

Reorganization Plans

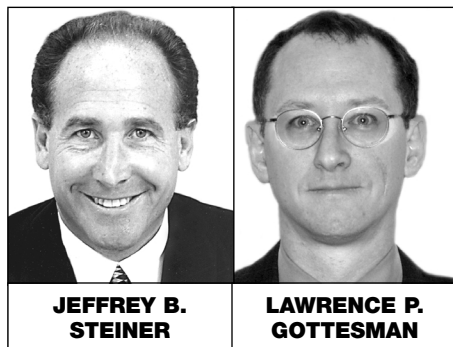
A Formula for Setting Cram Down Interest Rates

On May 1, 2004, a plurality of the U.S. Supreme Court issued an important decision in *Till v. SCS Credit Corp.* concerning the rate of interest to which a secured lender is entitled under a “cram down” plan under Chapter 13 of the Bankruptcy Code.¹ Although *Till* was decided under Chapter 13 of the Bankruptcy Code and although there are arguments for distinguishing a Chapter 11 cram down from one under Chapter 13, as a practical matter most if not all bankruptcy courts are likely to presumptively apply *Till* in the Chapter 11 context as well.

Under both chapters 11 and 13, if a plan proposes to satisfy a secured claim by promising a series of deferred cash payments over time rather than a lump sum payment, then the secured creditor is entitled to an interest component to ensure that it receives the present value of its allowed secured claim. As reflected in the *Till* decisions of the Bankruptcy Court, the District Court, Court of Appeals and the United States Supreme Court, a variety of approaches in determining the appropriate interest rate have been adopted. Section 1129(b) of the Bankruptcy Code,² governs “cram downs,” and its legislative history provide little guidance on how to determine the appropriate interest rate in a present value analysis.³

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Accordingly, “[t]he case law with regard to an appropriate [interest rate] for cram down purposes has blossomed into a ‘many colored splendor’ of conflicting and sometimes indecipherable formulas.”⁴ It has been noted that courts addressing the issue have applied different rationales and reached different results when deciding the appropriate interest rate.⁵ These approaches have included: (1) the current market rate for similar loans; (2) the rate the creditor must pay to replace the funds; (3) the risk-free rate; (4) the interest rate in the original contract; (5) the IRS judgment rate set forth in 26 U.S.C. §6621; (6) the statutory judgment rate; and (7) the Treasury Bill rate without a risk factor.⁶

Four Present Value Methods

The Bankruptcy Court in *Till* utilized the “prime plus” or “formula approach” in setting the cram down interest rate. This method involves taking the national prime rate and then adding an additional percentage to compensate for the risk of

non-payment posed by the debtor (the “formula approach”). In *Till*, this approach yielded an interest rate of 9.5 percent, based upon the then prevailing prime rate of 8 percent and a risk adjustment of 1.5 percent.⁷

The District Court reversed the Bankruptcy Court, finding that bankruptcy court should set the cram down rate of interest at the level the creditor could have obtained if it had foreclosed on the loan, sold the collateral and reinvested the proceeds in loans of equivalent duration and risk (the “forced loan approach”).⁸ The District Court determined that the appropriate rate under the forced loan approach was 21 percent.⁹

The Court of Appeals endorsed a modified version of the forced loan approach, holding that in a cram down proceeding, the present value inquiry should focus on the interest rate “that the creditor in question would obtain in making a new loan in the same industry to a debtor who is similarly situated, although not in bankruptcy.”¹⁰ To approximate that rate, the Court of Appeals looked to the pre-bankruptcy contract rate between the debtor and the secured creditor (21 percent).¹¹ The Court of Appeals, however, recognized that the contract rate could not account for all of the risks and economies attendant to a bankrupt, court-supervised debtor and therefore remanded the case to the Bankruptcy Court with instructions to afford the debtor and the secured creditor the opportunity to rebut the contract rate (the “presumptive contract approach”).¹²

The fourth approach was expressed in the dissenting opinion of the Court of Appeals, which advocated a cost of funds approach that would examine “what it would cost the creditor to obtain the cash equivalent of the collateral from an alternative source.” (the “cost of funds approach”).¹³

Supreme Court Analysis

In *Till*, the plurality rejected each of the three alternative approaches in favor of the formula approach, noting that “[e]ach of these approaches is complicated, imposes significant evidentiary costs, and aims to make each individual creditor whole rather than ensure the debtor’s payments have the required present value.”¹⁴

Three guiding principles informed the plurality’s analysis in *Till*:

First, the methodology for determining the appropriate interest rate should be essentially the same in each of the instances in which the Bankruptcy Code requires that the Bankruptcy Court determine the present value of a stream of payments.¹⁵ As such, the method that is adopted should be usable in any of these contexts.¹⁶

Second, the Bankruptcy Code expressly authorizes the Bankruptcy Court to modify the terms of any pre-bankruptcy agreement governing the debtor-creditor relationship; accordingly, little if any deference to the pre-existing contract is required.¹⁷

Third, the inquiry in setting the appropriate rate should be objective, rather than subjective.¹⁸

In the view of the *Till* plurality, each of the approaches used by the lower courts failed to satisfy these principles. The plurality rejected the forced loan approach, noting that it requires a Bankruptcy Court “to consider evidence about the market for comparable loans to similar (though nonbankrupt) debtors — an inquiry far removed from such courts’ usual task of evaluating debtors’ financial circumstances and the feasibility of their debt adjustment plans.”¹⁹ The plurality further noted that the forced loan approach overcompensates creditors because it considers risks and costs that are not relevant in the context of a court-administered cram down.²⁰

Similarly, the plurality objected to the presumptive contract approach as being too focused on the creditor’s use of the proceeds from a foreclosure sale and requiring debtors in conjunction therewith to perform extensive discovery regarding, among other things, the creditor’s cost of overhead, financial condition and lending practices.²¹

As to the cost of funds approach, the plurality noted that it “mistakenly focuses on the creditworthiness of the creditor” and like the presumptive contract approach, “imposes a significant evidentiary burden” on the debtor who is forced to discover evidence of the creditor’s financial condition.²²

‘Straightforward Inquiry’

The plurality noted that unlike the other approaches, the formula approach “entails a straightforward, familiar and objective inquiry and minimizes the need for potentially costly additional evidentiary proceedings.”²³ In the view of the plurality, the formula approach involves the relatively simple exercise of looking up the national prime rate and then adding an appropriate risk premium.²⁴

As a preliminary matter, the plurality noted that in its view the prime rate already takes into account “the financial market’s estimate of the amount a commercial bank should charge a credit-worthy commercial borrower to compensate for the opportunity costs of the loan, the risks of inflation, and the relatively slight default risk.”²⁵ Thus, in the view of the plurality, all that needs to be added is some premium to take into account that a debtor emerging from bankruptcy protection might pose more risk than a borrower that has not sought bankruptcy protection.²⁶

The plurality’s comments regarding determination of the risk premium are of particular interest and concern to secured creditors. Because the determination of this risk premium will be a major battleground for secured creditors contesting confirmation, it is worth quoting the plurality at length:

The appropriate size of that risk adjustment depends, of course, on such factors as the circumstances of the

estate, the nature of the security and the duration and feasibility of the reorganization plan. The court must therefore hold a hearing at which the debtor and any creditors may present evidence about the appropriate risk adjustment ... starting from a concededly *low* estimate and adjusting *upward* places the evidentiary burden squarely on the creditors, who are likely to have readier access to any information absent from the debtor’s filing (such as evidence about the “liquidity of the collateral market”) (quoting Justice Antonin Scalia, dissenting) (emphasis in original).²⁷

In *Till*, the Bankruptcy Court added a risk premium of 1.5 percent.²⁸ While not deciding the appropriate range of risk premiums, the Supreme Court plurality decision noted with apparent approval a range of 1 to 3 percent used in a variety of other reported decisions.²⁹ In the view of the plurality, the rights of the secured creditor are protected by the Bankruptcy Court’s determination that a particular plan is feasible — and that payment is therefore reasonably assured in the plurality’s view — rather than a high risk premium. According to the plurality, “the court ... [should] select a rate high enough to compensate the creditor for its risk but not so high as to doom the plan.”³⁰ If an excessively high rate is required to compensate for the risk of going forward, then the plan should not be confirmed.³¹

Concurring in the result, Justice Clarence Thomas argued that the Bankruptcy Code in most instances does not require any risk premium.³² Justice Thomas based his conclusion on the distinction between the present value of a stream of cash payments and the present value of a promise to pay over time.³³ Since this analysis was adopted by neither the plurality nor the dissenting opinion in *Till*, it is likely to have little express effect on the analytic approach adopted by the bankruptcy court going forward. To the extent that the dissenting opinion, however, signals a hostility to risk premiums, it may be taken into account by the lower courts going forward.

Justice Scalia (joined by Chief Justice William Rehnquist and justices Sandra Day O'Connor and Anthony M. Kennedy) agreed with the plurality that in determining the appropriate discount rate, debtor-specific risks must be taken into account.³⁴ In the view of the dissent, however, this argues for the utilization of the presumptive contract approach. The dissent argued that the rate achieved by the presumptive contract approach is a good indicator of actual risk to creditors and will provide a quick and reasonably accurate standard for bankruptcy courts to follow.³⁵

Critique of 'Till'

While a full-fledged critique of the plurality decision is beyond the scope of this article, a few salient points should be made.

First, the plurality decision, in equating the finding of feasibility, which is a requirement for confirmation, with a relatively low risk of default ignores not only practical experience but also the scope of the feasibility requirement. For example, a 1992 study of consummation rates of confirmed Chapter 11 plans in the Southern District of New York revealed that only 38 percent of confirmed plans for companies anticipating continued business operations after emergence from bankruptcy were actually consummated.³⁶ Moreover, the requirement of feasibility is satisfied if the Bankruptcy Court finds that a particular plan has a "reasonable" prospect of success; it does not require a "guarantee" of success.³⁷ In fact, given the propensity of bankruptcy court to favor reorganization, there is a significant risk that a plan may be found to be feasible yet still ultimately fail. A 1996 study revealed that within 14 years, 50 percent of all confirmed Chapter 11 plans that had been subject to a feasibility challenge were substantially modified or failed prior to full consummation.³⁸

Second, the relatively low range of risk premiums implicitly approved by the plurality seems inadequate to address the wide range of businesses, collateral classes, Chapter 11 plans and other factors that can have a meaningful effect on the risk of nonpayment following confirmation. For

example, in comparison to properties such as office space, hotels experience a relatively short lag between a change in economic or other conditions and hotel earnings.³⁹ Consequently, the total delinquency rate for hotel loans is approximately four times higher than that of commercial mortgage-backed securities as a whole.⁴⁰ The class of collateral alone, therefore, can greatly vary the risk of nonpayment.

Finally, the attempt to preserve plan feasibility by artificially keeping risk premiums low unfairly shifts the risk of the reorganization process to dissenting creditors.

Secured lenders with above-market interest rates on their existing loans will face increased demands by troubled borrowers for interest rate reductions, with the implicit or explicit threat of bankruptcy if such demands are not met. This environment will place increased pressure on holders of securitized commercial mortgages, which are particularly dependent upon the receipt of the original interest rate provided for in the pre-bankruptcy loan documents.

Considering Alternatives

This changed environment will require that holders of secured loans consider alternatives to bankruptcy as possibly being preferable. For example, under certain circumstances, a forbearance agreement that maintains the existing contract interest rate for accrual purposes while adopting a lower pay rate may be far preferable to a cram down battle that could result in a permanent reduction in the interest rate. Moreover, a bankruptcy filing after the borrower's failure to live up to the terms of a forbearance agreement may give the secured lender considerably more ammunition in arguing that the debtor's plan is not feasible.

If bankruptcy is either preferable or unavoidable, then Till will likely require holders of secured loans to act earlier and more aggressively to protect their rights. For example, it may be appropriate to seek early stay relief, appointment of a Chapter 11 trustee, or discovery under Bankruptcy Rule 2004 (with the goal of buttressing a case that the plan is unfeasible or at least particularly risky).

1. *Till v. SCS Credit Corp.*, No. 02-1016, 2004 U.S. LEXIS 3385, at *1 (U.S. May 17, 2004).

2. 11 U.S.C. §1129(b).

3. *In re Cellular Information Systems Inc.*, 171 B.R. 926, 938-39 (Bankr. S.D.N.Y. 1994) (citing *In re Oaks Partners Ltd.*, 135 Bankr. 440, 443 (Bankr. N.D. Ga. 1991)).

4. *Id.* (citing *In re Computer Optics Inc.*, 126 Bankr. 664, 671 (Bankr. D.N.H. 1991)).

5. See *In re River Village Assoc's*, 161 Bankr. 127, 135 (Bankr. E.D. Pa. 1993).

6. *Id.* at 135-137.

7. *Till*, 2004 U.S. LEXIS 3385, at *12-13 n.7.

8. *Id.* at *14-15 n.8.

9. *Id.*

10. *Id.* at *15 n.8 (quoting *In re Till*, 301 F.3d 583, 592 (2002)).

11. *Id.* at *15 n.8.

12. *Id.* at *15-16 n.8.

13. *Id.* at *16-17 n.9.

14. *Id.* at *23 n.16.

15. *Id.* at *18-19 n.9-n.10.

16. *Id.*

17. *Id.* at *19-20 n.11-n.12.

18. *Id.* *21-22 n.12-n.16.

19. *Id.* *23-24 n.16.

20. *Id.*

21. *Id.*

22. *Id.* at *25-26 n.17.

23. *Id.* at *27-28 n.18.

24. *Id.*

25. *Id.* at *4.

26. *Id.* at *4-5.

27. *Id.* at *27 n.17.

28. *Id.* at *5.

29. *Id.* at *29 n.19.

30. *Id.* at *30 n.19.

31. *Id.*

32. *Id.* at *38 (Thomas, J., concurring in judgment).

33. *Id.*

34. *Id.* at *48 (Scalia, J., dissenting).

35. *Id.*

36. Susan Jensen-Conklin, Do Confirmed Chapter 11 Plans Consummate? The Result of a Study and Analysis of the Law, 97 COM. L. J. 297, 324 (1992).

37. *In re Briscoe Enterprises Ltd., II*, 944 F.2d 1160, 1165-1166 (5th Cir. 1993); *In re Orlando Investors L.P.*, 103 B.R. 593, 600 (Bankr. E.D.Pa. 1989); See also *In re Eddington Thread Manufacturing Co. Inc.*, 181 B.R. 826, 832-3 (Bankr. E.D.Pa. 1995); *In re Schroick Construction Inc.*, 167 B.R. 569, 576 (Bankr. N.D. 1994).

38. Nancy Rhein Baldiga, Is This Plan Feasible? An Empirical Legal Analysis of Plan Feasibility, 101 COM. L. J. 115, 125-126 (1996) ("In order to test the hypothesis, the author reviewed all Chapter 11 Cases during a fourteen year period for which there was a reported decision involving feasibility. A total of 141 decisions were reported under the feasibility key in the West Bankruptcy Digest, 1989 edition, as updated through 1995").

39. Richard Parkus, Hotel Loan Performance in CMBS: An Analysis of Default Incidence and Loss Severity, 6 CMBS World 36, 38-39 (2004).

40. *Id.*

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