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Cramdown Interest Rates and Secured Creditors in Chapter 11: The Waters Are Still Muddy

Recently, the Fifth Circuit decided a case regarding the appropriate interest rate to be charged when a secured creditor's claim is "crammed down," pursuant to section 1129(b)(2)(A) of the United States Bankruptcy Code (Code), 11 U.S.C. §§ 101-1532. Unfortunately, the decision does little to clarify the confusion precipitated by the Supreme Court's 2004 decision of *Till v. SCS Credit Corp*., 541 U.S. 465 (2004), and perhaps even adds to it.

In *Wells Fargo Bank N.A. v. Texas Grand Prairie Hotel Realty, L.L.C.*, (*In re Texas Grand Prairie Hotel Realty, L.L.C.*, No. 11-11109, 2013 WL 776317 (5th Cir. Mar. 1, 2013)), the debtor borrowed $49 million from Wells Fargo's predecessor in interest in 2007, secured by various hotel properties and related assets. In 2009, the debtor was unable to pay Wells Fargo's note when it became due and filed a petition under Chapter 11. The debtor subsequently filed a plan of reorganization, which Wells Fargo rejected, valuing Wells Fargo's secured claim at just over $39 million. The debtor sought to cram down Wells Fargo's secured under section 1129(b), proposing to pay the secured loan over ten years with interest accruing at 5% per annum (1.75% above the prime rate). Wells Fargo argued that the loan should bear interest at 8.8% per annum. Both parties agreed that the "primeplus" formula endorsed by *Till* should apply, but hotly disputed what that formula required. The bankruptcy court adopted the debtor's expert's analysis and confirmed the plan. Wells Fargo appealed to the district court, which affirmed, and Wells Fargo appealed to the Fifth Circuit.

On appeal, the Fifth Circuit began by denying the debtor's motion for dismissal of the appeal on the grounds that it was equitably moot. Although the plan had been consummated and the debtor had made nearly $8 million of post-plan distributions, the Court was not persuaded that the issue before it—paying the secured creditor additional interest—would jeopardize the reorganization, especially given the undisputed improvement in the debtor's revenues and cash position since the filing of the petition, which improvement had continued post-confirmation.

The court then turned to the issue of what section 1129(b) of the Code required. Among other things, section 1129(b) provides that for a plan to be confirmed over the objection of a secured creditor, the creditor must receive deferred payments

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of a value at least equal to the allowed amount of the secured claim as of the effective date of the plan. Stated differently, the stream of payments must have a present value (applying the appropriate cramdown interest rate) equal to the secured creditor's claim as of the effective date. The issue is how the appropriate interest rate should be determined.

Wells Fargo argued that the controlling authority was the *Till* prime-plus formula. This formula required the application of the prime rate of interest (the rate charged by banks to creditworthy borrowers), as adjusted to account for the risk of default, the quality of the debtor's management, the commitment of the debtor's owners, nature and the quality of the collateral, and the duration and feasibility of the plan. The Fifth Circuit noted that *Till* was a Chapter 13 case involving auto financing, and the *Till* plurality's holding that the prime-plus formula was appropriate was motivated by the method's simplicity and objectivity. *Texas Grand Prairie Hotel* 2013 WL 776317 at *8. The prime-plus method avoided the protracted litigation and evidentiary burdens engendered by use of the coerced loan, presumptive contract rate and cost of funds approaches. *Id.*

Although the Supreme Court suggested that the prime-plus formula should also apply in Chapter 11, the Fifth Circuit noted this suggestion was dicta in a splintered plurality opinion and was not controlling precedent. *Id.* at *7. In addition, the Fifth Circuit pointed out that footnote 14 of the *Till* plurality opinion indicated that where efficient markets exist for exit financing in Chapter 11, a market rate approach might be more suitable for determining the appropriate cramdown interest rate. *Id.* at *9. The Fifth Circuit noted that many courts, including the Sixth Circuit in *In re American HomePatient, Inc.*, 420 F.3d 559 (6th Cir. 2005), have found footnote 14 persuasive and have concluded that the market rate approach should be used in Chapter 11 cramdowns where an efficient market for exit financing exists. *Texas Grand Prairie Hotel*, 2013 WL, at *8.

However, the Fifth Circuit also noted that after *Till*, most courts addressing cramdown in the Chapter 11 context have found that "efficient markets" did not exist, because there is rarely a market for a single loan with a term, size and collateral comparable to the forced loan contemplated under the respective cramdown plan. These courts have consequently defaulted to the prime-plus formula and applied the *Till* plurality's suggested risk adjustment range of 1% to 3% over prime. *Id.* at*6. The Fifth Circuit noted that these decisions did so even in the face of Justice Scalia's vigorous dissent in *Till*, which argued that the prime-plus formula grossly undercompensated secured creditors for the risk they faced,

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not by a couple of per cent, but by an order of magnitude. The prime-plus formula, said Scalia, resulted little more "than a smallish number picked out of a hat." *Id.* at *8 (citing the dissent in *Till*).

The Fifth Circuit then turned to the competing approaches. The debtor's expert began with the prevailing prime rate of 3.25%. He then evaluated the *Till* factors concluding that the debtor's hotel properties were well maintained and excellently managed, and that the debtor's owners were committed to the business. The expert noted that the debtor's revenues exceeded projections and that Wells Fargo's collateral was stable or appreciating. The expert opined that the debtor's cramdown plan would be tight, but feasible, and therefore concluded that a risk adjustment of 1.75%, which was within the 1% to 3% risk adjustment range of *Till*, was reasonable. Consequently, the cramdown interest rate of 5% was appropriate. *Id.* at *6.

Wells Fargo criticized this conclusion, pointing out that on the date of plan confirmation the market was charging rates in excess of 5% for smaller, over-collateralized loans to comparable hotel owners. *Id.* at*8. The Wells Fargo expert instead argued that a "market influenced" analysis within the context of the prime-plus formula was the more appropriate approach. Starting with the same prime rate of 3.25%, the Wells Fargo expert applied a weighted average of the interest rates the market would charge for multi-tiered exit financing comprised of senior secured debt (6.25%), mezzanine debt (11%) and equity (22%). This calculation yielded a blended rate of 9.3%, which the expert adjusted downward by 1.5% for the favorable financial circumstances of the estate, and upward 1% for the plan's tight feasibility, yielding a cramdown rate of 8.8%. *Id.* at *7.

In reviewing the bankruptcy court's acceptance of the debtor's approach and the rejection of the Wells Fargo approach, the Fifth Circuit agreed with Wells Fargo that no willing lender would have extended credit on the terms it was forced to accept under the cramdown plan. However, said the court, this was the natural consequence of the prime-plus method, which sacrifices market realities in favor of simple and feasible bankruptcy reorganizations. *Id.* at *8. The *Till* plurality approach and not Justice Scalia's dissent, said the court, has become the default rule in Chapter 11 bankruptcies. *Id.* Even the Sixth Circuit in *HomePatient*, which recognized the efficient market analysis, rejected the argument that the type of tiered financing proposed by Wells Fargo establishes the type of efficient markets justifying a market approach. *Texas Grand Prairie Hotel*, 2013 WL, at *8 n. 64. Finding that the bankruptcy court's decision to approve the debtor's cramdown rate of 5% was consistent with *Till* and endorsed by the vast majority of

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bankruptcy courts, and also finding that the decision was not clearly erroneous, the Fifth Circuit affirmed. However, in conclusion, the court said that it was not deciding that the prime-plus formula is the only, or even the optimal, method for calculating the Chapter 11 cramdown rate. *Id.* at *9. However, the court left unstated what method might be considered "optimal."

The *Texas Grand Prairie Hotel* decision is a puzzle. The court recognizes that *Till*, as a Chapter 13 case, is not controlling precedent in the Chapter 11 context. The court also notes that the prime-plus method of calculating cramdown interest and its 1% to 3% risk adjustment range is not the only, or even optimal, method to apply. Recognizing that no lender would make a loan to the debtor on the terms of the forced loan under the plan, the court finds that the prime-plus method sacrifices market realities in favor of simple and feasible bankruptcy reorganizations. The court also seems to approve of Justice Scalia's observation in *Till* that the prime-plus adjustment results in only "a smallish number picked out of a hat," *Id.* at *8, and that secured creditors to whom it is applied are undercompensated not by a couple percent but by "an order of magnitude." *Id.* at *6.

Notwithstanding the foregoing, the court observes that the *Till* plurality's prime-plus formula approach has become the default rule in Chapter 11 bankruptcies applied by a vast majority of bankruptcy courts. Seemingly based upon that, and perhaps because Wells Fargo argued that *Till* was controlling, the Fifth Circuit affirms the application of the *Till* prime-plus approach. In doing so, the court opted for simplicity and ease of application as opposed to market realities. The court is silent about the fact that lenders most often use the prime rate as a floating rate that changes as the market changes, rather than a rate that is fixed for the duration of a plan, in this case ten years.

Given the recent historically low prime rates, lenders should be on notice that one of the consequences of a debtor's resort to Chapter 11 is the risk arising under *Till* that it will be forced into a lending relationship for an extended period of time on terms that bear no relationship to what the market would dictate. In spite of these market realities, this seems to tilt the scales of equity heavily in favor of debtors to the disadvantage of secured lenders. Although *Texas Grand Prairie Hotel* seems to recognize this, it purposely avoids the opportunity to change it.

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