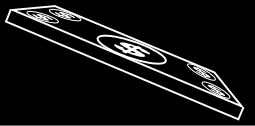


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The Developing Impact of *Till v. SCS* on Chapter 11 Reorganizations

Contributing Editor:
Richard E. Mikels¹

Mintz, Levin, Cohn, Ferris, Glovsky
and Popeo PC; Boston
rmikels@mintz.com

Co-author:
Adrienne K. Walker²

Mintz, Levin, Cohn, Ferris, Glovsky
and Popeo PC; Boston
awalker@mintz.com

The Supreme Court's plurality decision in *Till v. SCS Credit Corp.*, 541 U.S. 465 (2004), could be one of the most significant Supreme Court decisions on reorganizations since the passage of the Bankruptcy Code. We say "could be," because there seems to be continuing dispute among courts and commentators about whether *Till* even applies in chapter 11 reorganizations and how it should be interpreted. If *Till* applies to chapter 11 reorganizations and were it to be construed to require a cramdown interest rate of prime plus a factor of approximately 1-3 percent, then this could significantly alter the longstanding trend whereby chapter 11 has evolved into more of an effective creditor remedy than a source of debtor relief.³

¹ Richard E. Mikels is a shareholder in Mintz Levin's Boston office and chairman of the bankruptcy, restructuring and commercial law sections.

² Adrienne K. Walker is an associate in Mintz Levin's Boston office in the bankruptcy, restructuring and commercial law sections.

³ See Miller, Harvey R. and Waisman, Shai Y., "Does Chapter 11 Reorganization Remain a Viable Option for Distressed Businesses for the Twenty-First Century?" 78 Am. Bankr. L.J. 153, 197 (2004) (noting the expanding power and control of creditors in chapter 11 reorganizations), see, also, Mikels, Richard E. and Kaufman, Peter S., "Balancing Creditor and Equity Interests Provides Incentive to Utilize Chapter 11 for Mutual Benefit," 22-10 *ABI Journal* 26 (December/January 2004) ("chapter 11 appears to have gradually evolved into a more creditor-oriented procedure").

In *Till*, the Court determined the proper methodology to be applied in establishing a cramdown interest rate in chapter 13 cases. With respect to the application of *Till* in chapter 11 proceedings, Justice Stevens, writing for the plurality, referenced at footnote 10 eight separate provisions of chapter 11 of the Code and stated in the text of the plurality decision that:

[T]he Bankruptcy Code includes numerous provisions that, like the cramdown provision, require a court to "discoun[t]...[a] stream of deferred payments back to the[ir] present dollar value"...to ensure that a creditor receives at least the value of its claim." *Till*, 541 U.S. at 474 (citations omitted).

The Court went on to say:

We think it likely that Congress intended bankruptcy judges and trustees to follow essentially the same approach when choosing an appropriate interest rate under any of these provisions. *Id.*

Therefore, if the Court said nothing further on the subject, it would seem relatively clear that the method for determining the appropriate cramdown interest rate (*i.e.*, interest rate on going-forward payments) in a chapter 11 case would essentially be the same methodology as is required in a chapter 13 case. The Court, however, said more. Footnote 14 of the *Till* plurality decision suggests, at first blush, a seemingly inconsistent approach from the text. In footnote 14, the Court indicated that in a chapter 11 proceeding, if available, an efficient market rate can be used, rather than a formula rate approach. *Till* at 476, n.14. Accordingly, those with a bias toward debtor relief will tend to rely on the text of *Till* surrounding footnote 10, while those with a creditor orientation will look to footnote 14 to justify the view that *Till* does not need to be applied in a chapter 11 context.⁴ While on

⁴ It is interesting to note that footnote 14 does not specifically authorize the use of any ascertainable market rate as a cramdown rate. Rather, it indicates that there may be a well-recognized market for debtor-in-possession (DIP) financing and that this might serve as a very accurate "efficient market" to set as a cramdown interest rate. It is not clear whether the Court in footnote 14 meant to open the process to a bankruptcy court applying any readily ascertainable market rate that may have similarities to the proposed cramdown loan or whether the Court was suggesting that if a rate actually exists in the market for the type of loan in question and such a loan is available for DIPs, such a rate would be preferable to use over a formula rate.

its face footnote 14's reference to an efficient-market approach appears inapposite to the formula rate approach adopted in the text, there is a reading of the case that reconciles this seeming internal inconsistency.

The Court chose the formula rate approach, or footnote 14's efficient-market approach, because each one, based on the facts and circumstances of a given case, is readily ascertainable, uncomplicated, involves less in litigation costs and focuses on insuring that the payments equal the required present value, rather than insuring that each creditor is made whole based on the individual circumstances of that creditor. It was the inconsistency with these criteria that guided the Court in rejecting the coerced-loan rate method, the presumptive-contract rate method and the cost-of-funds rate method for determining the appropriate cramdown interest rate.⁵

It is not inconsistent to suggest that a formula rate approach is the best approach to accomplish these criteria where no readily ascertainable efficient market exists that may more accurately and more easily establish an appropriate cramdown interest rate. Footnote 14 could be viewed as perfectly consistent with the text surrounding footnote 10 in that in a chapter 11 context, markets may have developed that would allow for greater satisfaction of the very criteria that the Court's plurality decision looked to satisfy in determining an appropriate methodology for setting cramdown rates. If no such market exists, then the formula rate approach would be used to best satisfy the indicated criteria. Under this reading of *Till*, footnote 14 would not be viewed as an exception to the general rule, but rather it would be a further explanation of how the goals set forth by the Court can best be accomplished in the context of a chapter 11 case.

Prior to *Till*, four leading methodologies

⁵ See *Till*, 541 U.S. at 477.



Richard E. Mikels

for determining the appropriate cramdown interest rate had developed: (1) the formula rate; (2) the coerced loan rate, which requires an examined review of comparable loans to similar, nonbankrupt borrowers; (3) the presumptive-contract rate, which relies on the contract rate and can only be adjusted by the debtor or creditor's rebuttal of the presumptive rate; and (4) the cost-of-funds rate, which considers the creditors' sourcing of funds and costs of operation. See *Till*, 541 U.S. at 477-78. The Court concluded that the coerced-loan rate, the presumptive-contract rate and the cost-of-funds rate had significant defects in that they did not meet the criteria indicated above.

The formula rate approach "begins by looking to the national prime rate...which reflects the financial markets' estimate of the amounts a commercial bank should charge a creditworthy commercial borrower to compensate it for the opportunity costs of the loan, risk of inflation and relatively slight risk of default." *Till*, 541 U.S. 478-79.⁶ After ascertaining the prime rate, a court would then adjust the prime rate upward because of the risk of default posed by doing business with a bankrupt debtor rather than a prime commercial borrower, with consideration of (a) the circumstances of the estate, (b) the nature of the security and (c) the duration and feasibility of the reorganization plan. *Till*, 541 U.S. at 480. The Court did not require any particular percentage adjustment, although it cited with favor cases that applied an adjustment ranging between 1-3 percent. The Court also indicated that if the adjustment necessitated by the particular circumstances of a case is very high, that would constitute a feasibility issue, and the plan ought not to be confirmed.

It is not surprising that different Justices favored three distinctly different methods for determining the appropriate cramdown interest rate. It is also not surprising that, prior to *Till*, lower-court judges applied at least four different methodologies for determining the appropriate cramdown interest rates.⁷ Determining the appropriate methodology for establishing the cramdown interest rate is a particularly difficult question because the answer has significant socioeconomic, as well as legal, implications. If it is your view that public policy

⁶ The use of the prime rate to establish a long-term fixed rate increases the creditor's inflation risk. The prime rate floats over time, and therefore the risk of inflation is low. On the other hand, a rate that is fixed over a period of time involves a higher degree of inflation risk and would normally be somewhat higher than the prime rate for that reason alone.

⁷ While the following point is beyond the scope of this article, the authors note that over the course of years, there have been significant differences in judges' views on this issue, depending on the interest rate environment. For example, in a stable interest rate environment, use of the contract rate has obvious appeal. If rates are rapidly increasing, making the contract rate comparatively low, it could be argued that there would be a creditor windfall if the creditors' low bargained-for contract rate were adjusted up to a higher market at the time of cramdown. Likewise, in times where rates are dropping, saddling the debtor with a contract rate that is substantially above market rates seems inconsistent with the purposes of chapter 11 or 13.

should favor reorganizations, then it is necessary to recognize that in many instances (particularly where the debtor is overleveraged), the cramdown interest rate must be less than the market would dictate in order to have an economically feasible plan.⁸ If, on the other hand, you believe that the secured creditor is entitled to be paid in accordance with market expectations, then the cramdown rate would have to be blended, reflecting an appropriate rate on the portion of the loan that has the risk of senior secured debt, with an increase in rate to reflect any portion of the loan that has the risk of mezzanine financing, and an even higher rate to reflect any portion of the loan that has the risk of an equity investment.⁹

The plurality decision in *Till* and the concurring opinion of Justice Thomas construe the cramdown provisions of the Code in a manner that favors the debtor-oriented point of view. The plurality refers specifically to a proper cramdown interest rate that is "high enough to compensate the creditor for its risk, but not so high as to doom the plan." *Till*, 541 U.S. at 481. This can be taken as an indication that the Court is prepared to see secured creditors receive less-than-market rates in cramdown loans, a supposition borne out by its finding in *Till* of a 9.5 percent cramdown interest rate on a loan that was originally 21 percent. A more creditor-friendly approach is favored in Justice Scalia's dissent, where he suggests that the presumptive contract rate approach is appropriate and expresses concern that the plurality's formula rate approach will force secured creditors to receive substantially less than market rate returns.

Aftermath of *Till*

Subsequent to the *Till* decision, several bankruptcy courts and one appeals court have weighed in on the debate as to whether *Till* is applicable in chapter 11 cases and how cramdown rates should be determined. See *Bank of Montreal v. Official Comm. of Unsecured Creditors (In re Am. Homepatient Inc.)*, 420 F.3d 559 (6th Cir. 2005); *In re Deep River Warehouse Inc.*, 2005 WL 2319201 (Bankr. M.D.N.C. Sep. 22, 2005); *In re Prussia Assoc.*, 323 B.R. 572, 585 (Bankr. E.D. Pa. 2005); *In re LWD Inc.*, 2005 WL 567460 (Bankr. W.D. Ky. 2005). Each bankruptcy court decision

⁸ In *Associates Commercial Corp. v. Rash*, 520 U.S. 953 (2003), the Supreme Court determined that the proper method for valuation of collateral for confirmation purposes was to be based on the debtor's "actual use, rather than a foreclosure sale that would not take place..." *Id.* at 963. For the undersecured creditor, this will result in a larger secured claim than would a liquidation value, making cramdown more difficult.

⁹ Therefore, a debtor-oriented view would favor cramdown rates that would allow for businesses to be fixed and to continue operating with a resulting socioeconomic benefit to employees and communities, as well as benefiting lower classes of creditors and equity-holders. A creditor-oriented view would question the social utility of forcing an unwilling creditor into a coerced loan at less than market returns and of allowing a company back into commerce with a perpetual artificial advantage over its competitors that did not avail themselves of the protections of chapter 11.

indicated that although *Till* was instructive, it was not controlling in all chapter 11 cases. The Sixth Circuit went further and purported to follow the dictates of *Till*'s footnote 14 in endorsing an efficient market methodology for determining the appropriate cramdown interest rate in a chapter 11 case. See *American Homepatient*, 420 F.3d at 566-67.

In *American Homepatient*, the Sixth Circuit Court of Appeals interpreted *Till*'s footnote 14 to require that an efficient "market rate should be applied in [c]hapter 11 cases where there exists an efficient market. But where no efficient market exists for a [c]hapter 11 debtor, then the bankruptcy court should employ the formula approach endorsed by the *Till* plurality." *American Homepatient*, 420 F.3d at 568. The importance of *American Homepatient* is its holding that *Till* applies in chapter 11 cases. After answering that critical question, the court went on to find an efficient market rate of interest. The court ultimately decided that the appropriate cramdown interest rate reflected a first-lien loan rate that might be available to the debtor if the debtor were a well-capitalized, nonbankrupt operation. The court was influenced by the fact that it is the original loan that is being restructured, rather than a "new" coerced loan that is being granted. See *American Homepatient*, 420 F.3d at 568-69. In determining the appropriate efficient market rate, the Sixth Circuit felt that there was no need to look at the actual borrowing costs that would be borne by a borrower with the financial profile of the debtor since no new loan was being made.

The *American Homepatient* analysis demonstrates the difficulty courts have traditionally had, and continue to have, in finding an appropriate methodology to determine cramdown interest rates. It is interesting to note that the *American Homepatient* court went through its analysis only to apply an interest rate that coincidentally falls squarely within the prime-plus-1-to-3-percent range discussed in *Till*. In other words, both the plurality in *Till* and the Sixth Circuit opted for the debtor-oriented approach of a below-market cramdown interest rate. In answering the first question, "Does *Till* apply?," *American Homepatient* determined that *Till* is applicable in chapter 11 reorganizations. In finding an answer to the second question "in light of *Till*, what is the appropriate methodology for determining the cramdown interest rate?" The Sixth Circuit went to great lengths to justify what it believed to be an efficient market rate that would be consistent with *Till*'s footnote 14. Other courts may well have other views on how to find an efficient market rate. Once a

court diverges from the concept that an efficient rate needs to be something that is available in the market to a debtor-in-possession, the search for an applicable efficient market rate begins to resemble the search for a coerced-loan rate.

It will be interesting to watch how bankruptcy courts in the future will apply *Till* in chapter 11 cases. Some courts may determine that there is no efficient market rate applicable and may apply a formula rate within the prime-plus-1-to-3-percent range. Other courts may determine that there is no efficient market rate applicable, but may differ significantly in determining the premium over prime to be applied. Other courts may search for an applicable efficient market rate with widely varying results. Therefore, while *Till* could be construed in a manner that will provide the opportunity for increasing numbers of chapter 11 debtors to successfully restructure their businesses, *Till* might only have established a new path leading to the familiar result: future decisions with conclusions just as diverse as they were before *Till*. ■

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