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

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

Sarah P. Woo†

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 analyzed 222 residential developers that filed Chapter 11 bankruptcy petitions between November 2007 and December 2008. We find that only a very small proportion of these developers, as compared to previous similar large studies, confirmed a reorganization plan. Most of the cases were dismissed or converted to Chapter 7, culminating in foreclosure or liquidation sales. In the sample, 72.5% 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 92.2% of the time.

Investigating this liquidation preference, we develop explanations based on nuances in the creditor banks' lending functions, risk management and regulatory environment that have not been explored in the prior literature on bankruptcy. We posit that, during a severe recession, banks may prefer liquidation of the developers over reorganization because of a capital shortfall 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 so as to maximize an exogenous urgent need for capital and regulatory compliance.

Pursuing this hypothesis, we find that 45.4% of the secured lenders in our sample which are driving low confirmation rates are themselves failed or undercapitalized financial institutions. Furthermore, based on multivariate regression modeling, we find that the effect of a bank’s financial distress on the probability that it will file a lift-stay motion is economically large and statistically significant, after controlling for firm size, capital structure, housing market prices and region. Together, this is strong evidence that the standard theory of creditor behavior in bankruptcy is incomplete without consideration of the economic cycle or banking regulation.

† For comments on the drafts, I am very grateful to Lawrence M. Friedman, G. Marcus Cole, Alan D. Jagolinzer, Jay L. Westbrook and Lynn M. LoPucki. I also thank the bankers and risk managers who took time out to engage in enlightening discussions on bank regulation and the bankruptcy workout process, and my colleagues at the Global Association of Risk Association, former colleagues and friends at Moody’s, Fitch Ratings and Sungard for their feedback on the initial concepts and findings.
# Table of Contents

**I. Introduction** .................................................................................................................................................. 3

**II. Methodology** ............................................................................................................................................... 9

- A. Data on Residential Development Bankruptcies .......................................................................................... 9
- B. Research Design ....................................................................................................................................... 11
- C. Descriptive Statistics of the Sample .......................................................................................................... 16

**III. Chapter 11 Bankruptcy Outcomes of Residential Developers** ................................................................. 19

- A. General Findings ..................................................................................................................................... 20
- B. Do Dismissals and Conversions Necessarily Mean Liquidations? ................................................................. 24
- C. To What Extent were Cases with Confirmed Plans Reorganizations? ........................................................... 27
- D. Are the “Mega” Cases on the Track to Reorganization? ........................................................................... 29
- E. Benchmarking Economic Outcomes against Other Studies ........................................................................ 31
- F. Focusing on Cases with a Plan Filed ......................................................................................................... 33
- G. Casting a Wider Net with “Substantially Resolved” Cases ........................................................................ 36

**IV. The Road from Bankruptcy to Foreclosure and Liquidation** ................................................................. 38

- A. The Prevalence of Lift-Stay Motions ......................................................................................................... 38
- B. Relief under 11 U.S.C. § 362 ....................................................................................................................... 40
- C. Consent Orders and Agreed Stipulated Relief ............................................................................................ 48
- D. BAPCPA Amendments of the Single Asset Real Estate ("SARE") Proviso ........................................... 53

**V. Regulatory Pressure, Bank Regulation, and the Preference for Liquidation** ....................................... 56

- A. Cost of Capital Considerations ................................................................................................................ 58
- B. Regulatory Pressure to Reduce Concentration Risk ................................................................................ 63
- C. Procyclicality in Bank Behavior ............................................................................................................... 67
- D. Financially-Distressed Banks in the Data Sample ...................................................................................... 72

**VI. Conclusion** ......................................................................................................................................... 77

**Appendix I** ............................................................................................................................................... 79

**Appendix II** ............................................................................................................................................. 80
SIMULTANEOUS DISTRESS OF RESIDENTIAL DEVELOPERS AND THEIR SECURED LENDERS: AN ANALYSIS OF BANKRUPTCY & BANK REGULATION

I. INTRODUCTION

The United States is in the middle of a “perfect foreclosure storm”. According to the U.S. Congress Joint Economic Committee, an estimated $736,160,105,369 of housing wealth was lost from record numbers of foreclosures and falling home prices in 2007, and an estimated $1,144,177,880,280 in 2008.\(^1\) 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.\(^2\)

Amidst the constant bombardment of news and studies lamenting the problem of homeowners defaulting on their mortgages and being foreclosed upon, more attention needs to be paid to the problem of residential developers declaring bankruptcy. In normal times, the liquidation of a bankrupt residential developer might represent an efficient redeployment of assets, as property prices remain buoyant and other developers are standing by with financing and resources to continue the development. However, this is now no longer true in this current crisis, which has been marked by pervasive market failure. As financially distressed residential developers and builders go into liquidation or foreclosure, communities are now being abandoned half-built, to


the great detriment of those already moved in, warranties are lapsing, and developments are left with potholed roads, open sewers, and other hazards.³

Half-completed or fire-sale properties can also have a negative effect on the property values of wider communities and exacerbate serious problems in housing markets. The following excerpt from the March 2009 Oversight Report by the Congressional Oversight Panel shows how foreclosures on both developers and homeowners alike can have devastating effects:⁴

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

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

With so many residential developers entering bankruptcy, the question of whether the U.S. bankruptcy and debtor/creditor regime has shaped the current situation for the worse is urgent. Looking for answers to address this issue, we reviewed the bankruptcy literature and found a gap – there is little past empirical work focusing specifically on bankruptcies occurring during a severe downturn, nor studies on bankruptcies in the residential development industry.

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

We also found that secured lender control of bankruptcy proceedings was a major driver of these outcomes. This conclusion was supported by observations from the bankruptcy dockets showing 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, 72.5% 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 92.2% of the time.

The rise of secured creditor control in bankruptcy proceedings and their preference for liquidations and asset sales has been much discussed in the literature, and there is disagreement as to whether it is desirable. 5 Baird and Rasmussen argue that higher secured creditor control

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leads to more efficiency in resolving the fate of distressed companies. According to this view, 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.

On the other hand, Warren and Westbrook, LoPucki, and others argue that creditor control may result in the destruction of viable firms, and opine that Chapter 11 has a variety of important roles to play in terms of societal utility through maximizing the going concern value of a bankrupt firm. Our contribution to this debate, through an analysis of developer bankruptcies, is that secured creditor control, as embodied in the single-minded pursuit of foreclosure and liquidation, is not necessarily an optimal utilization of assets, given the glut of foreclosures and depressed real estate prices during this economic downturn.

Baird and Rasmussen have argued that “businesses in Chapter 11 have little going-concern value and sales are usually the best way to preserve whatever value exists”. Some may also argue, as did the counsel for the senior secured creditors in the bankruptcy of LandSource Communities Development ("LandSource"), a large residential developer, that secured lenders

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need to act quickly to protect their interests when asset prices or values are falling or depreciating, justifying swift liquidations which will preserve value:

(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.10

However, in this specific set of cases in the highly-distressed residential development industry, liquidations are not the necessarily the most optimal outcome, especially during a severe economic downturn. Under downturn conditions, prices are unlikely to reflect the true economic value of the assets – as reflected by the newly enacted Financial Standards Accounting Board (“FASB”) rules allowing institutions to not use mark-to-market accounting for certain long-lived assets.11 We thus agree with the judge in the LandSource case, whose response to this line of reasoning is as follows:


(Bankruptcy Judge, Hon. Kevin J. Carey): 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.\textsuperscript{12}

Next, we shift gears from analyzing bankruptcy dockets to focus on the key actor of these bankruptcy proceedings – the secured lender which, according to our data on residential developers, is typically a commercial bank. The central picture that emerges is that banks are highly-constrained profit-maximizing entities, with the banking regulatory environment being a significant constraint in the current context. Furthermore, we should consider whether optimal solutions are produced by a bankruptcy regime which allows a high degree of secured lender control at a time when many banks are fighting for their own survival – would these banks restructure the debts owed by debtors for long-term gain, or simply try to liquidate the assets as soon as possible in a bid to raise more capital?

We then tie together the threads of this discussion through an empirical analysis of the banks in our data sample and their state of financial distress. Testing our hypothesis that financial distress on the part of a bank is likely to translate into a liquidation preference, we built a series of probit models where we find that the effect of a bank’s financial distress on the probability that it will file a lift-stay motion is economically large and statistically significant, after controlling for firm size, capital structure, housing market prices and region.

This Article is organized as follows: Section II describes the methodology for the empirical data analysis, covering topics such as data sources, sample selection and the

\textsuperscript{12} \textit{In re} LandSource Communities Development, LLC, No. 08-11111 (Bankr. D. Del. June 8, 2008).
descriptive statistics of the sample. Section III documents our findings regarding the distribution of outcomes in the data sample. Section IV presents observations from an in-depth investigation of the bankruptcy dockets, analyzing the actions of secured lenders in moving debtors towards liquidation. Section V completes the discussion with insights regarding the capital adequacy issues of banks and other regulatory issues which help explain their preference for liquidation.

II. METHODOLOGY

A. Data on Residential Development Bankruptcies

This study revolves around the cases of residential developers and home builders across the United States which filed Chapter 11 bankruptcy petitions between November 1, 2007 and December 31, 2008, i.e., the current recession. 13 The target group is defined as companies which, at the time of the bankruptcy filing, were involved in the development and building of new single-family homes, condominium developments, developed lots and raw land, and excludes contractors and custom builders working exclusively on existing homes. The defining characteristic is that these companies own and develop residential real estate, the collateral underlying the acquisition, development and construction loans. This can be verified through a perusal of the Schedules of Assets and Total Liabilities (“Schedules”) and Statement of Financial Affairs filed in Chapter 11 proceedings.

We began by identifying residential developers and home builders which filed for Chapter 11 bankruptcy in United States bankruptcy courts across all districts during the specified time period, using a collection of sources such as The Troubled Company Reporter, Bankruptcy

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13 The recession technically began in December 2007. See National Bureau of Economic Research, Determination of the December 2007 Peak in Economic Activity (2008), http://www.nber.org/dec2008.pdf. However, we found in our archival searches that the flurry of residential development defaults started in November 2007, so we set the sample selection period to start on November 1, 2007.
Datasource, government agency databases, publications from industry associations such as the National Association of Home Builders and also searching the news archives for press releases, 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 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 Article, 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 bankruptcy relief under this Chapter expressly provides for liquidation, whereas this research is primarily concerned with why residential developers, with an opportunity to reorganize in bankruptcy, are going into liquidation. The exclusion of this segment of cases does not affect the findings in this Article for two main reasons.

First, in assessing the procedural and economic outcomes of these bankruptcies cases (discussed further in Sections 3 and 4 of this Article), we have benchmarked these against prior literature dealing only with Chapter 11. Second, being cognizant of the possibility that Chapter 7 cases can be converted to Chapter 11, especially those commenced by an involuntary petition, 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 7 and,
prior to the hearing for this conversion motion, the case was dismissed.\textsuperscript{14} There were 5 cases involving involuntary Chapter 7 petitions but these were not converted to Chapter 11.

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

\textit{B. Research Design}

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. The second thread of our examination is the type and extent of secured lender control in these developer bankruptcies.

With this in mind, we set out to track the resolution outcomes of these bankruptcy cases. 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;

\textsuperscript{14} \textit{In re} Kyle James Wheatley (dba Kevan James Construction Ltd), No. 08-61092 (Bankr. W. D. Tex. October 24, 2000).

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

\textsuperscript{16} See, for example, \textit{In re} Gandy, 229 F.3d 489, 499 (5th Cir. 2002).
• 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 (reorganization)
• 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 outcomes listed above. In trying to be as timely as possible in documenting and analyzing fairly unfamiliar phenomena with important consequences relating to the housing crisis, the implication is that since the cases are filed in 2007-2008, a number of them will still be unresolved. 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. Furthermore, the limitation on exclusivity periods (where only the debtor may file a

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17 The cut-off date adopted for assessing case resolution in this sample is July 31, 2009.
plan) as introduced by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA") currently facilitates a much faster resolution.

Second, Warren and Westbrook showed in their empirical study of Chapter 11 business cases that “substantial screening” occurs early in the case.18 Of all the cases that were eventually pushed out of Chapter 11 without a plan being filed, more than half were gone in less than six months, 70% were gone by nine months, and more than 80% were gone within a year.19 However, one may argue that weak cases are pushed out earlier in proceedings and that cases culminating in plan confirmations will take longer.

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

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

As such, 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 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 and research design, we identified 235 Chapter 11 cases of developer bankruptcies, a number 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 October 2008 and December 2008, i.e., these are the more recent cases which have not hit a major milestone as of the cut-off date.\(^{23}\)

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:\(^{24}\)

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

The literature suggests that in every instance where the Bankruptcy Code provides the Chapter 11 debtor with substantial power, it checks that power with avenues for creditor action.\(^{25}\) 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

\(^{23}\) Note that, of these 13 cases, 6 of them were filed in December 2008.

\(^{24}\) See, generally, 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 (last visited Aug. 5, 2009). 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 to Chapter 7, relief from stay, objection to the reorganization plan. We have considered all of these, apart from the last motion type which is typically filed in almost every instance where a reorganization plan is filed.

\(^{25}\) See, for example, Stephen J. Lubben, Credit Derivatives and the Future of Chapter 11, 81 AM. BANKR. L.J. 405, 418 (2007) [hereinafter Lubben, Derivatives]
correlative creditors’ powers thus include conversion, dismissal, relief from stay, the termination of exclusivity and the appointment of a trustee.

C. Descriptive Statistics of the Sample

The final sample consists of 153 “strictly resolved” cases and 58 “substantially resolved” cases, and 11 “mega” cases. Figure 1 below describes the distribution of cases in the sample by total assets and total liabilities at the time of the bankruptcy filing, excluding the “mega” cases.\(^\text{26}\)

<table>
<thead>
<tr>
<th>Share of Sample</th>
<th>$500K or less</th>
<th>$1M</th>
<th>$5M</th>
<th>$10M</th>
<th>$25M</th>
<th>$50M</th>
<th>$100M</th>
<th>More than $100M</th>
<th>Median</th>
<th>Mean</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Assets</td>
<td>2%</td>
<td>4%</td>
<td>26%</td>
<td>19%</td>
<td>27%</td>
<td>11%</td>
<td>6%</td>
<td>3%</td>
<td>$7.44M</td>
<td>$18.32M</td>
</tr>
<tr>
<td>Total Liabilities</td>
<td>1%</td>
<td>4%</td>
<td>30%</td>
<td>19%</td>
<td>26%</td>
<td>11%</td>
<td>7%</td>
<td>2%</td>
<td>$8.86M</td>
<td>$19.80M</td>
</tr>
</tbody>
</table>

These “mega” cases, where total assets exceed $250 million, are separately analyzed to avoid sampling issues. These were designated as complex cases in bankruptcy proceedings, owing to the multiple subsidiaries and affiliates. Based on our methodology which counts each entity as a separate “case” as long as no substantive consolidation has been ordered yet, the inclusion of these cases (which take longer to administer and resolve) may distort the overall results, since outcomes may be similar for entities in the same corporate group.

Based on the descriptive statistics, the data points in the sample are reasonably well-distributed across the board, in terms of size.\(^\text{27}\) Figure 2 presents the geographical distribution of

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\(^{26}\) 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 a few missing values where the debtor entered “TBD” in the Schedules.

\(^{27}\)
211 cases by the state of the bankruptcy filing, which shows a reasonably distribution across states, with natural concentrations in states worst hit by the housing crisis. As for the “mega” cases, 3 are filed in Delaware, 4 in California, 2 in Florida, and 2 in Illinois.

**Figure 2**

**Geographical Distribution of Cases**

<table>
<thead>
<tr>
<th>District</th>
<th>Count</th>
<th>District</th>
<th>Count</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alabama</td>
<td>2</td>
<td>Minnesota</td>
<td>2</td>
</tr>
<tr>
<td>Arizona</td>
<td>31</td>
<td>Mississippi</td>
<td>3</td>
</tr>
<tr>
<td>Arkansas</td>
<td>2</td>
<td>Missouri</td>
<td>2</td>
</tr>
<tr>
<td>California</td>
<td>16</td>
<td>Nevada</td>
<td>7</td>
</tr>
<tr>
<td>Colorado</td>
<td>6</td>
<td>New York</td>
<td>3</td>
</tr>
<tr>
<td>District of Columbia</td>
<td>1</td>
<td>North Carolina</td>
<td>27</td>
</tr>
<tr>
<td>Florida</td>
<td>23</td>
<td>Ohio</td>
<td>2</td>
</tr>
<tr>
<td>Georgia</td>
<td>13</td>
<td>Oregon</td>
<td>4</td>
</tr>
<tr>
<td>Idaho</td>
<td>2</td>
<td>Pennsylvania</td>
<td>1</td>
</tr>
<tr>
<td>Illinois</td>
<td>1</td>
<td>South Carolina</td>
<td>4</td>
</tr>
<tr>
<td>Indiana</td>
<td>1</td>
<td>Tennessee</td>
<td>5</td>
</tr>
<tr>
<td>Iowa</td>
<td>1</td>
<td>Texas</td>
<td>14</td>
</tr>
<tr>
<td>Kansas</td>
<td>1</td>
<td>Utah</td>
<td>4</td>
</tr>
<tr>
<td>Maryland</td>
<td>18</td>
<td>Virginia</td>
<td>5</td>
</tr>
<tr>
<td>Massachusetts</td>
<td>2</td>
<td>Washington</td>
<td>2</td>
</tr>
<tr>
<td>Michigan</td>
<td>5</td>
<td>Wisconsin</td>
<td>1</td>
</tr>
</tbody>
</table>

Looking at the geographical distribution, we note a few observations. First, the large number of cases in relation to North Carolina is partly due to 16 residential development entities, each managed by Landcraft Management LLC, but which are not substantively consolidated and have different resolution outcomes.

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

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27 There are relatively less companies with total assets or total liabilities under $5 million. This is expected – even small residential developer bankruptcies are generally bigger than small business bankruptcies due to the substantial real estate holdings.
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 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 valued between $300-600 million in bankruptcy proceedings.\(^{28}\)

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 markets in 2007, compared to 28.8% of the North Carolina region.\(^{29}\)

Nevada and Florida are also states with badly-hit housing markets where the proportion of cases in our sample may look relatively low. Besides the fact that 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.\(^{30}\) As for Nevada, we omitted from the sample bankrupt residential developers in Las Vegas which were also hotel and resort developers.\(^{31}\)

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

\(^{28}\) *In re* Dunmore Homes, Inc., No. 08-20569 (Bankr. E. D. Cal. November 8, 2007). *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).


\(^{30}\) *Id.*

\(^{31}\) For example, one case omitted is Lake at Las Vegas Joint Venture, LLC – the developer of a 3,592 acre resort destination which also comprises of two luxury hotels (including a Ritz-Carlton), a casino and golf courses. *See In re* Lake at Las Vegas Joint Venture, LLC, No. 08-17814 (Bankr. D. Nev. July 17, 2008).
III. Chapter 11 Bankruptcy Outcomes of Residential Developers

The key results of our data collection exercise are summarized in the table below, showing the distribution of outcomes from the sample (excluding the 11 “mega” cases). We have laid out in Figure 3 the distribution 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.

Figure 3

Distribution of Procedural Outcomes in the Dataset

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

The quick overview presented by the above table provides two main 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. Moreover, upon examining the cases with plan confirmation, we found that only 7 of these plans involve re-organization. Therefore, the actual re-organization rate is only 4.6% of the overall sample. Second, of the cases which are
substantively resolved, the majority of them have experienced relief from stay pursuant to foreclosure, with 44.8% having almost no assets left to support viable prospects of reorganization. These key findings will be discussed in detail throughout this Section.

A. General Findings

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

There is a stark contrast between this distribution of bankruptcy outcomes and those calculated from LoPucki’s Bankruptcy Research Database (“BRD”) used as a benchmark – see Figure 4 where we analyzed the full data sample from the BRD for 1980-2008 and a sub-sample for a prior downturn of 2001-2.

<table>
<thead>
<tr>
<th>Data Sample</th>
<th>Dismissal</th>
<th>Conversion</th>
<th>363 Sale</th>
<th>Plan Confirmation</th>
</tr>
</thead>
<tbody>
<tr>
<td>153 Residential developers and builders (2007-8)</td>
<td>55.6%</td>
<td>22.2%</td>
<td>11.1%</td>
<td>11.1%</td>
</tr>
<tr>
<td>733 Large Public Companies from BRD (1980-2007)</td>
<td>0.8%</td>
<td>4.1%</td>
<td>10.0%</td>
<td>85.1%</td>
</tr>
<tr>
<td>176 Large Public Companies from BRD (2001-2002)</td>
<td>1.7%</td>
<td>2.8%</td>
<td>19.3%</td>
<td>76.1%</td>
</tr>
</tbody>
</table>

Source: Lynn M. LoPucki, Bankruptcy Research Database

There was insufficient data to come up with the distributions for prior downturns such as 1980-1 (8 observations), 1990-1 (70 observations).
It is not unexpected that the level of plan confirmation in our data sample would be lower than that in the BRD, or that the dismissal and conversion rates would be higher, since the former consists of smaller companies in a particularly distressed industry (as opposed to a wide range of large public companies). However, the disparity in levels is extremely wide.

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

**FIGURE 5**

**EMPirical FINDINGS ON DISMISSAL AND CONVERSION RATES FROM PRIOR LITERATURE**

<table>
<thead>
<tr>
<th>Literature</th>
<th>Findings on Dismissals and Conversions</th>
<th>Data Sample</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ayotte and Morrison (2008)(^{33})</td>
<td>Conversion rate: 14%</td>
<td>153 cases, consisting of large corporate cases listed in the Bankruptcy Datasource “Public and Major Company Database” during the latter half of 2001, with median assets of $151M.</td>
</tr>
<tr>
<td></td>
<td>Dismissal rate: 9%</td>
<td></td>
</tr>
<tr>
<td>Morrison (2006)(^{34})</td>
<td>Northern District of Illinois cases:</td>
<td>Northern District of Illinois cases (1998-9): 470 cases (median assets of $114,160); All districts (from Survey of Small Business Finance) (1998-9): 13,457 cases (median assets of $320,971)</td>
</tr>
<tr>
<td></td>
<td>23.2% conversion rate and 43.6%</td>
<td></td>
</tr>
<tr>
<td></td>
<td>dismissal rate;</td>
<td></td>
</tr>
<tr>
<td></td>
<td>All districts:</td>
<td></td>
</tr>
<tr>
<td></td>
<td>39.4% conversion rate and 29.9%</td>
<td></td>
</tr>
<tr>
<td></td>
<td>dismissal rate</td>
<td></td>
</tr>
<tr>
<td>Bernant and Flynn (1998)(^{35})</td>
<td>Conversion rate: 35.4%</td>
<td>131,089 cases filed between 1989 and 1995 in different districts</td>
</tr>
<tr>
<td></td>
<td>Dismissal rate: 35.3</td>
<td></td>
</tr>
</tbody>
</table>


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

Next, we note that Warren and Westbrook’s study found relatively high dismissal rates over 60%, suggesting that weaker cases were culled early in bankruptcy proceedings.\(^\text{37}\) In that study, of all the cases eventually pushed out of Chapter 11 without a plan having been filed, more than half were gone by 6 months, 70% by 9 months, and more than 80% within a year.\(^\text{38}\) Examining our sample, we found that these developer bankruptcies, being considerably larger in size, were pushed out faster – 67% were gone by 6 months, 90% by 9 months and more than 95% within a year.\(^\text{39}\)

As for plan confirmation rates, the 11.1% 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

\(^{36}\) See, for example, Douglas G. Baird, Arturo Bris and Ning Zhu, \textit{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 (finding that most small business bankruptcies “never confirm a plan of reorganization. They are converted or dismissed…”).


\(^{38}\) \textit{Id.}

\(^{39}\) \textit{Id.} Note that Warren and Westbrook’s sample had a median total debt load of about $643,490 (1994 sub-sample) and $1.8 million (2002 sub-sample), compared to our sample with a median total debt load of $8.9 million.
17% confirmation rate.\textsuperscript{40} In more recent empirical studies, the confirmation rate hovered between 30%-75% – see Figure 6 below.

**Figure 6**

**EMPirical FINDINGS on PLAN CONFIRMATION RATES FROM PRIOR LITERATURE**

<table>
<thead>
<tr>
<th>Literature</th>
<th>Findings on Plan Confirmation</th>
<th>Data Sample</th>
</tr>
</thead>
<tbody>
<tr>
<td>Elizabeth Warren &amp; Jay L. Westbrook (2009)\textsuperscript{41}</td>
<td>1994: 30.3% confirmation rate; 2002: 33.4% confirmation rate</td>
<td>1994: 437 cases; 2002: 197 cases (Smaller cases, with only 2.62% (1994) and 25.19% (2002) over $5 million in total assets).\textsuperscript{42}</td>
</tr>
<tr>
<td>Ayotte &amp; Morrison (2008)\textsuperscript{43}</td>
<td>2001: 75% confirmation rate</td>
<td>153 cases, consisting of large corporate cases listed in the <em>Bankruptcy Datasource</em> “Public and Major Company Database” during the latter half of 2001, with median assets of $151M.</td>
</tr>
<tr>
<td>Morrison (2006)\textsuperscript{44}</td>
<td>Northern District of Illinois cases (1998-9): 33.2% confirmation rate; All districts (1998-9): 30.7% confirmation rate</td>
<td>Northern District of Illinois cases: 470 cases; All districts: 13,457 cases; Mainly small cases with 81.1% under $1 million in total assets.</td>
</tr>
<tr>
<td>Ancel &amp; Markell (1999)\textsuperscript{45}</td>
<td>1990-6: 39% confirmation rate</td>
<td>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.</td>
</tr>
<tr>
<td>LoPucki (1983)\textsuperscript{46}</td>
<td>47% confirmation rate</td>
<td>48 public company cases over twelve months in the Western District of Missouri, 1979-1980.</td>
</tr>
</tbody>
</table>


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

\textsuperscript{42} See Elizabeth Warren & Jay Lawrence Westbrook, *Financial Characteristics of Businesses in Bankruptcy*, 73 Am. Bankr. L.J. 499 (1999) at 568 (Table A); Warren and Westbrook, *Challenge*, supra, note 18, at 641 (Table 1).

\textsuperscript{43} Ayotte & Morrison, *supra*, note 33, at 26.

\textsuperscript{44} Morrison, *supra*, note 34, at 51.


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 more important part of the inquiry is the extent to which we observe liquidations of the bankrupt developers. This is addressed in the following Sections where we dug deeper into bankruptcy dockets to investigate the actual resolution in these cases.

**B. 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.\footnote{Occasionally, Chapter 11 cases convert to Chapter 7 after having first confirmed a plan of reorganization. See United States Department of Justice, *Issues in Chapter 7 Cases Converted from Chapter 11, 12 Or 13*, http://www.usdoj.gov/ust eo/public_affairs/articles/docs/nabtalk072000.htm (last visited Aug. 5, 2009).} 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 reasonable likelihood of rehabilitation, and debtors’ failure to file reports or pay fees. None of these involved section 363 sales.

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. A 1994 study cited anecdotal evidence from bankruptcy lawyers and judges that a fair number of cases were dismissed because parties have worked out a settlement that they were not able to achieve prior to the Chapter 11 filing. In contrast, Morrison’s 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.

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

Of the 85 dismissal cases in our sample, the main reason for dismissal was the bankruptcy estate had minimal valuable assets remaining available for liquidation or distribution, and that a plan was no longer feasible. Thus our investigations show that about 94% of the dismissals (i.e., 81 cases) involve some form of foreclosure or liquidation as an economic outcome – see the first three rows of Figure 7 below.

We observed that, in 55 of these cases (the first row of Figure 7 below), the motion for dismissal was preceded by orders granting secured lenders relief from stay to foreclose on

48 Bermant and Flynn, supra, note 35, at 8.
50 Morrison, supra, note 34, at 52.
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 cases (the second row of Figure 7), there were successful lift-stay motions by some, but not all, secured lenders, and certain assets remained with the estate. However, the debtors or the U.S. Trustee moved to dismiss the case by citing, inter alia, that there was no reasonable likelihood of reorganization and that Chapter 11 proceedings would not benefit the rest of the creditors.\(^5\) Such dismissals without restructuring of the capital structure typically exposed the firms to potential liquidation under state law, according to Morrison’s 2006 study with a finding that the probability of shutdown was very high in cases which exited without new capital structures.\(^6\)

---

**Figure 7**

**Breakdown of Dismissals in the Dataset**

<table>
<thead>
<tr>
<th>Dismissals (from Strict Resolution)</th>
<th>Count</th>
<th>Subtotal</th>
<th>% of Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Estate has minimal valuable Assets - dismissal preceded by lift-stay order on all assets</td>
<td>55</td>
<td></td>
<td>64.7%</td>
</tr>
<tr>
<td>Estate has minimal valuable Assets - dismissal preceded by lift-stay order on certain assets</td>
<td>8</td>
<td></td>
<td>9.4%</td>
</tr>
<tr>
<td>Reasons related to sale or foreclosure after bankruptcy</td>
<td>18</td>
<td>81</td>
<td>21.2%</td>
</tr>
<tr>
<td>Settlement of claims between creditor and debtor for continued operations</td>
<td>4</td>
<td>4</td>
<td>4.7%</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>85</strong></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

---

\(^5\) 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.

\(^6\) Morrison, *supra*, note 34, at 52.
Of the remaining 21.2% of dismissal cases (18 out of 81) which did not fall under the above category, the reasons for dismissal are summarized as follows:

- Motions by creditors to dismiss the case 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 (“SARE”) status;\(^{53}\)
- Proposed sale of substantially all real property (outside of the section 363 sale provisions) to a junior creditor which would continue negotiations with the senior secured lender.\(^{54}\)

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

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

While Chapter 7 is the prevailing method of business liquidation, Chapter 11 expressly contemplates liquidation through a plan.\(^{55}\) A liquidating plan may contemplate piecemeal

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

\(^{54}\) See, e.g., In re SMG Land Development LLC, No. 08-40902 (Bankr. D. Mass. March 24, 2008). The proposed acquirer of the real property, the holder of a junior lien, had entered into negotiations with Sovereign Bank; thereafter, the debtor dismissed the case since the estate would have no remaining assets available for distribution.
liquidation not much different from a typical Chapter 7 proceeding, but its key distinguishing features is that the debtor’s management can control the plan process and creditors can vote on the plan which may include deviations from the absolute priority rule.\textsuperscript{56}

In identifying the nature of the Chapter 11 plans in our sample, we went beyond the label affixed to the plans and examined the post-confirmation arrangement proposed by the debtor.\textsuperscript{57} For example, in the case of Landing Development, the debtor proposed a “Reorganization Plan” which laid out what was substantially a liquidation scheme. The plan provided for repayment of the secured lenders by compelling a liquidation sale of the existing residential development, and restricted the debtor to an inventory of no more than 16 homes.\textsuperscript{58}

Of the 17 cases where a plan was confirmed, only 7 involved reorganization plans, and the remaining were plans for liquidation. A typical liquidation plan in our sample essentially affords the developer the opportunity for an orderly sale process. To illustrate, in the plan confirmed for Heritage Homes, the debtor would be allowed to market its properties for a period of 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

\textsuperscript{55} See 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, e.g., OLIVER HART, FIRMS, CONTRACTS AND FINANCIAL STRUCTURE, 156 (1995).


\textsuperscript{57} Baird and Rasmussen, Twilight, supra, note 8, at 676 (Observed that many cases coded as “emerged” might actually be sales of some sort, ranging from a sale where the business did not emerge intact as an independent entity to a sale of substantial level of assets while maintaining the business as a discrete legal entity). In undertaking this study, we took pains to guard against this issue.

\textsuperscript{58} 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].
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.\(^5\)  

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 had already been foreclosed upon. This appears to fall within the grey area between reorganization and liquidation.\(^6\)

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.\(^7\) 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 comfort 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.

\textit{D. Are the “Mega” Cases on the Track to Reorganization?}

Of the 11 “mega” developer bankruptcies, 5 cases have been resolved and only one case, LandSource Communities, had confirmed a reorganization plan.\(^8\) One of the cases, Empire Land, had been converted to Chapter 7, after multiple lift-stay motions in pursuance of

\(^5\) \textit{See In re Heritage Homes Inc., No. 08-13285 (Bankr. W. D. Wash. May 29, 2008).}

\(^6\) \textit{See In re First Dartmouth Homes Inc., No. 07-12927 (Bankr. M. D. Fla. December 29, 2007).}


\(^8\) \textit{See In re LandSource Communities Development, LLC, No. 08-11111 (Bankr. D. Del. June 8, 2008).}
foreclosure by secured lenders were approved by the court. 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. Dunmore Homes occupied the most “extreme” end of the spectrum – at the time when the plan was confirmed, secured lenders had already foreclosed upon substantially all residential developments, leaving the developer’s assets consisting of land options, deferred compensation funds, receivables, deposit accounts and litigation claims.

At the time of writing, 4 out of the 11 “mega” cases saw debtors filing a plan – Tousa and DBSI with proposed liquidating plans, Woodside Group and WCI Communities with proposed reorganization plans. The remaining cases – the SunCal group and Neumann Homes had not filed a plan yet, but their progress in bankruptcy proceedings suggests that liquidation or sale is a likely outcome.

Neumann Homes was confronted with multiple successful lift-stay motions and, as it filed for bankruptcy on November 1, 2007, its exclusivity period to file a reorganization plan had expired at the time of writing, given the statutory maximum of 18 months under BAPCPA. It should be noted that distressed lenders (IndyMac, Guaranty Bank and GMAC) held more than 70% of the $115 million bank debt. Similarly, the SunCal group has as their primary secured lenders subsidiaries of the bankrupt Lehman Brothers, and the trustee has since condemned their

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63 See In re Empire Land, LLC, No. 08-14592 (Bankr. C. D. Cal. April 25, 2008).
64 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); In re Dunmore Homes, Inc., No. 08-20569 (Bankr. E. D. Cal. November 8, 2007).
65 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); In re WCI Communities Inc., No. 08-11643 (Bankr. D. Del. August 4, 2008); In re DBSI Inc., No. 08-12687 (Bankr. D. Del. November 10, 2008). Note that Woodside Group’s proposed reorganization plan must be put into context - the bankruptcy petition was filed on behalf of the 30 major banks and 5 insurance companies against 185 affiliated borrower/guarantor entities which had borrowed in excess of $600 Million on an unsecured basis.
role in burdening the estate with liabilities of at least $100 million. This raises the issue of the simultaneous distress of both developer and secured creditor which we will discuss further in Section 5.67

E. 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 153 cases is 81.7%. This is a composite of the following:

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

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).68 Figure 8 below summarizes the results of this benchmarking exercise.

67 In re Palmdale Hills Property, LLC, No. 08-17206 (lead case) (Bankr. C. D. Cal. November 6, 2008).
The liquidation rate for bankrupt developers in our study is high at 81.7% compared to these studies. A possible explanation is that the liquidation rates for the studies by Hotchkiss and Mooradian (2004) and Bharath et al (2007) relate to large companies, while our sample covers residential developers, which are mostly middle-market. On the other hand, even the most optimistic estimate of reorganization rates in the “mega” cases at 45.4% (assuming the 2 cases with proposed reorganization plans and the 2 pending cases will culminate in reorganizations, i.e., 5 out of 11) is not near the levels in these two prior studies. Furthermore, the 81.7% liquidation rate is still much higher than the rate found in the Morrison’s 2006 study on small business bankruptcies, not to mention the low 4.6% reorganization rate in our main sample of 153 cases against Morrison’s 24.2%.

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 sectors. However, if this 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, built during periods preceding the downturn, to be unsatisfactory.\textsuperscript{69} 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?

\textit{F. 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.\textsuperscript{70} It has been asserted that any Chapter 11 case that could be derailed before a plan could be filed was likely to be in so much trouble that reorganization was unlikely in the first place.

Applying this logic, 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 9 below, and economic outcomes, Figure 10. 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%.

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

\textsuperscript{70} Warren and Westbrook, \textit{Challenge, supra}, note 18, at 614.
Predictably, the plan confirmation rate has now increased, being 26.2% 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.\textsuperscript{71} Moreover, in terms of economic outcomes, in Figure 10 below, the level of reorganization is still low at 10.8%.

\begin{figure}
\centering
\caption{Procedural Outcomes}
\begin{tabular}{|l|cc|cc|}
\hline
 & \multicolumn{2}{c|}{Plan Filed} & \multicolumn{2}{c|}{No Plan Filed} \\
 & Count & \% & Count & \% \\
\hline
Converted Ch. 7 & 16 & 24.6\% & 18 & 20.5\% \\
Dismissal & 26 & 40.0\% & 59 & 67.0\% \\
Sale (363) & 6 & 9.2\% & 11 & 12.5\% \\
Plan Confirmed & 17 & 26.2\% & N/A & N/A \\
\hline
\end{tabular}
\end{figure}

\begin{figure}
\centering
\caption{Economic Outcomes}
\begin{tabular}{|l|cc|cc|}
\hline
 & \multicolumn{2}{c|}{Plan Filed} & \multicolumn{2}{c|}{No Plan Filed} \\
 & Count & \% & Count & \% \\
\hline
Liquidation & 51 & 78.5\% & 74 & 84.1\% \\
Reorganization & 7 & 10.8\% & N/A & N/A \\
Going Concern Sale & 6 & 9.2\% & 11 & 12.5\% \\
Others & 1 & 1.5\% & 3 & 3.4\% \\
\hline
\end{tabular}
\end{figure}

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 compare it to a proper measurement of the success of an emergency room. It was argued that, if an emergency room

\textsuperscript{71} Id.
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.72

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 have remarked, the bankrupt debtor must, while “in its most fragile state, either challenge the lender’s liens and security interests or seek to use the lender’s cash collateral over the lender’s objection, which if they are options at all, involve lengthy and resource-draining proceedings, or accede to the lender’s demands”.73 Furthermore, as we will discuss in the next Section, many of these developer bankruptcies were fraught with lift-stay motions. A developer kept busy fending off multiple lift-stay motions may not have the time and resources to file a plan. As the Official Committee of the Unsecured Creditors of Village Homes (a case 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.”74

72 Id.
73 Miller and Waisman, Reorganization, supra, note 8, at 185.
G. Casting a Wider Net with “Substantially Resolved” Cases

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

To address this issue, we have collected docket information on cases which are “substantially resolved”, 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 11 below summarizes the resolution status of these cases.

Figure 11
STATUS OF SUBSTANTIALLY RESOLVED CASES

<table>
<thead>
<tr>
<th>Category</th>
<th>Status</th>
<th>Count</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Order for relief from stay for substantially all assets*</td>
<td>26</td>
<td>44.8%</td>
</tr>
<tr>
<td>2</td>
<td>Order for relief from stay for certain assets*</td>
<td>9</td>
<td>15.5%</td>
</tr>
<tr>
<td>3</td>
<td>Plan filed by debtor and at least 1 order for relief from stay</td>
<td>6</td>
<td>10.3%</td>
</tr>
<tr>
<td>4</td>
<td>Plan filed by debtor and at least 1 lift-stay motion</td>
<td>4</td>
<td>6.9%</td>
</tr>
<tr>
<td>5</td>
<td>Plan filed by debtor; no lift-stay motions</td>
<td>9</td>
<td>15.5%</td>
</tr>
<tr>
<td>6</td>
<td>Sale motion filed and pending hearing</td>
<td>4</td>
<td>6.9%</td>
</tr>
</tbody>
</table>

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

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

Based on this optimistic scenario, we can add 28 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 11.1% plan confirmation rate can be increased to 20.4%, which is still lower than the range in prior empirical studies cited above.

It is thus easy to see that very optimistic assumptions are required before the debtors in our sample achieve a plan confirmation rate closer to the range in previous studies. As gleaned from the findings in sub-section F, only 26.2% of the cases where a plan was filed ended in confirmation. Further analysis of the “strict resolution” sample also shows that cases with a plan filed and at least one order for relief from stay (i.e., Category 3 cases) have a 17.8% chance of confirmation. Besides, we should also consider the fact that 33.3% of the cases in Category 2 (where a plan is not filed yet) were filed more than 12 months ago. Given the statutory maximum on plan filing exclusivity of 18 months and solicitation exclusivity of 20 months, these cases face a rushed timeframe and the probability that every one of these cases would reach plan confirmation is not that high.

Furthermore, as we discussed above, it is not merely plan confirmation which is important, but the confirmation of a reorganization plan. At first glance, 11 of the plans filed were liquidation plans and 8 were reorganization plans. As such, even if we assume that the remaining cases will culminate in reorganization, the addition of these cases to the overall sample will only bring the reorganization rate to 7.1%.

Note that in the case of First Dartmouth, the debtor managed to confirm a restructuring plan with the other creditors in relation to remaining assets, even though substantially all real estate has been foreclosed upon. See *In re First Dartmouth Homes Inc.*, No. 07-12927 (Bankr. M. D. Fla. December 29, 2007).
In this Section, we have shown evidence that residential developers are going into liquidation and foreclosure at an unprecedented rate. In the next Section, we will now present details on exactly how secured lenders are exerting their influence to push bankrupt developers into liquidation or foreclosure.

IV. THE ROAD FROM BANKRUPTCY TO FORECLOSURE AND LIQUIDATION

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. This is not surprising, as secured lenders often prefer a swift sale or liquidation of the debtor, compared to a Chapter 11 reorganization process fraught with uncertainty and delay. In fact, the gradual move toward greater control of Chapter 11 proceedings by secured lenders has allowed fuller expression of the lenders’ incentives for swift resolution of financial distress.\(^76\)

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

A. 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 153 cases (72.5%) where
at least 1 lift-stay motion pursuant to foreclosure was filed by a secured lender. More
importantly, in 92.2% of these 153 cases, an order granting the motions was entered.77

Examining other secured lender actions, we only observed 20 cases (9.5%) where the
secured lender moved to dismiss proceedings, 15 cases (7.1%) 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
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.78

The prevalence of these successful lift-stay motions suggests an issue worth investigating
further. After all, part of bankruptcy policy is based on the principle that there should be a
moratorium on asset grabs. In the following sub-sections, we analyze the reasons underlying

77 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 34, at 54, finding that creditors filed
lift-stay motions in 68% of all shutdowns and the court granted them 42% of the time. Note that these relate to small
business bankruptcies filed in 1989-90 and the numbers are based on shutdowns only, not the entire sample (i.e., the
proportion of lift-stay motions is much lower than the levels found in our sample).

78 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)
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?

B. Relief under 11 U.S.C. § 362

The filing of a bankruptcy petition triggers an automatic stay under section 362 of the Bankruptcy Code.79 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.80

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)).

We will now illustrate how secured lenders use sections 362(d)(1) and 362(d)(2) in Chapter 11 bankruptcy proceedings of residential developers. Village Homes of Colorado (“Village Homes”) represents a classic case. One of Colorado’s largest residential developers with around $200 million in annual revenues, Village Homes filed for bankruptcy on 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

80 See legislative history discussing the policy underlying the imposition of the automatic stay in H.R. REP. NO. 95-595, at 340 (1977).
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.\textsuperscript{81} 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 developed communities ranging from small residential infill to large-scale, mixed-use master plans, and offers a variety of home types and price ranges. In fact, some of the communities developed by Village Homes had received numerous local, state and national awards, including "Community of the Year" from the Home Builders Association of Metropolitan Denver every year from 2002 through 2007.

Nonetheless, like many residential developers, Village Homes’ Chapter 11 filing was precipitated by the onset of severe housing market downturn conditions as well as the credit crisis which caused a significant constriction of credit and reduced the funds that the developer had available to continue normal operations. At the time of bankruptcy, the company had 142 finished but unsold homes in inventory, 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).

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

\textsuperscript{81} See 1st day Affidavit, In re Village Homes of Colorado Inc., No. 08- 27714 (Bankr. D.Colo. November 6, 2008).
the lenders had limited security interests on personal property and that part of the cash belonged to home buyers who put down deposits.\textsuperscript{82}

In the midst of this dispute, the secured lenders also launched lift-stay motions pursuant to foreclosure against Village Homes.\textsuperscript{83} Note that the relief was sought very early in the case, when Village Homes was barely in Chapter 11 for two months and had had no chance to focus on 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.\textsuperscript{84} 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.\textsuperscript{85}

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.\textsuperscript{86}

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

\textsuperscript{82} Id.

\textsuperscript{83} On January 21, 2009, Guaranty Bank, as agent for the Lender Group, filed its motion for relief from stay. In re Village Homes of Colorado Inc., No. 08- 27714 (Bankr. D.Colo. November 6, 2008).


\textsuperscript{86} 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.
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.

This argument is considerably weak. As ruled by the district court which heard an appeal on the issue of “adequate protection” in the bankruptcy of Den-Mark Construction on April 7, 2009, the court rejected a similar argument, citing the Court of Appeals for the Third Circuit: 87

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

It should be noted that this case is premised on the policy that “Congress did not contemplate that a secured creditor could find its position eroded and, as compensation for the erosion, be offered an opportunity to recoup dependent upon the success of a business with inherently risky prospects.” 88 The question is whether legislators continue to adhere to this policy in the significant nationwide decline in housing prices starting in 2007, where almost all distressed real estate businesses can plausibly be considered to have inherently risky prospects.

87 See In re SwedeIand Dev. Group, Inc., 16 F.3d 552, 567 (3rd Cir. 1994)
88 Id.
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.\(^8^9\) 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.\(^9^0\) 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.\(^9^1\) The central argument was that without post-petition financing, Village Homes had no feasible way to continue its business, and that terms for financing the developer could not be agreed upon.

Since the secured lenders were thought to have a strong legal case during hearings, Village Homes eventually agreed to compromise and settle with its secured lenders on March 13, 2009.\(^9^2\) 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

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\(^8^9\) 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.

\(^9^0\) This is unsurprising, given the low market value of the uncompleted properties. In fact, it is a common phenomenon in developer bankruptcies, given the high loan-to-value ratios in loans extended to developers, and the sharp negative correction in real estate prices since 2007.


\(^9^2\) *In re Village Homes of Colorado Inc.*, No. 08- 27714 (Bankr. D.Colo. November 6, 2008). Note that the compromise happened after the initial exclusivity period expired. This case is also an example as to why companies which are not DOAs may not file a plan in time, given that the resources were tied up fighting lift-stay motions.
lots under construction and a portion of finished homes. 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.

From the docket, we have distilled three main arguments marshaled by these secured lenders in 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.

Judging from our findings regarding the numerous lift-stay motions approved, it appears that the current bankruptcy regime and bankruptcy judges are sympathetic to such arguments. To some extent, this might be a carry-over from times when many bankruptcies were a result of poor management, i.e., what finance scholars call idiosyncratic risk. This reasoning is less applicable in the current environment, where the entire residential development industry is collapsing along with housing prices nationwide, with many large and small firms alike entering bankruptcy. This situation, together with the massive fall in residential real estate prices and the dearth of financing, reflects systematic risk.

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93 Id.
94 In an empirical study on highly leveraged transactions of the 1980s which subsequently became financially distressed and filed for bankruptcy, it was found that high leverage, not poor firm or industry performance, was the
It is in such circumstances that the argument that the aggressive liquidation preferred by senior lenders is simply separating the wheat from the chaff falls apart. When the entire sector, if not the entire economy, is suffering, there are unlikely sales and transfers which amount to a “better” utilization of those assets.

Perhaps the bankruptcy case of Grusaf LLC, a middle-market developer of condominiums in Florida, elucidates more clearly the single-mindedness of many secured lenders on repossessing the property and pursuing foreclosure at all costs. 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. Nonetheless, the secured lender 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”).

As the secured lenders in the above case and in Village Homes’ bankruptcy themselves strongly argued, there was a 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

96 Id. Note that, at the time of this objection, the developer had just begun renting out some condominium units, and the process would have taken a while before it could make adequate protection payments to the bank.
infrastructure costs in sale contracts, a liquidation of the Debtors’ assets is unlikely to attract any but the most opportunistic buyer.⁹⁷

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

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

⁹⁷ In re 2W Homestead LP, No. 08-12195 (Bankr. W.D. Tex. November 3, 2008). See the disclosure statement filed by the debtor.
possible, and then assert their interest in the proceeds?\textsuperscript{98} [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 the overall portfolios of banks themselves, as they have other real-estate related assets which have to be marked to market.\textsuperscript{99}

\textit{C. Consent Orders and Agreed Stipulated Relief}

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 141 cases where the lender obtained relief from stay, 68 (48.2\%) of these involved consent orders or agreed stipulations between the developer and secured lenders. This proportion is much lower than the finding in a 1990 empirical study where 87\% of the lift-stay motions were settled

\textsuperscript{98} \textit{In re} Village Homes of Colorado Inc., No. 08- 27714 \text{\textemdash} (Bankr. D. Colo. November 6, 2008). See the response by the debtor to the motion for relief from stay filed by RFC, a secured lender. RFC refers to Residential Funding Corporation, part of the GMAC group, which has been financially-distressed itself during the bankruptcy proceedings – an issue which we will discuss in Section 5.

\textsuperscript{99} 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.”)
before the court rendered its decision. 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. 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”. 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 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 on, in exchange for the ability to retain some core assets. First, part of the settlement with the secured lenders included the appointment of a Chief Restructuring Officer (“CRO”). The secured lenders would provide the developer with two candidates and the 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.

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102 In re Village Homes of Colorado Inc., No. 08- 27714 (Bankr. D. Colo. November 6, 2008).
103 Id.
Next, while the lenders had now agreed to allow Village Homes to use its cash collateral according to an approved budget, the settlement provided contingent adequate protection to the secured lenders. This consisted 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.\textsuperscript{104}

A 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:\textsuperscript{105}

- 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 complied 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 complied with its obligations under the Consent Order, the Sale Period could be extended for two additional 3-month periods.
- The Company would actively market and sell the remaining 27 finished lots and 2 finished homes during the Sale Period.

\textsuperscript{104} Id.
\textsuperscript{105} In re Maryland Homes Palisades PA, LLC, No. 08-18286 (Bankr. D.Md. June 23, 2008).
At first glance, such arrangements may seem to have provided the developer a window of opportunity to work towards an orderly sale or reorganization. However, where the specified sales targets are overly ambitious in the context of the housing crisis, the developer can easily fall into non-compliance and the lender would then proceed with foreclosure – an occurrence in a number of cases.\textsuperscript{106}

Part of the consent order in the case of Maryland Homes Palisades PA carried darker overtones, complicated by the incentives of guarantors to be released from personal guarantees. In one of the provisions, the secured lender agreed that the principal could pay 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 where the debtor’s owner-manager has personally guaranteed the firm’s debt.\textsuperscript{107} If the firm’s assets at the outset of bankruptcy are sufficient to cover guaranteed debt to lenders, the owner-manager may favor early shutdown to avoid personal liability, at the expense of unsecured creditors. This is consistent with a line of literature criticizing Chapter 11’s manager-controlled process, particularly the conflict of interest problem.\textsuperscript{108}

\textsuperscript{106} See, e.g., \textit{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 foreclosure.

\textsuperscript{107} Morrison, \textit{supra}, note 34, at 28.

\textsuperscript{108} See, generally, A. Mechele Dickerson, \textit{Privatizing Ethics in Corporate Reorganizations}, 93 \textit{MINN. L. REV.} 875 (2009) (arguing that the fiduciary duties of managers during bankruptcy cases are ill-defined, and conflict of interest often occur, though this problem can extend to situations where a private trustee is appointed and controlled by one of the secured creditors). \textit{See also} the critique of Chapter 11’s manager-controlled model in Barry E. Adler, \textit{A
Upon an analysis of the bankruptcy docket data collected, we found that 39.7% of the consent orders contained some form of agreement by the secured lender to waive its deficiency claim and release insiders from their liabilities as guarantors.

An 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 obligations against the principal, in exchange for the termination of the automatic stay to proceed with foreclosure.\(^\text{109}\) There are also cases which played out like the case of Maryland Homes Palisades PA (discussed above) where the consent order fixed the guarantors’ obligations at a relatively low level.\(^\text{110}\) For example, in the case of Namwest LLC, part of the settlement required the guarantors to execute a note in the principal amount of $37,500 to the secured lender. In consideration of the conveyance of the properties (real estate with a scheduled value of $28 million and 50% interests in undeveloped land), the lender would cancel all outstanding debt owed by the guarantors.\(^\text{111}\)

It should be noted that the number of such occurrences may be higher, given that some cases involve side arrangements entered into by parties that were not filed into court.\(^\text{112}\) While it falls to bankruptcy judges to take into account the interests of junior creditors when scrutinizing

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


112 See, *e.g.*, *In re Bysynergy LLC*, No. 08-7680 (Bankr. D. Ariz. June 25, 2008), under-the-table arrangements between the secured lender and the developer came to light after the parties fell out. According to the motion filed requesting to stay the sale on February 2, 2009, a party, on behalf of the secured lender, allegedly told the principal that he would “lose personally everything” if he did not support their position and, in return, the latter would “receive some kind of an interest ‘on the back end’”.

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these deals, these findings introduce nuances to the role of creditors as positive agents of corporate governance.

D. 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. The change with the most significant impact on developer bankruptcies, however, 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 other than the business of operating the real property and activities incidental thereto.” 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 classified under SARE provisions. For example, Le Jardin, a developer which filed for bankruptcy on September 2, 2008, and which owned a luxury real estate project in South Fulton County, Georgia, consisting of 1,100 acres, of which 330 were developed at the time of bankruptcy, was considered an SARE. 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. 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, showing that the implementation of the new law tilts the field towards secured creditors.

114 In re Le Jardin LLC, No. 08-77019 (Bankr N. D. Ga. August 9, 2008).
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 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 from 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.\(^{116}\)

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, rather than the foreclosure of income-producing properties.

It may be that the BAPCPA amendments introduced changes to bankruptcy law that legislators, homeowners, and homebuilders alike may come to regret. Many of the amendments were clearly aimed at preventing the costs and delays owing to abuses of the bankruptcy process.

\(^{116}\) See, for example, In re Randall Martin Home Dobson Park LLC, No. 08-07689 (Bankr. D. Ariz. June 25, 2008).
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.

In this Section, we have discussed the impact of secured lender actions in relation to how the bankruptcies of residential developers were resolved. Noting that, to a great extent, the downturn in 2007-8 has contributed to the developers’ misfortunes; the next Section will analyze how the downturn has also created pressure on banks, and make a case that banks were influenced by factors beyond the simple economics of the bankruptcy case itself.

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

The above Sections discuss 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. In this section, instead of focusing on the position of the debtors, we shift the viewpoint to the position of the lenders, most of which are banks.117

FDIC statistics show that, as of the end of 2007, the total dollar amount of construction and development loans in the U.S. provided by banks was more than $559 billion.118 Therefore, it is not controversial to say that banks make up most of the secured lenders in the residential development industry. The composition of our data sample is consistent with this observation – at least one bank is involved as a senior secured lender in 92.3% of the cases.119

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


119 A small proportion of the senior secured lenders comprised of hedge funds. The sample also shows that hedge funds and finance companies involved in construction lending tend to take 2nd lien positions, presumably due to the higher rates of return offered by such tranches (without discounting for default risk).
Much of bankruptcy literature, in the discussion of the role and actions of banks, proceeds on the premise of banks as rational, profit-maximizing actors, with little reference to the actual regulatory environment in which banks function. One of the assumptions underlying the rise of secured creditor control 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 on that investment, and, when that happens, the value of the assets will be maximized through sale and reinvestment by third parties.

We will now show how a nuanced understanding of the institutional psychology and regulatory environment of banks will further explain how banks are motivated to pursue liquidations by factors extraneous to the bankruptcy case itself, exposing potential troubling implications for the theoretical underpinnings of our current bankruptcy regime. After all, it is questionable as to whether failed or failing banks should be in a position where they hold the reins of bankruptcy proceedings.

Proceeding on this line of reasoning, 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.

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120 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.
A. Cost of Capital Considerations

One key cost in the cost-benefit calculus of banks’ lending decision is seldom discussed in bankruptcy literature, and that is the cost of capital, or any other risk-based allocation of cost, such as the cost of loan-loss provisions, to the outstanding 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.\textsuperscript{121} 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 constantly 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.

\textsuperscript{121} 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. See, generally, Federal Deposit Insurance Corporation, Economic Capital and the Assessment of Capital Adequacy (2004), available at http://www.fdic.gov/regulations/examinations/ supervisory/insights/siwin04/economic_capital.html.
Essentially, regulators want banks to be well-diversified so as to not be in danger of collapsing due to losses in any one part of its portfolio, which can be driven by correlated, or systematic, events that manifest as higher-than-expected losses in that sub-portfolio. A well-diversified bank will see increasing losses in some parts of its portfolio generally offset by decreasing losses in another parts.\textsuperscript{122}

Undiversified portfolios, on the other hand, are more vulnerable to sudden shocks. To be considered well-capitalized, a bank has to target a level over 10\% of loan book value for unexpected losses.\textsuperscript{123} Regulators have assessed that if a bank is diversified in its exposures, the probability of capital exhaustion falls even further. The implication is that if a bank is not diversified, or excessively concentrated, the chance of capital-exhausting events grows unacceptably large. A bank must then either raise capital or reduce concentrations. Since raising capital is very expensive, and even more so in 2007-8, any method of capital relief will be appealing, including the liquidation of assets.

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


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

Exactly how disproportionate a share of capital the real estate book has to attract due to concentration risk is an exercise that consumes large resources at banks and depends very much on the result of financial analysis and portfolio modeling. In general, a bank’s estimate of how correlated the defaults of its debtors 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).\(^{124}\)

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

The cost of capital and provisions is thus part of the overall cost-benefit analysis that a bank performs when making business decisions, including making loans. 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.\(^{125}\) As an illustration of how cost of capital affects the decision-making process of banks, we have included in the Appendix I an example provided by a regional bank showing a wide disparity in loan spreads depending on the capital ratio levels.


\(^{125}\) See CHARLES SMITHSON, CREDIT PORTFOLIO MANAGEMENT, 262-65 (2003).
Next, in order to meet the shareholder-mandated return on risk-weighted assets and justify the risk-adjusted revenue relative to the risk-adjusted cost, banks must find a way to extract more value out of their debtors, particularly those that consume relatively more capital, which are, in this example, real estate loans. They can do this by either increasing fees and interest rates in the short term (and thereby increasing default risk in the midterm) or reducing what they perceive to be causes of default risk in the short term by imposing ever more 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.\footnote{The case of Whitney Lake is an illustration of how banks acted to reduce its concentration risk in construction loans. In 2007, one of the debtor’s banks, SunTrust, stated that it was exiting the construction lending business and that it 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. \textit{In re} Whitney Lake, LLC, No. 08-05729 (Bankr. D. S. C. September 12, 2008).} This would relieve the bank of its exposure to the debtor, even if it takes a short-term loss on its principal, because of the “invisible” cost of capital.

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

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

The savings on this “capital injection” through liquidating debtors’ assets instead of borrowing money may be higher than the discounted present value of the marginal increase in the value of the debtor in 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:128


128 To illustrate, Goldman Sachs, in September 2008, right after the collapse of Lehman Brothers, sold $5 billion of preferred stock to Warren Buffett yielding a 10% dividend a year, a rate more typically found in junk securities during the boom. See, e.g., Joe Peek & Eric S. Rosengren, *Bank Real Estate Lending and the New England Capital Crunch*, AMER. REAL ESTATE URBAN ECON. ASSOC. J. (1994), at 33.
Banks below minimum capital standards had only two options: increase equity with retained earnings or new capital, or shrink their assets. New England banks with large loan losses had little possibility of quickly restoring capital with retained earnings and did not raise additional equity… they can shrink their loan portfolios by tightening credit standards and, in some cases, calling or refusing to roll over loans. Because poorly capitalized banks feel more pressure to shrink their asset portfolios, their customers may find their loan conditions or loan availability altered, primarily because of the financial condition of their banks.

B. Regulatory Pressure to Reduce Concentration Risk

Pressure to exit the real estate lending market comes not only from a bank’s own perceived need to raise capital but also regulator action from outside the bank, linked to the regulator’s own perceived issue with the bank’s capital adequacy, although they are related. Regulatory pressure, however, is a larger issue and begins even before capital reaches inadequate levels. There is evidence, from the official correspondence and Congressional testimony, and findings from our interviews, that right before and during the current downturn, regulators encouraged banks to reduce their exposure to real estate-linked loans, especially construction loans.129 From our empirical observations, this pressure exceeded what one would expect from normal supervision, and created a high amount of pressure on banks to exit exposures to the residential development market, in any way possible.

129 The author of this article, at the 2008 Risk Management Association Annual Conference in Baltimore where regulators were present, observed that many sessions were peppered with comments from regulators and bankers regarding concentration risk in relation to commercial real estate lending, including construction lending.
This creates a high likelihood that banks, in order to avoid receiving regulatory sanctions, responded to the pressure by reducing commercial real estate concentrations through such solutions as liquidating debtors (i.e., getting them off the bank’s books), instead of 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 Article, but the fact remains that banking industry regulatory action is a factor that cannot ignored in the analytical framework of bankruptcy scholars.

Congressional comment about regulatory interference is a reliable indication that regulators are being active. 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, remarked that the way it sought to address high and increasing concentrations of commercial real estate loans at some banks was “too much of a ‘one size fits all’ formulation and effectively a cap on commercial real estate lending”. In a recent Capitol Hill testimony hearing, Michael Menzies, the Chairman of the Independent Community Bankers of America testified in Congress that “field examiners are overzealous and unduly overreaching and are, in some cases, second guessing bankers and

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professional independent appraisers and demanding overly aggressive writedowns and reclassifications of viable commercial real estate loans and other assets.”

He also cited reports from various community bankers about examiners requiring writedowns 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. 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”.

When FDIC Chair, Sheila Bair, says that she wanted to “send a message that regulators were concerned about growing CRE concentrations” and that banks should “manage concentrations according to an acceptable level of risk tolerance”, banks listen. 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. 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

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133 *Id.*

134 *Id.*


respondents reported tightening standards in commercial construction loan portfolios in 2008, as compared to 13% in 2007.\textsuperscript{137}

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”.\textsuperscript{138} He decried the practice, which he claimed to be driven by regulatory pressure, where borrowers, whose newly-assessed construction loans failed to meet certain loan-to-valuation ratios, were forced to pay the financial institutions an amount necessary to bring the loans into compliance with the original LTV ratios.\textsuperscript{139} Many borrowers are unable to meet these new financial requirements owing to the severe recession and may be forced into insolvency.

Approximately 1,020 comment letters were sent in response to the regulatory guidance on “Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices”, of which the majority were protests by community banks that the prescribed capital limitations would lead to a significant reduction in commercial real estate lending, especially construction lending.\textsuperscript{140} The guidance remained, however, and the evidence thus far suggests that banks may choose to exit the construction loan market under regulatory pressure and one of the swiftest ways includes liquidating bankrupt companies (regardless of firm viability), so as to present a “cleaner”-looking balance sheet. This upsets a major line of reasoning underlying giving banks


\textsuperscript{138}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).

\textsuperscript{139}\textit{Id.}

\textsuperscript{140}These letters are available at http://www.fdic.gov/regulations/laws/federal/2006/06comcrelending.html (last visited Aug. 5, 2009).
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.

C. Procyclicality in Bank Behavior

Much of what we have observed in the last few sections has been driven by the economic downturn. Our reading of existing bankruptcy literature is that it appears not to have taken into account the different implications of bankruptcy policy, particularly on the issue of secured creditor control, in different parts of the economic cycle. This is a glaring omission, given how lenders’ incentives and behavior tend to differ in a downturn and under stress as opposed to a more “normal” part of the economic cycle, when they are closer to the hypothetical rational long-term profit maximizing entity found in bankruptcy literature.

In general, we can describe banks as being highly procyclical.\textsuperscript{141} During good times, banks incur more risks than they reasonably should through, for example, excessive lending with poor standards, and in bad times, they make a drastic change and pull back on their lending, which incidentally exacerbates the wider downturn when all the banks do so simultaneously.\textsuperscript{142} Quite independently of the merits of the bankruptcy case, and somewhat independently of whether a bank is highly distressed and in need of capital or under regulatory pressure as well, banks will in general tighten lending standards during a recession and loosen lending standards in an expansion – see the two charts provided below.\textsuperscript{143}

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\textsuperscript{142} Id.
\end{flushleft}

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\end{flushleft}
FIGURE 12

CHANGES IN UNDERWRITING STANDARDS IN COMMERCIAL CONSTRUCTION LOAN PORTFOLIOS
(PERCENT OF RESPONSES)

<table>
<thead>
<tr>
<th>Year</th>
<th>Eased</th>
<th>Unchanged</th>
<th>Tightened</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003</td>
<td>2</td>
<td>61</td>
<td>37</td>
</tr>
<tr>
<td>2004</td>
<td>10</td>
<td>75</td>
<td>15</td>
</tr>
<tr>
<td>2005</td>
<td>29</td>
<td>63</td>
<td>8</td>
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<tr>
<td>2006</td>
<td>32</td>
<td>56</td>
<td>12</td>
</tr>
<tr>
<td>2007</td>
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<td>13</td>
</tr>
<tr>
<td>2008</td>
<td>8</td>
<td>43</td>
<td>49</td>
</tr>
</tbody>
</table>


FIGURE 13

PROPORTION OF BANKS TIGHTENING STANDARDS FOR COMMERCIAL REAL ESTATE LOANS

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

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

This is encouraged by banking regulation, which is generally procyclical in nature. It pressures banks to respond to increasing systemic risk by becoming far more conservative, on both projected expected as well as unexpected losses. In the next few paragraphs, we extend our specific discussion of capital and regulatory pressure on real estate concentrations into a general comment on procyclicality.

Procyclicality has been one of the most controversial issues during the discussion of Basel II regulatory proposals. Basel II, in its original conception, represents a more risk-sensitive capital framework whereby, as credit conditions change, minimum requirements change correspondingly.

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

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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.\footnote{Claudio Borio, Craig Furfine and Philip Lowe, supra, note 145.}

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.”\footnote{Zions Bank, \textit{ANPR on Revising Domestic Capital Adequacy Guidelines}, Public Comment Letter, 2006, available at http://www.fdic.gov/regulations/laws/federal/2005/05c37basel1a.pdf.}

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.\footnote{Cycle Clips, \textit{The Economist}, May 15, 2008, at http://www.economist.com/displayStory.cfm?story_id=11325492. The article also has some observations on the relationship between regulators and banks: “What you have to do every so often”, says a former regulator, “is pick a performance measure of some kind, line the banks up and shoot the dog. The rest will quickly cower at the other end of the row.”} Unfortunately, the eventual result of under-pricing credit is the urge to overprice it afterwards when a chain of defaults starts to occur. This over-pricing of credit by banks can clearly occur not just in loan origination but also in problem loan workouts, i.e., bankruptcy. In contrast, we do not have different doctrines relating to the level of creditor control in the bankruptcy regime depending on the economic cycle, although economic outcomes varies with the economic cycle which, in turn, drives key issues in determining whether bankrupt companies have going concern value or whether there is an efficient and liquid market for other firms to purchase the assets of bankrupt companies.
As large numbers of distressed banks, seeking liquidity, foreclose on homeowners and force properties onto the market, increasing supply and depressing prices, the net result is actually that the marked-to-market value of many bank assets will fall correspondingly – a precursor to bank failure (which had to be limited by the recent change in accounting rules to allow banks to not have to mark-to-market their assets). In a way, this posits a social dilemma, in which individuals acting independently in their own self-interests cause a problem that cannot be self-corrected by action of a market, because the damage is shared mainly among those which act later.

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.

149 Note that FDIC data shows that, as of December 31, 2008, commercial banks have an average of 44% concentration in real estate loans – see Federal Deposit Insurance Corporation, FDIC Quarterly Banking Profile (2008), available at http://www2.fdic.gov/qbp/grgraph.asp.
D. Financially-Distressed Banks in the Data Sample

The threads discussed so far in this section come together upon analysis of the banks that are secured lenders to the residential developers that we analyzed for this Article. If the secured lenders in our data sample are in financial distress (which we will define shortly), then they would suffer acutely from a high cost of capital, they would be under severe regulatory scrutiny (and ordered, privately or publicly, to reduce their risk concentrations in real estate), and they would pull back their financial support for the developers, whether ordered to do so by the regulator or not. All of this would translate into the liquidation preference which we observed.

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

- Has the bank failed and been seized by FDIC or another regulator?
- Has the bank failed, even though FDIC has not been appointed its receiver? Examples include Wachovia (FDIC-arranged rescue) and Lehman Brothers (Chapter 11 bankruptcy).
- Has the bank received at least 1 cease-and-desist order from a banking regulator for operating with an inadequate level of capital for its risk profile?150

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150 Note that empirical studies on bank capital and commercial real estate lending have found that, although poorly capitalized banks shrank their assets more than better capitalized institutions, the reduction was more dramatic if regulators imposed formal actions. See, generally, Joe Peek & Eric S. Rosengren, Bank Regulatory Agreements in New England, 15 FED. RESERVE BANK BOSTON NEW ENG. ECON. REV. 24 (1995); Joe Peek, Eric S. Rosengren & John S. Jordan, The Impact of Greater Bank Disclosure amidst a Banking Crisis (Federal Reserve Bank of Boston Working Paper Series no. 99-1, 1999), available at http://ideas.repec.org/s/fip/fedbwp.html.
• Has the bank been under-capitalized according to Prompt Corrective Action (“PCA”) directives?

Under the PCA directives, a bank is under-capitalized where its total risk-based capital ratio is less than 8%, its Tier 1 risk-based capital ratio is less than 4%, or Tier 1 leverage ratio is less than 4%. A bank is significantly under-capitalized when its total risk-based capital ratio is less than 6%, its Tier 1 risk-based capital ratio is less than 3%, or its Tier 1 leverage ratio is less than 3%.151

Based on these metrics, we found that 45.4% of the banks in our sample fell within these categories of financial distress between November 2007 and December 2008 - see Figure 14.152

![Figure 14](image_url)

**Table**

<table>
<thead>
<tr>
<th>Financial Distress</th>
<th>No.</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Failed Banks</td>
<td>58</td>
<td>26.1%</td>
</tr>
<tr>
<td>Banks with Cease-and-Desist Orders</td>
<td>31</td>
<td>14.0%</td>
</tr>
<tr>
<td>Under-Capitalized Banks</td>
<td>7</td>
<td>3.2%</td>
</tr>
<tr>
<td>Significantly Under-Capitalized Banks</td>
<td>5</td>
<td>2.3%</td>
</tr>
</tbody>
</table>

It is problematic that almost half the banks participating and exercising secured creditor control in developer bankruptcies were in financial distress themselves. More disturbingly, our results may have under-estimated the proportion of financially-distressed banks as well. FDIC

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152 Note that, in categorizing the banks into categories of financial distress, a bank which failed or received a cease-and-desist order, though under-capitalized as well, is only counted once in the former categories.
maintains a “Problem Bank” list which comprised 252 banks by the fourth quarter of 2008. In addition, we may not have captured financially-distressed banks which have been raising capital, including those participating in the US Treasury Department’s Troubled Asset Relief Program. As such, a failure to analyze the environment in which banks function is a glaring omission.

Investigating this point further, we undertake a quick analysis of the effect of a bank’s financial distress on the probability of the filing of a lift-stay motion pursuant to foreclosure using a probit regression model. The dependent variable equals 1 when a lift-stay motion was filed by a bank in the bankruptcy case and equals 0 when no lift-stay motions were filed in the case. Appendix II presents the variants of the model specifications and results.

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

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154 Federal Deposit Insurance Corporation, FDIC Quarterly Banking Profile (2009), available at http://www2.fdic.gov/qbp/2009mar/qbp.pdf. It was stated that most of the aggregate increase in capital came from participation in TARP.

155 In undertaking the multivariate regression, only the cases where there is at least one bank involved are used, i.e., 190 observations are used in each specification (after excluding cases with missing independent variables).
(the base category). Finally, Column (6) presents the “kitchen sink” model where all variables are tested in the regression.

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

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

At this juncture, we highlight two examples illustrating the possible negative impact of secured lender control over distressed residential development properties, where the lender is itself in financial distress. The first example involves the SunCal companies, where the bankruptcy trustee, upon undertaking due diligence of the real estate, condemned the role of Lehman Brothers affiliates in their role as secured lenders.\textsuperscript{156}

Lehman's funding practices, dictatorial control over the Projects' operations, and breach of its funding obligations created a common layer of unpaid unsecured debt that now burdens all of the Debtors' estates in the estimated amount of $100

\textsuperscript{156} \textit{In re} Palmdale Hills Property, LLC, No. 08-17206 (lead case) (Bankr. C. D. Cal. November 6, 2008).
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.\textsuperscript{157}

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

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

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

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

We have taken the first few steps to bridging the chasm between an understanding of the regulatory context in which banks function and the bankruptcy regime by analyzing banks’ regulatory environment and their sensitivity to the economic cycle and the cost of capital. We have shown that banks are highly-constrained profit-maximizing entities, and their actions are significantly driven by factors apart from the individual risk profiles of debtors. We have shown that when banks are struggling for their own survival, the liquidity, capital and regulatory crisis may contribute to banks preferring liquidation over reorganization.

This point, along with observations of banks’ liquidation preference in bankruptcy, is especially relevant in today’s environment where the government provides financial support to banks through the Troubled Asset Relief Program. It is sometimes argued that a capital infusion into either banks or their debtor firms should make both sectors better off, but in fact a cash infusion can increase the bargaining power of the sector receiving aid with regards to the other. Diamond and Rajan have argued that an infusion into banks large enough to prevent bank runs, but not large enough to extend the risk-taking horizon, may simply lead to debtors coming under more pressure than before by their banks.159 This is because banks are usually recapitalized only up to the point where they still have to struggle with profitability, whereas if distressed banks were closed and their loans sold to healthy institutions, these new creditors are more able to take

a long-term view of the case. Allied to our observations, this is a powerful argument for greater oversight of how banks taking government money treat their financially distressed debtors.

Finally, we leave the reader with an example of a bankruptcy reorganization of a residential developer. Proceedings of the NewFlorida Properties Corporation case in Florida finally drew to a close in December 2008, after a 7-year long bankruptcy reorganization process. In 2001, the developer’s 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 [name of the condominium] and the construction lender would not provide funds to complete the work”160. Such a description would befit most of the 222 developers in our sample. However, in contrast, the parties in the former case 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 a 100% dividend to all creditors and even a $3.6 million return to the developer.

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.

APPENDIX I

Example: How Cost of Capital Affects Bank Lending

This example is derived from a 2007 letter from Zions Bank to banking regulators:161

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

<table>
<thead>
<tr>
<th>Cost of Capital:</th>
<th>12%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax rate:</td>
<td>40%</td>
</tr>
<tr>
<td>Expense rate:</td>
<td>1.00%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Capital ratio:</th>
<th>Required Breakeven Spread1:</th>
</tr>
</thead>
<tbody>
<tr>
<td>2.5%</td>
<td>1.50%</td>
</tr>
<tr>
<td>4.0%</td>
<td>1.80%</td>
</tr>
<tr>
<td>5.0%</td>
<td>2.00%</td>
</tr>
<tr>
<td>6.0%</td>
<td>2.20%</td>
</tr>
<tr>
<td>8.0%</td>
<td>2.60%</td>
</tr>
</tbody>
</table>

1Pricing Spread which covers Cost of Capital

## Appendix II

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

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