K&L ALERT

Bankruptcy

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United States Supreme Court Rules on the Appropriate Interest Rate to be Utilized in a Bankruptcy "Cram Down" Plan

On May 17, 2004, the United States Supreme Court handed down an extremely important decision attempting to resolve a split among various courts as to the appropriate interest rate to be utilized by a bankrupt debtor against a secured lender in a "cram down" plan. *Till v. SCS Credit Corp.*, ___ S. Ct. __, 2004 WL 1085321 (2004).

BACKGROUND OF LEGAL ISSUE PRESENTED IN *TILL V. SCS CREDIT CORP.*

Chapters 11 and 13 of the Bankruptcy Code permit bankrupt debtors to confirm bankruptcy plans that force secured lenders to accept treatment of their indebtedness against their will, within certain statutory guidelines. This type of plan is typically referred to as a "cram down" plan. One of the statutory requirements of a "cram down" plan is that the debtor's proposed treatment of the secured lender must provide for payments to the lender over time whose total value, as of the plan's confirmation date, "is not less than the [claim's] allowed amount." This statutory provision, in turn, requires that the creditor receive disbursements whose total present value equals or exceeds the allowed secured claim. To satisfy these requirements, courts require a debtor's plan to provide the secured lender with a rate of interest that will provide to such lender the equivalent of the present value of the lender's allowed secured claim.

METHODS USED BY COURTS TO DETERMINE THE APPROPRIATE INTEREST RATE PRIOR TO *TILL V. SCS CREDIT CORP.*

Since the Bankruptcy Code does not specify what rate of interest is appropriate, courts have wrestled with the appropriate methodology to determine the rate of interest that must be paid by a debtor in a bankruptcy plan to satisfy statutory confirmation requirements. Various bankruptcy courts, federal district courts and federal courts of appeal have adopted a number of approaches to fill in the blanks left by the Bankruptcy Code as to the appropriate rate. These approaches, all discussed in the three Supreme Court opinions in *Till v. SCS Credit Corp.*, include the formula approach, the coerced loan approach, the presumptive contract rate approach, and the cost of funds approach.

TILL V. SCS CREDIT CORP.

The particular facts addressed by the Supreme Court in *Till v. SCS Credit Corp.* involved a Chapter 13 (or individual debt adjustment) plan. However, at least the plurality opinion, authored by Justice Stevens, found it likely that Congress intended bankruptcy courts to follow essentially the same approach when choosing an appropriate interest rate under other Chapters of the Bankruptcy Code, including Chapter 11.

Under the facts before the Court, the debtor's plan had proposed the lender an interest rate of 9.5% on its secured claim, a rate that was reached by augmenting the national prime rate of 8% to account for the nonpayment risk posed by borrowers in petitioners'

financial position. In confirming the plan, the bankruptcy court overruled the lender's objection that it was entitled to its contract interest rate of 21%. The district court reversed, ruling that the 21% rate was appropriate because cram down rates must be set at the level the creditor could have obtained had it foreclosed on the loan, sold the collateral, and reinvested the proceeds in equivalent loans. This approach is commonly referred to as the "coerced loan" approach. The Seventh Circuit Court of Appeals adopted even a different approach, holding that the original contract rate was a "presumptive rate" that could be challenged with evidence that a higher or lower rate should apply, and remanding the case to the bankruptcy court to afford the parties an opportunity to rebut the presumptive 21% rate. A dissenting opinion in the Seventh Circuit case proposed yet another approach, the "cost of funds rate," which focuses on what it would cost the creditor to obtain the cash equivalent of the collateral from another source.

On appeal to the Supreme Court, the issue squarely before the Court was the appropriate test to be adopted in a bankruptcy "cram down" scenario for a bankruptcy court to determine which rate of interest satisfies the statutory requirement of plan confirmation. The resolution of the issue, however, was not so square. Instead, three separate opinions were offered by Justice Stevens (writing the plurality opinion on behalf of four justices), Justice Thomas (concurring on his own), and Justice Scalia (dissenting with the Court's judgment on behalf of four justices). These opinions do not contain a majority voice definitively adopting any of the specific interest rate approaches developed by the lower courts. Under principles of Supreme Court plurality opinion interpretation, "[w]hen a fragmented Court decides a case and no single rationale explaining the result enjoys the assent of five Justices, the holding of the Court may be viewed as that position taken by those Members who concurred in the judgments on the narrowest grounds." *Marks v. United States,* 430 U.S. 188, 193, 97 S.Ct. 990 (1977). Therefore, to discern any holding from the *Till* decision, some degree of analysis of each of the three opinions becomes necessary.

Justice Stevens' plurality opinion rejected the coerced loan, presumptive contract rate, and cost of funds approaches utilized by the lower courts, and concluded that the appropriate formula to determine the appropriate interest rate in a "cram down" plan begins with the national prime rate, and thereafter makes certain adjustments based on various market factors. The plurality opinion found that the Bankruptcy Code does not give much guidance as to the manner in which the appropriate rate should be calculated. The promise of future payments to a lender is obviously worth less than an immediate lump sum payment, due to lost opportunity and the risks of inflation and nonpayment. In the marketplace, lenders look to the national prime rate, which reflects the financial market's estimate of the amount a commercial bank should charge a creditworthy commercial borrower to compensate for the loan's opportunity costs, the inflation risk, and relatively slight default risk. Likewise, the plurality opinion believed that a bankruptcy court should begin with the prime rate, and make adjustments to account for the greater nonpayment risk that bankrupt debtors typically pose. Such adjustments should take into consideration various factual circumstances that would require the bankruptcy court to hold a hearing to permit the debtor and creditors to present evidence about the appropriate risk adjustment. Factors that a bankruptcy court should take into consideration in determining the appropriate risk adjustment include the circumstances of the estate, the nature of the security, and the duration and feasibility of the reorganization plan.

Justice Thomas' concurring opinion, unlike those of the eight other Justices, did not believe that the plain meaning of the present value requirement of the appropriate Chapter 13 plan confirmation statute required any analysis regarding risk. Instead, stated Justice Thomas, a creditor receives the present value of its claim only if the total amount of the deferred payments includes the amount of the underlying claim plus an appropriate amount of interest to compensate the creditor for the decreased values of the claim *caused by the delayed payments*. In most, if not all cases, Justice Thomas believed that the Bankruptcy

Code's present value requirement is met where a bankruptcy plan proposes to simply pay a cash stream with the appropriate risk-free rate of interest, which would be most closely approximated by the prime rate.

Justice Scalia's dissenting opinion agreed with the plurality on a number of points of analysis, most notably that deferred payments must compensate for risk in order to meet the requirements of the relevant Bankruptcy Code provisions. However, the dissenting opinion sharply disagreed with the beginning point of the analysis as the prime rate of interest. Instead, Justice Scalia would have bankruptcy courts begin with the contract rate of interest as the starting point, to which a presumption would attach, only to be defeated by an evidentiary showing of a more appropriate rate. This starting point, according to the dissent, would more appropriately compensate a creditor for the actual risk of the bankruptcy plan.

Given the lack of a clear majority, the holding of the Court is difficult to discern. Utilizing the Court's plurality interpretive devices contained in *Marks*, several points of agreement of majority members may be significant. First, five Justices agreed that the presumptive contract rate is not the appropriate rate. Second, eight of the Justices agreed that risk of default must be taken into consideration when determining whether a secured creditor is receiving the present value of its claim in a Chapter 13 bankruptcy plan. Third, five of the Justices agreed that the prime rate of interest is the foundation of the analysis (with the plurality adding on for risk, and Justice Thomas ending there). Fourth, five of the Justices seem to agree that the appropriate rate is *no more* than the formula of the prime rate plus add-ons for risk. Which of these apparent points of agreement come to be viewed as "holdings" of the Court remains to be seen. In the mean time, without crystal clear guidance from the Supreme Court, it is likely that lower courts will remain split in their analysis of the issue. Only a change in the statute by Congress or a more decisive ruling from the Supreme Court will finally resolve the question.

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