

**CRAMDOWN INTEREST RATES IN THE  
COMMERCIAL CREDIT CONTEXT:  
ARGUMENTS FOR THE TWO-  
STEP APPROACH IN  
CHAPTER 11**

*MATTHEW WIENER\**

Introduction .....	224
I. Cramdown Plans and Interest Rates Under Chapter 11 .....	228
A. Interest Rates, Present Value, and Market Value .	229
B. Judicial Methods for Determining Cramdown Interest Rates .....	233
1. Formula Rates .....	233
2. Forced Loan or Coerced Loan.....	235
3. Cost of Funds .....	235
4. Contract Rate.....	237
C. The <i>Till</i> Decision and Adoption of the Formula Rate Approach .....	238
D. <i>Till</i> 's Famous Footnote 14 and the Two-Part Approach.....	239
II. <i>Momentive</i> Performance Materials and the Extension of the Formula Rate Approach into Chapter 11.....	240
A. <i>Momentive</i> Facts and Arguments.....	240
B. Judge Drain's Reasoning in <i>Momentive</i> and Adoption of the Formula Rate Approach .....	243
C. The Second Circuit's Recent Opinion Overturned <i>Momentive</i> and Implemented a Two-Step Approach.....	245
III. The Business of Banking .....	246
A. Bank Debt .....	247
B. Capital Markets Debt .....	249
C. Interest Rates in Commercial Credit Markets ....	250
D. Present Value and "Profit" .....	251

---

\* J.D., 2018, New York University School of Law; B.A., 2009, Vassar College. I would like to thank Marcel Kahan, Michael Walsh, and Paul Wiener for their thoughtful and incisive comments, as well as the New York University Annual Survey of American Law for providing the opportunity to publish this Note.

- E. The Market Value of the *Momentive* First Lien Notes Decreased as a Result of the Use of the Formula Rate Approach ..... 254
- IV. Arguments in Favor of the Formula Rate Approach .. 256
- V. Arguments Against the Formula Rate Approach and Its Use in the Chapter 11 Context ..... 259
  - A. The Formula Rate Approach Reduces Certainty and Predictability Which Will Negatively Affect Credit Markets and Increase Interest Rates Across the Board ..... 260
  - B. The Formula Rate Approach Fails to Compensate Secured Creditor Claims in the Risky Bankruptcy Context ..... 264
  - C. Because Chapter 11 Is Fundamentally Dissimilar to Chapter 13, the Formula Rate Approach Does Not Apply ..... 268
  - D. The Formula Rate Approach Inappropriately Creates an Option and Provides Negotiating Leverage for Chapter 11 Debtors ..... 270
- VI. The Two-Step Approach Adopted by the Second Circuit is Better Suited for Chapter 11 and the Commercial Credit Context ..... 271
  - A. The Two-Step Approach Is Easily Administered and Reduces Evidentiary Burdens on the Court and Debtor ..... 272
  - B. The Two-Step Approach Compensates Creditors for Risk Without Unduly Burdening Debtors..... 274
  - C. The Two Step Approach Facilitates Outcome Certainty and Protects the Justified Expectations of Creditors and Debtors ..... 275
- Conclusion ..... 276

INTRODUCTION

In *In re MPM Silicones, LLC*<sup>1</sup> (hereinafter “*Momentive*”), the Bankruptcy Court for the Southern District of New York addressed certain elements of the Bankruptcy Code’s “cramdown”<sup>2</sup> exception to the requirement that a plan of reorganization be approved by all

---

1. *In re MPM Silicones, LLC*, No. 14-22503-RDD, 2014 WL 4436335 (Bankr. S.D.N.Y. Sept. 9, 2014), *aff’d*, 531 B.R. 321 (S.D.N.Y. 2015).

2. Under the Bankruptcy Code, a “cramdown” refers to the confirmation of a debtor’s plan of reorganization over the objections of its creditors, provided certain requirements are met. *See infra* Part I for further explanation of the cramdown provisions of the Bankruptcy Code.

classes of claims and interests.<sup>3</sup> In particular, the *Momentive* Court was asked to determine the interest rate required on deferred payments made by a debtor pursuant to a cramdown plan in order to give its secured creditors, who voted against the plan, the present value of their secured claims. The methodology for determining such interest rates selected by the court was highly controversial and became the subject of significant litigation and academic discourse. Not only did it have a negative impact on the value of the secured claims at issue in *Momentive*, but it also had the potential to broadly affect the likelihood of plan confirmation by Chapter 11 debtors,<sup>4</sup> and the relative rights and bargaining power of creditors

---

3. See 11 U.S.C. § 1129(a)(7)(A)(i) (2010) (“The court shall confirm a plan only if . . . [w]ith respect to each impaired class of claims or interests . . . each holder of a claim or interest of such class . . . has accepted the plan . . .”).

4. Debtors may file for protection under various chapters of the Bankruptcy Code, though the three most commonly used are Chapters 7, 11, and 13. While Chapter 7 is not directly implicated in this Note, it is nonetheless significant, since a plan may not be approved under Chapters 11 or 13 unless the proposed payments under such plans are equal to the amount a creditor would receive under Chapter 7. See LYNN M. LOPUCKI & ELIZABETH WARREN, SECURED CREDIT: A SYSTEMS APPROACH 95 (7th ed. 2011). Under Chapter 7, a debtor’s nonexempt assets are surrendered to a bankruptcy trustee and liquidated. The proceeds of the liquidation are distributed to the debtor’s creditors, after which the debtor’s obligations may be discharged. *Id.* at 94; see also 7 COLLIER ON BANKRUPTCY ¶ 700.01 (Alan N. Resnick & Henry J. Sommers eds., 16th ed. 2010). Under Chapter 11, a debtor is given the opportunity to reorganize its business or to liquidate all or a portion of its assets in an orderly manner. *Id.* at ¶ 1100.01. The debtor (or in the case of an involuntary bankruptcy, the debtor’s creditors) proposes a plan of reorganization, which may include extension or modification of its obligations, such as reductions in interest rates and the principal amount owing. *Id.* During a Chapter 11 bankruptcy, the debtor remains in control of its assets, which it may operate, utilize, or sell. If the debtor’s plan is confirmed, the debtor ‘emerges’ from bankruptcy. Its obligations under the plan replace its obligations prior to bankruptcy and the debtor’s remaining debts, if any, are discharged. See LOPUCKI & WARREN at 95. There are few statutory limits on who may file for bankruptcy under Chapter 11. Chapter 13 is similar to Chapter 11, in that it permits a debtor, who remains in control of its assets, to propose a payment plan for its existing secured and unsecured creditors, usually over the course of three or five years. *Id.* In exchange for maintaining possession of its assets, the debtor promises to repay its pre-bankruptcy obligations out of future income. BARRY E. ADLER, DOUGLAS M. BAIRD, & THOMAS H. JACKSON, BANKRUPTCY: CASES, PROBLEMS, AND MATERIALS 38 (4th ed. 2007). Chapter 13 is only available to debtors with regular income and unsecured and secured debts of \$394,725 and \$1,184,200, respectively. See *id.*; see also 7 COLLIER ¶ 1300.14[3]. Thus, most large corporations are not eligible to file for bankruptcy under Chapter 13. If a debtor completes its Chapter 13 plan, its obligations are discharged and it remains in possession of its property. See 7 COLLIER ¶ 1300.01; see also LOPUCKI & WARREN at 95.

and debtors generally.<sup>5</sup> Fortunately, an October 2016 opinion by the Court of Appeals for the Second Circuit resolved some of this controversy.<sup>6</sup> It rejected the bankruptcy court's methodology and instead adopted one based, more appropriately, on ascertainable market rates of interest. Regardless, the issue remains highly polemical and subject to significant disagreement among courts, academics, and commentators.

Though much has been written about *Momentive* and despite the significant financial impacts of the decision on secured creditors, few have fully considered *Momentive's* impact on creditors in the commercial lending context. In fact, most who have addressed the subject have advocated for approaches to determine cramdown interest rates that are largely favorable to debtors but have failed to also consider the broader impacts on commercial credit markets. In this Note I will discuss the *Momentive* decision and critique the methodology it used to assign a below-market interest rate on replacement notes issued to objecting holders of secured claims under a cramdown plan. I will argue bankruptcy courts confronted with the determination of cramdown interest rates should instead follow the approach adopted by the Second Circuit, which better reflects prevailing market rates and more accurately provides crammed down creditors with the present value of their claims as required by the Bankruptcy Code.

Part I introduces the provisions of the Bankruptcy Code that allow confirmation of a plan over the objections of secured creditors and provides background on interest rates, present value, and market value. It also describes four methodologies courts have considered in determining which interest rate mostly fairly compensates creditors who receive replacement loans under such plans: the formula rate, forced loan, cost of funds, and contract rate approaches.<sup>7</sup> Part I then discusses the United States Supreme Court's decision in *Till v. S.C.S. Credit Corp.*,<sup>8</sup> which adopted the formula rate approach as the appropriate standard for determining cramdown interest rates in Chapter 13 bankruptcy cases.

Part II examines *Momentive's* extension of the formula rate approach from the Chapter 13 to the Chapter 11 context, beginning

---

5. See Waltraud S. Scott, *Deferred Cash Payments to Secured Creditors in Cram Down of Chapter 11 Plans: A Matter of Interest*, 63 WASH. L. REV. 1041, 1042 (1988).

6. *In re MPM Silicones, LLC*, 874 F.3d 787 (2d Cir. 2017).

7. This Note will use the term "loan" to describe all instances in which an entity "lends" money to a borrower, including credit facilities, such as term loans and revolving loans, and debt securities, including bonds and notes.

8. 541 U.S. 465 (2004).

with a discussion of the facts and background of that case, followed by an analysis of the court's reasoning. It then details the Second Circuit's holding, which overruled the bankruptcy court and opted instead for market (rather than court-improvised) valuations of the appropriate interest rate in Chapter 11 cases.

Part III describes the business of banking, the types of debt accessible to commercial borrowers, and the methodology of determining interest rates in commercial credit markets. It then argues courts should follow the Second Circuit and look to prevailing market rates when determining cramdown interest rates and that the exclusion of "profit" from such rates misconstrues the nature of interest rates. This effectively precludes secured creditors from receiving the present value of their claims. Part III then demonstrates the extent to which the replacement notes under *Momentive* fail to provide the value to holders of secured claims required by the cramdown provisions of the Bankruptcy Code.

Part IV and Part V consider, respectively, arguments for and against the formula rate approach, each focusing on administrability, evidentiary burdens on both creditors and debtors, reasonable compensation for risk, and outcome certainty in the bankruptcy process.

Finally, Part VI argues the formula rate approach should be abandoned in Chapter 11 in favor of the market-based analysis adopted in the Second Circuit. Had the Second Circuit's two-step approach been used in *Momentive*, the debtor's secured noteholders would have received an interest rate on their notes better keyed to prevailing market rates and avoided the steep losses in the market value of those securities post-confirmation. Unlike the formula rate approach, the two-step method is more easily administered because it relies, in the first instance, on ascertainable market rates and therefore reduces the likelihood of litigating disputes. Furthermore, in the event of litigation, the factual issues are likely to be narrow, thereby reducing the evidentiary burden as well as any costs associated with the production of such evidence. Moreover, this method is the single methodology which compensates creditors for their risk of lending to debtors emerging from Chapter 11 without unduly burdening such debtors who would have to seek financing from the market regardless. It also protects the expectations of both creditors and debtors with regard to their negotiations over contractual terms and best balances their interests according to a visible market.

I.  
CRAMDOWN PLANS AND INTEREST RATES  
UNDER CHAPTER 11

Section 1129(b) of Title 11 of the United States Code (the “Bankruptcy Code”) permits the confirmation of a plan over the dissent of one or more classes of impaired claims or interests<sup>9</sup> (hereinafter, all references to section 1129 refer to the Bankruptcy Code). While section 1129(b) requires a plan proponent to meet all the other requirements of section 1129(a),<sup>10</sup> including, for instance, feasibility,<sup>11</sup> so-called “cramdowns” are a powerful tool in the hands of a debtor.<sup>12</sup> In order to protect the interests of dissenting classes, section 1129(b) states that for a cramdown to be approved, the plan must not “discriminate unfairly”<sup>13</sup> and must be “fair and equitable”<sup>14</sup> to all impaired classes of claims. Section 1129(b)(2) provides three mechanisms by which a bankruptcy court may find a plan fair and equitable as to dissenting or impaired claims, any of which may independently satisfy this requirement. Importantly, a debtor may comply with section 1129(b)(2) by

---

9. See 11 U.S.C. § 1129(b) (2010) (“[T]he court, on request of the proponent of the plan, shall confirm the plan notwithstanding the requirements of [Section 1129(a)] if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan.”).

10. See *id.* (“[A]ll of the applicable requirements of subsection (a) of [section 1129] other than paragraph (8) [must be] met”); see also *In re DBSD N. Am., Inc.*, 419 B.R. 179, 204 (Bankr. S.D.N.Y. 2009) (stating Section 1129(b)(1) is a fundamental provision of the Bankruptcy Code, which “provides that if all applicable requirements of section 1129(a) are met other than section 1129(a)(8) (which requires that every impaired class vote in favor of the Plan), a plan may be confirmed so long as the requirements set forth in section 1129(b) are satisfied.”) (emphasis in original).

11. See 11 U.S.C. § 1129(a)(11) (2010).

12. See Daniel R. Wong, *Chapter 11 Bankruptcy and Cramdowns: Adopting a Contract Rate Approach*, 106 NW. U. L. REV. 1927, 1933 (2012).

13. 11 U.S.C. § 1129(b)(1). The term “unfair discrimination” means, in general, that no class of dissenting claims may receive value different from the value given to other similarly situated claims. See *In re Young Broad., Inc.*, 430 B.R. 99, 139–40 (Bankr. S.D.N.Y. 2010) (stating that as defined in Section 1129(b)(1), “a plan unfairly discriminates when it treats similarly situated classes differently without a reasonable basis for the disparate treatment.”).

14. 11 U.S.C. § 1129(b)(1); see also David Griffiths, *Momentous Decision in Momentive Performance Materials: Cramdown of Secured Creditors – Part I*, WEIL BANKRUPTCY BLOG (Sept. 9, 2014), <https://business-finance-restructuring.weil.com/chapter-11-plans/momentous-decision-in-momentive-performance-materials-cram-down-of-secured-creditors-part-i/> [<https://perma.cc/B8HT-BMWV>].

making payment to holders of secured claims gradually over time, even if junior claims are paid sooner.<sup>15</sup>

Section 1129(b)(2)(A)(i) is most relevant to the present discussion of *Momentive*, as it essentially permits a plan proponent to propose new loans for dissenting secured creditors,<sup>16</sup> provided those creditors retain liens securing their claims<sup>17</sup> and receive deferred cash payments with a value at least equal to the value of their interests in the collateral securing their claims on the confirmation date.<sup>18</sup> Within the debate over cramdowns, perhaps the only point of agreement is that the language of section 1129(b)(2) requires bankruptcy courts to conduct a present value analysis in assessing cramdown interest rates.<sup>19</sup>

#### A. *Interest Rates, Present Value, and Market Value*

An understanding of interest rates is fundamental to a discussion of the present value analysis required by the Bankruptcy Code. Interest rates reflect the price of money.<sup>20</sup> The real rate of interest is exclusive of inflation.<sup>21</sup> In contrast, the nominal interest rate reflects the current or inflation-adjusted price of money.<sup>22</sup> Nominal interest rates on defaultable securities are comprised of three ele-

---

15. See 7 COLLIER, *supra* note 4, at ¶ 1129.04[2]; see also *Matter of Penn Cent. Transp. Co.*, 458 F. Supp. 1234, 1283 (E.D. Pa. 1978) (“[T]he absolute priority rule does not require sequential distributions (i.e., cash payment in full to senior creditors before any distribution is made to junior creditors), but merely that the values represented by the higher-ranking claims are fully satisfied by the values distributed under the Plan.”).

16. See 7 COLLIER, *supra* note 4, at ¶ 1129.04[2][a].

17. See 11 U.S.C. § 1129(b)(2)(A)(i)(I).

18. See 11 U.S.C. § 1129(b)(2)(A)(i)(II) (“[T]hat each holder of a claim of such class receive on account of such claim *deferred cash payments* totaling at least the allowed amount of such claim, *of a value, as of the effective date of the plan*, of at least the value of such holder’s interest in the estate’s interest in such property . . . .”) (emphasis added).

19. See *United Sav. Ass’n of Tex. v. Timbers of Inwood Forest Assocs.*, 484 U.S. 365, 377 (1988) (“Under § 1129(b) a secured claimant has a right to receive under a plan the present value of his collateral. This entitlement arises . . . from the provision of § 1129(b)(2)(A)(i)(II) . . . .”). The legislative history of the Bankruptcy Code also indicates Congress explicitly intended present value to be analyzed in the confirmation of a plan. See H.R. Rep. No. 595, at 413-18 (1978), *reprinted in* 1978 U.S.C.C.A.N. 6370-71 (“[P]roperty is to be valued as of the effective date of the plan, thus recognizing the time value of money . . . .”).

20. See DAVID W. PEARCE, *THE DICTIONARY OF MODERN ECONOMICS* 370 (2nd ed. 1983).

21. See *id.* at 313 (stating nominal is “the opposite of real.”).

22. See *id.* (defining nominal as “the measurement of economic magnitude in current prices.”).

ments, each of which relates to a different aspect of the delayed use of money: the expected rate of inflation, the real rate of interest, and a default or credit risk premium.<sup>23</sup>

Inflation, or an increase in price levels,<sup>24</sup> decreases the spending power of money over time. If inflation occurs while a loan is outstanding, the money a lender provides to a borrower will be worth less when it is repaid. To protect lenders against this loss, interest rates incorporate the market's expectation of the average rate of inflation over the life of the loan.<sup>25</sup> The real rate of interest (to be distinguished from a real interest rate, which is the opposite of a nominal interest rate) is the interest in excess of inflation on a riskless security.<sup>26</sup> It is a form of compensation to induce a lender to postpone their consumption of funds between the present and a future date.<sup>27</sup> The real rate of interest and inflation should be identical for all borrowers, though both measures vary with the term of the loan.<sup>28</sup>

Variations in interest rates result from borrower-specific default (or credit risk).<sup>29</sup> Lenders price such risk, not all of which can be compensated for in any instance.<sup>30</sup> The greater the borrower's perceived risk, the greater the inducement must be for the lender to provide them with funds.<sup>31</sup> The interest rates on United States Treasury securities are some of the lowest in the market<sup>32</sup> because

---

23. See Scott, *supra* note 5, at 1046; see also J. FRED WESTON & EUGENE F. BRIGHAM, *ESSENTIALS OF MANAGERIAL FINANCE*, 345-46 (6th ed. 1982). A simple method for determining the real rate of interest is to subtract the inflation factor from the nominal interest rate. *Id.*

24. See PEARCE, *supra* note 20, at 209.

25. See Scott, *supra* note 5, at 1046; EUGENE F. BRIGHAM & JOEL F. HOUSTON, *FUNDAMENTALS OF FINANCIAL MANAGEMENT* 128-29 (8th ed. 1998); WESTON & BRIGHAM, *supra* note 23, at 345-46. The rate of inflation has been positive since World War Two. BUREAU OF LABOR STATISTICS, *CONSUMER PRICE INDEX - ALL URBAN CONSUMERS*, <https://data.bls.gov/pdq/SurveyOutputServlet> (last visited January 13, 2017, 2:20 PM).

26. See BRIGHAM & HOUSTON, *supra* note 25, at 128.

27. See WESTON & BRIGHAM, *supra* note 23, at 345.

28. See Scott, *supra* note 5, at 1047.

29. See *id.*

30. See generally Philip E. Strahan, *Borrower Risk and the Price and Nonprice Terms of Bank Loans*, *Fed Res Bank of N.Y. Staff Reports*, 1 (1990), [https://www.newyorkfed.org/medialibrary/media/research/staff\\_reports/sr90.pdf](https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr90.pdf) [<https://perma.cc/V7PK-ZBQS>].

31. See Scott, *supra* note 5, at 1047; see also Strahan, *supra* note 30, at 7 (“[L]oans more likely to end in default and loans where collection in default is more difficult carry higher interest rates than other loans.”).

32. The interest rate on a 30-year U.S. Treasury Bond was 2.87% as of October 2017. In comparison, the interest rate on high quality corporate bonds (i.e.,

they are considered to be risk free.<sup>33</sup> Riskier debt, such as consumer loans and certain commercial loans, bear higher interest rates to compensate lenders for the increased likelihood of default.<sup>34</sup>

The time value of money is the idea that a dollar today is worth more than a dollar tomorrow. When a creditor makes a loan, it is not repaid immediately. Rather, it may be paid in a lump sum at the end of the loan or according to a repayment schedule. During this period, the debt declines in value from a time preference perspective. Money decreases in value over time due to the non-eliminable risk of default, inflation, and the opportunity costs associated with the inability of the creditor to use the money right away, whether for investment or any other profitable purpose.<sup>35</sup> The longer the period of time, the lower will be the value of the money when repaid.<sup>36</sup>

Present value captures the worth of future money in terms of its value now, taking into account time value. The market value of a loan is a function of the present value of the payments it will generate over time.<sup>37</sup> The face value of that loan is independent of its market value.<sup>38</sup> When a debt is repaid over time, “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

---

rated AAA, AA, or A) was 4.21% in October 2017. *Compare Daily Treasury Yield Curves*, U.S. DEPT. OF THE TREASURY, <https://www.treasury.gov/resource-center/data-chart-center/interest-rates/Pages/TextView.aspx?data=yield> (last visited Oct. 4, 2017) [<https://perma.cc/C9ZT-85K2>] with *Corporate Bond Yield Curve Papers and Data*, U.S. DEPT. OF THE TREASURY, <https://home.treasury.gov/data/treasury-coup-on-issues-and-corporate-bond-yield-curve/corporate-bond-yield-curve> (last visited September 18, 2018).

33. ALAN N. RECHTSCHAFFEN, CAPITAL MARKETS, DERIVATIVES AND THE LAW: EVOLUTION AFTER CRISIS 109 (2d ed. 2014) (“Treasuries are backed by the full faith and credit of the U.S. government and have little or no credit risk . . . .”); *U.S. Treasury Securities*, FINRA <http://www.finra.org/investors/us-treasury-securities> (last visited October 10, 2017) [<https://perma.cc/XBN2-2BAU>] (describing U.S. Treasury securities as “the safest investments you can make, because all Treasury securities are backed by the “full faith and credit” of the U.S. government” and which bear “[n]o call risk and virtually no liquidity, event or credit and default risk.”).

34. See Scott, *supra* note 5, at 1047.

35. See *Till v. S.C.S. Credit Corp.*, 541 U.S. 465, 474 (2004); see also John K. Pearson, Dillon Jackson & Tim Nohr, *Ending the Judicial Snipe Hunt: The Search for the Cramdown Interest Rate*, 4 AM. BANKR. INST. L. REV. 35, 37 (3d ed.1996).

36. See Pearson et al., *supra* note 35, at 37.

37. See ASWATH DAMODARAN, INVESTMENT VALUATION: TOOLS AND TECHNIQUES FOR DETERMINING THE VALUE OF ANY ASSET 37 (3rd ed. 2012).

38. See *id.* (“[T]he value of debt is unaffected by changes in interest rates during the life of the loan or bond.”).

plus an appropriate amount of interest to compensate the creditor for the decreased value of the claim caused by the delayed payments.”<sup>39</sup> This is accomplished by determining the correct discount rate and then discounting the stream of payments to present value.<sup>40</sup> Market conditions affect the applicable discount rate. When a loan bears a market rate of interest (or when the market rate and the interest rate on the loan are the same), “the market will discount that [loan] at the same rate, and the present value of the [loan] will be its face amount.”<sup>41</sup> However, when a loan bears a below-market rate of interest, the market will discount it at a higher rate, resulting in a present value below its face amount. This is logical, as a rational market participant can achieve a higher rate of return on her investment by purchasing other loans bearing higher interest rates.<sup>42</sup>

To say that a loan has a “below-market interest rate” implies its interest rate is lower than the rate of interest on similar debt incurred by similarly situated borrowers. For instance, in *In Re Texas Grand Prairie Hotel Realty*, the rate of interest under the cramdown was below-market because it was lower than what other market participants would have charged for debt issued to a similarly situated debtor under similar terms. The court approved a 5% rate for a crammed down loan in reliance on the formula rate approach, consisting of a 1.75% risk adjustment over prime, when “the market was charging rates in excess of 5% on smaller, over-collateralized loans to comparable hotel owners” and “no willing lender would have extended credit on the terms it was forced to accept under the § 1129(b) cramdown plan . . . .”<sup>43</sup> The rate of interest under the cramdown was below-market because it was lower than what other market participants would have charged for debt issued to a similarly situated debtor under similar terms.

As noted above, the relationship between a crammed down interest rate and the market rate of interest can dramatically affect

---

39. *Rake v. Wade*, 508 U.S. 464, 472 n.8, (1993); see also LOPUCKI & WARREN, *supra* note 4, at 124 (“[T]he amount of money that must be paid at some later time to have a present value of \$X as of the effective date of the plan is \$X plus interest . . . .”).

40. *Rake*, 508 U.S. at 472 n.8; see also PEARCE, *supra* note 20, at 347.

41. 7 COLLIER, *supra* note 4, at ¶ 1129.03[2][b].

42. See STEPHEN A. ROSS, RANDOLPH W. WESTERFIELD & JEFFREY JAFFE, *CORPORATE FINANCE* 235-36 (9th ed. 2010). Conversely, where the market rate of interest is lower than the interest rate on the debt instrument, the security will be discounted at a lower rate, and its present value will exceed its face value.

43. *In re Tex. Grand Prairie Hotel Realty, LLC*, 710 F.3d 324, 336 (5th Cir. 2013).

the present value of a loan. The only way to provide creditors with the present value of their claims is to use prevailing market rates of interest. To the extent a below-market interest rate is assigned to a loan, it is virtually guaranteed that the present value of the loans will be below its face value.

*B. Judicial Methods for Determining Cramdown Interest Rates*

In conducting the present value analysis requisite for the approval of a cramdown under section 1129(b)(2), the bankruptcy court must determine an appropriate rate of interest, which when added to the debtor's deferred stream of payments is equivalent to the present value of the creditor's secured claim, determined as of the effective date.<sup>44</sup> Secured claims will not be deemed to have received fair and equitable treatment under a cramdown if deferred payments bear "insufficient interest to discount the payment to the allowed amount of the claim."<sup>45</sup> In such cases, the debtor's plan will not be confirmed. Unfortunately, the Bankruptcy Code does not provide a clear statutory directive on how bankruptcy courts should calculate appropriate cramdown interest rates.<sup>46</sup> Prior to *Till*,<sup>47</sup> the seminal case on judicial determination of cramdown interest rates in the Chapter 13 context, four approaches predominated, though the proper analysis of interest rates was contentious and subject to confusion.<sup>48</sup>

1. Formula Rate

The "formula rate" approach begins with a base rate and adjusts it upwards to accommodate the risk of non-payment by a specific debtor.<sup>49</sup> While the Supreme Court in *Till* used the national prime rate<sup>50</sup> as a base rate, other courts have relied instead on the

---

44. See Wong, *supra* note 12, at 1934; see also 7 COLLIER, *supra* note 4, at ¶ 1129.05[2][c].

45. 7 COLLIER, *supra* note 4, ¶ 1129.03[4][a][i][C]; see also Pearson, Jackson & Nohr, *supra* note 35, at 38 ("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.").

46. See *In re Am. Homepatient, Inc.*, 420 F.3d 559, 565 (6th Cir. 2005).

47. *Till v. S.C.S. Credit Corp.*, 541 U.S. 465, 474 (2004).

48. See Chaim J. Fortgang & Thomas Moers Mayer, *Valuation in Bankruptcy*, 32 UCLA L. REV. 1061, 1119 (1985) ("[F]ew bankruptcy issues have met with as much confusion as the determination of a proper discount rate.").

49. See *Till*, 541 U.S. at 479.

50. The prime rate generally refers to the interest rate used by commercial banks in lending to their most credit-worthy customers. See Ronald F. Greenspan & Cynthia Nelson, "UnTill" We Meet Again, *Why the Till Decision Might Not Be the Last Word on Cramdown Interest Rates*, AM. BANKR. INST. J., 48, 49 (Dec. 2004/ Jan. 2005)

treasury rate.<sup>51</sup> Regardless, the use of prime or any other easily and objectively ascertainable rate<sup>52</sup> was viewed in *Till* as facilitating rapid, expedient, and objective determination of cramdown interest rates.<sup>53</sup>

The size of the risk adjustment under the formula rate approach depends on “the circumstances of the estate, the nature of the security, and the duration and feasibility of the reorganization plan.”<sup>54</sup> Generally, the risk adjustment is between 1% and 3%.<sup>55</sup> In *Till*, the Court approved a risk premium over the prime rate of 1.5%,<sup>56</sup> resulting in a total interest rate of 9.5%.<sup>57</sup> Theoretically, no risk adjustment would be necessary if the court determined with certainty the debtor was not at risk of defaulting on its obligations.<sup>58</sup> However, such an outcome is highly, if not entirely, unlikely for corporate debtors<sup>59</sup> as only governments, with their ability to

---

(describing the national prime rate as “the base rate on corporate loans posted by at least 75 percent of the nation’s 30 largest banks.”).

51. See *Till*, 541 U.S. at 479 (using the “national *prime* rate”) (emphasis added); cf. *GMAC v. Valenti*, 105 F.3d 55, 64-65 (2d Cir. 1997) (remanding a Chapter 13 “case to the bankruptcy court for a recalculation of the interest rate based upon the *treasury rate* plus an additional risk premium.”) (emphasis added). The treasury rate refers to the return on investment, expressed as a percentage, on investments in U.S. government debt obligations.

52. See *In re Smith*, 178 B.R. 946, 952 (Bankr. D. Vt. 1995) (listing other base rates, including the “[f]ederal tax rate, federal or state legal rates, rates on consumer loans, Federal Land Bank rates” or an “average of several of these rates.”); see also Greenspan & Nelson, *supra* note 50, at 49 (describing other base rates, including LIBOR (London Interbank Offering Rate) and the Federal Home Loan Bank District Cost of Funds Index (COFI)). The use of these rates in any individual instance “depends on the type of loan, its duration (length) and lender circumstances. . . .” *Id.*

53. See *Till*, 541 U.S. at 479.

54. *Id.*

55. See *id.* at 480.

56. See *id.*

57. See *id.* at 471.

58. See *id.* at 479 n.18 (“[I]f the court could somehow be certain a debtor would complete his plan, the prime rate would be adequate to compensate any secured creditors forced to accept cramdown loans.”).

59. See Peter Schulman & C. Brad Peterson, *Understanding Discounting in Litigation*, COLO. LAW., Apr. 2007, at 23, 26 (stating while corporate securities cannot be considered risk free, certain “[i]nvestment-grade corporate bonds can yield rates of return that are only slightly higher than “risk-free” rates.”); see also Aswath Damodaran, *Estimating Risk Free Rates*, STERN SCH. OF BUS., <http://people.stern.nyu.edu/adamodar/pdfiles/papers/riskfree.pdf> (last visited Jan. 7, 2016) (stating the inability to rule out default risk means securities issued by private firms, regardless of their size or perceived safety, contain some degree of risk).

print money, may be considered risk free.<sup>60</sup> Recent history shows that even governments are not immunized against default.<sup>61</sup>

## 2. Forced Loan or Coerced Loan

Under the “forced loan” or “coerced loan” approach, a court sets the cramdown rate in order to bring the creditor to the level it would have obtained had it “foreclosed and reinvested the proceeds in loans of equivalent duration and risk.”<sup>62</sup> In other words, a creditor must be put in the same economic position it would have been had it liquidated the collateral securing its claim up front and made new equivalent loans to the reorganized debtor.<sup>63</sup> It assumes this rate is best determined by comparison to what a creditor would charge in the “open market for a loan of similar duration and risk as to the post-cramdown loan.”<sup>64</sup> Unlike the formula rate approach, the forced loan approach uses evidence of rates from actual credit markets.<sup>65</sup>

## 3. Cost of Funds

The “cost of funds” approach relies on the rate a creditor pays when it borrows for itself.<sup>66</sup> This approach makes two critical assumptions: first, that a creditor will cover any losses resulting from deferred payments by seeking new funds in the market, and second, that the creditor has access to additional funding.<sup>67</sup> Under this approach, the creditor must receive a rate equivalent to its cost of replacing the funds “locked up” in the replacement note issued

---

60. See Schulman & Peterson, *supra* note 59, at 26 (noting only U.S. treasuries are considered “risk-free” given the recognition by most investors of the extremely low likelihood of government default); see also Damodaran, *supra* note 59 (stating since governments control the printing of money, and therefore can always, at least theoretically, generate sufficient cash to meet their obligations, their securities are viewed as risk free).

61. For an example of a recent government default, see Nick Timiraos, Heather Gillers & Matt Wirz, *Puerto Rico’s Debt Crisis Deepens as Government Misses Payment*, WALL ST. J. (May 2, 2016), <http://www.wsj.com/articles/puerto-ricos-debt-crisis-turns-up-the-heat-on-congress-1462219483> [<https://perma.cc/WCE6-TLT5>] (describing the failure of the Puerto Rican government to honor a nearly \$400 million principal payment).

62. *Koopmans v. Farm Credit Servs. of Mid-Am, ACA*, 102 F.3d 874, 875 (7th Cir. 1996); see also *GMAC v. Valenti*, 105 F.3d 55, 63 (2d Cir. 1997).

63. See *Valenti*, 105 F.3d at 63 (quoting *Gen. Motors Acceptance Corp. v. Jones*, 999 F.2d 63, 69 (3d Cir. 1993)).

64. Wong, *supra* note 12, at 1936.

65. See *id.*

66. See *Valenti*, 105 F.3d at 63.

67. See Wong, *supra* note 12, at 1940.

under the cramdown plan,<sup>68</sup> or one that approximates the creditor's cost of funds.<sup>69</sup> Since the funds are no longer available to the creditor as a result of the cramdown plan, the creditor, theoretically, will be forced to obtain them elsewhere. Similarly to the formula rate approach, the cost of funds approach excludes creditor profits and administrative costs.<sup>70</sup> It posits the creditor is entitled only to the time value of money and should not be compensated for the other factors that ordinarily are included in an interest rate.<sup>71</sup>

Various criticisms have rendered the cost of funds approach the least widely accepted method for determining cramdown interest rates.<sup>72</sup> For instance, the cost of funds approach emphasizes the creditor's credit-worthiness over the debtor's.<sup>73</sup> It focuses on the former's credit history, business structure, capitalization, and operational efficiency, while ignoring the debtor's risk of default.<sup>74</sup> As a result, a poorly capitalized and inefficient creditor may receive a higher cramdown interest rate than a better capitalized and more efficient competitor with a lower cost of funds.<sup>75</sup> The variation among creditors and their abilities to borrow at specific rates would also require bankruptcy courts to engage in evidentiary proceedings to assess a given creditor's cost of funds on a case-by-case basis.<sup>76</sup>

The cost of funds approach also incorrectly assumes creditors have access to an unlimited supply of credit. Moreover, if a creditor

---

68. See *Gen. Motors*, 999 F.2d at 67 (“[W]e believe that it would be inappropriate to attempt to exclude consideration of ‘profit’ from a determination of the § 1325 interest rate. Moreover, we perceive no unfairness in including the profit component that anyone lending money in a commercial context expects.”).

69. See Todd J. Zywicki, *Cramdown and the Code: Calculating Cramdown Interest Rates Under the Bankruptcy Code*, 19 T. MARSHALL L. REV. 241, 254 (1994) (quoting 5 COLLIER ON BANKRUPTCY ¶ 1325.03 at 1325-46 (Lawrence P. King ed., 15th ed. 1993)).

70. See Michael Elson, *Say “Ahhh!”: A New Approach for Determining the Cram Down Interest Rate After Till v. SCS Credit*, 27 CARDOZO L. REV. 1921, 1934 (2006); see also *In re Ivey*, 147 B.R. 109, 117 (M.D.N.C. 1992) (describing an advantage of the cost of funds approach as the fact that “it does not include profit to the creditor.”).

71. See Zywicki, *supra* note 69, at 254. For further discussion on the components of interest rates, see section I.B, *infra*.

72. See Ry Ellison, *The Application of Till to Chapter 11 Cases in the Fifth Circuit*, 1 BUS. & BANKR. L.J. 28, 32 (2014) (claiming “the cost of funds approach is perhaps the least accepted of the various cramdown rate calculation methods.”).

73. *Till v. S.C.S. Credit Corp.*, 541 U.S. 465, 478 (2004).

74. See David G. Epstein, *Don't Go and Do Something Rash About Cram Down Interest Rates*, 49 ALA. L. REV. 435, 450-51 (1998).

75. See *id.* at 451.

76. See *GMAC v. Valenti*, 105 F.3d 55, 64 (2d Cir. 1997).

has limited credit to draw upon and a maximum amount of profit to generate through use of that credit, the creditor will suffer a loss as a result of borrowing merely to replace capital locked up in a replacement loan. That loss is equal to the interest rate the lender could enjoy on a loan to borrowers similar to the debtor minus transaction costs and cost of funds. The cost of funds approach fails to compensate the creditor for this loss by assessing a cramdown rate based merely upon the replacement of one pool of funds with another.<sup>77</sup>

#### 4. Contract Rate

Finally, the “contract rate” approach establishes a rebuttable presumption that the correct cramdown rate is the original interest rate negotiated in the pre-bankruptcy agreement between the creditor and debtor,<sup>78</sup> either of whom may provide evidence to challenge the presumptive cramdown rate in favor of one that is higher or lower.<sup>79</sup> For instance, evidence of changes in market conditions or the debtor’s risk profile as a result of a successful restructuring may be sufficient to convince the court to adjust the presumptive contract rate.<sup>80</sup>

The contract rate approach is often rightly criticized in that its starting point is the “stale” rate under the pre-petition loan. The factors that led the parties to agree to that rate may be completely different at the time of the confirmation of the plan. For example, there may be less debt on the debtor’s balance sheet, litigation claims against the debtor may have been eliminated, and the debtor’s collateral may be more or less valuable. In addition, market factors may have changed, especially if there is a long delay between the contract date and when the debtor emerges from Chapter 11.<sup>81</sup> Beginning with an “outdated” rate and introducing

---

77. See *United Carolina Bank v. Hall*, 993 F.2d 1126, 1130 (4th Cir. 1993) (arguing the cost of funds approach is flawed because “[w]hen it is recognized that every secured creditor has a limited amount of credit on which to draw, then it follows that utilizing some of that borrowing capacity without providing the secured creditor with the usual return on its capital produces a loss for the secured creditor.”).

78. See *Wong*, *supra* note 12, at 1938.

79. See *Till v. S.C.S. Credit Corp.* 541 U.S. 465, 473 (2004).

80. See *Wong*, *supra* note 12, at 1938.

81. See Aaron J. Bell, *Making Cramdown Palatable: Post-Confirmation Interest on Secured Claims in a Chapter 11 Cramdown*, 23 WILLAMETTE L. REV. 405, 419-20 (1987) (criticizing the failure of a court to take into account the twenty months between the date the contract was entered into and the date of confirmation, since “[i]t is doubtful that the twenty-month-old rate was an accurate indication of the market

expert testimony as to why it should be adjusted seems arbitrary. Additionally, when the post-petition creditor is a healthier and more credit-worthy company, the contract rate initially overcompensates the creditor and then obligates the debtor to provide evidence to force the interest rate to a more appropriate and lower level.

C. *The Till Decision and Adoption of the Formula Rate Approach*

In *Till*, a plurality of the Supreme Court rejected the forced loan, cost of funds, and contract rate approaches in the Chapter 13 bankruptcy context. Instead, the Court held the formula rate approach “best comports with the purposes of the Bankruptcy Code” and should therefore serve as the proper standard for determining cramdown interest rates.<sup>82</sup> In adopting the formula rate approach, the plurality reasoned the three discarded tests were too complicated, created expensive evidentiary proceedings, and prioritized making the creditor whole over ensuring an appropriate present value for the debtor’s future payments.<sup>83</sup>

By comparison, the formula rate approach took “its cue from ordinary lending practices.”<sup>84</sup> It used as a reference point the national prime rate, “which reflects the financial market’s estimate of the amount a commercial bank should charge a creditworthy commercial borrower.”<sup>85</sup> The *Till* Court believed bankruptcy courts would be able to easily determine the risk adjustment component of the formula rate approach, since much of the relevant evidence would already be contained in the debtor’s bankruptcy filings.<sup>86</sup> Finally, by starting with a low interest rate and adjusting upward, the plurality reasoned that the creditor, rather than the debtor, would suffer the brunt of any evidentiary burden. The plurality preferred this outcome because the creditor presumably had better access to any information absent from the debtor’s filings, such as evidence pertaining to the “liquidity of the collateral market.”<sup>87</sup>

---

at the time the plan became effective.”); *see also In re Mitchell*, 39 B.R. 696, 702 (Bankr. D. Or. 1984) (“It is obvious that a contract rate of interest is not an adequate indicator of current market conditions over an extended period of time.”).

82. *Till*, 541 U.S. at 480.

83. *Id.* at 477.

84. *Id.* at 478.

85. *Id.* at 479.

86. *See id.*

87. *Id.*

D. *Till's Famous Footnote 14 and the Two-Part Approach*

Despite *Till's* adoption of the formula rate approach, its footnote 14 suggests the approach for determining cramdown interest rates best suited for Chapter 13 may not be equally suited for Chapter 11.<sup>88</sup> The footnote distinguishes the limited market for lending to Chapter 13 debtors from the market for lending to Chapter 11 debtors.<sup>89</sup> In the latter, “numerous lenders advertise financing for chapter 11 debtors in possession.”<sup>90</sup> As a result, the footnote suggests, “when picking a cramdown rate in a chapter 11 case, it might make sense to ask what rate an efficient market would produce.”<sup>91</sup>

Courts relying on this footnote have adopted a two-step approach for determining an interest rate in Chapter 11 cramdowns. In the first instance, “the market rate should be applied in Chapter 11 cases where there exists an efficient market.”<sup>92</sup> However, in the absence of any efficient market for a Chapter 11 debtor, “the Bankruptcy Court should employ the formula approach endorsed by the *Till* plurality.”<sup>93</sup> Courts that have adopted this rule have found efficient markets exist where they offer loans “with a term, size, and collateral comparable to the forced loan contemplated under the cramdown plan.”<sup>94</sup> This analysis has allowed courts to continue relying on market rates in Chapter 11, where markets are efficient and supported by sufficient evidence. In Chapter 13, by contrast, the absence of an adequate or efficient market for lending to debtors implies there is no data on which to base a market-referenced

---

88. *See id.* at 476 n.14.

89. *See id.* (stating in Chapter 13, “there is no free market of willing cramdown lenders” but that this is not true in Chapter 11).

90. *See id.*; *see also* Griffiths, *supra* note 14.

91. *Till*, 541 U.S. at 476 n.14.

92. *In re Am. Homepatient, Inc.*, 420 F.3d 559, 568 (6th Cir. 2005); *see also In re 20 Bayard Views, LLC*, 445 B.R. 83, 111 (Bankr. E.D.N.Y. 2011); *Mercury Capital Corp. v. Milford Conn. Assocs., L.P.*, 354 B.R. 1, 12 (D. Conn. 2006) (on remand, the bankruptcy court was required to consider whether “an efficient market rate [existed] for the type of loan Mercury [was] forced to give the debtor under the competing plans.”); *In re Brice Rd. Developments, LLC*, 392 B.R. 274, 280 (B.A.P. 6th Cir. 2008) (“[I]n this circuit, in a chapter 11 case where an ‘efficient market’ exists, the market rate should be applied, and where no ‘efficient market’ exists, the formula approach endorsed by the Supreme Court . . . should be employed.”).

93. *Homepatient*, 420 F.3d at 568; *see also In re Bayard Views*, 445 B.R. at 111; *Mercury Capital* 354 B.R. at 13; *In re Brice*, 392 B.R. at 280 (“[I]n this circuit, in a chapter 11 case where an ‘efficient market’ exists, the market rate should be applied, and where no ‘efficient market’ exists, the formula approach endorsed by the Supreme Court . . . should be employed.”).

94. *In re Tex. Grand Prairie Hotel Realty, LLC*, 710 F.3d 324, 336 (5th Cir. 2013).

cramdown interest rate, such that the formula rate approach is a more desirable, if not the only option.

## II.

### MOMENTIVE PERFORMANCE MATERIALS AND THE EXTENSION OF THE FORMULA RATE APPROACH INTO CHAPTER 11

#### A. Momentive *Facts and Arguments*

In *Momentive*, Judge Drain extended the Supreme Court plurality's endorsement of the formula rate approach in Chapter 13 to a Chapter 11 case. The debtor, a silicon and quartz producer, filed for Chapter 11 protection in April 2014, at least in part as a result of a \$3.8 billion take private transaction sponsored by Apollo Global Management.<sup>95</sup> At issue were two classes of senior secured notes executed in 2012: \$1.1 billion in First Lien Notes and \$250 million in 1.5 Lien Notes (collectively the "Senior Secured Notes").<sup>96</sup> Both the First and 1.5 Lien notes were due to mature in October 15, 2020, and bore interest rates of 8.875% and 10%, respectively.<sup>97</sup>

The debtor's plan included a "deathtrap" provision.<sup>98</sup> If the Senior Secured Notes voted in favor of the plan, they would receive all outstanding principal and accrued interest in cash on the effective date. However, no make-whole premium<sup>99</sup> would be permitted under this option.<sup>100</sup> Alternatively, if the Senior Secured Noteholders voted against the plan, the debtor would instead provide them with replacement notes, which matured in seven, and seven and a half years depending on lien priority, with interest rates to be deter-

---

95. See Patrick Fitzgerald, *Apollo's Momentive Performance Materials Makes Chapter 11 Bankruptcy Filing*, WALL ST. J. (Apr. 13, 2014), <https://www.wsj.com/articles/apollos-momentive-performance-materials-makes-chapter-11-bankruptcy-filing-1397439652> [<https://perma.cc/5SEX-Q7L3>].

96. See *In re MPM Silicones, LLC*, 531 B.R. 321, 325 (Bankr. S.D.N.Y. 2015); David Griffiths, *Momentous Decision in Momentive Performance Materials: Cramdown of Secured Creditors – Part II*, WEIL BANKRUPTCY BLOG (Sept. 10, 2014), <https://business-finance-restructuring.weil.com/chapter-11-plans/momentous-decision-in-momentive-performance-materials-cramdown-of-secured-creditors-part-ii/>.

97. See *In re MPM Silicones, LLC*, 531 B.R. at 325.

98. See Griffiths, *supra* note 96.

99. A make-whole premium is a provision in a debt instrument allowing the issuer to retire or pay off the remaining debt early. The borrower must then pay the holder a lump sum based on the present value of the future payments not made as a result of the early retirement. See *Make-Whole Call Provisions*, CAPITAL ADVISORS GROUP (Oct. 31, 2004), <https://capitaladvisors.com/wp-content/uploads/2016/12/Make-Whole-Call-Provisions.pdf>.

100. See *In re MPM Silicones, LLC*, 531 B.R. at 326.

mined under the cramdown provisions in section 1129(b)(2) and by using the approach endorsed by the Supreme Court in *Till*.<sup>101</sup> In effect, the deathtrap offered the Senior Secured Noteholders one of two options: run the risk of receiving a below-market interest rate on the replacement notes, or forgo the make-whole premium and their right to receive the value of any uncollected future interest payments.

When the Senior Secured Notes voted against the plan,<sup>102</sup> the debtor attempted to cram it down over their objections. In response, the Senior Secured Notes argued the interest rates on the replacement notes violated section 1129(b)(2)'s fair and equitable requirement. They interpreted the *Till* plurality opinion to require the use of the formula rate approach only after a determination by the court that an efficient market did not already exist<sup>103</sup> or that a market rate of interest should be used to calculate a cramdown interest rate, when available. The Senior Secured Noteholders claimed such a market was in fact present. They pointed to the fact that the *Momentive* debtor had secured, and the bankruptcy court had approved, exit and bridge financing.<sup>104</sup> *Momentive* was the only case, post *Till*, in which the debtors had secured exit financing commitments prior to attempting to cramdown its secured creditors.<sup>105</sup> The Senior Secured Notes also provided evidence of a "robust and readily available" leveraged loan market.<sup>106</sup> The First Lien

---

101. *See id.*

102. *See In re MPM Silicones, LLC*, 531 B.R. at 326.

103. *See* Cramdown Objection of Wilmington Trust, National Association, as Indenture Trustee, to Confirmation of Debtors' Proposed Joint Chapter 11 Plan of Reorganization at 39, *In re MPM Silicones, LLC*, 2014 WL 4436335 (Bankr. S.D.N.Y. Sept. 9, 2014) (No. 7:14-BK-22503); Objection of Bokf, Na, as First Lien Trustee, to the Debtors' Joint Chapter 11 Plan and Confirmation of the Plan with Respect to the Terms of the Replacement First Lien Notes at 38, *In re MPM Silicones, LLC*, 2014 WL 4255115 (Bankr. S.D.N.Y. August 12, 2014) (No. 7:14-BK-22503). Certain courts have adopted this approach, or a near variant. *See, e.g., In re Prussia Assocs.*, 322 B.R. 572, 589 (Bankr. E.D. Pa. 2005) (arguing a caveat exists under *Till* footnote 14, such that the formula rate approach should not be applied where an efficient market exists). While the *Prussia Associates* court found a sufficiently efficient market existed, the totality of evidence did not permit it to conclude with certainty the appropriate market rate of interest, and as a result, it fell back on the formula rate approach. *Id.* at 590.

104. *See* Objection of Bokf, Na, *supra* note 103, at 30.

105. *See id.* at 39.

106. *Id.* ("[T]he current leveraged loan market is strong with over \$459.6 billion in leveraged loans and \$196.7 billion in high yield debt issued year-to-date (representing a total of \$656.3 billion in issuances) and provides an indication of a robust and readily available financing market."); *see also In re MPM Silicones, LLC*, 531 B.R. at 332; *In re MPM Silicones, LLC*, 2014 WL 4436335, at \*24.

Noteholders contended the court should therefore look to the “rate, tenor and terms” of the exit financing,<sup>107</sup> which served as an adequate market check and risk assessment of the debtors and their business, and no further.<sup>108</sup> In addition, the exit financing was to be secured by the same collateral and receive the same priority as the replacement First Lien Notes, yet under the formula rate approach, the First Lien Notes would be priced lower than the exit financing. Perversely, the 1.5 Lien Noteholders would be required to lend to the debtors “at an interest rate lower and on less favorable terms than the exit lenders under the Exit Facilities—despite the fact that the exit lenders will enjoy a superior (i.e., less risky) security position . . . .”<sup>109</sup>

Even if forced to concede the use of the formula rate approach, the Senior Secured Noteholders argued the bankruptcy court erred in its application of the method through its use of the then-current seven-year national treasury rate as a base rate rather than the national prime rate.<sup>110</sup> Since the debtors had relied on the risk-free treasury rate, the First Lien Trustees claimed the risk adjustment component of the formula rate approach was undervalued and should be adjusted higher.<sup>111</sup> In the words of the First Lien Trustees: “the incorrect use of the Treasury Rate as the base rate without any corresponding increase in the risk premium would effectively deprive the First Lien Noteholders of more than an additional full percentage point that they are entitled to.”<sup>112</sup>

Despite these arguments, Judge Drain agreed with the debtor’s application of the formula rate approach based on the national treasury rate. He approved a 4.1% interest rate for the First Lien Noteholders, and a 4.85% interest rate for the 1.5 Lien Noteholders, forcing the secured creditors to accept below-market interest rates on their securities.<sup>113</sup> Judge Drain only added 0.5% to the cramdown interest rates to reflect the use of the treasury rate,<sup>114</sup> in

---

107. See *Objection of Bokf, Na*, *supra* note 103, at 31.

108. See *id.* at 74-75.

109. Cramdown *Objection of Wilmington Trust*, *supra* note 103, at 33.

110. See *Objection of Bokf, Na*, *supra* note 103, at 52 (arguing the *Till* plurality “was clear that in utilizing the formula approach, the starting point is a base rate equal to the prime interest rate.”).

111. See *id.* at 54.

112. *Id.*

113. *In re MPM Silicones, LLC*, No. 14-22503-RDD, 2014 WL 4436335, at \*32 (Bankr. S.D.N.Y. Sept. 9, 2014).

114. At this juncture, it is important to address briefly the confusion between a cramdown interest rate based on prime and one based on treasury. Courts have incorrectly used these rates interchangeably, but their meaning and significance in

spite of the fact that at the time of the holding, the prime rate of 3.25% was more than 1% higher than the then-applicable treasury rate of 2.14%.<sup>115</sup>

*B. Judge Drain's Reasoning in Momentive and Adoption of the Formula Rate Approach*

In resolving the bankruptcy dispute, Judge Drain followed the Supreme Court's opinion in *Till*, as well as *Valenti*, a Second Circuit opinion.<sup>116</sup> He relied on starkly pro-debtor policy factors in addition to the argument that *Till* was binding in both Chapter 13 and Chapter 11. First, Judge Drain noted the purpose of a cramdown interest rate is “not to put the creditor in the same position that it would have been in had it arranged a ‘new’ loan”<sup>117</sup> Rather, the objective is to restore the creditor to “the same economic position it would have been in had it received the value of its allowed claim immediately.”<sup>118</sup> This distinction is significant and highlights Judge Drain's view that present value must be determined as to the value of the creditor's *claim*, which does not include any degree of profit,<sup>119</sup> not as to the value of the creditor's *loan*, which does.

Having rationalized the blanket exclusion of profits from cramdown interest rates, Judge Drain claimed market factors (such as those relied upon in the forced loan approach) are not applicable in “court-administered and court-supervised cramdown loans.”<sup>120</sup> Moving further, Judge Drain found market-based evidence, if relevant at all, was only applicable in setting a proper risk premium.<sup>121</sup> In instances where a bankruptcy court determined the

---

the cramdown context differ. In *Till*, for instance, the plurality used prime plus a credit risk adjustment in the range of 1 to 3%. However, the prime rate contemplates borrower default and incorporates compensation for credit risk (and therefore cannot be said to be truly risk free). Thus, in *Till*, the overall risk adjustment based on real interest rates appears to *exceed* the risk adjustment contemplated by the reasoning of the court. *Momentive*, by comparison, used a risk-free treasury rate, which matched the duration of the loan in question. Though Judge Drain suggested that in some instances, no risk adjustment would be necessary, in *Momentive*, he added .5% for the first lien replacement notes, and .75% percent for the 1.5 lien replacement notes.

115. See Objection of Bokf, Na, *supra* note 103, at 54.

116. See *id.* at 24; *GMAC v. Valenti*, 105 F.3d 55 (2d Cir. 1997).

117. *In re MPM Silicones, LLC*, 2014 WL 4436335, at \*25 (emphasis in original) (*quoting Valenti*, 105 F.3d at 63-4).

118. *Id.*

119. See *id.* For further discussion on the inclusion of profit in cramdown interest rate determinations, see Section I.A, *infra*.

120. *Id.* at \*26 (*quoting Till v. S.C.S. Credit Corp.*, 541 U.S. 465, 477 (2004)).

121. *Id.*

debtor would repay its obligations without risk, no premium on the replacement notes would be necessary.<sup>122</sup>

Unlike in the ordinary credit markets, *Momentive* also stated creditors who issue loans in the cramdown context, albeit under judicial coercion, need not be indifferent between immediate foreclosure and a discounted and deferred stream of payments.<sup>123</sup> Judge Drain accepted *Till's* argument that the very concept of a cramdown precludes creditor indifference, since presumably any creditor would prefer immediate foreclosure to the alternative.<sup>124</sup> In determining a fair and equitable cramdown interest rate on the replacement notes, the debtor was not obligated to provide the creditor a rate adjusted to reflect the lost earnings resulting from its inability to foreclose immediately and re-lend any proceeds in the market.<sup>125</sup>

Finally, *Momentive* summarily rejected arguments (included those forwarded by the Senior Secured Noteholders) stemming from *Till* footnote 14.<sup>126</sup> To Judge Drain, there was “no meaningful difference” between Chapter 11 and Chapter 13, and no justification for restricting the *Till* formula rate approach to the latter.<sup>127</sup> Judge Drain strongly discounted the footnote’s persuasive value, since it equated loans imposed on objecting lenders subject to cramdowns with debtor-in-possession financing.<sup>128</sup> He argued this comparison was incorrect, in part, because debtor-in-possession lenders want to make loans, whereas lenders subject to a cramdown do not.<sup>129</sup> Moreover, debtor-in-possession financing takes place at the beginning of Chapter 11 proceedings, while cramdown rates are determined at the end, when the debtor is “more stable and restructured.”<sup>130</sup> In addition, Judge Drain pointed out that the auto

---

122. *See id.*

123. *See id.*

124. *Id.* at \*25; *see also*. *Till v. S.C.S. Credit Corp.*, 541 U.S. 465, 476-77 (2004).

125. *In re MPM Silicones, LLC*, 2014 WL 4436335, at \*25.

126. *Id.* at \*28.

127. *Id.* at \*27.

128. *Id.* Indeed, footnote 14 appears to incorrectly include debtor-in-possession lenders within the “free market of willing cramdown lenders.” *Till v. S.C.S. Credit Corp.*, 541 U.S. 465, 476 n.14 (2004). However, it is not clear whether the Supreme Court viewed debtor-in-possession lenders as the *exclusive* evidence of such a market or whether it intentionally excluded post-petition or exit-financing. An equally plausible and more purposive interpretation is that where any such market exists, evidence of debtor-in-possession lenders may be used to determine cramdown interest rates in the Chapter 11 context and the name of the market or type of credit instrument is less relevant.

129. *Id.* at \*25.

130. *Id.*

loan market at issue in *Till* contained a greater number of active lenders and borrowers, all with access to substantial publicly available data, compared to that which existed for lenders and borrowers with regard to debtor-in-possession or exit financing in Chapter 11.<sup>131</sup> Judge Drain found it significant that the *Till* Court did not view the auto loan market as sufficiently competitive to support an approach other than the formula rate approach. Given the fact that only three exit lenders were available to lend to the *Momentive* debtors, Judge Drain claimed “footnote 14 is a very slim reed indeed on which to require a market-based approach. . . .”<sup>132</sup>

C. *The Second Circuit’s Recent Opinion Overturned Momentive and Implemented a Two-Step Approach*

Judge Drain’s holding in *Momentive*, including the generalized exclusion of so-called “profit” from crammed down interest rates, caused a grave injustice to the Senior Secured Noteholders. Fortunately, this portion of his opinion was recently overturned in the Second Circuit, which adopted instead a “two-step approach” relying primarily on market rates of interest. The Second Circuit refused to read the *Till* plurality as ignoring the relevance of efficient markets in determining Chapter 11 cramdown interest rates and stated that to do so would be a “major departure from long-standing precedent” which viewed value as best determined by analysis of the market.<sup>133</sup> It suggested courts should be limited in their ability to make valuation judgments independent of competitive choice, particularly when market valuations are available.<sup>134</sup> Pointing to the expert testimony provided by the Senior Secured Noteholders, the Second Circuit determined that a market rate for the cramdown debt did exist. As discussed, under the debtor’s deathtrap offer, the Senior Secured Noteholders could have accepted immediate payment for their notes. To fund this lump-sum cash-out payment, which was ultimately never required, the debtor sought market financing and was quoted interest rates between 5 and over 6 percent. Thus, the Second Circuit stated:

[W]here, as here, an efficient market may exist that generates an interest rate that is apparently acceptable to sophisticated parties dealing at arm’s-length, we conclude, consistent

---

131. *Id.*

132. *Id.*

133. *In re MPM Silicones, LLC*, 874 F.3d 787, 800 (2d Cir. 2017).

134. *See id.* (quoting *Bank of Am. Nat’l Trust and Sav. Ass’n v. 203 N. LaSalle St. P’Ship*, 526 U.S. 434, 457-58 (1999)).

with footnote 14, that such a rate is preferable to a formula improvised by the court.<sup>135</sup>

Ultimately, the Second Circuit refused to categorically reject the probative value of market rates of interests in the cramdown interest rate context and remanded the case to the bankruptcy court for re-determination of the appropriate rate.

### III. THE BUSINESS OF BANKING

In light of the foregoing, I will next discuss why the Second Circuit's two-step approach should be adopted as the standard for determining cramdown interest rates under Chapter 11 of the Bankruptcy Code, taking into account the operation of commercial credit markets as well as how such markets determine prevailing interest rates. Commercial credit takes many forms, depending on, among other factors, the debtor's credit quality,<sup>136</sup> size,<sup>137</sup> and leverage;<sup>138</sup> whether the debtor has proprietary information;<sup>139</sup> and prevailing market conditions.<sup>140</sup> Those seeking external financing may borrow from banks and other financial institutions or the capital markets. Often, borrowers prefer to issue debt securities, such as bonds and notes, and view banks as lenders of last resort. Banks impose stricter requirements than bonds on borrowers, which may

---

135. *Id.* at 801. The Second Circuit also distinguished Chapter 11 from the a "sub-prime loan in the Chapter 13 context" where "'value' can be elusive because the market is not necessarily efficient and the borrower is typically unsophisticated." *Id.*

136. See David D. Jenis & Vassil T. Mihov, *The Choice Among Bank Debt, Non-Bank Private Debt, and Public Debt: Evidence from New Corporate Borrowings*, 70 J. FIN. ECON. 3, 5 (2003) (finding "the primary determinant of the choice of debt instrument is the credit quality of the issuing firm.").

137. See Joel Houston & Christopher James, *Bank Information Monopolies and the Mix of Private and Public Debt Claims*, 51 J. FIN. ECON. 1863, 1864 (1996) (finding reliance on bank financing decreases with firm size and leverage); Shane A. Johnson, *An Empirical Analysis of the Determinants of Corporate Debt Ownership Structure*, 32 J. OF FIN. AND QUANT. ANAL. 47, 48 (1997) (stating "bank debt is concentrated among smaller firms.").

138. See Houston & James, *supra* note 137, at 1864.

139. See generally Jayant R. Kale & Costanza Meneghetti, *The Choice Between Public and Private Debt: A Survey*, 23 IIMG MGMT. REV. 5, 6-7 (2011) (reviewing the impact of proprietary information on the decisions of borrowers to obtain financing from public or private sources).

140. For instance, see Mark T. Leary, *Bank Loan Supply, Lender Choice, and Corporate Capital Structure*, 64 J. FIN. 1143, 1180 (2009) (finding expansions and contractions in the supply of bank loans cause variations in firms' debt placement structures).

take the form of more restrictive covenants or more covenants in general.<sup>141</sup> I focus below on the types of debt that may be negatively impacted by below-market cramdown interest rates.

#### A. *Bank Debt*

Loans are rarely executed on a bilateral or individual basis. Instead, loans are more frequently syndicated, or shared among a group of lenders.<sup>142</sup> Syndication has the benefit of spreading the funding obligations and associated risks among a group of institutions such that no entity bears the burden exclusively.<sup>143</sup> There exists a market for origination of syndicated loans among banks, finance companies, and institutional investors.<sup>144</sup> When a company wishes to take on debt, it retains an arranger, often an investment or commercial bank, to build out a “book” of potential creditors.<sup>145</sup> Creditors bid by offering to fund a percentage of the requested principal at a given interest rate.<sup>146</sup> Many credit structures contain market flex provisions, which allow the arranger to modify the terms of the loan within a certain set of parameters to make them more attractive to the credit market in the event the debt is under-subscribed.<sup>147</sup> The terms and rates on the debt are therefore the product of a competitive, market-driven bidding process.

---

141. See William W. Bratton, *Bond Covenants and Creditor Protection: Economics and Law, Theory and Practice, Substance and Process*, 7 EUR. BUS. ORG. L. REV. 39, 20 (2006) (noting “substantial protection,” as measured by covenant incidence and stringency, is the rule in credit agreements between borrowers and banks, but that when one looks to bond markets, there is a “reduction in the incidence and intensity of covenants, even for borrowers of the same risk class as the bank borrowers.”); Arthur E. Wilmarth, Jr., *The Transformation of the U.S. Financial Services Industry, 1975-2000: Competition, Consolidation, and Increased Risks*, 2002 U. ILL. L. REV. 215, 227-231 (discussing a continuum of borrowers, where borrowers with the strongest reputations and financial profiles borrowers are able to tap into the capital markets, but where more “opaque” borrowers are forced to lend from banks and incur more “restrictive covenants and collateral requirements”); R. STAFFORD JOHNSON, *DEBT MARKETS AND ANALYSIS* 273 (1st ed. 2013) (stating “[l]arger corporations, whose credit standings are often strong, prefer to finance their long-term and intermediate-term assets by selling corporate bonds and notes . . .”).

142. See STEVEN MILLER & WILLIAM CHEW, *A GUIDE TO THE LOAN MARKET* 7, STANDARD & POOR’S (Sept. 2011) [<https://perma.cc/S5ZK-9PTF>].

143. See *id.* at 8.

144. See *id.* at 10. Loan mutual funds may also provide retail investors with exposure to the syndicated loan market. *Id.* Thus, below-market cramdown interest rates have the potential to impact not only large banks and financial institutions, but individual retail investors saving for retirement or other investments.

145. See *id.* at 8.

146. See *id.*

147. See *id.*

A credit agreement is the arrangement between a syndicate of financial institutions and a borrower to provide a certain sum of money. Credit agreements can provide financing in many ways.<sup>148</sup> For long-term or intermediate-term financing needs, borrowers request a term loan.<sup>149</sup> A term loan is the extension of credit for a fixed period. The borrower must repay the principal sum advanced, either periodically or in a lump sum at the end of the term (often referred to as a balloon or bullet payment) as well as interest at predetermined intervals, based on either a fixed or variable rate.<sup>150</sup> Individual borrowers may have both a Term Loan A and Term Loan B. Term Loan As have progressive repayment schedules and are normally syndicated to banks. Term Loan Bs are carved out for syndication to nonbank institutional investors.<sup>151</sup>

Another credit structure is a revolving line of credit, sometimes referred to as a revolver or credit line. Revolvers act like corporate credit cards and allow a borrower to borrow, repay, and borrow again up to the amount committed by its creditors.<sup>152</sup> Credit lines are commonly used for short-term financing purposes<sup>153</sup> and may be tied to a borrowing-base. In such instances, the amount of money the creditor may borrow fluctuates with its current assets, such as inventory or cash and cash receivables.<sup>154</sup>

Such forms of credit are sold and traded among investors on a robust secondary market.<sup>155</sup> Many creditors originate loans with the intent of selling them on a secondary market immediately or shortly

---

148. See JONATHAN GOLIN & PHILIPPE DELHAISE, *THE BANK CREDIT ANALYSIS HANDBOOK* 97 (2d Ed. 2013).

149. See JOHNSON, *supra* note 141, at 23.

150. GOLIN & DELHAISE, *supra* note 148, at 99; see also STRAHAN, *supra* note 30, at 5 (describing a term loan as a facility where “[a] borrower receives a lump sum at the beginning of the contract and pays off the loan, plus interest, over time.”).

151. See MILLER & CHEW, *supra* note 142, at 16.

152. See *id.* at 16; GOLIN & DELHAISE, *supra* note 148, at 101-02.

153. See JOHNSON, *supra* note 141, at 23.

154. See MILLER & CHEW, *supra* note 142, at 16.

155. See *id.* at 21 (“Secondary sales occur after the loan is closed and allocated, when investors are free to trade the paper.”); Blaise Gadanecz, *The Syndicated Loan Market: Structure, Development and Implications*, BIS Q. REV. at 83-84, <http://ssrn.com/abstract=1967463> (stating “[s]yndicated credits are increasingly traded on secondary markets” and the “biggest secondary market for loan trading is the United States, where the volume of such trading amounted to \$145 billion in 2003.”); Robert M. Bushman & Regina Wittenberg-Moerman, *Does Secondary Loan Market Trading Destroy Lenders’ Incentives?*, Chicago Booth Research Paper No. 09-45 at 9, <https://perma.cc/3UKV-LA9S> (stating the size of the market for secondary loans was \$510 billion in 2008.).

thereafter.<sup>156</sup> Below-market interest rates can affect the value of loans trading on secondary markets in two ways. Firstly, the originators of the debt or investors in secondary markets who choose to sell the loans may be forced to do so at a discount, thereby taking a loss. In the alternative, creditors who hold the debt to maturity will utilize their capital in a sub-optimal manner, which may in turn affect their ability to bid competitively on other credit facilities or to meet their capital and funding requirements.

### B. Capital Markets Debt

As an alternative to borrowing from a bank or other institutional investors, companies may borrow from the capital markets. In the first instance, companies issue debt securities in the primary markets.<sup>157</sup> The process for issuing bonds is extremely complex from a regulatory perspective and is beyond the scope of this Note.<sup>158</sup> Of greater significance to a discussion of capital markets debt and cramdowns are secondary markets, or markets “for the buying and selling of existing assets and financial claims.”<sup>159</sup> The United States debt capital market is extremely large; the total value of corporate debt securities outstanding is in excess of \$8 trillion.<sup>160</sup>

The types of debt issued by companies and traded by investors vary widely by maturity, interest payment, covenant packages, and principal, and include convertibles, callable or redeemable securities, and credit sensitive securities.<sup>161</sup> While the exact number of years may vary, bonds are securities with longer maturities, whereas notes, such as those at issue in *Momentive*, typically have shorter maturities than bonds.<sup>162</sup> Entities that purchase securities become

---

156. See Bushman & Wittenberg-Moerman, *supra* note 155, at 3 (stating “at loan origination, lenders anticipate that a given loan will ultimately be sold in the secondary market.”).

157. See JOHNSON, *supra* note 141, at 25 (“[T]he primary market . . . is the market in which new securities are sold for the first time.”).

158. For a more detailed explanation of the regulatory framework and process for issuing debt securities, see RECHTSCHAFFEN, *supra* note 33, at 47-48.

159. JOHNSON, *supra* note 141, at 25. The volume of trading on secondary markets far exceeds the volume of trading on primary markets. *Id.*

160. See Jake Liebschutz & Brian Smith, *Examining Corporate Bond Liquidity and Market Structure*, U.S. DEP’T OF THE TREASURY (May 7, 2016) [<https://perma.cc/MX4T-DFQQ>].

161. See generally JOHNSON, *supra* note 141, at 274-291.

162. See *id.* at 273 (stating notes mature in under five years, whereas bonds mature in over five years); RECHTSCHAFFEN, *supra* note 33, at 51 (stating notes mature in under 10 years, whereas bonds mature in over 10 years).

creditors to the issuer<sup>163</sup> and include pensions, insurance companies, banks, other financial institutions, and households.<sup>164</sup> In exchange for lending to a company by purchasing its securities, creditors receive interest payments and the principal amount of their investment when the security matures.<sup>165</sup> Much like loans, creditors who receive below-market cramdown interest rates will take losses as their securities trade at discounts.

### C. *Interest Rates in Commercial Credit Markets*

In commercial credit markets, the terms of debt, including the interest rate, are the product of arms-length negotiations between willing borrowers and sellers. Such terms are specific to a debtor's financial condition, including the quality of the collateral (if any) securing the debt and also reflect the lender's desire to transact with that borrower.<sup>166</sup> The financial markets play an important role in this process by facilitating the movement of savings, or surplus capital, from those who possess it to those who do not.<sup>167</sup> Holding risk constant, during periods of easy money or when the supply of capital is high, demand for the savings held by any individual entity will be low, given its availability elsewhere. Conversely, if the money supply is low, borrowers must pay a higher price to access excess capital held by others. Thus, market rates of interest also depend on the interaction between supply and demand.<sup>168</sup> As a result, mar-

---

163. See James Woepking, *Private Capital and Development: Challenges Facing International Financial Institutions in a Globalized Economy*, 9 *TRANSNAT'L L. & CONTEMP. PROBS.* 233, 235 (1999); see also RECHTSCHAFFEN, *supra* note 33, at 47 ("From an issuer's perspective, issuing debt means borrowing money from the investor.").

164. See Goldman Sachs Global Investment Research, *Why Market Liquidity has Deteriorated*, 37 *TOP OF MIND* 1, 7 (2015), <http://www.goldmansachs.com/our-thinking/pages/macroeconomic-insights-folder/liquidity-top-of-mind/pdf.pdf> [<https://perma.cc/FP83-BVLW>] (listing pensions, insurance companies, banks and credit unions, other financial companies, broker-dealers, mutual funds and ETFs, households & non-profits, and the rest of the world as corporate bond in a chart titled "Changing Hands.").

165. See Woepking, *supra* note 163, at 235.

166. See Pearson et al., *supra* note 35, at 39; see also Scott, *supra* note 5, at 1051 (stating the underlying collateral also affects the risk component).

167. JAMES C. VAN HORNE, *FINANCIAL MARKET RATES AND FLOWS* 2 (5th ed. 1998) ("[T]he function of financial market is to facilitate the flow of savings from savings-surplus units to savings-deficit ones."); see JOHNSON, *supra* note 141, at 25 (reiterating the role of the financial markets in transferring funds, and stating businesses are almost always "deficit units," in that their current expenditures exceed their income from current projects and production; they are net borrowers).

168. See VAN HORNE, *supra* note 167, at 29.

ket rates float<sup>169</sup> in response to macroeconomic factors including the state of the economy, government policies (both monetary and fiscal), the current and expected levels of inflation, and international factors such as exchange rates and the flow of foreign capital.<sup>170</sup>

Commercial lenders provide a crucial intermediation function in financial markets.<sup>171</sup> Lenders borrow (or purchase) funds at one interest rate, whether from depositors or other commercial lenders, and then lend (or sell) those funds at a higher interest rate to borrowers.<sup>172</sup> Interest rates are therefore a source of revenue to commercial lenders, as well as a cost. The rate at which commercial lenders borrow is referred to as their “cost of funds.”<sup>173</sup> Since most commercial lenders are extremely creditworthy, the interest rates they must pay to their lenders are low.<sup>174</sup> In exchange for acting as intermediaries, commercial lenders earn a “spread,” or the margin between their funding costs and lending rates to borrowers.<sup>175</sup>

#### D. Present Value and “Profit”

Despite their agreement over the need to determine present value as part of a cramdown analysis, courts remain divided over whether present value should include profits for the secured creditor. As described above, an interest rate must be applied to a deferred stream of payments to ensure they are equivalent to the present value of a secured creditor’s claim. Many bankruptcy courts, such as the *Momentive* court, have adopted the view that the “value of a creditor’s allowed claim does not include any degree of profit”<sup>176</sup> and that the interest rate used to determine present value should not reflect the expectation of such an inclusion.<sup>177</sup> Various

---

169. Roger S. Cox, *Bankruptcy & Creditors’ Rights*, 48 SMU L. REV. 875, 909 (1995) (stating it is common practice in commercial loan transactions to use variable interest rates).

170. See JOHNSON, *supra* note 141, at 147.

171. See GOLIN & DELHAISE, *supra* note 148, at 87.

172. See *id.* at 88.

173. See TRACY G. HERRICK, *BANK ANALYST’S HANDBOOK* 163 (1st ed. 1973).

174. As of October 2017, the 1 month, 3 month, 6 month, and 1 year LIBOR was below 2%. See *LIBOR, other interest rates*, BANKRATE (last visited Oct. 4, 2017), <http://www.bankrate.com/rates/interest-rates/libor.aspx> [<https://perma.cc/C2PW-HDKZ>].

175. See GOLIN & DELHAISE, *supra* note 148, at 88.

176. *GMAC v. Valenti*, 105 F.3d 55, 64 (2d Cir. 1997).

177. See Elson, *supra* note 70, at 1932; *In re Smith*, 178 B.R. 946, 953 (Bankr. D. Vt. 1995) (“[T]he Bankruptcy Code simply does not require that reorganization plans provide secured creditors with their contractual profits, protection from risk, collection costs, etc. Rather, it requires only that creditors receive the present value

rationales underlie this perspective. For instance, the rate at issue in a cramdown attaches to a secured claim, not a loan.<sup>178</sup> Present value is therefore equivalent only to the value of the collateral on which the creditor may not foreclose, rather the value of the loan itself.<sup>179</sup> In addition, the source of the obligation to pay interest differs between a claim and loan: “a loan includes a contractual obligation to pay interest” whereas “the obligation to pay interest on a claim . . . is statutory, not contractual.”<sup>180</sup> When addressing secured creditor claims, the amount of interest should not be determined by reference to a contract or the market, but should instead rely on the appropriate statute and relevant judicial interpretations.<sup>181</sup> The bankruptcy court in *In re Dingley*, among others, has also opined that the Bankruptcy Code protects the creditor’s claim or interest in the property collateralizing the debtor’s pre-bankruptcy obligation, “not the creditor’s interest in the profit it had hoped to make on the loan.”<sup>182</sup> Using a rate that includes transaction costs, costs associated with advertising and overhead, and profit<sup>183</sup> would generate a stream of payments to the secured creditors whose present value was greater than the value of its claim.<sup>184</sup>

Yet, the foregoing arguments misunderstand “profit” in the context of interest rates and financial markets generally. Moreover, courts are not clear on what is meant by “profit” in a cramdown interest rate.<sup>185</sup> By reducing pre-petition bankruptcy rates based on some ambiguous notion of illegitimate “profit,” courts will consistently assign below-market interest rates to creditors, virtually ensuring they will not receive the present value of their loans. In reality, “profit” is the real interest rate component of an interest rate, or the cost to the creditor of “deferring present consumption until a

---

of their claims.”); *In re Dingley*, 189 B.R. 264, 269 (Bankr. N.D.N.Y. 1995) (arguing the plain language of Chapter 13 does not indicate any intent to preserve the “lender’s contract ‘market’ rate of interest i.e., profit” and that had Congress wished to provide creditors with their original interest rates, it would have drafted the statute accordingly).

178. See *Smith*, 178 B.R. at 951 (arguing claims “arise out of loans which went bad, but they are in no sense of the word ‘loans.’”).

179. See Zywicki, *supra* note 69, at 255.

180. *Smith*, 178 B.R. at 951.

181. See *id.*

182. *Dingley*, 189 B.R. at 269 (quoting *In re Hudock*, 124 B.R. 532, 534 (Bankr. N.D. Ill. 1991)).

183. See Elson, *supra* note 70, at 1932.

184. See *In re Cellular Info. Sys.*, 171 B.R. 926, 939 (Bankr. S.D.N.Y. 1994).

185. See Scott, *supra* note 5, at 1053 (stating “[c]ourts have concluded that interest rates should not include a ‘profit’ element. The meaning of that assertion is unclear.”).

later time” and “the normal return on capital without which loans would not be made.”<sup>186</sup> Even in a hypothetical risk-free and inflation-less environment, there would still be a positive real rate of interest. Otherwise, lenders would have no inducement to agree to an “exchange between current and future consumption.”<sup>187</sup> There is no “profit” in delayed consumption of funds.<sup>188</sup> Instead, “profit” is better viewed as a cost of capital requisite to entice the deferred use of money or the opportunity cost of having those funds locked up for a given period of time. By denying “profit” to creditors, courts deprive them of compensation for the taking of their present use of capital.<sup>189</sup>

As discussed, the real rate of interest and inflationary expectation should be identical for all borrowers. Interest rates vary depending on the riskiness of an individual borrower.<sup>190</sup> The risk premium is “the return to capital which compensates the owners of capital for the risk involved in its use in business ventures.”<sup>191</sup> Commercial lenders, with large capital cushions and often-implicit governmental backing, are low risk borrowers. Little compensation is required to induce the transfer of funds between them. Thus, lenders borrow funds from one another at a very low rate of interest, such as LIBOR, and extend credit to comparatively risky entities at higher interest rates.<sup>192</sup> The business model of commercial lending is predicated upon the assumption of this risk, a function for which lenders are necessarily compensated by capturing the interest rate spread. Spread, however, represents gross revenue, from which lenders must cover overhead, rent, salaries, and other costs of doing business. Lenders do not “profit” as a result of capturing the spread, in the sense of taking advantage of a borrower. Rather, they are compensated for providing a vital—and risky—economic function.

---

186. Zywicki, *supra* note 69, at 261; *see also* Monica Hartman, *Selecting the Correct Cramdown Interest Rate in Chapter 11 and Chapter 13 Bankruptcies*, 47 UCLA L. REV. 521, 535 (1999) (“Profit cannot be clearly distinguished from the break-even point or real rate of return that lenders require in order to make any loan.”).

187. Scott, *supra* note 5, at 1047.

188. Zywicki, *supra* note 69, at 261.

189. *Id.* at 261-62.

190. *See* section, I.A. *supra*.

191. PEARCE, *supra* note 20, at 388.

192. *See* Simon Constable, *What Is Net Interest Margin?*, WALL STREET J. (May 7, 2017), <https://www.wsj.com/articles/what-is-net-interest-margin-1494209342> (“A bank usually bases what it charges borrowers on long-term interest rates, while the interest it pays to get funds is based on short-term rates.”).

*E. The Market Value of the Momentive First Lien Notes Decreased as a Result of the Use of the Formula Rate Approach*

To demonstrate the decrease in value of the First Lien Notes resulting from the use by the *Momentive* court of the formula rate approach, I make the following assumptions: firstly, the market's valuation of the debt may be inferred by reference to the loan commitments obtained by the debtors to fund the cash-out alternative for the First and 1.5 Lien holders under the Plan's deathtrap provision.<sup>193</sup> The rate for the first lien committed facility was 4% plus LIBOR (with a floor on LIBOR of 1%).<sup>194</sup> The appropriate discount rate, therefore, was 5%, at a minimum. Secondly, interest payments of \$22,550,000 were made semi-annually, or the \$1.1 billion face value multiplied by 2.05%, half the stated 4.1% coupon interest rate under the cramdown. The present value of the First Lien Notes was approximately \$1,042,129,985, or \$57,870,015 below face value. The formula below demonstrates this result:

$$\begin{aligned} & \textit{First Lien Replacement Notes} \\ & = \$22,550,000 * \frac{\left[1 - \left[\frac{1}{(1.025)^{14}}\right]\right]}{.025} + \frac{\$1,100,000,000}{(1.025)^{14}} \end{aligned}$$

The debtor emerged from bankruptcy on October 24.<sup>195</sup> The present value of the replacement First Lien Notes, which began trading on October 31, was diminished even further. At this time, the market rate of interest was 6.026%<sup>196</sup> while the coupon rate on the replacement notes decreased from 4.1% to 3.88%.<sup>197</sup> The decreased coupon rate was likely a result of changes in rates on seven-year treasuries between September 9, 2014, the date of Judge Drain's bench decision, and late October, when the replacement

193. *In re* MPM Silicones, LLC, No. 14-22503-RDD, 2014 WL 4436335, at \*29 (Bankr. S.D.N.Y. Sept. 9, 2014).

194. *See id.*

195. Michael Vitti, *Taking a Deeper Look Into Momentive, Part I*, NATIONAL ASSOCIATION OF CERTIFIED VALUATORS AND ANALYSTS (Dec. 22, 2014), <http://quickreadbuzz.com/2015/12/22/taking-a-deeper-look-into-momentive-part-1/> [<https://perma.cc/KC6B-77X9>].

196. The market rate of interest is inferred from data obtained from Bloomberg Finance L.P.

197. *See Daily Treasury Yield Curve Rates*, U.S. DEPARTMENT OF TREASURY, <https://www.treasury.gov/resource-center/data-chart-center/interest-rates/Pages/TextView.aspx?data=yieldYear&year=2014> [<https://perma.cc/D9SE-9U5J>] (last visited Jan. 15, 2017).

notes began trading. It is not clear why the market rate of interest for *Momentive's* securities increased over the time period in question. However, the market's valuation is consistent with the B3 rating Moody's assigned to the replacement notes<sup>198</sup> and market interest rates on comparable corporate bonds at the time.<sup>199</sup> The replacement notes were valued by the market at approximately \$956,839,728, or \$143,129,984 below face value.<sup>200</sup>

*First Lien Replacement Notes*

$$= \$21,340,000 * \frac{\left[1 - \left[\frac{1}{(1.031)^{14}}\right]\right]}{.031} + \frac{\$1,100,000,000}{(1.031)^{14}}$$

Evidently, the market value of the notes decreased considerably, particularly after *Momentive's* confirmation hearings. The *Momentive* First Lien Noteholders' claim that "the face amount of the Replacement Notes will equal the amount of the Allowed Claims [and] the true value of the Replacement Notes will be far less"<sup>201</sup> is indeed correct. The graph below demonstrates the market's valuation of the notes over time and comports with the present valuation analyses above.<sup>202</sup>

---

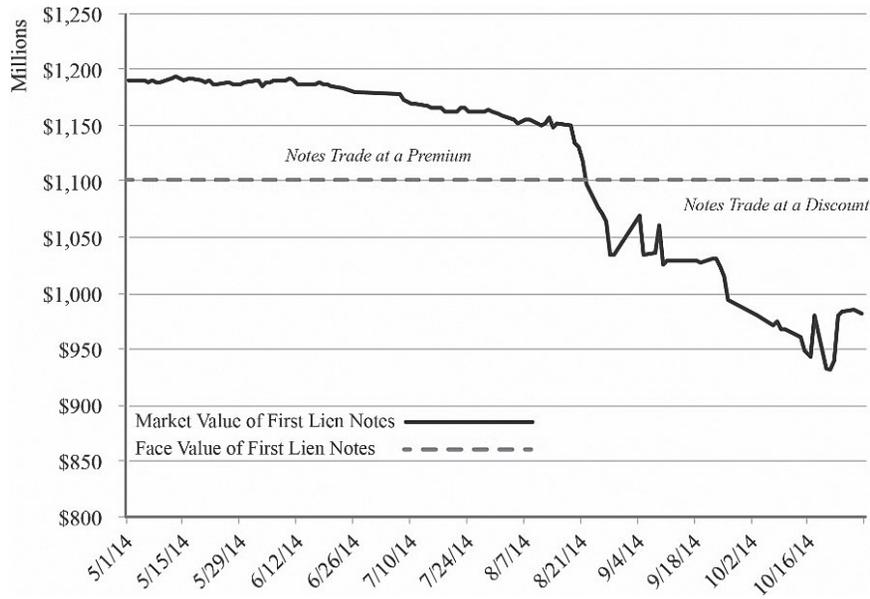
198. See Anthony Hill, *Rating Action: Moody's Assigns B3 to Momentive Performance's First-Lien Notes; Outlook Stable*, MOODY'S INVESTOR SERVICE (Jan. 16, 2015), [https://www.moody's.com/research/Moodys-assigns-B3-to-Momentive-Performances-First-Lien-Notes-outlook-PR\\_316652](https://www.moody's.com/research/Moodys-assigns-B3-to-Momentive-Performances-First-Lien-Notes-outlook-PR_316652) [<https://perma.cc/W4VS-5QH5>].

199. The BofA Merrill Lynch US High Yield B Effective Yield indicates a 6.06% rate of interest for October 30, 2014. See ICE Benchmark Administration Ltd., *ICE BofAML US High Yield B Effective Yield*, FEDERAL RESERVE BANK OF ST. LOUIS, <https://fred.stlouisfed.org/series/BAMLH0A2HYBEY> (last visited Jan. 15, 2017) [<https://perma.cc/SL8B-AG6G>].

200. Market value is inferred from data obtained from Bloomberg Finance L.P.

201. Cramdown Objection of Wilmington Trust, *supra* note 103, at 2-3.

202. Market value is inferred from data obtained from Bloomberg Finance L.P.



Prior to the onset of the confirmation hearings, the First Lien Notes traded at a premium.<sup>203</sup> By the date of the bench ruling, their market value had decreased, and the securities traded instead at a significant discount to face value, forcing the Momentive secured creditors to take heavy losses.

#### IV. ARGUMENTS IN FAVOR OF THE FORMULA RATE APPROACH

The formula rate approach, as applied in *Momentive* and *Till*, has engendered support for a variety reasons, including its potential to decrease unpredictability and the evidentiary costs on debtors and courts in Chapter 11. In addition, proponents argue it does not treat creditors unfairly, since creditors contemplate default ex ante and have the ability to offset risk through portfolio diversification and specialized drafting of individual credit agreements or bond indentures.<sup>204</sup>

203. Market value is inferred from data obtained from Bloomberg Finance L.P.

204. *But see* Scott, *supra* note 5, at 1055 (noting that when taken to its logical conclusion, this argument supports denying the creditor the value of its entire claim, since the creditor's initial contract rate contemplated this result, however,

Minimizing uncertainty and costs in bankruptcy is a valuable objective given the considerations a company or its creditors must weigh in determining whether to file for Chapter 11 or seek an alternative strategy. Adherence by courts to the principle of *stare decisis*, in addition to utilizing jurisprudential procedures that generate predictable outcomes, facilitates this objective.<sup>205</sup> The formula rate approach's reliance on treasury or prime, in addition to the view of both *Till* and *Momentive* that a 1-3% risk adjustment would be appropriate in most instances,<sup>206</sup> suggests cramdown interest rates will be contained within a relatively narrow band.<sup>207</sup> Particularly for the debtor, the certainty afforded by an approximate cap on cramdown interest rates aids in the planning required to file for Chapter 11, provides significant leverage in the negotiation of a plan, and facilitates securing additional post-Chapter 11 financing. By comparison, market-based tests can lead to a wider range of potential outcomes and debtors may find themselves saddled with large and unanticipated interest payments.<sup>208</sup>

In addition, proponents of the formula rate approach claim it reduces the evidentiary and financial burdens of the bankruptcy process on both the debtor and courts.<sup>209</sup> Moreover, under the

---

“[i]f courts took such a position, market rates would skyrocket and destroy an efficient credit economy.”).

205. See Thomas S. Green, *An Analysis of the Advantages of Non-Market Based Approaches for Determining Chapter 11 Cramdown Rates: A Legal and Financial Perspective*, 46 SETON HALL L. REV. 1151, 1176 (2016).

206. See *Till v. S.C.S. Credit Corp.*, 541 U.S. 465, 480 (2004); *GMAC v. Valenti*, 105 F.3d 55, 64-65 (2d Cir. 1997); *In re MPM Silicones, LLC*, No. 14-22503-RDD, 2014 WL 4436335, at \*26 (Bankr. S.D.N.Y. Sept. 9, 2014).

207. However, the *Till* court declined to explicitly “decide the proper scale for the risk adjustment.” 541 U.S. at 480. Perhaps as a result, not all courts have limited their risk adjustments to this range. See *McDonald v. Credit Acceptance Co.*, No. 11-12508-BC, 2011 WL 6643074, at \*1; (E.D. Mich. Dec. 21, 2011) (holding the “prime-plus” formula under *Till* does not prohibit interest rates exceeding three percent over prime and adding a “little less than twelve percent over prime” in a case involving a particularly high-risk debtor); *In re Burt*, No. 07-14617-DWH, 2008 WL 4365894, at \*1 (Bankr. N.D. Miss. May 1, 2008) (holding “a 4.25% risk factor should be added to the prime rate for an effective repayment interest rate of 9.5%.”).

208. See Green, *supra* note 205, at 1176-77.

209. See *id.* at 1176; see also Evan D. Flaschen, David L. Lawton & Mark E. Dendinger, *Losing Momentive: A Roadmap to Higher Cramdown Interest Rates*, 5 HARV. BUS. L. REV. ONLINE 100, 105 (2015), <http://www.hblr.org/wp-content/uploads/2015/06/Flaschen-Losing-Momentive-2.pdf> [<https://perma.cc/KKH9-3VPE>] (describing in a positive light modified versions of a formula rate approach that utilize a more “rigid standard” to avoid “significant” evidentiary costs that may arise in situations “without clear evidence of an established market for the secured

formula rate approach, there is no need to determine whether an efficient market exists.<sup>210</sup> For debtors, cost reduction is beneficial because it can result in more rapid emergence from Chapter 11 by healthier companies who enjoy greater financial resources.<sup>211</sup> The costs associated with spending more time in Chapter 11 are already numerous. These include losing customers and market share to competitors, needing approval by the court for transactions outside the ordinary course of business, and being required to pay statutory committee expenses.<sup>212</sup>

While each of the non-formula rate approaches may involve legal fees and expert fees to resolve disputes,<sup>213</sup> under the formula rate approach it should be relatively easy for courts to ascertain the current treasury or prime rate,<sup>214</sup> and the debtor's briefing will provide the court with much of the evidence necessary for determining an appropriate risk premium.<sup>215</sup> Courts are presumably comfortable examining this evidence, since they already must do so as part of the feasibility analysis required under section 1129(a)(11).<sup>216</sup> Such familiarity and expertise may save litigation costs, court time, and resources.<sup>217</sup>

Finally, formula rate approach supporters claim that as part of their normal operations, creditors contemplate default. The risk of

---

claim in question, evidence of comparable rates under similar circumstances, and the risk of nonpayment.”).

210. See Green, *supra* note 205, at 1198 (arguing “the potential uncertainty with respect to the efficiency” of markets in the Chapter 11 context means courts should continue to utilize a formula or non-market-based approach to determine cramdown rates).

211. See *id.* at 1175 (“Unanticipated post-petition fees and expenses can be detrimental to the debtor’s business. The evidentiary costs of a hearing on the efficiency of the market for comparable loans create another obstacle for a [debtor] attempting to get a plan confirmed. More financial resources are drained, and the likelihood of the debtor’s emergence from bankruptcy decreases.”).

212. WEIL, GOTSHAL AND MANGES, LLP, REORGANIZING FAILING BUSINESSES: A COMPREHENSIVE REVIEW AND ANALYSIS OF FINANCIAL RESTRUCTURING AND BUSINESS REORGANIZATION 12-8 - 12-10 (2006).

213. See *Till v. S.C.S. Credit Corp.*, 541 U.S. 465, 478 (2004).

214. See Elson, *supra* note 70, at 1926.

215. See *Till*, 541 U.S. at 479 (such evidence includes the “circumstances of the estate, the nature of the security, and the duration and feasibility of the reorganization plan.”).

216. See Green, *supra* note 205, at 1176; see also 11 U.S.C. § 1129(a)(11)(i) (2010) (requiring confirmation of a plan only if it is “not likely to be followed by the liquidation, or the need for further financial reorganization, of the debtor or any successor to the debtor under the plan . . .”).

217. See Green, *supra* note 205, at 1176.

bad debt is already partially reflected in the prime rate and may be mitigated further by credit agreement or bond indenture loan covenants. Creditors also hold diversified portfolios of debt to offset risk. Not only are creditors better candidates to bear risk than any single borrower, they are also less likely to be surprised by an unfavorable outcome stemming from a relationship with a debtor.<sup>218</sup> Additionally, and related to the benefits of certainty described above, creditors who expect to receive the formula rate may be able to predict the interest rate they will receive if the borrower seeks bankruptcy protection. Creditors may then “price their loans accordingly to prevent the risk of under-compensation.”<sup>219</sup> In this light, the fact that the formula rate approach can force a creditor to accept a replacement note bearing a below-market rate of interest is acceptable.<sup>220</sup>

V.  
ARGUMENTS AGAINST THE FORMULA RATE  
APPROACH AND ITS USE IN *MOMENTIVE*  
IN THE CHAPTER 11 CONTEXT

Notwithstanding the foregoing, the application of the formula rate approach in the Chapter 11 context is inappropriate. Notably, the American Bankruptcy Institute has explicitly recommended rejecting *Till* and the formula rate approach. It has advocated instead for the use of a rate that takes into account “the cost of capital for similar debt issued to companies comparable to the debtor as a reorganized entity.”<sup>221</sup> First, the formula rate approach increases creditor uncertainty, which negatively affects liquidity in and access to credit markets, particularly for less creditworthy borrowers (see Part A below). Second, application of the formula rate approach in Chapter 11 systematically undercompensates creditors who may effectively be coerced into loans to formerly bankrupt debtors on terms that would never have been approved in other contexts (see Part B below). Third, Judge Drain is incorrect in his assumption

---

218. *See id.* at 1177.

219. Elson, *supra* note 70, at 1927.

220. It is noteworthy that this argument for the formula rate approach essentially invites banks and lenders to increase credit rates on their loans to protect against acknowledged under-compensation. There is good reason to question whether borrowers generally would appreciate this approach of higher rates across the board.

221. AM. BANKR. INST., COMM’N TO STUDY THE REFORM OF CHAPTER 11, FINAL REPORT AND RECOMMENDATIONS 236-37 (2012), <https://abiworld.app.box.com/s/vwrcv5xv83aav14dp4h>.

that *Till* applies in the Chapter 11 context.<sup>222</sup> Not only does the *Momentive* court overlook the functional differences between the parties involved in and policy purposes of Chapter 11 as compared to Chapter 13, but it also fails to recognize that use of the formula rate approach provides debtors with valuable options, as well as significant leverage over their creditors.

A. *The Formula Rate Approach Reduces Certainty and Predictability, Which Will Negatively Affect Credit Markets and Increase Interest Rates Across the Board*

Under the formula rate approach, secured creditors face the uncertain outcome of receiving a below-market interest rate on a replacement note. Some have described the impact of the formula rate approach in *Till* as a “high-stakes game of chance.”<sup>223</sup> Depending on the jurisdiction and the bankruptcy judge, creditors may receive a range of results in cramdown proceedings that diverge from their estimates of an appropriate interest rate.<sup>224</sup> Since the formula rate approach ignores the original contract rate of interest negotiated at arm’s length by the parties pre-bankruptcy, there is no foreseeable way for creditors to contract around the risk of receiving less than full compensation.<sup>225</sup>

The risk adjustment itself also creates unpredictability and litigation risk. In Chapter 11, where cramdown financing may have long maturities, the difference between a 1% and 3% risk premium can have an enormous impact on the value of a loan.<sup>226</sup> *Till* lists

---

222. The debtor’s own briefing in *Till* suggests present value analyses pursuant to Chapter 11 are a “complex endeavor beyond the scope of consumer Chapter 13.” See Petitioners’ Reply Brief on the Merits at 1 n.1, *Till v. SCS Credit Corp.*, 541 U.S. 465 (No. 02-1016), 2003 WL 22873081 at \*2.

223. Jon W. Jordan, *No More Russian Roulette: Chapter 13 “Cram-Down” Creditors Take a Bullet*, 70 MO. L. REV. 1385, 1402 (2005).

224. See, e.g., *In re Texas Grand Prairie Hotel Realty, LLC*, 710 F.3d at 327 (5th Cir. 2013) (where the creditor argued for an 8.8% cramdown interest rate; the court ultimately approved a 5% rate); *In re Pluma*, 289 B.R. 151, 153, 157 (Bankr. S.D. Cal. 2003) (creditor argued for a 10% cramdown interest rate; the court approved 4.26%); *In re Duval Manor Assocs.*, 191 B.R. 622, 630-31 (Bankr. E.D. Pa. 1996) (where the creditor argued for a 12.44% cramdown interest rate; the court approved 7%); *GMAC v.*, 105 F.3d 55 (2d Cir. 1997) (where the creditor argued for 15.7%; the court remanded for determination of an appropriate rate based on treasury plus 1 to 3%).

225. See Jordan, *supra* note 223, at 1402-03.

226. A simplified example demonstrates this result: assume a debtor issues bonds with \$500,000,000 in principal, which mature in 10 years and exist in an economic environment where the national prime rate is 3% and the market rate is 5%. The bonds compound semi-annually and are owned exclusively by a single

four factors to be used in determining a risk premium: “(1) the probability of plan failure; (2) the rate of collateral depreciation; (3) the liquidity of the collateral market; and (4) the administrative expenses of enforcement.”<sup>227</sup> Other factors used by courts include the “quality of the lender’s collateral,” the “health . . . of the debtor’s business,” and “the feasibility and duration of the plan.”<sup>228</sup> Rather than facilitating the court’s goal of creating an objective process for determining cramdown interest rates, analysis of these factors remains inherently subjective, particularly with regard to its application in the case of an individual debtor.<sup>229</sup> The prediction that the formula rate approach in *Till* “will inevitably, and perhaps inappropriately, frame discussions as to the range of this [risk] adjustment”<sup>230</sup> has been borne out. Much of the controversy in cramdown cases now revolves around determination of an appropriate risk adjustment and expert testimony is often required.<sup>231</sup>

---

creditor when the debtor files for Chapter 11. On the first day of the cramdown proceeding, the court finds that the debtor is low risk and assigns a 1% risk premium for a total coupon rate of 4% on the post-confirmation debt. The present value of these bonds is approximately \$461 million, resulting in a \$39 million loss. Two days later, new information arises which convinces the court that the debtor is in fact much riskier. As a result, the court modifies its initial judgment and assigns a 3% risk premium, for a total coupon of 6%. The present value of the bonds is now \$539 billion. The difference between the two scenarios, a sum of \$78 million, demonstrates the significant impact of the risk premium and suggests creditors will be willing to fight to prove a debtor is high-risk.

227. *Till v. S.C.S. Credit Corp.*, 541 U.S. 465, 484 (2004).

228. *See Texas Grand*, 710 F.3d at 334.

229. *See Greenspan & Nelson*, *supra* note 50, at 70.

230. *Id.*

231. *See, e.g., Texas Grand*, 710 F.3d at 334-35 (Experts for both the creditor and debtor agreed on the formula rate approach as well as the use of a prime rate of 3.25% as the base rate, but disagreed on the size of the appropriate upward risk adjustment. The creditor’s expert argued for a total rate of 8.8% based on factors including the circumstances of the bankruptcy estate and the plan’s feasibility, while the debtor’s expert argued instead for a 1.75% adjustment.); *Woodmere*, 178 B.R. at 362 (the cramdown interest rate was “derived by applying the six (6) year U.S. Treasury Note plus a risk factor of 225 basis points to derive a percentage of 7.62%. Both parties offered expert testimony as to the appropriate interest rate” but the debtor’s expert witness argued for a risk factor of 225 basis points while the creditor’s expert witness argued for 450 to 500 basis points); *In re Gramercy Twins Assocs.*, 187 B.R. 112, 124 (Bankr. S.D.N.Y. 1995) (finding a 425 basis point risk premium was necessary to provide a creditor with the present value of its claim, despite creditor’s expert testimony for 500 to 575 basis points); *In re Danny Thomas Props. III Ltd. P’ship*, 231 B.R. 298, 301 (Bankr. E.D. Ark. 1999) (where the creditor’s cramdown interest calculation relied on a 30-year treasury obligation, plus a 2.5-3% risk premium, while the debtor instead argued for a base rate using a 10-year treasury obligation and added 2% for risk. Significantly, “[b]oth sides presented expert testimony as to the appropriateness of the respective

Even within a 1-3% band, there is likely to be considerable disagreement and significant evidentiary burdens for either party to support their proposed rate.<sup>232</sup>

The unpredictability described above can reasonably be expected to have a variety of negative effects on credit markets.<sup>233</sup> When creditors cannot identify with certainty and without excessive financial burden those borrowers who will ultimately file for bankruptcy, the creditors will default to treating all debtors the same. When provisions of the Bankruptcy Code shift risk from debtors to creditors, creditors will ex ante increase the rates of interest they require from all debtors in order to offset the risk of receiving a below-market and under-compensatory cramdown interest rate.<sup>234</sup> The dissenting opinion in *Till* underscored this potential outcome, arguing “[i]f subprime lenders are systematically undercompensated in bankruptcy, they will charge higher rates . . . .”<sup>235</sup> Viewed systematically, across the board interest rate hikes will wipe out the apparent benefit to borrowers as a class of the pro-debtor formula rate approach.<sup>236</sup> While individual debtors may receive a windfall in specific Chapter 11 cases, borrowers as a whole will suffer.<sup>237</sup>

Empirical evidence bears out the prediction that interest rates will increase in response to creditor uncertainty. In an analysis of judicial rulings from October 1979 through June 1993, Joshua Goodman and Adam Levitin determined the availability of mortgage cramdowns to Chapter 13 debtors increased interest rates on

---

rate.”); see also Daniel J. Carragher, *What the Supreme Court’s Prime Plus Ruling Means for Chapter 11*, AM. BANKR. INST. (July/Aug. 2004), <https://www.abi.org/abi-journal/what-the-supreme-courts-prime-plus-ruling-means-for-chapter-11> [https://perma.cc/ESC6-MHX6] (stating a “battle of the experts” will be necessary to determine the risk premium in a Chapter 11 cramdown).

232. See *In re Gillikin*, No. 09-60178, 2011 WL 7704353, at \*5 n.5, (Bankr. S.D. Ga. Mar. 3, 2011) (rejecting reliance on the “*Till* rate” of 1-3% as a per se risk adjustment, requiring instead that the debtor justify the proposed cramdown interest rate and then denying the debtor’s proposed disclosure statement for insufficiently disclosing its rationale for a suggested rate of 4%).

233. See, e.g., Wong, *supra* note 12 (describing the benefits of predictability as “lower lending risks” and enabling “lenders to appropriately evaluate the debt market.”).

234. See Zywicki, *supra* note 69, at 263-64; Jordan, *supra* note 223, at 1404 (stating as a result of cramdowns, “lending rates are likely to increase for all borrowers as creditors attempt to compensate for their bankruptcy losses.”).

235. *Till v. S.C.S. Credit Corp.*, 541 U.S. 465, 508 (2004) (Scalia, J., dissenting).

236. See Zywicki, *supra* note 69, at 263.

237. See *id.* at 264-65.

home loans by an average of 12 to 16 basis points.<sup>238</sup> The study suggests this effect might have been more pronounced had the total number of cramdowns been greater at the time.<sup>239</sup> Rajashri Chakrabarti and Nathaniel Pattison, focusing on auto loan rates after enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act, found that eliminating cramdowns resulted in an average 15-basis-point decrease in the interest rate on 48-month auto loans. In states with the highest rates of Chapter 13 filings, interest rates decreased by 30 basis points.<sup>240</sup> Admittedly, both of these studies are outside the Chapter 11 context and implicate forms of cramdown outside the purview of this Note. However, they both suggest the commercial lending market will respond to the availability of cramdowns. While the studies do not compare the cramdown interest rate to then-prevailing market rates, it is reasonable to assume that the greater the spread between these rates and the steeper the potential haircut suffered by the creditor, the more pronounced will be the effect on credit markets.

Interest rate increases will make it harder for borrowers to access capital, especially those at the margins,<sup>241</sup> and may increase their likelihood of default if they do.<sup>242</sup> For instance, the elimination of cramdowns may increase the size of auto loans issued, especially among subprime borrowers,<sup>243</sup> and the availability of

---

238. See Joshua Goodman & Adam Levitin, *Bankruptcy Law and the Cost of Credit: The Impact of Cramdown on Mortgage Interest Rates*, 57 J.L. & ECON. 139 (2014).

239. See *id.* at 156 (stating “Chapter 13 bankruptcy filings were relatively uncommon during the period in question, peaking at .6 percent of all residential mortgages, so Chapter 13 cramdown would have been a comparatively rare occurrence.”).

240. See Rajashri Chakrabarti & Nathaniel Pattison, *Auto Credit and the 2005 Bankruptcy Reform: The Impact of Eliminating Cramdowns*, FED. RESERVE BANK OF N.Y., Rep. No 797, at 3 (Oct. 2016).

241. See Jordan, *supra* note 223, at 1404 (arguing higher interest rates will preclude some high-risk debtors from obtaining credit); see also *Till v. S.C.S. Credit Corp.*, 541 U.S. 465, 508 (2004) (Scalia, J., dissenting) (“If subprime lenders are systematically undercompensated in bankruptcy, they will charge higher rates or, if they already charge the legal maximum under state law, lend to fewer of the riskiest borrowers. As a result, some marginal but deserving borrowers will be denied vehicle loans in the first place. Congress evidently concluded that widespread access to credit is worth preserving, even if it means being ungenerous to sympathetic debtors.”).

242. See Jordan, *supra* note 223, at 1405 (“By shifting the financial responsibility to non-bankrupt debtors who are able to obtain credit, the additional burden may force more debtors into bankruptcy.”); Zywicki, *supra* note 69, at 264.

243. See Chakrabarti & Pattison, *supra* note 240, at 25 (finding new subprime loans increased by \$142, relative to new prime loans, when cramdowns were prohibited).

mortgage credit.<sup>244</sup> A chilled credit market is also likely to dampen economic growth, since borrowers will not be able to access funds for new projects and investments.<sup>245</sup> Accordingly, as part of its recommendation to reject the formula rate approach, the American Bankruptcy Institute concluded that the method as applied in *Till* could have negative impacts on distressed debt markets and the liquidity they provide to borrowers.<sup>246</sup>

*B. The Formula Rate Approach Fails to Compensate Secured Creditor Claims in the Risky Bankruptcy Context*

The formula rate approach systematically fails to compensate secured creditors for assuming the risks associated with transacting with borrowers<sup>247</sup> and fails to provide secured creditors with the full value of their claims, as required by section 1129(b)(2)(A)(i)(II). In doing so, it represents a wholesale shifting of the risks and costs associated with bankruptcy and default to the secured creditor.<sup>248</sup> This is problematic for three reasons. Firstly, Chapter 11 debtors are at least as risky, if not riskier, than their counterparts who never enter bankruptcy. Secondly, default is more expensive in Chapter 11 than under other circumstances. Finally, cramdown loans are frequently coerced without equity cushions.

Chapter 11 plans are not a guarantee of future financial success or the debtor's ability to repay a replacement note in full, re-

---

244. See Wenli Li, Ishani Tewari & Michelle J. White, *Using Bankruptcy to Reduce Foreclose: Does Strip-Down of Mortgages Affect the Supply of Mortgage Credit?* 4 (Nat'l Bureau of Econ. Research, Working Paper No. 19952, 2014), <http://www.nber.org/papers/w19952> [<https://perma.cc/4BAX-XJNY>] (the elimination of cramdowns increased mortgage credit approval rates "by 0.9 percentage points, or 1%, in affected relative to unaffected regions.").

245. See Robert K. Rasmussen & David A. Skeel, Jr., *The Economic Analysis of Corporate Bankruptcy Law*, 3 AM. BANKR. INST. L. REV. 85 (1995) ("More expensive credit leads to a reduction in economic activity."). The financial crisis is an extreme example of the effects of a severely dampened credit market on the economy. See Eamonn K. Moran, *Wall Street Meets Main Street: Understanding the Financial Crisis*, 13 N.C. BANKING INST. 5, 73 (2009) (describing the financial crisis's reduction in the general availability of credit to businesses, which decreased their ability "to meet payrolls, pay suppliers, and purchase inventory," and significantly disrupted their ability to "borrow and finance spending, investment, and job creation.").

246. See AM. BANKR. INST., COMM'N TO STUDY THE REFORM OF CHAPTER 11: 2012-2014 FINAL REPORT AND RECOMMENDATIONS 236 (2014), <http://commission.abi.org/full-report> [<https://perma.cc/3544-JXZG>].

247. See *id.*; *Till v. S.C.S. Credit Corp.*, 541 U.S. 465, 491 (2004) (Scalia, J., dissenting).

248. See Zywicki, *supra* note 69, at 263 (describing the transfer of risk from debtors to creditors as a result of under-compensatory cramdown interest rates).

ardless of court or trustee supervision during the case or a successful restructuring.<sup>249</sup> One estimate of Chapter 11 recidivism, or the percentage of companies that emerge from Chapter 11 only to reenter a few years later (colloquially referred to as “Chapter 22,” or worse, “Chapter 33”), is approximately 15%.<sup>250</sup> Others have observed recidivism rates as high as one third of companies that emerge from Chapter 11.<sup>251</sup> The *Till* dissent points out that since already-bankrupt borrowers have demonstrated histories of financial instability, they are riskier than other debtors and more likely, “or at the very least, not systematically less” likely to default in the future or end up back in Chapter 11.<sup>252</sup> The formula rate approach itself suggests risk in bankruptcy is impossible to eliminate. If future results were guaranteed, the risk-free rate would be sufficient as a cramdown rate of interest and lending to Chapter 11 borrowers would be as safe as lending to the United States government. That a risk premium is almost always added indicates that risk of default is still contemplated after bankruptcy. Yet, the formula rate approach denies creditors full compensation for assuming it.<sup>253</sup>

While default is an expensive proposition to creditors generally, it is more so in the Chapter 11 bankruptcy context. Various empirical analyses have determined that as a proportion of assets, Chapter 11 costs more than both prepackaged bankruptcies and out-of-court restructurings.<sup>254</sup> There are various explanations for

---

249. See *Till*, 541 U.S. at 493-94 (Scalia, J., dissenting).

250. Edward I. Altman, *Revisiting the Recidivism – Chapter 22 Phenomenon in the U.S. Bankruptcy System*, 8 BROOK. J. CORP. FIN. & COM. L. 253, 273 (2014).

251. See Lynn M. Lopucki & Joseph W. Doherty, *Why Are Delaware and New York Bankruptcy Reorganizations Failing?*, 55 VAND. L. REV. 1933, 1934 (2002) (“[Prior] empirical finding[s] [show] that by February 2000, nine of the thirty companies (30%) emerging from bankruptcy reorganization in Delaware from 1991 to 1996 had filed for bankruptcy a second time” and that New York “had a refiling rate almost as high as Delaware’s (23%).”); Edward I. Altman, *Post-Chapter 11 Performance: Avoiding Chapter 22*, 21 J. APPLIED CORP. FIN. 53, 55 (“[R]oughly one-third of those firms emerging as a publicly registered company experience some form of subsequent distressed restructuring again, including the filing of a second (or third, or even more) bankruptcy.”).

252. *Till*, 541 U.S. at 494 (Scalia, J., dissenting). While certainly debatable, the dissent’s comment is supported by the statistics in Section IV.B, *infra*.

253. See *Gen. Motors Acceptance Corp. v. Jones*, 999 F.2d 63, 68 (3d Cir. 1993) (“[I]f the creditor had been allowed to freely construct and extend the loans coerced by the cramdown proceedings, it would have increased the lending rate based on the debtors’ demonstrably poor credit history.”).

254. Elizabeth Tashjian, Ronald C. Lease & John J. McConnell, *Prepacks: An Empirical Analysis of Prepackaged Bankruptcies*, 40 J. FIN. ECON. 135, 143 (1996) (“As a fraction of assets, the fees paid in prepacks lie between the average of 2.8% . . . for traditional Chapter 11 reorganizations and the 0.65% reported . . . for out-of-court

this phenomenon. For instance, the costs of foreclosure are higher in bankruptcy since repossession may be blocked by the automatic stay.<sup>255</sup> Moreover, various disputes may arise during bankruptcy, which, in addition to required disclosures and filings, necessitate costly legal and expert fees.<sup>256</sup> Such fees can easily increase to tens or even hundreds of millions of dollars<sup>257</sup> and serve to decrease the size of the debtor's estate and the potential for full reimbursement of a secured creditor's claim.

In contrast to loans issued in ordinary commercial lending markets, crammed down loans frequently do not contain an equity cushion<sup>258</sup> and the loan-to-value ratio in cramdowns may be close to or exactly 100%.<sup>259</sup> For creditors, equity cushions are important hedging tools, which afford protection against depreciation in the value of the collateral securing their loans.<sup>260</sup> Generally, loans with higher loan-to-value ratios are viewed by creditors as more risky, since the higher the ratio, the greater the creditor's risk of being under-secured if the borrower ultimately defaults.<sup>261</sup> Outside of Chapter 11, a creditor would reasonably increase the rate of interest charged to a borrower to offset the risk for lending without any

---

restructurings."); See Brian L. Betker, *The Administrative Costs of Debt Restructurings: Some Recent Evidence*, FIN. MGMT. 26, 57 (1997) (finding "the direct costs of traditional Chapter 11 cases average 3.93% of pre-bankruptcy total assets. This figure is significantly larger than average direct costs for prepacks (2.85%).").

255. See *Till*, 541 U.S. at 493 (Scalia, J., dissenting).

256. See Hon. Alexander L. Paskay & Frances Pilaro Wolstenholme, *Chapter 11: A Growing Cash Cow Some Thoughts on How to Rein in the System*, 1 AM. BANKR. INST. L. REV. 331, 335 (1993) ("There is no doubt that Chapter 11 has gained the reputation of a 'cash cow' for the professionals involved in the process.").

257. See Rasmussen & Skeel, Jr., *supra* note 245, at 90; Steve H. Nickles & Edward S. Adams, *Tracing Proceeds to Attorneys' Pockets (and the Dilemma of Paying for Bankruptcy)*, 78 MINN. L. REV. 1079 (1994) (describing the Eastern Airlines, Pan American Airlines, and LTV Corporation bankruptcies, where combined costs exceeded \$250 million).

258. An equity cushion refers to the value of collateral securing a loan in excess of the amount of that loan.

259. See Zywicki, *supra* note 69, at 260; see also *In re Gramercy Twins Assocs.*, 187 B.R. 112, 124 (Bankr. S.D.N.Y. 1995) ("[T]he relatively high loan to value ratio in this case, which is approximately 85%, increases the risk factor."); *In re 20 Bayard Views, LLC*, 445 B.R. 83, 112 (Bankr. E.D.N.Y. 2011) (describing a 100% loan-to-value ratio).

260. See *Gen. Motors Acceptance Corp. v. Jones*, 999 F.2d 63, 68 (3d Cir. 1993).

261. See Greenspan & Nelson, *supra* note 50, at 70.

cushion.<sup>262</sup> However, in the cramdown context, creditors are effectively deprived of the ability to do so.<sup>263</sup>

These risk factors suggest crammed down loans are more costly than those issued under ordinary market conditions<sup>264</sup> and Chapter 11 creditors should be compensated through higher rates of interest. However, the formula rate approach does not compensate the creditor for taking on these risks or make it whole with regard to the potential costs incurred. In failing to do so, it transfers value from the secured creditor to the ordinarily subordinate unsecured creditors or equity holders, potentially in violation of the absolute priority rule.

The absolute priority rule prohibits the allocation of property to junior classes, such as unsecured creditors, unless dissenting senior classes first receive the full value of their claims or all of a debtor's reorganization value.<sup>265</sup> Changes to a debtor's capital structure, which are made to benefit the debtor or a class of the debtor's claimants, may reduce the value available to other classes of holders of claims or interests.<sup>266</sup> A company undergoing reorganization has limited assets that it may distribute to its various stakeholders. Where a debtor receives a windfall in the form of an artificially depressed cramdown interest rate and is obligated to make smaller interest payments to a crammed down creditor, assets are concordantly made available to satisfy other claims, including those that are subordinate. Indeed, a criticism of Chapter 11, generally, is the ability of conflicted managers to inappropriately transfer wealth from creditors to equity holders.<sup>267</sup> By failing to

---

262. See Hartman, *supra* note 186, at 537 (claiming "no creditor would make a loan for 100 percent of the value of its collateral.").

263. See *Gen. Motors*, 999 F.2d at 68.

264. See *id.* (stating crammed down loans are more "costly than new loans that the creditor would have voluntarily extended.").

265. See 11 U.S.C. §§ 1129(b)(2)(B)(ii), § 1129(b)(2)(C)(ii); see also 7 COLLIER, *supra* note 4, at ¶ 1129.03[4][a][i] (the absolute priority is well stated as follows: "[a] plan of reorganization may not allocate any property whatsoever to any junior class on account of the members' interest or claim in a debtor unless all senior classes consent, or unless such senior classes receive property equal in value to the full amount of their allowed claims, or the debtor's reorganization value, whichever is less.").

266. See Steven L. Schwarcz, *The Easy Case for the Priority of Secured Claims in Bankruptcy*, 47 Duke L.J. 425, 429 (1997) (describing the Modigliani-Miller hypothesis to secured lending).

267. See Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 YALE L.J. 1043, 1045-46 (1992); see also Allan C. Eberhart, William T. Moore & Rodney L. Roenfeldt, *Security Pricing and Deviations from the Absolute Priority Rule in Bankruptcy Proceedings*, 45 J. FIN. 1457, 1458 (1990) ("[T]he amount paid

compensate secured creditors, the formula rate approach contravenes the absolute priority rule by providing this value to subordinate claimants who should not receive any payout until the secured creditors have been paid in full.

*C. Because Chapter 11 is Fundamentally Dissimilar to Chapter 13, the Formula Rate Approach Does Not Apply*

The rationales for accepting the formula rate approach, including those described in *Till*,<sup>268</sup> are less applicable in the Chapter 11 context as compared to Chapter 13. The competing goals of the Bankruptcy Code are often described as “rehabilitation” and “reorganization”<sup>269</sup> or providing a fresh start to a debtor while simultaneously allocating limited assets to its creditors.<sup>270</sup> A court overseeing a company through bankruptcy must therefore balance the ability of a debtor to successfully emerge from bankruptcy against the protection of the interests of secured creditors and other constituencies.

Chapter 13, which is aimed at insolvent persons, not businesses, clearly indicates a Congressional preference for the debtor-in-possession’s ability to achieve a fresh start.<sup>271</sup> It is designed to provide maximum relief to individuals who are viewed as deserving of the ability to start over again, freed of outstanding obligations.<sup>272</sup> Given this objective, the rights of creditors may be of secondary importance to the right of the debtor to achieve a start fresh. How-

---

to shareholders in excess of that due under strict adherence to the [absolute priority rule] is measured, and this amount is on average 7.6% of the total value paid to all claimants.”).

268. See *Till v. S.C.S. Credit Corp.*, 541 U.S. 465, 479-80 (2004) (describing rationales such straightforwardness, objectivity, familiarity, and cost reduction).

269. Harvey R. Miller & Shai Y. Waisman, *Is Chapter 11 Bankrupt?*, 47 B.C. L. REV. 129, 149 (2005).

270. See Elson, *supra* note 70, at 1944.

271. See *In re Goeb*, 675 F.2d 1386, 1388 (9th Cir. 1982) (acknowledging “Congress’ effort to give as many debtors as possible a fresh start through Chapter 13’s liberal discharge provisions”) (citations omitted); *In re Barnes*, 13 B.R. 997, 999 (D.D.C. 1981) (“The purpose behind Chapter 13 is to give the debtor a fresh start. . . .”); see also 8 COLLIER ON BANKRUPTCY ¶ 1300.02 (Alan N. Resnick & Henry J. Sommers eds., 16th ed.) (describing Congress’ intent for Chapter 13 as “to encourage, but not require, financially overextended *individual* debtors to make greater voluntary use of repayment plans commensurate with each debtor’s abilities, as the most effective means of improving, first, debtor relief and, second, creditor recoveries”) (emphasis added).

272. See Elson, *supra* note 70, at 1944.

ever, Chapter 11, which is intended for businesses<sup>273</sup> (though individuals can and do file for Chapter 11<sup>274</sup>), does not overtly prioritize this goal.<sup>275</sup> In the absence of an explicit rationale prioritizing the interests of debtors over creditors, there is less reason to apply an anti-creditor method, such as the formula rate approach, in determining cramdown interest rates.

The *Till* plurality's concerns regarding a debtor's financial burden are more salient in Chapter 13, where he or she is an individual with limited personal assets and any added burden could create disadvantages in the case's proceedings.<sup>276</sup> Justice Ginsburg's comments during oral arguments in *Till* "evidenced a concern that typical chapter 13 debtors cannot afford to pay experts, so a calculation method that required one would render proceedings increasingly complicated and prohibitively expensive."<sup>277</sup> Yet, the very consideration of multi-year repayment terms in a Chapter 11 case suggests not only that the debtor's business is economically viable, but also that during the pendency of the Chapter 11 proceeding it has been financially able to hire counsel and a valuation expert or financial advisor.<sup>278</sup> Additionally, the court's reluctance to use approaches requiring outside or market evidence is less relevant in the Chapter 11 context, in which judges often and willingly rely on expert testimony to better understand a debtor's business or de-

---

273. See 7 COLLIER, *supra* note 4, at ¶ 1100.01 (stating "Chapter 11 . . . is fashioned primarily for *business* debtors") (emphasis added).

274. See *Toibb v. Radloff*, 501 U.S. 157 (1991) (holding an individual debtor not engaged in business may reorganize under Chapter 11); see also Anne Lawton, *The Individual Chapter 11 Debtor Pre-and Post-BAPCPA*, 89 AM. BANKR. L.J. 455, 456 (2015) ("As the study's findings reveal, individual debtors comprise a sizeable proportion - more than one in five - of the chapter 11 debtors in the adjusted 2004 and 2007 . . . Moreover, the percentage of chapter 11 cases identified as individual filings increased from approximately 23% in 2004 to slightly more than 27% in 2007.").

275. See Wong, *supra* note 12, at 1944; Elson, *supra* note 70, at 1946 ("Any method of cramdown interest determination in Chapter 11 must therefore aid in the rehabilitation of the debtor, but should not prioritize the debtor's fresh start over the rights of creditors."); see also Miller & Waisman, *supra* note 269, at 144 (noting "Congress' intent to balance the interests of all parties involved in the Chapter 11 reorganization process.").

276. See Mark J. Thompson & Katie M. McDonough, *Lost in Translation: Till v. SCS Creditor Corp. and the Mistaken Transfer of a Consumer Bankruptcy Repayment Formula to Chapter 11 Reorganizations*, 20 FORDHAM J. CORP. & FIN. L. 893, 917 (2015).

277. *Id.* at 916.

278. See *id.* at 917; see Elson, *supra* note 70, at 1947 (stating "[p]arties entering into chapter 11 bankruptcy typically possess a much larger pool of assets than those in personal bankruptcy.").

velop valuations based on the financial markets and courts generally review financial statements and projections in the ordinary course.<sup>279</sup>

Indeed, *Till's* footnote 14 may be read as an attempt to differentiate Chapter 13 from Chapter 11. For instance, the *Till* plurality states that while there is a market for willing cramdown lenders in Chapter 11, “the same is *not* true in the chapter 13 context.”<sup>280</sup> The footnote then goes on to state, “[in] the Chapter 13 context, *by contrast* [to Chapter 11], 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.”<sup>281</sup> A fair reading of this language indicates the plurality was attempting to differentiate bankruptcies that occur in Chapter 11 and Chapter 13 rather than mandate the universal application of the formula rate approach in both contexts.<sup>282</sup>

*D. The Formula Rate Approach Inappropriately Creates an Option and Provides Negotiating Leverage for Chapter 11 Debtors*

Under certain circumstances, a debtor in Chapter 11 has a choice when dealing with secured creditors: it can seek debtor-in-possession financing to cash out its existing lenders or utilize the bankruptcy process to extend its existing secured debt at a court-determined cramdown interest rate. In *Momentive*, the debtor posed these alternatives to its creditors. The Senior Secured Notes could opt for the repayment of all outstanding principal and interest on their notes (without a make-whole) or receive replacement notes with an interest rate to be determined under the Bankruptcy Code.<sup>283</sup>

---

279. See Thompson & McDonough, *supra* note 276, at 917; Deborah Langehennig, *Application of the Till Interest Rate*, 68 TEX. B.J. 1022, 1027-28 (2005); see also *In re MPM Silicones, LLC*, 874 F.3d 787, 801 (2d. Cir. 2017) (“[W]e understand that the complexity of the task of determining an appropriate market rate of interest will vary from case to case. . . [b]ut, at the end of the day, we have no reason to believe the task varies materially in difficulty from the myriad tasks which we regularly rely on the expertise of our bankruptcy courts to resolve.”).

280. *Till v. S.C.S. Credit Corp.*, 541 U.S. 465, 476 n.14 (2004) (emphasis in original).

281. *Id.* (emphasis added).

282. See Thompson & McDonough, *supra* note 276, at 931 (Arguing that by distinguishing between “cramdown under the two chapters, the plurality implicitly adopts a perspective . . . that differentiates consumer bankruptcies from business reorganizations.”).

283. *In re MPM Silicones, LLC* 874 F.3d 787, 801-02 (2d. Cir. 2017).

If the debtor knows *ex ante* it will be able to refinance its debt at a lower interest rate than the one provided by a bankruptcy court, it will choose to pay down its existing obligations and incur new ones. Since the debtor must seek external financing to do so the rate of interest on the new obligations will be at market value. However, if the debtor believes a bankruptcy court will assign a cramdown interest rate that is higher than the prevailing market rate of interest (for instance, because market conditions have changed since the initial obligations were incurred), the debtor will seek to avoid litigating a new interest rate and provide its existing creditors with more favorable terms when attempting to confirm its plan. In either instance, the debtor benefits from the difference between the interest rate it would be forced to pay via a cramdown proceeding and the prevailing market rate. Moreover, even if the debtor does not view this option as such, the threat of a below-market interest rate provides the debtor with significant leverage over its creditors. If a secured creditor knows it stands to receive a below-market interest rate determined under the formula approach, the debtor may be able to compel it to accept covenant lite or other undesirable contractual features to avoid that outcome.

Certainly, the availability of external financing for a Chapter 11 debtor is not a given, and secured creditors can interfere with the debtor's ability to exercise this option profitably. However, the foregoing demonstrates that under the formula rate approach, the debtor is provided with additional value. To minimize that value, the appropriate cramdown methodology should be one that eliminates the gap between the market and cramdown rates. By systematically providing creditors with below-market rates, the formula rate approach fails to do so.

## VI.

### THE TWO-STEP APPROACH ADOPTED BY THE SECOND CIRCUIT IS BETTER SUITED FOR CHAPTER 11 AND THE COMMERCIAL CREDIT CONTEXT

In light of the foregoing, the formula rate approach is an inadequate measure for determining cramdown interest rates. Its one-size-fits-all technique does not adequately address the wide range of debtors, risk factors, and market factors that bankruptcy courts properly should consider as part of this analysis. In addition, by assigning below-market interest rates, the formula rate approach ensures creditors will not receive the present value of their loans. The two-step approach adopted by the Second Circuit, particularly in its reliance on current market interest rates, provides a better alterna-

tive and should be adopted as the standard in calculating cramdown interest rates. Unlike the formula rate approach, the two-step approach proceeds directly to determine the proper market-based rate for the specific post-confirmation loan, which in practice is likely to be readily determinable and within a relatively narrow range. In this regard, the two-step approach: should be easily administrable with low evidentiary costs (see Part A below); will properly compensate the creditor for the risk and costs it incurs in lending to debtors emerging from Chapter 11 (see Part B below); and will facilitate outcome certainty for both creditors and debtors (see Part C below). Use of the two-step approach will prevent the negative effects on creditors and credit markets described above and avoid outcomes where economic growth is hindered by creditor reticence or increased interest rates.

A. *The Two-Step Approach is Easily Administered and Reduces Evidentiary Burdens on the Court and the Debtor*

Reducing the evidentiary and financial burden on both the court and debtor is important in order to decrease strain on the judicial system, ensure the time spent in and associated costs of Chapter 11 are kept to a minimum, and increase the likelihood that the reorganized debtor is left with greater resources. As a practical matter, the two-step approach should easily achieve this objective because there exist a variety of sources of loan pricing information, including SEC filings, bankruptcy court filings, and major financial periodicals, upon which the court can rely to determine the appropriate cramdown rate.<sup>284</sup> Certainly, creditors have greater access to loan-pricing information than bankruptcy courts. Creditors may develop loan-pricing models in-house or purchase them from private vendors. As a result, they can assist in the determination of a market interest rate by filing documentation on their loan-pricing methodology and analysis of the specific debtor. Creditors would likely be incentivized to offer reasonable rates, particularly if the alternative was a cramdown well below market value.

The availability of such information to both parties should serve to narrow the range of negotiation and allow for resolution of

---

284. See Zywicki, *supra* note 69, at 259 (stating the “rates and terms available to borrowers for a standard loan are well-known and easily available to the public, through numerous financial reports and daily publications.”); see also Gary W. Marsh & Matthew M. Weiss, *Chapter 11 Interest Rates After Till*, 84 AM. BANKR. L.J. 209, 224 (2010) (“Established commercial interest rates frequently serve as a starting point for bankruptcy courts when they are attempting to discern market rates of interest.”).

the cramdown rate without litigation. In fact, the bid asked in the negotiation may well be narrower than the 1-3% risk adjustment to be resolved under the formula rate approach. However, if negotiation fails, the extent of expert testimony is likely to be limited to the debtor's financial position and prospects derived from the bankruptcy case. That experts may become involved is a weak argument against the forced loan approach, particularly given the heavy reliance on experts to determine the proper risk adjustment under the formula rate approach.<sup>285</sup>

While the goal of any cramdown interest rate approach must be to keep costs to a minimum, it is not always possible or necessary to eliminate them altogether. As compared to Chapter 13, Chapter 11 has a greater likelihood that debtors can afford to incur certain costs, should they choose to do so.<sup>286</sup> On balance, however, the availability of market data means the two-step approach offers the best chance to minimize such costs, when and if they arise.

Much has been made of the need to isolate an "efficient market" in order to determine a cramdown rate under the coerced loan approach.<sup>287</sup> However, those relying on this argument misunderstand the operation of commercial credit markets. Commercial lenders are fully capable of assessing individual borrowers and their risk profiles. As discussed, creditors have access to multiple internal and external resources for pricing debt. Prior to filing for bankruptcy, the debtor presumably felt confident in the ability of the creditor to do so and believed the rate, negotiated at arms-length, was sufficiently fair (otherwise they would not have agreed to the terms provided). That there was no debate over the efficiency of the market on which the creditor assigned such terms at the time of the original negotiation makes it unclear why the efficiency of the market post-confirmation has become a make-or-break factor in the determination of a cramdown interest rate. The rate proposed will

---

285. See *supra* section III.A.

286. See 7 COLLIER, *supra* note 4, at ¶ 1129.05[2][c][i] (stating the rationale of minimizing costs "while not absent from chapter 11 cases, is certainly minimized in larger chapter 11 cases" presumably as a result of the ability of a Chapter 11 debtor to bear any related evidentiary costs). See also Section IV.C., *supra* (discussing the differences between Chapter 11 and Chapter 13 debtors with regard to the former's superior ability to bear evidentiary costs).

287. See Green, *supra* note 205, at 1180-98 (discussing the application of the efficient capital market hypothesis and its application in the *Till* context for determining whether an efficient market exists on which to base coerced loan cramdown interest rates); Wong, *supra* note 12, at 1947-52 (discussing the efficient market approach and criticizing debtor-in-possession financing as a proxy for an efficient market).

also be subject to court review, though for the reasons mentioned above, the extent of that review is likely to pose minimal burden on bankruptcy courts and parties.

*B. The Two-Step Approach Compensates Creditors for Risk Without Unduly Burdening Debtors*

Cramdown rates based on real market data are the only rates that properly compensate creditors for risk, unless the market is distorted at the time. This occurred, for example, in late 2008 and early 2009.<sup>288</sup> Putting aside such exceptional circumstances, creditors expect a margin over their funding costs, which provides a reasonable return based on the credit risk of the borrower.<sup>289</sup> Were the creditor's funds not locked in the crammed down loan, it would presumably use those funds to capture the market rate on a loan to a different borrower.<sup>290</sup> Market-based cramdown rates afford this result without overcompensating the creditor,<sup>291</sup> since they reflect the credit community's appraisal of financing to similarly situated debtors and with similar terms.

At the same time, there is no undue burden on the reorganized debtor if it is required to pay such rates, since it would be forced to pay them were it to seek an alternative loan in the market. The Chapter 11 reorganization process is not intended to give the reorganized debtor a bonus interest rate and thereby a possible competitive advantage over other companies.<sup>292</sup> Perversely, if the below-market rate allowed the debtor to reduce prices, its competi-

---

288. See *S&P/LSTA U.S. Leveraged Loan 100 Index 10 Year Chart*, S&P DOW JONES INDICES, <https://us.spindices.com/indices/fixed-income/sp-lsta-us-leveraged-loan-100-index> [<https://perma.cc/5X5K-TNK8>] (last visited Nov. 15, 2015).

289. See *Gen. Motors Acceptance Corp. v. Jones*, 999 F.2d 63, 67 (3d Cir. 1993) (noting creditors reasonably anticipate a profit on their loans to debtors); *In re Cassell*, 119 B.R. 89, 92 (W.D. Va. 1990) (“The market rate does include ‘profit’ on the loan. Otherwise, no creditor would willingly make such a loan. The court feels that the profit component of the market rate is properly considered part of the cost of capital.”).

290. See Zywicki, *supra* note 69, at 262.

291. Creditor overcompensation would be prohibited under the fair and equitable standard. See 7 COLLIER, *supra* note 4, at ¶ 1129.03[4][a][i][C], n.101.

292. See Ian Dattner, *Chapter 11 Protection: Whom Are We Protecting?*, 38 COLUM. J.L. & SOC. PROBS. 287, 293 (2005) (describing the unfair competitive advantage afforded to a Chapter 11 debtor, particularly in a capital-intensive business, when it is able to reduce its debts and corresponding interest payments); see also Zywicki, *supra* note 69, at 251-252 (stating the Bankruptcy Code tries to preserve “the substantive rights of parties as defined outside bankruptcy” and therefore, “debtors should not see bankruptcy as an opportunity to improve their positions relative to creditors.”).

tors could be forced into Chapter 11. Creditors might also be forced to recognize such extensive impairments that they would also be faced with economic insolvency and ultimately require reorganization.<sup>293</sup>

*C. The Two-Step Approach Facilitates Outcome Certainty and Protects the Justified Expectations of Creditors and Debtors*

The two-step approach will facilitate outcome certainty in bankruptcy proceedings and protect the reasonable expectations of both creditors and debtors. The debtor and creditor entered into the pre-petition agreement on mutually agreeable terms and interest rates in the broader context of a functioning credit market after receiving competitive bids from other lenders where there was public information on market rates. Moreover, creditors undeniably enter commercial lending agreements with the expectation of generating sufficient revenue to at least fund their operations and cover overhead.<sup>294</sup> To deny them undermines their reasonable expectations and the pre-bankruptcy negotiation process entered into by creditors and debtors at arms-length.

In addition, aside from the fact that the post-confirmation financing is involuntary, there is no compelling reason for a different methodology to address cramdown rates. Once the two-step approach is firmly established, both creditors and debtors will have certainty as to the nature of their negotiations and that the ultimate cramdown rate will balance their interests according to a market that is generally visible from public sources. There may be unusual instances where the market information is not available, for instance, if a borrower has unique assets or businesses, but in that case, falling back on the formula rate approach is reasonable.

---

293. For instance, a “Troubled Debt Restructuring” is a form of impairment that occurs when a creditor agrees to modify the terms of a loan for reasons, whether legal or economic, it would not otherwise consider, such as an in a Chapter 11 cramdown. See OFFICE OF THE COMPTROLLER OF THE CURRENCY, BANK ACCOUNTING ADVISORY SERIES, at 23 (2016), [https://www.occ.gov/publications/publications-by-type/other-publications-reports/baas.pdf](https://www OCC.GOV/publications/publications-by-type/other-publications-reports/baas.pdf) [https://perma.cc/FRZ2-CDPY]. Such modifications may be imposed by a court and encompass any “reduction (absolute or contingent) of the stated interest rate for the remaining original life of the debt,” including interest rates which are below market. *Id.*

294. *Gen. Motors*, 999 F.2d at 67 (“Any creditor extending credit anticipates that over the course of the loan it will recover, in interest, its cost of capital and its cost of service . . . . When we focus on the present value of chapter [11] deferred payments to a secured creditor who has been forced to extend this new credit, this fact should not be ignored.”).

## CONCLUSION

Ultimately, the name of the approach for determining a cramdown interest rate is irrelevant.<sup>295</sup> Instead, the salient question is who should be responsible for assessing the terms and riskiness of a commercial credit transaction. The formula rate approach suggests courts are best able to handle this task and that risk in any case is minimal. The two-step approach adopted by the Second Circuit views the markets as superior. Ideally, the two would generate identical outcomes; however, various policy, social, and financial considerations force them to vary.

Significant controversy and lack of clarity persist in the cramdown interest rates context. Rather than clarifying the competing doctrinal views, *Momentive* and *Till* have only exacerbated the issue and both cases remain subject to criticism in relevant legal and professional communities. Fortunately, the Second Circuit's recent opinion overturning the application of the formula rate approach in Chapter 11 has restored sensibility to the Bankruptcy Code, at least within one portion of the country. In this Note, I have attempted to argue that courts must look to market rates to provide creditors with value equal to that of their interests in the collateral securing their claims on the confirmation date. As discussed, artificial rates supplied by courts do not accurately represent the economics of arms-length creditor-debtor relationships and consistently fail to provide commercial creditors with the present value of their claims. As the only cramdown interest rate methodology that relies on market rates of interest, the two-step approach is a superior option. Not only does the two-step approach reduce the evidentiary burden on the courts, debtors, and creditors as a result of the availability of market information by which the court may determine an appropriate cramdown rate, it also best compensates creditors for the risk they assume in lending to post-Chapter 11 debtors. In addition, the two-step approach affords ex ante certainty that the terms of a credit agreement will be honored and ex post certainty that the ultimate cramdown rate will be fair to both the creditor and debtor relative to a public market. As a result, courts should follow the two-step approach in future Chapter 11 cramdown proceedings.

---

295. See *In re Seasons Partners, LLC*, 439 B.R. 505, 520 (Bankr. D. Ariz. 2010) (“Whether one starts with a ‘base rate’ and adds for risk, or just accepts that a proven market rate includes relevant risk (in an appropriate case), the result should not vary by much.”).