What Does the Market Say, and Does It Matter?

Valuation Issues Inside and Outside of a Plan

Jaunty Judicial Debates

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CRAMDOWN OF SECURED CREDITORS UNDER A CHAPTER 11 PLAN

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I. Introduction

"Cramdown" refers to a situation in bankruptcy where, when one or more classes of creditors vote to reject a plan, such plan can nonetheless be confirmed under Section 1129(b) if, with respect to each dissenting class, the plan: (1) does not discriminate unfairly; and (2) it is "fair and equitable." 11 U.S.C. § 1129(b)(1).

Section 1129(b)(2)(A) provides the following three *alternative* options (which the Bankruptcy Code does not set forth as being exclusive) through which a plan can satisfy the fair and equitable prong of the cramdown standard with respect to a dissenting class of secured creditors:

(i) Retention of liens and present value of allowed secured claim: the plan provides that classes of dissenting secured creditors retain the liens securing their claims and receive deferred cash payments totaling the present value of their allowed secured claims (Section 1129(b)(2)(A)(i));

(ii) Sale of collateral & continuation of liens: the plan provides for the sale of property subject to the liens securing the claims held by the dissenting secured class, with such liens attaching to the proceeds of the sale (Section 1129(b)(2)(A)(ii)); or

(iii) Indubitable equivalent: the plan provides that classes of dissenting secured creditors realize the "indubitable equivalent" of their secured claims (Section 1129(b)(2)(A)(iii)).

Each of these options is discussed below, with a particular focus on the interest rate necessary to satisfy the requirement, under prong (i), that the crammed down secured creditor receive deferred cash payments totaling the present value of its claim. The enforceability of a subordination agreement (such as an intercreditor agreement) in a cramdown situation will also be discussed. That issue is likely to become more relevant in Chapter 11 proceedings, given the increasing sophistication of commercial financing transactions which involve, for example, multiple tranches of debt.

The discussion below includes reference to the recent decision in the Chapter 11 cases of Trump Entertainment Resorts, Inc. and its affiliates, in which the U.S. Bankruptcy Court for the District of New Jersey (Wizmur, J.) confirmed a reorganization plan that crammed down the company's secured lenders over the lenders' objections. In re TCI 2 Holdings, LLC, 428 B.R. 117 (Bankr. D.N.J. 2010).

II. Retention of Liens and Present Value of Allowed Secured Claim

A. Retention of Liens

There is a scant body of case law defining what it means for a secured creditor to retain its liens. At least one court has chosen to "strictly interpret" the retention requirement, holding that "[t]he Court will apply a standard definition of retain, i.e., 'to continue to hold, have, use, recognize, etc., and to keep.'" See CoreStates Bank, N.A. v. United Chem. Techs., 202 B.R. 33, 50 (E.D. Pa. 1996) (quoting Black's Law Dictionary 1316 (6th ed. 1991)). The CoreStates court found that strict interpretation was consistent with other decisions, noting that:

> The courts suggest a literal interpretation of the statute requiring lien retention is appropriate: it has become increasingly apparent from recent appella[te] decisions that the disruption of interests in property caused by bankruptcy cases must be minimal or non-existent.

Id. at 49-50; see also Ford Prods. Corp. v. Bank of New York (In re Ford Prods. Corp.), 159 B.R. 693, 695 (Bankr. S.D.N.Y. 1993) (dissenting creditors' liens were not retained where plan required secured claimants to subordinate the priority of their liens to leaseholders).

However, in the recent TCI 2 Holdings decision, the bankruptcy court applied the following more liberal standard:

> We interpret the plan as ensuring [retention of a lien] if the debtor fails to comply with its debt service obligations, [the secured creditor] would have the right to foreclose.

428 B.R. at 159. It is unclear whether other courts will adopt this more flexible "right to foreclose" standard, which could afford Chapter 11 debtors a greater range of options in seeking to cram down secured creditors.

B. Deferred Cash Payments Totaling the <u>Present Value of Allowed Secured Claims</u>

1. <u>Interest Rate</u>

The key issue in a cram down under Section 1129(b)(2)(A)(i) is determining the appropriate rate of interest on the deferred cash payments, so as to meet the statute's requirements that such payments equal the "allowed amount of [the secured] claim, of a value, as of the effective date of the plan."

The starting point for determining the appropriate cram down interest rate is the Supreme Court's decision in <u>Till v. SCS Credit Corp.</u>, 541 U.S. 465 (2004). In <u>Till</u>, the issue before the Supreme Court was the appropriate cram down rate of interest under a Chapter 13 plan. The Court first considered the four leading methodologies courts had previously developed for determining the appropriate cram down interest rate: (1) the formula rate, which starts with the national prime rate and is adjusted upwards to account for additional risk depending on the creditworthiness of the borrower (the so-called "prime-plus" 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. <u>See</u> <u>Till</u>, 541 U.S. at 477-78.

After rejecting the coerced loan, presumptive contract and cost of funds rates as being too complicated and costly, a plurality of the Supreme Court decided that the proper cram down interest rate was the formula rate, finding it to be a straightforward, familiar, and objective inquiry. <u>Id.</u> at 477-79. The Court noted that because bankrupt debtors typically pose a greater risk of nonpayment than solvent commercial borrowers, it was favorable for a bankruptcy court to be able to adjust the prime rate to accurately reflect an individual debtor's risk of non-repayment. <u>See</u> <u>id.</u> at 479. Although the Court did not decide on the proper scale of a potential upwards risk adjustment, the Court commented that a typical upward adjustment might range from 1.0% to 3.0%. <u>Id.</u> at 480.

Although <u>Till</u> concerned the cram down rate under a Chapter 13 plan, the Supreme Court stated: "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 [cram-down interest rate provisions in Chapters 11, 12 and 13]." <u>Id.</u> at 474. However, the Court (in a footnote) went on to note that, unlike in Chapter 13, a market rate of interest for Chapter 11 cram-down loans may be readily discernible:

> Because every cramdown loan is imposed by a court over the objection of the secured creditor, there is no free market of willing cramdown lenders.

> Interesting, the same is not true in the Chapter 11 context, as numerous lenders advertise financing for Chapter 11 debtors in possession. Thus, when picking a cramdown rate in a Chapter 11 case, it might make sense to ask what rate an efficient market would produce. In the Chapter 13 context, by contrast, the absence of any such market obligates courts to look to first principles and ask only what rate will fairly compensate a creditor for its exposure.

Id. at 477 n.14.

Following Till, courts generally determine a Chapter 11 cram down interest rate by first considering any evidence of available market financing of directly comparable loan facilities to determine an "efficient market" interest rate and, if there is no such evidence, imposing a prime-plus rate. See, e.g., In re American HomePatient, Inc., 420 F.3d 559, 568 (6th Cir. 2005) (holding that "the market rate should be applied in Chapter 11 cases where there exists an efficient market," but that "where no efficient market exists for a Chapter 11 debtor, then the bankruptcy court should employ the formula approach endorsed by the Till plurality"). The difference between a market rate of interest and a prime-plus rate of interest can be substantial, particularly in a distressed market environment.

a. Efficient Market Rate Approach

i. Establishing Evidence of Market Rate

Although no reported decision has set forth specific factors that must be considered when determining whether a loan is priced at an efficient market rate or how to properly support a theory alleging an efficient market rate, parties often attempt to demonstrate the existence of a market rate through the introduction of expert testimony. For example, in TCI 2, the court found that an efficient market existed and applied a market rate of 12%, after hearing the testimony of three financial experts. 428 B.R at 163. The primary determinate utilized by all experts was the rate of interest paid by comparable companies on comparable loans. Id. Similarly, in In re DBSB N.A., Inc., the court noted that: "[i]n determining the appropriateness of a proposed cramdown interest rate, courts in this district have looked to the market interest rate for loans with similar terms." 2009 Bankr. LEXIS 3341, *74-77 (Bankr. S.D.N.Y. 2009)

Lenders have not fared particularly well when they asserted "market evidence" based on loan facilities not comparable to the proposed cram down loan. See In re American HomePatient, 420 F.3d at 568 (finding lack of efficient market evidence based on lenders' comparison of the price of one loan consisting of senior debt and the price of a loan newly issued in the market, even though both loans were structurally similar); In re Brice Road Developments, 392 B.R. at 280-81 (rejecting the senior lenders' argument that the cram down rate should be derived from a mezzanine facility with a blended rate of 8.0182% because the pricing for such a facility was not comparable to the senior debt facility at issue).

Moreover, whether the exit financing market is an appropriate comparison in deriving the market cramdown rate is an open issue in the case law. Compare In re Winn-Dixie Stores, Inc., 356 B.R. 239, 255 (Bankr. M.D. Fla. 2006) (approving procedures used in debtor's search for exit financing and finding them an "efficient test of the market") with In re Northwest Timberline Enterprises Inc., 348 B.R. 412, 434 (Bankr. N.D. Tex. 2006) (rejected the notion that an exit financing search alone could support evidence an efficient market rate).

ii. Burden

Generally, the burden of establishing market evidence implying a higher interest rate than what would be derived under the formula inquiry is placed on the secured creditor seeking the higher rate. See Till, 541 U.S. at 478-81; see also In re Seaspan Development Corp., 2006 WL 2672298 at *3 (E.D. Tenn. 2006) (acknowledging that under Till, the burden of proof is on the lender to provide market evidence); In re Seaspan Development Corp., 2006 WL 2672298, at *3 (E.D. Tenn. 2006) (acknowledging that under Till, the burden of proof is on the lender to provide market evidence); but see In re DeTienne Assocs. L.P., 2005 Bankr. LEXIS 3122, *18-19 (Bankr. D. Mont. 2005) (finding that the burden of satisfying the cramdown requirements under section 1129(b) remained with the debtor despite the Supreme Court's decision in Till, and holding that the debtor failed to demonstrate that its proposed formula rate was fair and equitable).

b. Till Formula "Prime-Plus" Rate

i. Generally

If the secured creditor is unable to demonstrate evidence of an efficient market, the Court will apply Till's formula-based approach and derive a risk-based percentage that will be added to the prime rate. In determining the appropriate risk-based percentage to be added to the prime rate, courts consider various factors, including the following:

i) the circumstances of the estate;
ii) the nature of the security;
iii) the duration and feasibility of the reorganization plan;
iv) the amount financed;
v) the ratio of the amount financed to the debtor's assets;
vi) the debtor's leverage;
vii) the debtor's performance history;
viii) the debtor's industry; and
ix) the risk of default.

Various courts have adopted and applied this formula approach. See, e.g., In re Prussia Assocs., 322 B.R. 572, 591 (Bankr. E.D. Pa. 2005) (applying 1.5% risk premium where evidence indicated that debtor's operations were improving and value of collateral was appreciating); In re Field, 2005 WL 3148287, at *7 (Bankr. D. Idaho 2005) (applying 1.5% risk premium where creditor was oversecured); In re Cantwell, 336 B.R. 688, 693 (Bankr. D.N.J. 2006) (finding that due to creditor's sizeable equity cushion and right to continue foreclosure proceedings cramdown loan only warranted a risk premium of 1%); Northwest Timberline Enterprises, 348 B.R. 412, 434 (Bankr. N.D. Tex. 2006) (applying 5% risk premium where cramdown loan had no credible guarantees and debtor had history of weak performance); In re Louisiana Riverboat Gaming P'ship and Legends Gaming of Louisiana, LLC, Case No. 08-10824 (SVC), *Ruling of the Court*, at 39 (Bankr. W.D. La. June 7, 2009) (finding a market rate did not exist and using Till formula approach).

The Supreme Court did not set forth the proper percentage range for an upwards risk adjustment, but did comment that a typical upward adjustment might range from 1.0% to 3.0%. Id. at 480. Although some courts have accordingly confined their upward risk adjustment to 1.0% and 3.0% above the prime rate, the Supreme Court's observation in Till was explicitly not intended to be limiting. See Till, 541 U.S. at 479-81. The Till Court intended for bankruptcy courts to exercise discretion on a case-by-case basis to determine the risk adjustment that properly reflects the particular level of risk in the cramdown loan at issue. See id. (citing GMAC v. Valenti (In re Valenti), 105 F.3d 55, 64 (2d Cir. 1997) (concluding that a range of 1.0% to 3.0% upward risk adjustment is reasonable, but that it is left to the bankruptcy court to determine the appropriate rate of interest in the first instance).

c. Applicability of Till's Plurality Holding

Some courts have questioned whether the Supreme Court's plurality holding in Till constitutes binding authority. See In re DBSB N.A., Inc., 2009 Bankr. LEXIS 3341 at *75 (stating Till may *arguably* constitute authority in Chapter 11 cases); In re Prussia Assocs., 322 B.R. at 590 (holding that Till is not binding authority but is instructive); In re DeTienne Assocs. L.P., 2005 Bankr. LEXIS 3122 at *18 fn 4 (finding Till produced no majority rule which would constitute binding precedent). Courts that decline to follow Till or extend its holding to Chapter 11 proceedings generally resort to deriving appropriate cram down interest rates by reference to rates of similar facilities in the marketplace, or to rates contained in pre-petition agreements between the debtor and creditor. See In re DBSB N.A., Inc., 2009 Bankr. LEXIS 3341 at *75 (determining that the proposed plan's interest rate was appropriate by comparing it to the pre-petition contract rate); In re DeTienne Assocs. L.P., 2005 Bankr. LEXIS 3122 at *15 (finding that, although Till was not controlling, the applicable method for determining the appropriate cram down interest rate was either i) taking testimony on current market interest rates for similar loans in the region, or ii) using a formula starting with a base rate and adding a factor based on the risk of default and the nature of the security). Thus, as a practical matter, the standard applied by courts that profess not to follow Till and its progeny is similar to those that do follow Till and its progeny.

2. Non-Interest Rate Terms of Cram Down Loan

Aside from the interest rate, there is a split of authority as to whether a crammed down secured lender is entitled to "market standard" covenants (i.e., loan terms other than the interest rate) is unsettled. One court has held that a secured lender is entitled to market covenants to protect its interests in a cramdown loan. See In re Kellogg Square, 160 B.R. 343, 368-69 (Bankr. D. Minn. 1993) (holding that a creditor is "entitled to insist on the execution of new security instruments, with content equivalent to what the parties would reasonably negotiate on a loan origination at the present time" and secured lender is "entitled to demand market-standard terms as to all of the other points for which the debtor's proposed security deviates from current norms"). However, other courts have only required that the covenants in the cram down loan protect the lenders' security position. See In re Am. Trailer & Storage, Inc., 419 B.R. 412, 440-42 (Bankr. W.D. Mo. 2009); In re P.J. Keating Co., 168 B.R. 464, 473 (Bankr. D. Mass. 1994)); In re TCI 2 Holdings, LLC, 428 B.R. at 167 ("Nor must the post-confirmation loan documents be consistent with what the market would require for a new loan.").

In any event, to the extent the non-interest rate terms are modified from the pre-petition documents and/or do not reflect current market-standard terms, a secured lender may be entitled to an additional interest rate premium for any added risks. See In re Am. Trailer & Storage, 419 B.R. at 440-42 (lack of covenants resulted in increased interest rate); In re Sherwood Square Assocs., 107 B.R. 872 (Bankr. D. Md. 1989) (same).

III. Sale of Collateral & Continuation of Liens

This prong of the fair and equitable requirement includes six components:

(i) a sale;
(ii) subject to section 363(k) of the Bankruptcy Code (the section which permits credit bidding in a bankruptcy asset sale);
(iii) of property subject to a lien;
(iv) the sale is free and clear of the lien(s);
(v) the lien(s) attach to the proceeds of the sale; and
(vi) the plan treats the secured claim under either the "retention of liens / deferred payments" or the "indubitable equivalent" standard.

IV. Indubitable Equivalent

The phrase "indubitable equivalent" was introduced in In re Murel Holding Corp. by Judge Learned Hand. See 75 F.2d 941, 942 (2d Cir. 1935). Ruling that a secured creditor must receive the full value of its interest, claims and liens, Judge Hand held that a secured creditor cannot be deprived of its interest "unless by a substitute of the most indubitable equivalence." Murel Holding, 75 F.2d at 942. Treatment under a plan is the indubitable equivalent of a secured creditor's claim only if its sufficiency is beyond doubt. See Arnold & Baker Farms, 85 F.3d at 1421 ("'Indubitable' means 'too evident to be doubted'").

Where the plan proponent proposes to substitute or alter a secured creditor's collateral (and thus §§ 1129(b)(2)(A)(i) and (ii) cannot be satisfied), the plan can only be confirmed if it meets the indubitable equivalent standard. Moreover, any deferred payments must be equal to the present value of the secured claim (i.e., the interest rate must adequately compensate for the delay and risk associated with receiving deferred payments), consistent with the standards set forth above. See 124 Cong. Rec. 32,407 (1978) ("present cash payments less than the secured claim would not satisfy the standard because the creditor is deprived of an opportunity to gain from a future increase in the value of the collateral").

To the extent a plan proposes to alter the collateral securing a creditor's loan, providing the indubitable equivalent requires that the substitute collateral not increase the creditor's risk exposure. See In re May, 174 B.R. 832, 838 (Bankr. S.D. Ga. 1994). The indubitable equivalent standard requires both the absence of any reasonable doubt that the secured creditor will receive the payments to which it is entitled, and that the changes forced upon the objecting creditor are "completely compensatory," meaning the objecting creditor is fully compensated for the rights it is giving up. In re Investment Company of the Southwest, Inc., 341 B.R. 298, 324. (10th Cir. 2006).

The two main components of the indubitable equivalent standard -- safety of the principal amount owned and proper risk compensation -- require an analysis that focuses on the value of the alternative collateral and a comparison of the risks imposed on the creditor. In re Wiersma, 324 B.R. at 111 (9th Cir. 2005). The court in Wiersma held that indubitable equivalence exists when: (1) the proposed plan is feasible; (2) it is unlikely that the creditor's claim would ever become even partially unsecured; and (3) it is likely that the value of the property will increase. See Wiersma, 324 B.R. at 112.

In the recent TCI 2 Holdings decision, the court found that the indubitable equivalent standard required the plan to: "(1) protect the creditor's principal, and (2) provide for the present value of the creditor's claim." 428 B.R. at 160-161.

V. The Enforcement of Subordination Agreements in Cramdown Plans

Subordination agreements – such as intercreditor agreements – are enforceable in bankruptcy proceedings pursuant to Section 510(a), which provides that "[a] subordination agreement is enforceable in a case under this title to the same extent that such agreement is enforceable under applicable nonbankruptcy law." 11 U.S.C. § 510(a). Further, confirmation of a cramdown plan under Section 1129(b) requires that all of the requirements of Section 1129(a) (except for the requirement that all impaired classes accept the plan) are met. These requirements include Section 1129(a)(1) – i.e., "[t]he plan complies with the applicable provisions of this title." 11 U.S.C. § 1129(a)(1). Thus, Section 1129(a)(1) requires a plan to comply with Section 510(a) by giving effect to subordination agreements.

However, Section 1129(b)(1) provides that a cramdown plan may be confirmed "[n]otwithstanding section 510(a)." This provision appears to create an anomalous situation: giving literal effect to the "[n]otwithstanding section 510(a)" language would mean that a secured creditor can enforce a subordination agreement – including as a means to block confirmation – if its class votes to accept the plan, but cannot do so if its class votes to reject the plan. As one commentator has noted:

> § 1129(b), by virtue of its reference to § 510(a) in cramdown, appears to have the anomalous result of overriding § 510(a) and eliminating the enforcement of subordination agreements in cases in which the class rejects the plan.

Kenneth N. Klee, Adjusting Chapter 11: Fine Tuning the Plan Process, 69 AM. BANKR. L.J. 551, 561 (1995).

The recent TCI 2 Holdings decision appears to be the only case that addresses whether a secured creditor can enforce a subordination agreement to block confirmation of a cram down plan. In that case, the secured lenders argued the plan was not confirmable because it violated an intercreditor agreement that required, among other things, that the lenders receive payment in full in cash before junior noteholders received any distribution. In ruling on this issue, the bankruptcy court noted that it "understood" the "anomalous result" criticism, but was compelled to give meaning to the "notwithstanding" phrase. In re TCI 2 Holdings, LLC, 428 B.R. 117, 141 (Bankr. D.N.J. 2010). Thus, the court held:

> Even though section 510(a) requires the enforceability of subordination agreement in a bankruptcy case to the same extent that the agreement is enforceable under nonbankruptcy law, if a nonconsensual plan meets all of the § 1129(a) and (b) requirements, the court "shall confirm the plan."

Id.