# Pratt's Journal of Bankruptcy Law

AN A.S. PRATT & SONS PUBLICATION
JUNE 2013

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POSTMASTER: Send address changes to *Pratt's Journal of Bankruptcy Law*, A.S. Pratt & Sons, 805 Fifteenth Street, NW., Third Floor, Washington, DC 20005-2207.

*ISSN 1931-6992*

# Fifth Circuit Upholds "Absurd" Cramdown Interest Rate

LAWRENCE V. GELBER AND NEIL S. BEGLEY

*The U.S. Court of Appeals for the Fifth Circuit recently held that a bankruptcy court had not erred in applying a prime plus 1.75 percent interest rate to a secured lender's $39 million claim under a "cramdown" plan of reorganization. This article discusses the decision and its implications.*

The U.S. Court of Appeals for the Fifth Circuit recently held that a bankruptcy court had not erred in applying a prime plus 1.75 percent interest rate to a secured lender's $39 million claim under a "cramdown" plan of reorganization.[1] Under Bankruptcy Code § 1129(b), a plan of reorganization may be confirmed over the objection of a secured creditor, in other words "crammed down," if the stream of deferred payments under the proposed plan equal the amount of the secured creditor's allowed claim as of the effective date of the plan, as discounted to present value by applying an appropriate interest rate ("cramdown rate").[2] Despite its recognition that no willing lender would have extended credit on these terms, the Fifth Circuit

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Published by A.S. Pratt in the June 2013 issue of *Pratt's Journal of Bankruptcy Law*.
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nevertheless upheld the "absurd result" as a "natural consequence" of applying the cramdown rate calculation method set forth by the U.S. Supreme Court plurality in *Till v. SCS Credit Corp*.[3]

## FACTS

In 2007, Texas Grand Prairie Hotel Realty LLC and three of its affiliates (collectively, the "debtors") obtained a $49 million loan to acquire and renovate four hotel properties in Texas. The lender took a security interest in substantially all of the debtors' assets and eventually sold the loan to another lender (the "lender"). After a 2009 downturn in their business, the debtors were unable to pay the loan as it came due and filed for Chapter 11 protection on May 13, 2010.

In the bankruptcy court case, the lender's appraiser valued the collateral securing the loan at roughly $39 million. The debtors agreed and proposed a plan of reorganization that called for repayment of the lender's $39 million secured claim over a seven-year period at an interest rate of five percent, representing the prime rate plus 1.75 percent. The lender objected to confirmation of the plan, arguing, in part, that the five percent interest rate was insufficient. The bankruptcy court nevertheless confirmed the plan over the lender's objection, holding that the debtors had met the requirements for confirmation under the "cramdown" provisions of Bankruptcy Code § 1129(b).

## APPLICABLE LAW

Under Bankruptcy Code § 1129(b), a plan of reorganization can be confirmed over the objection of a secured creditor, if, among other things, it provides for deferred payments that, when adjusted for the time value of money, provide the secured creditor with at least the value of its collateral as of the effective date of the plan.[4] However, the Bankruptcy Code does not specify how to determine the appropriate discount rate (the "cramdown rate").

Many bankruptcy courts look to the U.S. Supreme Court's plurality decision in *Till* for guidance in determining the appropriate cramdown rate.[5] In *Till*, the Chapter 13 debtors financed a 1998 purchase of a truck with a secured loan at a 21 percent interest rate.[6] By 1999, the debtors were in de-

fault on the loan and filed for Chapter 13 protection. The debtors' proposed plan provided for the payment of the secured portion of the loan at a rate of 9.5 percent, which was calculated by adjusting the then-national prime rate of eight percent upward by 1.5 percent to account for additional risk of non-payment due to the debtors' financial condition.[7] This method of calculating the cramdown rate is known as the "prime-plus" or "formula rate" approach. The lender objected to the 9.5 percent rate, arguing that it would be entitled to a 21 percent rate if it were to foreclose on the truck and reinvest the proceeds in a loan of equivalent risk. The debtors' plan was confirmed over the lender's objection.[8]

On appeal, the district court rejected the "prime-plus" formulation in favor of a "forced loan" approach, which considers the rate the creditor could have obtained if it had foreclosed on the collateral and reinvested the proceeds in a loan of equivalent risk and duration. The Seventh Circuit agreed with the forced loan approach, but modified it to be merely a presumption, one that could be adjusted upward or downward based on evidence of the debtor's specific risk profile. For example, the Seventh Circuit reasoned that the appropriate rate might be higher given the higher risk in lending to a debtor or lower due to economies produced by court supervision of Chapter 13 plan payments.

On appeal, the Supreme Court considered, in addition to the prime-plus and forced loan methods, the merits of both the so-called "presumptive contract rate" approach, which looks at the prepetition contract rate and then adjusts upward or downward based on the particular facts of the case, and the "cost of funds" approach, which considers the cost the creditor would incur to obtain the cash equivalent of the collateral.[9] After a lengthy analysis, a plurality of the Supreme Court rejected the forced loan, presumptive contract rate, and cost of funds approaches as overly complicated, imposing significant evidentiary costs and focusing on making the creditor whole, rather than ensuring that the stream of deferred payments has the required present value adjustment.[10] The plurality thus held that the prime-plus approach best comports with the Bankruptcy Code because it "entails a straightforward, familiar, and objective inquiry," "minimizes the need for costly additional evidentiary proceedings" and "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."[11]

Although careful not to create a hard and fast rule on the appropriate risk adjustment scale (in other words, the "plus" in prime-plus), the plurality observed that other courts generally approve adjustments in the one to three percent range.[12] In footnote 14 of its opinion, the plurality further observed that in a Chapter 11 context, it might make sense to consider the rate that an efficient market would produce, if there exists at the time a free market of willing cramdown lenders.[13] In a dissenting opinion, Justice Scalia warned that the plurality's prime-plus approach would "systematically under compensate" creditors and that the 1.5 percent adjustment to the prime rate could not be viewed as anything except a "smallish number picked out of a hat."[14]

## BATTLE OF THE EXPERTS IN BANKRUPTCY COURT

At the plan confirmation hearing in *Texas Grand Prairie*, both the debtors and the lender offered expert witnesses on the issue of what cramdown rate the court should apply. The debtors and the lender even agreed that the applicable rate should be determined by applying the prime-plus approach endorsed by the *Till* plurality, but they disagreed on the application of the approach.[15] The debtors' expert quoted the applicable prime rate at 3.25 percent and then, using the one to three percent scale mentioned in *Till*, set the adjustment at 1.75 percent to reflect "just to the left of the middle of the risk scale."[16] In reaching that adjustment, the debtors' expert considered that the hotels were well-maintained, the debtors were committed to the business, the revenues exceed projections leading up to the hearing, the collateral was appreciating and the proposed plan was feasible, albeit tight.

The lender's expert agreed that the applicable prime rate should be 3.25 percent, but then adjusted upward by 6.05 percent to yield a "blended market rate" of 9.3 percent based on the weighted averages the market would charge for multi-tiered exit financing.[17] The lender's expert further adjusted the blended rate downward by 1.5 percent to reflect the favorable circumstances of the estate and then upward again by one percent to account for the tight feasibility of the plan, resulting in a cramdown rate of 8.8 percent.

The bankruptcy court agreed with the debtors' expert's approach and re-

jected as completely inconsistent with *Till* the lender's expert's use of a blended market-influenced rate as a benchmark before applying the adjustment. On appeal, the district court affirmed the bankruptcy court ruling.[18]

## FIFTH CIRCUIT SEES NO CLEAR ERROR

The lender appealed to the Fifth Circuit. As an initial matter, the Fifth Circuit had to determine what standard of review to apply to the bankruptcy court's determination of the cramdown rate. While conceding that a bankruptcy court's findings of facts under a cramdown plan confirmation are subject to review only for clear error, citing *Till*, the lender argued that the *methodology* used for calculating the cramdown rate is a matter of law and, accordingly, subject to *de novo* review.[19]

The Fifth Circuit rejected the lender's argument that *Till* is controlling precedent because *Till* was decided in the Chapter 13 context and, as a splintered, plurality opinion, is of limited precedential value, even in Chapter 13 cases. The Fifth Circuit noted that the many bankruptcy courts that have elected to follow *Till* in Chapter 11 cases have done so not because *Till* is binding precedent, but rather because they were persuaded by the reasoning in *Till*. The Fifth Circuit thus declined to bind bankruptcy courts to a specific methodology for determining Chapter 11 cramdown rates and proceeded to review the bankruptcy court's cramdown rate analysis only for clear error.[20]

The court agreed with the bankruptcy court that the debtors' expert's approach was an uncontroversial application of the *Till* plurality prime-plus method and that the debtors' expert engaged in a holistic evaluation of the debtors that supported the 1.75 percent upward adjustment.[21] The court viewed the lender's expert's approach, which required consideration of evidence of market comparable loans, as expressly rejected by the *Till* plurality.[22] It observed that *Till*'s footnote 14, although criticized by commentators, is used by many courts, including the Sixth Circuit Court of Appeals, to support a market-influenced approach in a Chapter 11 context when there is an efficient market for exit financing. Even assuming that footnote 14 has persuasive value, the Fifth Circuit reasoned that it would not support the lender's approach in the case at hand because even the lender's expert testified that there is no one in the market that would make a $39 million secured loan to these debtors.

Although the lender's expert reasoned that exit financing would be possible in the market if comprised of multiple tiers, such as senior debt, mezzanine debt and equity financing, the Fifth Circuit explained that courts have rejected the argument that such hypothetical cobbling together of multi-tiered financing represents an "efficient market," as envisioned by *Till's* footnote 14.

In affirming the bankruptcy court's application of the prime-plus approach, the Fifth Circuit commented that "the 'absurd result' is the natural consequence of the prime-plus method, which sacrifices market realities in favor of simple and feasible bankruptcy reorganizations."[23] The court further observed, evoking the language of Justice Scalia's dissent in *Till*, that "while it may be 'impossible to view [the debtor's expert's] 1.75 percent risk adjustment as 'anything other than a smallish number picked out of a hat,' the *Till* plurality's formula approach — not Justice Scalia's dissent — has become the default rule in Chapter 11 bankruptcies."[24]

## PRACTICAL CONSIDERATIONS

The Fifth Circuit's decision provides Chapter 11 debtors with an additional tool to propose low cramdown rates bearing little to no relationship to the risk profile of the loan. Further, more generally, *Texas Grand Prairie* serves as a good reminder that bankruptcy courts, in considering a plan confirmation, may not feel constrained by market expectations for debtor-creditor relationships, but instead may focus on the objectives of the Bankruptcy Code and the prospects of a successful plan of reorganization.

## NOTES

1 *Wells Fargo Bank N.A v. Texas Grand Prairie Hotel Realty, LLC (In the Matter of Texas Grand Prairie Hotel Realty, LLC)*, __ F.3d __, 2013 WL 776317 (5th Cir. Mar. 1, 2013).

2 *See* 11 U.S.C. § 1129(b)(2)(A)(i)(II) ("[E]ach holder of a claim of such class [must] 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.").

[3] 541 U.S. 465 (2004). *Texas Grand Prairie,* 2013 WL 776317 at *8.
[4] *See* 11 U.S.C. § 1129(b)(2)(A)(i)(II).
[5] *Texas Grand Prairie*, 2013 WL 776317 at *4.
[6] *Till*, 541 U.S. at 470.
[7] *Id.* at 471.
[8] *Id.* at 472.
[9] *Id.* at 477-78.
[10] *Id.* at 477.
[11] *Id*. at 479-80.
[12] *Id.* at 480.
[13] *Id.* at n.14.
[14] *Id.* at 501 (Scalia, J., dissenting).
[15] *Texas Grand Prairie*, 2013 WL 776317 at *1.
[16] *Id.* at *7.
[17] *See id.* at *7.
[18] *See Wells Fargo Bank, N.A. v. Texas Grand Prairie Hotel Realty, LLC*, 2011 WL 5429087 (N.D. Tex. 2011).
[19] *Texas Grand Prairie*, 2013 WL 776317 at * 4.
[20] *Id*. at *5.
[21] *See id.* at 7.
[22] *Id.* at *8.
[23] *Id.*
[24] *Id.*

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