By Frank W. DiCastri and Lindsey M. Greenawald

Cramdown for Unsecured Creditors: Since When Does "Best Interests" Mean Less Interest?

Frank W. DiCastri
Husch Blackwell LLP
Milwaukee

Lindsey M. Greenawald
Husch Blackwell LLP
Milwaukee

Frank DiCastri is a partner and Lindsey Greenawald is an associate with Husch Blackwell LLP in Milwaukee.

The authors recently represented an undersecured creditor in a chapter 11 case. The debtor's plan proposed to cram down the secured portion of the claim with a 10-year balloon note, amortized over 30 years, at an interest rate of 4.65 percent. The unsecured deficiency claim would also be crammed down on the same terms: a 10-year balloon, 30-year amortization and 4.65 percent interest. The debtor submitted a liquidation analysis supporting its view that unsecured creditors would receive $0 in the event of liquidation, and the plan proposed to allow equityholders to retain their interests.

In light of the present interest rate environment, the creditor objected to the treatment of the secured portion of its claim, but what about the unsecured portion? How could the interest rate for the unsecured claim not be higher than it was for the secured claim? That is, if the goal of interest is to compensate for the time value of money and the risk associated with payments over time, wouldn't there be more risk, and therefore more interest, for the creditor that holds no collateral? The authors were surprised when their research identified cases and secondary materials suggesting that in a rather common set of circumstances, cramdown interest rates for unsecured creditors should be lower than those required for secured creditors.

Applying *Till* to Unsecured Claims

Sections 1129(b)(2)(B)(i) and (ii) of the Bankruptcy Code govern the requirement that a cramdown plan be "fair and equitable" to a class of unsecured claims. To summarize, a plan must provide either (1) that holders of claims in the unsecured class are being paid in full — that is to say, "receiv[ing] or retain[ing] ... property of a value, as of the effective date of the plan, equal to the allowed amount of such claim" — *or* (2) that holders of claims or interests of junior priority are not receiving or retaining "any property." In the authors' aforementioned case, the debtor proposed that equityholders retain their interests, so the plan provided that unsecured creditors would be paid in full over time to satisfy clause (i). The meaning of clause (ii) — the absolute priority rule — was not implicated.

But the meaning of § 1129(b)(2)(B)(i) was squarely presented. At what rate of interest does an unsecured deficiency claim need to be compensated to receive "property of a value, as of the effective date of the plan, equal to the allowed amount of [the] claim"?[1] For purposes of this discussion, assume that the U.S. Supreme Court's plurality decision in *Till v. SCS Credit Corp.* applies to chapter 11 cramdowns, as many courts have concluded.[2] Even though *Till* involved a secured claim, assume also that bankruptcy courts generally apply the *Till* rationale to unsecured cramdowns, following the plurality's statement that "Congress intended bankruptcy judges and trustees to follow essentially the same approach when choosing an appropriate interest rate under any of these provisions" including § 1129(b)(2)(B)(i).[3]

Applying *Till* to the unsecured creditor in the case at hand suggested to the authors that the rate of interest for the deficiency claim should have been higher, perhaps considerably higher, than the rate of interest for the secured claim. *Till* instructs that the "formula" approach be followed in cramdown situations, which "begins by looking to the national prime rate," then applying a "risk adjustment" depending on "such factors as the circumstances of the estate, the nature of the security, and the duration and feasibility of the reorganization plan."[4] Stated in the simplest terms, the authors expect to see an upward risk adjustment for "nature of the security" when there is *no security*. Absent unusual circumstances, a creditor that accepts payment over time but cannot resort to collateral in the event of a default appears to face a far greater risk than a creditor that holds a security interest throughout the repayment period. The latter may resort to collateral, while the former holds nothing but a potentially empty promise to pay.

After all, the formula approach "tak[es] its cue from ordinary lending practices."[5] It is intended to be "straightforward, familiar and objective," and "depends only on the state of financial markets,

1 11 U.S.C. § 1129(b)(2)(B)(i).
2 *See, e.g., In re Texas Grand Prairie Hotel Realty LLC*, 710 F.3d 324, 336 (5th Cir. 2013) (noting that "the *Till* plurality's formula approach ... has become the default rule in Chapter 11 bankruptcies").
3 *Till v. SCS Credit Corp.*, 541 U.S. 465, 474, 474 n.10 (2004).
4 *Id.* at 478-79.
5 *Id.*

the circumstances of the bankruptcy estate, and the characteristics of the loan."[6] Thus, *Till* is taken to mean that traditional underwriting criteria should be utilized in the interest-rate analysis.

Unsecured Creditors: Beware of What Is in Your "Best Interests"

Several bankruptcy decisions suggest that an unsecured creditor's expectation of payment in a chapter 11 cramdown should be tempered by § 1129(a)(7), the so-called "best interest of creditors" test.[7] This prerequisite to confirmation requires that each holder of a claim or interest in an impaired class either has accepted the plan or will receive at least as much under the plan as it would in a hypothetical chapter 7 liquidation.

According to these decisions, if an unsecured creditor cannot expect to receive any property on account of its claim in a chapter 7 liquidation, a chapter 11 cramdown plan proposing to pay that creditor more than $0 does not impose any risk on the creditor, so the courts may do away with the risk-based components of the *Till* formula approach. The creditor does not need to be compensated for risk in a dividend-producing chapter 11 plan, these courts say, when, in any event, the creditor would not be paid in a chapter 7. This "nothing-to-lose" logic was explained more fully in the January 2016 issue of the *ABI Journal*:

> If the unsecured creditor's expected loss upon default is always $0, then the plan does not impose debtor-specific risk (or any risk, for that matter) on the unsecured creditor. An unsecured creditor who expects to receive $0 in liquidation gives up nothing by consenting to the plan treatment. Rather than imposing risk, the plan only improves the unsecured creditor's position. Therefore, Till might require compensation for the time value of money, but not *risk-based* compensation.[8]

What's "Best" for Unsecured Creditors Is Likely Not "Fair And Equitable"

The authors disagree with this position. First, nothing in the Bankruptcy Code suggests that the results of the "best interest of creditors" test herald the sufficiency of cramdown payments to a class of unsecured creditors. These are separate plan-confirmation requirements. Why should one assume that what is in the creditors' "best interests" for purposes of § 1129(a)(7) informs what is "fair and equitable" for the purposes of § 1129(b)(2)(B)? Indeed, the two Code subsections serve entirely different purposes.

Section 1129(a)(7) prevents a minority, dissenting impaired creditor from being steamrolled by the majority's affirmative vote unless the debtor can prove that the creditors are receiving more than they would in liquidation. It establishes an absolute minimum criterion of payment for any plan that does not receive the affirmative vote of all holders of claims in an impaired class, whether junior creditors or interests stand to receive any property or not.

On the other hand, the "fair and equitable" standard is guided by the absolute priority rule. Namely, if the holders of equity interests are to retain those interests, all creditors must be paid *in full*. This means the present-value calculation contemplated by *Till*. It is not enough to pay the creditors for the time value of money; to be paid in full in a cramdown situation, shouldn't creditors be compensated for risk?[9] Lest we forget, eight of the nine Justices in *Till* agreed that the rate of interest in a confirmed plan must include a premium for risk.[10] There is little reason to think that the Supreme Court would abandon that principle because the unsecured creditors would be wiped out in a hypothetical liquidation.

The irony is that equityholders also stand to receive nothing in liquidation (under these circumstances), yet they retain their interests and place the risk on unsecured creditors without just compensation.

Think of it this way: The *ABI Journal* article suggested that unsecured creditors should be compensated for risk when they stand to receive property in liquidation, but when those same creditors stand to receive nothing in chapter 7, they are not entitled to compensation for the risk of default in chapter 11. ("Consider yourself lucky" if you are receiving chapter 11 plan payments that exceed your projected chapter 7 dividend.) But conceptually, wouldn't the need for risk-based compensation be greater when the debtor's liabilities exceed its assets? The unsecured creditor's risk would appear to be greater when liquidation would produce a goose egg, not less. Certainly, traditional underwriting criteria would suggest so.

Instead, some courts and commentators flip the traditional perceptions of repayment risk in a chapter 11 case by handicapping the unsecured creditors with their likely recoveries in chapter 7.[11] The projected chapter 7 dividend becomes the creditor's functional allotment in a chapter 11 case, and the creditor's risk in a cramdown plan must be measured against that allotment. Viewed in this light, the lack of collateral is significant only insofar as it informs what the creditor would receive in a liquidation.[12] It does not affect risk in chapter 11.

6 *Id.* at 479.

7 *See, e.g., In re Renegade Holdings Inc.*, 429 B.R. 502 (Bankr. M.D.N.C. 2010); *In re Texas Star Refreshments LLC*, 494 B.R. 684 (Bankr. N.D. Tex. 2013).

8 Richard B. Gaudet and David L. Bury, Jr., "Zero Times Something Is Still Zero: Adapting *Till* to Unsecured Creditors," XXXV *ABI Journal* 1, 36-37, 61, January 2016, *available at* abi.org/abi-journal.

9 *See, e.g., In re Crosscreek Apts. Ltd.*, 213 B.R. 521, 545 (Bankr. E.D. Tenn. 1997) (finding that plan failed to satisfy § 1129(b)(2)(B) where unsecured creditor did not stand to receive interest to account for delay and risk of nonpayment).

10 548 U.S. at 474 (plurality), 485 (Thomas, J., concurring), 491 (Scalia, J., dissenting).

11 *See, e.g., In re STC Inc.*, Case No. 14-41014, 2016 WL 3884799, *18 (Bankr. S.D. Ill. April 7, 2016) ("The only risk GTT has is the liquidation value of $1.7 million."); *In re Texas Star Refreshments LLC*, 494 B.R. at 701-02 ("An unsecured creditor's prospects of repayment may indeed be enhanced if the debtor survives and the only other real alternative is liquidation.").

12 *See, e.g., In re Renegade Holdings Inc.*, 429 B.R. 502, 527 (Bankr. M.D.N.C. 2010) (concluding, without explanation or citation to authority, that "the nature of security, rate of collateral depreciation and liquidity of the collateral market do not impact an unsecured creditor's risks and are not relevant in this case"). *But see In re LMR LLC*, 496 B.R. 410, 434-35 (Bankr. W.D. Tex. 2013) (approving identical cramdown interest rates for secured and unsecured claims where plan expressly provided that creditor's lien would "continue to secure and protect its unsecured claim") (citing *Renegade* and *Texas Star*).

continued on page 58

from page 17

As the authors see it, however, the Bankruptcy Code commands a different result. The cramdown standards never ask what the unsecured creditor has at stake in the case; they never demand a measurement of the creditor's piece of the pie. Instead, they establish a clear and specific requirement when the unsecured creditor is compelled to wait for its money while the shareholders realize immediately the full potential of their equity interests: *payment in full on a present-value basis*. Discounting (or worse, eliminating) the risk-based component of the creditor's interest rate based on a hypothetical in which the creditor will not be paid in full (or will receive nothing at all) hardly seems like a logical step in a present value calculation designed to fully compensate the creditor.

There is nothing "straightforward" or "familiar" about a loan-underwriting criterion that measures a creditor's risk of payment with reference to terms (*pro rata* share of liquidation proceeds) that are not part of the newly proposed loan (payment in full over time). The risk of repayment must be measured in reference to what the plan says — not by reference to how well or poorly the creditor would fare under a different set of circumstances.[13]

13 *See, e.g., In re Noe*, 76 B.R. 675, 679-80 (Bankr. N.D. Iowa 1987) (rejecting debtors' proposed 6 percent interest rate for unsecured creditors when secured creditors stood to receive 10 percent, and, lacking any evidence of the appropriate rate for unsecured creditors, setting the rate at an equivalent 10 percent). In *Noe*, the debtors argued unsuccessfully that 6 percent interest was sufficient because a "considerable administrative expense tax" would have resulted from liquidation, thereby producing a lesser dividend for unsecured creditors. *Id.* at 679.

There is, perhaps, a price that the debtor must pay for the shareholders' full and immediate recovery of their equity, and that price includes interest calculated to account for the time/value of money and the risk of default under the debtor's plan. Only by insisting that the price is right can the courts avoid "the danger inherent in any reorganization plan proposed by a debtor ... that the plan will simply turn out to be too good a deal for the debtor's owners."[14]

Conclusion

Even where unsecured creditors stand to receive nothing in a chapter 7 liquidation, a chapter 11 debtor cannot allow its equityholders to retain their interests while cramming down a class of unsecured creditors with payments that omit adjustments for risk. To the contrary, where shareholders are trying to keep and avoid open-market competition for their equity, bankruptcy courts should be wary of "paid-in-full" plans that shortchange unsecured creditors with a "what have they got to lose?" attitude.

The irony is that equityholders also stand to receive nothing in liquidation (under these circumstances), yet they retain their interests and place the risk on unsecured creditors without just compensation. Whose "best interests" are being served then? abi

14 *See, e.g., Bank of America Nat. Trust & Savs. Assoc. v. 203 N. LaSalle St. P'ship*, 526 U.S. 434, 444 (1999) (citing legislative history supporting requirement that reorganization plan be "fair and equitable").

Copyright 2018
American Bankruptcy Institute.
Please contact ABI at (703) 739-0800 for reprint permission.