

# Establishing a Cram Down Interest Rate

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## Cram Down under a Plan of Reorganization

Section 1129 of the US Bankruptcy Code (“Code”) provides that a plan of reorganization (“POR”) may be confirmed over the objection of dissenting class of secured creditors if certain conditions are met. This provision, known as “cram down,” allows for the issuance of a new secured note payable over time that reflects an interest rate which will ensure that the present value of the note is equivalent to the secured portion of the creditor’s claim.<sup>1</sup> Hence, the determinant factor when assessing the adequacy of expected payments is the effective interest rate applicable to the new note. However, the Bankruptcy Code does not specify how to calculate the appropriate cram down interest rate. Accordingly, there has been considerable debate regarding the best method by which to derive the pertinent rate.

## The Till Case & Prevailing Models

Over time, various courts have advocated a variety of methods by which to determine the cram down interest rate. In *Till v. SCS Credit Corp.*, decided in 2004, the courts involved in the progressive stages of the proceedings had applied these varied techniques. Hence, the case ultimately went to the Supreme Court where the issue was to be decided once and for all.

While reviewing the case, the Court evaluated each of the interest rate models that had been utilized by the lower courts. Initially, the debtor proposed, and the bankruptcy court agreed, that an annual interest rate of 9.5% for the restructured note was appropriate. This was determined by using the so-called “formula approach,” wherein the interest rate is determined by starting with the national prime rate, 8.0% at that time, and adding to it a risk premium, in this case 1.5%, that reflects the borrower’s credit worthiness. The district court, however, reversed that position and sided with the lender that the proper method to employ was the “coerced loan rate,” which was consistent with the contract rate of 21%. Under this theory, deferred payments made under the restructured loan are considered imposed upon the creditor and the applied rate, therefore, should correspond to the rate applicable to a third party loan with similar terms and risk.<sup>2</sup> Still, the Seventh Circuit court modified that approach, holding that the original contract rate was a “presumptive rate” that could be challenged with evidence that a higher or lower rate should apply. And lastly, the dissenting opinion suggested another method known as the “cost of funds” approach, whereby the cost of the capital obtained by the lender is of primary relevance.

## Problems with Till

While *In Re Till* was supposed to establish an objective standard by which the cram down interest rate could be determined, it unfortunately lacked key guidance with regard to important computational elements. First, it failed to explain how the so called “risk premium,” which is added to the base rate of interest, is derived. In *Till*, the debtor arbitrarily determined that a 1.5% risk premium was appropriate, but that is hardly a tenable argument as indicated by Justice Scalia in his dissenting remarks.

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<sup>1</sup> See 11 U.S.C § 1325(a)(5)(B)(ii).

<sup>2</sup> *Bank of Montreal v. Official Committee of Unsecured Creditors (In re American HomePatient, Inc.)*, 2005 WL at \*5.

Additionally, the *Till* decision fell short of establishing a clear precedent. Indeed, the Court wondered aloud within its decision what “rate an efficient market would produce.”<sup>3</sup> In effect, the decision advocated a formula approach and then diluted that position by suggesting that a market-based rate may be more appropriate. Hence, it is not surprising that several courts and practitioners have effectively ignored the methodology suggested by *Till*.

### **The Blended Rate Approach - *In re Prussia Associates***

The first material case to evaluate the interest rate methodology set forth in *Till* was *In re Prussia Associates*, which was a single-asset real estate (SARE) case involving a secured lender who challenged the debtor’s proposed cram down rate of interest. In this case, the debtor had suggested a rate of 6.5% based on the testimony of its expert with regard to the prevailing market rates for similar loans. By contrast, the lender argued that the proposed rate was too low and suggested an alternative method commonly known as a “blended rate approach.” Under this technique, the lender stated, based on its market analysis, that refinancing a similar loan would require the use of two separate loans: a senior secured loan that reflected a commensurate rate of, say, 6.5%, and a second subordinate loan that reflected a much higher rate of, say, 16%, which, when combined with the first loan, would produce a “blended rate” of 9.7%. The debtor refuted this approach by citing *Till* and claiming that *Till* did not require consideration of prevailing market rates. The court considered this argument and commented that whereas *Till* suggested a certain method for determining a cram down rate, it fell short of a mandating use of the formula approach.<sup>4</sup> Indeed, the Court implies that the availability and cost of market financing should be a consideration when evaluating an appropriate cram down rate.

Ultimately, the court in *Prussia* concluded that after careful evaluation of the market evidence presented by both sides, there was insufficient basis with which to draw an informed conclusion. Hence, in the absence of conclusive data for the coerced loan approach, the court was left to resort to the formula approach as set forth in *Till*.

### **More on the Market Approach - *In re American HomePatient, Inc.***

In *Bank of Montreal v. Official Committee of Unsecured Creditors (In re American HomePatient, Inc.)*<sup>5</sup> the Sixth Circuit, relying on footnote 14 from *Till*, introduced a “nuanced approach” in determining the correct cram down interest rate in a Chapter 11 case. The Sixth Circuit did not expressly reject *Till*, but it also did not utilize the pure formula approach. Instead, the Sixth Circuit utilized the coerced-loan theory. As stated, under that theory the primary weight is afforded to current market rates of interest based on similar loans. Applying the coerced-loan theory, the bankruptcy court held that the appropriate level of interest for the lenders was equal to the six-year Treasury Bill interest rate plus 350 basis points, which in this case was equal to approximately 6.8%. The lenders appealed but failed in that attempt. In short, the court again decided upon a derivative of the formula/market approach which began with some form of base rate and added to it a premium for perceived risk.

### **Let’s Just Call it a Build-up Approach**

Whereas, *In re Till* failed to definitively settle the issue with regard to the best method for determining a cram down rate of interest, it still provides useful guidance in that the Justices essentially adopted a “base rate plus margin for risk” approach. Indeed, the credit markets in general price risk by first starting with some form of base rate and then add to it an additional premium to account for additional layers of risk—a method that, in one form or another, seems to prevail in cram down case law. Along these same lines, it is common to hear bond prices

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<sup>3</sup> *Till*, 541 U.S. at 477 n. 14.

<sup>4</sup> Footnote 14 to the *Till* opinion notes 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.” *Till*, 541 U.S. at 477 n. 14.

<sup>5</sup> *Bank of Montreal*, 2005 WL 1949548 (6th Cir. Aug. 16, 2005).

quoted as “X basis points over the Treasury Yield.” What the markets are really saying is that the Treasury Yield represents a “risk-free” proxy, to which you must add an additional premium to account for the additional risk an investor assumes by holding that bond. Further, when we look to the Capital Asset Pricing Model (CAPM), widely considered the seminal risk pricing model for pricing risky assets, we recognize that it is essentially an interest rate “build-up” model that starts with the risk free proxy and adds to it additional premiums to account for general market risk and asset specific risk.

So, in the final analysis, it makes sense to examine prevailing rates for similar credit quality loans and, more specifically, look at the market-based risk premium spreads for “speculative” over “investment grade” credits. By adding these spreads to an appropriate base rate, we have a reasonable proxy for pricing, say, a very high loan-to-value (LTV) real estate or equipment loan. This method is not only reasonable, but is easy to explain, easy to understand and has a very strong basis in theoretical finance and in market realities.

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