ENDING THE JUDICIAL SNIPE HUNT:

THE SEARCH FOR THE CRAMDOWN INTEREST RATE

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When all the horse trading fails to produce a plan by agreement, most proponents are quick to threaten cram down. FN1 It sounds simple: you propose a plan providing for repayment of the debt, throw in an interest rate or discount factor and the court confirms the plan. FN2 Significantly, the Bankruptcy Code **FN3** (the "Code") allows confirmation of a plan over the objections of a class of impaired creditors provided the plan is found by the court to be fair and equitable. FN4 At a minimum, the cramdown plan must provide that secured creditors will retain their liens on the collateral and receive deferred cash payments with a present value at least equal to the creditors' interest in the property. FN5 Prior to confirmation, the court need only determine that the interest rate contained in the plan reflects the current market rate. FN6 There is little agreement, however, on how that market rate is defined, FN7 what the actual market is or whether a market even exists. FN8 As neither the parties nor the courts agree on a description of the quarry or where to look, the search for the market equivalent of a cramdown interest rate is a true snipe hunt. To remedy this source of inconsistency, the authors propose that the Bankruptcy Review Commission consider formulating a means of determining a cram down interest rate which is better defined.

I. TIME VALUE OF MONEY

Confirmation of any plan of reorganization requires that the plan proponent compensate a secured creditor for any delay in receiving the payment of the value of its collateral. FN9 The courts agree that the Code requires a time− value of money analysis comparing the interest rate offered with the proposed deferred payments to the creditor at a minimum rate found by the court to fairly and equitably compensate the creditor for the delay. FN10

The time−value analysis is founded upon the concept that the right to a future payment is worth less than the right to immediate payment of the same amount, the difference being determined by the length of the delay. FN11 The rate used must reflect anticipated inflation over the term of the repayment plan and the resulting loss of purchasing power incurred by the creditor. "An interest rate is generally said to have three components: (1) inflationary expectations, (2) a "real" interest rate, and (3) a risk component." FN12 The initial rate is generally known as the real rate of interest. FN13 The debtor must not only provide the creditor with the real rate of interest, but the rate offered must also protect the lender against inflation. FN14 Since the actual rates of inflation in the future cannot possibly be known when a loan is made, the size of the inflation component is driven by expectations of future inflation rates. **FN15**

If the proposed rate of the plan is found to be appropriate by the court the plan may be confirmed. FN16 If the implied or proposed rate is less than the rate determined by the court to be fair and equitable, the plan cannot be confirmed. FN17 Since the "real" interest is theoretically the same in all loans, FN18 the argument in the courts is really over the inflation and risk factors and how those are determined.

II. APPROACHES TO DETERMINATION

A. The Interest Rate "Market"

In economic theory, interest rates are grounded in the concept of market efficiency. FN19 Efficient markets are said to exist when security prices reflect all available information which bears on the valuation of the instrument. FN20 Should actual rates in the market differ from the rates required by the lenders or the rates demanded by the borrowers based on either of their expectations, speculators will enter the market and force rates back into equilibrium. In other words, when the market does not reflect current inflationary expectations, an opportunity for arbitrage profits is created, which will force the two rates together. FN21 Consequently, market interest rates reflect expectations of

future inflation. FN22

Market rates of interest are thus "products of supply and demand and reflect the interaction of economic variables that affect the cost of lending money." **FN23** The real rate of interest has been hypothesized to be nearly constant over time, FN24 and is continually adjusted for anticipated changes in purchasing power through the use of an inflation factor. FN25 Since efficient markets require market rates to reflect anticipated inflation, "inflationary expectations and the real rate of interest are the same for all borrowers." **FN26** The risk premium is based on the borrower's characteristics and is determined by each individual lender. FN27

In actual banking practice, term loans and commercial loans are generally negotiated at arms−length. FN28 The terms offered to the borrower are often the result of the debtor's current financial characteristics, as well as the lender's desire to service the borrower's other needs or to secure future orders from the borrower. The role of financial markets in this process is to facilitate the flow of savings from saving− surplus economic units to saving−deficit economic units. FN29 The allocation of these savings occurs primarily on the basis of price, expressed as interest rates. **FN30** Thus, the "market price" of money is stated in terms of an interest rate. **FN31**

Financial institutions often employ package pricing policies which do not price a particular loan in isolation, but rather price the loan in relation to the profitability of the debtor to the lender as a whole. Business loans are negotiated on an individual basis and are part of the customer "package" which includes credit limits, interest rates, deposit balances and activity charges on other services. FN32 Additionally, the cost to the lender of making the funds available to the debtor varies based on the type of loan made. A single payment loan to a prime borrower with a line of credit involves very little cost, while a leased equipment loan would involve considerable advance investigation and preparation and a significant amount of supervision thereafter. FN33 The cost of making a loan to a debtor is often offset by the lender performing other, more profitable services for the debtor. Thus, the ultimate interest rate charged for a commercial loan is often the product of negotiations regarding more than just the credit transaction at hand. The loan is viewed as purchased by the borrower. Thus, the rate charged to the debtor is market driven only to the extent of providing the creditor with the real rate of interest and an inflation premium (protecting the creditor from potential loss of purchasing power from inflation), and then only if the rate has not been brought down by the use of compensating balances, price increases or other means. FN34 Since the rate used on commercial loans is individually negotiated, there is no market clearing price (interest rate) for commercial loans. However, few of the reported decisions apply to this analysis. For the most part, the courts have attempted to find or formulate a "market rate" in confirming plans. FN35

B. The Market Rate

The courts have generally concluded that the cramdown interest rate is to be measured by "market rates." FN36 Theoretically, a market rate is a "composite of rates determined in arms− length negotiations between buyers and sellers of funds in money markets." FN37 Unfortunately once the parties have reached bankruptcy court, negotiations generally have broken down, leaving the courts to determine whether the plan proposes the correct rate.

The first reported case addressing the issue of the appropriate cramdown rate under the Code imposed a 10% rate in chapter 13, rejecting a contract rate of 16.8%. FN38 Although the court's rejection of the contract rate was not based on a conclusion that the confirmation rate must reflect current market conditions, virtually all courts since have agreed that any cramdown rate must reflect prevailing *market* rates. FN39 The case law has exploded into a "many colored splendor" of conflicting, and often indecipherable, formulae as the courts have tried to describe their vision of the "market" approach. FN40

Although the courts seem to agree that a market rate approach should be used, there is no agreement about what the "market rate" is, what the "market" is, or even how a trial court should find either. FN41 Bankruptcy courts have used rates which have ranged from purely market driven rates (*e.g.*, rates charged by conventional lenders), to purely statutory rates (*e.g.*, judgment rates), and every combination in between. FN42 Moreover, in no reported case has a court actually found that a market exists for loans to debtors emerging from bankruptcy. FN43 The result is that the wide variety of rates used by the courts more closely resembles Justice Stewart's "I know it when I see it" FN44 approach to hard−core pornography than any rational economic or mathematical analysis.

For example, in *Fleet Finance, Inc. v. Ivey (In re Ivey),* FN45 the district court affirmed the bankruptcy court's use of a 13% interest rate using the coerced loan theory based on market rates for similar loans by banks, savings and loan associations, credit unions, and captive finance companies. **FN46** After exploring the advantages and disadvantages of the common approaches historically used to determine a proper discount rate in some detail, the district court rejected the coerced loan approach used by the bankruptcy court and endorsed the formula approach. FN47 The district court then excepted the case from its own rule and affirmed the 13% rate used by the bankruptcy court without reference to any theory whatsoever. FN48

In contrast, the Fourth Circuit identified the bankruptcy court's use of the formula approach as a cost of funds approach. FN49 It then rejected the cost of funds approach and endorsed the coerced loan theory. FN50 The circuit court then carved out an exception to its newly created rule and imposed the original contract rate. FN51 The bankruptcy court's approach was in fact designed to reflect current lending market conditions in the area and to adjust the rate in order to reflect the riskiness of the debtor. FN52 The rate eventually determined was the court's estimate of the rate the lender would charge the debtor for a new loan, not the bank's cost of funds. FN53 The Fourth Circuit then held that the rate should be based on the secured creditor's lending market . . . taking into account not only the rates which it obtains from similar loans in the area but also its expenses in obtaining those loans . . . . FN54 The bankruptcy court's formula approach should, therefore, have been upheld absent a showing of clear error. "If the bankruptcy court has correctly considered all of the elements involved in computing a discount rate, determination of the proper discount rate in a particular case is a factual inquiry." FN55 Thus, the Fourth Circuit: (1) improperly characterized the formula approach used by the bankruptcy court; (2) stated a separate rule to determine the appropriate discount rate; and (3) excepted the present case from the rule and enforced the original contract rate.

The market rate requirement, judicially imposed upon present value analysis required by the Code, FN56 is so elastic that it provides no guidance to the courts. FN57 Generally, the circuits have only required that whatever rate is eventually chosen, must resemble a market rate for a loan, similar in character, amount and duration hypothetically made to the debtor in the ordinary course of business. FN58 The circuits have refused to specifically identify a particular market for the bankruptcy courts to look to in determining the proper rate. FN59 The courts, therefore, are seemingly allowed to exercise free reign to subjectively fix the interest rate for a creditor objecting to a reorganization plan and are limited only by the requirement that the result be labeled a "market rate." FN60 Out of all the confusion, two basic approaches have come to dominate the attempts to define a market rate: (1) a coerced loan approach; and (2) a formula approach. FN61

C. The Coerced Loan Rate

Courts following the coerced loan market rate theory attempt to preserve the creditor's position by treating the repayment as a *coerced* loan from the creditor at the prevailing *market* rate. FN62 "The debtor is entitled to force the creditor to make a forced loan for 100 [%] of the appraised value of the collateral." FN63 The theory is apparently founded on *Collier's* statement:

It is submitted that deferred payment of an obligation under a plan is a coerced loan and the rate of return with respect to such loan must correspond to the rate which would be charged or obtained by the creditor making a loan to a third party with similar terms, duration, collateral and risk. It is therefore submitted that the appropriate discount rate must be determined by reference to the "market" interest rate. FN64

However, this theoretical foundation has been criticized, FN65 partly because *Collier's* suggests that "present value" includes both the administrative and lost opportunity costs of the creditor. FN66 There are some obvious problems with this approach.

The rates resulting from this approach seem based more on the court's intuition than any rational examination of actual lending patterns. FN67 Courts using the coerced loan approach have at various times used the rate the *secured creditor* would charge to the debtor, FN68 the lower of the contract rate or rate charged by the *secured creditor* in the ordinary course of business, FN69 or the current market rate *available to the debtor* for a similar loan in the region. FN70 One court declined to use creditor specific rates because it leaves too much control to the creditor and may contravene the "fair and equitable" language of section 1129(b) of the Code. FN71 Another rejected the new loan

perspective of the coerced loan approach and asserted that the term "similar loan" found in the Hardzog v. Federal Land Bank of Wichita (In re Hardzog) FN72 opinion refers to similar "workout" loans. FN73 An Ohio court averaged the Installment Sales Contract rate for the State of Ohio, the original contract rate, and an arbitrary 6% leveling factor in determining the proper rate. FN74 A Tennessee court recognized there was no similar market for the loan proposed by the plan and incorporated the formula approach within the coerced loan approach. FN75

The coerced loan approach, however, presumes that a "market" exists for the type of loan being forced upon the creditor. FN76 One court has acknowledged that Congress has given little guidance to the courts in how to determine a fair and equitable rate. FN77 "While the cases considering the issue are fairly uniform in agreeing that a market rate of interest is appropriate, the cases differ drastically in their interpretation of how a `market rate' is to be determined." FN78 Both the *Hardzog* and *Memphis Bank & Trust Co. v. Whitman* courts opined that the interest rate on similar loans was easily ascertainable in establishing the market rate for a coerced loan as a standard. **FN79** Both the Sixth and Tenth Circuits concluded that bankruptcy judges are generally familiar with current "market" conditions and should have little problem in their determination of present value: FN80

Bankruptcy [c]ourts, counsel, lenders, and borrowers should have a familiarity with current interest rates on like−type loans and when a dispute arises, the market rate should be easily susceptible of determination by means of a hearing where each party is given the opportunity to submit evidence concerning the current market rate of interest for similar loans in the region. FN81

In the authors' opinion the decisions in *Hardzog* and *Memphis Bank* have several things in common: each court reverses "efforts by [a] bankruptcy judge[ ] to render a pragmatic determination of the interest rates based on at least some semblance of an objective measurement;" FN82 each court "decline[s] to commit . . . to a superior alternative . . .;" FN83 and each provides "little practical help in determining which of the various potential `market rates' should be utilized as a basis in establishing the applicable interest rate." FN84 The circuit courts have apparently deferred to the experience and expertise of the bankruptcy courts to find this unidentified market known only to the bankruptcy courts. Since neither the *Hardzog* nor the *Memphis Bank* courts identified any specific market where a referent rate may be found, the use of the current market rate of interest used for similar loans in the region as a standard for a cramdown is difficult to apply.

Indeed, in no reported case has a court concluded, based on evidence presented, that any actual market exists in which a lender makes loans to debtors under the circumstances which generally prevail in reorganization. "[I]t is difficult to arrive at a current market rate of interest for a hypothetical new loan when there is no market for the loan proposed, no equity in the property and limited opportunity on the part of the debtor to obtain financing outside of the Bankruptcy Code framework." FN85 Bankruptcy courts, notwithstanding the faith of the circuit courts that bankruptcy judges are familiar with "market" conditions, have been unable to observe this "market" directly and therefore have been forced to rely on expert testimony provided by the parties. In fact, no case has affirmatively linked the terms of the reorganization plans at issue with a specific market in which rates are widely and timely reported and in which the terms of the instruments negotiated or traded mirror the characteristics of emerging chapter 11 debtors. The reason is simple: No similar loans are being made. FN86

For example, the court in *In re* Computer Optics, Inc. FN87 found that "there is no `market' in the real world for `similar loans' when dealing with a reorganized entity coming out of a chapter 11 proceeding and it . . . is not surprising that the case decisions taking such approach exhibit much conjecture and inconsistent results." FN88 Some courts have been willing to overlook this problem, however, proposing instead that the coerced loan theory is utilized to approximate a "similar" market. FN89 The use of the term "similar" does nothing but simply broaden an already vague term and thereby introduce even more uncertainty into an already clouded issue. FN90

While the *Hardzog* and *Memphis Bank* courts do not identify any particular market to which a bankruptcy court can refer, they suggest that the court receive testimony at a hearing which would expose the proper rate. FN91 Simply suggesting reference to "experts" does nothing to expedite a case and provides no meaningful standard to be used to measure the expert testimony at trial or on appeal. It turns the entire issue into a question of fact which can only be resolved through the presentation of evidence, and may be viewed as a make− work program for university professors, bank executives and industry consultants. In the absence of any identifiable market rate, however, a number of courts

have relied on expert testimony to fashion a rate that a *hypothetical* lender would charge to a *hypothetical* debtor with the same characteristics for the coerced loan in question. FN92 Not surprisingly, the creditor's expert invariably opines that no lender would make the proposed coerced loan on the terms offered in the plan, except possibly at a rate that would call into question the feasibility of the plan as a whole. FN93

Denying confirmation based on an expert's testimony that no market exists completely undermines the purpose of section 1129(b) by giving the creditor an iron clad veto of any plan. FN94 "The [d]ebtor's proposals for interest rate and amortization . . . should be considered on their merits without the automatic veto of applying the current market's loan−to−value standards." FN95 Allowing a creditor to frustrate the debtor's attempt to confirm a plan that is otherwise fair and equitable on the basis of a creditor's expert testimony would do little toward facilitating cooperation or negotiation between the parties and improving judicial economy.

The real issue from the creditor's perspective in withholding approval of the plan is either the creditor's interest in protecting the value of the collateral based on the likelihood of any successful reorganization, or an attempt by the secured creditor to coerce the debtor into treating the creditor more favorably. The intent of the creditor is not to have the rate adjusted upward in a subsequent plan, but rather to frustrate the debtor's attempt at a successful reorganization and force the debtor either into liquidation or back to the bargaining table. FN96 "The Code’s emphasis on coercing cooperation among the parties involved in a bankruptcy proceeding suggests that the primary purpose of the cramdown power must be to prevent creditors from *unreasonably* withholding consent from a plan." FN97

If, indeed, the purpose of reorganization is to facilitate renegotiation of credit terms, a reference to a market rate for refinanced obligations is neither conducive to settlement nor useful in litigation. As the courts have demonstrated, market rates are simply not much guidance.

D. The Workout Rate

Generally, lenders try to avoid legal action since it consumes their own resources as well as the debtor's, which may further damage the lender’s claim. Lenders often work closely with borrowers to establish revised repayment plans, provide general financial counseling, or give advice on financial management. FN98 These efforts are generally referred to as "workouts." FN99 For whatever reason, however, these workout negotiations often fail, and thus "[w]hen an out−of−court arrangement is inadequate to rehabilitate a business, the bankruptcy laws provide an alternative. An arrangement or reorganization [under bankruptcy law] binds nonconsenting creditors, and permits more substantial restructuring of a debtor's finances than does an out− of− court workout." FN100 The legislative history, it seems, contemplates the role of bankruptcy courts as facilitating or arbitrating the terms of a workout plan. **FN101** A cramdown proceeding is more like a forced workout agreement rather than a coerced loan. "In essence, the structure of [a cramdown agreement] is one created by statute with the terms to be determined, to the extent possible, in light of common practices in the marketplace." FN102 Therefore, the appropriate rate to use under conditions of a cramdown is a workout rate. FN103 However, resorting to a market rate determined by reference to other workout cases pays lip service to the large body of case law now on the books. Using workout interest rates inflexibly is no more appropriate than always using the contract rate or the band of investment approach. While workout rates are generally consistent within a close range of interest rates, it stretches the point to say that this constitutes a market rate. Workout agreements are often for very short terms and it is not appropriate to use such rates for the longer periods typically demanded by the debtor or required for feasibility of the plan.

E. The Formula Approach

The more logical, if not better, theory is the formula or risk factor approach. FN104 Rather than requiring the court to identify a similar market or investor to determine the appropriate cramdown rate, the formula approach requires the court to adopt a risk−free market rate as a base, and then add a risk premium corresponding to the court's determination of the riskiness of the reorganization plan. FN105 Courts generally limit their choice of a base rate to either treasury rates or a readily ascertainable prime rate. FN106 The determination of the risk premium, however, is based on the particular factual setting. FN107 Generally, the risk premiums range from a high of 4% FN108 to 0%. FN109 One court added an additional percentage point to the 8.5% rate offered by the debtor reasoning that "[a]n additional percentage point to offset risk and permits the court to `sin on the side of grace' . . . ." FN110 Another court

relied on what appears to be its own intuition cloaked in pseudo statistical language in determining the risk premium:

Although the rates obviously vary, the Court finds that the "center of gravity" of the commercial real estate loan market is a variable rate 2.25% in excess of the Eleventh District rate. Several lenders filed declarations stating their current rates were 2.5% in excess of the Eleventh District Rate. A recent survey of the rates charged by seven different savings and loan associations situated within the Eleventh District indicated that one of them established its standard rate at 2% in excess of Eleventh District rate, two had established their rate 2.15% in excess of Eleventh District rate, and that four had established their rates 2.25% in excess of Eleventh District rate. **FN111**

The court did not assess the risk to the creditor, objectively combine premiums charged in the commercial real estate market, or recognize that the premiums reported were not necessarily solely risk premiums.

The interest rate used should reflect the workout nature of the cramdown proceedings and allow for the protection of the creditor's interest in order to prevent dilution of the value of the creditor's collateral at the time of confirmation. FN112 The formula approach should be applied from the perspective of attempting to protect creditors' interests, without consideration of profit or opportunity costs, since they are an inseparable component of the coerced loan theory. Moreover, section 1129(b)(2)(A)(i) and (iii) and the corresponding legislative history clearly support the preservation of the value of the collateral. FN113

The formula approach is more clearly consistent with pre− Code case law FN114 and the legislative history of section 1129. FN115 In adopting this section, the Senate report referred to *Metropolitan Life Insurance Co. v. Murel Holding Corp. (In re Murel Holding Corp.),* FN116 as the standard to be used in interpreting the term "indubitable equivalent." **FN117** In *Murel,* Justice Hand linked the concepts of present value and adequate protection finding that a substitute clearly must both compensate for present value and the safety of the principal. FN118 In United Savings Ass'n of Texas v. Timbers of Inwood Forest Associates, Ltd. FN119 the Supreme Court rejected the inclusion of opportunity costs as part of a creditor's claim. Consequently, they were not subject to the adequate protection provisions of the Code. FN120 Since "the concepts of present value and adequate protection are the same" FN121 and since opportunity costs are not considered as part of a creditor's claim, as a result of the Supreme Court's decision in *Timbers,* FN122 it would be inconsistent to allow a creditor to recover opportunity costs under section 1129(b)(2)(A)(i)(II) under a present value analysis, but not under a section 1129(b)(2)(A)(iii) indubitable equivalent analysis. The rate should only compensate the creditor for the time value of its money and the risks to its principal. FN123

The nominal rate used should not reflect a profit component, administrative charges or opportunity costs to the creditor. Even proponents of the coerced loan theory admit that any contract rate is composed of a risk−free rate plus a risk premium and costs of administration. FN124 Under the formula approach, the court must first determine a risk−free base rate and then add an appropriate risk premium to that base rate. FN125 "Every lender faces the possibility that a borrower will default, although the degree of default risk, is to a certain extent, under the control [of the lender] . . . . regardless of the care in which loan applications are scrutinized, some borrowers inevitably will be unable or unwilling to meet their repayment schedules." FN126 A risk premium is a charge by a bank which is essentially an insurance premium protecting the bank in the event a borrower defaults on a loan. "Since the confirmation decision is an up or down decision, [c]ourts are reluctant to state an appropriate risk premium in excess of the risk free base." FN127 "Determination of an appropriate rate is a difficult question because unlike a lending institution . . . [the courts] do not have a lending manual which mechanically guides this analysis." FN128

The question then is: What interest rate will compensate the creditor if profit and opportunity costs are removed, the additional charges for administration and collection costs were reduced or eliminated and adequate protection assured? FN129 In addressing this issue, the court in In re Oaks Partners, Ltd. FN130 stated:

The court recognizes that no method of determining an appropriate cramdown rate is perfect. However, we are not looking for perfection, but only a reasonable method of assessing risks in order to decide whether to confirm a plan. . . . [A]scribing a particular number of basis points to the overall risk factor is easier said than done. The disappointed party . . . will likely think the adjustment arbitrary. FN131

The court in *United States v. Camino Real Landscape Maintenance Contractors, Inc. (In re Camino Real Landscape Maintenance Contractors, Inc.),* FN132 when confronted with the apparent arbitrariness, countered that: "rough estimates are better than no estimates. We are willing to rely on the expertise of the bankruptcy judge . . . particularly where no contrary evidence was introduced." FN133 "It appears generally though that risk premiums determined or approved by the courts are judgments made within acceptable ranges based on the facts in a particular case as of a particular time." FN134 It is not the court's duty to determine a specific rate, but rather only to rule on the fairness of the proposed rate. FN135 The determination of a risk premium based on the court's experience with other reorganizations and its familiarity with the debtor's plan, to be added to a base rate grounded in the financial markets is surely less arbitrary than estimating the rate a hypothetical lender would charge a hypothetical borrower in a nonexistent market or one conjured up by a party's expert.

F. Variable Rates

The market interest rate for commercial loans is very often a floating rate. **FN136**

Determining the feasibility of a plan is more difficult if the cash flow of the property can go negative in the event of an interest increase on a floating rate loan. FN137 However, floating rates often have caps and floors, and the proponent and the court can determine whether the cap on the floating rate is consistent with market practices and whether the plan is feasible with the cap in place. Without an interest rate cap, the court still can determine that in light of historical interest rate fluctuations, the plan is feasible. Often a floating rate will be lower than a fixed rate. However, a floating rate increases the risk of default and possible loss to the lender where the equity in the property is low or nonexistent. FN138 Again, market rates and practices for qualifying loans provide information for the court's consideration. A floating rate should be allowed in the appropriate case.

CONCLUSION

Most bankruptcy lawyers would rather forge a reorganization plan by agreement rather than resort to litigation. Cramdown litigation remains a viable impetus for settlement only if the courts can devise a consistent method for determining the appropriate interest rate for granting or denying confirmation. With the variety of approaches so widely divergent, the parties approach negotiations from opposite sides of a very broad spectrum. The current consensus that the standard is market rates is not only an impossibly vague referent, it is not founded in the language of the Code.

The Bankruptcy Review Commission should propose an amendment of the provisions of section 1129(b) (and the similar sections elsewhere in the Code) to require application of a formula approach based on a riskless base rate plus risk factors related to the characteristics of the debtor. This is closer to the economist's model of a real interest rate plus inflation and risk factors. Several possible base rates including an inflation factor can be determined by reference to financial periodicals. This would leave only the risk factor for litigation or further negotiation. FN139 A bankruptcy court is perhaps uniquely situated to assess the risk of further default. Moreover, it must make that assessment in any contested confirmation because it must determine if the plan is feasible. It is but a short step from concluding that a plan is feasible (more likely to succeed than fail) to quantifying more exactly the risk of loss or additional delay to the creditor.

A formula approach using a base rate readily determined by outside references and adding risk factors would facilitate settlement by narrowing the range of argument substantially. The length and documentation of the loan should reflect market practices for if the debtor seeks a longer term or freedom from customary contractual representations and warranties, the court should increase the risk factors. This would encourage parties to propose loan terms and durations consistent with reality. Use of the formula approach with reference to workouts, contract rate and the band of investment analyses as a check, but not a directive, would return the dispute back to the negotiation model in which reorganization originated.

Footnotes

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FN1 The "cramdown" provision of chapter 11 is found in 11 U.S.C. § 1129(b) (1994). This provision allows a plan to be confirmed even without the consent of each class of creditors. 4 DANIEL R. COWANS, BANKRUPTCY LAW AND PRACTICE § 20.27 (6th ed. 1994). Normally, a court may not confirm a plan unless each impaired class accepts the plan. 11 U.S.C. § 1129(a)(8) (1994). However, if a plan otherwise meets the standards set forth in § 1129(a), except that not all of the impaired classes have accepted the plan, the court can nevertheless confirm it under the § 1129(b)(1) "cramdown" provision if: (1) the proponent of the plan requests confirmation; (2) the plan does not discriminate unfairly; and (3) the plan is fair and equitable as to those classes of creditors which have not accepted it and whose interests are impaired under it. 11 U.S.C. § 1129(a), (b)(1).

FN2 A "plan" in a chapter 11 reorganization is essentially the "deal between the parties in interest offered by the proponent." 4 COWANS, *supra* note 1, § 20.18. "Confirmation of a plan permanently substitutes what was offered in the plan for the quantum of claims creditors held when the case was commenced." *Id.* In the event that the debtor breaches plan provisions after confirmation, creditors may only act upon the substituted claims, since the original obligations incurred by the debtor are not revived. *In re* Stratton Group, Ltd., 12 B.R. 471, 474 (Bankr. S.D.N.Y. 1981).

FN3 11 U.S.C. §§ 101−1330 (1994).

FN4 11 U.S.C. § 1129(b)(1) (1994); *see In re* River Village Assocs., 161 B.R. 127, 135 (Bankr. E.D. Pa. 1993) (stating that court may confirm chapter 11 debtor's plan over objections of creditors), *aff'd*, 181 B.R. 795 (E.D. Pa. 1995).

FN5 11 U.S.C. § 1129(b)(2)(A)(i) (1994). The cases in which unsecured creditors are entitled to interest are relatively rare, but the analysis which follows would apply.

FN6 General Motors Acceptance Corp. v. Jones, 999 F.2d 63, 71 (3d Cir. 1993) (holding appropriate interest rate under chapter 13 cramdown is interest rate charged for similar loan); United Carolina Bank v. Hall, 993 F.2d 1126, 1131 (4th Cir. 1993) (adopting rule "that looks to the [secured creditor's] lending market"); Hardzog v. Federal Land Bank (*In re* Hardzog), 901 F.2d 858, 860 (10th Cir. 1990) (finding current market rate for similar loans most appropriate interest rate); *River Village*, 161 B.R. at 135 (recognizing current market rate as alternative for determining acceptable interest rate). To understand the idea of a market rate of interest, a parallel can be drawn to "market price," which is defined as "[t]he price actually given in current market dealings . . . . The actual price at which given stock or commodity is currently sold, or has recently been sold in open market, that is, not at forced sale, but in the usual and ordinary course of trade and competition between sellers and buyers equally free to bargain . . . . " BLACK'S LAW DICTIONARY 971 (6th ed. 1990). An attempt to define a market rate of interest in the bankruptcy context, however would be self−contradictory. No one willingly makes loans to insolvent debtors for an amount approaching 100% of the value of the collateral. *See In re* Overland Park Merchandise Mart Partnership, L.P., 167 B.R. 647, 656 (Bankr. D. Kan. 1994).

For the purpose of brevity, this Article will refer to interest rates rather than discount factors. The authors feel that although there are technical differences, from a practical standpoint there is no difference in using one term over the other.

FN7 *See, e.g.*, Financial Sec. Assurance, Inc. v. T−H New Orleans Ltd. Partnership (*In re* T−H New Orleans Ltd. Partnership), 188 B.R. 799, 808 (E.D. La. 1995) (determining that appropriate interest is market rate of interest on similar loans between typical borrowers and lenders plus risk factor); NCNB Texas Nat'l Bank v. Hulen Park Place Ltd. (*In re* Hulen Park Place Ltd.), 130 B.R. 39, 42 (N.D. Tex. 1991) (same); *In re* Westwood Plaza Apartments, 147 B.R. 692, 701 (Bankr. E.D. Tex. 1992) (finding appropriate interest rate in cramdown was prime rate plus risk factor); *In re* Computer Optics, Inc., 126 B.R. 664, 672 (Bankr. D.N.H. 1991) (same). Courts often use the term "discount rate" and "interest rate" interchangeably, as both refer to the time value of money. *See In re* Kellogg Square Partnership, 160 B.R. 343, 363 n.34 (Bankr. D. Minn. 1993) (using "interest rate" and "discount rate" as identifying time value of money); H.R. REP. NO. 595, 95th Cong., 1st Sess. 414 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6370 ("[I]f the interest rate paid is [equal] to the discount rate used, the present value and face future value will be identical.").

FN8 *See Computer Optics*, 126 B.R. at 672 (finding use of general riskless rate plus percentage adjustment to cover risk preferable calculation of rate). *Compare River Village*, 161 B.R. at 138−39 (rejecting "coerced loan" approach in favor of risk−free rate plus risk factor because of lack of sufficiently established market) *with General Motors Acceptance*, 999 F.2d at 70 (using "coerced loan" approach because of ease in determining existing market rate).

FN9 The following analysis of various methods used to determine the cramdown interest rate is applicable to a number of sections of the Code:

The present value language in § 1129(b)(2)(A)(i)(II) is virtually identical to the present value language appearing in several other sections of the Bankruptcy Code. *Compare* 11 U.S.C. §§ 1129(a)(7)(A)(ii) and (C), 1129(a)(9)(B)(i) and (C), *with* 11 U.S.C. §§ 1225(b)(1)(A), 1225(a)(5)(B)(ii), 1325(a)(4), 1325(a)(5)(B)(ii) and 1325(b)(1)(A). Thus, cases analyzing the appropriate interest rate in a present value analysis under any of these sections are instructive.

River Village, 161 B.R. at 135. [L]anguage similar to the language of § 1129(a)(9)(C) appears in 11 U.S.C. subsections 1129(a)(7) and 1129(b)(2)(A) . . . ." United States v. Camino Real Landscape Maintenance Contractors, Inc. (*In re* Camino Real Landscape Maintenance Contractors, Inc.), 818 F.2d 1503, 1504 n.1 (9th Cir. 1987). Since section "1225(a)(5)(B) and [§] 1325(a)(5)(B) are identical, . . . the provisions should be similarly construed." United States v. Arnold, 878 F.2d 925, 928 (6th Cir. 1989). Hence the analysis applied in the present case may also be useful to courts considering any of these sections.

FN10 *See*, *e.g.*, Farm Credit Bank v. Fowler (*In re* Fowler), 903 F.2d 694, 697 (9th Cir. 1990) (requiring rate of interest to be reasonable in light of risks involved); United States v. Doud, 869 F.2d 1144, 1146 (8th Cir. 1989) (agreeing that discount rate should take into account risks involved); *Camino*, 818 F.2d at 1504 (same); *In re* Snowden's Landscaping Co., 110 B.R. 56, 58 (Bankr. S.D. Ala. 1990) (allowing for recoupment of time value of money).

FN11 This basic concept, of paramount importance to understanding § 1129(b), essentially recognizes that a dollar in hand presently is more valuable than a dollar received in the future. 5 COLLIER ON BANKRUPTCY [[paragraph]]1129.03, at 1129−104 (Lawrence P. King ed., 15th ed. 1995). Thus, present value may in part be explained by the proposition that a dollar today is equal to a dollar in the future plus the rate of interest that dollar would earn. *Id.*; *see* H.R. REP. NO. 595, *supra* note 7, at 413, *reprinted in* 1978 U.S.C.C.A.N. at 6369 (recognizing "time value" of money); *see also In re* Montgomery Court Apartments, Ltd., 141 B.R. 324, 341 (Bankr. S.D. Ohio 1992) (finding that appropriate discount rate assessed by court assures value of claim will not be diluted by delay in payment).

FN12 *In re* Oaks Partners, Ltd., 135 B.R. 440, 445 (Bankr. N.D. Ga. 1991); *see In re* Cellular Information Sys., Inc., 171 B.R. 926, 939−40 (Bankr. S.D.N.Y. 1994) (recognizing three components of interest rates).

FN13 *See* General Elec. Mortgage Corp. v. South Village, Inc. (*In re* South Village, Inc.), 25 B.R. 987, 998 n. 20 (Bankr. D. Utah 1982) (discussing considerations underlying assessment of increased risk rate upon default). The initial interest rate is the rate agreed upon by borrower and lender to be paid over the life of the loan. *Id.* This rate is based upon the assumption that the principle would be repaid on time. *Id.*

FN14 JAMES C. VAN HORNE, FINANCIAL MARKET RATES AND FLOWS 111 (2d ed. 1984); *see In re* Overland Park Merchandise Mart Partnership, L.P., 167 B.R. 647, 657 (Bankr. D. Kan. 1994) (requiring dissenting creditors to be paid at rate that includes real rate plus anticipated inflation).

FN15 U.S. Treasury Bills reflect the first two components of an interest rate and constitute the market's prediction of the inflation rate over the term of the note. This is sometimes referred to as the risk−free rate and is used in many of the decisions as the base rate to which risk factors are added. *In re* Bloomingdale Partners, 155 B.R. 961, 983 (Bankr. N.D. Ill. 1993) (recognizing 10 year Treasury Bonds as applicable risk−free base rate).

FN16 The rate also bears on the feasibility analysis. For the purposes of this discussion, feasibility problems are ignored. As a practical matter, however, choosing the rate becomes critical. If the inflation and risk factors are set too high, the plan will not work. *See Overland Park*, 167 B.R. at 658−59 (stating that to comply with Code, plan must not grant creditor rate which returns more than 100% of present value of claim).

FN17 "The court may not confirm notwithstanding nonacceptance unless the proponent requests and the court may then confirm only if subsection (b) is complied with. The court may not rewrite the plan." H.R. REP. NO. 595, *supra* note 7, at 414, *reprinted in* 1978 U.S.C.C.A.N. at 6370. "It must merely decide whether the plan complies with the requirements of [§] 1129(b). If so, the plan is confirmed, if not the plan is denied confirmation." *Id.* In practice, however, some courts will allow a debtor to amend the plan at confirmation to provide whatever rate the court finds is the market. *E.g.*, *In re* DeMaggio, 175 B.R. 144, 152 (Bankr. D.N.H. 1994) (allowing modification of plan in order to comply with rate set by court); *In re* Landing Assocs., Ltd., 157 B.R. 791, 822−23 (Bankr. W.D. Tex. 1993) (same). The amendment is included in the order of confirmation. *Id.*

FN18 VAN HORNE, *supra* note 14, at 93−94; *see In re* River Village Assocs., 161 B.R. 127, 139 (Bankr. E.D. Pa. 1993), *aff'd*, 181 B.R. 795 (E.D. Pa. 1995).

FN19 *See generally* Aneel M. Pandey, *Determining Interest and Discount Rates Applicable to Secured Claims in the Specter of Bankruptcy Law*, 30 SAN DIEGO L. REV. 549, 562−63 (1993) (discussing efficient markets and their effects on lenders' ability and willingness to lend); *see also Bloomingdale Partners*, 155 B.R. at 984. Fair and equitable interest rates below those on standard loans are not acceptable in cramdown plan where the market was at least semi−efficient. *Id.*

FN20 *See* Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 560−65 (1984) (discussing "Efficient Market Hypothesis" and theorizing how prices in market reflect all available information).

FN21 VAN HORNE, *supra* note 14, at 110−11.

FN22 EUGENE BRIGHAM, FUNDAMENTALS OF FINANCIAL MANAGEMENT 114 (6th ed. 1992); VAN HORNE, *supra* note 14, at 101.

FN23 Fleet Finance, Inc. v. Ivey (*In re* Ivey), 147 B.R. 109, 113 (M.D.N.C. 1992) (citing *In re* Benford, 14 B.R. 157, 160 (Bankr. W.D. Ky. 1981)).

FN24 VAN HORNE, *supra* note 14, at 93−94.

FN25 *See In re* Overland Park Merchandise Mart Partnership, L.P., 167 B.R. 647, 657 (Bankr. D. Kan. 1994) (using consumer price index as inflation factor); Michael S. Knoll, *The Second Generation of Notes Indexed for Inflation*, 39 EMORY L.J. 499, 515 (1990) (stating real rate of interest varies and to compensate need index for anticipated rate of inflation).

FN26 *See* Waltraud S. Scott, Comment, *Deferred Cash Payments to Secured Creditors in Cramdown of Chapter 11 Plans: A Matter of Interest*, 63 WASH. L. REV. 1041, 1046 (1988). Bankruptcy courts do not need to make explicit findings about the real rate of interest and the market's inflation expectations because any market based interest rate

will necessarily take them into account. *In re* Oaks Partners, Ltd., 135 B.R. 440, 445−46 (Bankr. N.D. Ga. 1991).

FN27 Again, bankruptcy practice departs from the economic model on the issue of the risk factor. Obviously, the lender in bankruptcy has concluded that the risk factor is too great to extend the loan. The risk factor portion is considered by those courts which use the "formula approach" discussed *infra*, notes 104−35 and accompanying text.

FN28 *See* H.R. REP. NO. 595, *supra* note 7, at 415, *reprinted in* 1978 U.S.C.C.A.N. at 6371 (noting interest rate in plan product of arms−length negotiation).

FN29 VAN HORNE, *supra* note 14, at 40.

FN30 *Id.*

FN31 Although the term interest rate is used, the actual rate the lender or investor expects or desires to receive on a loan or investment of given characteristics is the "yield to maturity," which is defined as the discount rate that equates the present value of the expected cash inflows to the investor (or lender) with the investors (or lenders) current cash outlay. BLACK'S LAW DICTIONARY 1616 (6th ed. 1990).

FN32 Paul S. Anderson, *Costs and Profitability of Bank Functions*, NEW ENG. ECON. REV., Mar.−Apr. 1979, at 43, 58−59.

FN33 *Id*. at 43.

FN34 For a concise and thoughtful review of the interest rate theory, see Scott, *supra* note 26, at 1045−51.

FN35 *See* General Motors Acceptance Corp. v. Jones, 999 F.2d 63, 67 n.4, 71 (3d Cir. 1993) (maintaining interest rate in plan should reflect rate given to one similarly situated to debtor); United Carolina Bank v. Hall, 993 F.2d 1126, 1131 (4th Cir. 1993) (adopting rule that looks to secured creditor's lending market in determining appropriate rate); Hardzog v. Federal Land Bank (*In re* Hardzog), 901 F.2d 858, 860 (10th Cir. 1990) (recognizing that most courts follow market rate approach).

"Prime rate," while sometimes used as a benchmark, is not a market rate for the simple reason that few loans are made at prime, the majority being made at prime plus some percentage. While some cases use the prime rate as a starting point, it is not ideal for analysis because the prime rate is not a risk− free rate.

FN36 It is not clear where the phrase market rate came from. The earliest reported case to discuss the concept, *In re* Landmark at Plaza Park, Ltd., 7 B.R. 653, 657 (Bankr. D.N.J. 1980), refers to 5 COLLIER ON BANKRUPTCY [[paragraph]] 1129.03 (Lawrence P. King ed., 15th ed. 1980). One of the first decisions to use the phrase presented its reasoning for using the market rate in three sentences. Memphis Bank and Trust v. Whitman, 692 F.2d 427, 431 (6th Cir. 1982). Subsequent cases have apparently assumed that market rates are applicable. *See* United States v. Roso (*In re* Roso), No. 95−2435, 1996 WL 32589, at *2 (8th Cir. Jan. 30, 1996); United States v. Neal Pharmacal Co., 789 F.2d 1283, 1289 (8th Cir. 1986); United States v. Southern States Motor Inns, Inc. (*In re* Southern States Motor Inns, Inc.), 709 F.2d 647, 651 (11th Cir. 1983), *cert. denied*, 465 U.S. 1022 (1984); United States v. Welco Indus., Inc. (*In re* Welco Indus., Inc.), 60 B.R. 880, 883 (Bankr. 9th Cir. 1986). However, nothing in the language of § 1129(b) requires a market analysis and at least one case has concluded that the market rate analysis is simply not supported by the language of the statute. *See In re* Computer Optics, Inc., 126 B.R. 664, 670−73 (Bankr. D.N.H. 1991) (arguing "there is no `market' in the real world for `similar loans' when dealing with a reorganized entity"). If statutory analysis does not compel reference to market rates, the Supreme Court might adopt a formula approach in attempting to reconcile the different methods employed by the circuits that have considered the issue.

FN37 Thomas O. Depperschmidt, *Choosing the Proper Interest Rate in Bankruptcy Proceedings: Resolution of Special Issues in the Sixth, Eighth and Ninth Circuits*, 18 N. KY. L. REV. 457, 471 (1991).

FN38 General Motors Acceptance Corp. v. Lum (*In re* Lum), 1 B.R. 186, 188 (Bankr. E.D. Tenn. 1979).

FN39 *See, e.g., Roso*, 1996 WL 32589, at *2; General Motors Acceptance Corp. v. Jones, 999 F.2d 63, 71 (3d Cir. 1993); United Carolina Bank v. Hall, 993 F.2d 1126, 1129 (4th Cir. 1993); Travelers Ins. Co. v. Bryson Properties, XVIII (*In re* Bryson Properties, XVIII), 961 F.2d 496, 500 (4th Cir. 1992); Hardzog v. Federal Land Bank (*In re* Hardzog), 901 F.2d 858, 860 (10th Cir. 1990); United States v. Doud, 869 F.2d 1144, 1145 (8th Cir. 1989); United States v. Camino Real Landscape Maintenance Contractors, Inc. (*In re* Camino Real Landscape Maintenance Contractors, Inc.), 818 F.2d 1503, 1505 (9th Cir. 1987); *Neal Pharmacal Co.*, 789 F.2d at 1289; Prudential Ins. Co. of Am. v. Monnier (*In re* Monnier Brothers), 755 F.2d 1336, 1339 (8th Cir. 1985); *Southern States*, 709 F.2d at 652−53; *In re* Underwood, 87 B.R. 594, 599−601 (Bankr. D. Neb. 1988); *In re* Benford, 14 B.R. 157, 159 (Bankr. W.D. Ky. 1981) ("The touchstone of providing present value of a claim to be paid in the future is responsiveness to current market conditions.").

FN40 *Computer Optics*, 126 B.R. at 671.

FN41 *E.g., In re* Oaks Partners, Ltd., 135 B.R. 440, 444 (Bankr. N.D. Ga. 1991).

FN42 *See In re* Mitchell, 77 B.R. 524, 526 (Bankr. E.D. Pa. 1987).

FN43 *See Computer Optics*, 126 B.R. at 670−73 (finding no market for loans to debtors). A number of courts have concluded that where no market exists, some other formulation such as a work− out rate should be applied. *In re* Stratford Assocs. Ltd. Partnership, 145 B.R. 689, 701−03 (Bankr. D. Kan. 1992).

FN44 Jacobellis v. Ohio, 378 U.S. 184, 197 (1964).

FN45 147 B.R. 109 (M.D.N.C. 1992).

FN46 *Id.* at 114−18.

FN47 *Id.*

FN48 *Id*. at 118.

FN49 United Carolina Bank v. Hall, 993 F.2d 1126, 1130 (4th Cir. 1993).

FN50 *Id.* at 1130−31.

FN51 *Id.* at 1131. The bankruptcy court approved the use of a 10% rate based on the prime rate for North Carolina banks of 8.5% and added a 1.5% risk premium based on the debtor's characteristics. *Id*. at 1128. The district court rejected the bankruptcy court’s formula approach as not accurately reflecting the market and advocated using rates reported in consumer credit markets to determine the proper cramdown rate. *Id*. The district court then rejected this approach, apparently wary of giving the bank a windfall, and chose the original contract rate because it was less than the rates found in the consumer credit market. *Id*. The Fourth Circuit upheld the district court’s rejection of the formula approach. *Id*. at 1131.

FN52 *Id.* at 1128. The bankruptcy court’s approach used the prime rate charged by North Carolina banks as its base and added a risk premium. *Id*. The Fourth Circuit confused the bank’s prime rate, is a rate on which banks lend money, with the rate banks acquire capital. The bankruptcy court’s approach is based on the lending market of North Carolina banks and not United Carolina Bank’s deposit or borrowing rate. *Id*. The rate a bank charges its customers is not in any way a factor required in determining the bank’s cost of funds.

FN53 *Id.* at 1130. The court concluded it was more equitable to treat the value of collateral retained by the debtor as a new loan, matching the rate to what the lender would otherwise obtain in a lending market. *Id.*

FN54 *United Carolina Bank*, 993 F.2d at 1131.

FN55 United States v. Doud, 869 F.2d 1144, 1146 (8th Cir. 1989) (citing United States v. Neal Pharmacal Co., 789 F.2d 1283, 1286 n. 8 (8th Cir. 1986)).

FN56 *See In re* River Village Assocs., 161 B.R. 127, 135 (Bankr. E.D. Pa. 1993), *aff'd*, 181 B.R. 795 (E.D. Pa. 1995). "The Bankruptcy Code and its legislative history provide little guidance on how to determine the appropriate interest rate in a present value analysis." *Id.*

FN57 *See* Scott, *supra* note 26, at 1048. "Courts using Collier's market rate analysis have found that the market produces many interest rates. In applying . . . [the] . . . analysis they have developed several definitions of the relevant market." *Id.* (footnotes omitted).

FN58 *See, e.g.*, General Motors Acceptance Corp. v. Jones, 999 F.2d 63, 71 (3d Cir. 1993) (holding rate is that which secured lender would charge for loan similar in character, amount and duration).

FN59 The decisions in United States v. Neal Pharmacal Co., 789 F.2d 1283 (8th Cir. 1986), United States v. Southern States Motor Inns, Inc. (*In re* Southern States Motor Inns, Inc.), 709 F.2d 647 (11th Cir. 1983), *cert. denied*, 465 U.S. 1022 (1984), United States v. Welco Indus., Inc. (*In re* Welco Indus., Inc.), 60 B.R. 880 (9th Cir. 1986) and Memphis Bank & Trust Co. v. Whitman, 692 F.2d 427 (6th Cir. 1982), "all reverse[d] efforts by bankruptcy judges to render a pragmatic determination of the interest rates based on at least some semblance of an objective measurement." *In re* Mitchell, 77 B.R. 524, 528 (Bankr. E.D. Pa. 1987).

FN60 *See* Scott, *supra* note 26, at 1048−51 (determining that courts have applied market rate theory differently). The courts have used other approaches: The cost of funds approach is designed to reimburse creditors for not receiving the value of their claim on the date of confirmation. *See In re* Jordan, 130 B.R. 185, 190 (Bankr. D.N.J. 1991); Campbell v. Ford Motor Credit Co. (*In re* Campbell), 16 B.R. 496, 497 (Bankr. N.D. Ill. 1982). Courts adopting this approach attempt to mitigate the damages to the creditor for not immediately receiving the value of their claim. The cost of funds approach requires the court to set the rate equal to what it will cost the creditor to replace that value. Todd J. Zywicki, *Cramdown and the Code: Calculating Cramdown Interest Rates Under the Bankruptcy Code*, 19 T. MARSHALL L. REV. 241, 253 (1994). The cost of funds approach, however, has been the subject of criticism. *See General Motors Acceptance*, 999 F.2d at 69 n.9; United Carolina Bank v. Hall, 993 F.2d 1126, 1130 (4th Cir. 1993) (stating "[a] major difficulty with this approach . . . is its underlying assumption that the secured creditor has an unlimited supply of credit"); Fleet Fin., Inc. v. Ivey (*In re* Ivey), 147 B.R. 109, 113 n.12 (M.D.N.C. 1992) ("Recent caselaw suggests that the majority of courts have abandoned the `cost of funds approach'. . . .") (citing *In re* Mellema, 124 B.R. 103, 105 (Bankr. D. Colo. 1991)). Other courts have variously used the federal judgment rate or the IRS judgment rate in confirming plans. *See In re* Tacoma Recycling, Inc., 23 B.R. 547, 549 (Bankr. W.D. Wash. 1982) (finding IRS rate to be prima facie evidence of appropriate discount rate if indicative of market conditions); *In re* Strong, 12 B.R. 221, 224−25 (Bankr. W.D. Tenn. 1981) (using IRS rate to compare discount rate).

FN61 Another theory has recently emerged as a basis for determining the market: A Band of Investment analysis requires the amount of the loan be divided into first and second priority components based on the loan−to−value ratio required by the lender. *See In re* SM 104 Ltd., 160 B.R. 202, 233−34 (Bankr. S.D. Fla. 1993) (employing "Band of Investment" theory); *In re* Bloomingdale Partners, 155 B.R. 961, 984−85 (Bankr. N.D. Ill. 1993) (same). Banded rates were used in *In re* Birdneck Apartment Assocs., II, L.P., 156 B.R. 499 (Bankr. E.D. Va. 1993), to account for the increased risk to the lender for loans made with a 100% loan−to−value ratio. *Id.* at 509. The rates for each band are blended together into a weighted average rate for the entire loan. *See SM 104*, 160 B.R. at 233. The first component represents the amount the lender would typically lend against the collateral. *Id.* The second component is the reciprocal of the first component and represents the minimum equity the debtor must have in the property in order to acquire the loan at the lenders most favorable rates. *Id.* Any funds lent beyond the loan to value ratio will require a higher interest rate, because the lenders preferred equity cushion is diminished. *Id.* Since a debtor in reorganization is presumed as seeking a 100% loan, the second priority funds, which represent what is normally the debtor’s equity in the collateral, will require a higher rate of return than the first priority funds. *Birdneck Apartment*, 156 B.R. at 510−11.

FN62 *See, e.g.*, United States v. Arnold, 878 F.2d 925, 928 (6th Cir. 1989) (recognizing that coercion is necessary since no lender will willingly make loan); *Southern States*, 709 F.2d at 652 n.7 (same); *Memphis Bank*, 692 F.2d at

431 (same).

FN63 *In re* Memphis Partners, L.P., 99 B.R. 385, 387 (Bankr. M.D. Tenn. 1989).

FN64 5 COLLIER, *supra* note 11, [[paragraph]] 1129.03, at 1129−104.

FN65 *See* Fleet Fin., Inc. v. Ivey (*In re* Ivey), 147 B.R. 109, 115−16 (M.D.N.C. 1992) (finding coerced loan approach seriously flawed); *In re* Collins, 167 B.R. 842, 845 (Bankr. E.D. Tex. 1994) (declining to follow coerced loan theory); *In re* Computer Optics, Inc., 126 B.R. 664, 671 (Bankr. D.N.H. 1991) (stating that *Collier's* reference to "coerced loan" has skewed analysis of present value).

FN66 *See Collins*, 167 B.R. at 845; *Fleet Fin.*, 147 B.R. at 116. Moreover, the Supreme Court has apparently rejected lost opportunity costs as a factor:

Distilled to its barest essence, the coerced loan theory is an argument for compensating the creditor for lost opportunity costs which result when the creditor is denied the ability to immediately seize and liquidate its collateral. In *United Sav. Assoc. of Texas v. Timbers Inwood of Forest Assocs., Ltd.*, 484 U.S. 365, . . . (1988) a similar argument was rejected . . . . The basis of the creditor's position rested on the argument that one of the interests in property enjoyed by a creditor consisted of the right to seize the property of a debtor in default and liquidate it. The proceeds of this liquidation could then be used in more immediate investment vehicles . . . . In *Timbers*, adequate protection was held not to encompass the prevention of lost opportunity costs on behalf of a creditor . . . . [T]he concepts of present value and adequate protection are the same, they serve to protect the status quo.

Collins, 167 B.R. at 845−46.

FN67 Zywicki, *supra* note 60, at 257−58. An argument against the new loan approach is that it is unrealistic; it requires "the calculation of an interest rate on a purely hypothetical loan, but a hypothetical loan that has no real−world counterpart . . . . [I]t is unlikely that any lender would voluntarily lend on a one−to−one loan to value ratio, as is the case in a cramdown forced loan." *Id.* at 257−58 (footnotes omitted).

FN68 General Motors Acceptance Corp. v. Jones, 999 F.2d 63, 68 (3d Cir. 1993) (examining coerced loan approach in chapter 13 context and determining that appropriate rate is that charged by creditor forced to extend credit).

FN69 Cardinal Fed. Sav. & Loan Assoc. v. Colegrove (*In re* Colegrove), 771 F.2d 119, 123 (6th Cir. 1985)

FN70 Hardzog v. Federal Land Bank (*In re* Hardzog), 901 F.2d 858, 860 (10th Cir. 1990); Memphis Bank & Trust Co. v. Whitman, 692 F.2d 427, 431 (6th Cir. 1982); *In re* Shannon, 100 B.R. 913, 939 (S.D. Ohio 1989).

FN71 *In re* Wolf, 61 B.R. 1010, 1012 (Bankr. N.D. Iowa 1986) ("Otherwise a creditor who exacts exorbitant interest rates would automatically be guaranteed the same rates in [c]hapter 11 reorganization. The irony of such a result under a `fair and equitable' standard is apparent.").

FN72 901 F.2d 858 (10th Cir. 1990).

FN73 *In re* Stratford Assocs. Ltd. Partnership, 145 B.R. 689, 702 (Bankr. D. Kan. 1992).

FN74 General Motors Acceptance Corp. v. Hyden (*In re* Hyden), 10 B.R. 21, 28 (Bankr. S.D. Ohio 1980); *see also* United States v. Southern States Motor Inns, Inc. (*In re* Southern States Motor Inns, Inc.), 709 F.2d 647, 651 (11th Cir. 1983) (acknowledging bankruptcy courts have not agreed on method for determining appropriate rate of interest), *cert. denied*, 465 U.S. 1022 (1984).

FN75 *In re* Aztec Co., 99 B.R. 388, 391 (Bankr. M.D. Tenn. 1989).

FN76 *Cf. In re* Computer Optics, Inc., 126 B.R. 664, 670−72 (Bankr. D.N.H. 1991) (pointing out that there is no real market for such loans).

FN77 Hardzog v. Federal Land Bank (*In re* Hardzog), 901 F.2d 858, 859 (10th Cir. 1990).

FN78 Id. at 859−60 (citations omitted).

FN79 *See id.* at 860 (stating that "market rate should be easily susceptible of determination"); Memphis Bank & Trust Co. v. Whitman, 692 F.2d 427, 431 (6th Cir. 1982) (stating interest rates "can easily be deduced").

FN80 See In re River Village Assocs., 161 B.R. 127, 137 (Bankr. E.D. Pa. 1993) (explaining that both *Hardzog* and *Whitman* relied on familiarity bankruptcy courts have with rates of similar loans), *aff'd*, 181 B.R. 795 (E.D. Pa. 1995).

FN81 Hardzog, 901 F.2d at 860. Just how this reference to the trier of facts' knowledge of economic conditions gets included in the trial record is not clear, nor is it clear how an appellate court can review a decision based in part on this general familiarity.

FN82 In re Mitchell, 77 B.R. 524, 528 (Bankr. E.D. Pa. 1987) (referring to *Memphis Bank*).

FN83 *Id.*

FN84 *Id.*

FN85 In re Jordan, 130 B.R. 185, 189 (Bankr. D.N.J. 1991); *see also Mitchell*, 77 B.R. at 527 ("[T]he term `market rate' is an illusory and practically meaningless concept unless a particular `market' is designated as a referent.").

FN86 A number of courts have had experts testify that no market exists for 100% loans with an untrustworthy credit history. *See In re* Aztec Co., 99 B.R. 388, 391 (Bankr. M.D. Tenn. 1989) (finding no market for loan with such characteristics); *see also In re* P.J. Keating Co., 168 B.R. 464, 472 (Bankr. D. Mass. 1994) ("[N]o market exists for the typical cram down loan . . . a forced loan to a borrower with a history of financial problems that is secured by collateral having a liquidation value barely enough to cover the loan."); *In re* Villa Diablo Assocs., 156 B.R. 650, 655 (Bankr. N.D. Cal. 1993) ("There is . . . no market which can quote terms for . . . the `cram down' loans Congress provided for in [c]hapters 11, 12 and 13 of the Bankruptcy Code."); *In re* Bloomingdale Partners, 155 B.R. 961, 977 (Bankr. N.D. Ill. 1993) ("An efficient `market' does not exist for loans equalling 100% of the value of collateral."); *In re* Eastland Partners Ltd. Partnership, 149 B.R. 105, 106 (Bankr. E.D. Mich. 1992) ("The parties agree that there is essentially no current market for similar loans.")

FN87 126 B.R. 664 (Bankr. D.N.H. 1991).

FN88 *Id.* at 672.

FN89 *See* Fleet Fin., Inc. v. Ivey (*In re* Ivey), 147 B.R. 109, 115 (M.D.N.C. 1992) (discussing fundamental problems with coerced loan theory).

FN90 *Id.*

FN91 *See* Hardzog v. Federal Land Bank (*In re* Hardzog), 901 F.2d 858, 860 (10th Cir. 1990) (suggesting use of hearings); Memphis Bank & Trust Co. v. Whitman, 692 F.2d 427, 431 (6th Cir. 1982) (stating proof can easily be adduced).

FN92 Jack Friedman, *What Courts Do to Secured Creditors in Chapter 11 Cram Down*, 14 CARDOZO L. REV. 1495, 1519 (1993). "The market rate is based on abstract groups of transactions between generalized debtors and creditors. Thus, the market rate granted by the courts is based upon a hypothetical `typical' borrower and a hypothetical `typical' lender. . . ." *Id.*; *see also In re* Birdneck Apartment Assocs., II, L.P., 156 B.R. 499, 509 (Bankr.

E.D. Va. 1993) (stating that "[creditor's] expert witness analyzed the debtor's proposal from a hypothetical refinancing perspective").

FN93 See In re Kellogg Square Partnership, 160 B.R. 343, 364 (Bankr. D. Minn. 1993) (discussing creditor's expert witness testimony); *In re* Oaks Partners, Ltd., 135 B.R. 440, 444−45 (Bankr. N.D. Ga. 1991) (stating creditors will induce experts to "testify there is no market" for proposed coerced loan); *In re* Wolf, 61 B.R. 1010, 1012 (Bankr. N.D. Iowa 1986) (referring to statement by creditor's expert witness that no lender would make such loan).

FN94 *In re* River Village Assocs., 161 B.R. 127, 138 (Bankr. E.D. Pa. 1993), *aff'd*, 181 B.R. 795 (E.D. Pa. 1995).

[T]he secured creditor could . . . present expert testimony that no lender would make a loan which is comparable . . . [to] the plan. The expert would then propose some high interest rate that a lender would require if it were to make such a loan. It is likely that the proposed rates . . . would be high enough to render the debtor's plan infeasible . . . [then] the court could not cram down the proposed plan.

Id.; *see also Birdneck Apartment*, 156 B.R. at 508−09 ("To deny confirmation because there is no actual market . . . would in effect be giving the market permission to repeal § 1129(b)(2)."); *In re* Eastland Partners Ltd. Partnership, 149 B.R. 105, 106 (Bankr. E.D. Mich. 1992) (stating that denying confirmation due to expert testimony is equal to repealing § 1129(b)(2)).

FN95 Kellogg Square, 160 B.R. at 366.

FN96 *See* Scott, *supra* note 26, at 1044 ("The threat of higher rates required in cram down increases the secured creditor's bargaining power during negotiations over the reorganization plan.").

FN97 Zywicki, *supra* note 60, at 265 (footnote omitted).

FN98 MONA J. GARDNER & DIXIE L. MILLS, MANAGING FINANCIAL INSTITUTIONS 376 (1991).

FN99 *Id.*

FN100 H.R. REP. NO. 595, *supra* note 7, at 220, *reprinted in* 1978 U.S.C.C.A.N. at 6180.

FN101 *See id.* at 220−24, *reprinted in* 1978 U.S.C.C.A.N. at 6179−83.

FN102 *In re* Villa Diablo Assocs., 156 B.R. 650, 655 (Bankr. N.D. Cal. 1993).

FN103 *See In re* Landing Assocs., Ltd., 157 B.R. 791, 821 (Bankr. W.D. Tex. 1993) (finding cramdown rate "ought to refer to a workout rate"); *In re* Stratford Assocs. Ltd. Partnership, 145 B.R. 689, 703 (Bankr. D. Kan. 1992) (holding market rate means market rate in similar situations).

FN104 *See* Farm Credit Bank v. Fowler (*In re* Fowler), 903 F.2d. 694, 696− 98 (9th Cir. 1990) (discussing risk factor approach); United States v. Doud, 869 F.2d 1144, 1144 (8th Cir. 1989) (affirming bankruptcy court's decision to add 2% adjustment for risk); United States v. Camino Real Landscape Maintenance Contractors, Inc. (*In re* Camino Real Landscape Maintenance Contractors, Inc.), 818 F.2d 1503, 1508 (9th Cir. 1987) (affirming risk factor adjustments); *In re* River Village Assocs., 161 B.R. 127, 135−39 (Bankr. E.D. Pa. 1993) (finding proper rate includes risk factor); *Villa Diablo*, 156 B.R. at 653 (applying formula approach).

FN105 See *Fowler*, 903 F.2d at 698 (stating risk premium is based on risk of default and nature of security); *Doud*, 869 F.2d at 1146 (stating that interest rate "should consist of a risk−free rate, plus additional interest to compensate . . . for risks"). Since the formula approach is consistent with the method financial institutions use to price loans and utilizes a market rate as its base, it satisfies the requirement that the rate must be a market rate. *In re* Aztec Co., 99 B.R. 388, 391 (Bankr. M.D. Tenn. 1989) (determining risk premium would be added by lender anyway); *In re* Underwood, 87 B.R. 594, 599 (Bankr. D. Neb. 1988) (concluding that differences between coerced loan approach and

formula approach are largely superficial).

FN106 *See In re* Shannon, 100 B.R. 913, 937 (S.D. Ohio 1989) (examining use of rates by various courts); *see also In re* Eastland Partners Ltd. Partnership, 149 B.R. 105, 107−08 (Bankr. E.D. Mich. 1992) (using treasury rate); *In re* Cellular Info. Systems, Inc., 171 B.R. 926, 944 (Bankr. S.D.N.Y. 1994) (using the London Inter Bank Offer Rate (LIBOR) as risk free rate in conjunction with banded rates within formula approach).

FN107 *See*, *e.g.*, *Eastland*, 149 B.R. at 107 ("The cases arrive at a variety of interest rates applied in different circumstances with different kinds of properties.").

FN108 In re P.J. Keating Co., 168 B.R. 464, 473 (Bankr. D. Mass. 1994) (concluding 4% above prime proper).

FN109 *In re* Jordan, 130 B.R. 185, 192 (Bankr. D.N.J. 1991). The court refused to add any risk adjustments on the basis that any assessment of the riskiness of the debtor is necessarily arbitrary and that the language of the Code does not contemplate any risk of noncompliance with the plan. *Id.*

FN110 *In re* Landing Assocs., Ltd., 157 B.R. 791, 822 (Bankr. W.D. Tex. 1993).

FN111 *In re* Orosco, 77 B.R. 246, 253 (Bankr. N.D. Cal. 1987).

FN112 Memphis Bank & Trust Co. v. Whitman, 692 F.2d 427, 429 (6th Cir. 1982) (discussing legislative history behind comparable chapter 13 provision requiring court to assess present value of collateral to avoid its dilution.)

FN113 See 11 U.S.C. § 1129(b)(2)(A)(i), (iii) (1994). Section 1129(b)(2)(A)(iii) requires that secured creditors not accepting the plan be provided with the "indubitable equivalent" of their claim. *Id. See also* Prudential Ins. Co. of Am. v. Monnier (*In re* Monnier Brothers), 755 F.2d 1336, 1338−39 (8th Cir. 1985) (acknowledging that creditor must receive indubitable equivalent).

FN114 *See* Metropolitan Life Ins. Co. v. Murel Holding Corp. (*In re* Murel Holding Corp.), 75 F.2d 941, 942 (2d Cir. 1935).

"[A]dequate protection" must be completely compensatory; and that payment ten years hence is not generally the equivalent of payment now. Interest is indeed the common measure of the difference, but a creditor who fears the safety of his principal will scarcely be content with that . . . unless by a substitute of the most indubitable equivalence.

Id.

FN115 The legislative history of §1129 makes it clear that the "indubitable equivalent" standard comes from *Murel*. S. REP. NO. 989, 95th Cong., 2d Sess. 127 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5913. *Murel*, in part, stands for the proposition that courts must provide adequate protection for secured creditors' interests, which means that they must receive either their collateral or the "indubitable equivalent". *Murel*, 75 F.2d at 942. Adequate protection is defined in § 361 of the Code, and the legislative history for that section has been interpreted to require an independent judicial assessment of risk to the creditor. Martin v. United States (*In re* Martin), 761 F.2d 472, 477 (8th Cir. 1985) (interpreting legislative history as requiring courts to make independent evaluation of debtor's risk to creditor to ensure that creditor's "bargained for risks" are protected).

FN116 75 F.2d 941 (2d Cir. 1935).

FN117 S. REP. NO. 989, *supra* note 115, at 127, *reprinted in* 1978 U.S.C.C.A.N. at 5913. "The indubitable equivalent language is intended to follow the strict approach taken by Judge Learned Hand in *In re Murel* . . . . " *Id.*

FN118 *See Murel*, 75 F.2d at 942−43.

FN119 484 U.S. 365 (1988).

FN120 *Id.* at 377 (rejecting creditor's assertion that "adequate protection" means creditor is entitled to compensation for period of stay).

FN121 *In re* Collins, 167 B.R. 842, 846 (Bankr. E.D. Tex. 1994).

FN122 *Timbers*, 484 U.S. at 377−78.

FN123 *See* Prudential Ins. Co. of Am. v. Monnier (*In re* Monnier Brothers), 755 F.2d 1336, 1338−39 (8th Cir. 1985) (finding that plan adequately protected creditor).

FN124 *In re* Fisher, 29 B.R. 542, 544 (Bankr. D. Kan. 1983) (stating that advocates of coerced loan theory admit contract rate of interest includes premium, administrative costs, profit and other elements).

FN125 *See* Alfred G. Adams, Jr., *The Mortgagee's Guide To Single Asset Bankruptcy Reorganizations*, 98 COM. L.J. 350, 375 (1993) (explaining that formula approach includes risk−free rate plus adjustment for risks associated with debtor); *see also* 5 COLLIER, *supra* note 11, [[paragraph]] 1129.03, at 1129−107 (stating that risk is component of adequate rate).

FN126 GARDNER & MILLS, *supra* note 98, at 323−28.

FN127 In re Sherwood Square Assocs., 107 B.R. 872, 884 (Bankr. D. Md. 1989). In *Sherwood*, the court denied confirmation of the plan because the interest rate was not fair and equitable. *Id.* at 886.

FN128 In re Collins, 167 B.R. 842, 847 (Bankr. E.D. Tex. 1994) (overruling creditor's objection to debtor's proposed interest rates).

FN129 In re Fisher, 29 B.R. 542, 546 (Bankr. D. Kan. 1983) (asking what lender would charge borrower if profit removed, all other costs reduced, and adequate protection assured).

FN130 135 B.R. 440 (Bankr. N.D. Ga. 1991).

FN131 *Id*. at 447.

FN132 818 F.2d 1503 (9th Cir. 1987).

FN133 *Id*. at 1508.

FN134 In re Sherwood Square Assocs., 107 B.R. 872, 884−85 (Bankr. D. Md. 1989).

FN135 *See* Scott, *supra* note 26, at 1043−45 (discussing court's role in interest rate disputes).

FN136 *See* Roger S. Cox, *Bankruptcy & Creditors' Rights*, 48 SMU L. REV. 875, 909 (1995) (stating that for some time common practice has been to use variable interest rates in commercial loan transactions).

FN137 *See* Griffith L. Garwood et al., *Consumer Disclosure in the 1990s*, 9 GA. ST. U. L. REV. 777, 791 (1993) (discussing increased risk with variable rate); *cf. In re* Immenhausen Corp., 172 B.R. 343, 348 (Bankr. M.D. Fla. 1994) (holding plan not feasible because debtor had "too much debt and too little cash flow to service secured and unsecured claims").

FN138 *See* Garwood et al., *supra* note 137, at 791 (stating that variable interest rate transactions are inherently more risky than fixed).

FN139 Using the present value principles discussed at the beginning of this Article, *see supra* notes 9−15 and accompanying text, if one could determine exactly the risk and amount of the loss and the date it would occur, this

would create a factor which when added to the risk− free rate, would equal present value. While this is not possible with mathematical certainty, it does focus the issue on loss or delay to the creditor, rather than default alone.