American Bankruptcy Institute

10th Annual
Southeast Bankruptcy Workshop

Determining Cram Down Interest Rates Post-Till
by
Honorable Michael G. Williamson
United States Bankruptcy Court
Tampa, Florida

***   *   ***

Kiawah Island Resort
South Carolina
July 27 - 30, 2005

American Bankruptcy Institute

Determining Cram Down Interest Rates Post-Till

by
Honorable Michael G. Williamson
United States Bankruptcy Court
Tampa, Florida

I. Approaches in Deriving Cram Down Interest Rates.

A. Formula approach.

The formula approach starts with a base rate such as prime and then adds points for risk. The formula approach was adopted by the Second Circuit in *In re Valenti*, 105 F.3d 55, 64 (2nd Cir. 1997) and by the Tenth Circuit in *In re Hardzog*, 901 F.2d 858, 860 (10th Cir. 1990).

B. Coerced loan approach.

There are two variations of the "coerced loan approach." One variation is that the interest rate in a cram down is the same as the creditor would receive if it could foreclose and reinvest the proceeds in loans of equivalent duration and risk. *See, e.g*., *Koopmans v. Farm Credit Servs*., 102 F.3d 874, 875 (7th Cir. 1996).

Another variation of this approach is to look to the rate that the debtor would pay outside bankruptcy to obtain a loan on terms comparable to the terms proposed in the plan. David G. Epstein, *Don't Go and Do Something Rash About Cram Down Interest Rates*, 49 Ala. L. Rev. 435, 442 (1998). The coerced loan approach was adopted by the Fourth, Sixth, Seventh, and Eleventh Circuits. See Epstein, 49 Ala. L. Rev. at 443.

C. Cost of funds approach.

Under this approach, the rate is determined based on what interest the creditor would have to pay to borrow the funds. No circuits have adopted the cost of funds approach.

D. Presumptive contract rate approach.

Under this approach, the court begins with the pre-petition contract rate, which creates a rebuttable presumption that either the creditor or the debtor can counter by persuasive evidence that the current rate is a different rate. *In re Smithwick*, 121 F.3d 211, 214 (5th Cir. 1997). This approach appears to be a variation on the coerced loan approach with the addition of the presumption.

II. *Till v. SCS Credit Corp.*, 124 S.Ct. 1951 (U.S. 2004).

A. Procedural Background.

1. In *Till*, 124 S. Ct. 1951 (2004), the Supreme Court had a typical chapter 13 case in which the debtors sought to "cram down" the lender that financed their truck. Under a cram down, the debtor must provide the creditor deferred cash payments whose total "value, as of the effective date of the plan, ... is not less than the allowed amount of such claim." *Till*, 124 S. Ct. at 1955 (citing 11 U.S.C. § 1325(a)(5)). In *Till*, the debtors' truck had a stipulated value of $4,000. The debtors proposed to pay this amount over the term of their chapter 13 plan with interest of 9.5 percent per year. The debtors arrived at this "prime-plus" or "formula rate" by augmenting the national prime rate of approximately 8 percent (applied by banks when making low-risk loans) to account for the risk of nonpayment posed by borrowers in their financial position.

2. The finance company objected to the proposed rate, contending that the company was "entitled to interest at the rate of 21%, which is the rate ... it would obtain if it could foreclose on the vehicle and reinvest the proceeds in loans of equivalent duration and risk as the loan" originally made to petitioners. *Till*, 124 S. Ct. at 1956.

3. At the hearing on its objection, the lender presented expert testimony establishing that it uniformly charges 21 percent interest on so-called "subprime" loans, or loans to borrowers with poor credit ratings, and that other lenders in the subprime market also charge that rate. The debtors countered with the testimony of an economics professor, who acknowledged that he had only limited familiarity with the subprime auto lending market, but described the 9.5 percent formula rate as "very reasonable" given that chapter 13 plans are "supposed to be financially feasible." *Id*. at 1957.

4. The District Court reversed. It understood Seventh Circuit precedent to require that bankruptcy courts set cram down interest rates at the level the creditor could have obtained if it had foreclosed on the loan, sold the collateral, and

reinvested the proceeds in loans of equivalent duration and risk. Citing respondent's unrebutted testimony about the market for subprime loans, the court concluded that 21 percent was the appropriate rate. *Id*.

5. On appeal, the Seventh Circuit endorsed a slightly modified version of the District Court's "coerced" or "forced loan" approach. *In re Till*, 301 F.3d 583, 591 (7th Cir. 2002). Specifically, the Seventh Circuit majority agreed with the District Court that, in a cramdown proceeding, the inquiry should focus on the interest rate "that the creditor in question would obtain in making a new loan in the same industry to a debtor who is similarly situated, although not in bankruptcy." *Id*. at 592. To approximate that new loan rate, the majority looked to the parties' prebankruptcy contract rate (21 percent). The court recognized, however, that using the contract rate would not "duplicat[e] precisely ... the present value of the collateral to the creditor" because loans to bankrupt, court-supervised debtors "involve some risks that would not be incurred in a new loan to a debtor not in default" and also produce "some economies." *Id*. To correct for these inaccuracies, the Seventh Circuit majority held that the original contract rate should "serve as a presumptive [cram down] rate," which either the creditor or the debtor could challenge with evidence that a higher or lower rate should apply. *Id*. Accordingly, the court remanded the case to the Bankruptcy Court to afford petitioners and respondent an opportunity to rebut the presumptive 21 percent rate.

6. The dissenting member of the Seventh Circuit panel, Judge Rovner, pointed out that the majority's presumptive contract rate approach overcompensates secured creditors because it fails to account for costs a creditor would have to incur in issuing a new loan. Rather than focusing on the market for comparable loans, Judge Rovner advocated either the Bankruptcy Court's formula approach or a "straightforward ... cost of funds" approach that would simply ask "what it would cost the creditor to obtain the cash equivalent of the collateral from an alternative source." *Id*. at 595- 596. Although Judge Rovner noted that the rates produced by either the formula or the cost of funds approach might be "piddling" relative to the coerced loan rate, she suggested courts should "consider the extent to which the creditor has already been compensated for ... the risk that the debtor will be unable to discharge his obligations under the reorganization plan ... in the rate of interest that it charged to the debtor in return for the original loan." *Id*. at 596.

B. Considerations in Choosing Appropriate Interest Rate.

In *Till*, the Court starts its analysis of the appropriate interest rate to apply by noting that the Bankruptcy Code provides little guidance as to which of the rates of interest advocated by the four opinions in this case -- the formula rate, the coerced loan rate, the presumptive contract rate, or the cost of funds rate -- Congress had in mind when it adopted the cramdown provision. The challenge for bankruptcy courts reviewing such repayment schemes, therefore, is to choose an interest rate sufficient to compensate the creditor for the concern that inflation may cause the value of the dollar to decline before the debtor pays and the risk of nonpayment. In determining the appropriate interest rate, the Court was guided by three considerations:

1. <u>Uniformity in Approaches</u>.

a) The Court notes that the Bankruptcy Code includes numerous provisions that, like the cramdown provision, require a court to discount a stream of deferred payments back to their present dollar value to ensure that a creditor receives at least the value of its claim. *See* 11 U.S.C. § 1129(a)(7)(A)(ii) (requiring payment of property whose "value, as of the effective date of the plan" equals or exceeds the value of the creditor's claim); §§ 1129(a)(7)(B), 1129(a)(9)(B)(i), 1129(a)(9)(C), 1129(b)(2)(A)(ii), 1129(b)(2)(B)(i), 1129(b)(2)(C)(i), 1173(a)(2), 1225(a)(4), 1225(a)(5)(B)(ii), 1228(b)(2), 1325(a)(4), 1228(b)(2) (same).

b) “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 provisions.” *Till*, 124 S. Ct. at 1959.

c) “Moreover, we think Congress would favor an approach that is familiar in the financial community and that minimizes the need for expensive evidentiary proceedings.” *Id*.

2. <u>Bankruptcy Court’s Authority to Modify Terms To Account for Change of Circumstances Brought About by Chapter 13 Filing</u>.

The Court notes that a bankruptcy court’s authority to modify the number, timing, or amount of the installment payments from those set forth in the debtor's original contract is perfectly clear (with the exception of mortgages secured by the debtor’s primary residence).

A modification of the loan terms is needed to account for intervening changes in circumstances resulting from the reduction of risk inherent in a successful chapter 13 case. The Court reaches this conclusion by noting that the post-bankruptcy obligor is no longer the individual debtor but the court-supervised estate. Several factors contribute to this reduction in risk:

a) First, a court may only approve a cramdown loan if it finds that the debtor will be able to make all of the required payments. Thus, such loans will only be approved for debtors that the court deems creditworthy.

b) Second, chapter 13 plans must "provide for the submission" to the trustee "of all or such portion of [the debtor's] future ... income ... as is necessary for the execution of the plan," *Id*., (citing § 1322(a)(1)), so the possibility of nonpayment is greatly reduced.

c) Third, the Bankruptcy Code's extensive disclosure requirements reduce the risk that the debtor has significant undisclosed obligations.

d) Fourth, as a practical matter, the public nature of the bankruptcy proceeding is likely to reduce the debtor's opportunities to take on additional debt.

3. An Objective Rather than a Subjective Standard Should be Applied.

Although section 1325(a)(5) entitles the creditor to property whose present value objectively equals or exceeds the value of the collateral, it does not require that the terms of the cramdown loan match the terms to which the debtor and creditor agreed pre-bankruptcy. Thus, a court choosing a cramdown interest rate need not consider the creditor's individual circumstances, such as its pre-bankruptcy dealings with the debtor or the alternative loans it could make if permitted to foreclose. Rather, the court should aim to treat similarly situated creditors similarly, and to ensure that an objective economic analysis would suggest the debtor's interest payments will adequately compensate all such creditors for the time value of their money and the risk of default.

The Court notes in its analysis that there is no readily apparent chapter 13 cramdown market rate of interest. That is, 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. "Interestingly, the same is not true in the Chapter 11 context, as numerous lenders advertise financing for Chapter 11 debtors in possession." *Till*, 124 S. Ct. at 1960, n. 14 (citing Balmoral Financial Corporation, http://www.balmoral.com/bdip.htm (advertising debtor in possession lending); Debtor in Possession Financing: 1st National Assistance Finance Association DIP Division, http://www.loanmallusa.com/dip.htm (offering "to tailor a financing program

... to your business' needs and ... to work closely with your bankruptcy counsel"). “Thus, when picking a cram down 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*.

C. Coerced Loan, Presumptive Contract Rate, And Cost Of Funds Approaches Rejected.

1. Applying the foregoing principles to the issue of which approach to adopt, the Court rejects the coerced loan, presumptive contract rate, and cost of funds approaches concluding that each of these approaches:

a) Is complicated,

b) Imposes significant evidentiary costs, and

c) Aims to make each individual creditor whole rather than to ensure the debtor's payments have the required present value.

2. For example, the coerced loan approach requires bankruptcy courts to consider evidence about the market for comparable loans to similar (though non-bankrupt) debtors -- an inquiry far removed from such courts' usual task of evaluating debtors' financial circumstances and the feasibility of their debt adjustment plans. In addition, the approach overcompensates creditors because the market lending rate must be high enough to cover factors, like lenders' transaction costs and overall profits that are no longer relevant in the context of court-administered and court-supervised cramdown loans.

3. Like the coerced loan approach, the presumptive contract rate approach improperly focuses on the creditor's potential use of the proceeds of a foreclosure sale. In addition, although the approach permits a debtor to introduce some evidence about each creditor, thereby enabling the court to tailor the interest rate more closely to the creditor's financial circumstances and reducing the likelihood that the creditor will be substantially overcompensated, that right comes at a cost: The debtor must obtain information about the creditor's costs of overhead, financial circumstances, and lending practices to rebut the presumptive contract rate. Also, the approach produces absurd results, entitling "inefficient, poorly managed lenders" with lower profit margins to obtain higher cramdown rates than "well managed, better capitalized lenders." 2 K. Lundin, Chapter 13 Bankruptcy § 112.1, p. 112-8 (3d ed.

2000). Finally, because the approach relies heavily on a creditor's prior dealings with the debtor, similarly situated creditors may end up with vastly different cramdown rates.

4. For example, suppose a debtor purchases two identical used cars, buying the first at a low purchase price from a lender who charges high interest, and buying the second at a much higher purchase price from a lender who charges zero-percent or nominal interest. Prebankruptcy, these two loans might well produce identical income streams for the two lenders. Postbankruptcy, however, the presumptive contract rate approach would entitle the first lender to a considerably higher cramdown interest rate, even though the two secured debts are objectively indistinguishable. *Till*, 124 S. Ct. at 1960.

5. The cost of funds approach, too, is improperly aimed. Although it rightly disregards the now-irrelevant terms of the parties' original contract, it mistakenly focuses on the creditworthiness of the creditor rather than the debtor. In addition, the approach has many of the other flaws of the coerced loan and presumptive contract rate approaches. For example, like the presumptive contract rate approach, the cost of funds approach imposes a significant evidentiary burden, as a debtor seeking to rebut a creditor's asserted cost of borrowing must introduce expert testimony about the creditor's financial condition. Also, under this approach, a creditworthy lender with a low cost of borrowing may obtain a lower cram down rate than a financially unsound, fly-by-night lender.

D. The Formula Approach Adopted.

1. The Court concludes that the formula approach has none of these defects. Taking its cue from ordinary lending practices, the approach begins by looking to the national prime rate, reported daily in the press, which reflects the financial market's estimate of the amount a commercial bank should charge a creditworthy commercial borrower to compensate for the opportunity costs of the loan, the risk of inflation, and the relatively slight risk of default. While the prime rate would be sufficient without adjustment if a loan to the debtor were risk free, the Court acknowledges, however, that “bankrupt debtors typically pose a greater risk of nonpayment than solvent commercial borrowers, the approach then requires a bankruptcy court to adjust the prime rate accordingly.” *Till*, 124 S. Ct. at 1961.

2. The appropriate size of that risk adjustment is dependent on “such factors” as:

a) The circumstances of the estate,

b) The nature of the security, and

c) The duration and feasibility of the reorganization plan.

3. The Court envisions that the bankruptcy court will hold a hearing at which the debtor and any creditors may present evidence about the appropriate risk adjustment. Some of this evidence will be included in the "debtor's bankruptcy filings," presumably, the debtor's schedules and statement of affairs, "so the debtor and creditors may not incur significant additional expense." *Till*, 124 S. Ct. at 1963. The procedure entails starting from a low estimate of risk and a corresponding small upward adjustment to the prime rate.

4. The evidentiary burden is then "squarely" on the creditor to justify a further upward adjustment. Shifting of the burden to the creditor is based on the assumption that creditors are likely to have readier access to any information absent from the debtor's filing (such as evidence about the "liquidity of the collateral market."). *Till*, 124 S. Ct. at 1963. Finally, the Court notes that "many of the factors relevant to the adjustment fall squarely within the bankruptcy court's area of expertise."

5. The Court's adoption of the formula approach is preferred by the Court to the coerced loan, presumptive contract rate, and cost of funds approaches, because the formula approach entails a straightforward, familiar, and objective inquiry, and minimizes the need for potentially costly additional evidentiary proceedings. Moreover, the resulting "prime-plus" rate of interest depends only on:

a) The state of financial markets,

b) The circumstances of the bankruptcy estate, and

c) The characteristics of the loan, not on the creditor's circumstances or its prior interactions with the debtor.

E. The Amount of the Risk Adjustment.

1. The Court did not decide the proper scale for the risk adjustment. The Court noted that the bankruptcy court had approved a risk adjustment of 1.5 percent, and other courts have generally approved adjustments of 1 percent to 3

percent. *Till*, 124 S. Ct. at 1963 (citing *In re Valenti*, 105 F.3d 55, 64 (C.A.2)). The Court was unpersuaded by argument that the high rate of defaults under chapter 13 plans justified a greater risk adjustment, noting that under 11 U.S.C. § 1325(a)(6), a bankruptcy court may not approve a plan unless, after considering all creditors' objections and receiving the advice of the trustee, the judge is persuaded that the debtor will be able to make all payments under the plan and to comply with the plan.

2. The Court appears to suggest a balancing between a rate high enough to compensate the creditor for its risk but not so high as to doom the plan. If the court determines that the likelihood of default is so high as to necessitate an "eye-popping" interest rate, *Till*, 124 S. Ct. at 1961 (citing 301 F.3d, at 593 (Rovner, J., dissenting)), the plan probably should not be confirmed.

3. In summary, the formula approach begins with a concededly low estimate of the appropriate interest rate and then requires the creditor to present evidence supporting a higher rate. This approach places the evidentiary burden on the more knowledgeable party, thereby facilitating more accurate calculation of the appropriate interest rate.

III. Does *Till* Apply in Chapter 11 Cases?

A. The Case For *Till*'s Application to Chapter 11 Cases:

1. Justice Stephens states in *Till*, "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 provisions." *Till*, 124 S. Ct. at 1959. Justice Stephens, in an accompanying footnote, then makes reference to:

a) The Best Interest of Creditors' Test of chapter 11 encompassed in 11 U.S.C. § 1129(a)(7)(A)(ii) (requiring payment of property whose "value, as of the effective date of the plan" equals or exceeds the value of the creditor's claim if the debtor were to be liquidated under chapter 7);

b) The right of a creditor electing 1111(b)(2) treatment to receive the present value of the collateral securing the claim under § 1129(a)(7)(B);

c) The right of certain priority creditors who have accepted the plan to receive deferred cash payments with a present value equal to their allowed priority claims under § 1129(a)(9)(B)(i);

d) The right of a governmental tax claimant to be paid in full in deferred cash payments over six years with a present value equal to their allowed priority claims under § 1129(a)(9)(C);

e) Under the cramdown provision of chapter 11, with respect to secured creditors that do not consent to the treatment under the plan, the right of such creditors to receive deferred cash payments with a present value equal to their allowed secured or unsecured claims and interest holders under § 1129(b)(2)(A)(ii)(sic—cite should be to (b)(2)(A)(i)(II)), 1129(b)(2)(B)(i), 1129(b)(2)(C)(i);

f) The Best Interests of Creditors Test in railroad reorganizations as provided in § 1173(a)(2);

g) The Best Interests of Creditors Test in chapter 12 cases § 1225(a)(4);

h) The cramdown provision of chapter 12 set forth in § 1225(a)(5)(B)(ii);

i) The Best Interests of Creditors Test with respect to a hardship discharge under chapter 12 § 1228(b)(2);

j) The Best Interests of Creditors Test in chapter 13 cases as set forth in § 1325(a)(4).

2. While in can be argued that *Till*'s discussion of the need for uniformity among the chapters with respect to the applicable interest rate is only dicta, as the Eleventh Circuit has stated "dicta from the Supreme Court is not something to be lightly cast aside." *Peterson v. BMI Refractories*, 124 F.3d 1386, 1392 (11th Cir. 1997).

3. It is in the context of discussing the various instances in which present value calculations must be made that Justice Stephens infers that Congress would favor an approach that is familiar in the financial community and that minimizes the need for expensive evidentiary proceedings. *Till*, 124 S. Ct. at 1959. This implies that the simplicity of the short-cut method of simply applying the prime rate adjusted slightly for risk factors should be applied universally in all chapters.

B. The Case Against *Till*'s Application to Chapter 11 Cases:

1. *Till* involves a chapter 13 debtor and a $4,895 claim secured by a used truck. A case can certainly be made that *Till* does not apply to chapter 11 cases that involve complex businesses, typically sophisticated parties, and significantly greater amounts of debt.

2. Accordingly, there is a good argument that the language in *Till* indicating uniformity in approaches among the various chapters is dicta. *See* Robert C. Goodrich, Jr. and Madison Cashman, "*Money in the 'Till,'*" 2004 Norton Bankr. L. Adviser 1 (October 2004)(citing *Colgrove v. Battin*, 413 U.S. 149, 157, 93 S. Ct. 2448, 37 L. Ed. 2d 522 (1973) (declining to follow its own dicta that the Seventh Amendment requires a jury of 12 persons in civil trials); *Central Green Co. v. United States*, 531 U.S. 425, 431, 121 S. Ct. 1005, 148 L. Ed. 2d 919 (2001) (interpreting actual language of Flood Control Act provision rather than following "admittedly confusing dicta" of a prior Supreme Court opinion); *Humphrey's Ex'r v. United States*, 295 U.S. 602, 627, 55 S. Ct. 869, 79 L. Ed. 1611 (1935) (dicta "may be followed if sufficiently persuasive" but is not binding)).

3. In *Associates Commercial Corp. v. Rash*, 520 U.S. 953, 117 S. Ct. 1879, 138 L. Ed.2d 148 (1997), the Supreme Court concluded that the valuation standard to be applied in the case should be passed on a "replacement" as opposed to liquidation standard. However, *Rash* was decided in the context of a chapter 13. Notwithstanding *Rash*'s application of a replacement value standard in a chapter 13 context, in a chapter 7 context of redemptions under section 722, there appears to be near unanimity in the cases that a wholesale valuation standard applies. *See, e.g.*, *In re Weathington*, 254 B.R. 895 (6th Cir. BAP 2000); *In re Smith*, 313 B.R. 785 (Bankr. N.D. Ind. 2004); *In re Neal*, 2004 WL 2032319 (Bankr. N.D. Iowa 2004); *In re Barse*, 309 B.R. 109 (Bankr. W.D.N.Y. 2004); *In re Bouzek*, 311 B.R. 239 (Bankr. E.D. Wis. 2004); *In re Washington*, 2003 WL 22119519 (Bankr. E.D. Ark. 2003); *In re Podnar*, 307 B.R. 667 (Bankr. W.D. Mo. 2003); *In re Zell*, 284 B.R. 569 (Bankr. D. Md. 2002); *In re Ard*, 280 B.R. 910 (Bankr. S.D. Ala. 2002); *In re Dobler*, 2002 WL 31342412 (Bankr. D.N.D. 2002); *In re Ballard*, 258 B.R. 707 (Bankr. W.D. Tenn. 2001); *In re Tripplett*, 256 B.R. 594 (Bankr. N.D. Ill. 2000); *In re Russell*, 2000 WL 33673802 (Bankr. M.D.N.C. 2000). *See also* 6 Lawrence P. King et al., Collier on Bankruptcy, ¶ 1722.05, at 722-9 (15th ed. rev. 2000) (interpreting § 722 to require liquidation valuation of secured claims). The one reported bankruptcy case which applied *Rash* in the context of a redemption under section 722 was reversed. *Smith v. Household Automotive Finance Corporation*, 313 B.R. 267 (N.D. Ill. 2004), reversing *In re Smith*, 307 B.R. 912 (Bankr. N.D. Ill. 2004).

4. Footnote 14 of *Till* provides strong support for the proposition that the Supreme Court in *Till* recognizes that chapter 11 cases are different and that the reasons for choosing the simplistic approach mandated by *Till* in a chapter 13 cram down do not apply to chapter 11.

a) Justice Stephens notes in this regard that in a chapter 13, the goal is not to arrive at an interest rate that makes the lender "subjectively indifferent between present foreclosure and future payment." *Till*, 124 S. Ct. at 1959. The very idea of a cramdown loan "precludes" a creditor's agreement to a cram down.

b) Justice Stephens then reasons that the fact that chapter 13 loans are by definition "crammed down" on an unwilling creditor "helps explain why there is no readily apparent Chapter 13 'cram down market rate of interest.'" *Till*, 124 S. Ct. at 1960, n. 14.

c) Importantly, Justice Stevens notes: "Interestingly, the same is not true in the Chapter 11 context, as numerous lenders advertise financing for Chapter 11 debtors in possession." *Id*.

d) He then comments, "[t]hus, when picking a cramdown rate in a chapter 11 case, it might make sense to ask what rate an efficient market would produce" noting that 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*.

e) One can argue persuasively from Justice Stephens' analysis, that in a chapter 13, courts are to be guided by the principle of fairly compensating a creditor for its exposure. In contrast, in a chapter 11 context in which one may look to a market to determine interest rates, a court should seek to determine "what rate an efficient market would produce."

f) The Court indicates that unlike in chapter 13 where there is no readily apparent chapter 13 cramdown market rate of interest, the market might provide guidance in a chapter 11 context. He discusses the availability of DIP financing as evidence of a readily observable market in the chapter 11 context. As discussed in Ronald F. Greenspan & Cynthia Nelson, *"UNTILL" WE MEET AGAIN, Why the Till Decision Might Not Be the Last Word on Cramdown Interest Rates*, 23-JAN Am. Bankr. Inst. J. 48 (2005), footnote 14 of *Till* "certainly will be secured lenders' most frequently cited reference to *Till*."

C. Is Prime Rate the Only Rate?

1. It is clear that the formula approach as adopted by *Till* begins with the prime rate as opposed to some other reference rate. As used in *Till*, the "prime" rate is the "national prime rate, reported daily in the press, which reflects the financial market's estimate of the amount a commercial bank should charge a creditworthy commercial borrower to compensate for the opportunity costs of the loan, the risk of inflation, and the relatively slight risk of default." *Till*, 124 S. Ct. at 1960. "A bankruptcy court is then required to adjust the prime rate to account for the greater nonpayment risk that bankrupt debtors typically pose." *Id*.

2. However, the statement found in footnote 14 that in a chapter 11, "when picking a cram down rate in a Chapter 11 case, it might make sense to ask what rate an efficient market would produce," appears to open the door for alternative interest rate-setting methods.

3. Once this door is opened, it would appear that other reference rates may be more appropriate. For example, prime may be appropriate for a revolving loan where the interest floats daily, and totally inappropriate for a loan secured by a shopping center repayable over 15 to 20 years at a fixed rate of interest. See Ronald F. Greenspan & Cynthia Nelson, *"UNTILL" WE MEET AGAIN, Why the Till Decision Might Not Be the Last Word on Cramdown Interest Rates*, 23-JAN Am. Bankr. Inst. J. 48, 49 (2005).

4. Other relevant rates may apply as determined by the market in which large corporate debtors typically obtain financing such as the London Interbank Offering Rate (LIBOR), Federal Home Loan Bank District Cost of Funds Index (COFI) and U.S. Treasuries. Financial markets generally consider these to be "risk-free" or nearly risk-free rates. Lenders typically add an adjustment or "spread" to the base rate to account for the risk and other attributes associated with a particular loan in question. Ronald F. Greenspan & Cynthia Nelson, *"UNTILL" WE MEET AGAIN, supra*.

5. This approach is admittedly not simplistic and brings into play all of the facts considered by commercial lenders in determining interest rates:

a) Type of loan -- asset based, construction, long term real estate;

b) Duration;

c) Special loan net worth covenants;

d) Borrowing limitations based on collateral availability;

e) Debt to collateral value;

f) Borrower's net worth;

g) Pro forma EBDITA available for debt service;

h) Industry considerations affecting the feasibility of the borrower's ability to perform during the term of the loan.

6. Another issue that was not dealt with by *Till* is whether the rate should float over the term of the loan. Prime is generally a floating rate in commercial transactions involving asset-based loans. It is one thing to use prime plus a risk factor for a 36-month financing of an automobile, it is another to lock in a 10- or 20-year real estate loan based on prime in the year that the cramdown plan provision is implemented.

IV. Determining the Risk Adjustment.

A. *Till* does not "decide the proper scale for the risk adjustment….". However, it does note that courts have "generally approved 1% to 3% percent" as a risk adjustment. *Till*, 124 S. Ct. at 1962. It cites as support for this proposition the chapter 13 case of *In re Valenti*, 105 F.3d 55, 64 (2nd Cir. 1997). This adds support to the proposition that *Till*'s conclusions are to be interpreted in the context in which they arose -- a chapter 13 case.

B. As set forth in *Till*, the appropriate size of that risk adjustment depends on various factors. It refers to "such factors" as the:

1. Circumstances of the estate. This term is not defined by the Supreme Court. The phrase "circumstances of the estate" implies an inquiry as to any matter that will impact on the debtor's performance under the loan and increase or decrease risk.

2. Nature of the security. Factors relevant to the security include its value, depreciation characteristics, and the debtor's use of the collateral. In a chapter

13 where the collateral has been valued, another consideration is that there will be no equity in the collateral for the loan. The debtor is repaying a loan equal to 100 percent of the value of the collateral since it is that value that determines the amount of the secured claim.

3. Duration of the plan. Relevant facts include expected inflationary trends over the term of the loan and interest rate volatility.

4. Feasibility of the plan. Feasibility relates to the debtor's ability to perform based on historical, current, and anticipated income. Feasibility is also affected by living expenses and other obligations to secured creditors and creditors to be paid under the debtor's plan.

Till, 124 S. Ct. at 1961.

C. The court is obligated to select a rate high enough to compensate the creditor for its risk but not so high as to doom the plan. If the court determines that the likelihood of default is so high as to necessitate an "eye-popping" interest rate, the plan probably should not be confirmed. *Till*, 124 S. Ct. at 1962.

D. Some courts have allowed "add-on interest" for purposes of calculating the interest rate for chapter 13 plans. "Add-on interest" is calculated by multiplying the interest rate times the principal and adding that amount to the principal in determining the total amount to be paid. Since the lender calculates in interest on the original balance, instead of the declining balance as in simple interest loans, the effective interest rate is almost double the stated rate. *In re Pokrzywinski*, 311 B.R. 846, 848 (Bankr. E.D. Wis. 2004). The issue of whether add-on interest will still be allowed was not addressed in *Till*, although it is clear from the computations discussed in *Till*, that add-on interest was not used in the case. It appears that such interest would violate the holding of *Till*. *Id*.

E. The reference to "such factors" means that the list is non-exclusive and other factors may be considered. These could include in the context of a chapter 13:

1. Past default history of the debtor on the loan in general;

2. Debtor's default on post-petition obligations under any pre-confirmation orders to include adequate protection orders;

3. Prior chapter 13 cases by the debtor;

4. Debtor's work history and job stability;

5. Good faith of the debtor (although this is a general confirmation requirement, a history of repetitive filings to frustrate foreclosure attempts by the secured creditor being crammed down may be relevant to good faith);

6. The amounts being paid to other creditors; and

7. Debtor's projected disposable income.

See also *In re Bivens*, 317 B.R. 755, 764 (Bankr. N.D. Ill. 2005).

F. One factor that *Till* did not resolve is to what extent that historical default rates should bear in fixing an interest rate under a case. While the point was argued in *Till*, the Court concluded that it did not need to resolve that dispute. A similar argument was made in *Bivens*, 317 B.R. at 768. In the case, the creditor had cited to a study of 71 Chapter 13 cases filed in the U.S. Bankruptcy Court for the Southern District of Mississippi between 1992 and 1998. *Id*. (citing Scott F. Norberg, *Consumer Bankruptcy's New Clothes: An Empirical Study of Discharge and Debt Collection in Chapter 13*, 7 Am. Bankr. Inst. L. Rev. 415, 427 (1999)). The study found a post-confirmation failure rate of 60 percent. This is an argument that still has validity if the lender has available figures from the district in which the case is being heard.

G. These could include in the context of a chapter 11 the pertinent underwriting criteria used by lenders in the relevant loan market to establish terms for similar loans. Other factors may include:

1. Evaluation of the plan proponent's experience, motivation, commitment and financial capacity to repay the loan;

2. Collateral value in liquidation;

3. Probability of plan failure;

4. Rate of collateral depreciation;

5. Liquidity of the collateral market;

6. Administrative expenses of enforcement;

7. Extent of any changes in the loan documents, e.g., changes in financial covenants, insurance requirements, default provisions, and remedies;

8. Post-confirmation ability to borrow money, secure debt, and sell property;

9. Presence or absence of sources for future capital in the form of debt or equity;

10. Loan to value ratios and advance rates; and

11. Market rates of interest.

"UNTILL" WE MEET AGAIN, *supra*; Norton Adviser, at 3.

V. Evidentiary Issues Raised by *Till*.

A. The Supreme Court contemplates that the court must hold a hearing at which the debtor and any creditors may present evidence about the appropriate risk adjustment. Some of this evidence will be included in the debtor's bankruptcy filings, however, so the debtor and creditors may not incur significant additional expense.

B. Under *Till*, the evidentiary burden is "squarely" on the creditors. *Till*, 124 S. Ct. at 1961. Accordingly, procedurally, the debtor will establish the prime rate. As discussed below, this can be done by asking the court to take judicial notice of the prime rate as published on the pertinent date as set forth below. The burden will then shift to the lender to introduce evidence, either from the debtor's filings, testimony of the debtor or lender representative, or expert testimony as relevant to one of the various factors, that justifies an upward adjustment.

C. While this burden shifting may appear to tilt the scales in favor of the debtor, it has been noted that there is a dearth of reported authority under chapter 11 in which the cramdown interest rate appears to have been affected by who has the burden of proof. Norton Adviser, at 2.

D. In district in which the court by local rule has adopted a presumptive rate, debtors may want to argue that local rules should no longer have applicability in light of *Till*. *See, e.g.*, *In re Berksteiner*, 2004 WL 2201300 (Bankr. S.D. Ga. 2004).

E. Creditors faced with an interest rate they perceive to not compensate them for the real risk as justified by the assurances that the debtor will not default, should argue (or bargain) for a "drop dead" clause giving them automatic relief from stay after a future default and failure to cure. *Bivens*, 317 B.R. at 770.

F. Judicial Notice.

1. Defined.

> A court's acceptance, for purposes of convenience and without requiring a party's proof, of a well-known and indisputable fact; the court's power to accept such a fact, the trial court took judicial notice of the fact that water freezes at 32 degrees Fahrenheit.

Black's Law Dictionary 851 (7th ed. 1999) (also termed judicial cognizance; judicial knowledge).

2. Rule 201--Judicial Notice of Adjudicative Facts.

> (a) Scope of rule. This rule governs only judicial notice of adjudicative facts.
>
> (b) Kinds of facts. A judicially noticed fact must be one not subject to reasonable dispute in that it is either (1) generally known within the territorial jurisdiction of the trial court or (2) capable of accurate and ready determination by resort to sources whose accuracy cannot reasonably be questioned.
>
> (c) When discretionary. A court may take judicial notice, whether requested or not.
>
> (d) When mandatory. A court shall take judicial notice if requested by a party and supplied with the necessary information.
>
> (e) Opportunity to be heard. A party is entitled upon timely request to an opportunity to be heard as to the propriety of taking judicial notice and the tenor of the matter noticed. In the absence of prior notification, the request may be made after judicial notice has been taken.

(f) Time of taking notice. Judicial notice may be taken at any stage of the proceeding.

(g) Instructing jury. In a civil action or proceeding, the court shall instruct the jury to accept as conclusive any fact judicially noticed. In a criminal case, the court shall instruct the jury that it may, but is not required to, accept as conclusive any fact judicially noticed.

(Jan. 2, 1975, P.L. 93-595, § 1, 88 Stat. 1930.)

3. Procedure.

a) Judicial notice may be taken at any stage of a proceeding, F.R.E. 201(f), including appeal. *Nantucket Investors II v. California Federal Bank (In re Indian Palms Associates)*, 61 F.3d 197, 204 (3rd Cir. 1995).

b) However, a party is entitled to be heard with respect to the propriety of taking judicial notice and the tenor of the matter noticed. In the absence of prior notification, the request may be made after judicial notice has been taken. F.R.E. 201(e). Thus, for example, if a bankruptcy court implicitly took judicial notice, sua sponte, in considering the debtor's schedules in arriving at a ruling, on appeal, the matter may be remanded to allow the disadvantaged party to be afforded notice and opportunity to respond. *Annis v. First State Bank of Joplin*, 96 B.R. 917, 920 (W.D. Mo. 1988).

c) Where judicial notice is taken without prior notice, the burden is on the disadvantaged party to make a request for a hearing to challenge the propriety of taking judicial notice. *Calder v. Job (In re Calder*), 907 F. 2d 953, 955 fn. 2. (10th Cir. 1990).

4. Scope--Adjudicative Facts.

Judicial notice is limited to adjudicative facts. Adjudicative facts are ones that are not subject to reasonable dispute because they are either:

a) Generally known within the territorial jurisdiction of the trial court, or

b) Capable of accurate and ready determination by resort to sources whose accuracy cannot reasonably be questioned.

5. Judicial Notice of Prime Rate.

a) A prevailing rate of interest is a proper subject for judicial notice. *Simpson v. United States*, 252 U.S. 547, 550, 40 S.Ct. 367, 368, 64 L.Ed. 709 (1920) ("we take judicial notice of the fact that at the time this tax was collected four per cent. [sic] was very generally assumed to be the fair value or earning power of money safely invested"). It is clear that the prime rate at a particular time is within the scope of adjudicative facts of which a court may take judicial notice. *See, e.g., Levan v. Capital Cities/ABC, Inc.*, 190 F.3d 1230 (11th Cir. 1999); *Piaubert v. Sefrioui*, 208 F.3d 221 (8th Cir. 2000); *Rankin v. DeSarno*, 89 F.3d 1123 (3rd Cir. 1996); *Reed v. NDC Megamarts, Inc.*, 73 F.3d 364 (7th Cir. 1996); *Havens Steel Co. v. Randolph Engineering Co.*, 813 F.2d 186 (8th Cir. 1987).

b) The fact that the prime rate is readily available from the Federal Reserve makes taking judicial notice of the prime rate for any particular date very simple. *Levan v. Capital Cities/ABC, Inc.*, 190 F.3d 1230 (11th Cir. 1999)("We take judicial notice of the Prime Rate on February 14, 1989, the date on which BFC issued its prospectus. This figure was provided by the Federal Reserve Board, and cannot reasonably be disputed.").

c) To access the prime rate for any date, go to http://www.federalreserve.gov/releases/h15/data/d/prime.txt.

d) Moreover, an appellate court may take judicial notice of a fact for the first time on appeal. *Gustafson v. Cornelius Co*., 724 F.2d 75, 79 (8th Cir. 1983); see also Fed. R. Evid. 201(f) advisory committee's note ("judicial notice may be taken at any stage of the proceedings, whether in the trial court or on appeal").

G. Opinion Testimony.

1. Rules.

a) Fed. R. Evid. 701--Opinion Testimony by Lay Witnesses.

> If the witness is not testifying as an expert, the witness testimony in the form of opinions or inferences is limited to those opinions or inferences which are (a) rationally based on the perception of

> the witness, and (b) helpful to a clear understanding of the witness' testimony or the determination of a fact in issue, and (c) not based on scientific, technical, or other specialized knowledge within the scope of Rule 702.

b) Fed. R. Evid. 702--Testimony by Experts.

> If scientific, technical, or other specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact in issue, a witness qualified as an expert by knowledge, skill, experience, training, or education, may testify thereto in the form of an opinion or otherwise, if (1) the testimony is based upon sufficient facts or data, (2) the testimony is the product of reliable principles and methods, and (3) the witness has applied the principles and methods reliably to the facts of the case.

c) Fed. R. Evid. 705--Disclosure of Facts or Data Underlying Expert Opinion.

> The expert may testify in terms of opinion or inference and give reasons therefor without first testifying to the underlying facts or data, unless the court requires otherwise. The expert may in any event be required to disclose the underlying facts or data on cross-examination.

d) Fed. R. Civ. P. 26(a)(2)--Disclosure of Expert Testimony.

> …a party shall disclose to other parties the identity of any person who may be used at trial to present evidence under Rules 702, 703, or 705 of the Federal Rules of Evidence.
>
> …this disclosure shall, with respect to a witness who is retained or specially employed to provide expert testimony in the case or whose duties as an employee of the party regularly involve giving expert testimony, be accompanied by a written report prepared and signed by the witness.

2. Expert Opinion Testimony--Daubert/Kumho and Fed. R. Evid. 702 (as amended eff. Dec. 1, 2000).

a) FRCP 26(a)(2). Subdivision (A) of Fed.R.Civ.P. 26(a)(2) requires disclosure of “the identity of any person who may be used at trial to present evidence under Rules 702, 703, or 705 of the Federal Rules of Evidence.” Subdivision (B) mandates a detailed written report from every “witness who is retained or specially employed to provide expert testimony in the case or whose duties as an employee of the party regularly involve giving expert testimony.” One way or the other, everyone who will offer expert testimony is, therefore, subject to disclosure.

b) Fed. R. Evid. 702. If expert opinion testimony is to be introduced, then the reliability requirements of Rule 702 apply. These requirements are found in the new language added to Fed. R. Evid. 702 as part of the December 1, 2000 amendments which now includes the requirements that:

(1) The testimony must be based upon sufficient facts or data. By its terms, according to the Committee Note, this is a “quantitative” test rather than a qualitative test. The issue is one of sufficiency.

(2) The testimony must be the product of reliable principles and methods. This requires a qualitative analysis. The principles and methods must be reliable.

(3) The witness must have applied the principles and methods reliably to the facts of the case. As with the second prong, this requires a qualitative analysis. The principles and methods must not only be reliable but must have been reliably applied by the expert in formulating the opinion.

The Committee Note to Fed. R. Evid. 702 makes it clear that the amendment is not intended to prevent a party from calling an industry expert to educate the judge about general principles without specifically applying those principles to the facts of the case. This would seem to be contrary to the wording of prong three. However, an expert of this type would still meet the requirements of prong three so long as the testimony is relevant and reliable, and the witness is qualified.

3. Examples of Bankruptcy Cases Holding That Daubert/Kumho Test was Not Satisfied.

a) <u>Testimony of Attorneys in Plan Confirmation</u>. The District Court in *In re Dow Corning Corp.*, 255 B.R. 445 (E.D. Mich. 2000), upheld the bankruptcy court’s decision to preclude the attorneys representing foreign claimants from Britain and Germany on whether plan of reorganization is fair when: (1) rules of ethics preclude testimony of participating attorneys and (2) they had financial interest in the outcome of confirmation of plan.

b) Testimony on Compensation in Chapter 7 Bankruptcy Case. The court in *In re Miniscribe Corp.*, 241 B.R. 729, 739-742 (Bankr. D. Colo. 1999), rejected Chapter 7 trustee's experts on reasonableness of fees because, in part, of their self-serving and perfunctory analysis.

c) Testimony on Sufficiency of Litigation Fund in Debtor's Plan. The court in *In re Dow Corning Corp*, 237 B.R. 364 (Bankr. E.D. Mich. 1999) held a Daubert inquiry and determined that the expert testimony on the issue of whether the proposed Chapter 11 plan's litigation fund was sufficient did not meet the test in that the accountant's testimony was based on numerous unproven assumptions.

4. Examples of Bankruptcy Cases Holding That Daubert/Kumho Test was Satisfied.

a) Expert Testimony Regarding Value of Debtor as Going Concern. The court in *In re Zenith Electronic Corp.*, 241 B.R. 92, 102-03 (Bankr. D. Del. 1999) held that the investment bank expert may testify as to the value of the debtor as a going concern basis for plan confirmation purposes even when it has a contingency fee arrangement with the debtor and was eligible to be retained by the debtor under § 327.

b) Expert Testimony Regarding Solvency. The court in *In re Valley-Vulcan Mold Co.*, 237 B.R. 322, 335-336 (B.A.P. 1999) held that expert on solvency qualified under Daubert and Kumho to testify in an action on fraudulent transfer.

c) Expert Testimony on Rehabilitation Costs. The court in *In re Syed*, 238 B.R. 133, 141-143 (Bankr. N.D. Ill. 1999) held that the experts on the rehabilitation costs on debtor's property met the Daubert /Kumho test even though the court did not hold a full Daubert hearing.

4. Lay Opinion Testimony.

a) Rule 701 provides:

> If the witness is not testifying as an expert, the witness' testimony in the form of opinions or inferences is limited to those opinions or inferences

> which are (a) rationally based on the perception of the witness, (b) helpful to a clear understanding of the witness' testimony or the determination of a fact in issue, and (c) not based on scientific, technical, or other specialized knowledge within the scope of Rule 702.

b) Amendment to Fed. R. Evid. 701. The December 1, 2000, amendment to Fed. R. Evid. 701 makes it clear that lay opinion testimony does not include opinions based on scientific, technical, or other specialized knowledge within the scope of Rule 702.

c) Traditional Lay Opinions. The Rule 701 amendment was not intended to change the law concerning the traditional types of testimony properly offered as lay opinion. Most often this would be an owner testifying as to value. *See Asplundh Mfg. Div. v. Benton Harbor Eng'g*, 57 F.3d 1190, 1196 (3d Cir. 1995).

d) FRCP 26(a)(2). The mandatory disclosure rules relating to expert witnesses do not apply to lay opinion testimony. Thus, the amendment to Fed. R. Evid. 701 is designed to ensure that "lay opinion" testimony which nevertheless deals with scientific, technical or other specialized knowledge will not qualify as lay opinion testimony for purposes of the rules.

e) In bankruptcy court, oftentimes, it is the owner that gives the opinion of value. It is generally accepted that an owner is competent to give opinion testimony about the value of the owner's property. *Brown*, 244 B.R. at 611; Russell, *Bankruptcy Evidence Manual*, 2001 Ed., § 701.2 at 819.

f) The advisory committee note to Rule 702 references that the types of witnesses who may provide expert testimony under Rule 702 are not limited to experts in the "strictest sense of the word, e.g., physicians, physicists, and architects, but also the large group sometimes called 'skilled' witnesses, such as bankers or landowners testifying to land values." *Brown*, 244 B.R. at 611; Russell, *Bankruptcy Evidence Manual*, 2001 Ed., § 701.2 at 819.

g) Alternatively, an owner may testify as to value as a lay witness under Rule 701. If testifying under Rule 701, the owner "may merely give his opinion based on his personal familiarity of the property, often based to a great extent on what he paid for the property." Russell, supra. Such testimony will be given little, if any, weight. *Id*.

h) On the other hand, if the owner truly has "knowledge, skill, experience, training or education" that would qualify the owner as an expert, then it is appropriate to require that the owner's testimony otherwise comply with Rule 702 and be based on reliable principles applied to sufficient data. As noted in the *Brown* case regarding such testimony, "Even though [the debtor's] testimony as to valuation is admissible, it should be subject to the same type of critical analysis as would the testimony of an independent 'expert.'" *Brown*, 244 B.R. at 612.

i) In *Brown*, the owner did not testify as to any specific values that she had found at "yard sales" for items similar in quality and condition to her property. In the court's view, her conclusion that her personal property had a value of $1,500 "was a figure just pulled out of the air." *Id*.

j) In light of the 2000 amendments to Rule 702, it appears appropriate to determine whether the testimony of an owner is being offered as the opinion testimony of a lay witness or is being offered as a "skilled witness." Advisory Committee Note to Rule 702. In the first instance, the testimony would be admissible but may receive little weight. Russell, supra, n. 50, § 701.2 at 819 ("if [the owner] has very little or no real expertise, the testimony will be given little if any weight"). In the latter instance, where the owner is testifying as an expert and given greater weight, the plain meaning of Rule 702 requires that the testimony should be subject to the rigors of a showing of reliability under Rule 702.

F:\WORDWILL\SEMINARS\ABI\2005\Till Summary.doc