SHEARMAN & STERLING LLP

GLOBAL RESTRUCTURING GROUP

CLIENT PUBLICATION

June 28, 2013

Two Recent Circuit Court Decisions on Cram Down

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Two recent decisions by United States Circuit Courts of Appeal separately address the rights of secured creditors, unsecured creditors and equity holders under cram down plans of reorganization. In *Wells Fargo Bank National Association v. Texas Grand Prairie Hotel Realty, LLC*,[1] the United States Court of Appeals for the Fifth Circuit upheld a bankruptcy court's determination of the appropriate rate of interest payable to the holder of a secured claim whose claim was being paid over time under a cram down plan, despite the spread above prime from which the interest rate was derived being lower than a third party would be willing to lend on. In *Castleton Plaza, LP*,[2] the United States Court of Appeals for the Seventh Circuit held that an insider of a shareholder relying on the "new value" exception to the absolute priority rule must, like an existing shareholder, expose the opportunity to competition.

Secured Creditor Cram Down and *Texas Grand Prairie*

Section 1129(b) of the Bankruptcy Code contains the requirements for "cram down," the common term for confirmation of a plan of reorganization that one or more impaired classes of claims or interests has not accepted. If the requirements for confirmation set forth in section 1129(a) of the Bankruptcy Code (other than acceptance by all impaired classes) have been satisfied, then the court can confirm a cram down plan that does not discriminate unfairly, and is fair and equitable with respect to each impaired non-accepting class.[3]

A plan is fair and equitable if, among other things, it satisfies the "absolute priority rule".[4] The Bankruptcy Code provides three alternatives for establishing that a plan is fair and

[1] 710 F.3d 324 (5th Cir. 2013).

[2] 707 F.3d 821 (7th Cir. 2013).

[3] 11 U.S.C. § 1129(b)(1).

[4] 11 U.S.C. § 1129(b)(2).

equitable, and thereby satisfies the absolute priority rule for purposes of cramming down a non-accepting class of secured claims. One alternative permits the cram down of a class of secured claims if the plan provides for deferred payments of a "value" at least equal to the "allowed amount" of the secured claims as of the effective date of the plan.[5] Because that "value" is paid out over time, one of the key issues in cram down fights is the appropriate rate of interest that the secured creditor must receive in order to ensure that the value of the stream of payments equals the allowed amount of the claim.

In 2004, a plurality decision of the Supreme Court in *Till v. SCS Credit Corp*,[6] a chapter 13 case, endorsed a "prime-plus" formula for calculating the appropriate cram down rate for classes of secured creditors. Under this approach, a bankruptcy court should start with the national prime rate (which is charged to the most creditworthy commercial borrowers) and then add a supplemental "risk adjustment" to account for the debtor's circumstances, the nature of the collateral and the feasibility and forecasts in the debtor's plan of reorganization. The plurality suggested that Congress likely intended that a similar approach should apply in chapter 11 cases, but qualified that conclusion by noting that it might be appropriate to consider the rate that an efficient market would produce, if there exists a free market for a comparable exit loan. The plurality did not fix the range of risk adjustment premiums, but noted that courts generally had approved adjustments of 1% to 3%. Justice Scalia warned in his dissenting opinion that the plurality's prime-plus approach would "systematically undercompensate"[7] creditors and that the rate the court approved was merely a "smallish number picked out of a hat."[8]

On March 1, 2013, the Fifth Circuit, in *Wells Fargo Bank National Association v. Texas Grand Prairie Hotel Realty, LLC*,[9] held that the bankruptcy court did not err in applying a prime plus 1.75% interest rate to a secured lender's claim under a cram down plan of reorganization. Even though the Fifth Circuit recognized that no willing lender would have extended credit on these terms, it nevertheless upheld the "absurd result" as a "natural consequence" of applying the prime-plus method set forth in *Till*.[10]

Texas Grand Prairie Hotel Realty, LLC and certain of its affiliates (collectively, the "Debtors") obtained a $49 million loan, secured by substantially all of their assets, to acquire and renovate four hotel properties in Texas. Wells Fargo (the "Lender") acquired the loan before the Debtors sought chapter 11 protection. The Debtors proposed a cram

[5] 11 U.S.C. § 1129(b)(2)(A)(i)(II).

[6] 541 U.S. 465 (2004).

[7] *Id.* at 492.

[8] *Id.* at 501.

[9] 710 F.3d 324 (2013).

[10] *Id.* at 336.

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down plan that called for repayment of the $39 million secured loan (the plan's value for the original $49 million loan) over a 7-year period at an interest rate of 5%, representing the prime rate plus 1.75%. The Lender contended that the 5% interest rate was inadequate. The Debtors and the Lender agreed that the applicable rate should be determined by applying the prime-plus approach, but disagreed on the application of the formula. The Debtors' expert quoted the applicable prime rate at 3.25% and, using the 1%-3% scale referenced in *Till*, set the adjustment at 1.75% to reflect "just to the left of the middle of the risk scale."[11] In reaching that adjustment, the Debtors' expert considered that the hotels were well-maintained, the Debtors were committed to the business, the revenues exceeded projections leading up to the hearing, the collateral was appreciating and the proposed plan, although tight, was feasible. The Lender's expert agreed that the applicable prime rate should be 3.25%, but adjusted that number by 6.05% to yield a "blended market rate" of 9.3% based on the weighted averages the market would charge for multi-tiered exit financing. The Lender's expert further adjusted the blended rate downward by 1.5% to reflect the favorable circumstances of the estate and then upward again by 1% to account for the tight feasibility of the plan, resulting in a cram down rate of 8.8%.[12]

The bankruptcy court agreed with the Debtors' expert's approach and confirmed the plan. It rejected, as inconsistent with *Till*, the Lender's expert's use of a blended market rate as a benchmark before applying the adjustment factors. On appeal, the district court affirmed. The Lender appealed to the Fifth Circuit.

After determining that the appeal was not moot, the Fifth Circuit analyzed the applicable standard of review of the bankruptcy court's determination of the cram down rate. The Lender contended that, under *Till*, the *methodology* used for calculating the cram down rate is a matter of law and, accordingly, is subject to *de novo* review. The Fifth Circuit held that *Till* was not controlling precedent because it was decided in the chapter 13 context and, as a splintered, plurality opinion, was of limited precedential value. Moreover, the Fifth Circuit cited precedent for the proposition that it would be imprudent to tie the bankruptcy court's hands by requiring a specific method of calculating cram down interest in a particular case. In recognition of the discretion that must be afforded to a bankruptcy court, the Fifth Circuit found that the bankruptcy court's cram down rate analysis should be reviewed under a "clear error" standard.[13]

The Fifth Circuit Court also noted that despite Justice Scalia's admonition in *Till*, following *Till*, the vast majority of bankruptcy courts in chapter 11 cases have applied the prime-plus formula. Although the Fifth Circuit expressly made clear that it was "not suggest[ing] that the prime-plus formula is the only – or even the optimal – method for calculating the Chapter 11 cramdown rate,"[14] it has become the "default rule."[15] It further noted that "[w]hile courts often acknowledge that *Till*'s Footnote 14 appears to endorse a 'market rate' approach under Chapter 11 *if* an 'efficient market' for a loan substantially identical to the cramdown loan exists, courts almost invariably conclude that such markets are absent."[16]

[11] *Id.* at 334.

[12] *Id.* at 335.

[13] *Id.* at 331.

[14] *Id.* at 337.

[15] *Id.* at 336.

[16] *Id.* at 333.

Courts that follow *Till*'s formula method in the chapter 11 context generally apply a "risk adjustment" of between 1% and 3%. Within that range, courts usually select a rate based upon a "holistic assessment" of the risk of non-payment, "including the quality of the debtor's management, the commitment of the debtor's owners, the health and future prospects of the debtor's business, the quality of the lender's collateral, and the feasibility and duration of the plan."[17]

The Fifth Circuit agreed with the bankruptcy court's determination that the Debtors' expert's approach was an uncontroversial application of *Till*'s prime-plus method and was properly supported by the expert's holistic evaluation of the Debtors' financial situation. The Fifth Circuit rejected, as inconsistent with *Till*, the Lender's expert's approach, which required consideration of evidence of market-comparable loans. While it acknowledged that courts sometimes rely upon *Till* to support a market-influenced approach in chapter 11 cases when there is an efficient market for exit financing that offers "a loan with a term, size, and collateral comparable to the forced loan contemplated under the cramdown plan," the Fifth Circuit concluded that it would not support the Lender's approach because there was no market for a $39 million secured loan to the Debtors.[18] Although the Lender's expert contended that exit financing might be possible in the market if it was comprised of multiple tiers, such as senior debt, mezzanine debt and equity financing, the Fifth Circuit rejected the notion that such hypothetical cobbling together of multi-tiered financing represents "efficient markets."[19]

Although the Fifth Circuit conceded that application of the prime-plus approach led to an "absurd result" under the facts of the case because "no willing lender would have extended credit on the terms it was forced to accept under the § 1129(b) cramdown plan," it nevertheless affirmed the bankruptcy court because "the 'absurd result' is the natural consequence of the prime-plus method, which sacrifices market realities in favor of simple and feasible bankruptcy reorganizations."[20] In other words, the result was caused by a proper application of the *Till* formulation.

Implications

The *Texas Grand Prairie* decision provides debtors in a cram down situation with ammunition to propose low rates on secured claims that bear little correlation to the risk profile of the loan. Indeed, even an "absurd result" may be upheld if the prime-plus test has been properly applied. At the same time, the decision makes clear that the Fifth Circuit leaves to the discretion of the bankruptcy courts the determination of the appropriate method of computing cram down interest in each particular case.

The "New Value" Exception and *Castleton Plaza*

Section 1129(b)(2)(B) of the Bankruptcy Code provides that classes junior in priority to a non-accepting class of unsecured claims (such as shareholders) cannot receive or retain any property "on account of" their claims or interest unless the non-accepting impaired unsecured creditor class will receive distributions having a value equal to the allowed amount of their claims. Many courts, however, recognize an exception if the shareholder contributes sufficient "new value" to the debtor and receives equity in the reorganized company. In such cases, the shareholder theoretically is not receiving property "on account of" its old equity, but in exchange for the new value that it contributes.

[17] *Id.* at 333-34.

[18] *Id.* at 337.

[19] *Id.*

[20] *Id.* at 336.

In its 1999 opinion in *Bank of America National Trust and Savings Association v. 203 North LaSalle Street Partnership*,[21] the Supreme Court held that the right to contribute new value does not belong solely to the existing shareholder; the debtor must allow competition for the right to provide that new value. The existing equity holder must allow others to either compete for the right to provide new value or propose a competing plan.

In *Castleton Plaza, LP*,[22] the Seventh Circuit addressed whether the competition requirement applies when an insider of the current shareholder, not the shareholder itself, provides the new value. George Broadbent directly and indirectly owned all of the equity in the debtor Castleton Plaza, which owned a shopping center. George also was the CEO of The Broadbent Company, which his wife, Mary Clare, wholly owned. The Broadbent Company managed Castleton Plaza and paid George a $500,000 salary.

Castleton Plaza proposed a plan of reorganization that would reduce the balance of a secured, $10 million note by almost $2 million, reduce its rate of interest from 8.37% to 6.25%, extend the loan for 30 years and eliminate the note's additional security. Unsecured creditors would be paid 15% of their allowed claims. Castleton Plaza would assume its management contract with The Broadbent Company. The plan canceled George's equity interest, and provided all of Castleton Plaza's equity to Mary Clare in exchange for her investment of $375,000.

The secured creditor objected, arguing that Castleton Plaza's assets had been undervalued (particularly in light of the proposed reduction of the company's secured debt), and offered to pay $600,000 for the new equity and pay the unsecured creditors in full. The secured creditor also asked the bankruptcy court to require that the offer to purchase the new equity be subject to a competitive auction process. The bankruptcy court denied the request and approved the plan as proposed. According to the bankruptcy court, competition was not necessary because section 1129(b)(2)(B)(ii) of the Bankruptcy Code, which contains the general absolute priority rule for unsecured creditors, looks only to whether "the holder of any claim [or interest]" that is junior to the impaired creditor's claim receives a recovery, and Mary Clare did not hold an interest in the debtor.[23]

On direct appeal, the Seventh Circuit ruled that Castleton Plaza's plan required competitive bidding for the right to provide new value. The Seventh Circuit reasoned that a "new value" plan that would distribute new equity to an insider of the old equity investor (the investor's spouse), would circumvent the absolute priority rule just as if new equity were distributed to the investor. The court observed that for many purposes an insider is treated the same as an equity investor, and that under section 101(31)(B)(vi) of the Bankruptcy Code family members of corporate managers are deemed insiders. The court also found George Broadbent would receive value from the equity that his wife was to acquire, including value from his wife's investment in the reorganized debtor and an increase in the family's wealth plus the continuation of his $500,000 salary as CEO of The Broadbent Company. The Seventh Circuit found that such a result could not be reconciled with *203 North LaSalle's* competition mandate, which "helps prevent the funneling of value from lenders to insiders . . . ."[24] The Seventh Circuit also found that the need for competitive bidding was particularly important

[21] 526 U.S. 434 (1999).

[22] 707 F.3d 821 (2013).

[23] *Id.* at 822.

[24] *Id.* at 824.

where, as here, the secured lender asserted that its claim was being substantially impaired under the plan because the debtor's assets were being undervalued.

Implications

Castleton Plaza provides some Circuit level precedent for situations in which new value is provided by an insider of the old equity holder – an issue on which bankruptcy courts have disagreed. It makes clear that the competition edict of *203 North LaSalle* should be applied to all "new value" plans, regardless of the source of the new value. Thus, it reaffirms the importance of giving substantive effect, rather than mere lip service, to the absolute priority rule. It also addresses a question that *203 North LaSalle* left unanswered: whether the market-testing mandate requires an auction, rather than merely taking expert testimony or granting the right to file a competing plan. *Castleton Plaza* makes clear that competitive bidding is required, at least in those cases where the new investment is by an insider of the old equity investor. As a result, *Castleton Plaza* is of interest to secured lenders generally, and especially to owners and creditors in single-asset real estate cases, where new value plans are common.

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