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Protecting Present Value

Do Extended Plan Payments Require Periodic Adjustments to the Till *Cramdown Interest Rate?*

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The Bankruptcy Code embodies a series of compromises between the interests of debtors and creditors. Debtors are protected by the automatic stay, but they must adequately protect creditors' interests in estate property to the extent that such interests are adversely impacted by the stay.[1] Debtors may also sell estate property "free and clear" of creditors' interests, but they must satisfy one of the five enumerated standards.[2] Debtors may confirm a reorganization plan over the objection of any class of creditors, but they must prove that the plan's treatment of such creditors is "fair and equitable."[3]

As to this final point (known as "cramdown"), each of the Bankruptcy Code's reorganization chapters includes a similar standard describing what constitutes fair and equitable treatment of a class of secured claims. Among other tests, debtors may confirm a plan over the objection of a class of secured claims if the plan proposes to pay the present value of the allowed secured claims with a stream of deferred payments.[4] Central to the present value determination is the proposed interest rate: If the interest rate is "below market," the stream of payments will yield the creditor less than the present value of its claim, and the plan cannot be confirmed.

As will be described herein, since the U.S. Supreme Court's seminal decision in *Till*, many courts have often applied the so-called "formula approach" to determine whether the interest rate proposed by the plan is a market rate that will ensure that objecting creditors receive the present value of their claims under the plan.[5] A recent decision from the U.S. Bankruptcy Court for the District of Nebraska provides a new wrinkle to the dilemma of protecting the payment of present value under *Till*: If debtors propose extended repayment terms, they must provide for periodic adjustment of the cramdown interest rate.[6]

The *Till* Formula Approach

Like many cases that lead to seminal decisions, the underlying facts of *Till* are inauspicious. About a year before their bankruptcy filing, the debtors, Lee and Amy Till, purchased a used truck for $6,395.[7] They entered into a retail installment contract with a finance company to fund the purchase, with the initial indebtedness amounting to $8,285.24, which included a 21 percent annual finance charge.[8] The debtors defaulted on the loan and filed for chapter 13 relief. The lender objected to the debtors' chapter 13 plan, which proposed to repay the lender at 9.5 percent interest per year based on a formula, the national prime rate of interest (8 percent) plus a premium of 1.5 percent to account for the increased risk of nonpayment based on the debtors' financial situation.[9]

The bankruptcy court confirmed the plan over the lender's objection under the cramdown provisions of § 1325(a)(5), holding that the interest-rate formula ensured that the lender received the present value of its secured claim under the plan.[10] On appeal, the district court reversed, adopting the so-called "forced-loan" approach, which required the debtors to pay the lender the same rate it would have received "if it had foreclosed on the truck, sold the collateral, and reinvested the proceeds in loans of equivalent duration and risk."[11] The Seventh Circuit then generally affirmed the application of the forced-loan approach, finding that the contract rate of 21 percent was presumptive, but remanding for consideration whether that rate should have been adjusted higher or lower based on the facts and circumstances of the case.[12]

The Supreme Court reversed and adopted the bankruptcy court's formula approach, holding that "we think Congress would favor an approach that is familiar in the financial community and that minimizes the need for expensive evidentiary proceedings."[13] By contrast, the forced-loan approaches adopted by the district court and Seventh Circuit were "complicated, impose[d] significant evidentiary costs, and aim[ed] to make each individual creditor whole rather than to ensure the debtor's payments have the required present value."[14] The Court then dictated that the formula approach should begin by

1 11 U.S.C. §§ 361-362.
2 11 U.S.C. § 363.
3 11 U.S.C. § 1129(b). *See also* 11 U.S.C. §§ 1225(a)(5) and 1325(a)(5).
4 *Id.*
5 *Till v. SCS Credit Corp.*, 541 U.S. 465 (2004).
6 *In re Elkhorn Crossing LLC*, No. BK16-80782, 2016 WL 6875893 (Bankr. D. Neb. Nov. 21, 2016).
7 *Till*, 541 U.S. at 470.
8 *Id.*
9 *Id.* at 471.
10 *Id.*
11 *Id.* at 472.
12 *Id.* at 472-73.
13 *Id.* at 474-75.
14 *Id.* at 477.

[t]aking its cue from ordinary lending practices ... by looking to the national prime rate, reported daily in the press, which reflects the financial market's estimate of the amount a commercial bank should charge a creditworthy commercial borrower to compensate for the opportunity costs of the loan, the risk of inflation, and the relatively slight risk of default.[15]

However, "[b]ecause bankrupt debtors typically pose a greater risk of nonpayment ... the approach then requires a bankruptcy court to adjust the prime rate accordingly."[16] The Court left the reasonable range of such adjustments up to the bankruptcy courts, but noted that courts applying the formula approach generally applied a risk adjustment of 1-3 percent.[17]

The *Elkhorn* Decision

Since the *Till* ruling, bankruptcy courts have debated the applicability of the formula approach outside the chapter 13 context, but have often used the approach based on the Court's statement, "We think it likely that Congress intended bankruptcy judges and trustees to follow essentially the same approach when choosing an appropriate interest rate" under §§ 1129(a)(7)(A)(ii), (a)(7)(B), (a)(9)(B)(i), (a)(9)(C), (b)(2)(A)(i)(II), (b)(2)(B)(i) and (b)(2)(C)(i); 1173(a)(2); 1225(a)(4) and (a)(5)(B)(ii); 1228(b)(2); and 1325(a)(5).[18] In the recent case of *In re Elkhorn Crossing LLC*, neither the debtor nor the creditor disputed that the formula rate applied in a chapter 12 cramdown dispute, but they differed on how it should be applied to the facts and circumstances of the case.[19]

In *Elkhorn*, the debtor was indebted to the creditor for a number of cross-collateralized loans, including a 16-year note secured by a first mortgage and assignment of rents on the debtor's real estate. The parties agreed that the creditor was oversecured by $1.2 million to $2.2 million.[20] The debtor proposed a plan to repay the creditor over 15 years at a fixed interest rate of 5.5 percent,[21] but the creditor objected, arguing that the proposed term was too long and the proposed interest rate failed to compensate the creditor for the present value of its claim, as required by § 1225(a)(5).[22]

While the bankruptcy court ultimately determined that the term of repayment was reasonable, it denied confirmation because the interest rate failed to provide the creditor with the present value of its claim. While applying the *Till* formula approach was appropriate, the court held that "some reasonable periodic adjustment of the rate during such a lengthy loan term is necessary to properly provide [the creditor] with the present value of its claim. Therefore, [the] Debtor's proposal to fix the interest rate ... for 15 years at the formula rate will not be approved."[23]

Practice Pointers

Although *Elkhorn* is a chapter 12 case, chapter 11 and 13 practitioners would be wise to pay attention to its implications. As more bankruptcy courts adopt the use of the formula approach for calculating cramdown interest rates in all chapters, the confirmation battlefield for debtors and secured creditors continues to narrow.

Counsel for secured creditors facing extended plan-repayment periods may utilize *Elkhorn*'s holding to object to a cramdown by arguing for various adjustments to the formula rate in order to ensure that their clients are receiving the present value of their claims, as Congress intended. The case law on such adjustments is largely undeveloped, and counsel will likely be granted broad leeway to draw on expert testimony about the types of adjustments that are necessary in order to ensure that the proposed treatment is both fair and equitable.

On the other hand, debtors' counsel may wish to object to this new development in the application of the formula approach. In so doing, counsel should consider whether the language of the cramdown provisions of each chapter — which, in each instance, require that the valuation be done "as of the effective date of the plan" — calls for the application of a fixed or variable interest rate. In addition, even if a variable rate is appropriate, are there corresponding impacts on the application of the risk factors contemplated by *Till*? To the extent that creditors attempt to rely on extensive expert testimony about periodic adjustments, counsel should also consider objecting by invoking the policy underlying the Supreme Court's adoption of the formula approach in the first place: To "minimize ... the need for expensive evidentiary proceedings."[24] Alternatively, debtors might also consider offering periodic adjustments to the cramdown rate when proposing extended repayment periods and attempt to avoid the confirmation battle altogether. **abi**

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15 *Id.* at 478-79.
16 *Id.* at 479.
17 *Id.* at 480 (citing *In re Valenti*, 105 F.3d 55, 64 (2d Cir. 1997) (collecting cases)).
18 *Id.* at 474. *See also In re MPM Silicones LLC*, No. 14-22503-rdd, 2014 WL 4436335 (Bankr. S.D.N.Y. Sept. 9, 2014) (applying formula approach in large chapter 11 case), *aff'd*, 531 B.R. 321 (S.D.N.Y. 2015). In his opinion, Hon. **Robert D. Drain** rejected the argument by objecting noteholders that footnote 14 in *Till* was intended to imply that the formula approach should not apply in chapter 11 cases because an "efficient market" exists for determining the cramdown rate in such cases (*i.e.*, the interest rate applicable to debtor-in-possession loans). *See Till*, 541 U.S. at 476 n.14 ("This fact helps to explain why there is no readily apparent Chapter 13 'cram down market rate of interest': Because every cramdown loan is imposed by a court over the objection of the secured creditor, there is no free market of willing cramdown lenders. Interestingly, the same is *not* true in the Chapter 11 context, as numerous lenders advertise financing for Chapter 11 debtors in possession.... Thus, when picking a cramdown rate in a Chapter 11 case, it might make sense to ask what rate an efficient market would produce. In the Chapter 13 context, by contrast, the absence of any such market obligates courts to look to first principles and ask only what rate will fairly compensate a creditor for its exposure.").
19 Indeed, under the applicable local bankruptcy rules, the formula rate is mandated as "the national average of the prime rate as published in the *Wall Street Journal* on the last day prior to the confirmation hearing ... plus two percentage points." Bankr. D. Neb. L.B.R. 3023-1. "If the creditor desires a different interest rate, it must specifically object to confirmation based upon the inadequacy of the interest rate and shall have the burden of proof by a preponderance of the evidence on the appropriate rate of interest." *Id.*
20 *Elkhorn*, 2016 WL 6875893, at *1-2.
21 *Id.* at *2.
22 *Id.*
23 *Id.* at *3.
24 *Till*, 541 U.S. at 475.