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Timbers of Inwood Forest, the Economics of Rent, and the Evolving Dynamics of Chapter 11

Edward R. Morrison†

I. Introduction

In January 1988, the Supreme Court held that one of the Bankruptcy Code's most important safeguards for secured creditors—''adequate protection'' of the creditor's interest in debtor property—does not include compensation for the delay caused by a bankruptcy proceeding. Adequate protection does include compensation for wear, tear, and other physical depreciation caused by the debtor's use of collateral, but it doesn't compensate the creditor for investment opportunities that were lost when the debtor filed a bankruptcy petition and prevented the creditor from foreclosing, selling the collateral, and investing the proceeds. The secured creditor may be able to capitalize on these investment opportunities at some point in the future—when the collateral is abandoned or payments are made under a plan of reorganization—but it receives no compensation in the interim. So held the Court in *United Savings Bank Ass'n of Texas v. Timbers of Inwood Forest Assocs*.[1]

Timbers is a landmark in United States bankruptcy law. Before the Court rendered its decision, the case attracted amicus briefs from the nation's leading practitioners and professors. Since then, the case has occupied a prominent place in nearly every bankruptcy textbook and is routinely cited for the important proposition that a debtor is not required to compensate undersecured[2] creditors for the delay caused by a lengthy, protracted bankruptcy proceeding.

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† Associate Professor of Law, Columbia Law School. I am grateful to Douglas Baird, Robert Ferguson, Christopher Mayer, and Alex Raskolnikov for helpful comments and conversations and to Ariana Cooper and David Forsh for research assistance.

1. 484 U.S. 365 (1988).

2. A creditor is ''undersecured'' if the value of its claim is greater than the value of its security interest in debtor property (collateral). Conversely, a creditor is ''oversecured''

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There is more to the story than this simple statement of black-letter law. If we look beyond the *United States Reports* and study the docket in the bankruptcy court and the statistics collected by the federal government, a very different account of *Timbers* emerges. Instead of a story about undersecured creditors, lost investment opportunities, and delay, *Timbers* is a story about the economics of rent, opt-out behavior, and speed.

Timbers arose from a fight between a bank and a real estate venture with a single asset, a Houston apartment complex, in which the bank held a security interest. As Section II below explains, the venture had filed a Chapter 11 petition; it had run out of cash and its debt to the bank exceeded the value of the complex. Two things happened within the first few weeks of the case. First, the venture agreed to turn over to the bank all rents (net of expenses) generated by the apartment complex. Next, the bank petitioned the court to lift the automatic stay unless the debtor made monthly ''adequate protection'' payments equal to the bank's lost investment opportunities, i.e., the opportunities it could have exploited had it been able to foreclose on the apartment complex, sell it, and invest the proceeds. The Texas bankruptcy court granted the bank's request, ordering the venture to make monthly payments *five times* larger than the rents currently being turned over to the bank. This is the order that was ultimately reviewed, and reversed, by the Fifth Circuit Court of Appeals and the U.S. Supreme Court.

This simple sketch of the bankruptcy court proceedings present a story of *Timbers* that is very different from the one commonly told. When the bank petitioned the court for adequate protection, it was hoping for more than just compensation for lost investment opportunities. The simple economics of rent, discussed in Section III, tells us that the bank was already receiving most of this compensation via the monthly rentals. When it petitioned the court for adequate protection payments that were 400% larger than the monthly rentals, the bank was probably betting on judicial error. If the court overvalued the monthly adequate protection payments—as it probably did—the bank could be certain that the case would end quickly. The debtor would be unable to make the payments. This would create ''cause'' for lifting the stay and allowing the bank to foreclose on the apartment complex. The bank's motion for adequate protection, then, was probably a gambit to terminate the bankruptcy process.

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if the value of the collateral exceeds the creditor's claim; the excess is often called an ''equity cushion.'' Thanks to 11 U.S.C. §506(b), *oversecured* creditors are entitled to periodic payments of interest at the rate specified in the underlying loan agreement. These payments are subtracted from the ''equity cushion;'' when the cushion is depleted, the payments end.

The bank wanted out, but it's easy to understand why. This was, as Section IV explains, a two-party dispute and the debtor had used federal bankruptcy law merely to delay foreclosure. There were, to be sure, a few other unsecured creditors (most of the unsecured debt was held by owners of the real estate venture), but the bank was willing to pay these creditors in full just to end the bankruptcy case. Nonetheless, the case dragged on. The owners, it seems, were gambling on resurrection: if they could delay the case long enough, property values might—just might—increase enough to render the venture solvent again. That was a pipe-dream and the bank was unwilling to subsidize the owners' gamble. Moreover, bankruptcy is expensive; lawyers, accountants, and financial advisors must be hired to run the process. Even if it would take as long to sell the property outside bankruptcy as it would to reorganize it inside a Chapter 11—and even if an out-of-bankruptcy sale would yield the same return to the bank as reorganization—the bank might still want to opt out of the bankruptcy process merely to avoid its administrative costs.

By the time it reached the Supreme Court, then, *Timbers* had morphed into something altogether different. It was no longer a complicated story about a bank's effort to opt out of the Code. It had become an abstract debate about the scope of the term ''adequate protection.'' And, as we will see in Section V, the Court's conclusion—denying compensation for lost investment opportunities—rests on shaky statutory analysis and has come under attack from many commentators. But if we view the case against its factual background, the Court's conclusion may make some sense. It effectively blocked the bank's effort to opt out of the bankruptcy process; many other provisions of the Code attempt to do precisely the same thing.[3]

Sensible or not, the Court's decision has had limited vitality, as Section VI explains. The decision has been overruled, in part, by Congress. Moreover, a rule denying compensation for lost investment opportunities is important only when bankruptcy cases are lengthy affairs. But case duration has fallen dramatically—by nearly 60% among cases involving large, publicly-traded corporations—since the Court handed down *Timbers*. Indeed, the Court may have contributed to the decline by uttering its famous dictum that a bankruptcy court should lift the automatic stay unless there is a ''reasonable possibility of a successful reorganization within a reasonable time.''[4]

Timbers, then, is a complicated story, with lessons on the economics of rent, opt-out behavior, and case speed. These lessons can't be drawn

3. *See, e.g.*, the Codes various rules prohibiting ''ipso facto'' clauses. 11 U.S.C. §§365(b)(2), 365(e)(1), 541(c)(1), 545.

4. 484 U.S. at 376 *supra* note 1.

from the Supreme Court's opinion. They can, I hope, be drawn from the Sections that follow.

II. The debtor: oil shocks and a gated community

Built in 1981, Timbers of Inwood Forest was (and still is) a gated community bordering Houston's Inwood Forest Golf Club. Sitting on approximately 6 acres, the community was home to fourteen one or two-story buildings with 190 or so rentable units,[5] ranging from 607 to 1,012 square feet.[6] Featuring enclosed patios and a community swimming pool, the apartments were (and still are) modest but comfortable homes.[7] In May of 1982, the complex was reported to be worth $6.25 million.[8]

Legally, Timbers of Inwood Forest was structured as a limited partnership with two general partners—Woody Mann, Jr., and Dorado Corp.—and about 30 limited partners.[9] Funds to build the complex came from a $4.1 million non-recourse[10] loan from United Savings Association of Texas, a local savings and loan (''S & L''). The loan was secured by the apartment complex, its rental income, and a $1.3 million personal guarantees from the general partners.[11] The complex was actually only

5. The case records offer conflicting reports on the number of units. Schedule B, Statement of All Property of Debtor (Mar. 21, 1985) [Docket 13], reports 192, but debtor's Hr'g Mem., at 1 (May 6, 1985) [Docket 29] reports 188 (Bracketed references to [Docket X] indicate the docket number for the cited source in the bankruptcy court proceedings.)

6. Schedule B, Statement of All Property of Debtor (March 21, 1985) [Docket 13].

7. When Timbers entered bankruptcy in 1985, the average monthly rent per unit was about $216, worth about $409 in current (2006) dollars. Today, according to various websites, the average monthly rental ranges from $435 to $600. In real (inflation-adjusted) terms, then, the rentals have not risen much over the past 20 years. The apartment complex remains a moderately-priced dwelling.

I computed the monthly rental in 1985 as follows: the debtor's monthly operating reports showed monthly rental revenue equal to about $39,000 at a time when the vacancy rate was about 25%. (See *infra* notes 88–89 and accompanying text.) Assuming the complex had 190 available units, the $39,000 in monthly revenue was generated by 181 apartments. Dividing $39,000 by 181 yields a per-unit monthly rental of about $216, in 1985 dollars. I converted that sum to current (2006) dollars using Bureau of Labor Statistics, *CPI Inflation Calculator* (visited Sept. 1, 2006) <http://data.bls.gov/cgi-bin/cpicalc.pl>.

Data on current rentals was drawn from the following websites: moveforfree.com (visited Sept. 29, 2006) <http://www.moveforfree.com/apartments/Texas/Houston/Timbers,of,Inwood,Forest,I,and,II.html>; Rent.com (visited Sept. 1, 2006) <http://www.rent.com/rentals/texas/houston-and-vicinity/houston/north-houston/>.

8. Hr'g Mem., at 1 (May 6, 1985) [Docket 29].

9. Statement of Financial Affairs, Item 21 (Mar. 21, 1985) [Docket 12].

10. The loan is described as a '' 'non-liability' note, pursuant to the provision of which United Savings may not seek a judgment against the Debtor for liability under the Note, but may only pursue its security therefore.'' Mot. for Relief from Stay of an Act Against Property, at 4 (Mar. 18, 1985) [Docket 7].

11. Emergency Mot. for Authority to Use Cash Collateral and Mot. for Expedited Hr'g, at 2 (Mar. 7, 1985) [Docket 5]; Tr. of Recorded Proceedings 31 (Apr. 17, 1985) [Docket 51].

''Phase I'' of a broader development plan. Mann and Dorado Corp. were also general partners of another entity, ''Timbers of Inwood Forest Apartments, Phase II.''[12]

What otherwise seemed an attractive residential development became a nightmare in the mid 1980s. The price of oil collapsed and Houston's oil-based economy fell with it.[13] Between 1981 and 1985, crude oil prices fell 40%; they fell another 50% in the first half of 1986 alone.[14] A gallon of crude cost $38 in 1981; it cost only $11.82 in July 1986.[15] As the price of oil plummeted, a large fraction of Houston's workers lost jobs: between 1982 and 1987, one out of every eight workers was suddenly unemployed.[16] Real estate prices were hit particularly hard. After years of overbuilding (spurred by overzealous and ultimately illiquid S & Ls), Houston found itself in 1986 with 200,000 vacant homes, twice as many vacancies as was typical for a city of its size.[17] These vacancies, combined with the local recession, produced a dramatic collapse in real estate prices. Between 1983 and 1988, the average home price fell about 25%, from about $106,000 to about $80,000.[18] Apartment rentals suffered more dramatic declines, falling in some areas by 67% relative to their 1982 levels.[19]

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12. Aff. of Woody Mann, Jr., Individually and Dorado Corporation, A Texas Corporation, at 2 (Apr. 30, 1986) [Docket 94].

13. *See, e.g.,* Jacqueline Lang Weaver, *The Federal Government As A Useful Enemy: Perspectives On The Bush Energy/Environmental Agenda From The Texas Oilfields*, 19 Pace Environ. L. Rev. 1, 20–21 (2001) (''Increasing supplies hit reduced demand, and oil and gas prices dropped precipitously starting in 1981, only eight short years after the embargo. Houston's economy tumbled; its real estate markets cratered.'' (footnote omitted)).

14. Dermot Gately, *Lessons From the 1986 Oil Price Collapse*, 2 BROOKINGS PAPERS ON ECONOMIC ACTIVITY 237, 238 (1986).

15. Stephen P.A. Brown and Mine K. Yücel, *The Effect of High Oil Prices on Today's Texas Economy*, SOUTHWEST ECONOMY, Sept.-Oct. 2004, at 1, 2 (visited Sept. 1, 2006) <http://www.dallasfed.org/research/swe/2004/swe0405a.html>.

16. Bill Gilmer, *High Oil Prices Boost Houston's Job Growth, Improve Local Outlook*, HOUSTON BUSINESS, Dec. 2000 (visited Sept. 1, 2006) <http://www.dallasfed.org/research/houston/2000/hb0008.html>.

17. Robert W. Gilmer and Iram Siddik, *1982–90: When Times Were Bad in Houston*, HOUSTON BUSINESS, June 2003, at 1, 4 (visited Sept. 1, 2006) <http://dallasfed.org/research/houston/2003/hb0304.html>.

18. Figures derived from data published by the Real Estate Center at Texas A & M University, available at <http://recenter.tamu.edu/data/hs/hs280a.htm> (visited Sept. 1, 2006). *See also* Leslie Haggin Geary, *Real Estate Horror Stories*, CNN MONEY, Dec. 2, 2002 (visited Sept. 1, 2006) <http://money.cnn.com/2002/12/02/pf/yourhome/q_housingbusts/> (''In just three years, from 1985 to 1988, the typical home price [in Houston] dropped by 21 percent—or from $78,600 to $61,800.'').

19. Fred A. Little, *Distress Situations: Limited Partner Defaults, Insolvency, Vulture Funds, Resales, and Offerings*, C282 ALI–ABA 377, 415 (Mar. 17, 1988) (''[O]verbuilding and a badly depressed oil economy in Houston caused that apartment market in 1985 to

By 1984, Timbers was one of the casualties of Houston's recession. Property that was once worth $6.25 million was now worth at most $4.25 million.[20] The vacancy rate had soared to about 50% and Timbers could no longer service its debt.[21] Its monthly payments amounted to about $46,000,[22] but rentals barely exceeded $10,000, even before subtracting maintenance costs and taxes. Hoping to bridge the gap, Dorado Corp. made periodic loans to Timbers; by July 1984, these loans totaled $467,000.[23] With no additional liquidity, Timbers suspended payments to the bank during the latter half of 1984; by February of 1985, it was eight months behind and United Savings[24] had commenced foreclosure proceedings in state court.[25] The bank had also brought suit against Dorado Corp., Woody Mann, and other guarantors.[26]

Timbers held onto its property by agreeing to an order, entered in state court, which postponed United's foreclosure proceedings for one month, until March 1985.[27] In exchange, United was given authority to take control of the property and collect February's rentals. This was, in hindsight, meager compensation. The agreed order gave Timbers just enough time to file a petition, on March 4, 1985, under Chapter 11 of the United States Bankruptcy Code.

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suffer a drop in effective rental rates, including concessions, of up to two thirds since the peak in 1982. In other words, an apartment which rented for $600 in 1982 currently could rent, with concessions, for about $200 per month.'').

20. Hr'g Mem. at 1–2 (May 6, 1985) [Docket 29].

21. Tr. of Recorded Proceedings at 59 (Apr. 17, 1985) [Docket 51].

22. Mot. for Stay Pending Appeal without Bond, Exhibit ''B'' (Aff. of Woody Mann, Jr., Individually and Dorado Corporation, A Texas Corporation), *filed in* United Savings Ass'n of Texas v. Timbers of Inwood Forest Assocs., Ltd., No. H–85–4529 (S.D. Tex. Aug. 15, 1985).

23. *Id.*

24. United too was in trouble, but its troubles were not driven entirely by the local recession. United was a thrift institution, commonly known as an S & L. Like many other S & L's during that period, it would soon be insolvent, to the tune of $1.6 billion by 1988. The government bailout of United would be the fifth largest S & L rescue. *See* Christopher Helman, *Timber!*, Forbes, Dec. 12, 2005, at 102.

25. Mot. for Relief from Stay of an Act Against Property at 3 (Mar. 18, 1985) [Docket 7].

26. Mot. for Stay Pending Appeal without Bond, Exhibit ''B'' (Aff. of Woody Mann, Jr., Individually and Dorado Corporation, A Texas Corporation), *filed in* United Savings Ass'n of Texas v. Timbers of Inwood Forest Assocs., Ltd., No. H–85–4529 (S.D. Tex. Aug. 15, 1985).

27. Mot. for Relief from Stay of an Act Against Property at 3 (Mar. 18, 1985) [Docket 7].

III. The creditor: adequate protection and the economics of rent

The first fifteen days of the case brought two motions—Timber's motion to use cash collateral[28] and United's motion for relief from the automatic stay[29]—that dominated the entire case. United's motion is well-known because it garnered the attention of the Supreme Court, as we will see. Timber's motion has gone largely unnoticed, yet it is—as I will argue here—central to understanding the dynamics of the case and the implications of the Court's decision.

The two motions were filed nearly simultaneously—Timbers' on March 7 and United's on March 18. The bankruptcy court turned first to the ''emergency'' motion for authority to use cash collateral. Because of United's security interest in rents generated by the apartment complex, Timbers needed permission—either United's or the court's—to use any rental income to fund ongoing operations, including payroll.[30] United offered its consent, but it did so under stringent conditions. Timbers could use the monthly rentals for only one purpose: to pay approved expenses outlined in a monthly budget.[31] Any leftover rentals would be remitted to United as a form of adequate protection.[32] Timbers would, in other words, be put on a diet: it could spend no more than $4,350 on monthly payroll, $1,750 on maintenance, and $6,250 on utilities.[33] Even

28. Emergency Mot. for Authority to Use Cash Collateral and Mot. for Expedited Hr'g (Mar. 7, 1985) [Docket 5].

29. Mot. for Relief from Stay of an Act Against Property (Mar. 18, 1985) [Docket 7].

30. 11 U.S.C. 363(c)(2).

31. Agreed Order Regarding the Debtor's Use of Cash Collateral, at 2 (Mar. 25, 1985) [Docket 16].

32. *Id*. at 3. The order characterized the payments to United as ''adequate protection'' of its interest in the cash collateral, not as payments that would be deducted from the bank's overall claim. Carlson hypothesizes that the payments to United might have been deducted from the bank's claim, but I find no evidence of this. *See* David Gray Carlson, *Adequate Protection Payments and the Surrender of Cash Collateral in Chapter 11 Reorganization*, 15 Cardozo L. Rev. 1357, 1371 (1994). Indeed, the bank's lift-stay motions suggest that it did not think the cash-collateral adequate protection payments reduced the value of its claim. In March 1985, United's first lift-stay motion valued its claim at approximately $4.2 million. Mot. for Relief from Stay of an Act Against Property, at 2 (Mar. 19, 1985) [Docket 7]. In January 1988, United filed another lift-stay motion, after the Supreme Court held that it was not entitled to compensation for lost investment opportunities. Although Timbers had transferred net rentals to the bank for nearly three years, United's lift-stay motion valued its claim at precisely the same amount—$4.2 million.

In any event, it matters little whether the monthly cash collateral payments reduced United's claim or not. In either case, it was receiving every cent that the property generated (net of expenses). These payments compensated United for the delay caused by the bankruptcy proceeding, which prevented it from foreclosing on the property, selling it, and investing the proceeds.

33. Agreed Order Regarding the Debtor's Use of Cash Collateral, Appendix (''Schedule of Estimated Monthly Operating Expenses'') (Mar. 25, 1985) [Docket 16].

if an expenditure fell below the budgeted amount, United could still challenge its necessity.[34] Timbers agreed and the court issued an agreed order, effectively handing control over Timbers' operations to United. This form of creditor control is commonly observed in Debtor-in-Possession (DIP) Financing Agreements today.[35]

The cash collateral order, then, gave United the benefits of ownership. Everyone agreed that the apartment complex was in excellent shape and under good management.[36] It was now under a budget as well, and monthly rentals were being swept into United's account. It seems likely that the bank could have done no better if it ran the complex itself.[37]

This is an important point. The cash collateral order gave United the right to all rental income generated by the apartment complex, net of approved expenditures. Assuming they were set properly—and we have no reason to suppose otherwise—the rents should have ensured that Timbers' owners earned as much from the apartment complex as they would have earned from alternative investments with comparable risk. Put differently, the owners should have charged monthly rentals that were high enough to compensate the owners for the ''opportunity cost'' of renting. Instead of renting out the individual units, they could sell the property and invest the proceeds. The return on such an investment is the opportunity cost of renting.

If we formalize this intuition, we can better understand what United was promised under the cash collateral order and what else it hoped to gain in the lift-stay motion. Begin, then, with the simple observation that no rational investor would invest in Timbers and rent the apartments unless the financial return from renting were at least as high as the return on alternative investments with comparable risk. The monthly return from renting obviously includes the rentals paid by tenants, R. But this is just the *direct* return from renting. Like any other investment, real estate appreciates (or declines) in value over time. Such appreciation is called a ''capital gain'' and represents an *indirect* return

34. In addition to imposing a budget, the order gave United the right to challenge the necessity of any particular expenditure. *Id*. at 3.

35. *See* Douglas G. Baird and Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. Pa. L. Rev. 1209 (2006).

36. *See, e.g.,* Hr'g Mem. at 2 (May 6, 1985) [Docket 29] (''Both appraisers [for debtor and United Savings] indicated that the condition and the management of the property was excellent.''[sic]).

37. *See, e.g.,* Reply to Resp. to Appellant's Mot. for Stay Pending Appeal without Bond, Ex. A (''Aff. of George Cornwell''), at Item 8 [Docket 57] (''[If it forecloses], United will receive only the excess cash generated by the Timbers' Property over and above the necessary operating expenses for maintaining the Timbers' Property, which is exactly what it is presently receiving under the Agreed Cash Collateral Order.'').

from renting: at some point in the future, the investor will sell the property and receive the capital gains. We can write this capital gain as $G = Pg$, where P is the current market price of the real estate and g the expected growth per period (here, for convenience, we will focus on monthly periods).

Thus, the monthly return from renting includes rentals, R, and expected capital gains, Pg. Renting, however, has costs. One is the wear and tear, or ''depreciation,'' caused by tenants' use of the units. We can represent this as $D{=}Pd$, where d is the rate of depreciation per month. Another cost is property taxes ($T{=}Pt$), assessed by local governments.[38] If we subtract these costs from the returns from renting, we have the following monthly net return from renting: $R+G\text{-}D\text{-}T=R+P(g\text{-}d\text{-}t)$.

This net return from renting should be at least as large as the return from alternative investments. If the apartment complex (worth P) were sold and the proceeds invested, they would yield a monthly return equal to $Q{=}Pr$. Here, r is the ''rate of return''; it compensates the investor for the time value of money (a dollar today is worth more than a dollar tomorrow) and risk (riskier investments attract investors by paying higher rates of return). We can, then, decompose r into two components: the rate of return on risk-free assets (i) and a risk-premium (b). The risk-free rate is the rate available on assets, such as bonds issued by the federal government (so-called ''T bills''), with a near-certain return. There is virtually no risk that the government will not honor its promise to pay interest (i) on its short-term bonds. There is such a risk when bonds are issued by private actors, such as corporations, which may suffer distress and default on their obligations. To induce investors to buy these risky bonds, private actors must offer to pay an interest rate r that is higher than the risk-free rate. The difference between r and i is called the risk premium: $r\text{-}i{=}b$.

With these definitions in hand, we can now say something concrete about the rentals that Timbers probably charged. These rentals should have been large enough to ensure that the monthly net return from renting was greater than or equal to the monthly return on alternative investments:

$$R + P(g-d-t) \geq P\,(i + b) \qquad (1)$$

If capital markets function properly, this inequality should be an equality. If the net return on renting exceeds the return on alternative investments, no one will invest in the alternatives. Investors will flock to real estate, which offers a higher return. But as investors pour money into real estate, the net returns will fall. Too much money will be

38. Technically, mortgage interest and property taxes are deductible, which reduces the total tax bill. Because Timbers was losing money, however, income taxes were irrelevant. In any event, I abstract from these issues and treat T as the *net* tax bill.

chasing too few investments; expected capital gains (g) will decline. The net return will decline until the return from renting equals the return from alternative investments. In equilibrium, then, the inequality should be an equality:

$$R + P(g-d-t) = P(i + b) \qquad (2)$$

This can be rearranged as a simple expression for monthly rentals:[39]

$$R = P(i + b + t + d-g) \qquad (3)$$

This is a helpful formula for several reasons. It makes clear why Houston's recession led to a dramatic reduction in rentals: as land prices (P) fell, rentals (R) slid too. More importantly, the formula makes clear that the court's cash collateral order assured United of some compensation for lost investment opportunities.[40] Recall that the court's order obligated Timbers to pay United all rents, R, after deducting maintenance costs and taxes, $P(d+t)$.[41] Thus, United expected monthly payments equal to p:

$$p = R-P(d + t) = P(i + b-g) \qquad (4)$$

We see, then, that the cash collateral order guaranteed compensation for lost opportunities, $P(i+b)$, *net of* expected capital gains, Pg.

IV. The bankruptcy court decision: when is rent not enough

United didn't think the cash collateral order was enough. It wanted full compensation for lost investment opportunities, not compensation discounted by expected capital gains. This brings us to the bank's motion for relief from the automatic stay.

A. Adequate protection and foregone opportunities

Timbers' Chapter 11 filing, United argued, was a bald effort to ''speculate on real property at the expense'' of the bank.[42] There was no

39. For more detailed analysis of the relationship between asset prices and rents, *see* Charles Himmelberg, Christopher Mayer, and Todd Sinai, *Assessing High House Prices: Bubbles, Fundamentals and Misperceptions*, 19 J. Econ. Perspectives 67 (Fall 2005); Dennis W. Carlton and Jeffrey M. Perloff, Modern Industrial Organization 77–78 (2d ed. 1994).

40. This observation has been made by others, who have noted that a security interest in the proceeds of collateral, such as rents, can serve as a substitute for interest payments on the value of the collateral. *See, e.g., In re* Timbers of Inwood Forest, 808 F.2d 363, 379 (5th Cir. 1987) (en banc) (Jones, J., dissenting) (''Rent is the quintessential measure of the time-value of real property.''); Brief for Thomas H. Jackson as Amicus Curiae 17, United Savings Ass'n of Texas v. Timbers of Inwood Forest Assocs., 484 U.S. 365 (1988) (No. 86–1602) (''[W]hen Congress provides fair market rent to a party, Congress is providing compensation for time value.''); Carlson, *supra* note 32, at 1370–71.

41. The cash collateral order does not mention taxes; I assume that Timbers would deduct property taxes from any rents turned over to United.

42. Mot. for Relief from Stay of an Act Against Property, at 4 (Mar. 18, 1985) [Docket 7].

business to save—only a piece of property to fight over.[43] And there were no other creditors who could benefit from the bankruptcy process. The remaining creditors held unsecured debt, and most of this was held by Timbers' own general partners.[44] United said it was willing to pay the unsecured creditors in full, just to end the case, but the general partners, it seems, were uninterested.[45] They too hoped for more; they wanted a return on their equity.

At the hearing on its lift-stay motion, United argued in the alternative for adequate protection. Although its own expert testified that the property was in ''excellent condition'' and slightly appreciating in value over time,[46] United argued that it was still entitled to compensation, namely compensation for the *foregone* return it would have earned, had Timbers' bankruptcy not prevented it from foreclosing on the property, selling it, and investing the proceeds at a market rate of interest. This was a somewhat novel argument at the time, but was compelled, United believed, by the text of the Code and prior caselaw.

Section 361(1) of the United States Bankruptcy Code[47] defines ''adequate protection'' as relief designed to compensate the secured creditor for ''a decrease in the value of [the creditor's] interest in [debtor] property.'' The ''value'' of the creditor's interest is the value

43. Interestingly, United's motion had an alternative ground for lifting the automatic stay: bad faith. Timbers' filing, United argued, was a bad faith filing and this too provided ''cause'' for lifting the stay. *See also* Tr. of Recorded Proceedings at 2 (Apr. 17, 1985) [Docket 51] (''The issues I'd like to raise involve not just the failure to provide adequate protection, but also my belief that on the law, this is not a good faith filing [under] the Bankruptcy Code, and that we are entitled to relief [from the] Stay on that basis.''). Indeed, Timbers interpreted the motion this way. *See* Hr'g Mem. of Law at 2 (May 6, 1985) (''For purposes of this Memorandum, Timbers is assuming that United is attempting to assert that cause exists [to lift the stay] because the bankruptcy petition was filed in bad faith.'').

This may seem like an odd argument, because bad-faith arguments are typically made in motions to dismiss. *But see In re* Corp. Déjà Vu, 34 B.R. 845, 846–47 (Bankr. D. Md. 1983). United, it seems, hoped a court would decide a lift-stay motion more quickly than a motion to dismiss. *See* Tr. at 32 [Docket 51] (''Now, I might [say] why, as a practical matter, we bring this up in the form of a 362 motion, and that is simply that with interest accruing at fifty thousand dollars . . . a month . . . we'd like to get a hearing as quickly as possible . . . A Motion to Dismiss would take us till who knows when.''). The court, however, concluded that issues relating to bad faith belonged in a motion to dismiss and refused to rule on them in the context of United's lift-stay motion. *See* Tr. at 40 [Docket 51].

44. Tr. at 33–34 [Docket 51].

45. *Id.*

46. *Id.* at 58 (United's expert testified that the ''present management, as far as running the apartments and leasing out, I would characterize as excellent.'').

47. 11 U.S.C. §361(1). Unless noted otherwise, statutes mentioned in the main text are provisions of the United States Bankruptcy Code.

that the creditor could obtain from a foreclosure sale, which includes—United argued—both the proceeds from the sale and the return from investing those proceeds. Indeed, §361(3) appears to support United's view. It states ''adequate protection'' includes any relief that ''will result in the realization by [the creditor] of the indubitable equivalent of [the creditor's] interest in [the debtor's] property.'' The phrase ''indubitable equivalent'' is a term of art, derived from Judge Learned Hand's pre-Code opinion, In re *Murel Holding Corp.*:

> It is plain that 'adequate protection' must be completely compensatory; and that payment ten years hence is not generally the equivalent of payment now. Interest is indeed the common measure of the difference, but a creditor who fears the safety of his principal will scarcely be content with that; he wishes to get his money or at least the property. We see no reason to suppose that the [Bankruptcy Act] was intended to deprive him of that in the interest of junior holders, unless by a substitute of the most indubitable equivalence.[48]

Although *Murel* is a pre-Code case, the same logic was applied to a post-Code case, In re *American Mariner Industries*,[49] by the Ninth Circuit, which held that ''adequate protection'' under §361 includes compensation for lost investment opportunities.

These ''lost opportunities,'' United argued, are economically indistinguishable from the costs of physical depreciation. When a bankruptcy filing prevents a bank from foreclosing, it prevents the bank from avoiding depreciation of the property in the hands of the debtor. The longer the case, the greater the depreciation and the larger the loss suffered by the bank: as its collateral falls in value, its expected payout at the end of the case dwindles. We can say exactly the same about foregone interest, United argued: when a bankruptcy filing prevents a bank from foreclosing, it also prevents the bank from selling the property, investing the proceeds, and receiving a market rate of interest. The longer the case, the greater the foregone interest and the larger the loss suffered by the bank. There was—and still is—no doubt that a creditor should be protected against physical depreciation of collateral. There is no reason, United argued, for treating foregone interest differently.[50]

United's argument found support in work by law and economic scholars, most notably Douglas Baird and Thomas Jackson.[51] The pri-

48. 75 F.2d 941, 942 (2d Cir. 1935).

49. 734 F.2d 426, 432–35 (9th Cir. 1984).

50. Tr. at 37 [Docket 51] (arguing that ''an undersecured lien Creditor is entitled to the indubitable equivalent [of its interest in the debtor's property], and that equivalent means . . . that if he's postponed from foreclosing, he will at least get, during the interim, the interest on his debt'').

51. *See, e.g.,* Douglas G. Baird and Thomas H. Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of*

mary goal of a Chapter 11 case, they noted, is to avoid premature liquidation and thereby increase the return to unsecured creditors and equityholders. These parties can benefit from the bankruptcy process. But secured creditors have little to gain. Their returns are capped by the value of the collateral: if the firm is liquidated immediately, they will receive the value of the collateral; if it is reorganized several years from now, they will still receive no more than the value of the collateral. They have little to gain, and much to lose, from the delay caused by a bankruptcy case. Consistent with this view, many provisions of the Code allocate the cost of delay to unsecured creditors and equityholders. Their claims, for example, are paid after administrative expenses, including attorney fees.[52]

Adequate protection can be seen in the same light, as a mechanism for achieving an efficient allocation of risk:[53] the downside risks inherent

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Secured Creditors in Bankruptcy, 51 U. Chi. L. Rev. 97, 127–29 (1984). *See also* Br. for Thomas H. Jackson as Amicus Curiae 3–15, 25, United Savings Ass'n of Texas v. Timbers of Inwood Forest Assocs., 484 U.S. 365 (1988) (No. 86–1602) (''Secured creditors are not the beneficiaries of a bankruptcy proceeding; they should not be asked to bear its costs.'').

52. 11 U.S.C. §1129(a)(9).

53. The efficiency of this risk allocation has been questioned by some scholars, who argue that secured creditors may be willing to share the risks of ''common disasters'' with unsecured creditors and equityholders. *See, e.g.,* Robert E. Scott and Thomas Jackson, *On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain*, 75 Va. L. Rev. 155 (1989). Although risk-sharing forces secured creditors to bear some of the costs of bankruptcy, it also reduces the incentives of insiders to engage in overly-risky, potentially wasteful behavior prior to the bankruptcy filing. If managers and equityholders realize that the firm is insolvent and that they will receive nothing in bankruptcy, they have strong incentives to gamble on the firm's resurrection; they might, for example, invest in high-risk, low-return projects. If the projects succeed, the firm recovers, managers keep their jobs, and equityholders retain valuable shares in the firm. If the project fails, the firm incurs a loss and enters bankruptcy, but the loss is borne entirely by creditors. Scott and Jackson note that this incentive to ''gamble on resurrection'' is mitigated when equityholders and managers are assured of some payoff in bankruptcy. This payoff is put at risk by gambles. One way to assure that these parties receive a payoff in bankruptcy, Scott and Jackson note, is to force secured creditors to bear some of the costs of the bankruptcy process. Indeed, if the costs of contracting were low, secured creditors would agree ex ante to share these costs, because doing so reduces managers' incentive to take wasteful gambles. Scott and Jackson hypothesize that contracting costs are high and that bankruptcy law may offer the kind of contract that the parties would have written had they been able to. This argument, however, assumes that bankruptcy is an exogenous event, like a hurricane. It seems more likely, as Barry Adler argues in *Bankruptcy and Risk Allocation*, 77 Cornell L. Rev. 439 (1992), that financial distress is endogenous. If so, risk-sharing has a downside. Although it reduces managers' incentive to take wasteful gambles *when a firm is insolvent*, it also reduces the incentive to avoid insolvency in the first place. Equityholders and managers realize that, in the event of insolvency, they will still receive a payoff. Risk-sharing, then, can generate a form of moral hazard: managers take fewer steps to avoid bankruptcy. The costs and benefits of risk-sharing are still the subject of debate. *See, e.g.,* Kenneth M. Ayotte, *Bankruptcy and Entrepreneurship: The Value of a Fresh Start*, J. L., Econ. & Org. (forthcoming 2007); Lucian Arye Bebchuk, *Ex Ante Costs of Violating*

in a lengthy bankruptcy case (depreciation of collateral, failure of the business) should be borne by the parties who will enjoy any upside (recovery of the business) namely, unsecured creditors and equityholders. One of the costs of the bankruptcy process is the secured creditor's foregone opportunity to force a foreclosure sale of the collateral and invest the proceeds. This is a right the creditor enjoys under state law. It is sensible to suspend it only if unsecured creditors and equity holders compensate other ''adequate protection'' to—the secured creditor. Without having to pay compensation, these parties will be too willing to attempt a reorganization, because they can foist some of the costs of delay on others.[54] And if secured creditors can anticipate these reorganization costs, they will take steps to protect themselves by, for example, limiting the supply of credit—offering smaller loans at higher interest rates—to potential borrowers. Future businesses may find it hard, perhaps impossible, to obtain loans.

Together, these arguments—grounded in the Code, caselaw, and economic logic—persuaded the bankruptcy court in *Timbers*. It granted United's motion for adequate protection.[55] The court found *American Mariner* particularly persuasive: the decision was ''clearly correct'' and ''achieved[d] a rational financial result.'' Accordingly, the bankruptcy court ordered Timbers to make monthly adequate protection payments equal to $42,500 beginning six months after the date of filing (September 1985).[56] The court assumed that, after foreclosure, the bank would take six months to sell the property, at which time it would receive $4.25 million.[57] Invested at a 12% interest rate, this sum would yield a monthly return of $42,500. Interestingly, the Court opined that these adequate payments should be in addition to the net rentals that Timbers had been paying to United pursuant to the cash collateral order.[58] The Court didn't have to reach that issue, though, because United agreed that Timbers could use the rentals to fund the monthly $42,500 payments.[59]

This order, Timbers believed, was a death sentence; there was no way it could make monthly payments in excess of $40,000. Recall that the cash collateral order put the debtor on a budget: monthly operating expenditures could not exceed $23,000. With property taxes running

Absolute Priority in Bankruptcy, 57 J. Fin. 445 (2002); Paul Povel, *Optimal Soft and Tough Bankruptcy Procedures*, 15 J. L., Econ. & Org. 659 (1999).

54. *See, e.g.,* Baird and Jackson, *supra* note 51, at 121–25.

55. Order (April 24, 1985) [Docket 36]; Mem. Op. (May 20, 1985) [Docket 40], 49 B.R. 454 (Bankr. S.D. Tex. 1985).

56. 49 B.R. at 461.

57. *Id*. at 458–59, 461.

58. Tr. at 111–22; 49 B.R. at 460.

59. Tr. at 109–10.

about $8,000 per month, total monthly expenditures were expected to run around $31,000. Thus, to pay $42,500 per month in adequate protection, the apartment complex would need to generate monthly rentals of at least $73,500. But a quick look at Timbers' operating reports shows monthly rents averaging about $39,000 prior to the court's order. After deducting maintenance costs, this left *net rentals* of only $8,000, far less than the $42,500 necessary to comply with the court's adequate protection order.[60] To be sure, net rentals in early 1985 reflected a vacancy rate around 25%. Everyone expected vacancy rates to fall in the near term, to about 5%.[61] United's expert testified that, with 5% vacancy, the apartment complex would generate approximately $705,000 in rents annually, or $58,750 per month.[62] Subtracting expenses of around $31,000 yields monthly *net rentals* of about $28,000, still far less than the adequate protection payments ($42,500) ordered by the court.

The court's order, then, was a death sentence because Timbers was destined to violate it, and a violation would constitute cause for lifting the automatic stay and allowing the bank to foreclose on the apartment complex. This reality didn't escape the court's attention:

> ''Counsel for one of the Debtors [argues] that [today's decision] reduces (and potentially eliminates) the Debtor's ability to reorganize. That [argument] is well founded.... The result is inescapable, however, since that is the only way ... to protect the creditor's statutory and potential constitutional rights in the collateral. The result is not as unfair as counsel suggests, however. If the Debtors cannot even fund the present value of foreclosure rights in the collateral, they have little equitable [claim] [sic] to a right to reorganize.''[63]

During a period when scholars regularly accused bankruptcy judges of being ''pro-debtor,''[64] this statement is a remarkable counter-example.

B. Judicial error and strategic gamesmanship

Notice something odd in the foregoing account: United's argument—and the court's order—assumes that the bank was not already receiving compensation for lost opportunities. But that was clearly not the case. As equation (4) made clear, the cash collateral order already obligated

60. Rents averaged only $36,000 during the entire case.

61. Tr. at 50.

62 *Id.*

63. 49 B.R. at 459 (footnote omitted).

64. *See, e.g.,* Baird and Jackson, *supra* note 51, at 126–27; Lynn M. LoPucki, *The Debtor in Full Control—Systems Failure under Chapter 11 of the Bankruptcy Code?* (pt. 1), 57 Am. Bankr. L. J. 99 (1983).

Timbers to make monthly payments that included compensation for lost opportunities, $P(i+b)$. To be sure, this compensation was reduced by expected capital gains, Pg, but United never argued that it was receiving *too little* compensation for lost opportunities. It argued that it wasn't receiving *any*. Then again, although the court didn't require it, United did permit Timbers to deduct monthly rents (p) from the adequate protection payments ordered by the court. Perhaps United sensed that it would be problematic (and invite judicial scrutiny) for it to demand monthly rents in addition to adequate protection payments.

There is still something odd here. The court ordered adequate protection payments equal to $42,500, but the (net) monthly rents generated by the complex amounted to only $8,000 currently and $28,000 at some point in the future. What explains the massive gap between these two numbers? Equation (4) implies that the two numbers should be close to each other, unless expected capital gains are large. To see this, rewrite equation (4) as follows:

$$P(i + b) - p = Pg \qquad (5)$$

Is it plausible that the difference between the court's order and actual rentals (the left-hand side of the equation) was driven by the parties' expectation of large capital gains in the future (the right-hand side)? The adequate protection order implies that, in the court's view, $P(i + b) = \$42{,}500$. Court records indicate that p was either $8,000 or $28,000. Plugging these numbers into the left-hand side of equation (5) leads to the conclusion that expected *monthly* capital gains, Pg, ranged from $14,500 (if $p = \$28{,}000$) to $34,500 (if $p = \$8{,}000$). If we also assume that P was approximately equal to $4 million (midway between the parties' estimates), then equation (5) tells us that the apartment complex was expected to appreciate in value at a rate of .36% to .9% per month (g), or 4.4% to 11% per year. Are these rates of growth plausible? Hardly. From the late 1980s to 2004, real housing prices in Houston actually *declined* (at a rate of about 1.2% per year).[65] Unless the market in 1985 was extremely optimistic about future capital gains, it seems unlikely that expected capital gains, Pg, can possibly explain the difference between the court's adequate protection order ($42,500 monthly) and the rents actually generated by the complex ($8,000 to $28,000 monthly).

An alternative explanation is judicial error. The court may have made a (big) mistake when it estimated $P(i+b) = \$42{,}500$. This is plausible; judicial error in valuation appears to be significant and frequent.[66]

65. See Himmelberg, Mayer, and Sinai, *supra* note 39, at 72.

66. *See, e.g.,* Douglas G. Baird and Donald S. Bernstein, *Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain*, 115 Yale L.J. 1930 (2006) (showing that observed deviations from absolute priority—senior creditors going unpaid even though junior interests receive value—often reflect efforts by the parties to settle disputes over

Here, the court assumed that the apartment complex was worth over $4 million. The most conservative estimate of *P*, an estimate of liquidation value offered by Timbers' expert, was $2.3 million, almost half of the court's valuation. If the court had adopted this conservative number, and applied the same 12% interest rate, monthly adequate protection payments would have equaled $23,000. Although still far in excess of net rentals at the time of the order ($8,000), this number is fairly close to the net rentals expected in the future (about $28,000).

Judicial error and expected capital gains explain the dramatic difference between the court's adequate protection order and the rents generated by the apartment complex.[67] These factors also explain why United was so vigorous in pursuing adequate protection *in addition to* the net rentals it was promised under the cash collateral order.

Adequate protection payments would guarantee United the same return—and perhaps an even larger return, if the judge erred in its favor—that it would have received had it been able to sell the complex and invest the proceeds. Net rentals offered something less—they offered compensation for lost investment opportunities *discounted* by expected capital gains (*Pg*). In theory, an *owner* charges lower rents as expected growth rises because the opportunity cost from renting (versus selling) falls when the property is expected to appreciate in value. But United wasn't the owner of this property. It had an interest in the property, but so did the unsecured creditors and equityholders. If the property appreciated, United would receive a greater return on its $4.4 million claim, which was secured by, but exceeded the value of, the apartment complex. But if the value of the property rose above $4.4 million, United would receive no benefit. Once the property was worth more than United's claim, the only beneficiaries would be the unsecured creditors and equityholders (and most of the unsecured debt was held by equityholders). Thus, although United was entitled to net rentals from the apartment complex, these rents effectively charged United for future capital gains (*gV*) that would benefit others. United's motion for adequate protection, then, might be seen as an effort to recover lost opportunities that went undercompensated by the net rentals turned over by Timbers.

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firm valuation); Kerry O'Rourke, *Valuation Uncertainty in Chapter 11 Reorganizations*, 2005 Colum. Bus. L. Rev. 403 (presenting evidence on the prevalence of valuation uncertainty and its sources).

67. In his amicus brief, Prof. Jackson acknowledged the possibility that the net rentals paid to United, pursuant to the cash collateral order, may have been sufficient compensation for lost opportunities. *See* Br. for Thomas H. Jackson as Amicus Curiae 15 n. 16, United Savings Ass'n of Texas v. Timbers of Inwood Forest Assocs., 484 U.S. 365 (1988) (No. 86–1602) (''Even if the bankruptcy judge used the wrong standard in deciding that the existing rentals did not necessarily provide adequate protection to United Savings, this issue (inherently fact-specific), would not be affected by reversal and remand by this Court on the issue before it.'').

This is the benign explanation for United's lift-stay motion. We know, of course, that it is highly incomplete. Expected capital gains cannot possibly explain the massive difference between Timbers' net rentals and the adequate protection that United requested (and the court ordered). An alternative, less benign, explanation is that United was trying to opt out of the bankruptcy process. It sought a court order that Timbers could not possibly fulfill. United's motion asked for monthly adequate protections that far outstripped Timbers' ability to pay. If the court granted the motion and Timbers was unable to comply, United could cite Timbers' non-compliance as ''cause'' for lifting the automatic stay under §362(d)(2). Seen this way, United's motion was an aggressive strategy for putting a quick end to the bankruptcy case. It was gambling the court would make a mistake and overvalue the property. If it did, the bank could short-circuit the bankruptcy process and avoid its attendant administrative costs.

Indeed, United was probably hoping for more than just a judicial mistake. It may have filed its lift-stay motion as a threat, to induce Timbers' owners to contribute additional capital to the estate. If the stay were lifted and the bank allowed to foreclose and sell the apartment complex, the tax consequences for the owners would have been significant. The difference between the sale price (perhaps as low as $2 million) and the value of the bank's nonrecourse claim (over $4 million) would have constituted taxable income to the partners.[68]

As we will see, the automatic stay was lifted in 1988, after the Supreme Court rendered its decision, and United foreclosed. Although we have no record of the sale price then, we do have information about subsequent sales during the mid–1990s. In September 1995, the complex was sold to a buyer, who obtained a $1.5 million mortgage (about $1.16 million in 1988 dollars).[69] It was sold again in October 1996 and the buyer obtained a $2.8 million mortgage ($2.17 million in 1988 dollars).[70] Based on these mortgages, it seems likely that, when United foreclosed in the late 1980s, it sold the property for no more than $2 million and may have sold for as little as $1 million. These figures offer strong support for the conclusion that the court made a grave error in valuing the property at $4.25 million and that United was either gambling on judicial error or using the lift-stay motion as a threat to induce Timbers' partners to commit additional funds to the business. The story of Inwood Forest, then, is in large part a story of error and strategic gamesmanship.

68. Commissioner v. Tufts, 461 U.S. 300 (1983).

69. According to Harris County, Texas, Property Transfer Records, the buyer was V A C Properties Co., which secured a $1.5 million loan from Klein Bank. See LexisNexis, TXSALE database, Doc. Number R615228.

70. The buyer was TCP Inwood Central Partners LP, which secured a $2.8 million loan from Riverway Bank. *See id*. at Doc. No. S195535.

V. On appeal

Faced with a death sentence, Timbers appealed and the Fifth Circuit, sitting in panel[71] and en banc,[72] reversed. Over a vigorous dissent, the en banc panel rejected the approach taken by the Ninth Circuit, as well as those adopted by the Fourth[73] and Eighth Circuits,[74] which had recently either sided with the Ninth or concluded that compensation for foregone investment opportunities was permitted under special conditions, but not mandatory. The judges of the Fifth Circuit admitted that §361 is ambiguous, but felt that pre-Code practice and legislative history clarified matters.[75] Prior to the 1978 Code, no creditor was entitled to periodic interest payments, except the oversecured creditor.[76] Neither the text of the 1978 Code nor its legislative history suggest, the court argued, that Congress abandoned this rule when it enacted the Code.[77] To the contrary, the Fifth Circuit noted, legislative history suggests that members of Congress expected undersecured creditors to be compensated for the misuse and depreciation of collateral, but not for foregone investment opportunities.[78]

But this does not mean, the Fifth Circuit cautioned, that undersecured creditors are powerless and can be forced to endure lengthy bankruptcy proceedings whenever their collateral is not depreciating physically.[79] A lift-stay motion under §362(d)(2)[80] offers one avenue for relief. A court should grant the motion if (A) ''the debtor does not have an equity in such property'' and (B) ''such property is not necessary to an effective reorganization.'' Condition (A) will be satisfied whenever the motion is filed by an undersecured creditor, whose claim (by definition) exceeds the value of the property in which it has a security interest.

71. 802 F.2d 777 (5th Cir. 1986).

72. 808 F.2d 363 (5th Cir. 1987) (en banc).

73. Grundy Nat'l Bank v. Tandem Mining Corp., 754 F.2d 1436 (4th Cir. 1985).

74. *In re* Briggs Transp. Co., 780 F.2d 1339 (8th Cir. 1985).

75. *In re* Timbers of Inwood Forest Assocs., Ltd., 793 F.2d 1380, 1389–1401 (5th Cir. 1986).

76. *Id*. at 1386–87.

77. *Id*. at 1387, 1393–1401.

78. *Id*. at 1393–1401.

79. *In re* Timbers of Inwood Forest Associates, Ltd., 808 F.2d 363, 370–73 (5th Cir. 1987) (en banc).

80. Section 362(d)(2) orders the court to lift the automatic stay with respect to certain property, on request of a party in interest, if ''the debtor does not have an equity in such property'' and ''such property is not necessary to an effective reorganization.'' 11 U.S.C. § 362(d)(2).

Condition (B) is harder to interpret. It is satisfied, the Fifth Circuit stated, unless the debtor can show ''that there is a reasonable possibility of a successful reorganization within a reasonable time. The mere indispensability of the property to the debtor's survival and the debtor's hopes of reorganization are insufficient to justify continuation of the stay when a reorganization is not reasonably possible.''[81] To be sure, the debtor's burden of proof will be less demanding early in a case, especially during the exclusivity period. Nonetheless, ''the debtor must do more than evince high hopes; he must be able to show a reasonable prospect for a successful reorganization within a reasonable time.''[82]

This was a bold statement. At the time, the same standard for granting a lift-stay motion—''a reasonable possibility of a successful reorganization''—could be found in many bankruptcy court decisions,[83] but no appellate court had previously addressed the issue. By embracing this standard, the Fifth Circuit made clear that bankruptcy judges must take seriously the debtor's burden of showing that certain property is ''necessary to an effective reorganization.''

Judge Edith Jones dissented. A former bankruptcy lawyer,[84] Judge Jones found the en banc's decision illogical. Section 361 protects the secured creditor's ''interest in [the debtor's] property.'' The creditor has no interest in the property itself (under state law, it does not have the right to keep the property[85] and, for regulatory reasons, banks often avoid holding real estate[86]). The secured creditor's ''interest,'' instead, is the right to foreclose immediately after default, force a sale of the property, and invest the proceeds. That, Judge Jones argued, is the only logical interpretation of the phrase ''interest in [the debtor's] property'' in 361.[87]

81. 808 F.2d at 370–71.

82. *Id*. at 371.

83. See cases listed in *id*. at 370–71 nn. 12–13.

84. Douglas K. Moll, *Less is More: An Interview with Edith Hollan Jones*, HOUSTON LAWYER, Nov.-Dec. 2001.

85. Br. for Thomas Jackson as Amicus Curiae at 9, *In re* Timbers of Inwood Forest Assocs., 808 F.2d 363 (1987) (No. 85–2678) (''It follows that when a debtor files a petition in bankruptcy, a secured creditor is not so much deprived of a particular piece of property as it is deprived of the right to use that property to obtain a certain amount of money at a certain time.'').

86. Reply to Resp. to Appellant's Mot. for Stay Pending Appeal without Bond, Ex. A (Aff. of George Cornwell), at Item 7, In re *Timbers of Inwood Forest Assocs., Ltd*., No. H–85–4529 (D. S.D. Tex. Sept. 23, 1985) [Docket 57].

87. *Timbers*, 808 F.2d, at 376–77 (Jones, J., dissenting). The en banc decision, Judge Jones believed, creates statutory anomalies. For one, the phrase ''indubitable equivalent'' means one thing in §361(3) and another in §1129(b)(2)(A), which governs cram-down of secured claims. In the former, thanks to the en banc decision, it covers only physical

The en banc's decision would, she believed, merely give debtors more room to delay bankruptcy cases, because they need not pay undersecured creditors for delay. The court's exhortation—that judges should grant a lift-stay motion unless there is ''a reasonable possibility of a successful reorganization''—is little more than empty words in a world where a

> hapless Chapter 11 effort may be kept aloft . . . for *years*, given moderately astute debtor's counsel, a court too busy or too docile to terminate the case, and a steady cash flow. The debtor survives in the meantime by consuming its assets, including any going-concern surplus that may have originally existed in the company.[88]

VI. In the Supreme Court

With a circuit split on its hands, the Supreme Court granted United Savings' petition for a writ of certiorari.[89] The Court affirmed. With Justice Scalia writing his first majority opinion in a bankruptcy case—unanimous no less—the Court agreed with the first circuit that the definition of ''adequate protection'' in §361(3) is ambiguous and might include compensation for foregone interest. This ambiguity disappears, the Court held, when §361 is read in tandem with at least four other provisions of the Code.

The ambiguity in §361 derives, in part, from the phrase ''interest in such property.'' Does this phrase refer to the secured creditor's interest in having the property ''applied in payment of the debt upon completion of the reorganization,''[90] in which case ''adequate protection'' only compensates for physical depreciation? Or does the phrase refer to the creditor's interest in foreclosing immediately, forcing a sale of the property, and investing the proceeds, in which case ''adequate protection'' also compensates lost investment opportunities?

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depreciation. In the latter, no one doubts that it covers depreciation as well as lost opportunities. If a plan of reorganization is crammed down over a secured creditor's objection, the plan must offer that the creditor payments that compensate it for wear and tear as well as delay. *See also* Collier on Bankruptcy 1129.05(2)(c) (15th ed. rev. 2006).

88. *Timbers*, 808 F.2d at 383 (Jones, J., dissenting).

89. This was no minor dispute and attracted the attention of the nation's leading bankruptcy professors and practitioners. Three amicus briefs supported United's position; counsel of record on these included Thomas H. Jackson, Frank R. Kennedy, and Robert K. Rasmussen (professors or soon-to-be professors). Another three amicus briefs were filed in support of Timbers; counsel on these included Kenneth Klee and Raymond Nimmer (professors or soon-to-be professors) as well as Martin Bienenstock, Richard Levin, Harvey Miller, and Ron Trost (prominent or soon-to-be prominent attorneys).

90. United Savings Ass'n v. Timbers of Inwood Forest Assocs., 484 U.S. 365, 370 (1988).

The same phrase, the Court noted, is used elsewhere in the Code, including §506(a), which reads:

> An allowed claim of a creditor secured by a lien on property in which the estate has an interest . . . is a secured claim to the extent of the value of such creditor's *interest in* the estate's interest in *such property*, . . . and is an unsecured claim to the extent that the value of such creditor's interest . . . is less than the amount of such allowed claim. [Emphasis added]

As used here, the Court said, the term " 'interest in property' obviously means [the secured creditor's] security interest without taking account of his right to immediate possession of the collateral."[91] This was obvious because a contrary reading would yield the odd result that a secured creditor's "allowed claim" would be in constant flux as it increased with the accumulation of interest. In case this wasn't obvious to the reader, for good measure the Court cited legislative history supporting the proposition that "value of such creditor's interest" means "value of the collateral."[92]

It is a bit surprising to find legislative history play a role in an opinion authored by Justice Scalia. It is more surprising to see this kind of statutory argument appear in the Court's analysis, for it suffers a basic weakness: Valuation of a secured creditor's "interest" under §506(a) is a different question from adequate protection of that "interest" under §361.[93] A secured creditor's interest in collateral is its right to foreclose upon the property, force a sale, and invest the proceeds. The present value of that right—the value that a court must determine under §506(a)—is simply the current value of the collateral, as the Court notes. If the creditor were able to foreclose immediately, it would obtain the value of the collateral immediately, which it could reinvest. But if the creditor is unable to foreclose immediately, and is forced to receive the value of the collateral at some future date, the value of its "interest" in the collateral depreciates. Only adequate protection under §361 can prevent this depreciation. Thus, permitting payment of interest under §361 is perfectly consistent with equating the creditor's "interest" with the value of the collateral under §506. The interest is valued under §506 and protected under §361.

The Court believed it found firmer ground in another provision of §506. In subsection (b), Congress explicitly addressed the issue of postpetition interest and made it available only to *over*secured creditors, who "shall be allowed . . . interest on such claim, and any reasonable fees, costs, or charges provided for under the agreement under which such claim arose." By explicitly permitting postpetition interest payments to

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91. *Id.* at 372.

92. *Id.*

93. A similar point is made by David Gray Carlson, *Postpetition Interest Under the Bankruptcy Code*, 43 Univ. Miami L. Rev. 577, 603 (1989).

oversecured creditors, the Court reasoned, the Code must implicitly prohibit such payments to undersecured creditors: ''If the Code had meant to give the undersecured creditor, who is thus denied interest on his *claim*, interest on the value of his *collateral*, surely this is where that disposition would have been set forth, and not obscured within the 'adequate protection' provision of §362(d)(1).''[94]

This conclusion is less obvious than the Court lets on. All §506(b) does is create a safe harbor for the oversecured creditor. Its contractual right to periodic interest payments—at the contract interest rate—is protected by §506(b).[95] But the presence of a safe harbor for oversecured creditors in one section does not imply the absence of any protection for undersecured creditors in other sections. Indeed, §362(d)(1) provides very different protection. Section 506(b) authorizes payment of interest at the contract rate. Section 362(d)(1), in contrast, preserves the creditor's ''interest'' in the collateral, which would presumably authorize payment of interest at a market rate that may exceed the contract rate. Indeed, interest payments under §506(b) may not protect an oversecured creditor's interest in collateral. To the extent that market rates exceed contract rates, the creditor suffers from its inability to foreclose on the property.

The Court found this argument ''implausible,''[96] particularly because it meant that an undersecured creditor could receive interest if it petitioned for it under §362(d)(1) at the beginning of a case but would not receive interest if it chose to ''forebear and seek it only at the completion of the reorganization.''[97] Why this is ''incomprehensible'' is unclear. The same effect characterizes any petition for adequate protection: the secured creditor who seeks compensation for depreciation fares better than the creditor who ''forbears'' and files no motion at all. In any event, the Court believed a contrary conclusion would be inconsistent with pre-Code bankruptcy law, which uniformly denied postpetition interest to undersecured creditors. This was, the Court said, ''part of the conscious allocation of reorganization benefits and losses between un-

94. *Id*. at 365.

95. This argument was pressed by Thomas Jackson, as amicus curia, and adopted by the United States, as amicus in support of United, and by Judge Jones in her dissent. *See* Br. for Thomas Jackson as Amicus Curiae at 26–29, United States Savings Ass'n v. Timbers of Inwood Forest Assocs., 484 U.S. 365 (1988) (No. 86–1602); Br. for Thomas Jackson as Amicus Curiae at 26–28, *In re* Timbers of Inwood Forest Assocs., 808 F.2d 363 (1987) (No. 85–2678); Br. for the United States as Amicus Curiae Supporting Petitioner at 22–23, United States Savings Ass'n v. Timbers of Inwood Forest Assocs., 484 U.S. 365 (1988) (No. 86–1602); *Timbers*, 808 F.2d at 380 (Jones, J., dissenting).

96. *Timbers*, 484 U.S. at 365. *See also* Br. for Raymond T. Nimmer as Amicus Curiae 5–6, United States Savings Ass'n v. Timbers of Inwood Forest Assocs., 484 U.S. 365 (1988) (No. 86–1602).

97. *Id*. at 374.

dersecured and unsecured creditors.''[98] Here we see an appeal to the ''share the hurt'' policy that has been at the root of bankruptcy debates for the past 25 years.[99]

The Court analyzed two more sections in order to shed light on the meaning of ''adequate protection.'' One is §552, which generally prevents security interests from attaching to property acquired postpetiton. The primary exception, contained in §552(b), permits attachment of a prepetition security interest to postpetition ''proceeds, product, offspring, rents, or profits'' generated by the creditor's collateral, provided the security interest is perfected with respect to such property. The Court thought it odd that, if undersecured creditors were to receive interest under §362(d)(1), they would effectively receive ''proceeds, product, offspring, rents, or profits'' without needing a perfected security interest in such property.[100] Why this is odd is unclear. Section 552(b), like §506(b), merely creates a safe harbor for certain types of creditors. In §506(b) the safe harbor protects oversecured creditors; here it protects creditors with perfected interests in proceeds of collateral. Again, the presence of a safe harbor for some secured creditors does not logically imply the absence of any protection for all undersecured creditors. But what is most interesting about this argument is its recognition that payment of proceeds (e.g., rents) under §552, is a rough substitute for payment of interest under §361. As we have seen, this is precisely what occurred here: United had a perfected interest in Timber's monthly rentals and received those rentals throughout the case.

Lastly, the court cited §362(d)(2), which offers an alternative ground for lifting the automatic stay. Section 362(d)(1), at issue in this case, allows a court to lift the stay ''for cause, including the lack of adequate protection of an interest in'' collateral. In contrast, §362(d)(2) permits lifting the stay when the debtor owns no equity in the property and the property is ''not necessary to an effective reorganization.'' If ''adequate protection'' includes compensation for lost investment opportunities, the Court reasoned, an undersecured creditor can always obtain relief under §362(d)(1): ''cause'' exists whenever compensation is not being paid. This, in turn, makes ''nonsense'' of §362(d)(2). That section has no utility, except in the odd case in which a creditor is receiving interest but

98. *Id*. at 365.

99. In its original panel decision, for example, the Fifth Circuit relied heavily on the ''rule that all creditors generally share some of the risk in a reorganization proceeding that a successful reorganization will not be feasible.'' *Timbers*, 793 F.2d 1380, 1382 (1986). For different visions of ''sharing the hurt,'' *see* Robert E. Scott, *Sharing the Risks of Bankruptcy:* Timbers*,* Ahlers*, and Beyond*, 1989 Colum. Bus. L. Rev. 183; Elizabeth Warren, *Bankruptcy Policy*, 54 U. Chi. L. Rev. 775 (1987).

100. *Timbers*, 484 U.S. at 374.

wants to foreclose anyway.[101] ''Petitioner offers no reason why Congress would want to provide relief for such an obstreperous and thoroughly unharmed creditor.''[102]

But is this such an odd case? Is a creditor ''thoroughly unharmed'' if it is receiving adequate protection payments that include compensation for lost investment opportunities? Hardly. The debtor can still impose a variety of costs on the debtor. Property can be at risk even when it is not depreciating. The debtor may, for example, have failed to purchase fire insurance. More worrisome is the situation in which the debtor has decided that it will sell or abandon collateral at some point in the future. If the property is worth less than the secured creditor's claim, the debtor has no incentive to maintain it or maximize its value. The property instead becomes a hostage in negotiations with the creditor. It is in cases like these where §362(d)(2) is useful, regardless of whether the debtor is paying adequate protection and regardless of whether adequate protection includes compensation for lost investment opportunities.[103]

The Court addressed several other arguments pressed by United Savings and rebutted them with similar analysis. Most surprising is the Court's willingness to ignore the obvious tension between its interpretation of §362(d)(1) and the text of §726(a)(5), which orders interest paid to unsecured creditors in the event the debtor is solvent at the case's end.[104] Under the Court's interpretation, *oversecured* creditors receive interest payments under §506(b), *unsecured* creditors can receive interest under §726(a)(5), but *undersecured* creditors will never receive interest. This anomalous treatment—undersecured creditors given less protection than unsecured creditors—was acknowledged by the Court but dismissed because ''it will occur so rarely that it is more likely the product of inadvertence than are the blatant inconsistencies petitioner's interpretation would produce.''[105]

As we have seen, the ''inconsistencies'' in United's interpretation are far from obvious. The Court, it seems, sided with Timbers without strong reasons for doing so. Why did the Court side with Timbers? Perhaps it cared little about the outcome and effectively flipped a coin. Perhaps it was reluctant to deviate from pre-Code practice. Perhaps it found persuasive the same policy that guided the Fifth Circuit: all creditors should ''share the hurt'' of a reorganization and a rule allowing

101. *Id*. at 374.

102. *Id*. at 375.

103. A similar point is made by Charles Jordan Tabb and Robert M. Lawless, *Of Commas, Gerunds, and Conjunctions: The Bankruptcy Jurisprudence of the Rehnquist Court*, 42 Syracuse L. Rev. 823, 837 n. 70 (1991).

104. *Timbers*, 484 U.S. at 365.

105. *Id*.

interest payments would minimize the ''hurt'' borne by secured creditors. This policy, as we have seen, is dubious. Why should secured creditors ''share the hurt'' in a process that offers them little or no benefit?

The Court's statutory analysis may be shaky, and its holding may be at odds with economic theory, yet the final outcome in *Timbers*—denying United's request for adequate protection—may have much to commend it. United's lift-stay motion, recall, was an aggressive effort to cut short the bankruptcy case. Although it was already compensated for most of its lost investment opportunities, the bank argued for additional compensation that far exceeded its lost opportunities and far outstripped Timbers' ability to pay. United, in other words, tried to cut short the bankruptcy process without having to prove that ''cause'' existed for lifting the stay under §362(d)(1). An important lesson of *Timbers*, then, is that the phrase ''adequate protection'' is not so malleable that it can support strategic opt-out behavior by secured creditors.

VII. Case impact: holdings and dicta

Timbers' legacy is mixed. Its holding has been limited by statute and is easy to circumvent in practice. More than fifteen years after the decision was handed down, it seems that only Justice Scalia's dictum—that relief from the stay should be granted unless there is a ''reasonable possibility of a successful reorganization within a reasonable time''—may have had a lasting effect.

In 1994, about seven years after the Court's decision, Congress responded with §362(d)(3).[106] The new section was a partial rejection of the Court's holding, and a partial vindication of its dictum. In ''single asset real estate'' cases that have lasted for more than 90 days, the section declared, a court ''shall'' offer relief from the automatic stay unless ''(A) the debtor has filed a plan of reorganization that has a reasonable possibility of being confirmed within a reasonable time'' or ''(B) the debtor has commenced monthly payments to [the secured creditor] . . . in an amount equal to interest at a current fair market rate on the value of the creditor's interest in the real estate.''[107] We see, then, a vindication of the court's dictum in (A) and a partial rejection of its holding in (B). At least in single asset real estate cases, adequate protection includes compensating the secured creditor for lost opportunity costs. About a decade later, in 2005, Congress muddied the waters by amending (B) to require monthly payments at the ''applicable nondefault

106. Bankruptcy Reform Act of 1994, Pub. L. No. 103–394, 108 Stat. 4106 (codified in scattered sections of 11 U.S.C. (2000)). Efforts to enact 362(d)(3) go back at least to 1991. *See, e.g.,* H.R.2867, 102d Cong., 1st Sess. §2 (1991).

107. 11 U.S.C. §362(d)(3) (1994) (amended 2005).

contract rate of interest,''[108] which may differ from the fair market rate but is simpler to compute (and so less subject to litigation).[109] These monthly payments, the 2005 amendments make explicit, can be made from the rents generated by the real estate (as they were in *Timbers*).[110]

But what is a ''single asset real estate'' case? Until 2005, it was a relatively small enterprise. As enacted in 1994, §101(51B) defined it as a ''single property or project . . . which generates substantially all of the gross income of a debtor and on which no substantial business is being conducted other than the business of operating the real property.'' So far, so good: this definition encompassed *Timbers* and most other real estate bankruptcies. But then came the kicker. Section 101(51B) concluded with a final qualification: a ''single asset real estate'' case was one in which the value of the secured debt did not exceed $4 million. $4 million? That's pocket change in most real estate bankruptcies. Even Timbers would not have qualified as a ''single asset real estate case.'' To make matters worse, the $4 million threshold wasn't even indexed for inflation; if it had been, the threshold would have risen to $5.3 million in 2005 (still a not very large number for most real estate cases). The threshold was finally abandoned in the 2005 amendments to the Bankruptcy Code.[111] Now just about every case involving a single piece of real estate will fall within the scope of §362(d)(3). It took Congress, then, over fifteen years to overturn *Timbers* in the context of real estate cases. Outside those cases, the holding is still good law.

Nonetheless, the holding is unimportant for many lenders. It has always been easy to avoid much of its impact. The simplest strategy is to take a security interest in a broad range of property (via a ''blanket lien'') and thereby reduce the likelihood of becoming an undersecured creditor subject to the rule in *Timbers*. For mortgagees, another strategy is to take a security interest in any rents generated by the mortgaged real estate.[112] As we have already seen, rentals include compensation for

108. Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. 109–8, sec. 444, §362(d)(3)(B)(ii), 119 Stat. 23 (to be codified at 11 U.S.C. §362(d)(3)(B)(ii)).

109. *See, e.g.,* Richard Levin and Alesia Ranney–Marinelli, *The Creeping Repeal of Chapter 11: The Significant Business Provisions of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005*, 79 Am. Bankr. L. J. 603, 641–42 (2005).

110. Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. 109–8, sec. 444, §362(d)(3)(B)(i), 119 Stat. 23 (to be codified at 11 U.S.C. §362(d)(3)(B)(i)).

111. Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. 109–8, sec. 1201(5), §362(d)(3)(B)(i), 119 Stat. 23, (to be codified at 11 U.S.C. §362(d)(3)(B)(i)).

112. *See, e.g.,* Scott, *supra* note 99, at 184 n. 5 (''The opinion in *Timbers* . . . invites secured creditors to include contractual 'wrap-around' clauses providing for a perfected security interest in post-petition rental value of the collateral. By transforming lost

the time value of money. Still another strategy is for a secured creditor to enter a subordination agreement with junior creditors (secured or unsecured), obligating them to divert any bankruptcy distributions to the secured creditor until it has been paid in full, including post-petition interest.[113]

Even when the decision in *Timbers* is hard to avoid, it may be unimportant. Consider the case of lenders with security interests in property other than real estate. When collateral takes the form of personal property, such as trucks and machines, physical depreciation is far more important than the interest foregone when the creditor is unable to force an immediate sale of the collateral. A year of depreciation typically dwarfs the foregone interest. This is especially true when interest rates are relatively low, as they have been since the days of *Timbers*.[114] For these lenders, then, the holding in *Timbers* may be a non-event.

To be sure, not all lenders can avoid *Timbers*' bite. This may become increasingly true with the advent of ''second-lien financing.'' A lender takes a ''second lien'' when it extends financing to a highly leveraged debtor and agrees that, in the event of default or bankruptcy, it will receive payment *after* existing (''first lien'') secured lenders are paid in full but *before* unsecured creditors receive anything.[115] Until recently, most second liens have been ''silent'' liens: the second-lien lenders agreed not to foreclose on collateral outside bankruptcy, to contest motions filed by first-lien lenders in bankruptcy (e.g., to lift the automatic stay or extend post-petition financing), or assert other rights—at least

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opportunity into explicit economic rents, the secured creditor may be able to escape the *Timbers* rule.'').

113. Subordination agreements, especially as applied to post-petition interest, must be drafted carefully to avoid ambiguity, as illustrated by In re *Bank of New England Corp*., 364 F.3d 355 (1st Cir. 2004). There the subordination agreement provided that, in the event of various contingencies including bankruptcy, the senior lender would receive full payment of principal as well as ''interest due or to become due'' before the junior lender received any payment. The First Circuit found it unclear whether this agreement covered post-petition interest. When a debtor files a bankruptcy petition, no interest ''become[s] due'' because the Bankruptcy Code suspends accrual of interest during the pendency of the case. On the other hand, the phrase ''due or to become due'' could include unmatured interest, notwithstanding the rules of the Bankruptcy Code. Faced with ambiguity, the court remanded for further factfinding.

114. The Federal Funds rate, for example, was over 9% in 1989 but has averaged about 4% since then. *See* Board of Governors of the Federal Reserve System, *Statistical Release H.15, Selected Interest Rates, Historical Data* (visited Sept. 1, 2006) <http://www.federalreserve.gov/releases/h15/data.htm>.

115. For the mechanics of second-lien financing, see David Line Batty and Jo Ann J. Brighton, *''Silent'' Second Liens—Will Bankruptcy Courts Keep the Peace?*, 9 N.C. Banking Inst. 1 (2005).

for a limited period—until first-lien lenders were paid in full.[116] A first-lien lender will not permit the debtor to take on second-lien financing without these and other covenants. Second-lien lending is attractive, despite these limitations, because the lender demands a relatively high interest rate and obtains (limited) negotiating leverage and payment priority that unsecured creditors do not enjoy.[117] Because second-lien lenders stand behind senior secured creditors, they are often highly under-secured and thus exposed to *Timbers'* holding, which may be a serious handicap in a lengthy, protracted bankruptcy.

Then again, recall that *Timbers* matters most when interest rates are high and cases drag on for years, during which time the undersecured creditor is uncompensated for the time-value of money. Since the 1980s, however, interest rates have fallen significantly. The prime rate—the rate charged by banks on short-term business loans—averaged 12 percent during the 1980s, fell to about 8 percent during the 1990s, and was only about 6 percent between 2000 and 2005.[118] Interest rates, then, have fallen by about 50% during the past 25 years, greatly reducing the cost of delay in a lengthy case.

And lengthy cases have become a rarity. Among large,[119] publicly-traded corporations, the median Chapter 11 case took about 31 months during the period 1980–87.[120] As Figure 1 illustrates, that figure fell to about 15 months—a 53% drop—during the eight years (1989–96) following the Court's decision in *Timbers*. During the 1997–2001 period, median case length fell even further, to about 13 months, another 15% reduction.

To be sure, some of this decline is surely due to the "prepackaged" and "prenegotiated" plans, which became popular during the 1990s. Prepackaged plans are hammered out by a debtor and its dominant

116. *Id*. at 6–15. *See also* Steven S. Kerr and Joanna Rovito, *Second-Lien Evolution Creates Higher Recovery Prospects—At First–Lien Lenders' Expense*, *in* STANDARD & POOR'S RATINGS SERVICES, A GUIDE TO THE LOAN MARKET 46–50 (Sept. 2005) (showing that, since 2004, second-lien lenders have become much less "silent" and acquired greater control over borrower collateral and greater negotiating leverage in the event of default or bankruptcy).

117. A second-lien lender, for example, has the right to be heard on the use of collateral and, depending on the terms of the loan agreement, to object to post-petition financing that will prime existing liens. *See* Batty and Brighton, *supra* note 136, at 15–16.

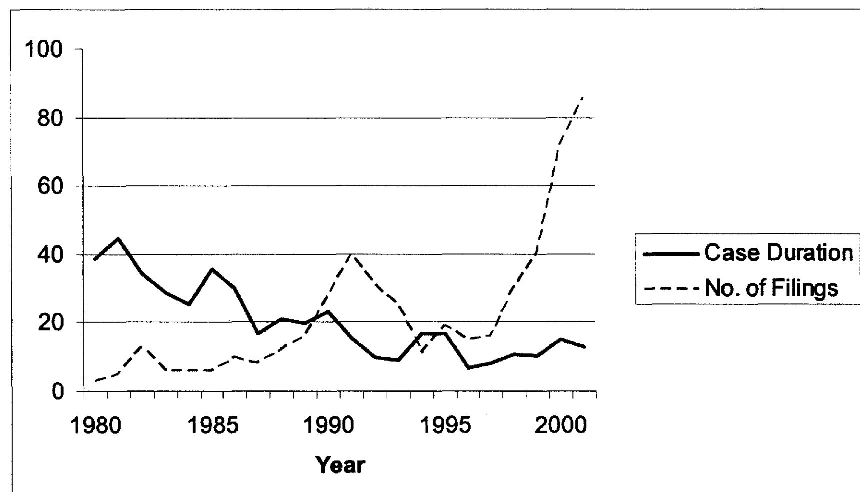
118. Prime rate data are taken from Board of Governors of the Federal Reserve, *supra* note 114.

119. A "large" corporation is defined as one with assets worth at least $500 million (in 1980 dollars) at the time of filing.

120. The statistics reported here and in Figure 1 are computed using Lynn LoPucki, *Bankruptcy Research Database* (visited Sept. 1, 2006) <http://lopucki.law.ucla.edu/bankruptcy_research.asp>. Medians reported in the text are weighted averages of the annual medians for the relevant periods.

creditors *prior to* a bankruptcy petition. A bankruptcy petition is filed only to bind dissenting, minority creditors. Immediately after filing, the debtor will typically submit its plan, which will generally be confirmed within a few weeks. Prenegotiated cases are similar, except that the debtor has lined up support from some but not all of the dominant creditors prior to the bankruptcy filing. A prenegotiated case may take longer to conclude than a prepackaged one. In both types of cases, however, the *Timbers* dicta loses much, if not all, of its force. For prepacks, an effective reorganization is "in prospect" on the very first day of the case. For prenegotiated cases, a plan will soon be formed. Thus, if we want to assess the impact of *Timbers* on case duration, it makes sense to exclude both types of cases from the calculation. (Indeed, it might make sense to study these cases separately; to the extent that *Timbers* reduced case duration and, therefore, made Chapter 11 cases less costly, it may have reduced the attractiveness of prepacks and prenegotiated cases.)

Figure 1: Median Case Duration (months), Chapter 11 Cases Involving Large Publicly-Traded Corporations



If we exclude these cases from the analysis, we see that case duration fell somewhat less dramatically—by 41% (from 31 to 18 months), not 53%—during the eight years following *Timbers*.[121] It fell another 4% during the 1997–2001 period.

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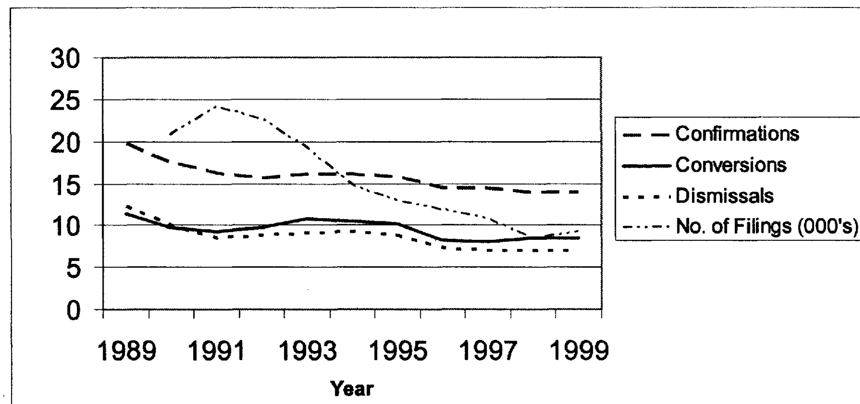
121. *Id.*

Most Chapter 11 cases don't involve such large corporations. Among businesses generally (about 90% of which are small firms with fewer than 200 employees),[122] we see similar patterns, as Figure 2 illustrates. The data, however, are surprisingly hard to find, especially for the 1980s.[123] Among cases with confirmed plans of reorganization, the median case time fell from 20 months in 1989 to 14 in 1999, a nearly 30% decline. We see a similar reduction among the slowest cases: in 1989, 80 percent of cases reached confirmation within 37 months; by 1999, 80 percent of cases reached confirmation in less than 25 months—a drop of about 32%. These statistics deal only with the minority of cases that end in confirmation. Most small business cases end in dismissal or conversion. Among these, similar patterns are evident. Median time to conversion and dismissal fell 25% and 35%, respectively, over the 1989–99 period (from 11.5 to 8.6 months for conversions; from 12.3 to 8.0 months for dismissals).[124]

Figure 2: Median Case Duration (months), All Chapter 11 Cases



These statistics are based on national surveys conducted by the federal government. Several academic scholars have analyzed small

122. United States Census Bureau, *Statistics of U.S. Business,* "1988–2004 U.S. and states, totals," (visited Jan. 8, 2007) <http://www.census.gov./csd/susb/Totals88–04.xls>.

123. Statistics in this paragraph are drawn from Gordon Bermant and Ed Flynn, *Outcomes of Chapter 11 Cases: U.S. Trustee Database Sheds New Light on Old Questions*, ABI J. (Feb. 1998) (for the year 1989), and from Ed Flynn, *United States Trustee Program: Report on Chapter 11 Cases, 1990–2001* (unpublished manuscript) (for years 1990–99).

124. Interestingly, total Chapter 11 filings declined (see Figure 2) during the same period that filings by large corporations were rising (see Figure 1) and filings by consumers were skyrocketing. This pattern remains something of a mystery, but may be explained by the increasing popularity of state-law alternatives to the Bankruptcy Code, including assignments for the benefit of creditors. *See* Edward R. Morrison, Bargaining Around Bankruptcy: Small Busines Distress and State Law (Jan. 2007) (working paper).

business cases in select jurisdictions. LoPucki, for example, studied Chapter 11 bankruptcy filings in the Western District of Missouri during the period 1979–80, the first year after the Bankruptcy Code went into effect. His data show that the median case lasted at least 7 months.[125] More recently, Morrison studied Chapter 11 filings in the Northern District of Illinois during calendar year 1998. The median case length in his study was shorter—about 5.7 months.[126] This difference may seem small in absolute numbers (1.7 months), but it is fairly large in proportionate terms (19%). Thus, both national surveys and close studies of particular jurisdictions show a decline in case duration over the past few decades.

It is tempting to attribute these declines in case duration to *Timbers*. The Supreme Court, in so many words, encouraged judges to put debtors on tighter leashes: a lift-stay motion should be granted, the Court said, unless a successful reorganization is clearly on the horizon. And, over the past 15 years, we have seen a significant decline in case duration, both in large and small business cases. Indeed, the Court's dictum may have had an impact on *Timbers* itself: two days after the Court's decision, United Savings filed a lift-stay motion in the bankruptcy court, citing the debtor's lack of a ''realistic prospect of reorganization,'' language quite similar to the Court's dictum. This motion was granted on February 20, 1988. The bank subsequently sold the apartment, on May 3, to a third party (for how much, we do not know).

But a healthy dose of skepticism should be brought to bear here. There are important difficulties in attributing real-world effects to *Timbers*. Correlation does not imply causation. The *Timbers* dictum may have been uttered when case length was already declining. Indeed, the past twenty years have seen significant change in the bankruptcy process. Creditors have gained greater control over the bankruptcy process; judges have become more sophisticated and less willing to allow failing firms to linger in bankruptcy. *Timbers* may have contributed to this development—it certainly did not retard it—but it is difficult to say whether its contribution was significant.

Indeed, it is not obvious that *Timbers* should have caused case length to fall. Roughly speaking, the Court encouraged bankruptcy judges to speed up their cases and, in the process, reduce the costs of bankruptcy to creditors. A lower-cost bankruptcy process reduces incen-

125. The phrase ''at least'' is used here because several cases were still pending when LoPucki's study went to press. Among cases ending in plan confirmation, median case length was at least 10 months; among cases ending in dismissal or conversion to Chapter 7, it was at least 5.5 months.

126. Edward R. Morrison, *Bankruptcy Decisionmaking: An Empirical Study of Continuation Bias in Small Business Bankruptcies*, J. L. & Econ. (forthcoming 2007).

tives for debtors and their creditors to resolve financial distress outside bankruptcy. As more firms enter the bankruptcy system, average case duration could rise, fall, or go unchanged. It could rise if the cases entering the system—the ''marginal cases''—are more complex and time-consuming than the cases that would have entered the system regardless of the dictum in *Timbers*. It could fall if the marginal cases are no more complex than the average case. The data show case length falling over time, but this could reflect factors other than the *Timbers* decision.

This is a problem common to all empirical legal scholarship: any court decision will cast a ''shadow'' over disputes that are, ordinarily, resolved or settled outside the legal system. This shadow will affect the parties' incentives to settle and alter the composition of cases in the courts. We cannot assume that a change in legal rules will only impact the kinds of cases we actually see. For every case in court, there are thousands of disputes settled outside of court, most of which are impossible to study systematically.

Moreover, if the dictum had any effect, it should have been a one-time reduction in case duration. That is, once judges took the dictum to heart, case duration should have fallen to a new, lower average. We should see case duration fall, but we should not see it fall continuously over time. We in fact see just the opposite: case duration has fallen continuously over time. Among cases involving large corporations, duration fell 28% between 1989 and 1996 and fell another 17% between 1997 and 2001. *Timbers* may have contributed to the decline, but it is not the only story. Much more is going on.

The most we can say, then, is that the past twenty years have seen constantly declining durations in Chapter 11 cases and that *Timbers* may have contributed to this important phenomenon. Chapter 11 is getting cheaper. Failing firms do not linger under the protection of the court; judges are increasingly willing to terminate the Chapter 11 process when a firm's prospects are bleak. As a result, it is rare to see long-lived cases in which professional fees escalate and creditors see their returns decay. *Timbers* was originally seen as a decision contributing to the inefficiency of the Chapter 11 process, because it forced secured creditors to bear some of the costs of the reorganization process. The decision seems not to have had that effect at all: if anything, it has contributed to the speed of the modern Chapter 11 process.

VIII. Conclusion

Timbers tells us several stories. One is the economics of rent. For United Savings, the stakes in *Timbers* were smaller than they might seem. When it requested compensation for lost investment opportunities, Timbers was already turning over all (net) rentals generated by the

apartment complex. And those rentals included compensation for lost opportunities, discounted by expected capital gains. One view of United's motion, then, is that it was an effort to avoid this discount. Another view is that United was gambling for more—it had nothing to lose and could benefit from judicial error in its favor. And it seems the court did indeed err in computing the payments necessary to compensate United. Seen this way, the Supreme Court's decision makes sense: it corrected an error.

But the Supreme Court did not grant certiorari merely to correct a factual error. It most likely did not even realize that such a mistake had occurred. It reviewed *Timbers* to decide whether, as a matter of statutory interpretation, the phrase "adequate protection" encompasses compensation for lost investment opportunities. The Court's decision, as we have seen, is far from satisfying. The phrase is ambiguous and the rest of the Code offers little clarification. Nonetheless, the Court rejected what may be the most intuitive interpretation—that "adequate protection" means compensating a secured creditor for *all* interests harmed by the automatic stay, including its interest in immediate foreclosure.

Here too, however, the stakes are much smaller than they appear. Congress has overruled *Timbers* in the context of single-asset real estate cases. Lenders have identified various strategies to limit their exposure to *Timbers*. And Chapter 11 cases have become much shorter, limiting the cost any secured lender will suffer from delay. This is the second story of *Timbers*: its interpretation of the Code has been largely neutralized by Congress, markets, and the bankruptcy process.