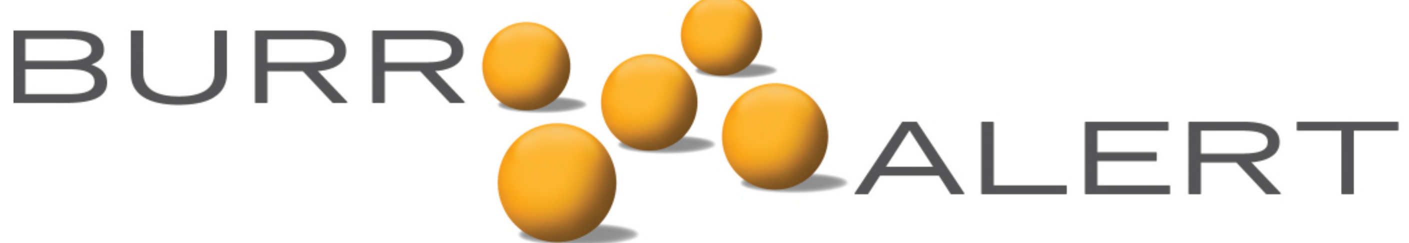

The Basics of Cramdown Interest Rates in Chapter 11

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A debtor in a chapter 11 bankruptcy may treat a secured claim in one of two ways in its plan of reorganization: (1) the debtor may propose to cure any existing default, compensate the creditor for any loss sustained by the creditor as a result of the debtor's default, and reinstate the debt pursuant to the provisions of the governing loan documents; or (2) the debtor may propose a plan of reorganization that modifies the rights and remedies of the secured creditor. In the former scenario, the secured creditor is "unimpaired" and is deemed to accept the debtor's plan of reorganization. In the latter scenario, the secured creditor is "impaired," and this "impaired" creditor may vote to reject the plan. In the event the "impaired" creditor votes to reject the plan, the debtor's plan of reorganization may still be confirmed over the "impaired" creditor's rejection of the plan, but only if the debtor satisfies certain conditions. The debtor's ability to have its plan of reorganization confirmed over a secured creditor's rejection of same is colloquially referred to as "cramdown."

The requirements for cramdown in chapter 11 are outlined in Section 1129(b) of the Bankruptcy Code. According to Section 1129(b), cramdown is only available where a debtor's chapter 11 plan of reorganization:

a) satisfies all of the confirmation requirements of Section 1129(a), save 1129(a)(8) -- the requirement that "[w]ith respect to each class of claims or interest—(A) such class has accepted the plan; or (B) such class is not impaired under the plan;"

b) provides "that the holders of [impaired secured] claims retain the liens securing such claims, whether the property subject to such liens is retained by the debtor or transferred to another entity, to the extent of the allowed amount of such claims;" and

c) provides that "each holder of [an impaired secured] claim of a claim of such class receive on account of such claim deferred cash payments totaling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder's interest in the estate's interest in such property."

In other words, a debtor in chapter 11 may not take advantage of the benefits of cramdown under Section 1129(b) unless the debtor's plan (1) meets the general requirements for confirmation of a chapter 11 plan of reorganization, except for the requirement that the plan be accepted by all classes of claims or not impair any class of claims; (2) provides that impaired secured creditors will retain their liens in the relevant collateral; and (3) provides that impaired secured creditors will receive future payments that are, at the very least, equivalent to the value of the allowed amount

of creditors' secured claims as of the effective date of the debtor's plan of reorganization. This article will focus on the third requirement for cramdown in a chapter 11 case.

In order to satisfy the third requirement, a debtor must propose an interest rate that will compensate impaired secured creditors for receiving deferred cash payments in lieu of a lump sum cash payment on the effective date of the debtor's plan of reorganization. This is required, of course, because future cash payments with a total nominal value equivalent to the nominal value of a present lump sum cash payment will be of less value to a secured creditor due to the time value of money.

Unfortunately, Congress did not supply a prescribed method for calculating the appropriate interest rate in the context of a chapter 11 reorganization (or any other type of bankruptcy case, for that matter). Consequently, for years courts considered various methods and approaches (namely, the coerced loan approach, the presumptive contract rate approach, the cost of funds approach, and the "prime plus" approach) when determining whether a proposed discount rate satisfied section 1129(b). In 2004, the Supreme Court issued an opinion which purported to resolve any dispute as to which of these approaches was the appropriate approach to use when determining the discount factor for a cramdown plan.

Till v. SCS Credit Corp.

The leading case on cramdown interest rates in the context of a chapter 11 reorganization is, oddly enough, the Supreme Court's decision in a case which addressed the cramdown proposal of two joint chapter 13 debtors—*Till v. SCS Credit Corp*[1] In *Till*, the chapter 13 debtors owned a used vehicle for which they owed $4,894.89 to SCS Credit Corporation. The debtors proposed to cramdown SC S's secured claim by making monthly payments to SCS with yearly interest of 9.5%. According to the debtors, the deferred monthly payments with 9.5% interest rate would satisfy the cramdown requirements of 11 U.S.C. § 1325(a)(5)(B) because they compensated SCS for the risk of debtors' nonpayment by adding 1.5% interest to the prevailing national prime rate of interest. SCS objected to this proposal and countered that it should receive a 21% interest rate, as SCS would be able to earn that type of interest rate if it were allowed to foreclose upon the loan, sell the vehicle, then reinvest the proceeds from the sale of the vehicle into a loan extended to a debtor in a financial situation similar to the debtors'. SCS also noted that a 21% interest rate was the appropriate interest rate because lenders would require such a rate of interest from borrowers in circumstances of financial distress.

With little guidance from the Bankruptcy Code on how to resolve this dispute, the Supreme Court considered the following four different approaches in an effort to determine how the discount rate for debtors' cramdown plan should be calculated: (1) the coerced loan approach; (2) the presumptive contract rate approach; (3) the cost of funds approach; and (4) the "prime-plus" approach. The coerced loan approach calculates the appropriate interest rate for a cramdown plan by determining the interest rate a creditor would receive if it were allowed to foreclose the debtors' loan and reinvest the proceeds of the sale into a new loan extended to a debtor in similar circumstances with a duration similar to the duration of the debtors' proposed cramdown plan. The

[1] 541 U.S. 465 (2004).

presumptive contract rate approach presumes that the interest rate provided by the contract between the parties should continue to be enforceable. However, this rate may be adjusted in either direction based upon the credit risk posed by the debtors. The cost of funds approach sets the interest rate for cramdown at the interest rate the creditor would have to pay in the event the creditor decided to borrow the cash equivalent of the collateral. This interest rate would be tied to the creditor's, not the debtor's, credit risk profile. The prime-plus approach calculates the appropriate interest rate for a cramdown plan by taking the prevailing national prime rate and adding a risk factor adjustment based on the "circumstances of the [bankruptcy] estate . . . and the characteristics of the loan."

In a plurality opinion, the Supreme Court held that the "prime-plus" approach is the superior method for determining the appropriate interest rate for a cramdown plan in chapter 13. In determining that the "prime-plus" approach is the correct approach, the plurality first considered (1) that Congress likely intended courts to use the same approach when determining the appropriate discount rate; (2) that chapter 13 of the Bankruptcy Code permits a court to modify the rights of the debtor's secured creditors, provided their claims are secured by collateral other than the debtor's principal residence; and (3) that, from a creditor's standpoint, the Bankruptcy Code requires an objective, as opposed to a subjective, approach when determining the appropriate discount rate. With these considerations in mind, the Court rejected the coerced loan approach, the presumptive contractive approach, and the cost of funds approach, since, according to the plurality, these approaches are "complicated, impose[] significant evidentiary costs, and aim to make each individual creditor whole, rather than to ensure that the debtor's payments have the required present value." On the other hand, the "prime-plus" approach "entails a straightforward, familiar, and objective inquiry, and minimized the need for potentially costly additional evidentiary proceedings." The Court further noted that the "prime-plus" approach was the superior method to use because the "'prime-plus' rate of interest depends only on the state of financial markets, the circumstances of the bankruptcy estate, and the characteristics of the loan, not on the creditor's circumstances or its prior interactions with the debtor."

The Court did not, however, provide a uniform method for courts to employ when determining the appropriate risk factor to be added to the prime rate of interest. Instead, the plurality simply noted that "[t]he 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 then proceeded to note that other courts utilizing the "prime-plus" approach had previously approved risk factor adjustments from 1% to 3%, but that courts should not be confined to this range of adjustments since courts should "select a rate high enough to compensate the creditor for its risk but not so high as to doom the plan."

Though *Till* addressed cramdown in the context of a chapter 13 bankruptcy case, the Court, in a footnote contrasting the absence of a free market of cramdown lenders for chapter 13 debtors to the availability of the DIP financing market to chapter 11 debtors, noted that "when picking a cram down rate in a Chapter 11 case, it might make sense to ask what rate an efficient market would produce."

Application of Till in Chapter 11

The existence of the aforementioned footnote in *Till* has led most courts burdened with the task of determining the appropriate cramdown interest rate in a chapter 11 bankruptcy case to first determine whether a preponderance of evidence exists to prove that an efficient market exists.[2] The burden of proof at this stage is squarely on the shoulders of the secured creditor; therefore, a secured creditor that believes an efficient market is readily available for a loan with characteristics similar to the plan proposed by the debtor and will provide a higher interest rate than the rate proposed by the debtor needs to be prepared to offer evidence supporting these beliefs.[3] If the secured creditor proves that an efficient market does exist, then courts will generally apply the interest rate available in this market, provided the interest rate is not so high that it craters the debtor's reorganization plan.

If there is no efficient market, then courts will apply *Till's* "prime-plus" approach, which, as previously discussed, means the court will start with the national prime rate of interest then add an appropriate risk factor adjustment.[4] As noted above, the Supreme Court did not provide significant guidance for determining the appropriate risk factor adjustment; however, lower courts have enunciated numerous factors that should be considered when determining the correct risk factor adjustment, including: (1) the nature and value of the collateral; (2) the potential appreciation or depreciation of the collateral; (3) the duration of the proposed repayment plan; (4) the debtor's ability to pay; (5) the stability of debtor's operations; (6) the debtor's cash flow; and (7) the existence and size of debtor's equity cushion in the collateral.[5] Though this list is not exhaustive, secured creditors trying to prove they are entitled to a specific cramdown interest rate under the Till approach should certainly plan to assert that they are entitled to the desired interest rate based upon some, if not all, of the foregoing factors.

SUMMARY

When a secured creditor votes to reject a debtor's chapter 11 plan of reorganization, the debtor may subsequently force the secured creditor to accept its plan of reorganization if the debtor's plan provides that the secured creditor will retain its lien in the collateral and receive deferred cash payments that are equivalent to the value of the secured creditor's allowed claim as of the effective date of the debtor's plan. In order to provide deferred cash payments that are equivalent to the value of the secured creditor's allowed claim as of the effective date of the debtor's plan, the deferred cash payments will need to include an interest rate that compensates the secured creditor

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[2] *See, e.g.*, *In re LMR, LLC*, 2013 WL 2299623, at *16 (Bankr. W.D. Tex. 2013); *In re Moultonborough Hotel Group, LLC*, 2012 WL 5464630, at *7 (Bankr. D. N.H. 2012); *In re Pamplico Highway Development, LLC*, 468 B.R. 783, 793 (Bankr. D. S.C. 2012).

[3] *See, e.g.*, *In re LMR, LLC*, 2013 WL 2299623, at *16; *In re Moultonborough Hotel Group, LLC*, 2012 WL 5464630, at *7.

[4] *See, e.g.*, *In re LMR, LLC*, 2013 WL 2299623, at *17; *In re Texas Grand Prairie Hotel Realty, LLC*, 710 F.3d 324, 332 (5th Cir. 2013); *In re Moultonborough Hotel Group, LLC*, 2012 WL 5464630, at *7; *In re Pamplico Highway Development, LLC*, 468 B.R. at 794. \

[5] *See, e.g.*, *In re LMR, LLC*, 2013 WL 2299623, at *17; *In re Moultonborough Hotel Group, LLC*, 2012 WL 5464630, at *6.

for the time value of its money and the risk of non-payment. If the secured creditor believes it is entitled to a higher interest rate than the rate proposed by the debtor based upon the availability of the higher interest rate in an efficient market for loans with characteristics similar to the plan proposed by the debtor, then the secured creditor needs to be prepared to provide evidence of this market-based interest rate. Additionally, the secured creditor will need to be prepared to show that this higher rate of interest will not torpedo the debtor's plan of reorganization.

If no efficient market exists for loans similar to the plan of repayment proposed by the debtor, then the secured creditor will need to work within the framework of *Till* when arguing for a certain rate of interest. As outlined above, secured creditors working within the confines of *Till* will want to assert that they are entitled to a certain risk adjustment to the national prime rate of interest based upon, among other things, (1) the nature of the collateral, (2) the potential appreciation or depreciation of the collateral, (3) the duration of the proposed plan of repayment, (4) the debtor's ability to pay, (5) the stability of debtor's operations, (6) the debtor's cash flow, and (7) the existence and size of the debtor's equity cushion in the collateral.

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