuilding industry.

The residential development and homebuilding industry grew to a very significant size during the real estate boom that ended in 2007. The industry consists of corporations both very large and very small, from the humblest firm of contractors consisting of only several employees to the very largest national builders like Kimball Hill and Lennar Corp. (“Lennar”). At the time of this study, Kimball Hill is undergoing liquidation in bankruptcy and Lennar is a shareholder of the now bankrupt LandSource. The attraction of this industry from the perspective of our study is that it extends through every state and most, if not all communities.

Moreover, the poor performance of construction loans has put immense pressure on the banking industry. In June 2008, FDIC Chairman Sheila Bair has stated that 75% of the newly-emerged problem banks up till June 2008 had concentrations in commercial real estate lending, or construction and development lending, or both.⁹ For example, at the time of the seizure of IndyMac Bank by regulators, 34.4% of IndyMac’s non-accruing assets were construction loans.¹⁰ What happens to the residential development industry thus has serious and significant implications for society as a whole, developers, home owners and banks alike.

⁹ Statement of Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation on The State of The Banking Industry: PART II before the Committee on Banking, Housing and Urban Affairs, U.S. Senate, June 5, 2008.

¹⁰ *U.S. Banking: 2008 Issues Review, Construction Loans*, A.M. Best Research, September 8, 2008.

In this Chapter, we will first review the industry; second, describe what we have observed in terms of the biggest problems in the industry today; and third, review the bankruptcy literature.

2.1 An Overview of the Residential Development Process in the United States¹¹

The residential development and homebuilding industry encompasses entities that primarily undertake new development projects for single-family homes and condominium homes communities. There are four primary stages of real estate development: predevelopment, planning and design, construction, and marketing.

During the predevelopment stage, the developer has to ensure that the site selected is primed for construction. A tract of “raw” (unimproved) land requires preliminary work such as constructing roads, fencing, gutters, utility, water lines and other infrastructure improvements necessary to make the land suitable for residential use. The next stage, of planning and design, involves the formulation of architectural and construction plans, landscape engineering, selection of suitable building materials, and dealing with issues such as zoning restrictions and private covenants.

Next, the construction stage, the one most visible to most of us, kicks in. It starts with a process of selecting a contractor, determining construction contract requirements, making a projected construction budget, disbursing funds based on completion of project phases, building the improvements, and monitoring construction progress. It typically involves a general contractor who is either an independent contractor or the developer who has assumed this role in order to control the entire construction process. Subcontractors are usually involved and they would have

¹¹ Office of Thrift Supervision, *Examination Handbook* (2009), available at <http://www.ots.treas.gov/?p=ExaminationHandbook>; specifically, see Section 740.

rights to file mechanics' and materialmen's liens over the property for their labor and costs in the construction process.

The final stage is the marketing, sale and lease of the homes developed in these sites. Usually a broker is involved to assist the developer in performing marketing analyses, making sales and rental projections and marketing or leasing the property. This process can begin prior to the completion of construction as developers market and sell presold homes (whereby home buyers put down a deposit and the developer agrees that the development will be substantially completed with a certificate of occupancy will be issued within a specified time period).

2.2 Societal Impact of Distressed Residential Developers

A news article in June 2008 described how “[p]rocess servers ... blanketed the Trend Homes community in east Gilbert with foreclosure notices” and that “construction activity ceased suddenly early this year, and more than a half-dozen unfinished homes stand in various stages of completion, sun-faded and coated with dust”.¹²

It is not an isolated case. Since late 2007, there have been numerous reports about unfinished residential developments dotting the landscape across America.

Another news report summed up a similar situation succinctly: “[w]hile construction has halted in some unfinished subdivisions, time and the elements roll on. The developments [part of the Den-Mark Construction group (“Den-Mark”)] face eroding facilities and image”.¹³ This article continued to report the story of Diane Hardy, a resident at one of these developments, Winston Ridge, who was paying \$550 a year in homeowners association (“HOA”) dues, but “had no privacy

¹² J. Craig Anderson, *Empty Feeling at Gilbert Subdivision: Foreclosures Spread to Developers' Vacant Lots*, The Arizona Republic, Jun. 18, 2008, at <http://www.azcentral.com/news/articles/2008/06/18/20080618biz-trendhomes0618.html>.

¹³ Jack Hagel & Matt Ehlers, *They Live in Real Estate Limbo: Residents Left in Unfinished Burbs*, The News & Observer, Apr. 6, 2009, at <http://www.newsobserver.com/news/story/1472343.html>.

fence, no walking trails” and she longed “for a second layer of asphalt to make the street level with protruding pipes...for now, she weaves through them, mindful of her tires”.¹⁴

What was not reported in the story was that the bankrupt owner of the Winston Ridge subdivision, Marcus Edwards Development LLC (“MED”, an affiliate of Den-Mark) had been embroiled in a dispute with its secured lender, SunTrust Bank, over the financing required for completing the property.¹⁵ MED sought to enter into a financing arrangement with another lender, Capital Bank. The problem was that Capital Bank wanted a priming lien over the property. SunTrust Bank launched a strong objection, claiming that the financing was nothing more than an attempt to shift to them the risk of loss of [MED’s] inordinately risky and purely speculative plan to continue development of the property”.¹⁶ Unfortunately for Diane Hardy, SunTrust won this battle.¹⁷ This is an example of how the complex mesh of bankruptcy laws filters down to the community level, affecting countless home owners.

Unfinished residential developments are not the only major way by which home owners are affected. Home owners in developments with under-funded HOAs have seen their HOA fees rise even as amenities and services are being diminished or eliminated, and the biggest debtors of HOAs are in fact the developers.¹⁸ Where a bankrupt developer falls into liquidation, the financial position of the HOA, an unsecured creditor, will be placed in jeopardy as well. Furthermore, home owners who have bought homes from bankrupt developers with construction defects are left with a warranty claim which may be of little value. Generally, claims by home buyers under these warranties are treated as pre-petition general unsecured claims in bankruptcy proceedings. Post-petition proceeds from assets sales and liquidation would go first to senior secured lenders, and in

¹⁴ *Id.*

¹⁵ *In re* Marcus Edwards Development, LLC, No. 08-02769 (Bankr. E.D.N.C. April 24, 2008).

¹⁶ *Id.* See Suntrust Bank’s brief in opposition to the motion requesting DIP financing.

¹⁷ See SunTrust Bank v. Den-Mark Construction, Inc., 2009 U.S. Dist. LEXIS 49431, No. 5:2008cv00529, (E. D. N. C. April 7, 2009).

¹⁸ J. Craig Anderson, *Unfinished Subdivisions Stuck with Underfunded HOAs*, The Arizona Republic, Dec, 21, 2008, at <http://www.azcentral.com/arizonarepublic/business/articles/2008/12/21/20081221biz-homeowners1221.html>.

these cases where there are very few assets left for the estate, the recovery on general unsecured claims is likely to be extremely low, if not close to zero.

In some cases, a bankrupt developer can file a motion with the court, requesting permission to honor warranty claims and other pre-petition customer obligations. We have observed that banks typically object to such motions, to the detriment of homeowners and home prices.¹⁹ Even in cases where some developers were able to obtain court authorization to honor pre-petition warranty claims, the claims are usually limited. A recent example is Mercedes Homes where the authorization was extremely limited – the company cannot expend more than 1% of a home’s final sale price on prepetition customer program obligations related to that home.²⁰ Caruso Homes was also authorized to honor warranty claims, subject to a cap of \$1,500 per home (inclusive of any pre-petition sums spent by the builder),²¹ and the Woodside Group would honor claims under the warranty program, excluding construction defect claims – the class of claims for which home owners really need to enforce warranties.²²

Moreover, in section 363 sales where the residential development was sold free and clear of all liens to a new buyer, the buyer would not be obligated under warranty contracts (which were typically not negotiated as part of the agreed “permitted encumbrances”). An example of this is Trend Homes where the new buyer in a section 363 sale, T2 LLC, was not contractually obligated for any warranty claims and has since so informed home owners living in the communities.²³

The impact of developer bankruptcies reaches beyond home owners to home buyers who have put down deposits for the purchase of homes before the recession. During the past few years, many developers had kept the deposits in their general operating accounts to fund development,

¹⁹ See, e.g., Columbia River Bank’s reply to the debtor’s motion for authorization to use its cash collateral, *In re Matrix Development Corp.*, No. 08-32798 (Bankr. D. Ore. June 10, 2008). In this case, the developer requested authorization to honor pre-petition obligations under its customer warranty program in a bid to retain goodwill and attempt a reorganization, and the secured lender lodged a strong objection.

²⁰ *In re Mercedes Homes, Inc.*, No. 09-11191 (Bankr. S.D.Fla. January 26, 2009).

²¹ *In re Caruso Homes, Inc.*, No. 08-18254 (Bankr. C.D.Md. June 23, 2008).

²² *In re Woodside Group, LLC*, No. 08-20682 (Bankr. C.D.Cal. August 20, 2008).

²³ See *In re PFP Holding, Inc.*, No. 08-00899 (Bankr. D. Ariz. January 31, 2008).

instead of placing them in escrow accounts. Where the homes were not eventually built or completed, deposit holders have to stand in line as unsecured creditors. While such buyers are considered under the Bankruptcy Code to be holding unsecured priority claims (for the purchase of a primary residence), the priority claim is only up to a small amount of \$2,425.²⁴ Any amounts exceeding this threshold are considered general unsecured claims which, historically, involve low recovery rates. In the case of Levitt & Sons, the deposit holders formed an official committee, where legal fees and costs were paid out of the bankrupt builder's estate.²⁵ Even with such legal support, the deposit holders were estimated to recover between 2.75% and 23.2%, upon court approval of the Chapter 11 liquidation plan.²⁶ These are deposits that could have been used to fund the construction or purchase of a home, but if invested in an unfinished project that is subsequently never finished, now become lost to the deposit holders.

As we keep reading about developers falling into foreclosure and liquidation, a broader perspective of this phenomenon yields bleak prospects due to the rippling effects of these foreclosures on neighboring properties. According to the U.S. Joint Economic Committee of Congress, an estimated \$736,160,105,369 of housing wealth was already lost from record numbers of foreclosures and falling home prices in 2007, and an estimated \$1,144,177,880,280 for 2008.²⁷ The Center for Responsible Lending also calculated that the decline in housing contribution to annual GDP to be between 2005 and 2008 was \$308 billion.²⁸ Where developer bankruptcies

²⁴ See 11 U.S.C. § 507(a) (2006). Note that deposit holders who have made an investment purchase are not entitled to a priority claim, and their position is that of general unsecured non-priority creditors.

²⁵ See *In re Levitt and Sons, LLC*, No. 07-19845 (Bankr. S.D.Fla. November 9, 2007)

²⁶ This level of recovery was supposed to be very high for a case of liquidation of a builder, according to the counsel for the committee in this case who has remarked in an email exchange with the author that "the result for deposit holders in that case was phenomenal, and garnered us kudos from the Court".

²⁷ U.S. Congress Joint Economic Committee, *State-by-State Figures: Foreclosure and Housing Wealth Losses*, (2008), available at

http://jec.senate.gov/index.cfm?FuseAction=Reports.Reports&ContentRecord_id=392cb915-9c45-fa0d-5a46-f61f6e619381&Region_id=&Issue_id=

²⁸ Center for Responsible Lending, *Solutions to the Foreclosure Crisis* (2009), available at

<http://www.responsiblelending.org/mortgage-lending/policy-legislation/congress/common-sense-solutions-are-within-reach.pdf>.

contribute to the supply of foreclosure properties on the market, it can serve to depress already reeling housing markets, resulting in more home owners being underwater on their equity and becoming plausible candidates for default and foreclosure themselves.²⁹

In this context, it appears that the resolution of developer bankruptcies has a profound impact on the prospect of recovery for housing markets and residential communities. To understand the interplay of issues in this sector, it is imperative to delve deeper into the inner workings of the bankruptcy cases, and investigate the extent to which certain facets of the process, or the interaction between the incentives of the participants and the current process, play a major role in shaping the outcomes of developer bankruptcies.

Unfortunately, there is little past empirical work on this industry, let alone bankruptcy literature specific to this industry. During the housing downturn in the early 1990s, around 15% of the developers and builders went out of business, according to the National Association of Home Builders (“NAHB”). According to the NAHB, the number of bankruptcy filings was very low in that period, as these companies simply shut down operations or moved into other ventures.³⁰ We confirmed this issue through an archival search for literature and news specifically on bankruptcies of residential developers and home builders in the 1990s. For example, an August 1990 report in the Washington Post stated that “[o]fficials in the home-building industry say the slowdown in the Washington area real estate market does not mean there will be more ghost-town developments. They say they have not seen any dramatic increases in the number of local builders going bankrupt.”³¹ A Newsday (New York) article in December 1990 reported that, amidst the real estate downturn, only a handful of construction properties had been seized in foreclosures, as “[l]enders

²⁹ Congressional Oversight Panel, *Foreclosure Crisis: Working Toward a Solution*, (March Oversight Report, 2009), available at <http://cop.senate.gov/documents/cop-030609-report.pdf>.

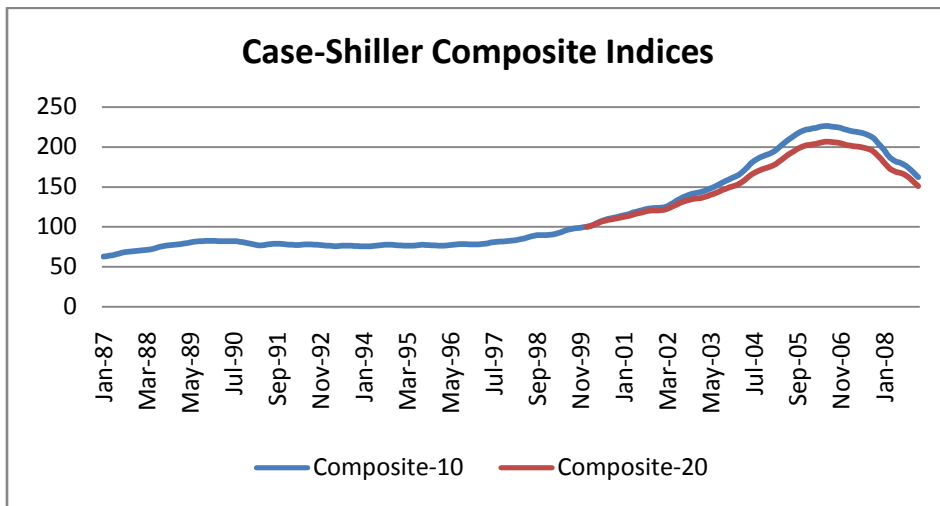
³⁰ Ruth Simon & Kemba J. Dunham, *When Home Builders Hit the Skids*, Wall St. J., Nov. 14, 2007, at D1.

³¹ Lori Silver, *Builder's Woes Hurt Owners; Deposits in Limbo in Potomac Project*, The Washington Post, Aug. 4, 1990 at E1.

and developers say the low level of foreclosures is the result of builders restructuring loans and soliciting cash-rich investors to buy into financially troubled properties.”³²

The existence of scant literature on this specific topic from the last twenty years may also be due to the fact that this is the first major nationwide decline in the housing prices since the Great Depression. While booms and busts in real estate have been common through the economic cycle, these occurrences over the last 50-60 years were typically regional, with the overlapping housing market cycles keeping national home price indexes relatively stable. The following chart depicts this situation graphically using the S&P Case-Shiller Home Price Indices, e.g., the composite index for the 20 metropolitan regions fell nearly 35% between December 2006 and December 2008.³³

Figure 1: Case-Shiller Home Price Indices (Composite-10 and Composite-20)



Source: Bloomberg

³² Jeanne D. Cooper, *Trouble Developing; It's Riches to Rags for Some Builders as the Economy Stalls*, Newsday (New York), Dec. 24, 1990 at 27.

³³ The S&P Case-Shiller Composite-20 Index was only started in 2000, so data prior to that cannot be reflected on the graph. See also the Housing Price Index tracked by the Federal Housing Finance Agency. This index can be adjusted for inflation using the CPI less shelter index to arrive at the real levels. We found that the peak-to-trough decline in the inflation-adjusted national Housing Price Index was around 7% in December 1989-June 1993, but the decline in the index between December 2006 and December 2008 exceeded 13%.

Nonetheless, through our study of the general literature, we have extracted key insights as a starting point for our analysis of bankrupt residential developers. The primary perspective we take as having the most impact on today's homebuilder Chapter 11 bankruptcies is the rise of secured lender control, and its ensuing implications. It should be noted that, unlike many other corporate debtors, residential developers tend to have heavily encumbered assets, owing in large part to their real property underpinnings, thereby creating significant power in the hands of secured lenders.

2.3 The Rise of Secured Lender Control

The rise of secured lender control is an issue which has garnered much contemporary attention as scholars and practitioners discuss the changing dynamics in corporate restructurings and the increase in liquidations. The literature is split as to whether secured lender control is a desirable phenomenon. On one side of the debate, the scholars sometimes collectively known as “contractualists” view bankruptcy essentially as a private regime characterized by bargains between lenders and debtors is a more efficient method of dealing with bankrupt companies than Chapter 11.³⁴ Related to this notion, reorganized companies that should be liquidated are considered a waste of resources, since by definition their assets are more efficiently and valuably employed elsewhere in the economy.³⁵

On the other hand, there are “non-contractualists” (for want of a better term) who argue that Chapter 11 has a variety of important roles to play in maximizing societal utility through

³⁴ See, e.g., Douglas G. Baird & Robert K. Rasmussen, *Chapter 11 at Twilight*, 56 Stan. L. Rev. 673, 675 (2003) [hereinafter Baird & Rasmussen, *Twilight*].

³⁵ See, e.g., Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. Pa. L. Rev. 1209 (2006) [hereinafter Baird & Rasmussen, *Governance*], James J. White, *Death and Resurrection of Secured Credit*, 12 Am. Bankr. Inst. L. Rev. 139 (2004) [hereinafter White, *Death*], Adler, *Primitives*, *Supra*, note 4, Stephen J. Lubben, *The Direct Costs of Corporate Reorganization: An Empirical Examination of Professional Fees in Large Chapter 11 Cases*, 74 Am. Bankr. L.J. 509 (2000) [hereinafter Lubben, *Costs*], Conrad B. Duberstein, *Out-of-Court Workouts*, 1 Am. Bankr. Inst. L. Rev. 347, 351 (1993), Edith H. Jones, *Chapter 11: A Death Penalty for Debtor and Creditor Interests*, 77 Cornell L. Rev. 1088, 1089 (1992), James J. White, *Harvey's Silence*, 69 Am. Bankr. L.J. 467, 473–74 (1995) [hereinafter White, *Silence*].

maximizing the going concern value of a bankrupt firm, beyond solving a co-ordination problem between creditors competing to seize assets, which may thus involve a period of re-organization, and that a system based on autonomous private bargaining would create unacceptable externalities.³⁶ They would point to the legislative history of the Bankruptcy Code which states that:

The purpose of a business reorganization case, unlike a liquidation case, is to restructure a business's finances so that it may continue to operate, provide its employees with jobs, pay its creditors, and produce a return for its stockholders. The premise of business reorganization is that assets that are used for production in the industry for which they were designed are more valuable than those same assets sold for scrap ... It is more economically efficient to reorganize than to liquidate, because it preserves jobs and assets.”³⁷

Warren stated that these Congressional comments, which were liberally sprinkled with discussions of policies to “protect the investing public, protect jobs and help save troubled businesses”, speak to societal concern about the community impact of bankruptcy and the “public interest” beyond the interest of the disputing parties.³⁸

That being said, debt has been considered the “missing lever of corporate governance” which works in situations where other levers have little effect.³⁹ The potential exercise of a secured creditor’s powers in bankruptcy has been argued to be a motivator of good corporate decision-

³⁶ See, e.g., Lynn M. LoPucki & Joseph W. Doherty, *Bankruptcy Fire Sales*, 106 Mich. L. Rev. 1 (2007) [hereinafter LoPucki and Doherty, *Fire*], Lynn M. LoPucki, *The Nature of the Bankrupt Firm: A Response to Baird and Rasmussen’s The End of Bankruptcy*, 56 Stan. L. Rev. 645 (2003) [hereinafter LoPucki, *Response*]. Warren and Westbrook, *Possession*, *supra*, note 4; Jay Lawrence Westbrook, *The Control of Wealth in Bankruptcy* 82 Tex. L. Rev. 795 (2004), Harvey R. Miller & Shai Y. Waisman, *Is Chapter 11 Bankrupt?*, 47 B. C. L. Rev. 129 (2005) [hereinafter Miller & Waisman, *Bankrupt*], Harvey R. Miller & Shai Y. Waisman, *Does Chapter 11 Reorganization Remain a Viable Option for Distressed Businesses For the Twenty-First Century?*, 78 Am. Bankr. L. J. 153 (2004) [hereinafter Miller & Waisman, *Reorganization*], Karen Gross, *A Response to J.J. White’s Death and Resurrection of Secured Credit: Finding Some Trees but Missing the Forest*, 12 Am. Bankr. Inst. L. Rev. 203 (2004). See also Lawrence Ponoroff & F. Stephen Knippenberg, *The Implied Good Faith Filing Requirement: Sentinel of Evolving Bank Policy*, 85 NW. U. L. Rev. 919, 960-61 (1991).

³⁷ H.R. Rep. No. 595, 95th Cong., 1st Sess. 220 (1977).

³⁸ Elizabeth Warren, *Bankruptcy Policy*, 54 U. Chi. L. Rev. 775, 788 (1987).

³⁹ Baird and Rasmussen, *Governance*, *supra*, note 35. See also Adam Feibelman, *Commercial Lending and the Separation of Banking and Commerce*, 75 U. Cin. L. Rev. 943 (2007).

making prior to, and in, bankruptcy. In fact, contractualists argue that senior creditors are in a better position to exercise control over the bankrupt company, compared to management or the bankruptcy court.⁴⁰ A key argument is that the extensive relationship between the major bank and the debtor, as well as the pre-default monitoring role by the bank, provides the bank with the informational advantage to decide whether the debtor should be allowed to restructure.⁴¹

Such views are occasionally asserted by banks in bankruptcy proceedings. For example, in the Chapter 11 proceedings of GT Architecture, in response to a plan filed by the debtor, Regions Bank stated that “with all due respect...in this market it is altogether unreasonable to assume that any *judicial determination* of value will be a reliable estimation of what Regions, or any other creditor forced to “eat dirt,” would ultimately realize upon final disposition” (italics added).⁴²

Westbrook has attacked such views with two aspects of a serious incentive problem.⁴³ First, the secured lender lacks the incentive to achieve efficient and socially desirable results. If the collateral can be quickly sold to realize proceeds to repay the secured debt in full (or sufficiently high, as tolerated in today’s falling markets), the lender is likely to pursue the path. If substantially higher values could have been realized through an investment of time and resources, these will not be realized in this circumstance, to the injury of other stakeholders. Second, the secured creditor has a positive incentive to acquire the collateral at its own sale at a very low price and then resell the collateral at a much higher price for its own account.⁴⁴

⁴⁰ Baird and Rasmussen, *End, supra*, note 4, at 752, 784-85. See also Barry E. Adler & Ian Ayers, *A Dilution Mechanism for Valuing Corporations in Bankruptcy*, 111 Yale L.J. 83 (2001). Adler and Ayres concluded that “[n]ot only do judges lack the business expertise of individual capital investors, but also a judicial valuation cannot benefit from the collective wisdom of market investors in the aggregate.”

⁴¹ See Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Bankruptcy*, 71 Tex. L. Rev. 51 (1992).

⁴² See Regions Bank’s objections to the plan filed by the debtor, GT Architecture (Entered 03/24/09), *In re GT Architecture Contractors Corp*, No. 08-69440 (N.D.Ga. May 20, 2008).

⁴³ Westbrook, *supra*, note 36.

⁴⁴ *Id.* See also Stephen J. Lubben, *The New and Improved Chapter 11* 93 Ky. L.J. 839 (2005) [hereinafter Lubben, *Improved*.] Lubben argued that “if the control rights description of the new chapter 11 is accurate, chapter 11 will only be used when it benefits the controlling creditor, and we should expect these sorts of creditors to capture most or all of these benefits. Moreover, we should expect that in some cases the use of chapter 11

To summarize, liquidation and reorganization can be viewed as alternative tools for the reallocation of resources within our economy, and the themes of this broader legal debate form a theoretical backdrop against which we will analyze residential developer bankruptcies. What is most striking about the particular context investigated in this paper is the under-explored but highly related theme of systematic risk, illiquidity, market failure and bank failures (i.e. the business failure of the secured lenders themselves).⁴⁵ In this severe economic downturn, there is little liquidity available for other “better-managed” residential developers to finance and buy up the assets of the bankrupt companies. This means that the process of healthy companies absorbing the assets of distressed companies and putting them to better use is much less effective, resulting in severely depressed prices in liquidation sales and the abandonment of residential projects. These abandoned properties, both completed and incomplete, would then depreciate quickly due to vandalism, exposure to the elements, and simple lack of maintenance.

The lenders can usually do little to stop this depreciation even as they struggle to find buyers for the property who will invest in maintenance.⁴⁶ Furthermore, since development projects require several project-specific investments of time and resources, any builder who is brought in by the bank to take over the development from the last builder often has to start over, rebuild relationships with contractors, demolish damaged structures, spend time finding out or renegotiating agreements with the municipality and homebuyers, and re-incur other startup costs already incurred by the previous builder, etc.

On the other hand, arguments can be made that the previous builder may not be the best party to complete the project. However, issues relating to secured creditor control may be exacerbated during a period of severe market disruption and bank failures. At this juncture, we

under a control rights regime will not be efficient; any gains come with corresponding losses to non-consenting parties.”

⁴⁵ It should be noted that Adler has remarked that “market failure stories help establish the battle lines between scholars such as Baird and Rasmussen, who favor the new world of chapter 11, and others such as Miller and Waisman, who pine for the old world.” Adler, *Primitives, supra*, note 4, at 225.

⁴⁶ We will illustrate this point in greater detail using the case of Suncrest discussed in Chapter 6 of this paper.

leave the reader with two examples illustrating the possible negative impact of secured lender control over distressed residential development properties.

The first example involves the SunCal companies, one of the largest private developers in California. In bankruptcy proceedings, the Chapter 11 trustee (who can normally be trusted to be somewhat neutral), upon undertaking due diligence of the real estate, condemned the role of Lehman Brothers affiliates in their role as secured lenders:⁴⁷

Lehman's funding practices, dictatorial control over the Projects' operations, and breach of its funding obligations created a common layer of unpaid unsecured debt that now burdens all of the Debtors' estates in the estimated amount of \$100 million. Furthermore, human lives and property are being put at risk from situations as diverse as: (a) potential levee failures, (b) airborne friable asbestos, (c) failure to provide dust and erosion control measures, (d) possible brush fires in densely populated areas during peak periods of the California fire season due to the failure to fund brush control, and (e) failure to provide adequate storm water control. In addition, the condition and value of the assets are wasting; fines have been assessed or threatened to be assessed due to the Projects' violation of governmental permits; entitlements are at risk; availability of resources such as water are at risk; governmental bonds are being called; and taxes and insurance are going unpaid.⁴⁸

This raises the question of whether these Lehman affiliates should be afforded the high degree of secured lender control in bankruptcy proceedings, given that the former's own financial

⁴⁷ See the Motion for Order: (1) Approving Overbid Procedures in Connection with Proposed Sale of Substantially All Assets of The Debtors' Estates; (2) Approving Break-Up Fee; (3) Disallowing Credit Bids Rights of Disputed Secured Creditors, Lehman Ali, Inc., Northlake Holdings and OVC Holdings; and (4) Setting Hearing on Approval of Sale of Assets filed by Trustee Steven M Speier, *In re Palmdale Hills Property, LLC*, No. 08-17206 (lead case) (Bankr. C. D. Cal. November 6, 2008).

⁴⁸ There are other news reports about local authorities, across the country, facing a rise in complaints about environmental and safety hazards from construction sites where work has been frozen. See, for example, Jim Carlton, *Deserted Building Sites Add to Property Bust's Toll*, Wall St. J. May 7, 2009 at A4.

distress might affect the decision-making process in ways extraneous to the residential developer. Indeed, we often find literature that is predicated on an assumption of financial (and strategic) strength on the part of secured lenders, and this is currently not the case.

The second example relates to Guaranty Bank's demolition of mostly-finished single-family homes and completed model homes in Victorville, California after foreclosure. City officials stated that Guaranty Bank had told them it would cost only \$100,000 to tear these down, but a lot more to finish a project, in addition to escalating city fines as vandals and squatters took over the homes.⁴⁹

While one may argue that these represent extreme examples, they highlight the importance for the bankruptcy regime to place boundaries and restraints on secured lender control in certain circumstances to avoid situations such as these which essentially results in destruction of value.

2.4 Conclusion

Having set the social and academic context for our research questions, we will now discuss the empirical methodology used in the investigation. It is important to reiterate that although we focus on bankruptcy and secured creditor control as the major phenomena through which we interpret the recent events observed, this paper means to take an empirical inter-disciplinary approach that is necessitated by the magnitude of the challenge faced in the residential development industry today.

⁴⁹ Michael Corkery, *No Sale: Bank Wrecks New Houses*, Wall St. J., May 5, 2009, at A3. Note the fact that squatters could have been living in the homes in this case suggest that some of these homes were probably close to completion.

Chapter 3: Empirical Methodology

This study revolves around the cases of residential developers and home builders across the United States which filed for Chapter 11 bankruptcy during the current recession beginning in late 2007. The target group is defined as companies which, at the time of the bankruptcy filing, were involved in the development and building of new single-family homes, condominium developments, developed lots and raw land, and excludes contractors and custom builders working exclusively on existing homes. The defining characteristic is that these companies own and develop residential real estate, collateral underlying the acquisition, development and construction loans. This can be verified through a perusal of the Schedules of Assets and Total Liabilities (“Schedules”) and Statement of Financial Affairs filed in Chapter 11 proceedings.

It is important to distinguish between the various types of empirical research that we have conducted for this paper. Firstly, we analyzed on a large scale the course in bankruptcy that residential developers have taken. The sampling and extraction methodology of this dataset makes up the bulk of this Chapter. An analysis of this dataset is the mainstay of Chapters 4 through 5. Secondly, we zeroed in on some cases where a detailed analysis is appropriate and take a case study approach, using a very detailed reading of the filings and other documents such as reports by third party commentators. These case studies and their selection process are mainly discussed in Chapter 6. Thirdly, we conducted over thirty interviews with bank employees and banking industry consultants in order to further understand the behavior of secured lenders that we have observed in Chapters 4 to 6, and discuss our findings in this area in Chapter 7.

3.1 Large-Scale Empirical Data Analysis

3.1.1 Sample Selection

The data is drawn from bankruptcy cases which started between November 1, 2007 and December 31, 2008. The recession technically began in December 2007, according to the Business Cycle Dating Committee of the National Bureau of Economic Research.⁵⁰ Earlier data is unlikely to be reflective of the housing market distress and credit freeze conditions which are being studied. Our sample is also likely to be a large proportion of all developer defaults going back several years, as there have been very few developer bankruptcies historically.⁵¹

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

Chapter 7 bankruptcies, being out of the scope of this paper, are not included in this sample. The key basis of why Chapter 7 bankruptcies do not fall within the ambit of this research is that

⁵⁰ National Bureau of Economic Research, *Determination of the December 2007 Peak in Economic Activity* (2008), available at <http://www.nber.org/dec2008.pdf>. Note that, while the recession technically started in December 2007, we found in our archival searches that the flurry of residential development defaults started in November 2007, e.g., of the 10 largest cases identified, 3 went into bankruptcy in November 2007. As such, we begin our data sample selection period on November 1, 2007.

⁵¹ Simon and Dunham, *supra*, note 30.

bankruptcy relief under this Chapter expressly provides for liquidation by a Chapter 7 trustee, whereas this research is primarily concerned with why residential developers and builders, with an opportunity to reorganize in bankruptcy, were going into liquidation. The exclusion of this segment of cases does not affect the findings in this paper for two main reasons. First, in assessing the procedural and economic outcomes of these bankruptcies cases (discussed further in Chapters 3 and 4 of this paper), we have benchmarked the outcomes identified from our data sample with literature which deal only with Chapter 11. For example, we are comparing the plan confirmation rate and reorganization rate in our data sample with those relating to Chapter 11 cases found in other empirical studies.

Second, being cognizant of the possibility that Chapter 7 cases can be converted to Chapter 11, especially those commenced by an involuntary Chapter 7 petition, we did a random sampling of 50 cases of Chapter 7 developer bankruptcies to test whether this is material to our research in terms of affecting the liquidation or reorganization rate. Of these 50 cases, there was only 1 case where the debtor moved to convert proceedings to Chapter 11. However, in less than 2 months, a motion was filed to convert the case back to Chapter 11 and, prior to the hearing for this conversion motion, the case was dismissed.⁵² There were 5 cases involving involuntary Chapter 7 petitions but these were not converted to Chapter 11. Also, in an interesting set of Chapter 7 cases involving a big corporate residential development group, the Ginn Companies, the trustee stated that he would “maintain the Debtors’ going concern value and maximize the value of the Debtors’ assets in connection with a sale of those assets”.⁵³ The Chapter 7 trustee in this case was acting in a unique fashion, akin to the sale process in Chapter 11, but the case outcome was still one of liquidation.

In selecting the sample of bankrupt developers, we identified a few sole proprietorships and other non-corporate business entities which were operating as developers. We recognize that, in

⁵² *In re* Kyle James Wheatley (dba Kevan James Construction Ltd), No. 08-61092 (Bankr. W. D. Texas October 24, 2000).

⁵³ *In re* Ginn-LA St. Lucie Ltd., LLLP, No. 08-29769 (lead case)(Bankr. S. D. Fla. December 23, 2008).

some contemporary bankruptcy literature, researchers generally exclude non-corporate debtors from their studies, preferring to draw an all-corporate sample. However, this study aims to be comprehensive in its representation of the Chapter 11 process for developers during December 2007 through 2008, so we have retained these entities, a total of two of them, in the sample.⁵⁴

Next, where there are cases of several companies belonging to a single holding company, these are considered as separate cases, unless the court allowed substantive consolidation such that the related companies would pool assets and liabilities. We believe that subsidiaries and affiliates in a corporate group should be considered separate legal entities (barring the piercing of the corporate veil). While joint administration is very common for corporate groups, courts have considered substantive consolidation an extraordinary measure.⁵⁵ This is because substantive consolidation “almost invariably redistributes wealth among [all] creditors”; creditors of a less solvent entity will gain at the expense of creditors of the more solvent entity and vice versa.⁵⁶

3.1.2 Research Design for Docket Analysis

The first part of this research is designed to rigorously study the resolution outcome of Chapter 11 bankruptcy proceedings and verify the phenomena observed in the residential development industry during this economic downturn, as discussed in Chapter 2. The second thread of our examination is the type and extent of secured lender control in these developer bankruptcies.

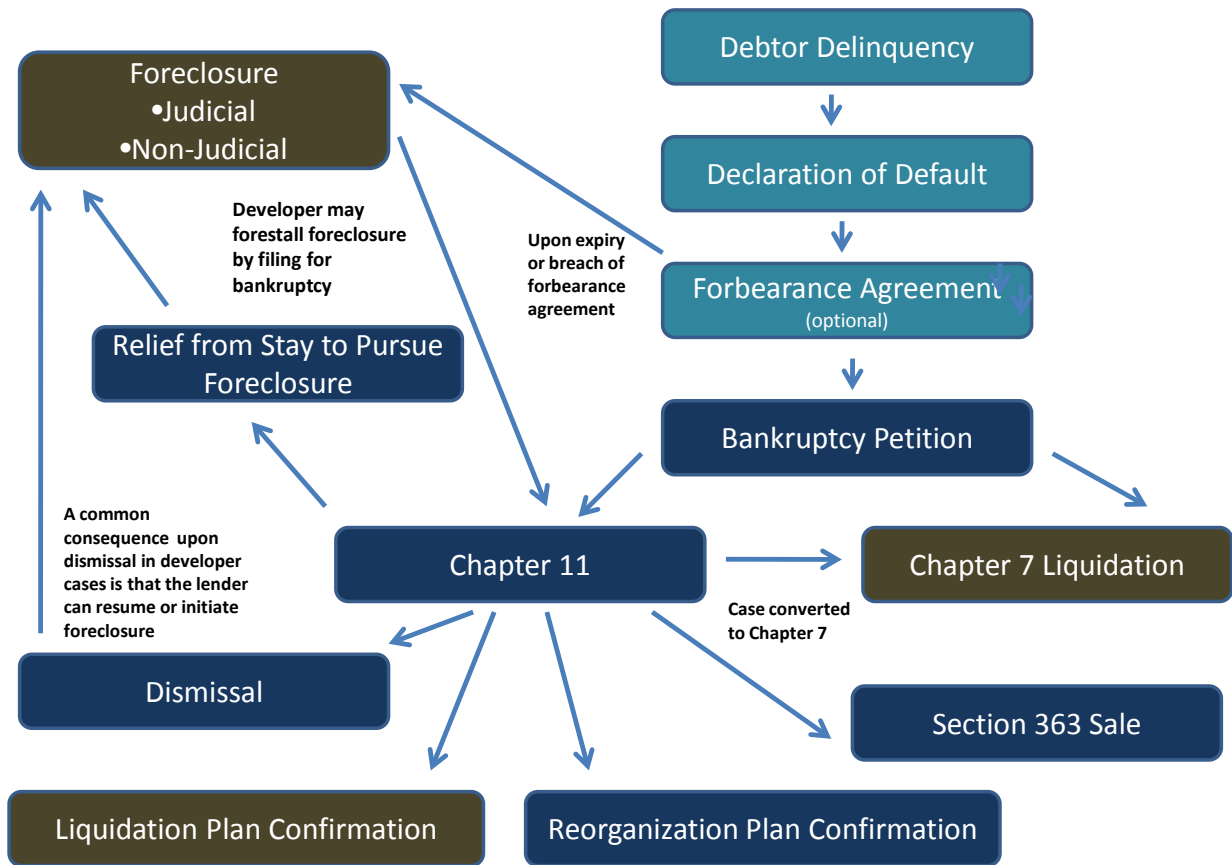
⁵⁴ The 2 cases in the data sample which involved sole proprietors – Moore Builders/Grady Franklin Moore II and Mace Homes/Billy James Mace. *See In re Grady Franklin Moore II (dba. Moore Builders)*, No. 08-06592 (Bankr. D. S. C. October 21, 2008) and *see In re Billy James Mace (dba. Mace Homes)*, No. 08-06124 (Bankr. M. D. Tenn. July 17, 2008).

⁵⁵ *See, for example, In re Gandy*, 229 F.3d 489, 499 (5th Cir. 2002).

⁵⁶ *See In re Auto-Train Corp.*, 810 F.2d 270, 276 (D.C. Cir. 1987).

With this in mind, we set out to track the resolution outcomes of these bankruptcy cases. Figure 2 shows the path of a typical process undergone where a residential developer defaults on a construction loan.

Figure 2: Paths of a Typical Construction Loan Default by a Residential Developer



Since we are primarily concerned with the Chapter 11 process, the procedural outcomes captured are categorized as follows:

- Confirmation of a reorganization plan;
- Confirmation of a liquidation plan;

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

As for the economic outcomes, we categorized them as follows:

- Continuation of the business with new capital structure
- Shutdown of the business (foreclosure or liquidation)
- Going-concern sale

A limitation of this study is that a number of cases in the sample are currently unresolved in terms of the five outcomes listed above.⁵⁷ In trying to be as timely as possible in documenting and analyzing fairly unfamiliar phenomena with important consequences for our society, the implication is that since the cases are filed in 2007-2008, a number of them will still be unresolved. However, a balance has to be struck between the importance of analyzing a recent phenomenon at the core of the current recession, and the need for “methodological purity” in terms of using cases which meet a strict definition of resolution.

The reasoning for this is twofold. First, a key objective of this study is to examine secured lender control and their actions in moving a bankruptcy case in one way or another. In the current volatile environment with declining real property values, secured lenders have been acting quickly to safeguard their collateral and we are documenting the kind of actions taken in that respect. Second, Warren and Westbrook showed in their empirical study of Chapter 11 business cases that “substantial screening” occurs early in the case.⁵⁸ Of all the cases that were eventually pushed out of

⁵⁷ The cut-off date adopted for assessing case resolution is May 15, 2009.

⁵⁸ Warren and Westbrook, *Challenge, supra*, n5.

Chapter 11 without a plan being filed, more than half were gone in less than six months, 70 percent were gone by nine months, and more than 80 percent were gone within a year.⁵⁹

However, one may argue that weak cases are generally culled by creditors and courts earlier in bankruptcy proceedings and that cases culminating in plan confirmations or reorganizations will take longer. To address this issue, we looked in the literature to find out the time to resolution of cases as varied by outcomes. A study of 1,096 public companies filing for Chapter 11 between 1979 and 1990 found the median time to resolution by economic outcomes to be as follows: 1.1 years (merged or acquired); 1.2 years (liquidated); 1.4 years (emerged as a public company) and 1.3 years (emerged as a private company).⁶⁰ This shows that the difference in time to resolution is not much different across the board. It should also be noted that the companies in our data sample may be smaller (since it includes private middle-market companies – see the assets and liabilities distributions summarized in Section 3.1.3) and therefore likely to take shorter time for parties to sort out the issues. Furthermore, the limitation on exclusivity periods (where only the debtor may file a plan) as introduced in 2005 by the Bankruptcy Abuse Prevention and Consumer Protection Act of (“BAPCPA”) currently facilitates a much faster resolution.

Given the above reasons and the need to avoid sampling bias, we include cases which are “substantially resolved”, as compared to the above categorization of procedural outcomes for cases which are “strictly resolved”. To qualify as “substantial resolution”, we consider the filing of a Chapter 11 plan, the filing of a motion for a section 363 sale of substantially all assets as major milestones towards resolution, and successful lift-stay motions.

The metric for plan filing is inspired by Warren and Westbrook’s empirical study.⁶¹ It is thought to be a useful indicator for sorting cases which are “Dead-on-Arrivals” (“DOAs”) to those are plausible candidates for reorganization. The sale motion filing is a corollary for plausible

⁵⁹ *Id.*

⁶⁰ See Edward I. Altman, *Bankruptcy, Credit Risk, and High Yield Junk Bonds*, 492 (2002).

⁶¹ Warren and Westbrook, *Challenge, supra*, note 5.

candidates for bankruptcy sale. On the other hand, lift-stay motions pursuant to foreclosure and their ensuing orders are important in the residential development context. Cases where the core real estate has been foreclosed upon are likely to result in conversion or dismissal, even if proceedings subsequent to the order might be moving along slowly.

As such, 6 categories of “substantial resolution” outcomes are designated as follows:

- Where the court has ordered relief from stay for substantially all assets for the secured lenders(s) to pursue foreclosure;
- Where the court has ordered relief from stay for certain assets for the secured lenders(s) to pursue foreclosure;
- Where the debtor has filed a plan and no lift-stay motions have been filed by secured lenders yet;
- Where the debtor has filed a plan and at least 1 lift-stay motion has been filed by a secured lender;
- Where the debtor has filed a plan and the court has entered at least 1 order for relief from stay for a secured lender to pursue foreclosure; and
- Where a motion for a sale of substantially all assets under section 363 has been filed and is pending hearing.

Given the above sample selection method and research design, we identified 235 Chapter 11 cases of developer bankruptcies, which is large enough to draw empirically-based conclusions. We eliminated a small proportion – 13 cases – from the sample which did not fall within any of the categories of outcomes. All 13 were filed between September 2008 and December 2008, i.e., these are the more recent cases which have not hit a major milestone.⁶²

⁶² Note that, of these 13 cases, 6 of them were filed in December 2008.

The other set of information tracked under the bankruptcy docket analysis are the types of actions taken by secured lenders. We include significant motions and court rulings during Chapter 11 proceedings. These include:⁶³

- Lift-stay motions to pursue foreclosure;
- Dismissal of the case;
- Appointment of a trustee;
- Termination of exclusivity or the filing of a competing plan;
- Conversion of the case from Chapter 11 to Chapter 7; and
- Provision of debtor-in-possession (“DIP”) financing.

The literature suggests that in every instance where the Bankruptcy Code provides the Chapter 11 debtor with substantial power, it checks that power with avenues for creditor action.⁶⁴ The primary elements of a debtor’s power include initiation of the procedure, the trigger of an automatic stay and exclusivity (the exclusive right to file a plan during the first 120 days). The correlative creditors’ powers thus include conversion, dismissal, relief from stay, the termination of exclusivity and the appointment of a trustee.

We include the provision of DIP financing in this list, even though it is not a formal creditor power endowed by the Bankruptcy Code. Debtors often have insufficient cash reserves for operating the business at the inception of the Chapter 11 case and require funding to keep the business afloat. In that sense, the creditors hold an upper hand in bargaining positions owing to

⁶³ See Tom Chang & Antoinette Schoar, *The Effect of Judicial Bias in Chapter 11 Reorganizations*, Manuscript, available at http://www.rsm.nl/portal/page/portal/ERIM/Content_Area/Documents/5. In this empirical study, the authors consider the most important creditor-filed motions in the Chapter 11 process to be the motion for case dismissal, conversion of the case to Chapter 7, relief from stay, objections to the reorganization plan. We have considered all of these, apart from the last motion because such objections are filed almost in every instance where a reorganization plan is filed.

⁶⁴ See, for example, Stephen J. Lubben, *Credit Derivatives and the Future of Chapter 11*, 81 Am. Bankr. L.J. 405(2007) [hereinafter Lubben, *Derivatives*]

their ability to provide financing to bankrupt entities. That being said, we will discuss in Chapters 5 and 6 the problems of secured lender control underlying DIP financing arrangements.

3.1.3 Descriptive Statistics of the Sample

The final sample consists of 132 “strictly resolved” cases and 79 “substantially resolved” cases, and 11 “mega” cases for separate analysis (mainly to avoid sampling issues). These “mega” cases have scheduled total assets exceeding \$250 million and have been designated as complex cases in bankruptcy proceedings, owing to the multiple subsidiaries and affiliates which were not necessarily substantively consolidated. Based on our methodology which counts each entity as a separate “case” as long as there is no substantive consolidation, the inclusion of these cases, where the outcomes may be similar for entities in the same corporate group, could distort the overall results.⁶⁵ The following charts describe the distribution of cases in the sample by total assets and total liabilities at the time of the bankruptcy filing, excluding the 11 “mega” cases.⁶⁶

⁶⁵ See, for example, *In re* TOUSA Inc., No. 08-10928 (Bankr. S.D.Fla. January 29, 2008), where the Chapter 11 bankruptcy involved 39 debtors, with joint administration in one lead case. However, since the general tenor of the case is likely to be similar across most of the debtors, the inclusion of all the debtors (given that there is no substantive consolidation order at the time of writing) may bias the sample in mainly reflecting the characteristics of the “mega” case.

⁶⁶ It should be noted that while the Schedules require debtors to report the “current value”, ie, market value, most debtors either use book value or the value from the last appraisal. There are also some missing values where the debtor entered “TBD” in the Schedules.

Figure 3: Distribution of Total Assets

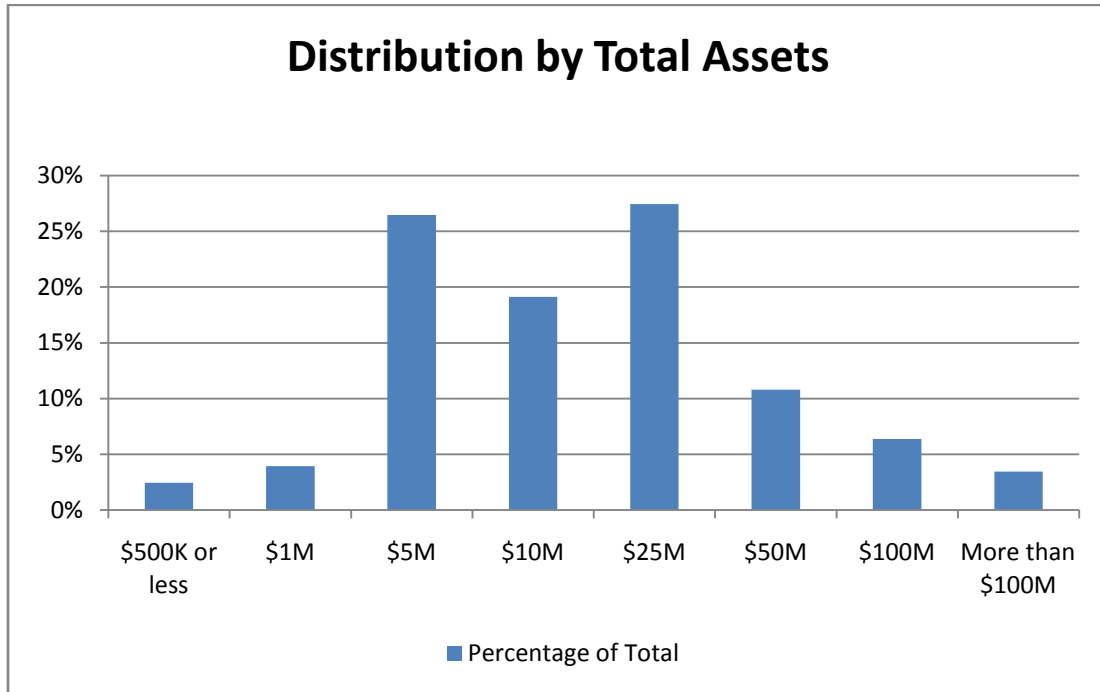
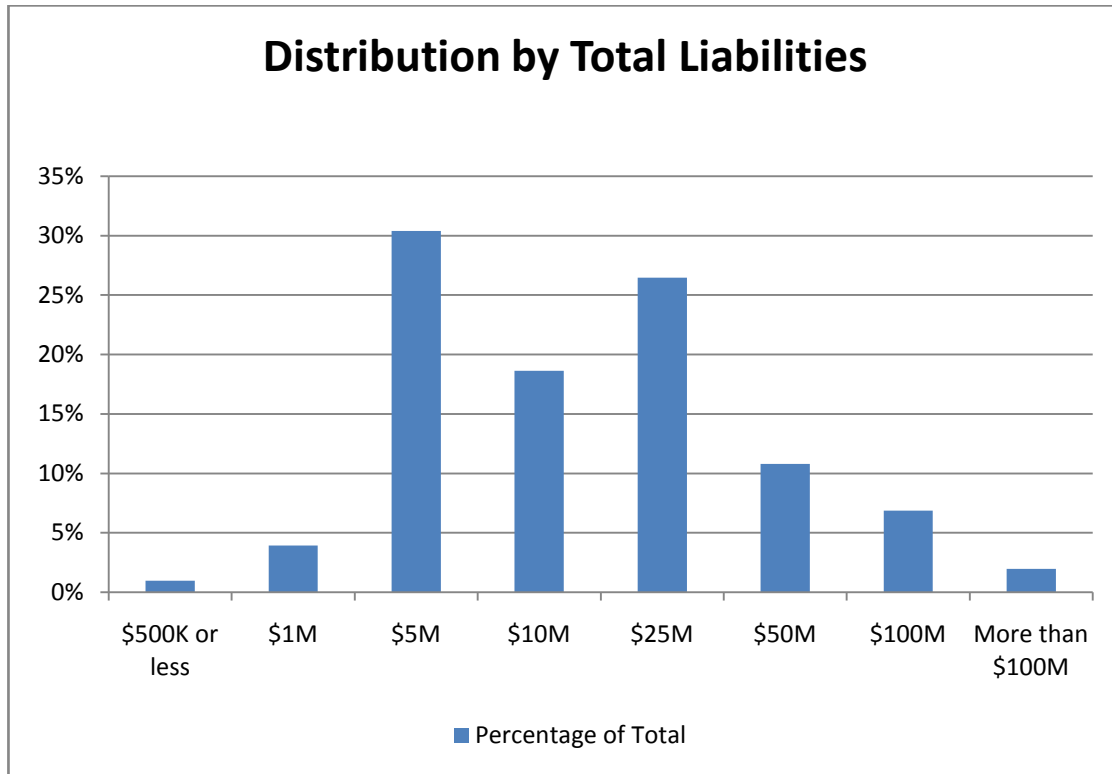


Figure 4: Distribution of Total Liabilities



These figures show that the data points in the sample are reasonably well-distributed across the board, in terms of size.⁶⁷ Figure 5 shows the geographical distribution of 211 cases by the state of the bankruptcy filing, which shows a reasonably distribution across states, with natural concentrations in states which have suffered more severely from the housing crisis. As for the 11 “mega” cases, 3 are in Delaware, 4 are in California, 2 are in Florida, and 2 are in Illinois.

Figure 5: Geographical Distribution of Cases

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

Looking at the geographical distribution, we note a few observations. First, the large number of cases in relation to North Carolina is partly contributed by 16 residential development entities, managed by Landcraft Management LLC (the “Landcraft Properties”), which are not substantively consolidated and have differing resolution outcomes in bankruptcy proceedings.

⁶⁷ Note that while there are relatively less companies with total assets or total liabilities under \$5 million, this is expected – even small residential developer bankruptcies are generally bigger than small business bankruptcies due to the substantial real estate holdings.

Second, the number of cases in relation to California may seem a tad low, given that the Californian housing market is considered to be one of the worst-hit in the country. Part of this is due to the fact that we have already captured a large proportion of bankrupt residential developments in California through the 4 mega cases – LandSource, Dunmore Homes, the SunCal companies and Empire Land. For example, at the time of bankruptcy, Dunmore Homes alone had 26 communities in northern and central California, and the SunCal companies constitute one of the largest private residential developers in California, with more than 250,000 residential lots and 10 million square feet of real estate (mainly in California) valued between \$300-600 million in bankruptcy proceedings.⁶⁸

Another reason is that large companies have a disproportionately huge market share in California. To illustrate, the 10 largest residential developers and builders in the United States (including non-defaulted companies) occupied 52.3% of the Southern California and 56.4% of the Central California housing markets in 2007, compared to 28.8% of the North Carolina region.⁶⁹

Third, Nevada and Florida are also states with badly-hit housing markets where the proportion of cases in our sample may look relatively low. Besides the fact that 2 of the mega cases are in Florida, it should be noted that the 10 largest residential developers and builders in the United States occupied 72.1% of the Miami/Miami Beach/Kendall area and 63.2% of the Cape Coral/Fort Myers area in 2007.⁷⁰ As for Nevada, we omitted from the sample bankrupt residential developers in Las Vegas which were also hotel and resort developers.⁷¹

⁶⁸ See disclosure statement filed by the SunCal companies, *In re* Palmdale Hills Property, LLC, No. 08-17206 (lead case) (Bankr. C. D. Cal. November 6, 2008).

⁶⁹ Fitch Ratings, *US Homebuilding/Construction: The Chalk Line – Quarterly Update: Spring 2009* (2009), available at www.fitchratings.com.

⁷⁰ *Id.*

⁷¹ For example, one case omitted is Lake at Las Vegas Joint Venture, LLC – the developer of a 3,592 acre resort destination which not only consists of residential units, but also two luxury hotels (including a Ritz-Carlton), a casino, a specialty village shopping area, 3 golf courses and clubhouses. See *In re* Lake at Las Vegas Joint Venture, LLC, No. 08-17814 (Bankr. D. Nev. July 17, 2008).

3.2 Research Design for Elucidating the Behavior of Secured Lenders

After an examination of the data on secured lender control in this area, we moved from the general to the particular. The second part of the research illustrates how secured lenders might be using their controlling position to act in a way which is not necessarily optimal. Due to the difficulties of effectively coding such information into a systematic database, the case study method is utilized. The reasons underlying the case selection process are discussed in Chapter 6. Unlike the prior literature which is primarily focused on theoretical arguments about the pros and cons of secured lender control, we will illustrate, using these cases, the extent by which the use of DIP financing shaped the bankruptcy outcome and highlight the incentive problem of secured lender control, and the extent to which DIP financing actually benefits the debtor and other stakeholders.

3.3 Survey of Banking Industry Participants

As mentioned at the beginning of this chapter, we conducted a number of interviews in the banking industry⁷² in order to further understand the behavior of secured lenders that we have observed in Chapters 4 to 6. These interviews were aimed at gaining an understanding of the interviewees' viewpoints as well as elicit commentary on how financial institutions functioned as well as the regulatory framework within which they operated. These interviewees span the range of very large and very small US banks, as well as the US subsidiaries of foreign-owned banks. These interviews were relatively unstructured, so as to maximize the potential for unforeseen insights. The interviews were based on the following themes:

⁷² The group of interviewees includes lenders, risk managers, chief credit officers, workout managers and banking industry consultants.

- How do banks assess the profitability and riskiness of a potential debtor, in particular, a debtor whom your organization has extended an acquisition, development and construction loan?
- What processes do banks use to control the lending and origination process?
- What processes do banks follow to assess and monitor borrower risk?
- What is the impact of regulation on how banks operate?
- How does the credit cycle affect how bank operate in general, and specifically in relation to lending processes?
- How does the loan workout team work, and in relation to the rest of the bank?

The interviews were not conducted to elicit confidential information, but rather to elicit responses of what these banking participants view the workings and regulatory culture in banks (including their opinions on how banks, apart from their employers, work). However, owing to the sensitive issues surrounding banks and Congressional intervention in the financial industry, the participants have agreed to the interviews conditional on their identities being kept confidential. Findings from these interviews were supplemented by comment letters from banks to regulators as well as personal observations from a stint in consulting for banks' risk management teams.⁷³

Having discussed the design of the three main branches of our general empirical research methodology, we will now move on in the next few chapters to discuss our findings.

⁷³ These personal observations stem from work for banks' risk management teams in the US, Canada and Europe, including Basel II gap analyses, development and validation of risk rating scorecards, risk-based pricing models, calibrating through-the-cycle ratings versus point-in-time ratings, analysis of credit portfolio and correlations, etc.

Chapter 4: Findings from the Bankruptcy Dockets

The key results of our data collection exercise are summarized in the table below, which shows the division of outcomes in the data sample (not including the 11 mega cases). We have laid out the distribution of outcomes for the main dataset where the cases have been resolved using a strict definition of resolution, and the augmented dataset containing cases that we consider to be substantively resolved (see the definitions of resolution under the methodology discussion in Chapter 3).

Figure 6: Distribution of Procedural Outcomes in the Dataset

Procedural Resolution of Cases				
		Count	Subtotal	% of Subtotal
Strict Resolution	Converted to Chapter 7	23		17.4%
	Dismissal	77		58.3%
	Section 363 Sale	17		12.9%
	Plan Confirmed	15	132	11.4%
Substantive Resolution	Order for relief from stay for substantially all assets	35		44.3%
	Order for relief from stay for certain assets	11		13.9%
	Plan filed by debtor and at least 1 order for relief from stay	10		12.7%
	Plan filed by debtor and at least 1 lift-stay motion	7		8.9%
	Plan filed by debtor; no lift-stay motions	14		17.7%
	Sale motion filed and pending hearing	2	79	2.5%
Total		211		

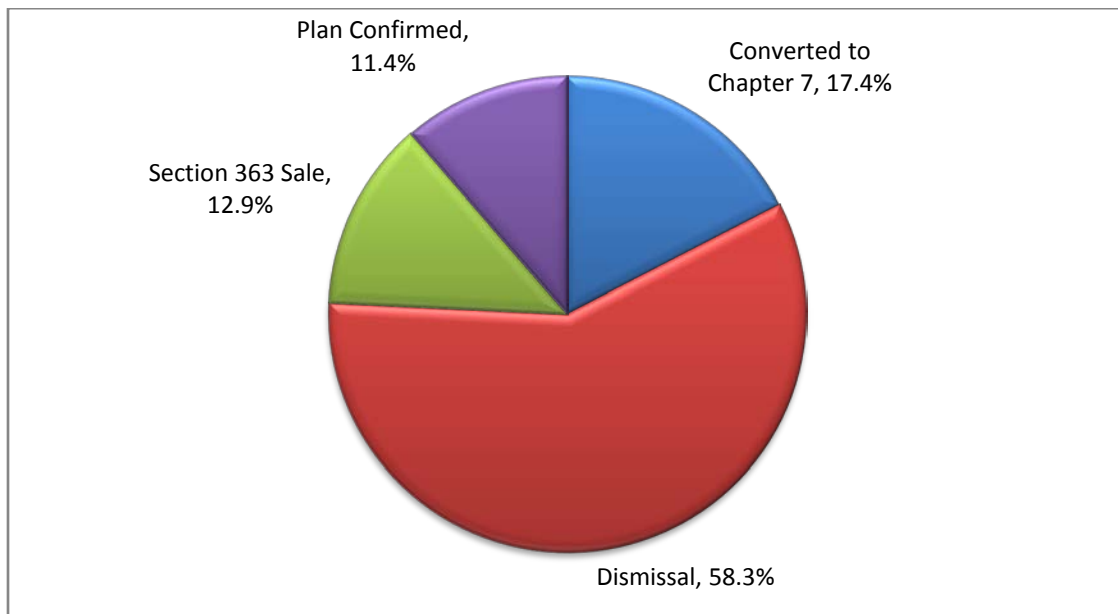
The quick overview presented by the above table provides two insights upon which we will elaborate. First, Chapter 11 cases in the residential development industry in this time period are least likely to be resolved through a confirmed plan and are more frequently dismissed or

converted to Chapter 7 bankruptcy. Second, of the cases which are substantively resolved, a majority of them have experienced relief from stay pursuant to foreclosure, with 44.3% having almost no assets left to support viable prospects of reorganization. Moreover, upon examining the cases with plan confirmation, we found that only 7 of these plans were for re-organization. The other 8 confirmed plans were for liquidation. Therefore, the actual re-organization rate is only 5.3% of the overall sample. These key findings will be discussed in detail throughout this chapter.

4.1 General Findings on the Distribution of Bankruptcy Outcomes

Using data collected from the Chapter 11 bankruptcy dockets of residential developers and home builders, we arrived at a distribution of outcomes as shown in Figure 7. This distribution is based on the 132 cases (excluding 11 “mega” cases) where there has been “strict resolution”, i.e., plan confirmation, consummation of a section 363 sale, conversion to Chapter 7 and dismissal.

Figure 7: Distribution of Outcomes in Developer Bankruptcies for the Main Dataset



The most striking point in this empirical distribution is that an overwhelming majority of the Chapter 11 cases ended in dismissals and conversions. Furthermore, plan confirmation rates stood at a low level of 11.4%. See the stark contrast between this distribution of bankruptcy outcomes and that calculated from LoPucki’s Bankruptcy Research Database (“BRD”) used as a benchmark – see Figure 8 where we analyzed the full data sample from the BRD for 1980-2008 and a sub-sample for a prior downturn of 2001-2.⁷⁴ It is expected that the level of plan confirmation for our data sample is likely to be lower than that in the BRD, since the former mostly consists of middle-market companies in a particularly distressed industry (as opposed to a wide range of large public companies), but the disparity in levels is extremely wide.

Figure 8: Comparison of Bankruptcies in the Residential Development Industry (2007-8) with Large Public Bankruptcies

Data Sample	Dismissal	Conversion	363 Sale	Plan Confirmation
132 Residential developers and builders (2007-8)	58.3%	17.4%	12.9%	11.4%
733 Large Public Companies from BRD (1980-2007)*	0.8%	4.1%	10.0%	85.1%
176 Large Public Companies from BRD (2001-2002)*	1.7%	2.8%	19.3%	76.1%

Source: Lynn M. LoPucki, Bankruptcy Research Database

Drilling into the rate of dismissals and conversions, we found little attention in prior studies on the proportion of dismissal rates in bankruptcy proceedings, except for the following papers which provided indicative levels for these procedural outcomes – see Figure 9.

⁷⁴ There was insufficient data to come up with the distributions for prior downturns such as 1980-1 (8 observations), 1990-1 (70 observations).

Figure 9: Empirical Findings on Dismissal and Conversion Rates from Prior Literature

Literature	Findings on Dismissals and Conversions	Data Sample
Ayotte and Morrison (2008) ⁷⁵	(2001) Conversion rate: 14%; Dismissal rate: 9%	153 cases, consisting of large corporate cases listed in the <i>Bankruptcy Datasource</i> “Public and Major Company Database” during the latter half of 2001, with median assets of \$151M.
Morrison (2006) ⁷⁶	Northern District of Illinois cases (1998-9): 23.2% conversion rate and 43.6% dismissal rate; All districts (1998-9): 39.4% conversion rate and 29.9% dismissal rate	Northern District of Illinois cases: 470 cases (median assets of \$114,160); All districts (from Survey of Small Business Finance): 13,457 cases (median assets of \$320,971);
Bernant and Flynn (1998) ⁷⁷	(1989-95) Conversion rate: 35.4%; Dismissal rate: 35.3	131,089 cases filed between 1989 and 1995 in different districts

Compared to the rates documented in the Ayotte and Morrison (2008) study, the conversion rate in our data sample is similar but the dismissal rate at 58.3% seems extremely high. On the other hand, the combined conversion and dismissal rates in our data sample (75.7%) seems comparable to those in Morrison (2006) and Bernant and Flynn (1998) study. Note, however, that these two studies were based on small business bankruptcies.

The Morrison (2006) study recorded that 83.9% and 83.1% of the cases from the Northern District of Illinois sample and the Survey of Small Business Finance sample had fewer than 20

⁷⁵ Kenneth Ayotte & Edward R. Morrison, *Creditor Control and Conflict in Chapter 11* (Columbia Law and Economics Research Paper No. 321; Northwestern Law & Econ Research Paper No. 08-16, 2008), available at <http://ssrn.com/abstract=1081661>.

⁷⁶ See Edward R. Morrison, *Bankruptcy Decisionmaking: An Empirical Study of Continuing Bias in Small Business Bankruptcies* (Columbia Law Sch. Ctr. for Law and Econ. Studies, Working Paper No. 239, 2006), available at <http://ssrn.com/abstract=880101> or DOI: 10.2139/ssrn.461031.

⁷⁷ See Gordon Bermant & Ed Flynn, *Bankruptcy by the Numbers, Outcomes of Chapter 11 Cases: U.S. Trustee Database Sheds New Light on Old Questions*, 2 Am. Bankr. Inst. J., (1998) and Douglas G. Baird & Edward R. Morrison, *Bankruptcy Decision-Making*, 17 J. L. Econ. & Org. 356.

employees, respectively. The Bernant and Flynn (1998) study using the U.S. Trustee database of Chapter 11 filings between 1989 and 1995 included cases in all districts with a U.S. Trustee program without filtering for size. As this study did not provide a size distribution, we sought to estimate the asset ranges, using another large-scale study – Warren & Westbrook’s study in relation to the Business Bankruptcy Project from 23 judicial districts across the nation.⁷⁸ In that study of 2,905 cases in 1994, only 6.5% of the cases had total assets between \$1-5 million and 2.6% with total assets above \$5 million. The ensuing implication is that bankrupt residential developers during this downturn are being dismissed and converted at similar rates to small business bankruptcies. This is disturbing because these are much larger companies which went into financial distress with substantial real estate holdings.⁷⁹

As for plan confirmation rates, the 11.4% level which we found is low compared to the findings in other studies. Considering older studies, a 1997 report by the National Bankruptcy Review Commission cited a report by the Administrative Office of the US Courts that found a 17% confirmation rate.⁸⁰ In more recent empirical studies, the confirmation rate hovered between 30% and 75% from samples with both small and large bankruptcy cases – see Figure 10 below. Furthermore, the plan confirmation rate calculated from LoPucki’s BRD (see Figure 8 above) for large public companies between 1980 and 2007 is even higher at 85.1%.

⁷⁸ See Elizabeth Warren & Jay Lawrence Westbrook, *Financial Characteristics of Businesses in Bankruptcy*, 73 Am. Bankr. L.J. 499 (1999) [hereinafter Warren & Westbrook, *Characteristics*].

⁷⁹ See, for example, Douglas G. Baird, Arturo Bris and Ning Zhu, *The Dynamics of Large and Small Chapter 11 Cases: An Empirical Study* (Yale ICF Working Paper, Paper No. 05-29, 2007), available at <http://ssrn.com/abstract=866865>. Baird, Bris and Zhu’s study made the following comment about small business bankruptcies: “Most have assets worth only a few hundred thousand dollars. Of these, most never confirm a plan of reorganization. They are converted or dismissed and leave little or nothing for ordinary general creditors. The story is not significantly different for the small businesses that reorganize successfully. These businesses have secured obligations and tax obligations that approach the value of the available assets. In a word, the typical small business bankruptcy leaves ordinary creditors with little or nothing.”

⁸⁰ See Nat’l Bankr. Review Comm’n, Report of the National Bankruptcy Review Commission, ch. 2, nn. 781–82 (Oct. 20, 1997), available at <http://govinfo.library.unt.edu/nbrc/report/09amass.html>, and Bermant and Flynn, *supra*, note 77.

Figure 10: Empirical Findings on Plan Confirmation Rates from Prior Literature

Literature	Findings on Plan Confirmation	Data Sample
Elizabeth Warren and Jay Lawrence Westbrook (2009)	1994: 30.3% confirmation rate; 2002: 33.4% confirmation rate ⁸¹	1994: 437 cases; 2002: 197 cases (Small cases, with only 2.6% (1994) and 25.2% (2002) over \$5 million in total assets).
Ayotte and Morrison (2008) ⁸²	2001: 75% confirmation rate	153 cases, consisting of large corporate cases listed in the <i>Bankruptcy Datasource</i> “Public and Major Company Database” during the latter half of 2001, with median assets of \$151M.
Morrison (2006) ⁸³	Northern District of Illinois cases (1998-9): 33.2% confirmation rate; All districts (1998-9): 30.7% confirmation rate	Northern District of Illinois cases: 470 cases; All districts: 13,457 cases; Mainly small cases with 81.1% under \$1 million in total assets.
Ancel and Markell (1999) ⁸⁴	1990-6: 39% confirmation rate	2393 Chapter 11 cases filed between 1990 and 1996 (around 340 cases a year), in Region 10 of the United States Trustee’s Office, including Indiana and the Southern and Central Districts of Illinois.
LoPucki (1983) ⁸⁵	47% confirmation rate	48 public company cases over twelve months in the Western District of Missouri, 1979-1980.

⁸¹ Warren and Westbrook, *Challenge, supra*, note 5. Note that Warren and Westbrook discussed a screening effect (i.e., where weaker cases were culled early in bankruptcy proceedings. They found that the confirmation rate for cases that survived six months was much higher – 41% in 1994 and 47% in 2002. To check whether this “screening effect” has affected the findings in this paper, we checked the plan confirmation rate for cases which survived six months. The result only budged slightly upwards, showing a 12.5% confirmation rate.

⁸² Ayotte & Morrison, *supra*, note 75.

⁸³ Morrison, *supra*, note 76.

⁸⁴ Steven H. Ancel and Bruce A. Markell, *Hope in the Heartland: Chapter 11 Dispositions in Indiana and Southern Illinois, 1990-96*, S. C. L. Rev. 343 (1999).

⁸⁵ Lynn M. LoPucki, *The Debtor in Full Control—Systems Failure Under Chapter 11 of the Bankruptcy Code?*, 57 Am. Bankr. L. J. 99 & 247, 272-73 (1983).

Moving on, we seek to look beyond the procedural outcomes of these developer bankruptcy cases to the economic outcomes, as discussed in the research methodology. The most important part of the inquiry is the extent to which we observe liquidations of the residential real estate of bankrupt developers. This is addressed in the following sections where we dug deeper into bankruptcy dockets to investigate the actual resolution in these cases.

4.2 Do Dismissals and Conversions Necessarily Mean Liquidations?

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

However, there is a hybrid form of conversion cases where a going concern sale under section 363 is first undertaken, followed by a conversion to Chapter 7.⁸⁶ Since such cases would be considered sales, rather than liquidation cases, we reviewed the sample to identify whether any of the Chapter 7 conversions were preceded by section 363 sales. We found that all of the conversion cases were preceded by at least one order granting a secured lender relief from stay to pursue foreclosure, except for 8 cases. The latter were converted to Chapter 7 by the U.S. Trustee, citing reasons such as the debtors' failure to proceed with reorganization in timely fashion, an absence of

⁸⁶ Occasionally, Chapter 11 cases convert to Chapter 7 after having first confirmed a plan of reorganization. See Richard C. Friedman, *Issues in Chapter 7 Cases Converted from Chapter 11, 12 Or 13*, United States Department of Justice, available at: http://www.usdoj.gov/ust/eo/public_affairs/articles/docs/nabtalk072000.htm.

reasonable likelihood of rehabilitation, and debtors' failure to file reports or pay fees. None of these involved section 363 sales. As such, we find that the percentage of Chapter 7 conversion cases with foreclosure or liquidation as an economic outcome in the sample of 132 "strict resolution" cases is 17.4%.

Moving onto case dismissals, prior studies have stated that dismissals can sometimes follow a successful accommodation between a debtor and its creditors without the need for a court-approved Chapter 11 plan.⁸⁷ Indeed, a 1994 study cited anecdotal evidence from experienced bankruptcy lawyers and judges that a fair number of cases were dismissed because debtors and creditors have worked out a settlement that they were not able to achieve prior to the Chapter 11 filing.⁸⁸ On the other hand, the empirical study on 103 business bankruptcies in the Northern District of Illinois in 1998-9 showed that 83.4% of the dismissal cases ended in the shutdown of the business – see Figure 11 below.

Figure 11: Economic Outcomes in Dismissal Cases, Morrison (2006)

Economic Outcomes	Frequency
Continuations:	8.3%
Exited with new capital structure	8.3%
Going concern sale	0.0%
Shutdowns:	83.4%
Shutdown before exiting bankruptcy	18.8%
Exited without new capital structure	64.6%

While these studies refer to older data, they show that the economic outcomes in dismissal cases are very idiosyncratic, and there was no systematic factual inquiry regarding the circumstances behind the dismissal of these cases. Bearing this in mind, and conjecturing that the data available today may be better than that in the past because of the increasing conversion of

⁸⁷ Bermant and Flynn, *supra*, note 77, at 8.

⁸⁸ See Samuel L. Bufford, *What Is Right About Bankruptcy Law and Wrong About Its Critics*, 72 Wash. U. L.Q. 829 (1994).

information into electronic formats and their availability over common platforms, we investigated the filings documenting the reasons for the dismissals of these cases.

Of the 77 dismissal cases in our sample, the main reason for dismissal was the bankruptcy estate had minimal valuable assets remaining available for liquidation or distribution, and that a plan was no longer feasible. Our investigations show that about 95% of the dismissals (i.e., 73 cases) involve some form of foreclosure or liquidation as an economic outcome – see the first three rows of Figure 12 below.

We observed that, in 47 of these 73 cases (the first row of Figure 12 below), the motion for dismissal was preceded by orders granting secured lenders relief from stay to foreclose on substantially all real property of the developer, or orders granting relief on certain core assets (typically accompanied by the debtors' motions to abandon interests in the remaining assets to creditors). Dismissal is a logical step in such cases since the expense of Chapter 11 proceedings can no longer be justified where the lift-stay actions meant that there were no more assets of significant value available for distribution to the general creditor body.

In 8 of these 77 cases (the second row of Figure 12), there were successful lift-stay motions by some, but not all, secured lenders, and certain assets remained with the estate. However, the debtors or the U.S. Trustee moved to dismiss the case by citing, *inter alia*, that there was no reasonable likelihood of reorganization and that Chapter 11 proceedings would not benefit the rest of the creditors.⁸⁹ Such dismissals without restructuring of the capital structure typically exposed the firms to potential liquidation under state law. Morrison's 2006 study found that the probability of shutdown was very high in cases which exited without new capital structures.⁹⁰

⁸⁹ Note that where the case was dismissed by motion filed by the U.S. Trustee, the motion will usually include reasons such as the failure to file reports and schedules, quarterly pay fees, etc.

⁹⁰ Morrison, *supra*, note 76.

Figure 12: Breakdown of Dismissals in the Dataset

Dismissals (from Strict Resolution)		Count	Subtotal	% of Total
Foreclosure or Liquidation as an economic outcome	Estate has minimal valuable Assets - dismissal preceded by lift-stay order on all assets	47	73	61.0%
	Estate has minimal valuable Assets - dismissal preceded by lift-stay order on certain assets	8		10.4%
	Reasons related to sale or foreclosure after bankruptcy	18		23.4%
Otherwise	Settlement of claims between creditor and debtor for continued operations	4	4	5.2%
TOTAL		77		

Of the remaining 23.4% of dismissal cases (18 out of 73) which did not fall under the above category, the reasons for dismissal are summarized as follows:

- Motions by creditors to dismiss the case to pursue state law remedies such as foreclosure which were approved by the court;
- Voluntary motions by the debtors following contentious hearings on lift-stay motions or court determinations of Single Asset Real Estate status;⁹¹
- Proposed sale of substantially all real property (outside of the section 363 sale provisions) to a junior creditor which would continue negotiations with the senior secured lender.⁹²

⁹¹ An implication of being classified as a Single Asset Real Estate is to affect the deadline date for submission of a confirmable plan or the commencement of monthly interest payments. *See, e.g., In re Valle Grande Properties LLC*, No. 08-11016 (Bankr. E.D.Cal. February 28, 2008), the debtor stated in a filing prior to dismissal that it “believes that the Court now has sufficient jurisdiction to enter an order in relief”.

⁹² *See, e.g., In re SMG Land Development LLC*, No. 08-40902 (Bankr. D. Mass. March 24, 2008). At the time of the filing of bankruptcy, the real property was the subject of a pending foreclosure action instituted by the secured lender, Sovereign Bank. The proposed acquirer of the real property, the holder of a junior lien, had entered into negotiations with Sovereign Bank. As such, the debtor believed that cause existed for the dismissal since the estate would have no assets remaining available for liquidation or distribution.

Only 4 of these cases actually involved settlements of the claims between the developers and its creditors, and in one case, a third party entity purchased the claim of the secured lender and agreed to allow the debtor to continue in operation.

Therefore, with 94.8% of the dismissal cases found to have culminated in foreclosure or liquidation and 100% of the Chapter 7 cases being liquidation cases, the results from this empirical analysis at this point reflect the high rate of liquidation in the residential development industry during this time period.

4.3 To What Extent were Cases with Confirmed Plans Reorganizations?

While Chapter 7 is the prevailing method of business liquidation, Chapter 11 expressly contemplates liquidation through a plan.⁹³ A liquidating plan may contemplate piecemeal liquidation not much different from a typical Chapter 7 proceeding.⁹⁴ The key distinguishing features of Chapter 11 liquidations is that the debtor's management can control the plan process, creditors can vote on the plan which may include deviations from the absolute priority rule. On the other hand, trustees are appointed in Chapter 7 cases adhere strictly to the priority distribution scheme.

In identifying the nature of the Chapter 11 plans in our sample, we went beyond the label affixed to the plans and examined the post-confirmation arrangement proposed by the debtor.⁹⁵

⁹³ 11 U.S.C. § 1123(b)(4) (2006). It has been said that it is a "false dichotomy that paints chapter 11 as the tool of reorganization with chapter 7 as the sole means of liquidation". See, for example, Oliver Hart, *Firms, Contracts and Financial Structure*, 156 (1995) ("Chapter 7 calls for a bankruptcy company to be sold off for cash. In contrast, Chapter 11 is an attempt to allow companies to reorganize."). See also Douglas G. Baird, *The Uneasy Case for Reorganizations*, 15 J. Legal Stud. 127 (1986) [hereinafter Baird, *Uneasy*]

⁹⁴ Warren and Westbrook, *Challenge, supra*, note 5.

⁹⁵ Baird and Rasmussen, *Twilight, supra*, note 36. Baird and Rasmussen observed in their empirical studies that many cases coded as "emerged" might actually be sales of some sort, ranging from a sale where the business did not emerge intact as an independent entity under a reorganization plan to a sale of substantial level of assets while maintaining the business as a discrete legal entity. It has also been argued that "corporate reorganizations today are the legal vehicles by which creditors in control decide which course of action - sale, prearranged deal, or conversion of debt to a controlling equity stake - will maximize their

For example, in the case of Landing Development, the debtor proposed a “Reorganization Plan” which laid out what was substantially a liquidation scheme. The plan provided for repayment of the secured lenders by compelling a liquidation sale of the existing residential development, and restricted the debtor to an inventory of no more than 16 homes.⁹⁶

Of the 15 cases in our sample where a plan was confirmed, only 7 involved reorganization plans, and the remaining were plans for liquidation. Note that the proportion of liquidating plans in this sample is much higher than what Warren and Westbrook found – in their study, less than 21% of the confirmed plans in their sample were liquidating plans.⁹⁷ This finding also implies that the reorganization rate is actually 5.3% in the sample of 132 cases, a level much lower than the reorganization rates found other prior empirical studies (which we will discuss in detail in Section 4.5).

The typical plan in our sample essentially affords the developer the opportunity for an orderly liquidation, instead of a forced sale by the secured lenders. To illustrate, in the plan confirmed for Heritage Homes, the debtor would be allowed to market its properties for a period of 6 months from the date of confirmation. In the event that these properties were not sold within the agreed time frame, the estate would abandon its interests and allow secured lenders to pursue foreclosure. If the sales were to generate net proceeds in excess of the secured claims, the proceeds would be held in a disbursement trust account for the benefit of unsecured creditors.⁹⁸

As for the 7 cases with reorganization plans, one of them, First Dartmouth, would restructure the claims with its remaining creditors, even though substantially all of its real property

return”. Skeel, *supra*, Note 4, also claimed that many of the cases that researchers code as “reorganization” looked “an awful lot like” liquidations on inspection. In undertaking this study, we aim to guard against this issue.

⁹⁶ See *In re* Landing Development Inc., No. 08-31686 (Bankr. D. Ore. April 14, 2008). At the time of plan confirmation, the development consisted of 26 townhouses and 89 lots. The plan stated that “At no time shall the standing inventory or townhome units exceed 16 (including any that are *under construction*), excluding the 4 model townhome units” [*Italics added*].

⁹⁷ Warren and Westbrook, *Challenge, supra*, note 5.

⁹⁸ See *In re* Heritage Homes Inc., No. 08-13285 (Bankr. W. D. Wash. May 29, 2008).

had already been foreclosed upon. This appears to fall within the grey area between reorganization and liquidation.⁹⁹

An interesting observation developed from those cases with a confirmed reorganization plan is that 4 out of 7 of these cases involved recently-completed developments which have started to generate rental income.¹⁰⁰ This is not surprising, as developers of income-producing real estate are more likely to be able to make regular payments to secured lenders and therefore more comfortable in terms of a lower probability of default on restructured claims. However, it should be noted that the broader socio-economic impact of the liquidation and foreclosure of unfinished homes is far more severe than that of completed and income-producing properties.

4.4 Are the “Mega” Cases on the Track to Reorganization?

Of the 11 “mega” developer bankruptcies, only 4 cases have been resolved and all of these have culminated in liquidation. One of the cases, Empire Land, had been converted to Chapter 7, after multiple lift-stay motions in pursuance of foreclosure by secured lenders were approved by the court.¹⁰¹ Kimball Hill, Dunmore Homes and Levitt & Sons had confirmed liquidation plans, respectively. In these 3 cases, a portion of the real estate assets were sold or foreclosed upon, by the time of confirmation. In terms of this, Dunmore Homes occupied the most “extreme” end of the spectrum – at the time when the plan was confirmed, secured lenders had already foreclosed upon

⁹⁹ See *In re* First Dartmouth Homes Inc., No. 07-12927 (Bankr. M.D. Fla. December 29, 2007).

¹⁰⁰ See, e.g., *In re* North Park Village LLC, No. 07-06618 (Bankr. D. Ariz. December 7, 2007), *In re* Northpoint Village of Utica LLC, No. 08-53097 (Bankr. E.D.Mich. May 29, 2008), and *In re* The Towers of Channelside LLC, No. 08-00939 (Bankr. M.D.Fla. January 25, 2008).

¹⁰¹ See *In re* Levitt and Sons, LLC, No. 07-19845 (Bankr. S.D.Fla. November 9, 2007), *In re* Kimball Hill, Inc., No. 08-10095 (Bankr. N. D. Ill. April 23, 2008), and *In re* Empire Land, LLC, No. 08-14592 (Bankr. C. D. Cal. April 25, 2008).

substantially all residential developments, leaving the developer's assets consisting of land options, deferred compensation funds, receivables, deposit accounts and litigation claims.¹⁰²

At the time of writing, there are 4 out of the 11 "mega" cases for which the debtors had filed a plan – Touse and the SunCal companies with proposed liquidating plans, Woodside Group and LandSource Communities (which we are using as a case study in Chapter 6) with proposed reorganization plans.¹⁰³ Note that the SunCal companies are situated in unique circumstances since their primary secured lender, affiliates of the Lehman Brothers, is also in Chapter 11 bankruptcy. Moreover, given serious concerns that the Lehman affiliates' claims could be equitably subordinated to those of other creditors and the ongoing bankruptcy of Lehman Brothers, the bankruptcy court had denied motions for relief from stay filed by the Lehman affiliate and, in the recent motion for sale of certain SunCal properties, the trustee had requested that the court expressly disallow the credit bid rights of the Lehman affiliates, i.e., the rights of the secured lender to bid at the sale and offset its claim against the purchase price (something which we have not observed in other cases in our data sample).¹⁰⁴

The remaining cases – DBSI, Neumann Homes and WCI – had not filed a plan yet. Neumann Homes and DBSI had been confronted with multiple successful lift-stay motions from secured lenders.¹⁰⁵ It should also be noted that Neumann Homes filed for bankruptcy on November 1, 2007 such that its exclusivity period to file a reorganization plan is drawing close to the statutory maximum of 18 months under BAPCPA, and WCI has been particularly slow in progressing through

¹⁰² See *In re Dunmore Homes, Inc.*, No. 08-20569 (Bankr. E. D. Cal. November 8, 2007)

¹⁰³ See *In re TOUSA Inc.*, No. 08-10928 (Bankr. S.D.Fla. January 29, 2008), *In re Woodside Group, LLC*, No. 08-20682 (Bankr. C.D.Cal. August 20, 2008), and *In re LandSource Communities Development, LLC*, No. 08-11111 (Bankr. D. Del. June 8, 2008). Note that the bankruptcy of Woodside Group is a very unique case and its proposed reorganization plan must be put into context. The bankruptcy petition was filed on behalf of the 30 major banks and 5 insurance companies against 185 affiliated borrower/guarantor entities which had borrowed in excess of \$600 Million on an *unsecured* basis.

¹⁰⁴ *In re Palmdale Hills Property, LLC*, No. 08-17206 (lead case) (Bankr. C. D. Cal. November 6, 2008).

¹⁰⁵ See *In re DBSI Inc.*, No. 08-12687 (Bankr. D. Del. November 10, 2008), and *In re Neumann Homes, Inc.* No. 07-20412 (Bankr. N. D. Ill. November 1, 2007).

its proceedings, having filed two motions to extend the exclusivity period to file the plan and only filing its schedules of assets and liabilities about 5 months after the bankruptcy filing date.¹⁰⁶

4.5 Benchmarking Economic Outcomes against Other Studies

Based on the above analyses, we conclude that the actual rate of liquidation in the “strict resolution” sample of 132 cases is 78.8%. This is a composite of the following:

- 54.3% from dismissals (73 cases with liquidation or foreclosure as an outcome);
- 15.2% from Chapter 7 conversions (all of the 23 cases which were converted); and
- 4.5% from confirmed plans of liquidation (8 cases).

We proceed to benchmark the economic outcomes in this study against those of prior empirical studies – Hotchkiss and Mooradian’s 2004 study on Chapter 11 cases for 1,400 public companies Chapter 11 filings for 1979-2002, Bharath’s 2007 study on public companies Chapter 11 filings for 1980-2005, which showed a liquidation rate of 18.8%, and the Ayotte & Morrison (2008) and Morrison (2006) studies (discussed above in Section 4.1).¹⁰⁷

Figure 13 below summarizes the results of this benchmarking exercise.

¹⁰⁶ See *In re* WCI Communities Inc., No. 08-11643 (Bankr. D. Del. August 4, 2008)

¹⁰⁷ Edith S. Hotchkiss, Kose John, Karin S. Thorburn & Robert Mooradian, *Bankruptcy and the Resolution of Financial Distress* (Working Paper, 2008), available at <http://ssrn.com/abstract=1086942>, Sreedhar T. Bharath, Venkatesh Panchapagesan & Ingrid M. Werner, *The Changing Nature of Chapter 11* (Fisher College of Business Working Paper No. 2008-03-003, 2007), available at <http://ssrn.com/abstract=1102366>, Morrison, *supra*, note 76.

Figure 13: Benchmarking Economic Outcomes against Prior Studies

Literature/Data	Liquidations	363 Sale	Reorganization	Others*
132 Residential developers and builders (2007-8)	78.8%	12.9%	5.3%	3.0%
Bharath, Panchapegesan and Werner (2007)	18.8%	11.3%	59.3%	10.5%
Hotchkiss and Mooradian (2004)	21.5%	7.6%	70.6%	
Morrison (2006)	62.1%	5.3%	24.2%	8.4%
Ayotte and Morrison (2008)	66.0% (includes 363 sales) ¹⁰⁸		32.0%	

The liquidation rate for bankrupt developers in our study is high at 78.8% compared to these studies. A possible explanation is that the liquidation rates for the studies by Hotchkiss & Mooradian (2004) and Bharath et al (2007) relate to large companies, while our sample covers a range of companies, mostly middle-market. On the other hand, even the most optimistic estimate of reorganization rates in the “mega” cases at 45.4% (assuming the 2 cases with proposed reorganization plans and 3 pending cases will culminate in reorganizations, i.e., 5 out of 11) is not near the levels in these two prior studies. Furthermore, the 78.8% liquidation rate (covering a fairly well-distributed sample across both big and small companies) is still much higher than the rate found in the Morrison (2006) study on small business bankruptcies, not to mention the low 5.3% reorganization rate in our main sample of 132 cases against the 24.2% documented in the former study.

Another interpretation is that these prior studies cover an entire economic cycle, while this sample is drawn from a severe downturn from one of the most distressed sector. However, if this

¹⁰⁸ Ayotte and Morrison (*supra*, note 75) provided results in relation to the economic outcome of the bankruptcy cases in terms of whether a Chapter 11 case concluded with a traditional reorganization or whether the case concluded in a sale of the entire firm. The latter category includes liquidating plans of reorganization, section 363 sales, conversions to Chapter 7, and dismissals.

turns out to be an important explanation for the difference in our results, then it raises a critical question: should bankruptcy policy be shaped by data averaged across the economic cycle? After all, large changes in the U.S. bankruptcy regime have in the past occurred during severe downturns, when, presumably, society found the contemporary regime, presumably built during the good period preceding the downturn, to be unsatisfactory.¹⁰⁹ It is apparent that the causes of bankruptcy, and the socio-economic outcomes, differ greatly depending on whether it is a boom or bust period. Should the remedies then not be different as well?

4.6 Focusing on Cases with a Plan Filed

A possible criticism against the above analysis is that it will be more realistic to first filter out dead-on-arrival (“DOA”) cases, i.e., cases where the debtor arrived at Chapter 11 in such a state as to have no chance of survival. In Warren and Westbrook’s study, this is proxied by the situation where the debtor did not file a plan throughout the case.¹¹⁰ It has been asserted that any Chapter 11 case that could be derailed before a plan could be filed was likely to be in so much trouble that reorganization was unlikely in the first place. Applying this logic, we re-analyzed the data after identifying the cases where the debtor had proposed a Chapter 11 plan, and the results in terms of procedural outcomes, presented in Figure 14 below, and economic outcomes, Figure 15. Each figure shows the proportion of each outcome in the cases where a plan was filed, compared to the proportion of outcomes in only the cases where no plan was filed. Each column should add up to 100%.

¹⁰⁹ Miller and Waisman, *Reorganization, supra*, note 36.

¹¹⁰ Warren and Westbrook, *Challenge, supra*, note 5.

Figure 14: Procedural Outcomes

	Plan Filed		No Plan Filed	
	Count	%	Count	%
Converted Ch7	6	11.8%	17	21.0%
Dismissal	24	47.1%	53	65.4%
Sale (363)	6	11.8%	11	13.6%
Plan Confirmed	15	29.4%	N/A	N/A

Predictably, the plan confirmation rate has now increased, being 29.4% in the sub-sample of cases where the debtor had proposed at least one plan. However, the plan confirmation rate is still very low, compared to Warren and Westbrook’s findings in relation to cases with a plan filed – 65.5% in 1994 and 71.6% in 2002.¹¹¹ Moreover, in terms of economic outcomes, the level of reorganization is still low at 13.7%.

Figure 15: Economic Outcomes

	Plan Filed		No Plan Filed	
	Count	%	Count	%
Liquidation	37	72.5%	67	82.7%
Reorganization	7	13.7%	N/A	N/A
Going Concern Sale	6	11.8%	11	13.6%
Others	1	2.0%	3	3.7%

The approach of using the filing of a plan as evidence of being “DOA” is problematic because it mainly focuses the attention on the actions of the debtors. In justifying this measurement approach to sort out the DOAs, Warren and Westbrook compared it to a proper measurement of the success of an emergency room. It was argued that, if an emergency room attracts a large number of DOAs, even the best-run emergency room will score badly in a system that simply counts the number of people who die in the emergency room.

¹¹¹ *Id.*

If the DOAs were to be excluded, this would allow us to measure the skill of the emergency room staff in being able to control what they could control. This analogy does not work as well where the actions of other stakeholders, in particular secured lenders, are likely to affect the debtor's ability to file a plan. To re-use the Warren and Westbrook analogy, this is like having emergency rooms where there are people apart from the doctors and patients present deciding on whether or not to have life-saving treatment.

As Miller and Waisman remarked, the bankrupt debtor must, while “in its most fragile state, either challenge the lender's liens and security interests or seek to use the lender's cash collateral over the lender's objection, which if they are options at all, involve lengthy and resource-draining proceedings, or accede to the lender's demands”.¹¹² Furthermore, as we will discuss in the next chapter, many of these developer bankruptcies were fraught with lift-stay motions. A developer who is kept busy fending off lift-stay motions from multiple secured lenders, may not have the time and resources to file a plan. As the Official Committee of the Unsecured Creditors of Village Homes (a case which we discuss further in Chapter 5) stated in a response to a lift-stay motion by the lender, “the Debtor has been constantly forced into litigation with its secured creditors...rather than focused on a re-organization...The Motion [for relief from stay] continues this unfortunate trend.”¹¹³

4.7 Casting a Wider Net with “Substantially Resolved” Cases

Another possible criticism of the findings in this paper is the potential for sample selection issues. Since we are using recent cases between November 1, 2007 and December 31, 2008, it is

¹¹² Miller and Waisman, *Reorganization, supra*, note 36.

¹¹³ See *In re Village Homes of Colorado Inc.*, No. 08- 27714 (Bankr. D.Colo. November 6, 2008).

conceivable that the cases which may result in plan confirmation are still in a pending stage and that reorganization cases may take a longer time to reach resolution.

To address this issue, we have collected docket information on cases which are “substantially resolved”, considering successful lift-stay motions, the filing of a Chapter 11 plan and the filing of a motion for a section 363 sale of substantially all assets as major milestones towards resolution. Figure 16 summarizes the status of resolution of these cases.

Figure 16: Status of Substantially Resolved Cases

Category	Status	Count	%
1	Order for relief from stay for substantially all assets*	35	44.3%
2	Order for relief from stay for certain assets**	11	13.9%
3	Plan filed by debtor and at least 1 order for relief from stay	10	12.7%
4	Plan filed by debtor and at least 1 lift-stay motion	7	8.9%
5	Plan filed by debtor; no lift-stay motions	14	17.7%
6	Sale motion filed and pending hearing	2	2.5%

*Plan may have been filed by debtor prior to order for relief from stay.¹¹⁴

**No plan has been filed by debtor yet.

The most optimistic scenario regarding the substantially resolved cases will involve an expectation that all of the cases in Categories 2-5 in Figure 16 will result in a confirmed plan. These cases do have some probability of reaching plan confirmation: a plan has been filed but not yet confirmed for cases in Categories 3-5; and while an order for relief has been granted regarding certain assets for cases in Category 2, it is still possible for the debtor to file a plan. In this scenario, we have excluded the category with a pending sale motion and Category 1 cases. While it is possible that the latter may still culminate in plan confirmation,¹¹⁵ there is a very high likelihood that these

¹¹⁴ Of the 35 cases, 14 of them involved a plan being filed (typically prior to the order for relief from stay).

¹¹⁵ In the Chapter 11 proceedings of First Dartmouth, the debtor managed to confirm a restructuring plan with the other creditors in relation to remaining assets, even though substantially all real estate has been foreclosed upon. See *In re First Dartmouth Homes Inc.*, No. 07-12927 (Bankr. M.D. Fla. December 29, 2007).

cases will eventually move towards dismissal or conversion, given the loss of substantially all assets.

Based on this optimistic scenario, we can add 42 cases from Categories 2-5 to the 15 cases with a plan confirmed (in the “strictly resolved” sample). This means that the original estimate, based on the strictly-resolved cases, of the 11.4% plan confirmation rate can be increased to 27.0%, which is a level close to the lower boundary of the range provided by prior empirical studies cited in Section 4.1.

It is thus easy to see that very optimistic assumptions are required before the debtors in our sample achieve a plan confirmation rate consistent with previous studies. As gleaned from the findings in Section 4.6, only 29.4% of the cases where a plan was filed ended in confirmation. Further analysis of the “strict resolution” sample also shows that cases with a plan filed and at least 1 order for relief from stay (i.e., Category 3 cases) only have an 18.2% chance of confirmation. Besides, we should also consider the fact that 27.2% of the cases in Category 2 (where a plan is not filed yet) were filed more than 12 months ago. With a statutory maximum of plan filing exclusivity of 18 months and solicitation exclusivity of 20 months under BAPCPA, these cases face a rushed timeframe and the probability that every one of these cases would reach plan confirmation is not that high.

Additionally, upon undertaking more in-depth investigation, we found that at least 8 of the cases in Categories 2-5 have reached a state showing a depressed likelihood of reaching plan confirmation. 4 of these cases are made up of the Landcraft properties (briefly mentioned in Chapter 3).¹¹⁶ In these cases, while the debtor had filed a plan earlier, they had since defaulted on their cash collateral budgets, following which the secured lender had recently obtained an order

¹¹⁶ The companies managed by Landcraft Management are not substantively consolidated and the group is not a “mega” cases since the consolidated total assets at the time of bankruptcy were below \$500 million, so they are considered separate entities for the purposes of the data sample.

terminating their use of collateral and successfully petitioned the court to appoint a trustee.¹¹⁷ Another case, Whitney Lake, had recently been denied plan confirmation by its creditors and at least one secured lender had filed on April 10, 2009 a motion to dismiss, convert or appoint a trustee.¹¹⁸ There are also 3 other cases which are currently facing concurrent motions for conversion or dismissal.

Furthermore, as we discussed above, it is not merely plan confirmation which is important, but the confirmation of a reorganization plan. At first glance, 12 of the plans filed were liquidation plans and 19 were reorganization plans. Of these 19 cases, 5 of them consist of Whitney Lake and the Landcraft properties. As such, even if we assume that the remaining cases will culminate in reorganization, the addition of these cases to the overall sample will only bring the reorganization rate to 10.0% - still less than half of 24.2% level in Morrison's study of small business bankruptcies (which is the lowest number found in prior empirical studies).

4.8 Conclusion

Now that we have drawn out some statistical results from our relatively comprehensive dataset, it is clear that the outcomes of bankruptcy cases for that we have studied are very different from those of prior studies. The main finding is that only a small minority of developers re-organize in Chapter 11, with the vast majority ending up in liquidation or foreclosure. We will now proceed in the next two Chapters to investigate why.

¹¹⁷ Specifically, see text in Fifth Third Bank's filing of default notice against the Landcraft affiliate, Kelsey Glen, *In re* Kelsey Glen LLC, No. 08- 06503 (Bankr. E. D. N. C. September 22, 2008).

¹¹⁸ See *In re* Whitney Lake, LLC, No. 08-05729 (Bankr. D. S. C. September 12, 2008).

Chapter 5: The Road to Liquidation and Foreclosure

One of the key conclusions of the preceding chapter is that the majority of the companies in our sample is either in liquidation, foreclosure, or headed in that direction. Our analysis, which we will detail in this chapter, is that getting to a reorganization plan is not easy, even though the Bankruptcy Code endows the debtor with the power of exclusivity in coming up with that plan.

This is not surprising, as secured lenders often prefer a swift sale or liquidation of the debtor, compared to the Chapter 11 reorganization process fraught with uncertainty and delay.¹¹⁹ In fact, the gradual move toward greater control of Chapter 11 proceedings by secured lenders has allowed fuller expression of the lenders' incentives for swift resolution of financial distress. Indeed it has been argued that "in the modern era of swift and competitive global capital flows, investors will not tolerate bankruptcy laws and practice that impose undue delay, risk, and uncertainty".¹²⁰

This appears to be the position in the residential development industry, at least as evidenced by the low reorganization rate tracked in the last chapter. In this chapter, we will shed light on the arsenal of weapons employed by secured lenders in moving debtors down the path to liquidation or foreclosure.

This chapter is organized as follows:

5.1: Lift-stay actions

5.1.1: A general discussion of the relief from stay as the main weapon of creditors, and why courts grant relief from stay

5.1.2: The case where debtors consent to relief from stay

¹¹⁹ Adler, *Primitives*, *supra*, n4.

¹²⁰ *Id.* See also Todd J. Zywicki, *The Past, Present, and Future of Bankruptcy Law in America*, 101 Mich. L. Rev. 2016 (2003).

5.1.3: A legislative mistake? The situation of Single Asset Real Estate

5.2: Sale of the debtor's assets as an alternative option to lift-stay and the use of credit bids

5.1 The Prevalence of Lift-Stay Motions

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

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

Given the high combined rate of dismissals and conversions, it indicates a prevalence of lift-stay motions pursuant to foreclosure.

Indeed, this is the main finding borne out in bankruptcy docket analysis of secured lender actions. In the overall sample of 211 developer bankruptcies, there are 152 cases (72.0%) where at least 1 lift-stay motion pursuant to foreclosure was filed by a secured lender. More importantly, in 90.1% of these 152 cases, an order granting the motions was entered.¹²¹

Examining other secured lender actions, we only observed 19 cases (9.0%) where the secured lender moved to dismiss proceedings, 14 cases (6.6%) where the secured lender moved to convert the case to Chapter 7, and 10 cases (4.7%) where the secured lender moved to appoint a trustee and 3 cases (1.4%) where the secured lender moved to terminate exclusivity or file a

¹²¹ Note that there is a dearth of literature regarding the proportion of lift-stay motions and their approval in bankruptcy proceedings, but we did find one study by Morrison, *supra*, note 76, which provided empirical findings in this area. It was found that creditors filed lift-stay motions in 68% of all shutdowns and the court granted them in only 42% of the time. Note that these relate to small business bankruptcies filed in 1989-90 (see fuller discussion of Morrison, *supra*, note 76, in Section 4.1). The numbers are also based on shutdowns only, not the entire sample (i.e., the actual proportion of lift-stay motions is much lower than the levels documented in our data sample, given the 62.1% liquidation rate in the Morrison (2006) study).

competing plan. Note that these actions are not mutually exclusive – we have observed that it is relatively common for lenders to file a motion for dismissal and conversion, in the alternative.¹²²

The prevalence of these successful lift-stay motions suggests an issue worth investigating further. After all, part of bankruptcy policy is based on the realization that there should be a moratorium on asset grabs.¹²³ In the following sub-sections, we analyze the reasons underlying these lift-stay motions. What are the grounds used by secured lenders in support for relief from the automatic stay to foreclose on the real property? To what extent is it a product of the legislation or driven by market forces and the incentives of the insiders such as guarantors?

5.1.1 Relief under §362(d) of the Bankruptcy Code

The filing of a bankruptcy petition triggers an automatic stay under section 362 of the Bankruptcy Code. Part of the fundamental protections afforded to debtors, the automatic stay is meant to provide debtors with breathing space from their creditors during which they can attempt to structure a plan to repay their debts or arrange for relief from the financial pressures that drove them into bankruptcy.¹²⁴

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

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

¹²² See, e.g., *In re Le Jardin, LLC*, No. 08-77019 (Bankr. N. D. Ga. August 9, 2008), and *In re Taro Properties Arizona I LLC*, No. 08-10427 (Bankr. D. Ariz. August 13, 2008)

¹²³ Lynn M. LoPucki, *Secured Credit: A Systems Approach*, 5ed (2005) [hereinafter LoPucki, *Systems*].

¹²⁴ See legislative history discussing the policy underlying the imposition of the automatic stay in H.R. Rep. No. 95-595, at 340 (1977).

Rather than go through the black-letter law on relief from the automatic stay, we choose to illustrate how secured lenders use sub-sections 362(d)(1) and 362(d)(2) in Chapter 11 bankruptcy proceedings of residential developers. Village Homes of Colorado (“Village Homes”) represents a classic case. One of Colorado’s largest residential developers with around \$200 million in annual revenues, Village Homes filed for bankruptcy on Nov 6, 2008. Prior to the recession which began in 2007, Village Homes would hardly have seemed like a candidate for lift-stay motions pursuant to foreclosure. Its profile appeared to be in line with a plausible candidate for debt restructuring and reorganization, with a reasonable chance of success.

Since its founding in 1984, Village Homes has built nearly 10,000 homes in Colorado.¹²⁵ It has active communities in seven locations throughout the Denver metropolitan area, two locations in northern Colorado (Fort Collins and Longmont), and two locations in the Colorado mountains (Granby and New Castle). It has a diversified homebuilding portfolio, developing communities ranging from small residential infill to large-scale, mixed-use master plans, and offering a variety of home types and price ranges. In fact, some of the communities developed by Village Homes had received numerous local, state and national awards, including "Community of the Year" from the Home Builders Association of Metropolitan Denver every year from 2002 through 2007.

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

¹²⁵ See 1st day Affidavit, *In re* Village Homes of Colorado Inc., No. 08- 27714 (Bankr. D.Colo. November 6, 2008).

Four days after the bankruptcy filing, the first volley fired by a secured lender, Guaranty Bank (the administrative agent for the lender group), was a motion objecting to the use of cash collateral. A highly contentious dispute ensued. While the secured lenders took the position that the cash Village Homes had on hand constituted their cash collateral, the developer argued that the lenders had limited security interests on personal property and that part of the cash belonged to home buyers who put down deposits.¹²⁶

In the midst of this dispute, the secured lenders also launched lift-stay motions pursuant to foreclosure against Village Homes.¹²⁷ As the Official Committee of Unsecured Creditors commented in its response to the secured lender's lift-stay motion, the relief was sought very early in the case, when Village Homes was barely in Chapter 11 for two months and had had no chance to focus on re-organization. First, under the ground of "cause" in the lift-stay motions, the secured lenders argued that there was "lack of adequate protection". "Lack of adequate protection", a term of art defined only by example in the Bankruptcy Code, is generally considered the most common basis for finding cause to grant relief in bankruptcy proceedings.¹²⁸ Generally speaking, a secured creditor's interest is adequately protected when provisions that the court considers adequate has been made to protect the secured creditor from loss as a result of a decline in the value of the secured creditor's collateral during the imposition of the automatic stay.¹²⁹

¹²⁶ In the complaint filed by the debtor against the lender group (adversary proceedings), *In re Village Homes of Colorado Inc.*, No. 08-27714 (Bankr. D.Colo. November 6, 2008), the debtor stated: "The Lender Group does not have a security interest in any of the Debtor's property, other than specific real estate. The lenders other than the Lender Group also do not have security interests in any of the Debtor's property other than real estate, with the exception that: (1) several of the lenders have filed UCC financing statements to perfect a claimed security interest in fixtures relating to their real property collateral, and (2) several of the lenders have filed financing statements that describe personal property collateral relating to their real property collateral, such as water rights and development rights."

¹²⁷ On January 21, 2009, Guaranty Bank, as agent for the Lender Group, filed its motion for relief *In re Village Homes of Colorado Inc.*, No. 08- 27714 (Bankr. D.Colo. November 6, 2008) from the automatic stay imposed by section 362(a) of the Code with respect to all of the collateral for the Syndicate Loan Agreement. On January 22, 2009, RFC filed its Motion for Relief from the automatic stay imposed by §362(a) of the Code with respect to all of the collateral for the separate loan owed to RFC.

¹²⁸ See, generally, Automatic Stay, 1-362 Collier Bankruptcy Manual P 362.07 (3d ed. rev.) (2008)

¹²⁹ LoPucki, *Systems, supra*, note 123.

In particular, the lenders cited the decline of residential real estate values and the lack of adequate protection payments as showing that they, the secured lenders, were not protected from any deterioration in the value of its collateral. Moreover, they argued that the debtor had not closed any sales of houses under the terms of the Ordinary Course Order entered by the Court and had only closed five “short sales” by the time of the lift-stay motion.¹³⁰

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

It should be noted that Village Homes’ argument is considerably weak. As ruled by the district court which heard an appeal on the issue of “adequate protection” in the bankruptcy of Denmark Construction on April 7, 2009, the court rejected a similar argument, citing the Court of Appeals for the Third Circuit:¹³¹

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

¹³⁰ In this context, short sales mean sales of real estate in which the proceeds from the sale fall short of the balance owed on a loan secured by the property sold.

¹³¹ See *In re Swedeland Dev. Group, Inc.*, 16 F.3d 552, 567 (3rd Cir. 1994)

It should be noted that this case is premised on the policy that “Congress did not contemplate that a secured creditor could find its position eroded and, as compensation for the erosion, be offered an opportunity to recoup dependent upon the success of a business with inherently risky prospects.”¹³² The question is whether legislators continue to adhere to this policy in the significant nationwide decline in housing prices starting in 2007, where almost all distressed real estate businesses may be considered to have inherently risky prospects.

Next, the secured lenders argued that the debtor had no equity in the property and that the property was not necessary for an effective reorganization. They were able to quickly show that Village Homes had no equity in the real estate.¹³³ In the course of the creditors’ meetings, the debtor acknowledged that the deficiency for creditors might be higher than the \$35 million deficiency shown by values reported in its Schedules of Assets & Liabilities, owing to the depressed values of uncompleted properties.¹³⁴ Village Homes reported in its Schedules total liabilities of \$138,414,003.59, of which the bulk was owed to senior secured lenders, and total assets of \$103,898,087.88.

The secured lenders then proceeded to assert that there was no prospect of a successful reorganization. Citing precedents, arguments were advanced that the mere indispensability of the property to the debtor’s survival and the debtor’s hopes of reorganization were insufficient to justify continuation of the stay when reorganization is not reasonably possible.¹³⁵ The central argument was that without post-petition financing, Village Homes had no feasible way to continue its business, and that they had been unable to agree on the terms of financing the developer.

¹³² *Id.*

¹³³ Note that in many cases, this issue is not as clear-cut for several other developers and, in those instances, the litigation would center on the different appraisal values of the real estate, including issues such as whether the “as is” or “upon completion” values should be used. In some of these cases, if the court had assigned a different value, the outcome might have been different.

¹³⁴ This is unsurprising, given the low market value of the uncompleted properties. In fact, it is a common phenomenon in developer bankruptcies, given the high loan-to-value ratios in loans extended to developers, and the sharp negative correction in real estate prices.

¹³⁵ See *In re Coones v. Mutual Life Ins. Co.*, 168 B.R. 247, 259 (D. Wyo. 1994).

Nonetheless, possibly because the secured lenders were thought to have a strong case during hearings, Village Homes eventually agreed to compromise and settle with its secured lenders on March 13, 2009.¹³⁶ While not being a case which culminated in an order for relief and foreclosure, the developer agreed to a forced sale of “Non-Core Assets”, which included most of the residential lots under construction and a portion of finished homes.¹³⁷ In the agreed stipulation, Village Homes acknowledged that it had no equity in these “Non-Core Assets” and that they were not necessary to an effective reorganization such that relief from stay was appropriate under §362(d)(2) of the Bankruptcy Code.

We are now able to distill three main arguments marshaled by the secured lenders of Village Homes when asking bankruptcy courts for relief from stay to foreclose, summarized as follows:

- The market value of their collateral has plunged with the sharp decline in residential real estate values and the developer has no equity in the collateral because it was over-leveraged in the first place;
- No lender has offered to refinance the project, so reorganization is not possible; and
- There have been no or very few offers to purchase homes (or the project itself) as a result of the housing market crisis.

We shall discuss these arguments in turn, throughout the chapter. Judging from our findings regarding the high number of lift-stay motions granted, it appears that the current bankruptcy regime and bankruptcy judges are at least open to such arguments, if not sympathetic.

¹³⁶ See Consent Order, *In re* Village Homes of Colorado Inc., No. 08- 27714 (Bankr. D.Colo. November 6, 2008). This happened after the initial exclusivity period for which Village Homes has to move to extend exclusivity. This case is also an example as to why companies which are not DOAs may not file a plan in time, given that the resources were tied up fighting lift-stay motions.

¹³⁷ See Exhibit A (part of the term sheet outlining the compromise and settlement) in the Consent Order and compare the properties on the term sheet with Schedule A in the Schedules of Assets and Liabilities filed earlier, *In re* Village Homes of Colorado Inc., No. 08- 27714 (Bankr. D.Colo. November 6, 2008).

To some extent, this might be a carry-over from times when many bankruptcies were, indeed, a result of poor management, i.e., idiosyncratic risk.

This reasoning does not seem to ring true in the current situation, where the entire residential development industry seems to be collapsing along with the entire nation's housing prices, with numerous large and small firms entering bankruptcy alike – a situation reflecting systematic risk.¹³⁸ The argument that the aggressive liquidation preferred by senior lenders is simply separating the wheat from the chaff falls apart in such circumstances. When the entire sector, if not the entire economy, is suffering, there are unlikely sales and transfers that can affect an increase in societal benefit through “better” utilization of those assets.

Perhaps the bankruptcy case of Grusaf LLC, a middle-market developer of condominiums in Florida, elucidates more clearly the single-mindedness of many secured lenders on repossessing the property and pursuing foreclosure, at all costs. In this case, the developer proposed a plan providing for the sale and marketing of the property within 6 months from the entry of the confirmation order, and if the sale was not consummated, the property would be surrendered to the bank. There was no mention of short sales in the proposed liquidation plan, and the developer had just begun renting out some condominium units (though the rent received was insufficient to pay off the bank's debt). Nonetheless, the secured lender, Fifth Third Bank, objected strongly to the proposed plan, citing its feasibility (that the developer had “no reasonable prospect of being able to sell its property”), and its unfairness and inequity (that the plan did not “propose to make any payments to the Bank during the six month period within which the Debtor propose[d] to sell the Bank's collateral”).¹³⁹

¹³⁸ In an empirical study on highly leveraged transactions of the 1980s which subsequently became financially distressed and filed for bankruptcy, it was found that high leverage, not poor firm or poor industry performance, was the primary cause of financial distress. Gregor Andrade & Steven Kaplan, *How Costly is Financial (not Economic) Distress? Evidence from Highly Leveraged Transactions that Became Distressed*, 53 J. Fin. 1443 (1998).

¹³⁹ *In re Grusaf, LLC*, No. 07-bk-12701 (Bankr. M. D. Fla. December 21, 2007).

As the secured lenders in the above case and in Village Homes' bankruptcy themselves strongly argued, there was a complete lack of buyers for the residential real estate. How are these creditors supposed to "capture" the resources of the business, especially in relation to properties under construction, and reinvest them? Indeed, another bankrupt developer remarked in a court filing in relation to their properties where the common area and certain infrastructure were still work-in-progress, "[w]ithout amenities and competing with sellers in the market who provide for infrastructure costs in sale contracts, a liquidation of the Debtors' assets is unlikely to attract any but the most opportunistic buyer."¹⁴⁰

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

In fact, one of the court filings by the debtor, Village Homes, highlights this policy puzzle:

*There is a fundamental inconsistency in the position RFC [a secured lender] has taken regarding their assertion of a housing market decline in the RFS Motion versus their position on the Debtor's Sale Motion. RFC objected to the Debtor's proposal to sell homes quickly and resolve disputes over the proceeds at a later time. Apparently RFC was not worried about a declining market in that context, but now contend that the court should grant it relief from stay because of its fears about a declining market. **Does RFC really expect that the Short Sales it objected to will somehow turn into higher priced sales if it is given relief***

¹⁴⁰ *In re* 2W Homestead LP, No. 08-12195 (Bankr. W.D. Tex. November 3, 2008). See the disclosure statement filed by the debtor.

from stay, and do so quickly enough to overcome the feared market decline?

If RFC really fears that home prices are going to decline, wouldn't it be more logical to consent to all of the sales the Debtor currently has under contract, get them closed as quickly as possible, and then assert their interest in the proceeds? Most of the sales contracts the Debtor has for homes in its inventory were entered into pre-petition and are therefore at pre-petition prices. If RFC's claim that it is afraid of a declining market is true, they certainly won't be able to sell homes at pre-petition prices like the Debtor can.¹⁴¹ [Emphasis added by author]

Finally, it should be noted that construction loans make up a very large proportion of bank lending, and a mass unloading of the assets of developers onto the market will have large ramifications for the property values of very many communities and people. It would even indirectly hurt the value of their overall portfolios, as they have other real-estate related assets that would lose value due to over-supply of houses.¹⁴²

5.1.2 Consent Orders and Agreed Stipulated Relief

¹⁴¹ See the response by the debtor to the motion for relief from stay filed by RFC, a secured lender, *In re Village Homes of Colorado Inc.*, No. 08- 27714 (Bankr. D.Colo. November 6, 2008). This filing is set in the context where ResCap, like the other secured lenders in this case, were moving for relief from stay for substantially all the real estate assets of Village Homes. At the same time, they had also objected to short sales proposed by the debtor which was trying to increase home sales by lowering the prices. In the motion to undertake short sales filed by Village Homes, the debtor argued that the inability to close such sales would increase its holding costs (e.g., taxes, insurance, utilities, and maintenance) and prevent them from paying mechanic's lien claimants. The debtor also proposed to use cash proceeds from the sales to fund construction of additional homes.

¹⁴² H.R. Rep. No. 1106, 111st Congress, 1st Sess (2009) (speech of Rep Zoe Lofgren of California, citing Mark Zandi, Chief Economist of Moody's who was Senator McCain's economic adviser during his Presidential Campaign that "[g]iven that the total cost of foreclosure to lenders is much greater than that associated with Chapter 13 bankruptcy, there is no reason to believe that the cost of mortgage credit across all mortgage loan products should rise.")

As we saw from the case of Village Homes, the lift-stay motions were resolved by a stipulation between the parties whereby the developer agreed to a liquidation of non-core assets. Examining the information which we collected from the bankruptcy dockets, we identified that, of the 137 cases where the lender obtained relief from stay, 66 (31.3%) of these involve consent orders or agreed stipulations between the developer and secured lenders. This proportion is much lower than the finding in an old 1990 empirical study where 87% of the lift-stay motions were settled before the court rendered its decision.¹⁴³ This may be a possible indicator of the level of contentiousness in these developer bankruptcies.

We then ask the question: in the cases with consent orders, why would debtors consent to a relief from stay when it leads to foreclosure and, particularly in cases of smaller developers, where it might potentially mean a shutdown of the firm? The most common reason cited in these consent orders or stipulated relief is the desire to avoid contested proceedings.¹⁴⁴ For instance, in the stipulation entered into by Village Homes, the developer stated that its compromise benefited the estate by “avoiding the costs of litigating the relief from stay motion, providing certainty to the Debtor of the lots it will be entitled to build on in the future”.¹⁴⁵ In addition, these consent orders often embody a compromise whereby the secured lender agreed to foreclose on a limited set of assets, or postpone foreclosure proceedings with “drop dead” provisions if certain milestones were not reached within a specified time period. In exchange, the developer would agree to make certain adequate protection payments, or cede a degree of control over its operations to the lender.

Continuing with our illustration using Village Homes, we examined some key aspects of what the developer had to compromise, in exchange for the ability to retain some core assets. First, part of the settlement with the secured lenders includes the appointment of a Chief Restructuring Officer (“CRO”). The secured lenders would provide the developer with two candidates and the

¹⁴³ Charles Shafer, *Determining Whether Property Is Necessary for an Effective Reorganization: A Proposal for the Use of Empirical Research*, Ann. Surv. Bankr. L. 79 (1990).

¹⁴⁴ See, for example, *In re Taro Properties Arizona I LLC*, No. 08-10427 (Bankr. D. Ariz. August 13, 2008)

¹⁴⁵ *In re Village Homes of Colorado Inc.*, No. 08- 27714 (Bankr. D.Colo. November 6, 2008).

developer had agreed to select one of them. Amongst other things, the CRO would control the sales of homes, and the payment of lenders and other creditors from the net proceeds of sale, i.e., the main operations of Village Homes in bankruptcy.

Next, while the lenders had now agreed to allow Village Homes to use its cash collateral according to an approved budget, the settlement provides contingent adequate protection to the secured lenders. This consists of a lien on receivables from an insurance premium refund of \$1.5 million and a trust fund refund of \$0.4 million. Furthermore, the parties executed mutual releases, including the release of claims by the developer against the secured lenders for preference claims exceeding \$10 million.¹⁴⁶

Another genre of lift-stay consent orders involves a “negotiated truce” between the developer and secured lenders, whereby the former would be given a specified time period to sell its property outside foreclosure. An example can be found in the case of Maryland Homes Palisades PA. The following provides an overview of the terms in the stipulation terminating automatic stay filed on January 20, 2008:¹⁴⁷

- The automatic stay in relation to the property of the Palisades Project would be terminated immediately with respect to the bank’s rights and remedies;
- The bank would forbear from exercising its rights to foreclose provided the Company complies with the terms of the Consent Order;
- The bank agreed to allow the Company until March 15, 2009 (the “Sale Period”) to market the property for sale, and if the Company complies with its obligations under the Consent Order, the Sale Period could be extended for two additional 3-month periods.

¹⁴⁶ *Id.* In discussing the release of preference claims against the secured lenders in the parties’ stipulation, the debtor stated that “the Lenders have indicated that they would vigorously defend the preference claims and would assert a variety of affirmative defenses. The litigation over the preference claims would therefore be costly and prolonged and of uncertain outcome.”

¹⁴⁷ *In re* Maryland Homes Palisades PA, LLC, No. 08-18286 (Bankr. D.Md. June 23, 2008).

- The Company would actively market and sell the remaining 27 finished lots and 2 finished homes during the Sale Period.

At first glance, such arrangements may seem to provide the developer a window of opportunity to work towards an orderly sale or reorganization. However, an issue is that where the specified sales targets are overly ambitious in the context of the housing downturn, the developer can easily fall into non-compliance and the lender would then proceed with foreclosure – an occurrence in a number of cases.¹⁴⁸ In fact, this phenomenon of developers agreeing to barely attainable sales targets is not limited to the area of consent orders for relief from stay. As we will discuss in a case study relating to secured control in DIP financing in the next chapter, the developer of the Shores of Panama development had to meet stringent sales requirements such that it quickly defaulted on the DIP financing agreement.

Besides this problem, part of the consent order in the case of Maryland Homes Palisades PA carried more sinister overtones, complicated by the incentives of guarantors to be released from personal guarantees – an issue which is seldom discussed in bankruptcy literature. In one of the provisions, the secured lender agreed that the principal could pay the fixed sum of \$325,000 in full and final satisfaction of his personal guarantee obligations in respect to the company's debt, regardless of the status of the sales of homes.

This issue has been raised in a prior study which found that bankruptcy theory may benefit from greater scrutiny of a company's capital structures than heretofore undertaken. The capital structure below the level of the senior secured debt matters in cases in which the debtor's owner-manager has personally guaranteed the firm's debt.¹⁴⁹ If the firm's assets at the start of a case are

¹⁴⁸ See *In re Tucson Copper Hills Estates LLC*, No. 08-02557, (Bankr. D.Ariz. March 13, 2008), where a settlement was reached between the secured lender and the debtor on October 20, 2008. However, the developer did not manage to sell the property by the deadline set in the stipulated relief. The case was dismissed on Jan 12 and the lender proceeded to foreclose on the property.

¹⁴⁹ Morrison, *supra*, note 76.

sufficient to covered guaranteed debt to senior lenders, the owner-manager may favor early shutdown or, at the very least, will not undertake efforts to prolong the life of a failing firm to avoid personal liability, at the expense of unsecured creditors.

Upon an analysis of the bankruptcy docket data collected, we found that 41.5% of the consent orders contained some form of agreement by the secured lender to waive its deficiency claim and release the insiders from their liabilities as guarantors. It should be noted that the number of such occurrences in reality may be higher, given that some cases involve side arrangements entered into by parties which were not filed into court.¹⁵⁰ A common clause in such consent orders would read as follows:

ORDERED that, as a condition of the lifting of the automatic stay, Eastside waives any claims under its notes and loan documents to a deficiency balance above the value of the respective Centerra Ridge Property and the Amber Ridge Property, including, without limitation, any similar deficiency claim against the Debtor R&B, Brandon Robertson and Rollin Rocket, IV, respecting the Eastside debt. This release shall be deemed effective at such time as the stay has been lifted and the foreclosure sale has been conducted without objection by the Debtor, Brandon Robertson or Rollin Rocket, IV.¹⁵¹

Another illustration is the case of Crosswinds at Lone Star Ranch 1000, Ltd, where the secured lender agreed, *inter alia*, to drop the lawsuit filed in a state court enforcing guarantee

¹⁵⁰ See, for example, *In re Bysynergy LLC*, No. 08-7680 (Bankr. D.Ariz. June 25, 2008), a developer of single-family homes in Arizona. Under-the-table arrangements between the secured lender and the developer came to light after the parties fell out in negotiations. According to Emergency Motion for Reconsideration and Request to Stay any Sale on February 2, 2009, a party on the secured lender's end was alleged to have told the principal that he would "lose personally everything" if he did not support their position and, in return, the latter was promised that he would "receive some kind of an interest 'on the back end'".

¹⁵¹ See *In re R&B Construction Inc.*, No. 08-62023 (Bankr N.D.Ga. February 4, 2008).

obligations against the principal, in exchange for the termination of the automatic stay to proceed with foreclosure.¹⁵² There are also cases which played out like the case of Maryland Homes Palisades PA (discussed above) where the consent order fixed the guarantors' obligations at a relatively low level.¹⁵³ For example, in the case of Namwest LLC et al, part of the settlement required the guarantors to execute a promissory note in the principal amount of \$37,500 to the secured lender, M&I Bank, and in consideration of the conveyance of the properties (including real estate in various stages of development with a scheduled value of \$28 million and 50% membership interests in two pieces of undeveloped land), M&I Bank would cancel all outstanding debt owed by the guarantors.¹⁵⁴

These observations lead us to conclude that bankruptcy judges may need to begin discounting the "consensual" nature of such proposed consent orders.¹⁵⁵ Indeed, the old adage that "desperate times call for desperate measures" may explain why parties "consent" to such agreements. It falls to bankruptcy judges to also take into account the interests of the unsecured creditors and junior secured creditors when scrutinizing deals between the debtor and the senior secured lenders. Moreover, the part played by guarantees, as documented in contractualists' writings, complicates the incentives picture for debtors, as well as introduces nuances to the role of creditors as positive agents of corporate governance.¹⁵⁶

¹⁵² In exchange for lifting the automatic stay to permit PCR to foreclose on the property and withdraw the plan, PCR would pay \$450,000 into the estate of Crosswinds at Lone Star Ranch 1000 Ltd, dismiss the lawsuit enforcing guarantees and exchange mutual releases. The docket showed no objections filed by unsecured creditors, but the rushed timeframe should be taken into account as well – 10 days elapsed between the filing of the motion to authorize the compromise and settlement agreement and the court order approving this motion. *See In re Crosswinds at Lone Star Ranch 1000, Inc.*, No. 08-40262 (Bankr. E. D. Texas February 4, 2008).

¹⁵³ *In re Maryland Homes Palisades PA, LLC*, No. 08-18286 (Bankr. D.Md. June 23, 2008).

¹⁵⁴ *In re Namwest, LLC*, No. 08-13935 (Bankr. D.Ariz. October 10, 2008).

¹⁵⁵ LoPucki and Doherty, *Fire, supra*, n36. See the views expounded in the study regarding judicial passivity.

¹⁵⁶ Note that the incentive problem of insiders is not limited to consent orders relating to relief from stay, or section 363 sales (as illustrated in the case study of Suncrest in Chapter 6). We detected several instances of this problem in the plan confirmation process. For example, *In re Randall Martin Home Higley Park LLC*, No. 08-03097 (Bankr. D.Ariz. March 25, 2008), FDIC (successor to First National Bank of Arizona) argued in a lift-stay motion that the debtor's principal had personally guaranteed repayment of the debtor's outstanding debt to the 2nd lien lender (about \$22 million), and that explained the debtor's Chapter 11 plan which proposed a

5.1.3 BAPCPA Amendments of the Single Asset Real Estate (“SARE”) Proviso

In this sub-section, we explore a question often asked in post-BAPCPA days – whether the 2005 legislative changes have made the bankruptcy regime even more biased towards creditors. The original intention of the BAPCPA was to make it more difficult for serial and abusive filings to stand. Significant changes include the introduction of a statutory presumption of bad faith for certain repeat filers, and restrictions on automatic stay for repeat filers within 12 months. What is causing a significant impact in developer bankruptcies is the change to the SARE proviso.

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

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

The debtor must have achieved one of the two actions on the date that is the later of 90 days after the entry of the initial order for relief or 30 days after the court determines that the case is subject to SARE provisions.

Before BAPCPA went into effect, the Bankruptcy Code defined a SARE case as one involving “real property constituting a single property or project... which generates substantially all of the gross income of a debtor...and in which no substantial business is being conducted by a debtor

“substantial give away” to the 2nd lien lender. Amongst others, part of the plan contemplates that the 2nd lien lender would receive all new membership interests in the reorganized entity, in exchange for exit financing of up to \$3 million.

other than the business of operating the real property and activities incidental thereto.”¹⁵⁷ Also, the debtor’s aggregate non-contingent, liquidated secured debts have to be less than \$4 million, which meant that larger real estate projects did not fall within the ambit of SARE cases.

BAPCPA eliminated the \$4 million cap, and with the distressed housing market, this has resulted in an increase in the number of developers and builders classified under SARE provisions. For example, Le Jardin, a developer which filed for bankruptcy on September 2, 2008, owned a luxury real estate project in South Fulton County, Georgia, which had 1,100 acres, of which 330 were developed at the time of bankruptcy, was considered an SARE.¹⁵⁸ This is despite having, as of December 31, 2006, aggregate assets and liabilities of approximately \$53 Million.

Another example is that of Crosswinds at Lone Star Ranch 1000, a development with 944 acres of land in Denton Country, Texas, with an appraisal value in February 2007 of \$162 million, and secured claims over property of about \$61 Million. It was also considered a SARE case.¹⁵⁹ Prior to the BAPCPA changes, these cases would not have been considered within the ambit of the SARE provisions for expedited relief, which the secured lender obtained. It is unreasonable to expect cases involving such huge properties and dollar value amounts of real estate would have had their time for plan filing limited to a very short time frame, thus proving that the implementation of the new law tilts the field towards secured creditors.

With the compressed deadline and a secured lender which had indicated its skepticism of reorganization prospects through the filing of the lift-stay motion, it might be unrealistic to expect a

¹⁵⁷ See 11 U.S.C. § 101(51B) (2002). In determining SARE, courts “in essence, are testing whether a project is “owned by an entity whose sole purpose [is] to operate. . . real estate with monies generated by the real estate.” *In re Philmont Dev. Co.*, 181 B.R. 220, 223 (Bankr. E.D. Pa. 1995), affirmed in post-BAPCPA case of *Kara Homes (In re Kara Homes, Inc., 363 B.R. 399, 404 (Bankr. D. N.J. 2007))*. It was also stated in the *Philmont* case that “[t]he terms single asset case, or single asset real estate case, are well-known and often used colloquialisms which essentially refer to real estate entities attempting to cling to ownership of real property in a depressed market” – a position which may explain the bias towards secured lenders once a case falls within the ambit of the SARE provision.

¹⁵⁸ See Consent order (September 30, 2008), *In re Le Jardin LLC*, No. 08-77019 (Bankr N.D.Ga. August 9, 2008)

¹⁵⁹ See Order determining SARE status, *In re Crosswinds at Lone Star Ranch 1000, Inc.*, No. 08-40262 (Bankr. E. D. Texas February 4, 2008).

bankrupt developer to fulfill the first prong of section 362(d)(3) of being able to file a reorganization plan with a reasonable chance of being confirmed. As for the second prong, a cursory review of the cases showed that many debtors were unable to make monthly payments as well, given slow home sales in the distressed housing market with slow home sales. These requirements may be significantly more onerous during severe downturn conditions, as gleaned by cases where, following the determination of SARE, the debtors would simply dismiss the case voluntarily to permit foreclosure. Knowing that it would be unlikely to achieve either of the two specified actions, the developers in these cases might have considered that there was no point in waiting for an order for relief to be entered against them.¹⁶⁰

It should be noted that the required action of making monthly payments presents a natural bias against developers with unfinished properties. Developers which are still in the process of construction are unlikely to be holding income-producing properties which may allow them to make monthly payments. Nonetheless, as we discussed briefly earlier in relation to the higher chance of income-producing properties being the subject of reorganizations, it is the glut of foreclosed unfinished properties which poses worse socio-economic issues, than the foreclosure of income-producing properties.

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

¹⁶⁰ See, for example, *In re Randall Martin Home Dobson Park LLC*, No. 08-07689(Bankr. D.Ariz. June 25, 2008)

5.2 Section 363 Sales as an Alternative to Foreclosure

For secured lenders seeking to liquidate the real estate collateral, there are two alternatives outside the path of relief from stay and foreclosure. One option is to sponsor a Chapter 11 liquidation plan, which was what Barclays Bank envisioned in its first October 2008 plan in the LandSource case (elaborated in the next chapter). This has not been prevalent in 2008 developer bankruptcies, possibly due to the delay and expense involved in being a plan proponent. Next, under section 363(f), a debtor-in-possession or a bankruptcy trustee may sell the property of the bankruptcy estate “free and clear” of liens and other encumbrances.

As we found in Chapter 4 of this paper, 12.9% of the sample of 211 cases was resolved through a section 363 sale of substantially all assets. Taking into account the fact that the sale rate is much higher than the reorganization plan confirmation rate, this section discusses why a secured lender might push for a bankruptcy sale.

There are situations where a secured lender may prefer a section 363 sale over foreclosures. The first arises when there are certain liens which might not be extinguished by a foreclosure, thereby reducing the value of the property. Second, the secured lender might not be entitled to assert a deficiency claim of the outstanding amount of its claim, depending on state foreclosure laws. In states where deficiency judgments can be pursued, state legislations have imposed conditions, e.g., a waiting period, on the recovery of the difference between the amount owed on the loan and the amount collected at the foreclosure auction.

This issue was raised in LandSource, where both 2nd lien lenders and unsecured creditors mention that the 1st lien lenders chose Delaware bankruptcy over the foreclosure laws of California, even though at least 80% of the real estate collateral was located in California. One offered reason is that California has stringent anti-deficiency protections for borrowers, which restrict lenders from pursuing borrowers or guarantors for the “deficiency” that may exist between the sale price and the

outstanding balance of the loan.¹⁶¹ These other stakeholders claimed that, should the 1st lien lenders have proceeded with foreclosure, they might have to forego deficiency claims, or go through a cumbersome “judicial foreclosure process”.¹⁶²

Similarly, in the bankruptcy of Suncrest, LLC (a case study in the next chapter), the Committee for Unsecured Creditors argued that the secured lender, Zions Bank, pushed for a section 363 sale because it was motivated by its entitlement to a deficiency claim of the outstanding amount of its claim (minus the credit bid). This claim would not exist if Zions Bank were to pursue foreclosure pursuant to Utah law under the Trustee Foreclosure Act.

Moreover, there was an additional motivation for Zions Bank to prefer a bankruptcy sale over foreclosure. The secured lender might have originally planned to sell the property as a going-concern, or a “packaged deal”, but it did not have any security interest on a property known as Lot 60.¹⁶³ Lot 60, a section of real estate in SunCrest’s common area that houses, *inter alia*, a fire station and the Club, was a critical component of the development and an omission from the sale might have had a significant impact on the value of the rest of the development. If Zions Bank had chosen the lift-stay/foreclosure path, it would not have been able to foreclose on Lot 60.

¹⁶¹ California Code of Civil Procedure § 580(d) provides in part as follows: “No judgment shall be rendered for any deficiency upon a note secured by a deed of trust or mortgage upon real property or an estate for years therein hereafter executed in any case in which the real property or estate for years therein has been sold by the mortgagee or trustee under power of sale contained in the mortgage or deed of trust.”

¹⁶² In a letter to banking regulators, Bay Cities National Bank commented that real estate loans in states with anti-deficiency laws such as California were riskier because an institution could not go after a borrower for a deficiency unless it was done on a judicial foreclosure basis. This is a process that took 12 months and in the meantime “an institution is at a total loss...while the property remains as Other Real Estate Owned, because the institution cannot sell it for a minimum of 1 year”. See comment letter by Bay Cities National Bank in response to proposed “Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices” on February 6, 2006.

¹⁶³ See Zions Bank’s acknowledgement that it did not have a first lien on Lot 60 of the Suncrest property in the Brief In Support Of Debtor’s Motion For Approval To: (A) Sell Substantially All Assets Of The Estate Free And Clear Of Liens, Claims, Interests, And Encumbrances, (B) Assume And Assign Certain Executory Contracts And Unexpired Leases, And For Related Relief filed by Suncrest LLC on June 25, 2008. See *In re* Suncrest LLC, No. 08-22302 (Bankr. D. Utah April 11, 2008).

Another attractive aspect to lenders regarding section 363 sales is the characteristically low prices obtained in such sales and the lender’s ability to put in a credit bid for the property.¹⁶⁴ The seminal 2007 study on bankruptcy sales by LoPucki and Doherty found that, generally, “the debtors agree to sell at low prices, the auctions are rushed, and in most cases only a single bidder participates”.¹⁶⁵ Historical data in LoPucki and Doherty’s study shows that the recoveries in reorganization cases are more than double those from section 363 sales, controlling for various firm characteristics at the time of the bankruptcy filing.¹⁶⁶

Digging into data from the dockets, we found a pattern of winning credit bids in the sub-sample of cases where the resolution outcome was the order approving the section 363 sale. In this sub-sample, 47.1% of the cases represent the sale of substantially all assets to a secured lender with a credit bid, and only in 2 cases out of 10 did the lender which put in a credit bid fail to purchase the property in the auction. The following table summarizes the cases with the winning credit bids:

Figure 17: Credit Bids in the Sample of Residential Developers

Residential Developer	Buyer	Sale Amount	Scheduled Value	Outstanding Claim
Virginia Homes BR, LLC	Meridian Construction Capital	620,685	944,266	2,017,252
Delaware Homes DR, LLC	Wachovia Bank	3,000,000	1,991,166	7,723,167
Maryland Homes HM, LLC	RBC Real Estate Finance	2,885,000	1,172,825	6,625,793
Virginia Homes WS, LLC	Meridian Construction Capital	817,375	511,810	2,000,265
Virginia Homes HO, LLC	M&T Bank	850,000	1,354,462	2,502,906
Shores of Panama LLC	Silverton Bank (successor to Vision)	68,700,000	164,230,000	74,287,415

¹⁶⁴ Section 363(k) of the Bankruptcy Code permits creditors to bid up to the full amount of their secured debt claim to acquire the assets to which their lien is attached in exchange for cancelling of indebtedness in the amount of the bid. If the amount of debt to be forgiven is larger than the cash amount bid by an outside party, the debt forgiveness may be deemed to be the “highest and best” bid.

¹⁶⁵ LoPucki and Doherty, *Fire, supra*, n36.

¹⁶⁶ Id. Note the follow-up papers to this study which debate the issue of whether recoveries in reorganization cases substantially exceed those in sale cases. See, for example, James J. White, *Bankruptcy Noir*, 4 Mich. L. Rev. 106 (2008) [hereinafter White, *Noir*], and Lynn M. LoPucki & Joseph W. Doherty, *Bankruptcy Verite*, 106 Mich. L. Rev. 721 (2008) [hereinafter LoPucki and Doherty, *Verite*].

	Bank)			
Suncrest LLC	Zions Bank	25,302,000	44,471,476	43,701,440
Den-Mark Homes SC Inc¹⁶⁷	Land South Partners (successor to Regions Bank)	2,170,520	2,655,800	2,170,520

While this is a small sub-sample from which we cannot draw statistically significant findings, the 363 sale shows two things. Firstly, a pattern of winning credit bids may be further evidence of lender control over the bankruptcy sale process. Secondly, the findings highlight a potential trend regarding the positive incentive of a lender to acquire the collateral at its own sale at a low price, capturing any future upside, and yet leaving room for deficiency judgments.

As gleaned from Figure 17, the credit bid prices are generally very low, usually under 60% of the outstanding amount of the claim. As the court opined in the matter of Tampa Bay Associates in relation to credit bids, “[t]he lender has the opportunity to become the highest bidder and take title to the property, preserving future appreciation for itself if it feels that the sale price is too low”.¹⁶⁸ We will discuss this aspect in further detail in Chapter 6 where 2 of the case studies analyzed involve section 363 sales.

As a side note, when analyzing the bid price, we believe it is more accurate to compare it to the outstanding claim rather than the scheduled value. This is because it is not easy to discern from the Schedules whether the value reported is at book (or cost) or from a recent appraisal, and when, if so, that appraisal was conducted. It is more likely that the outstanding claim is based on certain LTV ratios at origination (i.e., appraisals at origination) and gives us a better sense as to the value when the loan was extended.

¹⁶⁷ Note that this case does not, strictly speaking, involve a sale of substantially all assets of Den-Mark Homes, SC, Inc. Den-Mark Homes, SC, Inc., has been undertaking section 363 sales outside the ordinary course of business to sell its sub-division. We include it in the table above because the sale of the entire subdivision in this case is on the same scale as sales conducted by smaller developers. See *In re Den-Mark Homes, SC, Inc.*, No. 08-02766 (Bankr. E. D. N. C. April 24, 2008)

¹⁶⁸ *In re Matter of Tampa Bay Associates*, 864 F.2d 47 (Court of Appeals, Fifth Circuit).

One of the factors which LoPucki and Doherty attributed the low recoveries in these sale cases was illiquidity. As we illustrated using the case of Village Homes in Section 5.1.1, the residential development industry is currently in the throes of severe illiquidity – “no buyers, no lenders”. In this light, a section 363 going concern sale which offloads the business into the hands of new investors and forces a confirmation of the net present value of the business at the time of the sale, minus the takeover premium for the acquirer, may not be in the best interests of the estate and the overall creditor body.¹⁶⁹ We can expect that in a climate of illiquidity, that the takeover premium is extremely high.

This leads to the next question: if bankruptcy sales occurring in this severely deteriorating housing market are very likely to fetch low prices, how much higher is the takeover premium for residential developments sold prior to completion where one has to add completion risk premium (taking into account construction risk and uncertain events between the present and completion)? Indeed this issue has been raised by an objection filed by the second lien lender against the sale pushed for by the first lien lender in the case of Waterbrook Peninsula:¹⁷⁰

Peninsula believes that the proposed bulk sale is not in the best interest of the creditors, and particularly the mortgage holders. Such a sale does not maximize the value of the collateral to the estate. To the contrary, Peninsula believes that the value of the collateral will be maximized by completing construction of the buildings, obtaining a certificate of occupancy, and either marketing the units or then selling the completed project to a buyer "in bulk". Selling the building in its

¹⁶⁹ Thomas B. Astebro & Joachim K. Winter, *More than a Dummy: The Probability of Failure, Survival and Acquisition of Firms in Financial Distress* (University of Waterloo Working Paper, 2002), available at <http://ssrn.com/abstract=260949>. While takeover premiums for acquired distressed firms are substantial, while debt restructuring involving forgiveness of liabilities is a common outcome in reorganizations.

¹⁷⁰ See *In re Waterbrook Peninsula LLC*, No. 08-18603 (Bankr. S. D. Fla. June 25, 2008).

current, unfinished condition at a bulk sale as proposed in the Sale Motion does not maximize the value of the collateral.

One possibility, which we will take every opportunity to raise in this paper, is that previous studies of evidence for or against the efficiency of liquidations and 363 sales have not controlled for the credit cycle.¹⁷¹ We have not seen in any study by scholars debating bankruptcy policy based specifically on time period chosen with extremely low market liquidity, yet we are seeing clear evidence today that the excess and scarcity of credit can be responsible for inflated and deflated prices, respectively. As a result, we advocate that a tempering of enthusiasm for market-based solutions in industries and circumstances when markets are functioning imperfectly and buyers are far less numerous than sellers, and consider reasonable alternatives to the instant realization of highly depressed prices for assets to the detriment of most stakeholders in these cases.

5.3 Conclusion

This chapter has discussed the reasons why the debtors that we studied found it difficult to propose a plan of re-organization. We touched on the issue of the difficulties which debtors face in obtaining financing for operations in bankruptcy – a ground raised in lift-stay motions. Following from this, we will investigate, in the next chapter, the extent that DIP financing supports an attempt at re-organization, and how lenders may use DIP financing to strengthen their control over the debtor and realize their preference for liquidation.

¹⁷¹ While some studies attempt to control for the economic cycle by performing the regression with market metrics (e.g., LoPucki & Doherty's paper, *Fire, supra*, n36, includes the S&P 500 as a factor in the regression, though the sample only uses data where plan confirmations occurred in 2000-4), it may be extremely difficult to rely on such quantitative exercises, given the vast changes in the economy and financial system over the past 2 decades and the clustering of defaults/bankruptcies during recessions. Moreover, data from the last downturn may not be applicable, e.g., the Financial Services Authority of the United Kingdom issued regulatory guidance in 2008 cautioning banks against using data from the 2001-2 recession in assessing the risk of defaults during the current recession.

Chapter 6: Lender Control through DIP Financing

In the earlier chapter, we analyzed observations from the bankruptcy proceedings of residential developers which might explain how secured lenders might have contributed to the inability of debtors to re-organize through the use of lift-stay motions. Also, the pattern of winning credit bids at relatively low prices suggests a substantial level of secured lender control to achieve an outcome which is aligned with the lenders' incentive to purchase the real estate at an auction at a fire-sale price and then capture the potential upside.

This chapter deals with the follow-on question: would these bankruptcies in the residential development industry have been resolved differently, if they were able to obtain financing?

In Professor Todd Zywicki's recent testimony before Congress, he stated that a major factor contributing to the growing trend towards liquidation in Chapter 11 cases was the reduced availability of DIP financing as a result of continued problems in the credit markets.¹⁷² This is not too far off from the constant mantra chanted by government officials ever since the start of the recession in 2007 – “getting the banks to lend again” – which has been touted as being the top priority item of the governmental agenda ever since President Obama took office.

True enough, the DIP financing application has often been viewed as one of the most important of the first day motions.¹⁷³ Debtors may not have adequate cash reserves for operating the business throughout Chapter 11 proceedings and operation of the business is essential to the

¹⁷² *Circuit City Unplugged: Did Chapter 11 Fail to Save 34,000 Jobs?:* Hearings before the Committee on Commercial and Administrative Law, 111st Cong., 1st Sess. (2009) (testimony of Todd Zywicki).

¹⁷³ See, for example, *In re The Colad Group, Inc*, 324 B.R. 208 (Bankr. W.D.N.Y., 2005).

maintenance of a going concern on which a reorganization plan will be based.¹⁷⁴ Even a short cessation of business reorganization may irreparably damage prospects for reorganization.¹⁷⁵

In addition to the provision of liquidity and working capital, some studies asserted that DIP financing provides benefits in terms of a signaling effect – the fact that lenders are willing to extend credit in bankruptcy can be a positive signal regarding the firm’s future prospects.¹⁷⁶ The above logic is also supported by findings from finance literature that companies which obtain DIP financing are more likely to emerge from reorganization and less likely to liquidate.¹⁷⁷

Set against these notions is literature arguing that secured creditors may acquire substantial control of Chapter 11 cases through DIP financing, where the “[l]enders may secure preferential treatment of both their prepetition and postpetition debts, while collecting high rates of interest and large fees and effectively gaining control over the debtor, its management, and the chapter 11 case itself.”¹⁷⁸ There are also empirical studies finding that firms that receive DIP financing have a shorter time to resolution, given that DIP lenders tend to facilitate a quick liquidation and prevent further value loss to themselves, where the investment does not appear to

¹⁷⁴ See Mark S. Scarberry, Kenneth N. Klee, Grant W. Newton, & Steve H. Nickles, *Business Reorganization in Bankruptcy: Cases and Materials* (3ed., 2006)

¹⁷⁵ *Id.*

¹⁷⁶ See, for example, Sris Chatterjee, Upinder S. Dhillon & Gabriel G. Ramirez, *Debtor-in-Possession Financing*, 28 J. Banking & Fin. 3097 (2004). Chatterjee et al showed that reliance on DIP financing resolves information asymmetries between management and creditors, thereby helping to reveal the true value of the firm.

¹⁷⁷ See, for example, Maria Carapeto, M., 2003, *Does Debtor-in-Possession Financing Add Value?* (IFA Working Paper No. 294-1999, 2003), available at <http://ssrn.com/abstract=161428>, Faye Elayan & Thomas Meyer, 2001, *The Impact of Receiving Debtor -in-Possession Financing on the Probability of Successful Emergence and Time Spent Under Chapter 11 Bankruptcy*, 28 J. Bus. Fin. & Acctg. 905 (2001), Sandeep Dahiya, Kose John, Manju Puric & Gabriel Ramírez, *Debtor-in-possession financing and bankruptcy resolution: Empirical evidence*, 69(1) J. Fin. Econ. 259 (2003). However, doubt has been cast upon the significance of such findings. For example, Skeel cited that many of the cases that researchers code as “reorganization” looked an awful lot like liquidations on inspection. As Baird & Rasmussen, *End, supra*, n4, have observed, many cases coded as “emerged” may actually be sales of some sort, ranging from a sale where the business did not emerge intact as an independent entity under a reorganization plan to a sale of substantial level of assets while maintaining the business as a discrete legal entity.

¹⁷⁸ See, for example, George W. Kuney, *Hijacking Chapter 11*, 21 Emory Bankr. Dev. J. 19 (2004)

perform well.¹⁷⁹ While the claims of other creditors may be impaired by a forced fire sale of assets, DIP lenders will still be able to recover the loans in full owing to their super-priority status.¹⁸⁰

In analyzing the underlying incentives of DIP lenders, Skeel offered the following insights:¹⁸¹

Things look rather different from DIP financiers' secure perch at the top of the priority ladder. Because they face a downside risk if the debtor's fortunes are volatile, but their upside potential is fixed, DIP financiers have an incentive to minimize volatility and to compress the debtor's risk profile. In Chapter 11, the simplest way to do this is to convert most or all of the debtor's assets to cash through sales. It is important not to overstate the point. If the debtor's business is truly viable, and the lender hopes to continue its lending relationship with the firm, the desire for future business will counteract the impulse toward liquidation. If the debtor is not viable, on the other hand, liquidation may be just what the doctor ordered. On the margin, however, there is a risk that DIP lenders will put pressure on the debtor to liquidate too many assets too soon if they are calling the shots.

While Skeel's caution against overstating the point that DIP lenders would resort to liquidating the company might have held true during benign periods, the economic crisis since 2007 represents one of the most volatile periods for a long time. Moody's Investors Service reported that the default rate in March 2009 was the highest number in a single month since the

¹⁷⁹ Elayan & Meyer, *supra*, n179 177

¹⁸⁰ *Id.* in terms of the relationship between recoveries and DIP financing, Elayan and Meyer found that DIP-financed firms enjoyed higher recoveries. Carapeto's (*supra*, note 177) study added that the higher recovery rates on the enterprise level typically resulted from higher recoveries obtained by senior secured creditors

¹⁸¹ Skeel, *supra*, note 4.

Great Depression and called the current recession “the deepest economic slowdown since World War II”.¹⁸²

It is in this economic climate and in relation to one of the most financially distressed sectors, for which bankruptcy outcomes can lead to serious social consequences, where we will examine the interplay of these DIP financing issues raised. Through the case studies, we seek to address questions such as the extent to which the financing benefited the bankrupt estate, and the extent to which the bankruptcy regime allowed secured lenders to manipulate proceedings to shape the outcomes of the cases. We will also attempt to review whether the bankruptcy outcomes may be sub-optimal, e.g., by following one of the cases through the aftermath of the concluded sale.

The rest of the chapter will be organized as follows:

- 6.1 Brief discussion of developer bankruptcies with DIP financing, including our findings of the proportion of cases which obtained financing and the reasons underlying the selection of the case studies for detailed examination
- 6.2 Case study of Shores of Panama, Inc. (“Shores”)
- 6.3 Case study of Landsource Communities Development, LLC (“LandSource”)
- 6.4 Case study of Suncrest, LLC (“Suncrest”)
- 6.5 General themes and analyses from the case studies

6.1 Overview of Cases with DIP Financing

From an analysis of the information collected from bankruptcy dockets, we recorded the cases with DIP financing from lenders or third parties.¹⁸³ While 6 out of 9 of the “mega” cases

¹⁸² See John Glover, *Default Count Rises to Highest since Great Depression*, Bloomberg, Apr. 7, 2009, at <http://www.bloomberg.com/apps/news?pid=20601103&sid=aJSFrifNWAE&refer=us>

¹⁸³ In some cases, the companies obtained DIP financing from the principal. We have not discussed these in the text since the focus of the study is on secured lenders’ actions.

involved DIP financing, a very small proportion, 13 cases out of the sample of 211 cases (6.2%) obtained DIP financing from existing lenders or third parties. This appears in line with observations that there is a reduced availability of financing for bankrupt developers.

Nonetheless, what is more troubling is that, most of the cases which obtained DIP financing did not culminated in reorganizations. Among the 6 “mega” cases, only LandSource has proposed a reorganization plan so far. In relation to the rest of the “mega” cases with DIP financing arrangements in place, liquidation plans had been filed or confirmed, apart from 2 pending cases.

As for the 13 “non-mega” cases with DIP financing, their resolutions are outlined as follows:

- 5 cases had been resolved via a section 363 sale of substantially all assets;
- 1 case is pending court approval of its section 363 sale motion;
- 3 cases which have been resolved by liquidation, one converted to Chapter 7 and two dismissed to allow the lender to pursue foreclosure;
- 3 cases are pending the confirmation of its Chapter 11 plans, of which two involved liquidation plans and one involved a reorganization plan;

Of the 5 sale cases, 4 of them were sold to the DIP lender at the auction held in accordance with section 363. This fits with a growing theme in contemporary bankruptcy commentary in relation to DIP lenders’ incentives and ability to push for a sale,¹⁸⁴ and is increasingly able to dictate the course of bankruptcy proceedings.¹⁸⁵

As for the 3 cases which were liquidated, the financing came with very clear and specific terms regarding the use and purpose of the funding for two of these cases. In one of the cases, MW Johnson, the financing was entered into with a specific liquidation plan intended. The secured

¹⁸⁴ LoPucki & Doherty, *Fire*, *supra*, note 36.

¹⁸⁵ Skeel, *supra*, note 4.

lenders agreed to provide post-petition financing to allow the developer to undertake orderly sales of the real estate collateral, and once the sales were closed, the case was promptly converted to Chapter 7.¹⁸⁶

In the other case, Morgan & Company, Inc., the developer obtained DIP financing from SunTrust Bank to allow the completion of Phase 1 of the project. This financing was contingent on, inter alia, the assumption of debtor's pre-petition contract with another home builder, KB Home Raleigh-Durham, Inc. ("KB"), to purchase the developed lots pursuant to the purchase price in the contract. However, KB subsequently amended the contract by substantially reducing the purchase price. As such, SunTrust argued that it "directly effects [sic] SunTrust who is to receive 90% of the purchase price paid by KB" and that "[w]ithout KB or another third party willing to purchase the lots in Phase I at an adequate purchase price, SunTrust is not willing to proceed to provide an additional \$1.4 million to the Debtor under the SunTrust DIP Financing". The bank proceeded with a lift-stay motion pursuant to foreclosure, which was granted and the case was dismissed.¹⁸⁷

As for the third case in this category – Hawthorne on North 3rd, LLC, bankruptcy proceedings were dismissed after the secured lender, Corus Bank, initially made available post-petition financing of \$106,842 to fund ongoing operations and pay liability insurance premiums. However, when it became clear that the developer was unable to find financing from alternative sources (including insider contributions), the bank obtained relief from stay to foreclose upon the condominium property, and the case was dismissed subsequently.¹⁸⁸

Next, we note that, while the sample size is small with respect to this specific area, it appears that the majority of the resolved cases did go down the path of a section 363 sale. In this context, we choose to do a more detailed examination of the cases which have been resolved through a section 363 sale. To this end, we have selected one case relating to condominium

¹⁸⁶ *In re* MW Johnson Construction, Inc., No. 08-32874 (Bankr. D. Minn. June 13, 2008).

¹⁸⁷ *In re* Morgan & Company, Inc., No. 08-05066 (Bankr. E. D. N. C. July 30, 2008).

¹⁸⁸ *In re* Hawthorne on North 3rd, LLC, No. 08-04094 (Bankr. D. Ariz. April 14, 2008).

development (Shores) and one case relating to single family homes (Suncrest). The former involved a completed residential development, while the latter involved a partially developed community.

These two cases also provide an interesting counterpoint to each other, one involved a debtor which was initially attempting a reorganization and the other involved a debtor which was going along with the sale from the outset. In Shores, the developer filed a reorganization plan but the property was eventually sold to the secured lender (using a credit bid) upon the developer's default on the DIP financing agreement. On the other hand, the secured lender and developer of Suncrest pre-negotiated the sale, and agreed that the DIP financing would be used mainly to facilitate the sale. As for the third case study, we chose LandSource from the class of "mega" cases which come with more complicated capital structures. One of the more interesting aspects about LandSource is the ease in which the secured lender first proposed a liquidation plan, then a reorganization plan. In the following sections, we proceed to lay out the circumstances in each case as an observer, then explore the general themes and implications to the thesis in section 6.5.

6.2 Shores of Panama, Inc.

Shores, the developer of a condominium complex in Panama City Beach, Florida, filed for bankruptcy in the Northern District of Florida on Feb 26, 2008. The condominium development plan provided that the complex would be developed as two separate, but adjoining, condominiums named Shores of Panama I ("Shores I"), and Shores of Panama II ("Shores II"), on 6.7 acres of land. Shores completed construction of Shores I on June 22, 2007 and Shores II on September 24, 2007.¹⁸⁹

¹⁸⁹ An overview of the background of Shores of Panama is provided in the disclosure statement filed on September 15, 2008. *In re* Shores of Panama, No. 08-50066 (Bankr. N. D. Fla. February 26, 2008).

Shores closed the sale of 326 of the 411 residential units in Shores I upon completion of Shores I, but it failed to close any units in Shores II. Some contracted purchasers also began to obtain judgments allowing them to terminate their purchase obligations and to recover their deposits.¹⁹⁰ These events culminated in Shores' bankruptcy, at which time it still owned 85 units of Shores I and 290 units in Shores II, as well as other commercial properties in the complex.

At the time of bankruptcy, Shores listed \$174 million in Assets, of which \$164 million came from valuing the remaining condominium units at \$438 per square foot ("psf"). The Company listed \$113 million in Liabilities, including \$74 million owing to Vision Bank, secured over all assets of the Company.¹⁹¹ Compared to other developers, Shores was, at that time, considered to have a lower than average risk of liquidating as construction had been completed and a debt restructuring could have allowed the developer to focus on marketing the unsold units. However, unless the units were sold quickly, there might be insufficient cash to maintain operations, without additional financing. While condominium unit sales brought in close to \$99 million in 2007, total sales in the first two months of 2008 was under \$1 million.

On July 31, 2008, Shores filed a motion to obtain DIP financing from its secured lender, Vision Bank, for an amount not exceeding \$2 million.¹⁹² The DIP financing would carry an interest rate of prime rate plus 4%, with a maturity date of December 31, 2008 whereupon Shores would be required to make full payment of all principal and interest amounts outstanding.

The proceeds of advances under the DIP financing could only be used in accordance with a cash budget provided. More importantly, the DIP financing was made subject to certain sales requirements including the following:¹⁹³

¹⁹⁰ *Id.* Part of this is related to the crash in the retail mortgage lending market such that many contracted purchasers were no longer able to arrange for financing to close the sales.

¹⁹¹ *In re* Shores of Panama, No. 08-50066 (Bankr. N. D. Fla. February 26, 2008). See the schedules of assets and liabilities filed on March 15, 2008.

¹⁹² *Id.* See the motion authorizing DIP financing from Vision Bank filed on July 31, 2008.

¹⁹³ *Id.* See the order authorizing DIP financing from Vision Bank filed on September 2, 2008.

- Shores was required to close the sale of a minimum of two (2) condominium units by September 5, 2008 and two (2) additional condominium units in September and each month thereafter;
- The minimum net sales proceeds from these required sales would be \$580,000 by September 5, 2008 and the same amount again by September 30 and thereafter per month, provided that (i) units would not be sold for less than \$345/square foot without the lender's consent and (ii) furniture packages and other concessions would not exceed \$20,000 without the lender's consent;
- The sales requirement would continue each month until the date of the DIP Loan Maturity and was cumulative, and additionally, provided that Debtor must (i) in the period ending September 30, 2008, have entered into at least two (2) contracts for the sale of units with arms-length purchasers who have not previously entered into a contract with Debtor, which contracts meet the minimum prices set forth above and include payment of a deposit and a requirement to close within sixty (60) days; and (ii) enter into at least two (2) such contracts in every thirty (30) day period thereafter during the term of the Agreement.

Failure to comply with these sale requirements was among the list of event of defaults specified in the DIP financing package (including typical events such as the date by which the debtor had to file the Plan and Disclosure Statement, obtain confirmation of the filed plan, etc). Upon the occurrence of any of the events of default, Shores' right to use cash collateral and to borrow money under the DIP loan would terminate immediately and the lender would be able to institute a sale of Shores' property.¹⁹⁴

It is worth noting that the court approved a provision in the DIP agreement that in the event that the lender was the successful bidder but the court did not approve the sale to the lender, the

¹⁹⁴ *Id.*

automatic stay would be deemed lifted immediately for the lender to pursue foreclosure of the property. Note how the DIP arrangement purported to circumvent judicial authority in a scenario where the court decision was inconsistent with the lender's objectives to acquire the property.

Nonetheless, the court issued an order authorizing the post-petition financing arrangement on September 2, 2008. The order stated:¹⁹⁵

Good cause exists for approval of the Debtor's agreement to the financing by Lender under the terms set forth herein and the entry of this Order will minimize disruption of the Debtor as a "going concern" and is in the best interest of the Debtor, its creditors and its estate. The terms upon which the Debtor is authorized to use Cash Collateral are determined to be fair under the circumstances.

Barely three days after this order was granted, Shores was considered to be in default under the DIP financing arrangement due to non-compliance with the sale requirement, including:¹⁹⁶

- Failure to close the sale of a minimum of 2 condominium units by September 5, 2008;
- Failure to close the sale of at least two additional units in September 2008; and
- Failure to enter into at least two contracts in September 2008 for the sale of units with arms-length purchasers who had not previously entered into a contract with the Debtor, which contract meets the minimum agreed prices.

On October 15, 2008, the secured lender filed with the Court its Certificate of Default, triggering the sales procedure agreed in the DIP financing arrangement.¹⁹⁷ Shores moved for the

¹⁹⁵ *Id.*

¹⁹⁶ *Id.* See the objection by Vision Bank arguing, *inter alia*, that the disclosure statement filed by the debtor was unnecessary, filed on October 20, 2008.

continuance of the hearing on the disclosure statement and reorganization plan which it has filed earlier in September. However, the bank filed strong objections on October 20, 2008 that the plan was no longer feasible as a result of the default. It considered the disclosure statement and plan to restructure over a 6-year time period unnecessary and a waste of time.¹⁹⁸

At this juncture, time was running out for Shores. According to sale procedure, if a motion to sell the property to a stalking horse was not filed within 60 days from the filing of the Certificate of Default, the lender was authorized to sell Shores' properties at an auction. This date was reached on December 18, 2008, when the lender filed a motion for a section 363 sale of substantially all assets of Shores.¹⁹⁹

Shores then withdrew its disclosure statement and reorganization plan on December 22, 2008, and focused its efforts on objecting to bid procedures in the sale motion in a bid to improve their existing position. As Shores saw it, a major problem with the auction sale proposed by the lender was:

*The Sale Motion, and the procedures as proposed by the Bank, do not provide for any marketing of the real property, including the retention of a broker or the payment for the costs of marketing in the event the sale of the property does not generate sufficient interest above the amount of the bank's secured debt. Further the procedures seek a quick sale of the property without sufficient time necessary to properly market the property and generate interest that would create competitive bidding on the property.*²⁰⁰

¹⁹⁷ *Id.* See the motion by Vision Bank attaching a Certificate of Default against the debtor filed on October 15, 2008.

¹⁹⁸ *Id.*

¹⁹⁹ *Id.* See the motion to sell substantially all assets filed by Silverton Bank on December 18, 2008. Note that, by this time of the case, the original secured lender, Vision Bank, had assigned its claim to Silverton Bank.

²⁰⁰ *Id.* See the objections raised by the Official Committee of Unsecured Creditors to the sale of substantially all assets of Shores of Panama filed on December 22, 2008.

In the sale motion, the lender did not even agree to the use of its cash collateral to pay a sufficient broker's fee to cover the marketing costs and expenses. The lender's response was that the Official Committee of Unsecured Creditors could have retained a broker upon Shores' default. As such, insufficient marketing of the property was not due to the bank's action, but the "Committee's inaction". Moreover, the bank asserted that it was not contractually obligated to pay marketing costs and did not agree to the use of its cash collateral to pay for such costs.²⁰¹ This evidenced a clear intention in the bank's lack of interest to have a fair auction which had generated sufficient bidding interest.²⁰²

During the hearing on January 21, 2009 regarding the procedures for the section 363 sale, the court ordered the lender to revise the sale motion. The court approved the retention of NorthMarq Realty Services, Inc. as broker, but the rest of the bidding procedures were left relatively unchanged from the ones originally proposed by the lender.²⁰³ The minimum bid was set at \$80 million, and subject to the lender's right of a credit bid, the sale of the property would be for **all cash** at closing. The minimum bid did not apply to the lender, who could bid any amount of its claim up to the total of the sums owed to it. Note, however, the rushed time frame was approved over objections of the Committee of Unsecured Creditors that they had solicited proposals for 4 qualified real estate brokers to locate a stalking horse or other bidders, and the latter indicated that a minimum of 2 months was required to property market the development.

On March 5, 2009, the auction took place, with the lender as the sole qualified bidder. The lender put in a winning credit bid of \$68.7 million. Of this amount, the lender agreed to pay \$1 million to the estate of Shores for administrative expenses incurred by unsecured creditors

²⁰¹ *Id.*

²⁰² *Id.* As the Official Committee of Unsecured Creditors remarked in this case, "the Bank, in so doing, is more motivated by a desire to take the property back, through its ability to credit bid its debt, while at the same time chill bidding, by providing for a quick sale with no marketing or financing to encourage a broker to take on such an engagement."

²⁰³ *Id.* See the order approving the terms and conditions of an auction filed on January 29, 2009.

(including itself as a holder of a deficiency unsecured claim). The court approved the sale the next day, having found that the auction was conducted in a “non-collusive, fair and good faith manner”.²⁰⁴

After the section 363 sale of the property to Silverton Bank, it appeared that the secured lender merely continued selling the condominium units in the ordinary course of business. A list obtained from a real estate agent for the Shores of Panama property provided the following list prices and psf price for available units, as of April 15, 2009 (see Figure 18), and these numbers were consistent with the prices in sales closed in April 2009, according to Bay County Clerk records (see Figure 19).

Figure 18: List Price and Psf of Condominium Units on Sale at Shores of Panama (4/15/09)

Unit Type	Type K 1184 sqft 2 BR/ 3BA+BK	Type L 1102sqft 2br/ 2.5ba+bk	Type K 1184 sqft 2 BR/ 3BA+BK	Type H 1453 sqft 2 BR/ 3BA+BK	Type L 1102sqft 2br/ 2.5ba+bk	Type K 1184 sqft 2 BR/ 3BA+BK	Type N 936 sqft 1 BR/ 2BA+BK	Type N 936 sqft 1 BR/ 2BA+BK	Type N 936 sqft 1 BR/ 2BA+BK	Type R 1523 sqft 3 BR/ 3BA+BK	Type S 1279 sqft 2 BR/ 2.5BA+BK	Type T 951 sqft 1 BR/ 2BA+BK	Type U 1400 sqft 3 BR/ 3BA
List Price	\$ 266,400	\$ 247,950	\$ 266,400	\$ 326,925	\$ 247,950	\$ 266,400	\$ 210,600	\$ 210,600	\$ 210,600	\$ 357,905	\$ 351,725	\$ 237,750	\$ 350,000
Psf	\$ 225	\$ 225	\$ 225	\$ 225	\$ 225	\$ 225	\$ 225	\$ 225	\$ 225	\$ 235	\$ 275	\$ 250	\$ 250

Source: Northmarq Realty listings.

Figure 19: Sales closed for Shores of Panama Units in April 2009

Sale Date	Unit	Sq Foot	Price (\$)	Psf
4/21/2009	2331	1,400	350,000	250
4/24/2009	523	1,102	248,000	225
4/24/2009	529	1,279	319,800	250

Source: Public records compiled from Bay County Clerk database

These post-section 363 sale activities did not seem to differ from the developer’s proposed operational plan in the Disclosure Statement – to pay off the debt using sale proceeds through retail

²⁰⁴ *Id.* See the order authorizing the sale of the Shores of Panama property free and clear of all liens filed on March 6, 2009.

sales of the units, based on an estimated average price of \$243 psf in 2009. The main difference is: based on Silverton Bank's purchase price, the property was valued at approximately \$180 psf in relation to residential space, and this valuation does not include the value of commercial space in the buildings. In fact, the bank's purchase price did seem low, in comparison to sales closed between the time of the bankrupt developer's default on the DIP financing agreement and the section 363 sale. During that time period, three sales were closed at \$348 psf.²⁰⁵

The above observations help illustrate the incentive problem of secured lenders to acquire collateral at the bankruptcy sale free and clear of all liens at a low price, thereby capturing the upside at the expense of more junior creditors. At the above-cited psf levels, the property valuation may be roughly estimated at around \$90 million, exceeding the \$74 million owed to the secured lender (which means that unsecured creditors might have gotten some recovery).²⁰⁶ One of the main constituents hurt in this case is the group of pre-petition purchasers who had put down deposits and were now considered unsecured creditors or junior creditors holding judgment liens.²⁰⁷ According to the Schedules of Assets and Liabilities, the developer was holding more than \$3.5 million in earnest money deposits and was subject to around \$4 million in judgment liens held by purchasers who sued earlier to recover the deposits.

What is most interesting in the aftermath of this case is that Silverton Bank was shut down by regulators on May 1, 2009. The bank failure was largely attributed to massive loan losses in construction lending. As early as February 26, 2009 prior to the auction, the bank's regulator, the Office of the Comptroller of the Currency had issued a cease-and-desist order, mandating that the

²⁰⁵ *Id.*

²⁰⁶ *Id.* Note that in one of the objections raised by the Committee of Unsecured Creditors, evidence was provided from 4 brokers (Northmarq, CB Richard Ellis, Cushman & Wakefield and Marcus & Millichap indicating that, after doing their own independent research, appraisals and market analysis, they estimated that they could secure bids in excess of \$80 million which would be enough to surpass the bank's secured debt and provide a recovery for other creditors.

²⁰⁷ In an interview by the author with a purchaser of presold units of Shores of Panama, it was found out that she and other purchasers of presold units were given the opportunity to purchase her unit from Silverton Bank at a higher price, but she was informed that she would not be given any credit for the deposits placed earlier in 2005.

bank increase its capital ratios.²⁰⁸ At the end of 2008, the bank's Tier 1 capital ratio was 8.57% (close to the minimum level required under the regulatory framework), and the order gave the bank 150 days to boost its ratio to 11%. The bank was also censured by the Atlanta Federal Reserve Board for risky behavior in April 2009.²⁰⁹

Owing to the bank's rapidly deteriorating capital position at the time it pushed for the section 363 sale, it made most sense from the bank's perspective to raise capital by quickly "repossessing" the property at a fire sale, rather than work through a reorganization process (which may take more time). Even if the bank may obtain a higher discounted rate of return in a reorganization scenario, calculations regarding the marginal increase in return must take into account the conditional probability of the bank's survival as a going concern during the reorganization timeframe. This sheds light on issues underlying banks' preference for sale and liquidation, which we will discuss further in Chapter 7.

6.3 Landsource Communities Development, LLC

Along with 20 of its affiliates, Landsource Communities (together, "LandSource") filed for Chapter 11 bankruptcy in the District of Delaware on June 8, 2008. LandSource, a Delaware limited liability company, was formed in November 2003 as a joint venture holding company in residential real estate development for Lennar Corporation ("Lennar") and LNR Property Corporation ("LNR"). In January 2004, LandSource acquired the Newhall Land and Farming Company ("Newhall"), a developer of 15,000 acres in Santa Clarita and two master planned communities in California, for approximately \$1 billion.²¹⁰

²⁰⁸ Marissa Fajt, *CEO, COO Leave Silverton Financial*, *American Banker*, Apr. 9, 2009, at 20.

²⁰⁹ *Id.*

²¹⁰ *In re* LandSource Communities Development, LLC, No. 08-11111 (Bankr. D. Del. June 8, 2008). The background of Landsource is discussed generally in the first disclosure statement filed in November 2008.

Landsource owned real estate in various stages of development in five states – 50 communities with more than 34,000 homesites,²¹¹ with a significant portion in California. Its California assets were considered prime real estate. They include some of the only undeveloped acreage in the greater Los Angeles area, about 15,000 acres known as Newhall Ranch lands. Through its ownership of Newhall, the LandSource Group also owned Valencia Water Company ("Valencia Water"). Valencia Water is a public utility in California that services certain LandSource Group communities, with a customer base of over 29,000 metered connections.

In February 2007, MW Housing Partners ("MWHP") paid \$970 million in cash and property, including 4,000 homesites, in exchange for a 68% stake in LandSource. MWHP is 95% owned by the California Public Employees' Retirement System ("CALPERS"), with the remaining 5% split equally between MWHP's managers, Macfarlane Housing, LLC and Weyerhaeuser Realty Investors, Inc. In the press release for the deal, Landsource assets were valued at more than \$2.6 billion, though the book value was \$1.3 billion.²¹²

As part of the transaction, LandSource closed a \$1.55 billion bank debt financing, consisting of the following facilities secured by LandSource assets:²¹³

- \$200 million undrawn five-year Revolving Credit Facility (first lien secured debt)
- \$1.106 billion six-year Term Loan B Facility (first lien secured debt)
- \$244 million seven-year Second Lien Term Facility

At the time of closing, the LTV ratio (debt to appraised value of assets) was pegged at 51.7%, which is generally considered low. This ratio, however, spiked in September 2007 when an

²¹¹ *Id.* These states are California, Nevada, Arizona, Texas, New Jersey and Florida.

²¹² Lennar Corporation, *LandSource Completes the Addition of a New Strategic Partner*, PRNewswire, Feb. 28, 2007, at <http://phx.corporate-ir.net/phoenix.zhtml?c=65842&p=irol-newsArticle&ID=968191&highlight=>.

²¹³ *Id.*

appraisal of the assets showed that LandSource's assets' market value had declined to approximately \$1.79 billion. As a result, LandSource was out of compliance with the "Borrowing Base Limitation" under the first lien credit agreement and would have to make mandatory prepayments. At that point, the developer managed to negotiate forbearances with its lenders.²¹⁴

However, when the forbearance agreements expired and the parties failed to reach an agreement on an out-of-court restructuring, Barclays Bank declared a default on April 21, 2008.²¹⁵ Note that Barclays Bank was originally the sole lead arranger and bookrunner for the credit facilities. Subsequently, Bank of New York was appointed the administrative agent for the 2nd lien lenders, while Barclays Bank remained a lender and administrative agent for the 1st lien lenders.

As part of its first day motions in bankruptcy, LandSource moved for DIP financing from Barclays Bank, comprising of a \$135 million revolving credit facility and \$1.05 billion term loan, the latter being a roll-up of the pre-petition obligations to the 1st lien lenders.²¹⁶ The proposed post-petition financing arrangement was met with violent opposition from almost every constituent. On the first day hearing, the bankruptcy judge remarked at the start that "the proposal is an extraordinary DIP in my experience."²¹⁷

The 2nd lien lenders filed an immediate statement that the DIP financing should not be approved because "it is inappropriate, overreaching and is in the interest of just one creditor – the prepetition first lien lenders-who, conveniently, are also the lenders under the Proposed DIP Facility...With little legal or factual support, the Proposed DIP Facility contains almost every known

²¹⁴ *In re* LandSource Communities Development, LLC, No. 08-11111 (Bankr. D. Del. June 8, 2008) See the affidavit supporting first day motions filed on June 8, 2008.

²¹⁵ *Id.*

²¹⁶ *Id.* For more details on the proposed roll-up arrangement, see the motion authorizing DIP Financing from Barclays Bank on behalf of 1st lien lenders filed on June 24, 2008. A roll-up is a provision allowing for all proceeds received by the debtor from the sale of its assets or in the course of business to be applied to pre-petition debt first, until such debt is paid in full, before being applied to post-petition debt.

²¹⁷ *Id.* See remarks excerpted from the transcript of hearing of first day motions held on June 10, 2008.

form of extraordinary relief.”²¹⁸ The Committee for Unsecured Creditors responded that the package was designed “(a) to give the First Lien Lenders a dominating position over the Committee concerning the inevitable liquidation to follow and (b) insure that the First Lien Lenders receive the entire recovery from the unencumbered assets that currently exist...The DIP Financing therefore is not in the best interests of these estates - an immediate liquidation would be preferable.”²¹⁹

What was most problematic about the DIP financing proposed by Barclays Bank was the roll-up and refinancing of the pre-petition obligations of the 1st lien lenders. It was “extraordinary” in being an extremely blatant device to benefit only the 1st lien lenders, including provisions such as the following:²²⁰

- The roll-up was to be secured with priming liens over all assets, including assets that were unencumbered by the 1st lien lenders. Certain assets were not previously pledged to the first lien lenders, including the assets of Valencia Water Company (which was valued between \$80-100 million),²²¹ and could have provided recovery to unsecured creditors. There were other assets pledged to third parties prior to the bankruptcy, which Barclays Bank sought to prime. One such party, Poe Investment Company, LLC, objected to the proposed DIP financing as “no more than an end run around the explicit

²¹⁸ *Id.* For more details, see the objections raised by the 2nd lien lenders filed on June 9, 2008. Note the “tranche warfare” and litigation over the inter-creditor agreement which happened in this case. Barclays Bank asked the Court to strike BoNY Mellon's objections as it constituted a breach under their Intercreditor Agreement. The Agreement arguable prohibited the Second Lien Lenders from challenging any DIP Financing supported by the First Lien Lenders, including by filing and pursuing the Second Lien Objections. BoNY Mellon countered that it had the right to object to certain portions of the DIP Financing Motion, because the Intercreditor Agreement expressly authorizes BoNY Mellon and the Second Lien Lenders to object to “any ancillary agreements or arrangements regarding Cash Collateral use or the DIP Financing that are materially prejudicial to their interest.”

²¹⁹ *Id.* See the preliminary objections filed by Committee of Unsecured Creditors on June 24, 2008 and the full objections filed subsequently on July 7, 2008.

²²⁰ *Id.*

²²¹ *Id.* In the objections filed by the Committee of Unsecured Creditors, evidence is presented that the Debtors' senior vice president and chief financial officer, Donald Kimball, had opined that the value of just one of these Exempt Assets – the Valencia Water Company could be \$80 to \$100 million, based on his understanding of water company valuation methodologies.

- requirements of section 364 of the Bankruptcy Code”.²²² The proposed arrangement would also deprive unpaid vendors from the right to assert mechanics’ liens, even though post-petition services by these contractors was valuable in advancing the progress of development on the real estate.
- The pricing for the proposed financing (or rather, refinancing) was considered “usurious”,²²³ “shocking” and “unconscionable”.²²⁴ The applicable interest margin on the rolled up debt would be at least twice higher than the pricing under the pre-petition facility. If any portion of the 1st lien debt had been under-secured at the time of bankruptcy such that it would not accrue any interest, the proposed facility would now benefit the 1st lien lenders in the millions in the context of a billion dollar roll-up. The lenders proposed two commitment fees and a letter of credit fee of 6%, additional commitment fees (undisclosed owing to “commercially sensitive” reasons) and prepayment premiums upon facility termination on monies not borrowed. In fact, these fees and escalated interest costs would eat significantly into the amount of financing provided through the \$135 million revolver.
 - The proposed arrangement also included liens over avoidance actions, a section 506(c) waiver (thereby allocating the costs of sale and liquidation to other stakeholders), broad releases from lender liability claims and assertions of equitable subordination, and binding findings of fact with respect to validity of its liens with a 60-day challenge period and a \$75,000 budget for 1st lien debt in excess of \$750 million.

²²² *Id.* See, for example, the objections filed by Poe Investment Company, LLC on July 7, 2008.

²²³ *Id.* See the objections raised by the 2nd lien lenders on June 9, 2008.

²²⁴ *Id.* See also the additional objections filed subsequently by the 2nd lien lenders on July 7, 2008.

Furthermore, the proposed DIP financing provided for “outright control” of LandSource and the bankruptcy proceedings. The main elements of control are outlined as follows:²²⁵

- Immediate retention of a Chief Restructuring Officer acceptable to the 1st lien lenders. There were no negotiated controls or limitations on the lenders’ discretion in this regard.
- LandSource’s abandonment of its right to plan exclusivity. Reflecting a “private bargain” on exclusivity periods over that provided in the Bankruptcy Code, the entities had to file a plan satisfactory to the lenders within 120 days and requests for additional time would have to be approved by the lenders before LandSource could make an extension motion to the bankruptcy court. Only one 60-day extension would be permitted.
- Forced resignation of the executive committee and board of directors of the parent company, if Landsource failed to propose a satisfactory plan of reorganization within the allotted time, the former would be replaced by the CRO serving as a one member board.
- Covenants with 7-10% for liquidity variances. The covenants did not allow LandSource to carry forward positive variances for use in later months. This meant that, in relation to disbursements, LandSource “must use their money or lose it, limiting the Debtors’ flexibility and potentially creating additional risk for trade creditors providing services post-petition on payment terms.”²²⁶
- Immediate forced sale of assets selected by the lenders on a dictated-time line, with 100% of the proceeds applied to pay down the DIP loans including the \$1 billion of rolled up debt, and application of 100% of all insurance proceeds, tax refunds , purchase

²²⁵ *Id.*

²²⁶ *Id.*

price adjustments and other amounts that may not presently constitute collateral securing the 1st lien debt obligations to be applied to pay down DIP loans within one business day of receipt.

The last provision mentioned was most disturbing and could make the DIP financing obtained illusory. Where LandSource was using the monies under the \$135 million revolver to liquidate its assets and pay down the DIP loans, including the rolled up debt, the sale proceeds would essentially be “recycled” into the 1st lien debt. In light of these circumstances, the bankruptcy judge denied approval for the DIP financing on the proposed terms. In his ruling, he also alluded to provisions in the DIP arrangement which “smacks too much of trying to manage the governance of the Debtor during the course of the [Chapter] 11.”²²⁷

The court gave the parties an opportunity to negotiate and come up with a better proposal. Eventually, the parties agreed to the proposed DIP financing arrangement, with three major concessions from the 1st lien lenders:²²⁸

- The DIP loans would not encumber LandSource’s interest in Valencia Water Company, avoidance actions and assets which were not previously the subject of liens under the 1st lien credit facilities.
- The parties agreed to a “Sharing/Turned-Over Distribution” scheme whereby 50% of the distributions made to lenders on account of their deficiency claims would be turned over for the benefit of allowed non-priority unsecured claims.

²²⁷ *Id.* See the transcript of hearing held on July 14, 2008.

²²⁸ *Id.* Details of the concessions can be gleaned from a comparison of the initial motion for DIP financing and the consent order authorizing DIP financing provided by Barclays Bank filed on July 19, 2008.

- LandSource and the Committee were given a 90-day period to challenge the validity of the 1st lien lenders' liens, with a budget of \$500,000 from the proceeds of the DIP revolver.

The consent order was approved on July 21, 2008. It should be noted that, during the hearings, the roll-up issue was largely argued as one of business judgment. Even with the concessions provided in the final consent order, the DIP financing weighed heavily in favor of the 1st lien lenders. It came out in the filings that efforts to locate independent financing were quickly abandoned because the 1st lien lenders made clear that they would strongly resist any priming financing.²²⁹

Subsequently, upon the expiry of the exclusivity period on October 6, 2008, LandSource failed to file a reorganization plan. The events which followed, according to the colorful remarks in the objections lodged by the 2nd lien lenders, appeared to be “a rerun of the opening act of these cases”.²³⁰ On October 14, 2008, Barclays Bank filed a liquidating plan with the bankruptcy court, without a disclosure statement. Instead, Barclays Bank moved to have the disclosure statement filed under seal – an action quickly withdrawn after encountering swift and firm opposition from the U.S. Trustee.²³¹

²²⁹ *Id.* Note that the existing case law provides little guidance as to the quantity or quality of evidence a debtor must provide in establishing an inability to obtain alternative financing as required by section 364(d)(1)(A). An established precedent, *In re Antico Mfg. Co.*, 31 B.R. 103, 105 (Bankr. E.D.N.Y. 1983), found that section 364(d)(1) was satisfied where president of debtor company offered testimony of his inability “to obtain unsecured or non-superpriority financing from other sources, such as Citibank and New York City Executive Volunteer Corps” and “contacted a number of companies in regard to the possible purchase of an equity interest in [the company], but was refused by all”.

²³⁰ *Id.* See the objections raised by the 2nd lien lenders to the liquidation plan proposed by Barclays Bank filed on October 15, 2008.

²³¹ *Id.* See the objections raised by the US Trustee to the motion by Barclays Bank to file under seal the Disclosure Statement on November 4, 2008. Specifically, the US Trustee stated: “The Motion seeks extraordinary relief. To propose that a Chapter 11 Disclosure Statement, one of the seminal documents in the case, a document which the Court must approve as containing adequate information so that it can be transmitted to all creditors to solicit their acceptance or rejection of a plan, is extraordinary and flies in the face of the very purposes which a disclosure statement is intended to address and serve.”

In the subsequently filed disclosure statement, Barclays Bank outlined a plan providing for the sale of substantially all of LandSource's assets through an auction. An appraisal of the assets would first be conducted at the confirmation hearing on the plan and bidding procedures. The auction would then be held no more than 120 days after confirmation. All bids placed at the auction would be cash offers, subject to the secured lenders' right to credit bid their claims. This meant that the 1st lien lenders could either cash out or become owners of various assets.

The objections filed by the 2nd lien lenders (albeit their own agenda) best summarized what was most problematic about this situation, pointing to the incentive problems of secured lender control which we alluded to earlier:²³²

Stepping back for a moment, there is no reason for an immediate fire sale of the Debtors ' assets. We are in the midst of an unprecedented financial crisis and estate prices are reeling – all of which suggests affording the Debtors a reasonable reorganization period and a thoughtful sale process. Instead, the Plan contemplates a quick auction process to sell substantially all of the Debtors ' assets within 120 days of confirmation of the Plan. It would be one thing if confirmation truly benefited Debtors, but at this stage, it appears that confirmation of the Plan would change little. The Debtors were required by the DIP Credit Agreement to sell their non-core assets during the chapter 11 cases and use the proceeds to pay down the DIP Facility. That process is ongoing and would be no different if conducted pursuant to a plan (and it may even be concluded prior to the confirmation of the proposed Plan). The Debtors ' most significant assets – Newhall and Valencia – still required funding to continue the entitlement and

²³² *Id.* See the objections by the 2nd lien lenders to liquidation plan proposed by Barclays Bank filed on November 5, 2008.

development process whether the Debtors are in or out of chapter 11.²³³ Confirmation of this Plan may simply be a mechanism for the First Lien Lenders to complete what they were prevented from doing at the outset of these cases - taking control.

The credit bid process belies the reasons for the First Lien Lenders ' fire sale, go-it-alone approach. Newhall and Valencia, which were appraised for \$2 billion just 23 months ago, are the crown jewels of the Southern California real estate market. The market for multi-billion dollar, undeveloped properties is obviously depressed. The Plan contemplates credit bidding by the First Lien Lenders, who will form a "Newco" to take over the credit-bid properties. While no one can predict the prices at which these properties will be sold, given the depressed market, the Second Lien Agent surmises that the First Lien Lenders hope the Plan affords them the opportunity to bid in their debt – in a process which they will control-to acquire this multi-billion dollar property for a fraction of its true value, with the upside accreting to them.

The parties then went back to the negotiating table and this plan was not confirmed. In the meantime, the continued liquidation of assets, as envisaged under the DIP financing agreement, continued. LandSource filed a sale motion on November 19, 2008 for an order approving bidding procedures for the sale of various real property under section 363 and authorizing stalking horse agreements with a reasonable break-up fee.

²³³ "The concern with Barclay's plan was that the assets of Landsource are of several different types," said Debra A. Dandeneau, counsel for the Landsource debtors. "For example, Newhall Land is a functioning, ongoing business that has entitlements for master-planned communities, and so the value really does not lie in selling it off in pieces." Linda Coburn, *Newhall Land Bankruptcy Impact Still Unknown: Work Continues but Concern about The Future Looms*, San Fernando Valley Business Journal, Nov. 24, 2008, at <http://www.allbusiness.com/government/government-bodies-offices-law-courts-tribunals/11733108-1.html>.

Six months later in March 2009, Barclays Bank filed a new plan whereby it was willing to undertake a debt-equity swap, with a major reason being that Lennar had agreed to provide an equity infusion in the firm.²³⁴ This plan proposed a reorganized LandSource in which 1st lien lenders would receive up to an 85% stake, while Lennar would get a 15% stake in exchange for a \$140 million capital injection in the restructured entity.²³⁵ The plan incorporated a settlement with Lennar and its affiliates over certain litigation.²³⁶ A rights offering would also be initiated to raise an additional \$140 million, with 1st lien, 2nd lien and unsecured creditors being offered a subscription right to purchase allocated rights offering units in the new entity. A liquidation trust would be set up to distribute junior interests to unsecured creditors.²³⁷

6.4 Suncrest LLC

Suncrest, LLC (“Suncrest”) filed for Chapter 11 bankruptcy on April 11, 2008. Suncrest is the developer of a master planned community in Draper City (“the City”), which is located less than 20 miles from Salt Lake city center. At the time of bankruptcy, approximately 2,452 home sites remain unsold out of a total of 3,903 sites that were available originally for development and sale.²³⁸

The development was largely completed in terms of construction, except for the common areas. The residents-only club building and pool area were 95% complete, landscaping was 80% complete, and the basketball court/ice rink area was about 15% complete. However, the development was beset with other problems. It was not in compliance with the terms of a Master

²³⁴ Jacob Adelman, *Lennar Tries to Reclaim Role in Calif. Project*, Associated Press, May 30, 2009 at <http://abcnews.go.com/Business/wireStory?id=7714413>.

²³⁵ *In re* LandSource Communities Development, LLC, No. 08-11111 (Bankr. D. Del. June 8, 2008). Reorganization Plan (Mar 20, 2009),

²³⁶ *Id.*

²³⁷ *Id.*

²³⁸ *In re* Suncrest LLC, No. 08-22302 (Bankr. D. Utah April 11, 2008). A general discussion of the profile and background of Suncrest can be found in the motion authorizing DIP financing filed on April 22, 2008.

Development Agreement with the City owing to defective construction of local roads, the water system, the parks and trails, the City's bonding requirements and other instances of non-compliance with city geological ordinances. There was also a stormwater drainage problem which led to damages to the adjacent properties.

When Suncrest filed for bankruptcy, it reported Total Assets of \$54,057,921.96 and Total Liabilities of \$55,329,651.10.²³⁹ The bulk of these liabilities were owed to its secured lender, Zions First National Bank ("Zions"). Zions had extended a land development loan of \$40 million and provided an additional \$18 million in letters of credit. The amounts outstanding under these facilities, at the point of bankruptcy, were approximately \$39,974,691.00 and \$3,726,749.12 respectively.²⁴⁰ Repayment of these obligations was guaranteed by Suncrest's sole member, WB Land Investment, L.P. ("WLI").

What makes this case an interesting study is how it develops a theme which we mentioned earlier in Chapter 5 as to how the incentive of insiders to avoid liability under guarantees can affect the governance and outcomes of the bankrupt developer.

In this case, Zions and WLI entered into a Guaranty Termination Agreement in January 2008 whereby WLI paid Zions \$5 million in exchange for complete and unconditional release of liability under the Zions loans. Instead of applying the payments against the loans, Zions held the funds in a "suspense account by [Zions] for application as [Zions] deems appropriate in its sole discretion".²⁴¹ After further negotiations, Zions, WLI and Suncrest entered into a Restructuring and Refinancing Agreement ("R&R") on March 27, 2008.²⁴²

²³⁹ *Id.* See details in the schedules of assets and liabilities filed on May 16, 2008. The secured claims amounted to \$44,471,476.29 and unsecured non-priority claims totaled \$10,813,174.81. Of the Total Assets, personal property was scheduled at around \$10 million – probably an over-statement since more than 80% of that value was in the form of lot buyback options. The most valuable personal property was comprised of accounts receivable amounting to approximately \$400,000.

²⁴⁰ *Id.*

²⁴¹ *Id.* See the objection to the expedited motion authorizing DIP financing by Zions Bank filed on May 2, 2008.

²⁴² *Id.*

Under the R&R, Suncrest would file for Chapter 11 bankruptcy whereby it would conduct a section 363 sale. Zions would retain its right to credit bid the amount of its secured claim at the section 363. An unusual clause was included here – if Zions purchased the Suncrest development at the sale auction and later sold the asset at a profit, it would pay back the amount that WLI advanced under the negotiated DIP financing facility (discussed below).²⁴³ This meant that while WLI, the equity holder would participate in any upside of a subsequent resale, the Suncrest estate comprising of the other creditors would not share in any of this potential profit.

Additionally, both Zions and WLI executed mutual releases. It should be noted that, though Zions previously released WLI from its liabilities under the guarantee, WLI still faced co-debtor liability of about \$6.6 million in contingent performance bonds. The release of this liability was stated as a material condition of the proposed sale agreement.²⁴⁴

Finally, a DIP financing package pursuant to a section 363 sale was agreed to in the R&R. Under this DIP financing facility, the total amounts which Zions and WLI funded under the DIP Financing facility are summarized as follows:²⁴⁵

<u>Zions</u>	
Cash Collateral	\$ 110,924.78
Funding 5/28/08	\$ 68,705.22
Funding 6/17/08	\$ 229,846.35
Total DIP Facility	\$ 298,551.57
Total Commitment	\$ 849,312.00
Utilization	35.15%

<u>WLI</u>	
Funding 5/28/08	\$ 178,217.92
Funding 6/17/08	\$ 114,923.17
Total DIP Facility	\$ 293,141.09
Total Commitment	\$ 424,020.00
Utilization	69.13%

²⁴³ *Id.*

²⁴⁴ *Id.* Specifically, see the exhibit on the Real Estate Purchase and Sale Agreement (Section 7) attached to the sale motion filed on June 25, 2008.

²⁴⁵ *Id.* Specifically, see the exhibit on the post-petition budget attached to the order authorizing DIP Financing filed on May 22, 2008.

The agreed budget, part of the DIP financing arrangement, showed the parties' focus on financing specific expenses related to consummating a bankruptcy sale. Of the total of \$773,479 budgeted for 8 weeks following petition date, 52.7% of these funds were earmarked for sale and legal costs. The overheads of \$101,379 were set with an assumption of a reduced staff of 3 personnel (a financing specialist, a land specialist and an administrative assistant), evidencing the absence of any consideration for potential prospects of reorganization.²⁴⁶

On the day when Suncrest filed its Chapter 11 petition, it concurrently filed the sale motion which contemplated an initial bid deadline of June 9, 2008 and an auction on June 11, 2008, i.e., 2 months away. Amidst objections by other creditors, the auction was later postponed to June 23, 2008, with the bid deadline and sale hearing moved to June 19, 2008 and June 25, 2008, respectively.

Despite the postponement, the sale process was just over 2 months. According to findings by the Committee of Unsecured Creditors ("Committee"), the real estate broker did not start the sales effort in earnest until May 10, 2008, leaving the marketing time for a 3000+ acre project to a mere 41 days.²⁴⁷ There was also no stalking horse bid obtained for the auction.

The case was fraught with objections regarding the non-transparency of proceedings to the general creditor body. For example, an old appraisal report was only made available to the Committee on May 30, 2008, after the Committee filed a motion to compel its production. Zions did not disclose that it had a more current appraisal until it was found out during a 2004 Examination. When asked to produce it, Zions claimed that it could not be produced under a claim of attorney-client privilege and/or work product. The court, however, ruled on June 19, 2008 (the day of the bid deadline) that the appraisal was a non-confidential document which should be released to the Committee.

²⁴⁶ *Id.*

²⁴⁷ *Id.* See the objections raised by the Official Committee of Unsecured Creditors to the sale of substantially all assets of the debtor free and clear of liens filed on June 24, 2008.

Next, we examine the proceedings at the actual sale auction on June 23, 2008.²⁴⁸ There were three qualified bidders at the auction: Huffines Land Holding Partners, R&B Suncrest LLC (“R&B Suncrest”) and Zions. R&B Suncrest started with an opening bid of 7 million dollars cash, plus full assumption of the Master Development Agreement with Draper City and a limited number of executory contracts. It should be noted that one of the requirements for the auction was that all bids were to be in cash for bidders other than Zions]

There was a surprise awaiting the bidders right at the beginning of the auction, when it was announced that there was a revised sale contract. The debtor’s attorney said soon after the start of the auction that “I don’t know the exact time this form circulated...there have been the following changes to that contract”. The bidders took a brief adjournment of 10 minutes to look over the revised contract before returning to the bidding process. After the adjournment, Huffines Land Holding Partners announced the withdrawal of their bid, upon perusal of the revised Real Estate Purchase & Sale Agreement.²⁴⁹

The next bid was put in by Zions, with a total of \$25,302,000 (see the allocation in Figure [], subject to the Master Development Agreement but without assumption of executory contracts. Once Zions made this credit bid (see Figure 20 below), the remaining cash bidder withdrew from the auction, and Suncrest accepted Zions’ bid.²⁵⁰

Figure 20: Zions Bank’s Bid at the Auction

Property	Amount	Cash/Credit Bid
Personal Property	\$ 100,000.00	DIP Credit
Lot 60	\$ 198,551.57	DIP Credit
	\$ 251,448.43	Cash
All Other Real Property	\$ 24,752,000.00	Credit
Total Bid	\$ 25,302,000.00	

²⁴⁸ *Id.* See details in the transcript of the auction filed on June 24, 2008.

²⁴⁹ *Id.*

²⁵⁰ *Id.*

After the auction, the Committee filed a vehement objection to the sale, stating that:²⁵¹

The proposed sale is not supported by a sound business purpose for the benefit of the Debtor's estate. Instead, the Sale Motion is merely a mechanism for the Debtor's senior lender, Zions FNB ("Zions") to foreclose its liens against the Debtor's collateral and enable the Debtor's sale member, WB Land Investment, L.P. ("WLI") to avoid potential contractual liability. The Sale Motion is an abuse of the bankruptcy process in favor of a single creditor and is not in the best interest of other creditors and the Debtor's estate.

The consummation of the sale would have left the estate administratively insolvent and the unsecured creditors with no recovery. However, the court approved the sale to Zions on July 26, 2008 over the Committee's objections. Of the issues argued by parties, the court concluded that the key factors weighing in favor of Zions include:²⁵²

²⁵¹ *Id.* See the objections raised by the Official Committee of Unsecured Creditors to the sale of substantially all assets of the debtor free and clear of liens filed on June 24, 2008.

²⁵² *Id.* The court ruled that the sale process was properly conducted, stating the following evidence: "HCI mailed the sale flier directly to approximately 2,866 developers, brokers, real estate agents, REITs, and other contacts, and sent the flier via electronic mail to approximately 1,173 developers, brokers, real estate agents, REITs, and other contacts. Additionally, HCI advertised the sale of the Property on several Internet web sites including Highland Commercial: www.hciutah.com, Loopnet: www.loopnet.com. Land Unlimited: www.landbrokermls.com, and Google: www.google.com. HCI also placed ads for the Property in various print media outlets including the Wall Street Journal (twice), Dallas Morning News (twice), New York Times (twice), L.A. Times (once), Las Vegas Sun (twice), Denver Post (twice), Salt Lake Tribune (4 ads), Deseret News (4 ads), The Enterprise (4 ads), Park Record (4 ads), Ogden Standard Examiner (4 ads), Provo Daily Herald (4 ads). Throughout the process, HCI engaged in regular contact with potential bidders, conducted numerous meetings to address questions and concerns, and regularly updated all parties involved as new information was uncovered. As a result of these substantial efforts, a total of 2,172 "clicks", from 45 different states and at least 32 different countries were generated from the Internet advertising, 118 sale packages were distributed, 23 potential buyers signed confidentiality agreements, and 7 of those potential buyers received access to the Virtual Data Room to conduct due diligence." See details in the transcript of the sale hearing on June 26, 2008.

- The appraisal showed that the value of the property “as is” was \$40,500,000 in terms of market value and the liquidation value was pegged at \$25,100,000. Zions’ bid exceeded the liquidation value slightly, and it was more than 3 times higher than the other qualified bid. There was no evidence of another credible bid.
- The court considered current market conditions, constraints in the credit market and, most importantly, that the real estate market has been declining and softening since the commencement of proceedings. Evidence showed that the value of the property was declining such that prompt resolution of the case was preferred.

Finally, the court added an important factor for this case to the list of seven factors established in the case of *Medical Software* in determining whether a sound business reason exists for the proposed sale, stating that:²⁵³

The sale brings finality to a very chaotic situation that exists in the market place. The debtor has no funds to operate the property. Zions is owed substantially more than the apparent value of the property. And to defer approval of the sale will only enhance the cost to the estate and to other creditors and parties. Some finality is required in this case. And that, in itself, appears to be, and the Court finds, a legitimate business purpose.

Finally, the sale closed on June 30, 2008. Nonetheless, the Committee continued their battle against WLI and Zions. The Committee first filed a motion requesting court authorization to file complaints against Zions and WLI (granted on July 3, 2008), and then moved for the appointment of

²⁵³ *Id.*

a Chapter 11 trustee in an attempt to improve their bargaining position vis-à-vis Zions Bank.²⁵⁴ This eventually led to a settlement which, accordingly to filings, was supposed to help parties avoid costly and time-consuming litigation.

Under the settlement, WLI would advance \$353,755 to the Suncrest estate, without seeking security and asserting a repayment claim (\$103,755 as the balance of its committed DIP funding and \$250,000 in additional settlement proceeds). Zions would advance \$242,783 to the Debtor's estate (the balance of Zions' DIP funding commitment) without seeking security and asserting a repayment claim and Zions agreed to waive a substantial part of its deficiency claim, except for a general unsecured claim of \$7.5 million.²⁵⁵

This meant that over \$13 million of deficiency claims of Zions and \$25 million of claims of WLI were eliminated. The settlement helped the estate avoid administrative insolvency, since payment obligations to administrative professionals were being eliminated in the sum of \$100,000. However, only about \$365,000 in cash, after payment of certain expenses, was available for other administrative, priority and unsecured claims, resulting in a nominal recovery for unsecured creditors.

What followed from this juncture addresses an even more interesting question: what happens after the secured lender got what it wanted, the residential development?

Speaking to the Salt Lake Tribune, the spokesman for Zions said that "Zions does not plan to develop the property itself... now that the judge has ruled and the sale is final, our primary objective is to get it sold. We'd like to do that as quickly as we can".²⁵⁶ This is a clear indication that the section 363 sale conducted in bankruptcy proceedings was no more than a prelude to an actual sale where the bank would have the luxury of time to market and negotiate with potential buyers. More interestingly, by October 2008, Zions Bank started publicly soliciting and negotiating a sale of

²⁵⁴ *Id.* See the motion by the Official Committee of Unsecured Creditors requesting the appointment of an examiner filed on August 5, 2008.

²⁵⁵ *Id.* See the consent order granting the motion to approve a global settlement filed on October 17, 2008.

²⁵⁶ Steve Gehrke, *Judge OKs Zions' \$25.3M bid for SunCrest*, The Salt Lake Tribune, Jun. 27, 2008.

the property to R&B Suncrest, the unsuccessful bidder in the sale auction.²⁵⁷ After two months of negotiations, centered on the assumption of liabilities under the Master Development Agreement and the infrastructure problems of the development, R&B Suncrest backed out. R&B Suncrest told the City that these issues made “the purchase of the property no longer financially feasible”.²⁵⁸

In the aftermath, Zions spent months wrangling with the City over the Suncrest development. In a public letter written by the City, it was stated that:²⁵⁹

One of the largest obstacles to resolve is the roads. We now know that some of the roads in the development were not built to the standards required by the SunCrest Development Agreement and have already failed or are beginning to fail. The City has already accepted ownership of some of these roads and with that has accepted responsibility for repairing and maintaining these. Last year the City spent \$1.3 million repairing Traverse Ridge Road and expects to spend at least \$3.3 million over the next three years to repair other roads that are failing. There are other roads which have not yet been accepted by the City including SunCrest Drive, parts of Deer Ridge Drive, and the Eagle Crest road area. The City is requiring that the owner or developer of the property repair these roads, either to the standards required in the SunCrest Development Agreement or some other mutually acceptable standard before the City will take ownership, thereby saving taxpayers the expense.

Note that during the proposed sale process, the City had filed an objection to ensure that the court understood the contractual agreements taken on by the new buyer and cure obligations

²⁵⁷ Christopher Smart, *SunCrest deal collapses; Draper hopes to salvage plan*, The Salt Lake Tribune, Dec. 18, 2008.

²⁵⁸ *Id.*

²⁵⁹ See Draper City, Public Letter (2008), available at: <http://suncrestresidents.blogspot.com/2008/12/letter-from-city-manager.html>

required to complete the infrastructure in the subdivision. The defaults owing to the defective construction would have to be cured even if the new buyer opted to stop the development process.²⁶⁰ In December 2008, as negotiations over the completion of the infrastructure completion (especially in relation to the repair of the roads) turned to hostility, Zions terminated its banking relationship with the City.²⁶¹ However, its responsibilities for Suncrest continued, as gleaned from the continued filings in the bankruptcy docket in relation to its involvement in the roads issue and other liabilities alleged by owners of adjacent properties.²⁶²

At the time of writing, Zions has not found a buyer for the property and according to the county land records for Utah, the bank has been selling some peripheral lots in the development in a piecemeal fashion.²⁶³ This aftermath involving Zions’ inability to sell the Suncrest property after repossession is unlikely to be an isolated case. The following table presents financial data on Zions’ construction and development loan charge-offs and Other Real Estate-Owned (“OREO”) assets:

Figure 21: Excerpt from Zions Bank’s FDIC Call Report (in thousands)

	Construction Charge-Offs	Construction OREO	Total OREO	Construction OREO/ Charge-Offs	Construction OREO/ Total OREO
2008	29,934	30,705	68,403	102.6%	44.9%
2007	860	85	6,159	9.9%	9.9%
2006	602	-	2,406	-	-

Source: Federal Deposit Insurance Corporation

²⁶⁰ *In re Suncrest LLC*, No. 08-22302 (Bankr. D. Utah April 11, 2008). See the conditional objection to the section 363 sale filed by Draper City earlier in June 24, 2008.

²⁶¹ Donald W. Meyers, *Zions Bank boots Draper*, The Salt Lake Tribune, Dec. 26, 2008.

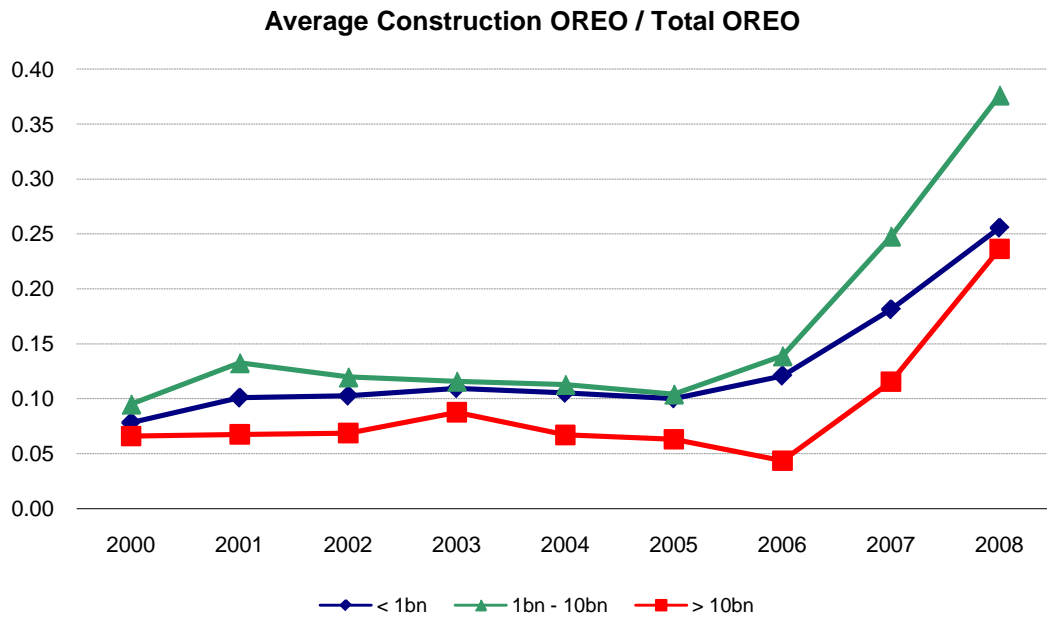
²⁶² *In re Suncrest LLC*, No. 08-22302 (Bankr. D. Utah April 11, 2008). See, for example, motions relating to settlement with DJ Investments.

²⁶³ An additional issue can be raised here in relation to the SARE provision in BAPCPA. As we mentioned earlier (see note 157), a key reasoning underlying the SARE provision is that such entities would not be able to undertake partial liquidation which may be necessary for financing rehabilitation. Note that the Suncrest case can easily fall within the ambit of the SARE provision, and Zions Bank’s action in selling off some lots constitute partial liquidation, which a debtor in such huge SARE cases could have done. See evidence of Zions Bank’s sale activities in Utah country land records, 2008-9, available at:

<http://www.co.utah.ut.us/Dept/Record/LandRecordsandMaps/DocDescSearchSub.asp?Submit=Submit&avB lock=&avLot=&avName=e&offset=30>

According to the above table, the construction OREO, foreclosed properties which the bank has taken possession, represents a substantial 44.9% of the total OREO. Furthermore, the 102.6% level for the Construction OREO/Construction Charge-Offs ratio, as of 2008 year-end, confirms the observations which we have made about the inability of the bank to sell off construction properties which it had foreclosed and repossessed. These assets accumulated on its balance sheet as OREOs, a high level relative to the charge-offs (the latter being the value of delinquent loans charged against loss reserves).²⁶⁴ In any case, this problem may not be unique to Zions – see Figure 22 showing the huge proportion of construction OREO in other commercial banks.

Figure 22: Average Levels of Construction OREO over Total OREO in U.S. Commercial Banks



Source: Federal Deposit Insurance Corporation (The lines represent banks with under \$1 billion in total assets, \$1-10 billion in total assets and over \$10 billion in total assets, respectively.)

²⁶⁴ Note that the 10-K released by Zions reported that its OREO balance has increased 898% compared to the first quarter of 2008, available at <http://www.sec.gov>.

6.5 General Themes and Analyses from Case Studies

In this section, we tie together the general themes and insights revealed from the case studies to address the following questions:

- To what extent did the DIP financing shape the outcome of the cases and support the thesis on the incentive problems of secured lender control?
- How did the DIP financing actually benefit the developer and stakeholders, apart from the secured lender?

6.5.1 Analyzing Secured Lender Control and the Incentive Problem

In the case of Shores, one may first characterize the section 363 sale as a direct consequence of the default on the DIP financing agreement which triggered the sales procedure.²⁶⁵ In fact, the sales requirements with which the developer failed to comply might be considered unrealistic. With the final DIP financing order entered on September 2, 2008, Shores was required to close at least 2 condominium units with minimum net sales proceeds of \$580,000 by September 5, 2008.

As the developer stated in its disclosure statement filed on September 15, 2008:²⁶⁶

[T]he present market conditions make it difficult to sell in a bankruptcy case because such sales require more flexibility in negotiations. Debtor sought and

²⁶⁵ See, for example, Sudheer Chava & Michael R. Roberts, *How Does Financing Impact Investment? The Role of Debt Covenants*, 63 J. Fin. 2085 (2008). The paper spoke about lenders' rights prior to default, arguing that "[u]pon breaching a covenant, control rights shift to the creditor who can use the threat of accelerating the loan to choose their most preferred course of action or to extract concessions from the borrower to choose the borrower's most preferred course of action". The case of Shores appears to be consistent with this position, even though the process in which the default occurred is supposed to be supervised by the bankruptcy court.

²⁶⁶ *In re Shores of Panama*, No. 08-50066 (Bankr. N. D. Fla. February 26, 2008). Disclosure Statement, *supra*, note 6.

received authority to sell over 20 units at the outset of the Bankruptcy Case. However, by the time that the authority was granted, the market price had decreased to the point that the purchasers were not willing to close their purchases at the agreed price. This resulted in a series of addendums to those contracts. As a result only two (2) contracts have closed since the Petition Date... the Debtor did not have the funds to engage the realtors it had selected to begin the marketing efforts.

From the perspective of the secured lender, one may argue that the DIP financing motion was first filed on July 31, 2008, and Shores had two months to work towards closing the sales. A countervailing argument is that the purchasers might have been loath to close the sale without the comfort that the developer had sufficient post-petition financing in place for maintenance and payment of condominium dues.²⁶⁷ Neither would Shores have the liquidity to pursue an aggressive marketing plan. The brief period of actually having DIP financing in place and the rushed time-frame might be likely factors affecting Shore's ability to close sales.

Next, the outcome of the section 363 sale was also shaped by the secured lender. The sale motion, along with the bidding procedures, was proposed by the secured lender. As we discussed above, the lender asserted that it did not have to expend any funds on marketing the properties and stated that it was not responsible for the insufficient marketing of the property. The lender did not even agree to the use of its cash collateral to pay a broker, though the court subsequently ordered the retention of a broker.

In this context amidst the weak housing market, it was unsurprising that the secured lender was the only qualified bidder at the auction. Furthermore, the requirement that the sale had to be

²⁶⁷ Such sentiments by home buyers may be reflected in statements such as these: "I'm a pre-construction purchaser, who really would like to own a unit at Shores, but I feel that the fate of those units is still up in the air, and I'd rather wait and see if the prices come down even further if Silverton fails." Jason Koertge, *Shores of Panama Selling at Near Auction Prices*, PCB Daily, Nov. 10, 2008, at <http://pcbdaily.com/?p=2641>.

all cash at closing might be extremely unattractive to other potential bidders at a time where the country was experiencing a liquidity crisis.²⁶⁸

Next, the review of the proceedings in Suncrest showed it to be an even clearer case that the sale was a direct result contemplated in the DIP financing arrangement itself. In fact, the R&R pre-negotiated and signed prior to the bankruptcy filing was premised on the occurrence of a section 363 sale. Despite the objections of the unsecured creditors, the court found the sale to be a “legitimate business purpose”, even though we have observed manipulations surrounding the auction such as the rushed time frame, the surprise revision in the sale contract, etc.

Nonetheless, a fair assessment of the Suncrest case study suggests that it was not merely the secured lender shaping the bankruptcy outcome, but also the facilitation of the insiders who were incentivized to push through a sale in exchange for a release of their guarantees and other contingent liabilities. This is in line with a theme presented in the preceding chapter regarding certain consent orders for relief from stay.

Moving onto LandSource, we are confronted with a case where “outright control” exerted by the 1st lien lenders was hotly contested from first day motions requesting the authorization of the onerous DIP financing package. In terms of shaping the outcome of the bankruptcy of LandSource, the provision limiting LandSource’s ability to plan exclusivity kicked in after 120 days, allowing Barclays Bank to file a liquidation plan. Although the final outcome seemed to have culminated into a reorganization, the proceedings had been largely driven by Barclays Bank which handpicked the Chief Restructuring Officer, dictated the milestones of asset disposition prior to plan confirmation (assets were sold with sale proceeds amounting to around \$70 million), and controlled the budget within a 7-10% variance. The appointment of the Chief Restructuring Officer is a significant move

²⁶⁸ Note the double standards of the banks in insisting on “all cash” bids in section 363 sales. In section 7.4.2, we will discuss how banks are allowed by regulators to provide favorable financing for buyers of foreclosed properties (and encouraged to do so in order to reduce OREO holdings on their balance sheets).

which might have taken away much of the decision-making power of the debtors and transferred control to the 1st lien secured lenders.²⁶⁹

Thus, it is clear from our case studies that the DIP agreement, both in the concessions given by the debtor to obtain DIP financing (in one case, releases given to insiders) and in the kind of control given over to the lender by the terms of the DIP financing in terms of the operation and management of the debtor, provides the lender a great deal of control over the bankruptcy process.

Overall, our case studies support the classic paradigm in relation to the incentive problems involved in secured lender control. In these cases, the secured lenders can utilize their control via provisions in the DIP financing agreement to swiftly sell or liquidate a debtor to maximize the value of their security interests, and at the same time, they are incentivized to taking over the property at depressed prices, whether as part of a credit bid or pursuant to a reorganization plan. These plans on the part of the secured lenders also show little consideration for the interests of other parties.

Moreover, the bankruptcy regime allows for the striking of private bargains, including arrangements such as the DIP financing agreement in Shores which pre-empts any court decision which does not approve of the section 363 sale to the lender. The question is, to what extent are these arrangements truly “consensual” bargains? As Judge Walsh of the Bankruptcy Court for the District of Delaware once remarked that, as a result of the lender's leverage over the debtor, debtors tend to agree to provisions that are “unnecessary, overreaching or just plain wrong”.²⁷⁰ The judicial passivity or deference to business judgment, with its nebulous discretionary scope, as exhibited in the 3 cases studies, is troubling. It effectively means that secured lenders are free to maximize their own returns, at the expense of other stakeholders, with relatively few restraints.

²⁶⁹ Miller & Waisman, *Reorganization, supra*, note 36.

²⁷⁰ See note by Judge Walsh referenced in Miller & Waisman, *Reorganization, supra*, n36. Note that the bankruptcy judge is completely dependent on the parties to provide the necessary facts, because she does not have the resources to do an independent financial and operational analysis of the plan's feasibility. See also, Ashley J. Austin, *Food For Thought: The Efficiencies Achieved by Trimming an Industry at Overcapacity through Mergers Vs. Chapter 11 Reorganizations*, 25 Bank. Dev. J. 147 (2008).

As the description of the aftermath of the sale in Suncrest suggests, secured lenders, once the owners of the debtor's assets, do not always behave in the way a true owner would in developing the property. They may be trying (just as the debtor was, prior to the sale) to sell off the property while incurring a minimum of further investment in the property, leading to such phenomena, as we have seen, of residential communities which require repair and continued construction. This sound, ironically and literally, like a case of "collateral damage". Even the Federal Reserve Chairman, Ben Bernanke, has commented on the irrationality of the lenders' behavior in an analogous situation, referring to the lenders' preference for foreclosures even though foreclosures dissipates much of the value of the property.

6.5.2 Characterizing the Benefits of the DIP Financing

As Lubben posed the questions in a 2004 study, "Chapter 11 has then become a system of corporate reorganization that is dominated by a single creditor, or at least a small group of sophisticated creditors. Is this a good thing? Speed of resolution is the obvious benefit, and the reason why these leading scholars believe that chapter 11 is much improved. But what are the costs?"²⁷¹

These are the question which we seek to address in this sub-section. In judging whether the outcomes of these cases with DIP financing turned out to be optimal, the Suncrest case illustrates a situation akin to the "Dog in the Manger" fable referenced at the start of this paper. The secured lender took over the property, yet it was unable to sell the development and it had problems completing the infrastructure in the residential subdivision. The end-result, at the time of writing, includes roads "which have already failed or are beginning to fail" and substantial expenditures to

²⁷¹ Lubben, *supra*, n44.

the City, not to mention the possible anguish to home owners living in this partially-developed community.

While we did not illustrate the aftermath for LandSource, the forced sale and liquidations (carried out through the case, regardless of plan confirmation) were arguably sub-optimal since they could contribute further to declining prices in the housing markets, i.e., adding to the amount of housing wealth wiped out in this country. Specifically, the concluded sale prices might serve as comparables for appraisals and other forms of value determination in other bankruptcy proceedings, e.g., in support of the business purpose of another section 363 sales or the grounds supporting lift-stay motions. In the rest of this sub-section, we will go through the specific benefit obtained through the availability of DIP financing.

In relation to Shores, the benefit from the DIP financing appeared marginal, especially since the developer was considered to be in default of the facility barely three days after the entry of the final DIP financing order. The question is: could Shores have continued throughout the process with the intention of reorganization, without the DIP financing in the first place? After all, the monthly operating reports filed for August 2008 showed that, without any infusion from the secured lender, the developer was still able to keep afloat. With a starting cash position of \$57,075 at the time of bankruptcy, Shores had total cumulative receipts of \$906,465 and disbursements of \$257,522, and thereby an ending balance on August 30, 2008 of \$706,018.²⁷²

One may argue that Shores' cash position at that time might not have allowed it to continue operating without post-petition financing. Looking at the monthly operating reports for February 2009 (the month prior to the auction sale on March 5, 2009), we observe that, without funding from the secured lender, Shores would have accumulated a shortfall by the end of February.

²⁷² *In re* Shores of Panama, No. 08-50066 (Bankr. N. D. Fla. February 26, 2008). See details in the Monthly Operating Report filed for the period of August 2008.

Figure 23: Excerpt of Cumulative Cash Balances from Monthly Operating Report ending February 28, 2009²⁷³

<u>Item</u>	<u>(\$)</u>
Total Receipts	2,450,788
Funds Available for Operations	2,507,862
Total Disbursements	1,854,965
Closing Balance	652,897
DIP Loan	1,438,100
DIP Loan Fees	45,000
Total Receipts from DIP Lender	1,393,100
<hr/>	
Difference between Closing Balance and Receipts from DIP Lender	740,203

Source: Shores of Panama, Monthly Operating Reports filed in Bankruptcy Court

Examining the details of the operating report, we provide a breakdown of the Total Disbursements of \$1,854,965 reported in Figure 23 into the major items of expenditure by the developer:

- Condominium dues of \$1,006,399
- Repairs and maintenance of \$391,839
- Utility payments of \$188,846 and a utility assurance deposit of \$26,235
- Professional fees of \$143,701

Based on these financials, it may be a fair argument that the financing advanced by the secured lender helped to maintain the properties through the expenditures on repairs and maintenance, contribution to condominium dues (funding for common areas) and, literally, keep the lights on through payments to utilities.

However, given the final outcome where the property of Shores was sold to the secured lender at around 41.8% of its initially-scheduled value, to what extent did the DIP financing benefit

²⁷³ *Id.* See details in the Monthly Operating Report filed for the period of February 2009.

the various other stakeholders? One may even argue that the recovery rate for unsecured creditors could be higher but for the DIP financing, if instead the developer simply sold the property in an auction or private sale earlier for cash, or a mixed cash-debt deal, without negotiating the DIP financing arrangement.²⁷⁴

In another alternative outcome, the developer could arguably have taken early action to reduce the price of the units or agree to concessions to entice buyers who have put down deposits to close the sales. The DIP financing typically prevented such actions in the face of declining prices. In fact, when the Company first received court approval to proceed with home closings in May 2008, there were at least 2 purchasers who did not want to consummate the contracts due to falling home prices.

To convince the purchasers to close the sales, the Company acted creatively to revise some terms not controlled by the DIP arrangement to make purchasing a home more attractive. One of the purchasers was given a reserved parking space and a \$15,000 credit towards closing costs. The other was provided with a furniture package and a promise from the Company to pay the first two years' of homeowner's assessments. Nonetheless, this process was fraught with difficulties – the court docket showed evidence of objections by the secured lender even though these arrangements were allowed eventually.²⁷⁵ If it is difficult for the developer to strike such compromises, it might be even harder to do short sales.²⁷⁶

It would not be too farfetched to consider the secured lender in this case as the main beneficiary of the bankruptcy proceedings, especially if it were able to capture any price

²⁷⁴ It is possible that in light of the liquidity crisis, it would have been extremely difficult for the debtor to find an alternative buyer as well. However, this same argument applies to the conduct of the section 363 sale.

²⁷⁵ *In re Shores of Panama*, No. 08-50066 (Bankr. N. D. Fla. February 26, 2008). A quick scan of the bankruptcy docket will show multiple objections by Vision Bank to motion filed by the debtor to approve compromises with home purchasers. See, for example, the objection filed on May 23, 2008.

²⁷⁶ As we discussed earlier in Chapter 5, Village Homes faced strong opposition to its proposal to undertake short sales, *supra*, note 113. *In re Village Homes of Colorado Inc.*, No. 08- 27714 (Bankr. D.Colo. November 6, 2008).

appreciation in the long run. The other creditors would have to make do with the \$1 million paid into the estate, along with any potential avoidance actions.

A similar analysis can apply to that of Suncrest in terms of addressing whether the company could have been kept afloat for reorganization. However, the benefit of the DIP financing was *expressly* marginal, since the involvement of the insiders meant that the funds obtained were mainly used to prepare for, and consummate the sale process. Indeed the release of the contingent liabilities of the insider was a material condition of the R&R where the bankruptcy sale was contemplated. As we observed in the case study above, the Committee of Unsecured Creditors considered the sale a mechanism for foreclosure sanctioned by the bankruptcy court. A similar remark was made by the unsecured creditors in LandSource.²⁷⁷

Turning to the case of LandSource, we begin our analysis by alluding to an amusing snippet in the media. The Turnaround Management Association and The Deal LLC, organizations announced in a review of 2008 bankruptcies that the second biggest DIP financing deal of 2008 was “the \$1.19 billion committed to real estate developer LandSource Communities Development LLC”.²⁷⁸ As we have seen, this was really mostly a roll-up. This leads to a question – is a roll-up facility truly considered financing in the sense that it benefits the debtor? It does not provide liquidity for the debtor in bankruptcy and its main purpose is to strengthen the position of the pre-petition secured lenders. Nonetheless, it arguably confers a benefit, often being a “mandatory condition” of the financing package.

In addressing this issue, courts have struggled to balance debtors' need for and ability to obtain financing with the fundamental premise that bankruptcy is a collective proceeding designed for the benefit of creditors.²⁷⁹ In recent years, the practice of incorporating roll-ups in DIP financing,

²⁷⁷ *Supra*, note 219.

²⁷⁸ The Deal LLC, *The Deal Pipeline Releases 2008 Bankruptcy Financing and Adviser Rankings*, Business Wire, Jan. 30, 2009, at http://findarticles.com/p/articles/mi_m0EIN/is_2009_Jan_30/ai_n31336368/.

²⁷⁹ Michael A. Fagone, *How Far Is Too Far? Curbing Abuses in First-Day Motion Practice*, 24 Nov. Am. Bankr. Inst. J. 12 (2005)

thereby transforming a pre-petition claim into a post-petition claim, has become frequent, if not commonplace.²⁸⁰ In our survey of developer bankruptcies in 2008, there are at least 2 other cases where the DIP financing involved a roll-up – WCI Communities and TOUSA Inc.

One major argument advanced by 2nd lien lenders and unsecured creditors during the DIP financing hearings was that the value of the financing package proposed by Barclays Bank was illusory. The bankruptcy judge himself stated that “there's just no evidence of value of anything here... I have to be convinced, or at least the Committee has to be convinced, that there's some light at the end of the tunnel as a reason for doing that.”²⁸¹

While the parties subsequently agreed on a consent order with the 1st lien lenders making a few concessions, the value of the DIP financing arrangement was not that high for most stakeholders, apart from the 1st lien secured lender. The actual liquidity offered of \$135 million was largely to be put to use in executing sale of assets according to a timeline dictated by Barclays Bank and most of the net sales proceeds were turned over to Barclays Bank.

Nonetheless, as LandSource lawyers argued during the DIP financing hearings, the \$135 million “from the Debtors’ point of view preserves options ... [o]ptions to achieve a reorganization plan with an infusion of capital, as well as other options”.²⁸² It may be fair to describe the DIP financing offered by the 1st lien lenders as being analogous to a call option.²⁸³ The junior creditors held a call option on the firm’s assets, with the strike price equal to the amount of debt outstanding to the senior creditors, though the junior creditors might consider the premium that they paid for

²⁸⁰ James J. White, *A Symposium on the Code After 25 Years: 1978- 2003: Article & Response: Death and Resurrection of Secured Credit*, 12 Am Bankr Inst L Rev 139 (2004) [hereinafter White, *Response*]

²⁸¹ *In re LandSource Communities Development, LLC*, No. 08-11111 (Bankr. D. Del. June 8, 2008). See the transcript of the hearing relating to the DIP financing motions held on July 14, 2008.

²⁸² *Id.*

²⁸³ This is akin to real option analysis. A real option is the right to undertake a certain business decision, and although it is different from a financial option (because it is not tradeable), it shares the similar valuation methodologies. Options can be divided into call options and put options. The buyer of a call option has the right, but not the obligation to buy a certain quantity of an underlying instrument from the seller of the option by a certain time for a fixed price (the “strike price”). The seller is obligated to sell the instrument should the buyer decides to exercise the option. The buyer pays a fee (the “premium”) for this right.

this option (e.g., the high interest rates and “extraordinary provisions”) to be extremely high. The value of the option would be a function of the volatility of the assets and the maturity of the option, i.e., the timeline set by the 1st lien lenders in terms of limits on LandSource’s ability to extend the plan exclusivity period.

Indeed the option might have expired after the exclusivity period expired. In fact, the outcome might have been disastrous had Barclays Bank followed through with, and managed to confirm, its first liquidation plan filed in October 2008. That would have entailed a fire sale of substantially all the assets of a giant residential real estate developer where the lender reserved the right to credit bid. Besides a potential scenario where unsecured creditors (including employees with priority claims, trade creditors and home owners affected) recover almost nothing on their claims, there may be a domino effect of such a fire sale on the housing values of neighboring properties.

However, the debtor was subsequently able to obtain an agreement from Lennar to provide a \$140 million capital infusion, which enabled the parties to negotiate with the 1st lien lenders to drop its request for a hearing to confirm its liquidating plan and allow the formulation of an alternative plan. This essentially meant that the 1st lien lender extended the maturity of the option. It should be noted that the case is still pending. If everything went according to the newly proposed reorganization plan which proposes some level of recovery for junior creditors, the latter would be in a position where the price of the underlying assets exceeded the strike price such that the option actually has positive monetary value.

6.6 Conclusion

The case studies discussed in this chapter have highlighted many of the issues raised for and against DIP financing agreements and assessed them in light of severe economic downturn.

While recognizing secured credit comes with strong priority and control rights, we question whether the forced sales or liquidation of developers in a downturn market is simply the best thing that can be done given the liquidity shortage, whether bankruptcy regime should allow the short horizon on the part of the lenders to prevail, and sanction lenders' strategies which may lead to socially sub-optimal outcomes.

Before moving onto the discussion elucidating the inner workings and regulatory culture of these secured lenders, we will conclude this chapter with two snippets taken from hearings in the bankruptcy proceedings of the LandSource case. Together, they capture the issues at the heart of the debate of how the legal regime should balance the interests of parties in relation to distressed residential real estate development.

(Counsel for Barclays Bank, Bruce R. Zirinsky): *[T]his is a wasting asset. This is a depreciating asset. Values are declining. This is not about controlling the case, this is about providing lenders who are willing to accommodate a debtor and the other financial constituents a reasonable time to come up with a plan, a consensual plan. At the same time, we have to be very cognizant about protecting interests of the lenders whose assets are at risk here...We have -- and it doesn't take an expert. One just has to read the newspapers every day. We have assets that are declining in value. They have declined dramatically in value since the time the loan was made, and they are continuing to decline in value.*²⁸⁴

(Bankruptcy Judge, Hon. Kevin J. Carey): *[M]any times arise in situations in which the Debtors' business is just falling apart on an hourly basis. And value is being*

²⁸⁴ *In re* LandSource Communities Development, LLC, No. 08-11111 (Bankr. D. Del. June 8, 2008). See the transcript of the hearing relating to DIP financing motions held on June 25, 2008.

*lost so rapidly that unless things are moved quickly, at the end there's nuttin' for nobody. Here it's a real estate case...And I understand the atmosphere in which your client is now trying to survive, but you know, in my experience eventually the value comes back. The question is how fast, and how much, and what are the liquidity needs in the meantime, and will you be able to make a deal with the other constituents.*²⁸⁵

²⁸⁵ *Id.* See the transcript of the hearing relating to first day motions held on June 10, 2008.

Chapter 7: The Regulatory Culture and Inner Workings of Banks

Chapters 4 through 6 presented evidence of secured lenders' preference for foreclosures and liquidations, and the significant degree of control which these lenders exercised over bankruptcy proceedings in the current legal regime. Their ability to push through their agenda in relation to bankrupt residential developers may lead to sub-optimal outcomes, such as lenders themselves being stuck with unfinished properties, as illustrated in the aftermath of the Suncrest case. This evidence can help support the case for legislative intervention in mitigating foreclosures and liquidations in the residential development industry, as Congress has done in the area of individual mortgage defaults. However, some may still argue that the status quo should be left alone because of overall efficiency arguments for giving secured creditors dominance (as discussed in Chapter 2). For example, it is often argued that any reforms which undermine the control endowed by secured lending and alter lenders' rights would increase borrowing costs and reduce the availability of credit.²⁸⁶

Such arguments are premised on simplistic pictures of banks as rational, profit-maximizing actors and often made with little reference to the environment in which banks function.²⁸⁷ While part of such bankruptcy literature is premised on the role and actions of banks, e.g., in monitoring debtors and functioning as a lever of corporate governance, there is a gap in such literature regarding how banks actually function. The failure to merge an understanding of modern banking,

²⁸⁶ *The Growing Mortgage Foreclosure Crisis: Identifying Solutions and Dispelling Myths*: Hearings before the Subcommittee of Commercial and Administrative Law, 110th Cong., 1st Sess. (2008) (testimony of the Honorable Jack Kemp). Specifically, the Honorable Jack Kemp remarked "[s]ome lender representatives have claimed that HR 3609 [Emergency Home Ownership and Mortgage Equity Protection Act of 2007] would drive up interest rates and harm the securities market".

²⁸⁷ See Charles Tabb, *Of Contractarians and Bankruptcy Reform: A Skeptical View*, 12 *Am. Bankr. Inst. L. Rev.* 259 (2004). Tabb argued against the central assumption of contractualists that parties are rational, pointing to behavioral economic studies that show people acting in systematically irrational ways.

its regulation-infused culture and the institutional psychology of banks into an analysis of bankruptcy law creates an incomplete picture for social policy reforms. In fact, the aftermath of the Shores of Panama case study should be a wake-up call. After all, it is questionable as to whether failed or failing banks should be in a position where they hold the reins of bankruptcy proceedings.

Using findings from more than 30 interviews with bankers, official comment letters from banks to their financial regulators, Congressional testimonies, and personal observations accumulated in bank risk management consulting practice, with occasional reference to finance and business literature, this chapter will attempt to describe how banks are more complex (and inefficient) creatures than portrayed in much of the theoretical literature. Among others, we will provide a more in-depth look at how the cost of capital and varying sources of profit affect banks' decision-making processes and explain a preference for liquidation. The central picture that emerges is that banks are *highly constrained* profit-maximizing entities. These constraints include incomplete information, inadequate risk management systems, fragmented decision-making, conflicting incentives within the bank itself, competitive pressures and most of all, the regulatory framework and culture with active (but occasionally erratic) supervision by regulators.

7.1 Focusing on Banks and the Banking Regulatory Context

Before we do so, we shall spend some time explaining why we focus here on banks when much of the theoretical literature has referred to secured creditors rather than banks, and why that matters. Empirically, from our data, the originators of the first lien secured construction loans are mostly commercial banks, even if hedge funds may take a junior provision or eventually buy the debt.²⁸⁸ This is supported by statistics from FDIC showing that, as of the end of 2007, the total

²⁸⁸ Almost all the cases in the sample involve at least one bank as secured lender. While contractors and sub-contractors can be secured creditors by virtue of mechanics' liens on the underlying property to the extent of

dollar amount of construction and development loans in the U.S. provided by banks is more than \$559 billion.²⁸⁹ Therefore, it is not controversial to say that commercial banks make up most of the secured lenders in the residential development industry.²⁹⁰

One possible explanation for this is economies of scale. Lending is the major revenue-generating activity of a bank, apart from deposit-taking, allowing banks to dedicate resources to creating a large and specialized lending apparatus, with all its supervisory, executive, and evaluative appendages. They are able to give secured credit, which is complicated and theoretically requires heavy monitoring, relatively cheaply due to efficiencies of scale so as to allow a bank to offer credit at a price lower than non-banks, all else being equal, and thus gain market share. The ability of banks to take deposits also gives them a pool of very cheap funding which non-banks find hard to compete with, as banks can again lower interest rates on loans and still maintain a profitable spread, compared to institutions which have to borrow in the open market. Thus, banks can and do dominate secured lending.

However, in order to behave like a bank, an institution, by regulation, actually has to be a bank, because banks have the potential to create contagious risks in a financial system and carry out spectacular frauds, like Allen Stanford's Stanford International Bank, and the Bank of Credit and Commerce International ("BCCI") before that. Institutions in the U.S. that wish to lend like a bank have to apply to government bodies to obtain a banking charter and follow bank regulations under the supervision of a regulatory body such as the OTS, FDIC, the OCC, or the Federal Reserve. The

the value of their labor and materials, the amounts of such secured debt is typically substantially lower than that of the secured construction loan. The data sample shows that hedge funds and finance companies involved in construction lending tend to take 2nd lien positions, presumably due to the higher rates of return offered by such tranches (without discounting for default risk).

²⁸⁹ See FDIC data and statistics generally available at <http://www.fdic.gov/bank/statistical/index.html>.

²⁹⁰ Here, we refer primarily to US Banks. However, as we have seen, foreign banks such as Barclays, are also participants in the phenomena we have observed. They are also subject to the generally the same regulations as US Banks, under the globally-agreed Basel II framework. Large, internationally active foreign banks also generally have the same cultural and institutional challenges as big banks in the US.

performance requirements are onerous, and regulatory supervision can be very restrictive, especially during the downturn.²⁹¹

The lack of discussion on how capital requirements, regulatory restrictions and pressure affect the behavior of banks highlights a more general problem, that there is precious little analysis by scholars of bankruptcy as to whether banks undertake actions for reasons other than profit maximization at net present value. Even though profit maximization can be assumed generally, there is little discussion of the fact that banks do not merely follow absolute profit maximization, based on rates of return, but rather risk-adjusted profit maximization, based on return per unit of capital at risk (the so-called Risk-Adjusted Return on Capital metric, or “RAROC”). The latter, based on our findings, is now the predominant paradigm within banks, but there is little discussion of this mix of performance management and formal risk management frameworks that banks now use.

The lack of reference to the regulatory environment of banks is particularly glaring in the current environment, where the U.S. government is essentially taking over or heavily interfering with the management of dozens of banks, to the extent of setting their executives’ pay. The US Federal government is also using TARP funds (and other methods of persuasion) to force many banks to either reduce risk (by unloading certain assets as quickly as possible) or even assume risk (as with how Bank of America was dragooned into consummating the acquisition of Merrill Lynch in December 2008 despite the revelation of unforeseen losses).²⁹²

Even absent the banking crisis, the growing role of the international banking industry regulatory regime known as Basel II, and its strictures on banks’ capital requirements, have had a profound impact on banks. Tied into the concept of regulatory supervision is the growing importance of a formal risk management function within banks, which now determine the parameters within which banks are supposed to lend. Yet, there is little discussion of the regulated

²⁹¹ See reports regarding the current eagerness of banks to return TARP funds – for example, Paritosh Bansal, *Regulators may not want TARP money back soon*, Reuters, Apr. 9, 2009, at <http://www.reuters.com/article/newsOne/idUSTRE5378S620090409?sp=true>.

²⁹² Dennis K. Berman, *BofA's Merrill Deal Exposes Myth of Transparency*, Wall St. J., Jan. 20, 2009, at C3

risk management framework of a bank, given the liberal description in the bankruptcy literature of debtors as risks and how the price of credit can be affected by legislative interventions. It is obvious that banks must somehow rank their debtors in terms of their risk, yet there is no discussion of how this happens, and the extent to which this affects their behavior or monitoring function in relation to debtors, over the life of the lending relationship.

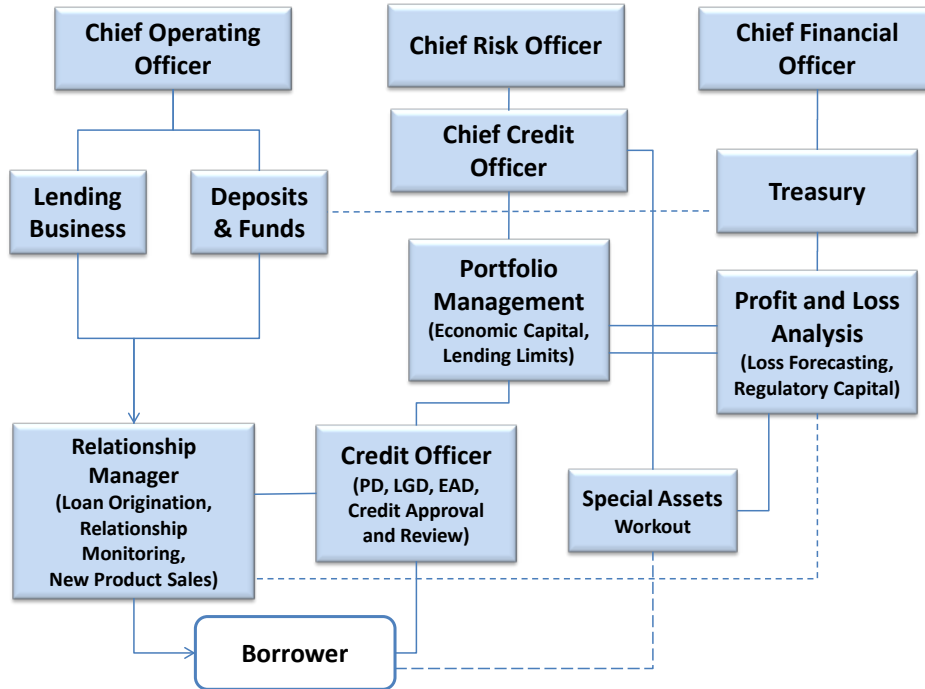
The issue of how different parts of a bank work together as assets move from the purview of one part of the bank to another and how each team deals with the assets, is not typically addressed, yet this is intimately connected with risk assessment and monitoring. To illustrate, our interview findings provided the insight that, in most banks, the department which handles bankrupt debtors (often called the workout or special assets group) usually functions quite separately from other teams, with their own incentives and compensation schemes.²⁹³ On the topic of compensation, we found that, in many cases, the compensation of bank employees who are assigned to own the relationship with a bankrupt company are not tied to the credit risk of loans originated or monitored, although the recovery risk (a key component of credit risk) is central to the function of the workout team.²⁹⁴ This raises interesting questions of whether the left hand and the right hand know what the other does, and yet most analyses seem predicated on banks as single-minded monolithic entities.

In Figure 24 below, we provide a simplified organization chart of a typical bank showing the three main decision-making units which we have referred to in this paper.

²⁹³ Workout managers may also be incentivized to liquidate, given the sheer number of cases on their desks. As a workout manager stated in response to a question regarding the high level of liquidations undertaken by his department, “many of the lenders are pushing it [liquidation] as they are trying to lighten the work load”.

²⁹⁴ Most loan officers and loan originators are not paid or compensated based on how well loans recover after default or bankruptcy. Instead their incentive bonuses are usually based on the volume of loans originated. See, generally, Sumit Agarwal & Hefei Wang, *Motivating Loan Officers: An Analysis of Salaries and Piece Rates Compensation* (Federal Reserve Bank of Chicago Working Paper, December 8, 2008), available at SSRN: <http://ssrn.com/abstract=1287689>.

Figure 24: Overview of a Typical Bank's Organization Chart



At times, the actions undertaken by banks do not seem in line with economic logic. As Federal Reserve Board Chairman Bernanke said in a speech in December 2008, “On the surface, private economic incentives to avoid foreclosure would appear to be strong for the lender as well as the borrower. Foreclosure dissipates much of the value of the property... However, despite the substantial costs imposed by foreclosure, anecdotal evidence suggests that some foreclosures are continuing to occur even in cases in which the narrow economic interests of the lender would appear to be better served through modification of the mortgage.”²⁹⁵

The rest of this chapter will provide perspectives relating to the regulatory framework of banks, their inner workings and corporate structures, and a historical and empirical perspective of

²⁹⁵ Ben S. Bernanke, *Housing, Mortgage Markets, and Foreclosures*, Speech at the Federal Reserve System Conference on Housing and Mortgage Markets, Washington, D.C. (2008), available at <http://www.federalreserve.gov/newsevents/speech/bernanke20081204a.htm>.

how banks managed credit risk. Tying these observations back into the discussion of why it matters for the bankruptcy framework, we will explore 2 main issues – firstly, the reasons why banks have a strong preference for liquidation which may be unrelated to the individual financial characteristics of the bankrupt borrower in question and, secondly, the tenuous link between credit risk (especially the recovery risk component primarily affected by diminishing lender control or reducing liquidations in bankruptcy) and the availability/cost of credit to creditworthy borrowers.

7.2 Explaining the Liquidation Preference of Banks

One of the key arguments of contractualists is that a secured creditor choosing to exert its dominant control in bankruptcy to force liquidation of a firm will do so only because it maximizes return and, when that happens, the value of the assets will be maximized through sale and reinvestment by third parties. However, this section will present three main perspectives explaining how banks' preference for liquidation during the downturn may arise from factors extraneous to the bankruptcy case, and the individual characteristics and asset value of the bankrupt borrower. These perspectives include cost of capital considerations, regulatory pressures to reduce concentrations to commercial real estate loans and procyclicality issues, thereby undermining the argument that banks will maximize value within the case in question.

7.2.1 Cost of Capital Considerations and Increasing Capital through Liquidations

One key cost in the cost-benefit calculus of banks' lending decision is seldom discussed by bankruptcy theorists, and that is the cost of capital, or any other risk-based allocation of cost, such as the cost of loan-loss provisions, to a loan.

Capital can be thought of as the equity cushion that a bank is required by regulators to have on hand so as to absorb large *unexpected* losses in its exposures.²⁹⁶ This is in contrast to its provisions for expected losses, for which banks keep an allowance on their balance sheet, formally known as the Allowance for Loan and Lease Losses, against which loan losses are charged off, and replenished by more provisions, which are taken out of net income. In order to prove to regulators that it is well-capitalized, a bank needs to show, among other things, how its capital allocation to each sector of its portfolio compares to that sector's potential for large losses.

Capital is higher than simply the sum of average losses across all loans because of what finance academics call systematic risk (which is related to the concept of beta) on the risk of the portfolio as a whole, on top of the risks posed by individual debtors. Lack of diversification on the part of the bank creates another layer of risk invisible to the individual debtors but with a large potential impact on how the bank will treat them, because that risk will end up being allocated back to the portfolio components.

Essentially, regulators want banks to be well-diversified so as to not be in danger of collapsing due to losses in any one part of its portfolio, which can be driven by correlated, or systematic, events that are specific to that sub-portfolio. A well-diversified bank will see increasing losses in some parts of its portfolio generally offset by decreasing losses in another parts.²⁹⁷ Undiversified portfolios, on the other hand, are more vulnerable to sudden shocks.

²⁹⁶ In risk management, there are 2 kinds of capital, Economic and Regulatory. Regulatory capital is an accounting-based measure of the capital regulators expect a bank to have and is used widely, and can be regarded as a minimum level. Economic capital is a measure of a bank's cushion of solvency calculated using economic models, and can be thought of as the capital required to reach a certain standard of solvency. Regulators are also very interested in economic capital levels. In calculating economic capital, a bank would measure probabilities of default, the loss on the loan if it does default, the size of its exposure at default, and an estimate of how likely its loans are to default at the same time, or how correlated its exposures are to one another. Not every bank calculates economic capital, but the larger banks do. Even if a bank does not calculate economic capital, it has to calculate so-called regulatory capital, which is closely related in terms of the kinds of inputs considered. Banks such as Bank of America, SunTrust, JP Morgan, Barclays, HSBC, Wachovia, Bank of New York Mellon, and PNC, etc, are well known to use economic capital models.

²⁹⁷ See Harry M. Markowitz, *Foundations of Portfolio Theory*, 46 J. Fin. 469 (1991).

The simple example of this is the current situation in the housing market, where banks have found themselves overexposed to the housing market. Pursuant to efforts to reduce, belatedly, their concentration in real estate loans and discourage further origination of construction loans, banks have assigned a very high internal cost to carrying real estate loans, part of which is a cost of capital.

Because generally acceptable capital levels tend to target a level around 10% of loan book value, if a bank has a large concentration in real estate, it needs to keep a disproportionately large amount of capital to cover sudden spikes in real-estate losses.²⁹⁸ For example, if real-estate loans represented 30% of a bank's loan book, and every other sector was relatively small in comparison, a bank would need to carry more than 3% capital against real estate loans. This is because each other sector's gains and losses can be generally expected to offset each other, but they are unlikely to offset in sum extreme losses on real estate loans if that sector went south, because it is so large. The 10% number is essentially an average across the whole book, so higher-than-average sub-portfolio risks (balanced by the lower-than-average ones) attract higher than 10% capital. If a bank is especially concentrated, regulators might order it to carry more than 10% capital.

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

²⁹⁸ Note that, in this example, we are assuming that the bank has to keep 10% capital and, in a fully diversified portfolio, the capital to be carried against 30% of its loan books would be 3%. Next, note that regulators often look to a bank's so-called Tier 1 and Tier 2 capital levels, relative to total assets, to judge its solvency. Statements from regulators on satisfactory capital ratios are where we get the 10% rule mentioned in the text (See statement from the Office of the Comptroller of the Currency on the definition of "Well-Capitalized" banks, <http://www.occ.treas.gov/fr/cfrparts/12CFR06.htm>). When discussing economic capital, analysts are more likely to speak in terms of probabilities of capital exhaustion. For example, if a bank wanted only a 0.02% probability of insolvency, which is equivalent to a AAA-rated issuer bond rating, then it would need a certain dollar amount of capital, and a smaller amount of capital if it was satisfied with a 0.04% probability of insolvency.

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

The cost of capital and provisions is thus part of the overall cost-benefit analysis that a bank performs when making business decisions, including making loans. That is why, for banks, it is no longer enough to speak of Return on Assets, because this ignores risk. Instead, they use Risk-Adjusted Return on Capital, which incorporates the cost of capital, concentration risk, and other kinds of portfolio-wide risk. As an illustration of how cost of capital affects the decision-making process of banks, we have included in Appendix 3 a loan pricing example provided by a regional bank showing a wide disparity in loan spreads depending on the capital ratio levels.

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

However attractive the notion of selling the debt to another financial institution, this option may not be possible during a liquidity crunch. In a downturn, liquidity will be scarce and prices low. The next best option for the bank dealing with concentration risk in its portfolio would be to end the relationship with the debtor somehow. If the debtor will not consent to ending the relationship

and refinancing the loan with some other institution, it may serve the bank's purposes to find a reason to declare an event of default, foreclose on the debtor and liquidate its assets.²⁹⁹ This would relieve the bank of its exposure to the debtor, even if it takes a short-term loss on its principal, because of the "invisible" cost of capital.

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

A bank, when liquidating a bankrupt firm, will not only receive the market price of the liquidated asset, but also save the cost of raising capital equivalent to that asset's price. Under normal conditions, this price is usually negligible, as the credit risk of banks as counterparties themselves is negligible. In a credit crunch, however, this price becomes extraordinarily high. For example, Goldman Sachs, in September 2008, right after the collapse of Lehman Brothers, sold \$5 billion of preferred stock to Warren Buffett yielding a 10% dividend a year, a rate more typically found in junk bonds during the boom.³⁰⁰

²⁹⁹ The case of Whitney Lake is an illustration of how banks acted to reduce its concentration risk in construction loans. During a 2007 meeting between Whitney Lake and one of its banks, SunTrust, the latter stated that it was exiting the construction lending business and that Whitney Lake should move its loans (almost \$30 million) to another lender within 60 days. At the time, the debtor was not in default. SunTrust then refused to advance any additional funds. Operating with reduced funding amidst the housing crisis, the debtor eventually defaulted on interest payments. For more details, see the disclosure statement approved on March 20, 2009. *In re Whitney Lake, LLC*, No. 08-05729 (Bankr. D. S. C. September 12, 2008).

³⁰⁰ Erik Holm, *For Buffett, Goldman Deal Looks like a Pot of Gold*, The Washington Post, Jul. 26, 2009, at G4.

The savings on this “capital injection” through liquidating debtors’ assets instead of borrowing money may be higher than the discounted present value of the marginal increase in the value of the debtor in re-organization over liquidation. Yet, this capital cost is entirely dependent on the health of the bank. A very healthy and well-capitalized bank with a low cost of capital would have less pressure to liquidate its distressed debtors in search of liquidity. Another way of looking at it is that banks are analyzing the return on assets for these transactions, conditional on their own survival. This issue is essentially encapsulated in the following quote from a paper on bank real estate lending and the New England capital crunch in the 1980s:³⁰¹

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

7.2.2 Regulatory Pressure to Reduce Exposures Contribute to Liquidation Preferences

Pressure to exit the real estate lending market comes not only from the need to raise capital but also regulator action linked to perceived capital adequacy issues. There is evidence, from the official correspondence and Congressional testimony, and findings from our interviews, that regulators encouraged banks to reduce their exposure to real estate-linked loans, especially

³⁰¹ Joe Peek & Eric S. Rosengren, *Bank Real Estate Lending and the New England Capital Crunch*, Journal of the American Real Estate and Urban Economics Association (1994), at 33.

construction loans.³⁰² From our empirical observations, this pressure exceeded what one would expect from normal supervision, and created a high amount of pressure on banks to exit exposures to the residential development market, in any way possible.

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

Prior to the official start of the recession, Congressman Spencer Bachus, addressing the House Sub-Committee on Financial Institutions and Consumer Credit on regulatory guidance on commercial real estate, had remarked as follows:

The [Guidance on Concentrations in Commercial Real Estate] proposal³⁰³ seeks to address high and increasing concentrations of commercial real estate loans at some banks and savings associations. The agencies suggest recent examinations show that risk management practices and capital levels of some institutions are

³⁰² The author, at the 2008 Risk Management Association Annual Conference in Baltimore where regulators were present, observed that many sessions were peppered with comments from regulators and bankers regarding concentration risk in relation to commercial real estate lending, including construction lending.

³⁰³ Board of Governors of the Federal Reserve System, *Concentrations in Commercial Real Estate Lending, Sound Management Practices*, FDIC Financial Institution Letters (2006), available at <http://www.fdic.gov/news/news/financial/2006/fil06104.html>. This was subsequently updated in 2008 - see Board of Governors of the Federal Reserve System, *Managing Commercial Real Estate Concentrations in a Challenging Environment*, FDIC Financial Institution Letters (2008), available at <http://www.fdic.gov/news/news/financial/2008/fil08022.html>. Note the supervisory limits on the Loan-To-Value ratios in construction lending in these FDIC Financial Institution Letters. An institution may "lend up to 65 percent of the value for raw land, 75 percent for land development or finished lots, 80 percent for multifamily residential construction, and 85 percent for 1- to 4-family residential construction...the institution should ensure that the borrower maintains appropriate levels of hard equity throughout the term of the loan."

not keeping pace with their increasing CRE loan concentrations. In turn, the Guidance sets forth thresholds for assessing whether an institution has a CRE concentration and should employ heightened risk management practices ... the proposed Guidance is too much of a "one size fits all" formulation and is effectively a cap on commercial real estate lending.³⁰⁴

In a recent Capitol Hill testimony hearing, Michael Menzies, the Chairman of the Independent Community Bankers of America testified to the Committee on House Financial Services that "field examiners are overzealous and unduly overreaching and are, in some cases, second guessing bankers and professional independent appraisers and demanding overly aggressive writedowns and reclassifications of viable commercial real estate loans and other assets".³⁰⁵

He also cited reports from various community bankers about examiners requiring write-downs or classification of performing loans due to the value of collateral irrespective of the income or cash flow of the borrowers, placing loans on non-accrual even though the borrower was current on payments, downgrading of solid loans simply because they are located in a state with a high mortgage foreclosure rate, etc.³⁰⁶ He ended his speech with a plea that "examiners should take a longer-term view of real estate held by banks as collateral and should not demand aggressive write-downs and reclassifications of loans based on forced sales of real estate that occur during illiquid or dysfunctional markets".³⁰⁷

³⁰⁴ *A Review of Regulatory Proposals on Basel Capital and Commercial Real Estate: Hearings before the Subcommittee on Financial Institutions and Commercial Credit, 108th Cong., 2d Sess. (2006) (opening statement of Chairman Spencer Bachus).*

³⁰⁵ *Exploring the Balance between Increased Credit Availability and Prudent Lending Standards: Hearings before the Committee on Financial Services, 111st Cong., 1st Sess. (2009) (testimony of Michael Menzies).*

³⁰⁶ *Id.*

³⁰⁷ *Id.*

Sheila Bair, who chairs FDIC, remarked in March 2008 that banks had “competed fiercely for deals, turned a blind eye to the loose terms that were available in the market,” and as a result “took on significant undiversified concentrations”³⁰⁸. When a senior regulator says that she wanted to “send a message that regulators were concerned about growing CRE concentrations” and her words of wisdom to banks is that they should “manage concentrations according to an acceptable level of risk tolerance”, banks listen.³⁰⁹ After all, FDIC has the authority to close banks that it deems to be risky and under-capitalized and did so regularly throughout 2008 and 2009.³¹⁰ In line with this regulatory focus on reducing concentration risk, the Office of Comptroller of Currency, which supervises a separate segment of commercial banks, reported in a survey of credit underwriting standards that 49% of its bank respondents reported tightening standards in commercial construction loan portfolios in 2008, as compared to 13% in 2007.³¹¹

Subsequently in August 2008, Senator Ron Wyden wrote a letter to Sheila Bair, citing that “the recent FDIC directive to member institutions to reassess the valuations of collateral underlying outstanding commercial homebuilding debt may actually be forcing financially stable borrowers into default”.³¹² He decried the regulatory practice where borrowers, whose newly-assessed construction loans failed to meet the original 35% loan-to-valuation (“LTV”) ratio, were being

³⁰⁸ Sheila C. Bair, *Remarks by FDIC Chairman Sheila C. Bair to the Independent Community Bankers Association*, Orlando, Florida (2008), available at

<http://www.fdic.gov/news/news/speeches/archives/2008/chairman/spmar0508.html>.

³⁰⁹ *Id.*

³¹⁰ FDIC maintains a depressingly long list of banks, available at

<http://www.fdic.gov/bank/individual/failed/banklist.html>.

³¹¹ Office of the Comptroller of the Currency, *Survey of Credit Underwriting Practices*, June 2008, available at

<http://www.occ.treas.gov/cusurvey/2008UnderwritingSurvey.pdf>. The main findings in the survey are: After four years of eased underwriting standards, the examiners reported net tightening of commercial credit standards for the 12 months ending March 31, 2008. The 2008 survey results indicate that more than half of the surveyed banks tightened commercial underwriting standards, more than triple the number of banks reported to have tightened in 2007. Commercial real estate lending, including construction lending, remains a primary concern among examiners given the rapid growth of these exposures and banks’ significant concentrations relative to their capital. *See also* Federal Reserve Board, Senior Loan Officer Opinion Survey, June 2008, available at <http://www.federalreserve.gov/boarddocs/snloansurvey> (citing similar findings).

³¹² See a letter from Ron Wyden (Oregon) to Sheila Bair (August 27, 2008), available at <http://www.pathtodefault.com>, addressing the potential consequences certain FDIC policies were poised to inflict upon Oregon’s home building industry and small financial institutions and requesting consideration of alternative approaches that may lessen these impacts.

forced to pay the financial institutions an amount necessary to bring the loans into compliance with the original LTV ratios.³¹³ Many borrowers may be unable to meet these new financial requirements owing to the severe recession and may be forced into insolvency, in which event the lending banks will then assume ownership of the collateral housing inventory. In such a regulatory environment, it is unlikely that banks will have room for patience for the re-organization of bankrupt homebuilders, even if the long-term value is higher, and regardless of the vehement objections of other stakeholders.

Approximately 1,020 comment letters were sent in response to the regulatory guidance on “Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices”, of which the majority were protests by community banks that the prescribed capital limitations would lead to a significant reduction in commercial real estate lending, especially construction lending (see a sampling of these comments in Appendix 2.1. The evidence thus suggests that banks may choose to exit the construction loan market, under regulatory pressure and one of the swiftest ways includes liquidating bankrupt companies (regardless of firm viability), so as to present a “cleaner”-looking balance sheet. This upsets a major line of reasoning underlying giving banks dominant control over the bankruptcy process, since the economics and concerns underlying their decisions in a bankruptcy are not purely predicated on the merits of the case.

7.2.2 Inherent Procyclicality in Bank Lending

Much of what we have observed in the last few sections has been driven by the economic downturn. In this section, we will expound further on why bank behavior (and in particular, their lending and risk management strategies) is particularly sensitive to the economic cycle, perhaps much more sensitive than the typical hypothetical rational long-term profit maximizing entity.

³¹³ *Id.*

However, the literature appeared not to have taken into account the different implications of bankruptcy policy in different parts of the economic cycle.

The conventional portrayal of bank behavior in bankruptcy literature overlooked the fact that banking behavior can not only be cyclical but highly pro-cyclical, i.e., it can exacerbate the cyclical behaviour of the real economy.³¹⁴ In a nutshell, during good times, banks incur more risks than they reasonably should through, for example, excessive lending with poor standards; in bad times, they change lending policies reducing drastically the loans to the economy and exacerbating the downturn.³¹⁵

Empirical evidence generally suggests that banks tighten lending standards during a recession and loosen lending standards in an expansion – see the three charts provided below.³¹⁶ A 2003 study focusing on a behavioral view of lending practices found evidence for a “memory hypothesis” under which the ability to differentiate accurately between high-risk and low-risk debtors deteriorated over time as loan officers forget the lessons of the last recession with large credit losses. When the bank again experienced large losses, standards are tightened drastically, and the cycle begins again.³¹⁷

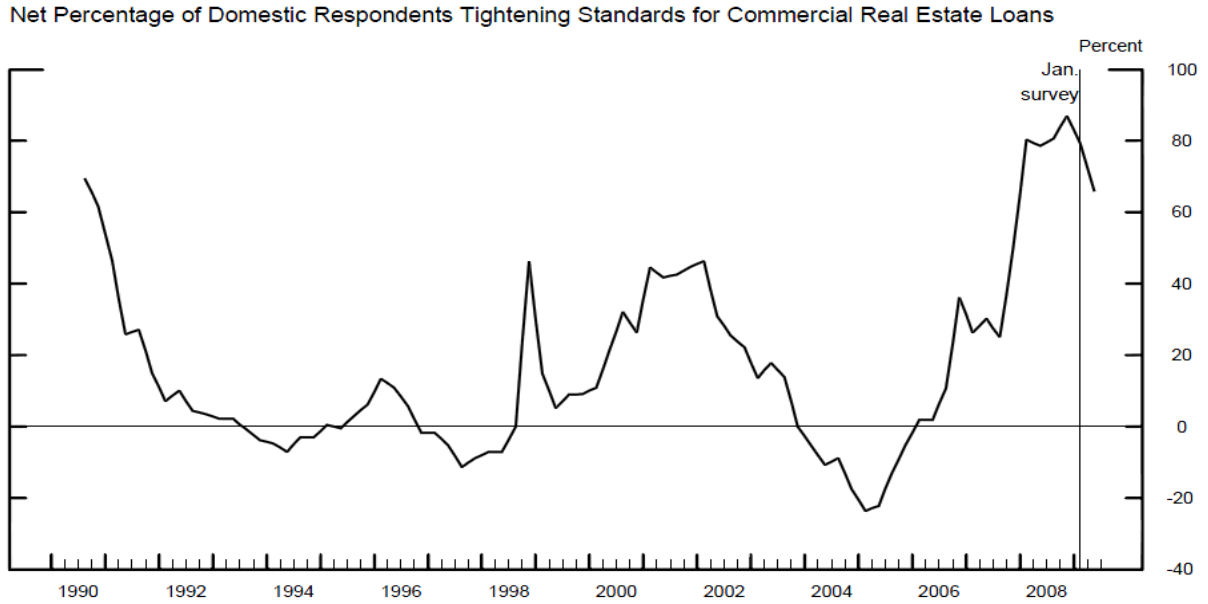
³¹⁴ Miguel Fernández Ordóñez, *Procyclicality in the Banking Activity*, BIS Central Bankers' Speeches, May 2009, available at <http://www.bis.org/review/r090507c.pdf>.

³¹⁵ Id.

³¹⁶ Michael B. Gordy and Bradley Howells, *Procyclicality in Basel II: Can We Treat the Disease Without Killing the Patient?* (Federal Reserve Board Working Paper, 2004), available at http://www.bis.org/bcbs/events/rtf04gordy_howells.pdf.

³¹⁷ Berger, Allen N. and Gregory F. Udell, *The Institutional Memory Hypothesis and the Procyclicality of Bank Lending Behavior* (Bank of International Settlement Working Paper No. 125, 2003), available at <http://www.bis.org/publ/work125.pdf>.

Figure 25: Proportion of Banks Tightening Standards for Commercial Real Estate Loans



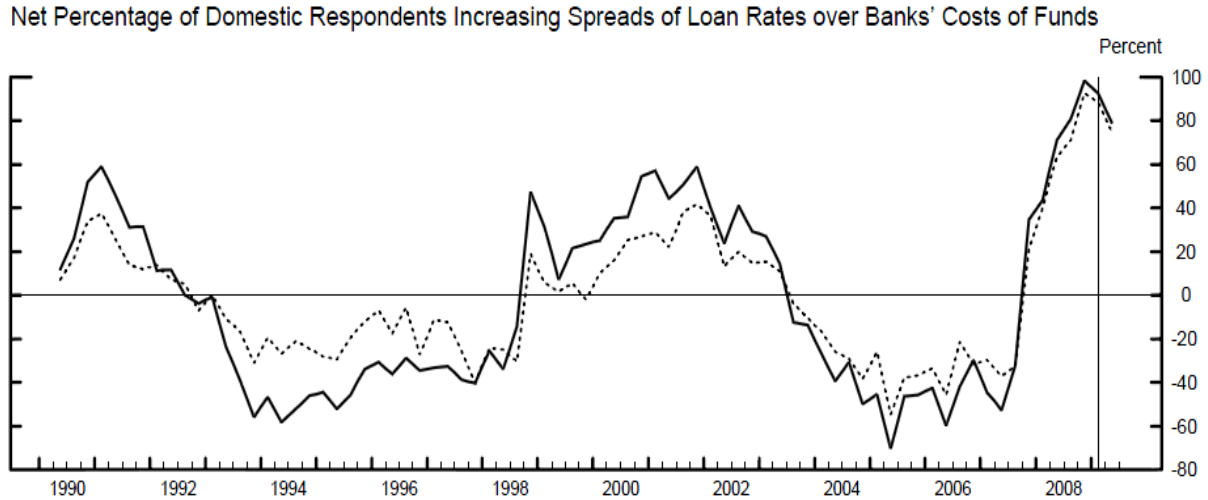
Source: Federal Reserve, April 2009 Senior Loan Officer Opinion Survey on Bank Lending Practices

Figure 26: Changes in Underwriting Standards in Commercial Construction Loan Portfolios (Percent of Responses)

	Eased	Unchanged	Tightened
2003	2	61	37
2004	10	75	15
2005	29	63	8
2006	32	56	12
2007	28	59	13
2008	8	43	49

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

Figure 27: Proportion of Banks Increasing Spreads of Loan Rates over Costs of Funds



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

After several years of increasingly accommodative credit terms, the financial market disruption in 2007 caused an abrupt change in risk appetite and a renewed focus on fundamental credit principles by bank lenders. Banks and other investors have suffered major losses resulting from the disruption in their ability to distribute both commercial and retail credit exposures during the past year. The subsequent tightening of credit underwriting standards – higher credit spreads, more financial covenants, less borrower leverage – is the expected response to the mark-to-market losses on the held for sale portfolio as well as more thorough scrutiny of the credit risk of banks by regulators and investors. It has been argued in finance literature that an additional material source of financial procyclicality is the inappropriate responses by financial market participants to changes in risk over time, difficulties in measuring risks and incentives to react to risk, even if correctly measured, in ways that are socially suboptimal.³¹⁸

³¹⁸ Claudio Borio, Craig Furfine and Philip Lowe, *Procyclicality of the financial system and financial stability: issues and policy options* (Bank of International Settlement Working Paper No. 1, 2001), available at <http://www.bis.org/publ/bppdf/bispap01a.pdf>.

Actually, procyclicality in bank behavior also stems from capital requirements that tend to be lower when times are good (banks' capital requirements are lower when debtors' risks appear minimal during good times), and capital requirements that are much higher when times are bad (as debtors all start to look risky). Indeed procyclicality has been one of the most controversial issues during the discussion of Basel II regulatory proposals.³¹⁹ Basel II, in its original conception, represents a more risk-sensitive capital framework whereby, as credit conditions change, minimum requirements change correspondingly. Specifically, under the Basel II Advanced Internal Ratings-Based approach, capital requirements constitute an increasing function of the primary credit risk drivers (namely, probability of default, loss given default and exposure at default). During the downturn, these risk drivers would deteriorate, leading to greater capital requirements; and the converse is true during upswings such that banks keep less capital during good times.

This could have an undesirable effect on the overall economy if banks, according to a more risk-sensitive regulatory capital system, are obliged to significantly alter their lending behavior across the economic cycle.³²⁰ Economic agents (basically households and firms) will experience serious difficulties in recovering under these adverse economic conditions. This means that the most unfavorable part of the business cycle may become more accentuated where banks cut down on credit, aggravating the general economic situation and magnifying the economic downturn. The

³¹⁹ See, e.g., Claudio Borio, Craig Furfine and Philip Lowe, *Procyclicality of the financial system and financial stability: issues and policy options* (Bank of International Settlement Working Paper No. 1, 2001), available at <http://www.bis.org/publ/bppdf/bispap01a.pdf>, Linda Allen & Anthony Saunders, *Incorporating Systemic Influences into Risk Measurements: A Survey of the Literature*, 13 *Financial Markets, Institutions & Instruments* 2, Jeffery D. Amato & Craig H. Furfine, *Are Credit Ratings Procyclical?*, 28 *Journal of Banking & Finance* 2641 (2004), Anil K Kashyap & Jeremy C. Stein, *Cyclical implications of the Basel II capital standards* (Federal Reserve Bank of Chicago Working Paper, 2004), available at <http://faculty.chicagobooth.edu/anil.kashyap/research/basel-final2.pdf>, Jesus Saurina Salas & Carlos Trucharte, *An Assessment of Basel II Procyclicality in Mortgage Portfolios* (Banco de España Working Paper No. WP-0712, 2007), available at <http://ssrn.com/abstract=989285>, William R. White, *Procyclicality in the Financial System: Do We Need a New Macrofinancial Stabilisation Framework?* (Bank of International Settlement Working Paper No. 193, 2006), available at <http://ssrn.com/abstract=891765>.

³²⁰ Ashley Taylor & Charles Goodhart, *Procyclicality and volatility in the financial system: The implementation of Basel II and IAS 29, 2004*, (Financial Markets Group and London School of Economics Preliminary Draft, 2004), available at http://ashleytaylor.org/procyvol_draft_sep2004.pdf.

opposite will occur in the benign part of the business cycle, leading to dramatic swings in the economic cycles.³²¹

This observation is borne out by the current crisis, where the U.S. government has been forced to encourage, cajole, and even threaten banks into keeping up a flow of credit.³²² Clearly, banks are not pricing at origination for a probable but future point where economic downturns will cause default rates to increase. If any single bank did, they would be under-cut on price by banks which neglected to “prepare for a rainy day”. One of the findings from the interviews and comment letters is that banks frequently complained about how regulations relating to risk management can place them at a competitive disadvantage. For example, Zions Bank stated in a 2006 letter to bank regulators stating that Basel II capital requirements “will be updated continuously as new default, exposure, and loss given default data are incorporated into the quantitative analysis. In times of low losses, the capital required by Basel II banks will drift lower...in good times large banks will operate at an increasing competitive advantage in various types of lending compared to community and regional banks, and will squeeze them out of the market or into lower quality credits.”³²³

A key item on the Basel II agenda among regulators now is about how to regulate capital in a counter-cyclical way, and force banks not to under-price credit during times of economic expansion.³²⁴ If banks have to be heavily regulated in this respect, it can hardly be argued that they might insist on increasing borrowing costs for a marginal increase in risk in secured debt. Unfortunately, the eventual result of under-pricing credit is the urge to overprice it afterwards when a chain of defaults starts to occur. This hangover is what truly restricts credit.

³²¹ Id.

³²² See, e.g., Michael R. Crittenden and David Enrich, *TARP Cash Isn't Moving Forward*, Wall St. J., Apr. 16, 2009, at <http://online.wsj.com/article/SB123981607918021761.html>.

³²³ Zions Bank, *ANPR on Revising Domestic Capital Adequacy Guidelines*, Public Comment Letter, 2006, available at <http://www.fdic.gov/regulations/laws/federal/2005/05c37basel1a.pdf>.

³²⁴ *Cycle Clips*, The Economist, May 15, 2008, at http://www.economist.com/displayStory.cfm?story_id=11325492. The article also has some good observations on the relationship between regulators and banks: ““What you have to do every so often”, says a former regulator, “is pick a performance measure of some kind, line the banks up and shoot the dog. The rest will quickly cower at the other end of the row.” “

As large numbers of distressed banks, seeking liquidity, foreclose on homeowners and force properties onto the market, increasing supply and depressing prices, the net result is actually that the marked-to-market value of many bank's assets will fall correspondingly³²⁵ – a precursor to bank failure. In a way, this posits a social dilemma, in which individuals acting independently in their own self-interests cause a problem that cannot be self-corrected by action of a market, because the damage is shared mainly among those which act later. One remedy is government action which can incorporate the positive externality of slowing foreclosures and liquidations through legal reforms, although it is possible that privately, banks might come together to negotiate a co-operative solution, but this is not likely as they will suffer from free-rider problems, and are also unwilling to reveal too much information on their individual situations to their competitors.

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

7.3 The Tenuous Link between Credit Risk and Borrowing Costs

Many of the arguments made by lenders' advocates and underlying contractualist approaches center around the reaction of banks to the perceived riskiness of debtors, and how laws that limit creditor remedies against debtors can significantly affect the price and availability of credit, thereby passing on regulatory costs to the consumers of credit. Actually, the perspectives in Section 7.2 have already helped counter a substantial part of these arguments – if banks have a liquidation preference grounded outside the credit risk of specific transactions and the individual borrowers,

³²⁵ Note that FDIC data shows that, as of December 31, 2008, commercial banks have an average of 44% concentration in real estate loans – see Federal Deposit Insurance Corporation, FDIC Quarterly Banking Profile (2008), available at <http://www2.fdic.gov/qbp/grgraph.asp>.

then legislative intervention to mitigate the proportion of liquidations and foreclosures should logically not increase the inherent risk of these credit transactions.

Moreover, there is not much discussion of whether banks are able or willing to increase their prices in a competitive landscape when an economic upswing occurs, or discussion of that competitive landscape itself. One observation is that regulatory attempts to increase the amount of capital that banks are required to hold against riskier assets and strengthen underwriting standards were generally met with objections from the banks themselves. Instead of arguing that the regulatory costs would be passed on to consumers, interviews and comment letters show that banks usually claim that they would be unable to increase pricing to pass along increased capital costs owing to competitive pressures. A colorful remark made by a community banker complains about having to compete with loans “funded by the WaMus of the world at ridiculously low fixed rates that we can't meet.”³²⁶ As we know, Washington Mutual (“WaMu”) eventually failed.

The twist to this story is that if it were true that small banks could not compete with large banks on price, the logical conclusion would be that more small banks would be bought up by large national banks with more economies of scale to survive lower margins, leading eventually to much larger national financial institutions that would then be “too big to fail” and large amounts of systemic risk, a complaint laid against big banks which have both required billions of dollars of government support in the past year. It is also possible that if enough banks systematically underpriced risk to gain market share, again leading to systemic risk, then in general banks would be very reluctant to raise the price of risk due to competitive pressure (no matter how “irrational”, for as JM Keynes famously said, the market can remain irrational longer than you can remain solvent).

³²⁶ America California Bank, Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices, Public Comment Letter, 2006, *available at* <http://www.fdic.gov/regulations/laws/federal/2006/06c06crelending.html>.

Competitive pressures aside, we note that while the bankruptcy literature does attempt to take into account legal costs, transaction costs, opportunity costs, the loss on the loan owing to the failure to recover principal and accrued interest in full, etc, it paints an incomplete picture. This section attempts to mend the gap through a discussion of the sources of profit for banks, how banks manage and monitor credit risk through an overview of the systems that banks employ at the level of individual debtors and loans, and how profit considerations may distort risk assessments. In other words, how does risk enter the bank's notion of profitability?

7.3.1 The Source of Growth in Bank Profits: Fees and Securitization Deals

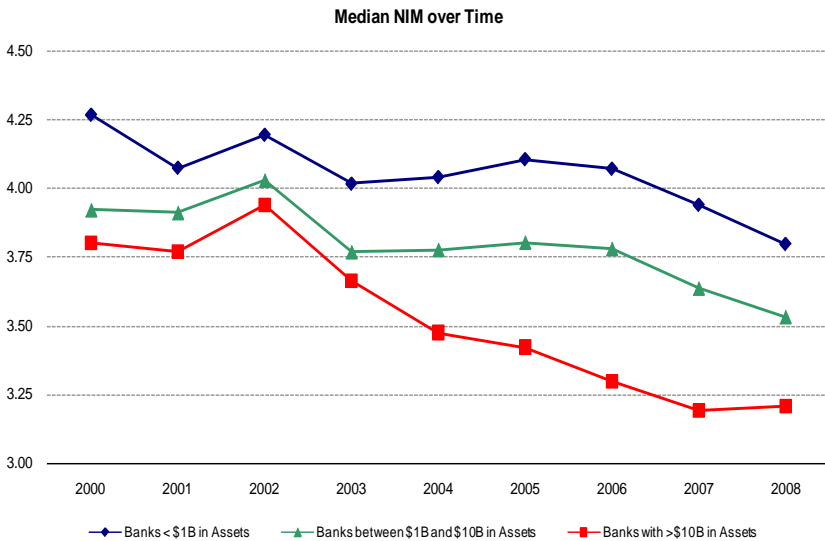
Theories about the role of secured credit in Chapter 11 generally do not take into account the cost/benefit ratio of the whole relationship, only the secured credit transaction itself. Yet, internal analysis performed by several banks, according to our interview findings, has shown that the interest earned by the bank on loans by themselves often do not pass the bank's hurdle rate for return on the sum of risk-adjusted capital, provisions, and funding costs used to fund the loan. A key observation from our interviews is that what banks rely on to make a loan profitable are the deposit accounts that a debtor is often required to keep with its major secured creditor (a source of low-cost funding for the bank), and the upfront closing fees and administrative fees that banks charge to arrange loans. In fact, the once-phenomenal growth of loan securitization confirms this.

Earnings from interest are seldom substantial, when compared to the various types of loan closing fees. Figure 28, compiled from FDIC data on commercial banks, illustrates the decline of Net Interest Margin ("NIM") for banks. NIM is the difference between interest income generated by earning assets, such as loans, and expenses incurred on interest-bearing liabilities, such as deposits and borrowings. According to a FDIC report, NIMs have been under pressure for some time (it was

4.69% in 1992), partly as a result of increased price competition within the banking industry, from nonbanking firms that offer bank-like products and marketplace innovations.³²⁷

This means that, once a loan is originated, the most profitable part of the relationship, the loan closing fees, would be over and those fees would not be paid again. Given this situation, it provides a strong incentive (during the boom) to close the deal at market rates, instead of haggling over a truly risk-based interest rate, and offload the loan after origination.

Figure 28: Net Interest Margins of U.S. Banks over Time



Source: Compiled from FDIC Data.

Indeed our interview responses have revealed a brilliant move by banks during this downturn to originate loans to new buyers of properties which it had previously foreclosed upon (the so-called Other Real Estate Owned (“OREO”) assets), thereby improving profitability through fees. The Commercial Bank Examination Manual published by the Federal Reserve Board expressly allows banks to promote the sale of foreclosed real estate by offering nonrecourse financing to

³²⁷ Federal Deposit Insurance Corporation, *Does Net Interest Margin Matter to Banks?*, FDIC Outlook, 2004, available at <http://www.fdic.gov/bank/analytical/regional/ro20042q/na/infocus.html>.

buyers.³²⁸ In the section on OREO, it was stated that “[b]anks may facilitate the sale of foreclosed real estate by requiring little or no down payment, or by offering loans with favorable terms”.³²⁹

In addition, banks have, over the years, used securitization as a means to transfer off their books the credit risk of loans and adjust capital held under the regulatory framework. The phenomenon of loan securitization is worth discussing at this point. A plank of the contractualist argument is that banks insist on covenants and other rights to monitor, restrain and control how a firm uses its assets because they are trying to preserve collateral value, even prior to bankruptcy.³³⁰ If so, the popularity of loan securitization right up to 2007, with Wachovia and Bank of America buying what turned out to be ticking time bombs in the forms of Golden West and Countrywide Financial expressly to feed their loan securitization activities in creating Collateralized Debt Obligations (CDOs) and Collateralized Loan Obligations (CLOs), must stand as a counter-argument.

Once securitized, loans are usually off the books of banks and they need to worry far less about them, even if the bank retains a tranche of the CDO or CLO structure. The monitoring ability of the owners of the CDO / CLO tranches is compromised because the collateral agent is usually a separate entity, and these agents often do not have the apparatuses and large staff that actual banks have in undertaking workouts. Even when a bank is the collateral agent, it is the investment banking part of the bank which is involved (typically functioning as a separate entity), not the commercial banking part.

³²⁸ Federal Reserve Board, *Commercial Banking Examination Manual*, 2008, available at <http://www.federalreserve.gov/boarddocs/supmanual>.

³²⁹ Id. Note that the commercial banking examination manual noted that profit should only be recognized in full when the collectability of the sales price is reasonably ensured and when the seller is not obligated to perform significant activities after the sale to earn the profit. Collectability should be assessed by considering “factors such as the credit standing of the buyer, age and location of the property, and adequacy of cash flow from the property”. Since collectability not only depends on the value of the collateral, but also the credit risk of the buyer, the bank is essentially substituting the probability of default of the new buyer for the already-high probability of the former owner (owing to the default), thereby improving the level of Risk-Adjusted Return on Capital.

³³⁰ Lubben, *Derivatives*, *supra*, note 64.

In fact, in a 2008 speech by Federal Reserve Board Chairman Bernanke, he commented on the apparent market failure owing in part to the widespread practice of securitizing mortgages, saying that “[it] typically results in their being put into the hands of third-party servicers rather than those of a single owner or lender. The rules under which servicers operate do not always provide them with clear guidance or the appropriate incentives to undertake economically sensible modifications...More generally, the sheer volume of delinquent loans has overwhelmed the capacity of many servicers, including portfolio lenders, to undertake effective modifications”.³³¹

Another implication of the above observations is that the monitoring function of banks, which is important to the idea of efficiency of secured credit as a source of corporate governance, is not a straightforward one. Therefore, theories that the benefits of monitoring, mentoring and restraint by the banks of debtors would flow to all stakeholders, including unsecured creditors, “ensuring that the ship that carried their common financial destinies would have a better chance remain afloat”³³² cannot be accepted at face value.

7.3.2 Credit Risk Management at Banks: The Unvarnished Version

An examination of the link between credit risk and the price and availability of credit would be remiss without a discussion of credit risk management in banks and its problems. In this section, we present empirical evidence of the wide variations in underwriting standards, the inadequate design and implementation of risk management systems at banks, and the incomplete tracking of historical loan data and default loss histories.

A major reason it is important to expound on these issues is the fact that the risk assessment of construction and development loans extended to residential developers and home builders is not straightforward – they are neither consumer loans (for which banks can easily

³³¹ Bernanke, *supra*, note 295.

³³² See Robert E. Scott, *A Relational Theory of Secured Financing*, 86 Colum. L. Rev. 901(1986)

change risk-based pricing through the use of FICO scores, the typical credit risk metric) or large corporate loans (for which agency ratings or standard models are available). As gleaned from the asset distribution of our data sample, outside the 11 “mega cases”, (see Chapter 3), most of these are “middle market” loans.

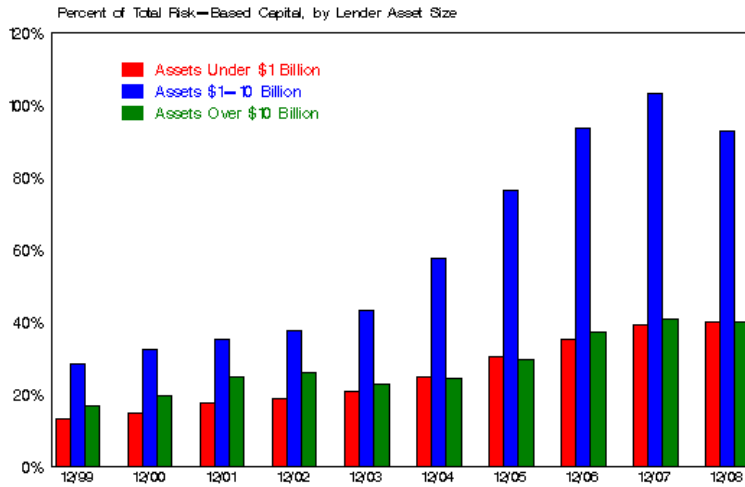
Next, at first glance, these perspectives may seem at odds with observations from our interview findings that some banks (usually the big banks) have spent a great deal on risk management, especially in implementing Basel II and other upgrades relating to that framework. However, as the recent results from the governmental Supervisory Capital Assessment Program of 19 major banks showed, 10 banks were shown to be insufficiently capitalized.³³³ In terms of their construction loan portfolios, these ranked ahead only of subprime mortgages, credit cards, and 2nd lien mortgages in terms of loss rates.

These findings provide circumstantial evidence that even big banks have underestimated the likelihood, or probability, that these kinds of loans would default, as well as the loss they would experience after the default. We will also show further on in this chapter that even these bigger banks have problems tracking historical loan default events and loss rates, presumably essential information being the outcomes of resolution of defaults and bankruptcies (i.e., products of the legal process).

Moreover, as we will show later in this section, the smaller banks have repeatedly admitted to not having sufficient resources to undertake similar risk management assessment or adhere to certain underwriting standards. As the Figure below shows, these smaller banks do have large exposures to construction and development loans.

³³³ Federal Reserve Board, *The Supervisory Capital Assessment Program: Overview of Results*, 2009, available at <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20090507a1.pdf>.

Figure 29: Median Construction and Development Loan Concentrations in Commercial Banks (1999-2008)



Source: Federal Deposit Insurance Corporation

Furthermore, these actually constitute the main constituency which initially resisted calls from regulators to pull back from construction lending in 2006 as the market began to show signs of weakening – see empirical evidence compiled from a sampling of comment letters in Appendix 2.1. Most of these comments smacked of over-confidence and suggested that these banks resisted more than token investment in risk management. Before proceeding to the details, we leave the reader with a quote from a 2006 comment letter by Silverton Bank (the failed bank discussed in the Shores of Panama case study) in response to the proposed regulatory guidance on “Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices”:³³⁴

Based upon experience, historical loss factors, and general state of capital throughout the banking sector, we are not persuaded that there is sufficient evidence to justify the Agencies in imposing, on all insured institutions, an arbitrary

³³⁴ Bankers’ Bank (now known as Silverton Bank), Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices, Public Comment Letter, 2006, available at <http://www.fdic.gov/regulations/laws/federal/2006/06comcrelending.html>.

requirement that financial institutions maintain additional capital to support concentrations in commercial real estate loans. We view the Guidance to single out commercial real estate for no reason other than media coverage, inconsistent economic forecasts and isolated instances at a nominal number of banks... We are unaware, however, of any financial institution failure over the past decade that has been attributable to a concentration of credit in real estate or in any other economic sector. To the contrary, it is our understanding that the principal underlying causes of bank failures over the past fifteen years have been fraud, abuse, or other unlawful conduct, on the part of bank management and, on occasion, bank customers.

7.3.2.1 Wide Variations in Underwriting Standards

One possible counter to arguments asserting that laws which limit creditor remedies will drive up the cost of credit and reduce its availability to needy borrowers is the cyclical fluctuation of lending standards and wide variations in underwriting practices of different banks. Being such nebulous creatures, underwriting standards can be difficult to link to the price and availability of credit, especially in relation to middle-market loans where there are no benchmark risk indicators such as FICO scores and agency ratings.

Evidence for the wide variations in underwriting standards came recently in the form of the results of the Supervisory Capital Assessment Program of 19 major banks. It was reported that approximately 200 examiners poring over the banks' portfolios have found widely differing standards for loans, leading them to focus on loan quality in the reviews.³³⁵ In addition, we observed a similar finding from banks' comment letters – see a sampling of these in Appendix 2.2.

³³⁵ Craig Torres, *U.S. Regulators Put Emphasis on Loan Quality in Tests*, Bloomberg, Apr. 21, 2009, at <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=atVfnBjVKZ00>.

7.3.2.2 Inadequate Design and Implementation of Credit Risk Management Systems

This sub-section of the paper provides a general overview of some major problems in relation to the design and implementation of a sound credit risk management systems. Among the key problems plaguing many banks are poorly-calibrated risk rating systems, resistance by smaller banks against systematic rating and stress-testing methodologies prescribed by regulators.

Banks, especially the larger ones, often treat debtors not so much as individual risks but as a member of a class of debtors whose risk is calculated from the average of that particular class, unless the debtor represents a particularly large exposure for the bank relative to its entire portfolio of loans. Therefore, if a debtor's absolute probability of bankruptcy is changing but its membership of a risk class remains the same, its risk, to the bank, can be the same until the bank re-classifies the debtor or the risk profile of that class is re-evaluated. This approach saves banks time but not necessarily money (even if time is money), particularly if it is slow to reclassify failing debtors.

The implementation of the 'risk averaging' approach is through a rating system. Essentially, all debtors are placed into one of around seven to twelve grades, also known as risk ratings, depending on the bank. These are completely analogous to the ratings of rating agencies on bonds, such as AAA or BBB. However, as we will show, banks' internal ratings are somewhat inferior to even the agency ratings (which are now being widely derided as having been unable to predict the current crisis) and have far less granularity and precision.

To generate these ratings, most banks in the U.S. now follow a *scorecard* system based on regulatory guidance.³³⁶ Essentially, front-line lenders, the people who meet the debtors and

³³⁶ For a discussion of the kind of scorecard system used by banks, *see, generally*, Department of Treasury, Office of the Comptroller of Currency, Office of Thrift Supervision, Federal Reserve Board, Federal Deposit Insurance Corporation *Proposed Supervisory Guidance for Internal Ratings-Based Systems for Credit Risk Advanced Measurement Approaches for Operational Risk, and the Supervisory Review Process (Pillar 2) Related to Basel II Implementation, Federal Register Notice* (2007), available at <http://www.fdic.gov/regulations/laws/federal/2007/07basell.pdf>.

negotiate the loan, are supposed to use a common scorecard generated by risk managers to generate a rating. Having a common scorecard (with different scorecards for different kinds of borrowers) among the lenders is how the bank ensures that it is rating the risk of its obligors in a way that is consistent across different loan officers.

Figure 30 demonstrates how three different loan officers, who, if asked to rate loans completely subjectively and based on their own experience, may arrive at different rank-orderings and risk assessments compared to the bank average. Each officer's ratings are distinguished by color. A scorecard system, which asks loan officers to answer specific questions about the borrower and then awards points depending on a pre-set system, reduces the scope for this.

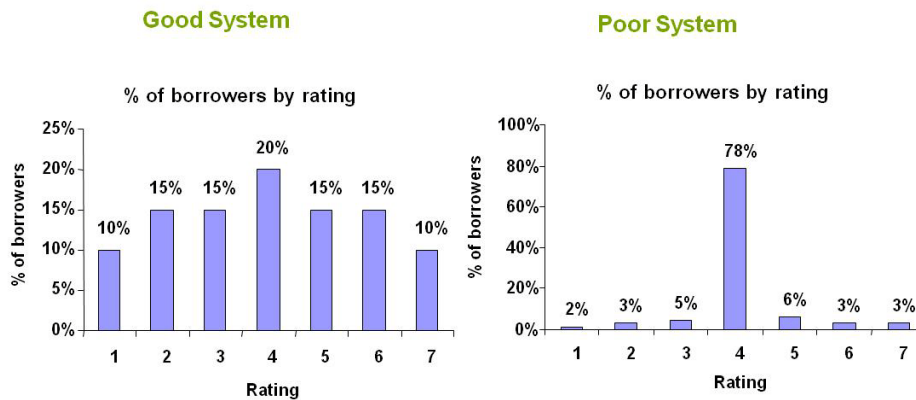
Figure 30: Rank Ordering of Credits by Loan Officers



Source: Courtesy of Financial Services Consulting Department, SunGard, Inc.

Risk managers, as a department, are supposed to design the scorecard such that it is capable of differentiating between higher and lower risks between borrowers. The demonstrable ability of risk rating scorecards to create differentiable classes of borrowers is a particular focus of regulators and regulatory frameworks such as Basel II. Figure 31 shows an example of the kind of rating distribution that is found desirable, compared to one that is not.

Figure 31: Comparing the Distribution of Borrowers in Different Buckets in Rating Systems



Source: Courtesy of Financial Services Consulting Department, SunGard, Inc.

The graph on the left above shows a fairly bell-shaped distribution of risks within the portfolio of loans, with about 10% of the bank’s loans being of very high quality, or the best rating (best being the lowest numeric rating) and 20% of the loans being of the middling rating.

A poor system of risk rating would be one on the right, which is quite incapable of distinguishing risk such that all the bank’s loans were in the middle, implying either that the bank was magically able to lend only to borrowers of exactly the same kind of riskiness, or that the lenders were unwilling (or unable) to make a stand that a debtor was highly risky or very safe. Such a rating system as one on the right reduces a bank’s ability to price according to risk. And yet, our interviews show that numerous banks still acknowledged having a poor rating distribution, and that jokes about the “middle finger” in their portfolio risk ratings distribution were still legion.

The implication is that these banks tended to have a binary approach to increasing risk: either a debtor was safe, or else it started missing payments, upon which the banks had no choice but to send it to the workout team. There is little gradation of response, which is what one would expect if banks were truly pricing to risk. Bankers even have a name for it: “Managing by Exception”. Essentially, the bank will ignore debtors until they make themselves conspicuous by breaching a covenant or missing a payment.

A contemporary example is provided by the recent seizure of The Community Bank of Loganville by FDIC, which had total assets of \$681 million and deposits of \$611 million. In an interview with the Wall Street Journal, Stanley Kelley, owner and chairman of the bank said that “he didn't realize business was so poor until bank examiners showed up late last year.” The bank’s third-quarter 2008 report to regulators “showed that nearly 40% of its loans, most of which were for home construction, were delinquent or uncollectible. The big hit came when two big developers he was financing sought bankruptcy protection” and it “was the first time it occurred to [him that the bank] might not be able to recover”.³³⁷

The practice of managing by exception, as well as the fact that banks are just not differentiating risk very well, is a blow to contractualist theories that secured creditor control entails strong elements of corporate governance. These theories are probably more relevant to the very largest debtors and loans in a bank’s portfolio, where the concentration risk that they represent is such that the bank cannot afford to manage by exception. The theory that reducing banks’ rights as secured creditors will increase pricing because of the elevated debtor risk is weakened, if banks do not really differentiate risk well such that loan origination and pricing thresholds can also be differentiated.

Furthermore, since the advent of the Basel II regulatory framework, regulators have encouraged management teams, including those which are not opting in for Basel II, to develop scorecards which require more specific and objectively verifiable pieces of information. This allows them to use the default experience of the bank as data that can be used to feed risk management models to calculate default risk and the appropriate risk rating for borrowers. In fact, regulatory supervisors are increasingly demanding that banks are capable of demonstrating that these rating methodologies have been back-tested on data to prove their ability to differentiate higher and

³³⁷ Gary Fields, *Tough Times for Town Fathers*, Wall St. J., Apr. 10, 2009, at A1, and Joe Rauch, *Community Bank of Loganville Seized By Federal Regulators*, Atlanta Business Chronicle, Nov. 21, 2008, at <http://www.bizjournals.com/atlanta/stories/2008/11/17/daily102.html>.

lower risks. Owing to the high level of resources that a bank may have to pour into such scorecard development exercises, several of the smaller banks which we have interviewed are still showing resistance against moving towards such systematic rating methodologies.³³⁸

Moreover, in relation to the regulatory guidance on “Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices” (as discussed earlier), regulators intended for banks to properly measure and control commercial real estate risk by performing stress-testing. Banks were encouraged to analyze the portfolio by property type, geographic area, market analysis, appraisals at origination and subsequent valuation, loan structure, etc. Many smaller banks showed fierce resistance to these – see a sampling of comment letters in Appendix 2.3.

7.3.2.3 Incomplete Tracking of Historical Default and Loss Data

Another major issue in relation to banks’ risk management is that, even for those banks which have accepted that they would adopt systematic risk rating and stress-testing methodologies; their data on debtors is often incomplete and not available in sufficient quantities for rigorous analysis. Although banks have had electronic records for their loan accounting system for many years, many of them, even the largest, did not upgrade from paper files to an electronic system for their debtor risk information systems until the last five years.³³⁹

³³⁸ In an interview with the director on the board of a community bank in California, the response as to why a data-driven methodology for evaluating debtors was not adopted was provided as follows: “Although we are a conservative bank, we make loans to some whose quantitative characteristics might seem risky. Yet, we make the loan because we have known the lender or the lender’s family quite well and are confident that they will find a way to repay even under adverse circumstances. Thus, I do not believe that we have “inadequate risk management processes.” Our record confirms this. We use a great deal of “know-your-customer” judgment as well as financial analysis on a case-by-case basis...Given this, I am not sure what role a database would play.”

³³⁹ To be fair, there is a segment of commercial banks developed sophisticated risk ratings system to monitor credit deterioration prior to default, but they remain in the minority owing to the substantial investments in infrastructure to allow for the capture of electronic records, the linkage of loan accounting system and financial statement database, the construction, validation and calibration of data-driven risk rating

In fact, our interviews revealed that a large bank in the Northeast, which is one of the thirty largest banks in the U.S., did not implement electronic records for debtor financial statements until 2005. This means that they do not even have electronic data from the last downturn in the economy. It is not likely that they are able to build statistically validated risk rating scorecards that can capture the effect of downturns on their debtors with such a short history.³⁴⁰ Indeed, even Citibank in 2007, in response to regulatory exhortations to retain data beyond the minimum required period for risk management models, commented that it “might not be feasible and can be very expensive, as several systems do not have 5 years of historical data readily available. Going back into tapes and archives to apply new improvements can be extremely costly.”³⁴¹

A major area in relation to the incompleteness of data relates to that of Loss Given Default (“LGD”).³⁴² This is supposed to be the loss relative to principal that a bank might experience where a debtor defaults or files for bankruptcy. Simply put, this is one of the most important metrics for the part of the bank which directly participates in bankruptcy proceedings, given that it is the key outcome of the legal process itself. Where many banks are shown not to care very much about this metric, it is difficult to make arguments that limiting secured lender control and thereby affecting the level of LGD will lead to significant changes in credit policy.

It should be noted that LGD is multiplied by the Probability of Default, which is a function of the risk rating, to obtain an Expected One-Year Loss (“EL”) that is supposed to be subtracted from the expected profit. Technically, regulators today expect banks to calculate their EL. While it is not a requirement to use EL in decision-making, or to calculate profitability, EL is similar to a nominal

scorecards, and quantitative portfolio management models taking into account correlations of credits. Note that these are in the minority.

³⁴⁰ Statistical rating models built on data that primarily comes from a good part of the economic cycle, without data from a bad part of the economic cycle, will tend to under-predict risk.

³⁴¹ Citigroup, *Basel II Supervisory Guidance*, Public Comment Letter, 2007, available at <http://www.fdic.gov/regulations/laws/federal/2007/07c14BASELII.pdf>.

³⁴² Fields, *supra*, note 336.

cost of risk. Despite the importance of this metric, most banks do not have any data to truly model LGD beyond simple averages largely based on the kind of collateral the loan is secured by.³⁴³

A bank as large as Wachovia once declared to regulators in 2007 that it was too expensive and difficult to obtain data on the expected recoveries on defaulted debtors.³⁴⁴ The Bank of New York expressed a similar sentiment, stating in 2007 that it had no hard data on real estate exposures “over the last dozen years to estimate downturn LGDs” and a “very limited internal default history to estimate LGD for [their] wholesale portfolio”.³⁴⁵ Regulators expect that all banks smaller than the largest twenty banks in the US will use the Basel II Advanced Internal-Ratings Based Approach for credit risk, and the other will use the Standardized approach or Foundation Approach, which means that LGDs are either fixed by asset class or given as benchmarks from regulators, meaning that most banks will not even get to estimate their own LGD, yet recoveries in bankruptcies constitute the set of data that contractualists assume to have a major impact on secured lenders’ decision-making.³⁴⁶

³⁴³ According to the interviews, in relation to construction loans, risk managers only have a few point estimates for the LGD metric used. For example, some banks categorized the collateral underlying construction loans as: (i) stabilized and income-producing property; and (ii) pre-stabilized property. They would have 2 historical average numbers for use in risk assessments. When quizzed whether risk managers use different numbers for different geographical regions, the consensus is that there was insufficient historical data to come up with a “good number”, so the LGD lookup tables did not incorporate regional differences.

³⁴⁴ Wachovia Bank, *Proposed Supervisory Guidance for Internal Ratings-Based Systems for Credit Risk*, Public Comment Letter, 2007, available at <http://files.ots.treas.gov/comments/0ac6f584-e767-414e-b594-dae953fb8975.pdf>.

³⁴⁵ Bank of New York, *NPR for Risk-Based Capital Standards: Advanced Capital Adequacy Framework*, Public Comment Letter, 2007, available at http://www.federalreserve.gov/SECRS/2007/April/20070412/R-1261/R-1261_43_1.pdf.

³⁴⁶ In fact, a peripheral observation from interviews is that the bankers (outside of the workout team) interviewed showed little understanding of the bankruptcy process. In an interview with a senior risk manager in a regional bank located in upstate New York, we discussed the risk assessment guidelines and rating templates used by loan officers. What was surprising was that the criteria for estimating bankruptcy recovery in the rating templates were almost solely based on historical averages. When asked why the rating method did not include any room for subjective criterion or overrides based on specific characteristics of the debtor or collateral, the interviewee responded that it is “not possible” to arrive at another number, since the bankruptcy “recovery should be based solely on collateral type”. This shows a patent failure to take into account the degree of maneuvering seen in bankruptcy proceedings where the recovery process is not cut and dried.

In fact, our interview findings show that, up till the onset of the present crisis, valuations of collateral rarely took place more frequently than once a year, and probably not more than once after the initial valuation made at the point of loan origination, unless debt servicing problems were reported. Even when the bank is making an attempt to value collateral such as real estate or inventories, the process of appraisal has been criticized as being problematic.³⁴⁷ According to our interviews, one major Mid-West bank could not even internally agree, without an intervention from an outside consultant on what of several kinds of valuation should be used to assess collateral. This provides evidence contradictory to theories assuming that secured lenders closely monitor collateral values and any changes in the legal framework which affects their risk in this aspect will affect decision-making process in the secured credit process. Of course, banks are now very concerned about collateral values, but this merely reinforces the earlier point on procyclicality.

Next, it appears that many assumptions in the contractualist literature about banks' practices of recovery maximization on a secured loan are in relation to actions occurring only after bankruptcy (or default) has already taken place, not at the point of origination or during the life cycle of the loan prior to default. In fact, the treatment of personal guarantees from owner-managers of firms, including residential developers, provides a good illustration of this insight.

As we have seen from findings in Chapters 5 and 6 of this paper, personal guarantees do play a somewhat pivotal role in facilitating the outcomes of some developer bankruptcies. Banks would use the enforcement or enforceability of guarantee obligations as a form of leverage, as

³⁴⁷ See, e.g., Jann Swanson, NAHB Applauds GSE Adjustments of Appraisal Guidelines, Mortgage News Daily, at http://www.mortgagenewsdaily.com/07152009_nahb_applauds_gse_quot_tweak_quot_of_appraisal_guidelin_es.asp. According to this article, members of the National Association of Home Builders have expressed serious concerns that appraisers have often used sales of homes in foreclosure or other distressed circumstances as comparables for appraisals of new homes without having made the appropriate value adjustments. Properties that are used as comparables are not subject to the same degree of scrutiny as the subject property. In the case of new home appraisals, comparable properties are often older and, if involved in a foreclosure or distressed asset sale, may suffer from neglect and damage that would not be known unless the appraiser conducted thorough inspections. Unfortunately, most agencies require only cursory reviews of the condition of comparables, which means that appraisers may overlook damage and neglect and, as a result, insufficiently adjust the values of properties that are used as comparables.

exhibited by the significant portion of consent orders for lift-stay motions motivated by releases to guarantors. However, insights from the interviews conducted and Basel II comment letters paint a different picture of the value of guarantees at the time of origination. It appeared that risk management departments in banks often do not have a systematic way of tracking and incorporating the risk mitigation effects of guarantees in their credit rating processes.

Speaking for numerous banks, the American Bankers Association in a comment letter stated that Basel II regulatory requirements for tracking and rating both borrowers and guarantors are “burdensome and unnecessary for risk measurement”, especially for middle-market lending where guarantees are common practice.³⁴⁸ A Basel II comment letter from Northern Trust encapsulates this phenomenon in a more poignant remark:³⁴⁹

*Section 33 of the NPR [Notice of Proposed Rule-making] presents a framework for dealing with guarantees that is too complex for many credit portfolios. The challenge posed by that complexity is not in the computation of the parameter impacts of guarantees; rather, **it is the operational difficulty of creating an additional ratings process for guarantors and guarantees and of tracking that data and maintaining that process over the lives of the guarantees...** The LGD [Loss Given Default] Adjustment Approach described in the NPR requires banks to rate guarantors and guarantees in the same manner as they rate direct credit extensions. That is often not the prevailing practice at banks. [Emphasis added by author]*

³⁴⁸ American Bankers Association, *Risk-Based capital Standards: Advanced Capital Adequacy Framework*, Public Comment Letter (2007), available at <http://files.ots.treas.gov/comments/18c3ff54-6442-41c0-9db5-908f152e5b94.pdf>.

³⁴⁹ Northern Trust, *Risk-Based capital Standards: Advanced Capital Adequacy Framework*, March 26, 2007. Public Comment Letter (2007), available at <http://files.ots.treas.gov/comments/3f9c5ab8-7da7-4b55-a008-ac2cee6f1560.pdf>.

We note, however, that the risk management of a bank would be seriously remiss if it did not carry over the lessons learned by the workout group to the lending group in a general way over time. Nonetheless, the link is often not a continuous one, and the feedback loop can be very long, depending on the size and complexity of the institution.³⁵⁰

7.4 Conclusion

Focusing on the regulation-infused culture and inner workings of banks, this chapter has provided perspectives that banks' preference for liquidation may not necessarily be driven by the prospects of the debtor's reorganization and their potential recoveries under reorganization scenarios. Regulatory pressure, cost of capital considerations and procyclicality issues may be compelling reasons contributing to the liquidation preference, especially during a downturn and liquidity crisis. This chapter has also shown that there is a complex and sometimes tenuous link between credit risk, as measured and managed by banks, and the price of credit in the considerations of banks. In sum, this chapter has sought to reveal insights surrounding the role of banks as secured lenders.

³⁵⁰ In an interview with one of the largest financial institutions in the US (which dominates the credit card industry), the risk managers lament that they were unable to build risk models which reflected bankruptcy proceedings due to workout managers "ignoring [their] repeated requests for information".

Chapter 8: Concluding Remarks

We are in the midst of a major foreclosure crisis, extending beyond residential mortgage defaults to the bankruptcies of residential developers. The foreclosures or fire sales of new homes and unfinished residential developments not only have a domino effect on housing prices, but also affect home owners and purchasers in a myriad of ways. Against this backdrop, using timely data collected from 222 bankruptcy dockets between November 2007 and December 2008, the key findings are as follows:

1. About 5.3% of Chapter 11 developer bankruptcies in that period managed to confirm a reorganization plan, and the majority of cases were resolved through liquidation.
2. Lift-stay motions pursuant to foreclosure were filed by secured lenders in 72.0% of the cases, and more importantly, in 90.1% of these cases, the motions were granted. In the alternative, banks undertook section 363 sales, of which a substantial portion was purchased at deep discounts by these same banks through credit bids.
3. The proportion of cases in our data sample which obtained DIP financing is extremely low, and for those cases which received DIP financing, the use of DIP financing did not necessarily change the resolution outcome from the prevalent outcome of liquidation, as illustrated through the case studies. On the contrary, the DIP financing arrangements strengthened a secured lender's control over the residential developers, allowing them to shape the outcomes of bankruptcy proceedings.

Our findings are consistent with general insights in the existing literature that secured creditor control in bankruptcy is more likely to lead to liquidation. However, in this specific set of

cases in the highly-distressed residential development industry, liquidations are not the necessarily the most optimal outcome, even for the secured lenders themselves, especially during a severe economic downturn. Throughout the paper, we have explored the themes of systematic risk, illiquidity, market failure and bank failures in these bankruptcies of residential developers.

In the debate as to whether a policy change is necessary in light of the economic turmoil, we are often confronted with the school of thought that reforms changing the rights of secured creditors and thereby increasing the risk of debtors to banks might increase borrowing costs and reduce the availability of credit. Such arguments are premised on banks being rational, profit-maximizing actors without reference to the regulatory environment in which banks function. Before we can properly analyze the question of whether the current crisis points to a need for legal reforms, we must bridge the chasm between an understanding of the regulatory context in which banks function and the bankruptcy regime.

Filling this gap with findings from interviews with bankers and comment letters from banks to regulators, we have shown that banks are highly-constrained profit-maximizing entities, and their actions are significantly driven by factors apart from the risk profiles of debtors. Furthermore, insights into the regulatory pressures, risk management practices and capital considerations, especially during this liquidity crisis when banks are struggling for their own survival, provide us with a better perspective as to why banks would prefer liquidation over reorganization.

At this juncture, we leave the reader with an example of a residential development bankruptcy case where all creditors recovered their outstanding claims in full. Proceedings of the Blue and Green Diamond Condominium case in Florida finally drew to a close in December 2008, after a long bankruptcy reorganization process. In 2001, the bank started foreclosure proceedings and 3 months later, the developer filed for bankruptcy to forestall foreclosure. At that time, the residential project was described as being “under a dark cloud...[b]rokers wouldn't sell units, the subcontractors would not work on the Blue and Green Diamonds and the construction lender

would not provide funds to complete the work”.³⁵¹ However, the parties managed to achieve a consensus on a long-term strategy to finish construction and sell the units at “retail prices” to individual buyers – a strategy which provided funds for 100% payouts to all creditors and even a \$3.6 million return to the developer.

Finally, we recommend the following areas for further research:

- Bankruptcy regimes in other countries which reasonably restrain secured lenders in pushing for foreclosures and liquidations of assets, especially in the real estate sector where secured lenders typically have a significant power over proceedings;
- Possible introduction of an independent asset management entity charged with the liquidation of distressed residential developments in a way that minimised downward pressure on financial and property markets, similar to the Resolution Trust Corporation created to deal with the aftermath of the S&L crisis;
- Possible reform of the bankruptcy regime to take into account issues which arise mainly as a result of market failure, bank failures and the credit cycle, and research into definitions of market failure that can form the basis of bankruptcy legislation;
- Further research into the economic outcomes subsequent to the resolution of bankruptcy proceedings.

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

³⁵¹ *Blue and Green: Bankruptcy Case Resolved; Creditors Get 100%*, South Florida Business Journal, Dec. 15, 2008, at <http://www.bizjournals.com/southflorida/stories/2008/12/15/daily5.html>.

Appendix 1: Glossary

Appendix 1.1 Bankruptcy Terms

Anti-Deficiency Laws

Where real estate collateral is sold to repay the loan, a “deficiency” may exist between the sale price and the outstanding balance of the mortgage usually exists. Some jurisdictions permit the pursuit of the deficiency against the borrowers or guarantors. However, some states have anti-deficiency laws which provide that deficiency judgments are not available under certain circumstances. Some anti-deficiency statutes prevent deficiency judgments for debts secured by mortgages or deeds of trust on residences, and they apply to residential property owned by developers, because the focus is on the type of property protected, not the type of borrower (see, for example, *Mid Kansas Federal Savings & Loan v. Dynamic Dev. Corp.*, 167 Ariz 122, 804 P.2d 1310 (1991))

Credit bid

Section 363(k) of the Bankruptcy Code provides that in a sale not in the ordinary course of business, the holder of a lien securing an allowed claim may bid at the sale and, if it is successful, may offset its claim against the purchase price of the property. The right of a lienholder, whose lien was not in bona fide dispute to bid at a sale free and clear of liens, was generally recognized under prior law, and this right is continued by section 363(k). The right of the creditor to offset its claim is of significant value. It enables a creditor to purchase property, often without having to part with new funds. The creditor may bid-in an amount up to its entire claim; the offset is not limited to any previously determined secured claim.

Debtor-In-Possession (DIP) Financing

In order to maintain operations after filing for bankruptcy, many firms would need new funds. However, these funds would not be advanced unless their providers are given extra assurance of their return in the form of priority over pre-petition claims. Bankruptcy Code §364 governs this post-petition funding, referred to as DIP Financing. Section 364 provides for possible ways to structure DIP financing with higher priority and increased collateralization:

- Credit with a super-priority over administrative expenses (§364(c)(1)).
- Credit with a lien on previously unencumbered assets (section §364(c)(2))
- Credit with an inferior or junior lien as collateral on those assets which are already encumbered and subject to an existing lien (§364(c)(3))
- Combination of a super-priority expense of administration with either a lien on unencumbered assets or a junior lien on already encumbered assets
- Credit with a lien granted equal to or on a par with an existing lien on encumbered assets (section §364(d)(1))
- Credit with a lien priming an existing lien which exists on the asset to be encumbered, usually with adequate protection furnished to the primed party (section §364(d)(1))

The court may award such protections to the lender, provided that the debtor can show that credit on more favorable terms is unavailable and the interests of the pre-petition creditors are adequately protected.

Exclusivity periods

Section 1121 of the Bankruptcy Code provides the debtor with an exclusive period during which only the debtor may file a plan. In most cases, this period is 120 days after the date of the order for relief, although in small business cases this period is 180 days after the order for relief. The court may reduce or increase this exclusive period under appropriate circumstances, but not beyond 18 months after the order for relief in an ordinary case or 300 days after the order for relief in a small business case. In larger cases in particular, it is common for the court to increase this period several times to enable the debtor to formulate and negotiate an acceptable plan. If the debtor does not file a plan, or obtain the requisite acceptances, within the time specified in section 1121 of the Code or within such time as the court may fix, or if a trustee is appointed, any party in interest may file a plan of reorganization.

Plan confirmation

The court must confirm the proposed plan of exit from Chapter 11 (either re-organization or liquidation) if the requirements of section 1129(a) are met. These include requirements that the plan be proposed in good faith, that each creditor or equity interest holder either have accepted the plan or be entitled to receive at least what it would receive in a chapter 7 liquidation of the debtor, and that each class has either accepted the plan or is not impaired under the plan. The court may confirm a plan even if not all impaired classes of creditors have accepted the plan. In such a case, however, at least one impaired class must have accepted the plan (not counting the votes of any insider) and the plan must be fair and equitable, satisfying the absolute priority rule as to the nonaccepting class. In other words, in order to cram down a plan, classes of creditors must be treated in a strict order of priority, with no junior class receiving any distribution unless the claims of a nonaccepting senior class is to be satisfied in full.

Priming

Under § 364(d), after notice and hearing, the court may authorize a debtor to obtain credit or incur debt secured by a senior or equal lien on property of the estate that is already subject to a lien if the debtor shows two things: (1) the debtor is unable to obtain such credit otherwise and (2) the interests of the current lien holder will be adequately protected should the proposed senior or equal lien be granted. The debtor, not the creditor, has the burden of proof on the issue of adequate protection. This usually occurs when debtors seek to secure post-petition debtor-in-possession (“DIP”) financing under § 364(d) of the Bankruptcy Code but need to prime the liens of their pre-petition lenders in order to do so. (Also see definition of DIP Financing above)

Relief from Stay/Lift-stay motions

Section 362 provides for an automatic stay from foreclosure of the debtor’s assets upon the filing of a bankruptcy petition under any chapter of the Bankruptcy Code. Section 362(d) sets forth the grounds for a petitioner to obtain relief from the stay. Upon the filing of a request by an interested party, the Court may also grant relief from automatic stay under limited circumstances. That is, the

Court may terminate or modify the stay so that a creditor may foreclose upon or repossess certain secured property held by the debtor.

Roll-up

Provision allowing for all proceeds received by the debtor from the sale of its assets or in the course of business to be applied to pre-petition debt first, until such debt is paid in full, before being applied to post-petition debt (which is subject to stronger lender protections) (commonly referred to as a “roll-up”). A roll-up provision requires the use of post-petition financing to pay, in whole or in part, pre-petition secured debt. As these are essentially tools “with which to extract value from the estate to the detriment of more junior interests”, the fact that a DIP lender is able to push through such provisions is a demonstration of control.

SARE

11 U.S.C. § 101(51B) (2006) defines single asset real estate as “real property constituting a single property or project, other than residential real property with fewer than 4 residential units, which generates substantially all of the gross income of a debtor who is not a family farmer and on which no substantial business is being conducted by a debtor other than the business of operating the real property and activities incidental.” One implication of being classified as a SARE is to affect the deadline date for submission of a confirmable plan or the commencement of monthly interest payments.

Section 363 Sale

11 U.S.C.A. § 363(b)(1), (f) authorizes trustees to sell assets free and clear of liens outside the ordinary course of business “after notice and a hearing”. There has been disagreement historically on the issue of whether and under what circumstances a chapter 11 debtor may sell substantial assets under section 363. It is now generally accepted that Section 363 allows such sales in chapter 11, as long as the sale proponent demonstrates a good, sound business justification for conducting the sale before confirmation, that there has been adequate and reasonable notice of the sale, that the sale has been proposed in good faith, and that the purchase price is fair and reasonable. These factors are considered to assure that the interests of all parties in interest are protected and that the sale is not for an illegitimate purpose. Attempts to determine plan issues in connection with the sale will be improper and should result in a denial of the relief requested.

Section 506(c)

In general, expenses associated with the administration of a bankruptcy estate, absent an agreement to the contrary, must be paid from assets of the estate unencumbered by any security interest or lien, and are not chargeable against a secured lender’s collateral. Section 506(c) of the Bankruptcy Code provides, however, for an exception to this general principle. Under § 506(c), a trustee or debtor in possession may recover from property securing an allowed secured claim the “reasonable, necessary costs and expenses of preserving or disposing of, such property to the extent of any benefit to the holder of such claim.” The premise underlying § 506(c) is that the unsecured creditors should not be required to bear the costs of preserving a secured creditor’s collateral. However, the lender may require, as a condition to providing such financing, a waiver of the debtor's right to surcharge its collateral under § 506(c).

Short sale

A sale of real estate in which the proceeds from the sale fall short of the balance owed on a loan secured by the property sold. The lender agrees to discount the loan balance due to economic or financial hardship of the debtor. A short sale in real estate occurs when the outstanding obligations (loans) against a property are greater than what the property can be sold for. Short sales are a way for homeowners to avoid foreclosure on their homes and still be able to pay off their loan by settling with lender.

Stalking horse

Prior to an auction of the assets, debtors encourage an initial, prospective purchaser (usually one judged to be the best or most able to make the highest bid during the auction), to be the “stalking horse,” and submit an offer from which competitive bidding may commence (often in reliance upon the initial bidder’s due diligence). This process, theoretically, may help to increase the amount of the starting bid. In return, the stalking horse gets certain advantages, such as a break-up fee if it is not the winner of the auction.

Appendix 1.2 Finance and Risk Management Terms

Allowance for Loan and Lease Losses (ALLL)

The ALLL is something that all US banks must report on their balance sheets for accounting reasons. The ALLL is supposed to be a reserve, or provisions, against potential losses on the current book of loans, as estimated based on historical loss rates or expected changes in the loss rate. In general, ALLL does not cover large unexpected increases in the expected loss on their current book, for that is more properly the function of capital. In every accounting period, the bank “charges-off” the equivalent value of expected and realized losses in its loan book from the ALLL, but replenishes it with extra provisions based on going-forward expectations. Charge-offs cause a deduction in Net Income. Banks have been variously accused of using ALLL as a way to smooth earnings, by over or under-estimating charge-offs and provisions.

Capital (Regulatory and Economic)

A bank’s capital, as used in the banking industry, has many technical definitions but the theme in common is that capital is the ultimate buffer that a bank has against insolvency. Generally, a bank approaches insolvency because of losses on its loans, although if its short-term sources of funding dry up it will also go operationally insolvent. Generally, the latter occurs because a bank’s own creditors believe that its loan losses are unsustainable, so the terms are linked.

Banking regulatory supervision is primarily aimed at preventing banks from becoming insolvent, as they are regarded as key financial intermediaries whose collapse would cause systemic risk and create a domino effect. In order to prevent bank managers from accumulating risks that might cause the bank to collapse, regulators have imposed rules on how much capital a bank (or other regulated financial institutions) should have on its books to buffer against loan losses. There are varying classes of quality of capital, which is beyond the scope of this glossary. This amount of capital is usually far in excess of the average loss a bank might experience so as to assure investors, counterparties, and the public that the bank is prepared for large unexpected losses and downturns.

One way of distinguishing Regulatory and Economic capital is that Regulatory capital is the absolute minimum capital that a bank must hold according to formulas that are established for all banks of a common class and based on percentages of their assets, based on the perceived riskiness of those kinds of assets in general. Economic capital is the amount of capital that regulators and the bank itself think that the bank requires in order to achieve a standard of solvency above and beyond the minimum, based on more parameters than required by regulatory capital. A solvency standard is analogous to a bank wishes to achieve AAA vs AA vs A probability of default for itself.

Correlations

One reason that capital is not simply a function of expected loss rates on a bank’s loan book is that defaults among borrowers do not occur independently, but rather in correlation to the economy and other macro-variables. In other words, when things are going well, defaults are very low, but when the economy goes south, defaults occur all at once. The probability of a firm defaulting, when

measured on a firm by firm basis, tends to understate the effect of correlations, and in portfolio-level risk management when calculating economic capital a bank must impose from the top down an estimate in the increase in portfolio default rates and losses due to increased default risk that are uneven across a portfolio, such that some lending types and locations may suffer more than others. For example, consumer lending in general is considered to have generally low correlations to regional events as they are highly diversified and much of their economic activity does not depend on trade. Oil companies, however, are seen to have high correlation because of their exposure to the global and national economy. Regulatory capital has far less granularity of perspective on correlations than economic capital.

Exposure at Default (EAD)

The Exposure at Default is the percentage of the total committed value of a loan that the debtor has drawn down on at the moment that the debtor is considered to have defaulted on the loan. Consider a revolving line of credit that has a total committed value of \$1 Million, but which is currently drawn down by only \$500,000. A bank, for regulatory reasons, needs to estimate how much on average its debtors who are going to default manage to draw down on their lines of credit before the bank can stop them. It might estimate that its distressed debtors are only able to suddenly draw down 60% of their undrawn amounts (in this case, another \$300,000) before the bank freezes their credit line. The EAD in this case is \$500,000 plus \$300,000, or 80% of \$1M. A Term Loan, fixed principal loan, would clearly always have 100% EAD.

Loss given Default (LGD)

Banks must estimate the net present value of their economic loss upon an event of Default as defined in “Probability of Default” (see definition below) using an estimate of the discounted cash flows. Typically, banks smaller than the largest twenty or so in the United States do not calculate discounted cash flows, and use general estimates or benchmark estimates based on the main type of collateral and the value of the collateral.

Probability of Default (PD)

The probability over a defined horizon such as one year in the future that a debtor will default on its loans. Default is theoretically defined as the occurrence of an event that leads the lender to believe that the likelihood of recovering its entire amount owed is slim. Practically, regulators have defined default as when an obligation to pay interest or principal is 90 days past due; the loan has been considered impaired by the bank and classified as no longer accruing interest and or the bank has written down the value of the loan as a result; when the debtor has declared bankruptcy; or there has been a distressed exchange of the obligation for another one. Banks are required to associate a Probability of Default with each of their debtors.

Generally, banks will issue an internal risk rating, which is a numerical or letter grading similar to those issued by the national bond rating agencies such as Moody’s or Standard and Poor’s, to each borrower, and then use a master rating map between ratings and PD.. Therefore, PD is not normally calculated as a continuous variable but rather a discrete one, except at the most sophisticated banks.

Appendix 2: Sampling of Bank Comment Letters

Here, in support of various arguments we have made in the text, we present evidence from Comment Letters written by banks and bank associations in response to Notices of Proposed Rulemaking from regulators. These letters are long and the accuracy of our method of extracting quotations may be verified by reading the letters themselves, which are available on <http://www.fdic.gov/regulations> (Google site-searching is recommended).

Appendix 2.1: Competitive pressure and objections to capital guidance on CRE Lending

We have argued in this text that banks have resisted regulatory guidance on risk limits in their CRE lending. Here, we show that banks were expressly welcoming more CRE exposure, and also that banks also believed themselves to be in a highly competitive market for construction loans. In this combined situation, banks did not raise interest rates sufficiently in response to higher risk, because they would have lost market share. If banks could raise rates, they would have simply passed on the incremental cost of capital. The fact that they resisted doing so implies that rates could not rise high enough to compensate for risk. Instead, banks increased their risk profile, which led to the many bank failures in 2008 and 2009 which we have referenced elsewhere.

Bank	Comment
Bay Bank and Trust Co, Florida	“The capital limitations as proposed in the Guidance appear overly restrictive and the definition of a commercial real estate (CRE) loan appears excessively broad. The proposed limitations based on capital would result in many small community banks, well capitalized by all other measures to be deemed as undercapitalized relative to CRE loans. The adherence to the capital measurements as proposed in the Guidance would ultimately result in a sharp curtailment in CRE lending by small community banks. CRE lending is a valuable niche that is well served by small community banks. The banks and the communities they serve depend heavily on the availability of CRE loans. Such a substantial contraction (credit crunch) in CRE lending would have an immediate detrimental impact in the real estate market. In addition, an imposed limitation on the amount of CRE loans that is based on a bank’s level of capital would have a disparate impact on small community banks. The proposed capital thresholds will place small banks at a distinct competitive disadvantage with large regional banks. The Guidance as proposed would ultimately result in a major shift of commercial loan and

	deposit volume from small community banks to large regional banks.”
First Alliance Bank, Tennessee	“Since the nation's banks are presently so heavily involved in commercial real estate lending, the effect of this proposal may be to freeze or lower the level of this lending in the banking system... We should also note here that this may have a far greater impact on small banks than on larger banks. Small banks tend to be located in smaller towns or in growing suburbs of cities. Real estate development and real estate collateral are very important to these banks and concentrations are largely unavoidable for many. Stringent percentage restrictions on this primary business activity coupled with overly burdensome requirements for monitoring concentrations may be detrimental to the small bank's ability to grow profitably and also to the communities which they serve.”
North Carolina Bankers Association	“Imposing the proposed thresholds could drastically curtail CRE lending in many markets and lead to job losses. Any resulting shortage of available credit would substantially affect real estate prices and community development. Additional harm could also occur if financial institutions are forced to turn to riskier investments to try to remain profitable.”
New York Bankers Association	Our concern is that some of the recommended practices may be interpreted to require tightened underwriting standards or increases in capital where the risk profile of the institution may not warrant any changes. Statements such as “[E]ven when individual CRE loans are underwritten conservatively, large aggregate exposures to related sectors can expose an institution to an unacceptable level of risk” may encourage analysts, examiners or shareholders to question the risk management techniques of even the most conservative lenders. Therefore, they may compel lenders in some cases to react by significantly increasing costly risk management techniques or even reducing otherwise profitable types of lending.”
Massachusetts Bankers' Association	<p>“We are still concerned that [the required capital held against] some residential mortgage loans, particularly those with LTVs greater than 90 percent, will increase substantially. Significant increases in these risk weightings may reduce the ability of our member banks to make loans available to first-time homebuyers and other borrowers with limited down payment resources.”</p> <p>“While we support the use of LTV ratios in determining risk-weightings, we also support the Agencies allowing, but not mandating, institutions to periodically update LTVs to better reflect the risk of their portfolios.”</p>
Bay Bank and Trust Co. of Panama City, Florida	“Residential construction loans to builders for the construction of individual housing units should also be excluded from the definition of a CRE loan. It appears that potential credit problems that may result from an anticipated cyclical downturn in the real estate market would be more equitably addressed by an overall tightening in CRE loan underwriting standards, such as a downward adjustment of the supervisory loan/value limits” [Author's comment: a tightening of underwriting standards would have been too late

	to save any bank that was over-concentrated in CRE, as this would affect only new originations, not prevent losses on existing loans]
Wainwright Bank and Trust Company of Boston, MA	“[T]he guidance recommends increased capital levels for banks with CRE concentrations. This requirement will place a serious burden on small banks with limited opportunities to raise additional capital except through the retention of earnings. Therefore, these institutions would be forced to reduce levels of a strong earning asset in commercial real estate during a period of significantly reduced margins.”

Appendix 2.2: Underwriting Standards

In January 2006, regulators issued for public comment a proposed guidance on “Concentrations in Commercial Real Estate Lending, Sound Risk Management Practice” that called for banks to prepare for a possible downturn by comparing their underwriting standards with those for loans available in the secondary market. Among other things, this would have helped banks understand if they could relieve loan losses and obtain capital by disposing of loans in the secondary market.

The response of banks was to object, often very strongly. Usually, objections included references to how banks didn’t see the need to compare their underwriting criteria to others’. The cynic, of course, would argue that the real reason is that their underwriting criteria would not compare favorably. For example, the quote from America California Bank shows that they were willing to make CRE loans on properties where the cash flow was insufficient to make interest payments, on the basis of future appreciation in the value of the land.

Bank	Comment
First Carolina Bank, Desert Community Bank, et al	“Setting underwriting criteria to a “secondary market” standard would be difficult, based on the limited number of secondary markets available to community banks and would also severely limit the judgmental aspects of our loan approvals. Better said, if all banks must underwrite to a specific standard, is there a need for community banks? We are relationship bankers who know our customers. We urge the regulatory agencies to consider such “soft information” rather than making commercial real estate loans a commodity.”
America California Bank	<p>“I’m sorry, but if community banks had underwriting standards like the secondary market, we wouldn’t have any CRE exposure at all...An example would be debt service coverage. In San Francisco, many multi-family or mixed use properties do not have decent debt service because the market relies on appreciation, not income streams. We would make these loans if other sources of cash are available to the borrower to meet the debt service.</p> <p>I would consider it a waste of my time to find out what the secondary market standards are and justify my policies if they deviate. In addition, establishing long term plans for credits that deviate sounds a lot like the reporting we do for criticized and classified assets. Another waste of time and paper for good, performing assets. I feel that banks with good asset quality should be judged on credit performance not deviation from standards that are too rigid for the communities we serve. I think delinquency and charge off experiences in community banks speaks most clearly to underwriting standards.”</p>
Red Rock Community Bank, Ann Arbor Commerce Bank	“Setting underwriting criteria to a “secondary market” standard would be difficult, based on the limited number of secondary markets available to community banks and would also severely limit the judgmental aspects of our loan approvals. Better said, if all banks must underwrite to a specific standard, is there a need for community banks? We are relationship bankers who know

	our customers. We urge the regulatory agencies to consider such "soft information" rather than making commercial real estate loans a commodity."
Citizens Bank	"We have concerns that some of the practices in the proposed guidance, such as portfolio stress testing and comparison of the institution's underwriting standards for individual property types with standards that exist in the secondary market, are more appropriate for larger and more complex financial institutions than for smaller community banks."
Shore Bank	"Our loans are underwritten to standards that we have found to be successful for both profitability and mission, but they are our standards, not those of the secondary market. In other words, we do not believe we need secondary market validation of the quality of our loans."
Community Development Bankers Association	"We also strongly disagree with the emphasis the Guidance places on underwriting to secondary market standards. Many of the credit opportunities in low income communities do not meet standardized underwriting criteria."

Appendix 2.3: Resistance to portfolio management, stress-testing and Management Information Systems for CRE lending

The proposed regulation regarding Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices”, which was opened for comment in January 2006 and already referred to in this text, contained suggestions that banks should do the following:

“An institution should measure and control CRE credit risk on a portfolio basis by identifying and managing concentrations, performing market analysis, and stress testing.

A strong management information system is key to the successful implementation of a portfolio management system...To accurately assess and manage portfolio concentration risk, the MIS should provide meaningful information on CRE portfolio characteristics that are relevant to the institution's lending strategy, underwriting standards, and risk tolerances.

Institutions are encouraged, on either an automated or manual basis, to stratify the portfolio by property type, geographic area, tenant concentrations, tenant industries, developer concentrations, and risk rating. Institutions should be able to aggregate total exposure to a borrower including their credit exposure related to derivatives, such as interest rate swaps. MIS should maintain the appraised value at origination and subsequent valuations. ... Management reporting should be timely and in a format that clearly shows changes in the portfolio's risk profile, including risk-rating migrations.

In addition, the MIS should provide management with the ability to conduct stress test analysis of the CRE portfolio for varying scenarios. There should also be a well-defined, formal process through which management reviews and evaluates concentration and risk management reports, as well as special ad hoc analyses in response to market events.”

In our opinion, these suggestions sound eminently reasonable requirements for the proper monitoring and management of a bank’s lending risks. Instead, they received many objections.

Bank	Comment
Independent Community Bankers of America	“Community banks believe that the proposal’s recommendations regarding MIS enhancements and stress testing are particularly costly and burdensome to community banks; the costs will most likely out weigh the benefits for smaller banks, with the result being an unwarranted and unnecessary contraction in CRE lending.”
Wilmington Trust	“Requirements for formalized portfolio stress-testing and contingency-planning place community banks at a decided disadvantage. The guidance

	acknowledges that stress-testing at the portfolio level is an evolving practice, but this is an understatement. Absent the in-house quantitative analysis teams enjoyed by large regional banks, and given the lack of available tools for tracking and aggregating project-specific risk components, "stress testing" would be limited to broad measures with questionable data integrity."
Weymouth Bank	"I am also opposed to the proposed guidance because it will place a significant regulatory burden and cost to community banks without yielding the desired benefit. Much of the analytical requirements such as stress testing and market analysis are beyond the expertise of most community banks under \$500 million and will simply require smaller banks to hire consultants at exorbitant rates which may ultimately be passed on to borrowers by way of higher lending rates or absorbed by banks resulting in weaker earnings."
National BancShares	"The proposed guidance provides for increased board oversight, new policies and procedures, strategic planning, new underwriting guidelines, contingency plans, new risk ratings, feasibility studies, sensitivity analysis, stress testing, monitoring and so on. Attempting to comply with all of these requirements will require a great deal of time and expense for a community bank, and, no matter how hard we might try, full compliance will all these complicated new requirements will be virtually impossible. Indeed, community banks struggle to understand what all of these provisions mean in terms of what would be required of us, much less how we could possibly manage to comply with them."
Beverly Cooperative Bank	"The requirement, however, that institutions routinely stress test their entire CRE portfolio is new. Stress testing (assess risks) each CRE loan is a part of a normal loan approval and renewal process. Community Banks do not, however, have the financial software and sophisticated data bases to periodically stress test the entire CRE loan portfolios nor is this type of testing particularly useful. It is also disappointing that these requirements are heavily focused on mega bank systems and capabilities at the expense of community banks."
Country Club Bank	"We view the recommendations regarding stress testing and management information system (MIS) improvements as costly, burdensome and unnecessary for community banks like ours that already closely monitor their loans and customers."
American Bankers' Association	[Regulations should not] require a credit risk modeling process to specify "how quickly obligors are expected to migrate from one rating grade to another in response to economic cycles." [as] Lenders cannot reasonably predict <i>a priori</i> the rate of change of the credit risk rating of borrowers under all potential circumstances.

Appendix 3: Loan Pricing Example

The following loan pricing example is derived from a comment letter from Zions Bank to banking regulators on March 26, 2007 regarding “Risk-Based Capital Standards: Advanced Capital Adequacy Framework; 71 Federal Register 55830”:

“As a simple illustration of the powerful market effects of the Basel proposals, we provide a simple loan pricing example. Suppose that five banks, all with 5% or higher total bank leverage ratios, allocate five different capital ratio levels to a conventional commercial loan.

These five differing ratios result from differences in either internal Basel II models and/or the rules-based Basel Ia method. (In this example, it is assumed that a bank can allocate as low as 2.5% capital to commercial loans, since it could make up the shortfall for its total bank leverage ratio either by allocating more than 5% capital to other loan types and/or through allocations of capital for operations risk.)

For all banks, we assume that the required return on capital is 12%, the marginal tax rate is 40%, and the average expense rate for originating and servicing loans is 1.0%. We have adopted these simple assumptions to spotlight the effects of differing capital allocations on required loan spreads.

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

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

¹Pricing Spread which covers Cost of Capital

There is a wide disparity in loan spreads over cost of funds required to provide a 12% return on capital from a low of 1.50% to a high of 2.60%. Such differences would logically provide significant competitive advantages for the banks at the low end of the capital range.”