AMERICAN COLLEGE OF BANKRUPTCY
2017 INDUCTION EDUCATION SESSIONS

Interest-ing Issues
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Hon. Robert D. Drain (moderator)
United States Bankruptcy Judge
Southern District of New York

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INTEREST IN BANKRUPTCY
(Gaming the System/What is an Unacceptable Windfall?)

I. Valuation as it pertains to secured claims and the right to reorganization value, and its relation to the proper post-effective date present value interest rate.

A. Effect of Assocs. Commer. Corp v. Rash, 520 U.S. 953 (1997), on Till v. SCS Credit Corp., 541 U.S. 465 (2004)

B. Remaining discretion in valuing secured claims after Rash. Compare In re SW Boston Hotel Venture, 748 F.3d 393 (1st Cir. 2014), In re Residential Capital, LLC, 501 B.R. 549 (Bankr. S.D.N.Y. 2013), In re Sunnyslope House, Ltd. P'ship, 838 B.3d 975 (9th Cir. 2016)

II. Till and judicial discretion over post-effective date rate in chapter 11 cases

A. How much discretion does Till permit in chapter 11? Does the size of the case (complexity, assets, length of delay and amount of fees case will bear) matter? In re Bayard Views, LLC, 445 B.R. 83 (Bankr. E.D.N.Y. 2011)

B. Is there a constitutional or 1129 limitation (i.e. is 1129 materially different than 1325) on the court's power to set the post-effective date rate under Till?

III. Sources of authority on postpetition/pre-effective date interest. Equity: unsecured claims, secured claims. Sexton v. Dreyfus, 219 U.S. 339 (1911); Vanston Bondholders Protective Committee v. Green, 329 U.S. 156 (1946); Bankruptcy Code: sections 506(b), 726/1129(a)(7), 1123(d), 1124

IV. Section 1124 and the default rate/compound interest, etc.

Is default rate interest required after the 1994 amendment to section 1123(d)? In re New Investments, Inc., 840 F.3d 1137 (9th Cir.); In re Campbell, 513 B.R. 846 (Bankr. S.D.N.Y. 2014). See H.R. Rep. No. 103-835 at 55: "It is the Committee's intention that a cure pursuant to a plan shall operate to put the debtor in the same position as if the default had never occurred." What was overturned when Congress in section 1123(d) overturned Rake v. Wade, 508 U.S. 464 (1993)? What is the proper interpretation/function of section 1124(2)(C)'s requirement that the claimant be compensated for any "damages incurred as a result of any reasonable reliance by such holder on such contractual provision or such applicable law"? In re Manville Forest Products Corp., 60 B.R. 403 (S.D.N.Y. 1986) (no compound interest and 1124). Should bankruptcy be a lender's profit center, especially when the lender is being paid in full?

V. 506(b) and judicial discretion

A. What are the limits in selecting a postpetition interest rate under 506(b)? Compare In re Residential Capital, LLC, 508 B.R. 851 (Bankr. S.D.N.Y. 2014), and Urban Communicators PCS Ltd. P'ship v. Gabriel Capital, L.P., 394 B.R. 325 (S.D.N.Y. 2008), and In re Residential Capital, LLC, 501 B.R. 549 (Bankr. S.D.N.Y. 2013), In re Bownetree, LLC, 2009 Bankr. LEXIS 2295 (Bankr. E.D.N.Y. July 24, 2009).

B. Applicability, if any, of Travelers Cas. & Sur. Co. of Am. v. PG&E, 549 U.S. 443 (2007)?

C. How much does it matter that the word "reasonable" isn't applied in section 506(b) to interest but only to fees, costs or charges?

D. How rebuttable is the presumption in favor of the contract rate, and should that presumption be weaker for the default rate?

Hypothetical: Minor prepetition default resulted in acceleration of secured note, triggering default rate increase of 6% over non-default rate of prime plus 3%, plus 5% late fee, plus 5% make-whole. Creditor is vastly oversecured. Loan matures in 9 months. Debtor seeks to confirm plan with postpetition interest at non-default rate, no late fee, no make-whole, 10 year note at prime (3%) plus 1.5% (same collateral and covenant protections). Unsecured creditors paid in full but over 10 years. Is the plan confirmable over the secured creditor's objection? Would the result be different if the unsecureds' distribution would be reduced to 70% if the new secured note must bear a "market rate" of interest (15%) and the postpetition default rate and late fee and make-whole were enforced? Is the make-whole postpetition interest or a charge/fee?

VI. "Disguised" postpetition interest for undersecured creditors

A. Common law rule of perfect tender. HSBC Bank USA v. Calpine Corp., 2010 U.S. Dist. LEXIS 96792 (S.D.N.Y. Sept. 14, 2010): no claim allowed, as unmatured postpetition interest.

B. Prepayment/make-whole/anti-redemption provisions for undersecured creditors: allowed liquidated damages or postpetition interest or charges/fees? Compare In re School Specialty, Inc., 2013 Bankr. LEXIS 1897 (Bankr. D. Del. Apr. 22, 2013), In re Trico Marine Servs., 450 B.R. 474 (Bankr. D. Del. 2011) (liquidated damages) and Paloian v. LaSalle Bank NA, 508 B.R. 697 (Bankr. N.D. Ill. 2014) (unmatured interest)

C. No-call provisions. Compare HSBC Bank USA v. Calpine Corp., 2010 U.S. Dist. LEXIS 96792 (S.D.N.Y. Sept. 14, 2010) (unmatured interest) and In re Chemtura Corp., 439 B.R. 561, 600 (Bankr. S.D.N.Y. 2010) (canvassing split in caselaw).

D. Interest rate swaps. Role of section 560. Thrifty Oil Co. v. Bank of America Nat'l Trust & Sav. Ass'n, 310 F.3d 1188 (9th Cir. 2002).

Gaming Chapter 11: Cramdown Interest, Makewholes and Swap Claims

By Thomas Moers Mayer[1]

In chapter 13 there is a debtor – a real person. Valuing the debtor's truck at "blue book" retail prices rather than foreclosure prices makes it difficult for the person to repay the truck loan.[2] Allowing cram down of the truck loan at prime plus 3% makes it easier for the person to repay the truck loan.[3] The fight really is between the debtor and the secured creditor. Unsecured creditors are marginal participants in chapter 13; they usually receive trivial payments under plans that fail frequently,[4] and whether the debtor keeps his or her truck will have only marginal effect on already marginal recoveries.

These considerations may not apply in corporate chapter 11 cases. The fight between debtor and secured creditor in chapter 11 cases is shaped by two factors not present in chapter 13:

- An insolvent debtor pays some or all of its claims with new equity; ***but***
- The debtor ***cannot*** cramdown secured claims with equity.[5]

[1] Partner and Co-head of the Creditors Rights & Bankruptcy Department, Kramer Levin Naftalis & Frankel LLP.
[2] Associates Commercial Corp. v. Rash, 520 U.S 953 (1997) ("*Rash*").
[3] Till v. SCS Credit Corp., 541 U.S. 465 (2004) ("*Till*").
[4] "Study after study, including this one that relies on the most recent available data, has found that only about one-third of consumers who enter chapter 13 complete their repayment plans." Greene, Patel & Porter, *Cracking the Code: An Empirical Analysis of Consumer Bankruptcy Outcomes*, 101 MINN. L. REV. 1031, 1032 & n.3 (2017). Two studies prior to the Great Recession showed that unsecured creditors recovering on average 16-19.5 cents on the dollar in chapter 13 and only 33% of chapter 13 plans are completed. Li, *What Do We Know About Chapter 13 Personal Bankruptcy Filings?* PHILADELPHIA FEDERAL RESERVE BUSINESS REVIEW Q4 2007 at p. 24, available at www.philadelphiafed.org.
[5] Section 1129(b)(2)(A) requires that a dissenting class of secured claims receive either (i) payments with present value equal the allowed amount of their claims, secured by a lien on their collateral, (ii) proceeds from the sale of their collateral, or (iii) the "indubitable equivalent" of their secured claims. "Unsecured notes as to the secured claim or equity securities of the debtor would not be the indubitable equivalent." 124 Cong Rec. H. 11,103 (Sept. 28, 1978); S 17,420 (Oct. 6, 1978).

If the debtor cannot surrender or sell a secured creditor's collateral, or lacks cash flow to either refinance the secured loan or service new cramdown notes, then the debtor survives only by issuing equity to the secured creditor at an enterprise value acceptable to the secured creditor. This will be the lowest defensible enterprise value – the lower the value, the greater percentage of equity that will go to the secured creditor. [6]

The corollary is that a corporate debtor will wage a fight over cramdown interest rates only if it can afford to do so – if it has more than enough cash flow to service cramdown notes and a reason to believe that unsecured creditors (or old equity) will control the post-reorganization company and thus select and compensate post-reorganization management, or (in the case of makewholes) if an asset sale has reduced the estate to cash and the fight is simply over allocation of the proceeds.

Otherwise, most managements will choose to negotiate an equity plan with the secured creditor. Their interests will be aligned. The secured creditor's low-ball enterprise value diminishes the [apparent] value of the straight equity, and the [actual] strike price of stock options, promised to management in its post-effective date compensation plan.[7] A plan paying a secured creditor in equity also reduces debt on the reorganized company, which tends to appeal to the bankruptcy court. Professor Casey's justification for cramdown – "the [secured] creditor cannot demand the right to take its asset away"[8] -- while correct in theory is often meaningless in practice.

Thus, unless a secured creditor is bent on using a high interest rate to force a low-value sale, wars over interest – over cramdown interest rates under section 1129(b), allowance of interest or makewhole claims under section 506(b), or the determination of "cure" interest under

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[6] Gilson, Hotchkiss & Ruback, *Valuation of Bankrupt Firms,* 13 REV. FIN. STUDIES 43 (2000).
[7] *Id*., at 45.
[8] Casey, *Bankruptcy's Endowment Effect*, 33 EMORY BANKR. DEV. J. 141, 159 (2016)

section 1124(2) – have nothing to do with ***increasing*** estate value and have everything to do with ***allocating*** estate value, usually between secured creditors on the one hand, and unsecured or equity holders on the other.[9] The chapter 13 debtor fights these wars because it must; the chapter 11 debtor fights these wars because it can.

In deciding who should win such wars, I suggest that courts consider whether the debtor fights to reallocate value from secured to unsecured creditors because it must (to survive or enhance value), or whether it fights simply because it can. In two recent cases -- *In re MPM Silicones LLC* ("*Momentive*")[10] and *In re Energy Future Intermediate Holdings LLC* ("*EFIH*") – the debtor explicitly used bankruptcy to take value from secured creditors and give it to unsecured creditors without financial compulsion (or the excuse of "enhancing estate value"). This paper analyzes the legal and philosophical questions posed starkly by the perfect facts of these cases.

Part I examines *Momentive*, where the debtor used cramdown under Section 1129(b)(2) to refinance its secured debt with below-market interest rates – was this result dictated by chapter 13 precedent or was it unfair and inequitable under Section 1129(b)(1)?

Part II examines *EFIH*, where the debtor tried to use chapter 11 to redeem notes without paying a makewhole premium – was this appropriate? When should a makewhole be allowed, and when should it be disallowed?

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[9] For simplicity's sake, I assume the reallocation is always from secured creditors to other classes. A plan can also issue notes with below-market rates to unsecured creditors in order to shift value to equity, but this happens rarely -- only where old equity retains a majority of the reorganized equity, thus giving management an incentive to fight interest battles with unsecured creditors. *See In re* Dow Corning Corporation, 456 F.3rd 668 (2006).

[10] 2014 Bankr. LEXIS 3926 (Bankr. S.D.N.Y. Sept. 9, 2014), *aff'd*, *531 B.R. 321* (S.D.N.Y. 2015), *appeal pending*, Case No. 15-1682 (2d. Cir.).

Part III widens the field of vision to include interest rate swaps – and shows that resistance is futile. At the end of the day, limitations on interest or makewholes can be largely circumvented by the Bankruptcy Code's exaltation of derivate instruments.

I. Cramdown & Momentive

Momentive's balance sheet may be summarized as follows

- Total Enterprise Value: $2.0-2.4 billion
- 8.875% 1st Lien and 10% 1.5 Lien debt: $1.35 billion
- 2nd Lien debt: $1.61 billion

That made the 1st and 1.5 liens well over secured, and the 2nd Lien an undersecured "fulcrum security" -- the logical recipient of Momentive's reorganized equity and thus the future masters of Momentive's management. It is probably relevant that the 2nd Liens were held by Apollo, which also held a controlling interest in the pre-bankruptcy equity and was thus management's original sponsor. The 1st and 1.5 Liens asserted a makewhole which ballooned the size of their secured claims by about $200 million.

Momentive offered the 1st 1.5 Lines a choice: full payment of $1.35 billion in cash – i.e., waive the makewhole – or litigate the makewhole claim but be paid in "cram-down" notes bearing interest at rates ranging from 4.1% to 4.85%. Momentive itself admitted that the cramdown rates were below market rate for such notes[11] and one commentator estimated that the lower rates cost the 1st and 1.5 Liens $200 million in value[12] (or, roughly the amount of the additional makewhole claim).

[11] Momentive estimated that the cram-down rate was only 87% of the market rate.
[12] Vitti, *Secured Creditors Lost Almost $200 Million in Economic Value Due to the Imposition of Below Market Interest Rates, Taking a Deeper Look Into Momentive, Part 1*, http://quickreadbuzz.com/2015/12/22/taking-a-deeper-look-into-momentive-part-1/

Judge Drain disallowed the makewhole (discussed below) and upheld the below-market cram-down interest rate under the authority of two chapter 13 cases – *Till* in the Supreme Court[13], *Valenti* in the Second Circuit.[14] In Judge Drain's view, these cases compelled the court to approve cramdown interest rates so long as they were between prime rate plus 1% and prime rate plus 3%.

Till opted for the "certainty" of the prime-plus-1-to-3% formula because the Supreme Court viewed the alternatives – rates charged by the particular creditor for its loans, the creditor's "cost of funds", or the return the creditor would receive from relending the money – as too dependent on the ***creditor***. *Till*'s rejection of creditor-specific damages was correct but led to error. The "market rate" is not the rate which compensates the crammed-down creditor for making a coerced loan. The loan shark is not entitled to collect its extortionate interest; the near-insolvent lender is not entitled to cover its higher cost of funds, the inefficient lender is not entitled to collect its above-average transaction costs. But none of this relates to the "market rate" or justifies the rejection of "the market rate" as the appropriate cramdown rate.

The market rate is (or should be) the lowest rate the debtor can pay ***any*** lender to refinance the loan. In correctly holding that a crammed-down creditor is not entitled to collect ***its*** profits, cost of funds and transactions costs, *Till* erred by rejecting "the market rate" as (by definition) including any lender's profits, cost of funds and transactions costs.

Setting a cramdown rate at lower than the lowest refinancing rate provides an incentive for an individual debtor to obtain credit at a sub-prime rate and then cut his or her payments to a prime-based rate under chapter 13, perhaps within months of the original loan.

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[13] 541 U.S. 465 (2004).
[14] 105 F.3d 55 (2nd Cir.1997)

This is not far from what the Tills actually did. They borrowed in 1998. They defaulted after making a year's payments and filed in 1999. The Supreme Court allowed the Tills to cut the interest rate on their car loan from 21% to 9%, in part on the ground that a cram-down loan to a chapter 13 debtor, enforced by a chapter 13 trustee under a chapter 13 plan, is safer than a loan to a non-debtor. This is a highly dubious conclusion given that 67% of all chapter 13 plans fail.[15] The plurality brushed aside the chapter 13 failure rate with the comment that courts should confirm better chapter 13 plans – in other words, the cram-down rate will ignore reality because the courts should fix the reality.

Why should the Bankruptcy Code empower the Tills to forcibly refinance their loan by cramdown at 9% if they could have refinanced their loan – or obtained a replacement truck on credit – at a market rate? The question has answers in chapter 13.

First, a chapter 13 debtor may not have access to a "market rate" -- even the amicus brief filed by the commercial lending industry carefully avoided representing that a "market" existed for loans in chapter 13.[16]

This is not surprising. The Supreme Court had previously held in in *Associates Commercial Corporation v. Rash*[17] that the amount of a secured claim is determined by the retail or replacement value of its collateral. This created an allowed secured claim greater than the foreclosure value of the collateral – i.e., a "loan-to-value" ratio of more than 100%. Once the loan-to-value ratio is pegged at more than 100% under *Rash*, it is intellectually difficult to construct a "market rate" based on the debtor's ability to obtain replacement financing. Few

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[15] *See* Greene, Patel & Porter *and* Li, *supra*, n. 3.

[16] *See* Brief Amicus Curiae For Commercial Lenders In Support Of Respondent, 2002 U.S. Briefs 1016 at*5-*7 & n.3; 2003 U.S. S. Ct. Briefs LEXIS 845 at **10-13 & n.3 (Oct. 24, 2003). The Commercial Lenders dilate upon the trading market for bank debt, but they never allege that there is a market for loans to chapter 13 debtors.

[17] 520 U.S. 953 (1997).

lenders will make a secured loan where, on day one, the collateral is worth less than the money extended.[18]

Rash's use of "retail" or "replacement" value not only eliminated (or severely restricted) the ability to refinance secured loans in chapter 13; it also diminished the intellectual validity of a "market rate" as compensating the secured creditor for making a "forced loan".

The principal amount of the "forced loan" would be the amount realized on foreclosure. Using "retail" or "replacement" value sets the principal amount of a crammed down loan substantially above the amount of the "forced loan". In *Rash*, foreclosure value was $31,875, replacement value was $41,000 – approximately 28% higher. *Till* had a three-year plan. At three years, a 28% premium is equal to more than 9% a year in simple interest -- which would bridge most of the gap between the 9% formula rate and the "market rate" of 21% that were the goal posts in *Till*.

Second, most chapter 13 debtors simply cannot pay a higher rate. There is no other creditor constituency to bear the increased cost of a higher cramdown rate.

Third, a lower cramdown interest rate can be rationalized as consistent with "the overriding rehabilitative purpose of Chapter 13."[19]

None of the foregoing makes any sense in a chapter 11 case where the debtor can readily refinance its existing debt. Empowering cramdown at a below-market rate simply transfers value from the secured creditor who the debtor could pay in cash to the unsecured creditors whose equity benefits from the below-market rate.

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[18] The foregoing conclusion can be challenged with reference to the recent bubble in sub-prime mortgage lending, where lenders extended "NINJA" ("no income, no job, no assets") loans to any borrower regardless of credit, secured by any home regardless of value, based on pooling millions of such loans and statistical judgments that sufficient number borrowers would pay sufficient amounts of principal, [high] interest and [higher] fees so as to return a profit to the investors in the pool. However, it is not clear that NINJA credit is available to chapter 13 debtors.

[19] Taddeo v. DiPierro, 685 F.2d 24, 29 (1982) (Lumbard, J.), quoting *In re Davis, 15 Bankr. 22, 24* (Bankr. D. Kan.), *aff'd*, 16 Bankr. 473 (D. Kan. 1981)..

In chapter 11, there is no policy goal favoring transfer of value from secured to unsecured creditors, or from unsecured creditors to equity – if anything, the bias goes the other way under Section 1129(b)(1)'s "fair and equitable" requirement..

"Fair and equitable" derives from Chapter X of the Bankruptcy Act. To quote the Supreme Court:

> "[T]he words "fair and equitable" in Chapter X are terms of art, and no plan can be "fair and equitable" which compromises the rights of senior creditors in order to protect junior creditors.[20]

Chapter X's "fair and equitable" rule applied up and down the capital structure:

> Beginning with the topmost class of claims against the debtor, each class in descending rank must receive full and complete compensation for the rights surrendered before the next class below may properly participate. Thus the principle is applied as between senior and junior secured creditors, between secured creditors and unsecured creditors, between unsecured creditors and stockholders, between different classes of stockholders, and, of course between secured creditors as a whole and stockholders.[21]

It is true that Chapter X decisions allowed a fair degree of leeway in interpreting how much value was sufficient to satisfy the senior classes and thus the absolute priority rule. Professor Markell cites these decisions (and their author, Justice and former SEC Commissioner William O. Douglas) for the proposition that a plan's provision of interest does not have to be perfect, just "good enough".[22]

However, appellate decisions under Chapter X applied its "fair and equitable" standard only after:

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20 Case v. Los Angeles Lumber Co., 308 U.S. 106, 115-116 (1939); Consolidated Rock Co. v. Du Bois, 312 U.S. 510, 527-529 (1941).

[21] J.W. MOORE & R.S. OGLEBAY, 6A COLLIER ON BANKRUPTCY ¶ 11.06 at 210-212 (L.P. King & A. Herzog, 14th ed. 1977)

[22] *See* Group of Institutional Investors v. Chicago, N. St. P. & P.R. Co., 318 U.S. 523, 564-565 (1943):

> "It is sufficient that each security holder in the order of his priority receives from that which is available for the satisfaction of his claim the equitable equivalent of the rights surrendered."

quoted in Markell, *To Market, To Market: Momentive and Secured Creditor Cram Down Interest Rates*, 36 BANKR. L. LTR. No. 2 at 6 & n.29 (Feb. 2016).

- The SEC had evaluated the plan[23] and (usually) found it fair and equitable[24];
- The district court had determined the plan was fair and equitable[25] and sent it out for a vote;
- holders of two-thirds of the claims or interests in each and every class had accepted the plan;[26] and
- The district court determined at the confirmation hearing, again, that the plan was fair and equitable.[27]

Thus in Chapter X, every single class had voted in favor of a plan before a "fair and equitable" fight ever reached an appellate court. Appellate decisions (or dicta) upholding treatment as "fair and equitable" were therefore ratifications of the will of a two-thirds majority in each class over the objection of minority holdouts. Such decisions provide weak, if not entirely distinguishable, precedent for cramming down a dissenting class under Section 1129(b)(1) of the Bankruptcy Code.[28]

Finally, there is the language of Section 1129 itself. Section 1129(b)(1) requires that the plan to be "fair and equitable" to a dissenting class. Section 1129(b)(2) provides that fair and equitable ***<u>includes</u>*** meeting paragraph (2)'s requirements, such as (with respect to a secured creditor) the requirement of payments "of a value, as of the effective date of the plan, of at least the value of [the creditor's] interest in the estate's interest in such property." "Includes" is explicitly not a limitation under Section 102(3).

Thus "payment of a value" equal to the allowed secured claim is a necessary but not a sufficient condition to a "fair and equitable" finding – and the courts have so held:

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[23] The district court was required to refer all cases with public debt exceeding $3,000,000 to the SEC for evaluation. Bankruptcy Act of 1898 § 172, 11 U.S.C. § 572 (1976).

[24] The Commission did not have to find the plan "fair and equitable" for it to proceed, and courts occasionally approved a plan over the Commission's objection. Matter of Lower Broadway Properties, 58 F. Supp. 615 (S.D..Y. 1945) (Rifkind, J.) However, its report was entitled to "great weight." 6 COLLIER ON BANKRUPTCY Part 2 ¶ 7.36 at 1305-06 (J.W. Moore 14th ed.; rev'd 1977 Lawrence P. King & Asa Herzog).

[25] Bankruptcy Act of 1898 § 174, 11 U.S.C. § 574 (1976)

[26] Bankruptcy Act of 1898, § 179, 11 U.S.C. § 579 (1976).

[27] Bankruptcy Act § 221, 11 U.S.C. § 621 (1976).

[28] By contrast, decisions that reject a plan as not "fair and equitable" even after it has been accepted by two thirds of every class should constitute strong precedent under Section 1129(b)(1).

> Simple technical compliance with the requirements of section 1129(b)(2) does not assure that the plan is fair and equitable. Instead, this section merely sets minimal standards that a plan must meet, and does not require that "every plan not prohibited be approved."[29]

Chapter 13 is not structured in such a fashion. Section 1325 contains no bicameral equivalent of chapter 11's section 1129(b)(1) & (2), no overriding requirement of "fair and equitable"[30] – indeed, that phrase is never used in chapter 13.[31] I submit that a plan imposing a below-market rate on a dissenting secured class in lieu of refinancing such class from available credit is not "fair and equitable" under Section 1129(b)(1) even if the cram-down rate falls within *Till*'s prime+1-3% range and thus deemed satisfactory under Section 1129(b)(2).

Such was the plan in *Momentive*. Momentive could have refinanced its 1st and 1.5 Lien Notes at a market rate – we know that because Momentive actually did raise the money to do so. The imposition of a lower cram-down rate was simply a gift to the 2nd Lien Bonds who were going to own the debtors' equity (and thus control management's compensation post-chapter 11). (The "fair and equitable" argument does not appear in the briefs filed with the bankruptcy court; the indenture trustee for the 1st Liens raises the argument in its Second Circuit brief.[32])

A sensible rule of law would set a cramdown rate at a market rate – the rate the debtor would have to pay to refinance --where there is a market and such rate is readily ascertainable, as it was in *Momentive*. Only if a market rate was not available would the court fall back on the *Till*

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[29] *In re* Sandy Ridge Dev. Corp., 881 F.2d 1346, 1352 (5th Cir. 1989), *quoted in In re* Kennedy, 189 Bankr. 589, 599 (Bankr. D.N.J. 1993) (cramdown of mortgagee into new 20-year mortgage was not "fair and equitable"); See *also In re D & F Constr., Inc., 865 F.2d 673, 675 (5th Cir. 1989)*, using the general "fair and equitable" requirement to disapprove plans that provide, for example, current payments of unsecured claims while delaying payment on secured claims through with "negative amortization" (i.e., accrual of interest).

[30] Thompson & McDonough, *Lost in Translation: Till v. SCS Credit Corp. and the Mistaken Transfer of a Consumer Bankruptcy Repayment Formula to Chapter 11 Reorganizations*, 20 FORDHAM J. CORP. & FIN. L., 893 (2015).

[31] *In re* Shat, 424 Bankr. 854, 868 n.45 (Bankr. D. Nevada 2010): "Chapter 13 has no 'fair and equitable' requirement for confirmation. *11 U.S.C. § 1325(b)(1)*. The same is true for chapter 12. *Id. § 1225(b)(1)*."

[32] Brief for Defendant/Appellant BOKF, NA, 15-1682 (2nd Cir. Sept. 4, 2015) at pp. 20-21.

formula rate in a chapter 11 case. This is, in fact, the rule in the Sixth Circuit.[33] The Second Circuit could adopt that rule. If instead the Second Circuit affirms *Momentive*, that would present a conflict in the circuits – and give the Supreme Court a chance to provide a sensible rule for cramdown interest rates in Chapter 11.

Note that such a rule would not deprive the debtor of the ability to reset its rates under cramdown if market rates had declined – unless the debtor had agreed to an enforceable makewhole premium.

II. Energy Future Holdings, Inc. and Makewholes

At the time of their chapter 11 filings, Energy Future Holdings, Inc. ("EFH")'s subsidiary, Energy Future Intermediate Holding Company LLC ("EFIH"), had outstanding approximately $4 billion in 1st Lien Notes bearing interest at 6% and 10%, and $2 billion in 2nd Lien Notes issued with interest at 11% and 11.75%.[34] Both EFIH 1st and 2nd Lien Notes were secured by EFIH's 80% equity interest in a regulated utility. This collateral was worth so much that EFIH's $1.4 billion in ***unsecured*** notes were trading at above par when EFIH filed, and the ***unsecured notes of EFIH's parent, EFH***, expected to receive at least 37.5 cents on the dollar.

Thus the EFIH 1st and 2nd Lien notes were dramatically oversecured.

Section 3.07 of each indenture provided that EFIH would pay, upon "optional redemption" prior to a stated date, an "Applicable Premium". The "Applicable Premium" was the present value of all future payments of interest, using as the discount rate a rate equal to the rate payable on U.S. Treasury bills of comparable maturity plus 50 basis points. The

[33] *In re* American Homepatient Inc., 420 F.3d 559, 568 (6th Cir. 2005).
[34] The author represents the indenture trustee for the EFIH 2nd Lien Notes and his partner Gregory Horowitz argued the case before the United States Court of Appeals for the Third Circuit.

“Applicable Premium” is commonly called a “makewhole” because it is intended to compensate the bondholder -- “make the bondholder whole” -- for the loss of future interest payments.

Both indentures provided for acceleration upon bankruptcy under Section 6.02.

Section 3.07, providing for payment of “Applicable Premium” upon an early “redemption”, said nothing about acceleration. Section 6.02 of the 1st Lien indenture required payment of principal and accrued interest upon acceleration. Section 6.02 of the 2nd Lien Indenture provided for payment of interest, principal and “premium if any” upon acceleration. In neither indenture did Section 6.02 refer to the “Applicable Premium” in Section 3.07.

The two “Applicable Premiums” exceeded $800 million, EFH and EFIH explicitly stated in pre-bankruptcy SEC filings that they would use chapter 11 to avoid paying the makewholes.

Immediately after filing, EFIH entered into two post-petition credit agreements for the purpose of paying off all 1st and 2nd Lien notes by tender or redemption. EFIH offered to settle the makewhole premiums at various fractions of their amounts through cash tender offers. Holders of 1st Lien notes who did not tender were redeemed at par plus accrued on June 19, 2014 – two months into the chapter 11 case. The tender offer to the 2nd Lien notes and the 2014 redemption of untendered 2nd Lien Notes was withdrawn for reasons not relevant to this paper. EFIH partially redeemed the 2nd Lien notes approximately a year after filing, and filed numerous plans providing for cash payment of the balance based on disallowance of the “Applicable Premium”.

The indenture trustees for the 1st and 2nd Lien notes each brought a declaratory judgment to allow the “Applicable Premiums”.

Bankruptcy Judge Sontchi disallowed the Applicable Premiums on the ground that acceleration had voided the right to a premium. In his decision disallowing the 1st Lien's makewhole he wrote:

> 45. The Court begins its analysis with the most relevant provision, the acceleration provision of section 6.02 of the Indenture. Under section 6.02, "in the case of an Event of Default arising under clause (6) or (7) of Section 6.01(a) hereof, all outstanding Notes shall be due and payable immediately without further action or notice." Here, EFIH's filing for bankruptcy was an Event of Default arising under clause (6) of Section 6.01(a). Thus, the Notes were automatically accelerated on the Petition Date and became due and payable immediately without further action or notice of the Trustee or any Noteholder. (Indenture § 6.02,¶2.)
>
> 46. There is no reference in Section 6.02 to the payment of the "Applicable Premium" upon an automatic acceleration, nor is section 3.07 incorporated into section 6.02. . . .
>
> 47. Under New York law, an indenture must contain express language requiring payment of a prepayment premium upon acceleration, otherwise it is not owed. *See* Northwestern Mut. Life Ins. Co. v. Uniondale Realty Assocs., 11 Misc. 3rd 980, 816 N.Y.S.2nd 831, 836 (N.Y. Sup. Ct. 2006). . . . *In re* MPM Silicones, LLC [2014 Bankr. LEXIS 3926] (Bankr. S.D.N.Y. Sept. 9, 2014) ("*Momentive*")."[35]

Judge Sontchi found that in the absence of specific language making the "Applicable Premium" due upon or after acceleration, the claim for the premium would not be enforceable under the indenture or New York law because the redemption was no longer voluntary.

> When the EFIH Debtors filed for bankruptcy, the Notes automatically accelerated and became due and payable immediately. Under New York law, a borrower's repayment after acceleration is not considered voluntary. This is because acceleration moves the maturity date from the original maturity date to the acceleration date and that date becomes the new maturity date. Prepayment can only occur prior to the maturity date, and acceleration, by definition, advances the maturity date of the debt so that payment thereafter is not prepayment but instead is payment made after maturity. . . .Thus, the Trustee's claim that the EFIH Debtors' repayment was an optional redemption must fail.[36]

[35] *Id*., 527 Bankr. at 191-92. Citation to two other bankruptcy court cases omitted.
[36] Id. at 195.

The indenture trustees for both the 1st and 2nd Lien notes appealed. The Court of Appeals for the Third Circuit reversed in an opinion by Judge Ambro.[37] Judge Ambro distinguished between "prepayment", which by definition must be a payment before maturity, and "redemption" as provided for in Section 3.07:

> New York and federal courts deem "redemption" to include both pre-and post-maturity repayments of debt . . . . Accordingly, EFIH's June 19, 2014 refinancing was a "redemption" within the meaning of § 3.07.[38]

Judge Ambro rejected *Northwestern Mutual*, cited by both Judge Sontchi below and by Judge Drain in *Momentive*, as an applicable precedent for several reasons. *Northwestern Mutual* was a trial court case not binding on the Third Circuit. More important, Judge Ambro found it inconsistent with *NML Capital v. Republic of Argentina*[39], where the New York Court of Appeals (the state's highest court) had held that interest continued to accrue both before and after acceleration. The New York Court of Appeals had reasoned that Argentina could have provided for the cessation of interest after acceleration but failed to do so and thus interest continued to accrue. Judge Ambro found *NML Capital* controlling:

> The takeaway for us is that § 3.07 applies no less following acceleration of the Notes' maturity than it would to a pre-acceleration redemption.[40]

Thus, an "optional redemption" could occur both before and after acceleration. Judge Ambro continued:

> Whether the redemption was "[o]ptional" is next up. EFIH argues that refinancing the Notes was not optional because § 6.02 made them "due and payable immediately without further action or notice" once it was in bankruptcy. EFIH, however, filed for Chapter 11 protection voluntarily. Once there, it had the option, per its plan of reorganization, to reinstate the accelerated Notes' original

[37] In re Energy Future Holdings
[38] Id. at 254-55, citing, among other authorities, *Fed. Nat'l Mortg. Ass'n v. Miller, 123 Misc. 2d 431, 473 N.Y.S.2d 743, 744 (N.Y. Sup. Ct. 1984)* ("debtor may redeem" mortgage by "pay[ing] . . . accelerated debt") and *N.Y. U.C.C. § 9-623*, Official Comment No. 2 ("To redeem the collateral . . . of a secured [**14] obligation [that] has been accelerated, it would be necessary to tender the entire balance.").
[39] 17 N.Y.3d 250, 952 N.E.2d 482, 928 N.Y.S.2d 666 (N.Y. 2011).
[40] *Id*. at 259.

maturity date under *Bankruptcy Code § 1124(2)* rather than paying them off immediately. It chose not to do so, and instead followed the path laid out six months before in its SEC 8-K filing. . . .

Indeed 'a chapter 11 debtor that has the capacity to refinance secured debt on better terms . . . is in the same position within bankruptcy as it would be outside bankruptcy, and cannot reasonably assert that its repayment of debt is not 'voluntary.'" . . . . .

Events leading up to the post-petition financing on June 19, 2014 demonstrate that the redemption was very much at EFIH's option. . . .

The irony is that the Noteholders did not want to be paid back on June 19, 2014. They attempted to rescind the Notes' acceleration on June 4, 2014, but were blocked by the automatic stay. . . . When EFIH redeemed the Notes, it did so "on a non-consensual basis," that is, over the Noteholders' objection. . . . . Logic leaves no doubt this redemption of the Notes was "[o]ptional" under § 3.07.[41]

Therefore acceleration of the EFIH notes was irrelevant and the makewhole was payable. The Third Circuit remanded to the bankruptcy court for further proceedings.

The Debtors sought a rehearing en banc, and while the rehearing petition was pending announced a settlement of the makewhole disputes at 95% of the claimed amount for the EFIH 1st Liens and 87.5% of the claimed amount for the EFIH 2nd Liens. The Debtors have moved to approve the settlement in bankruptcy court.

EFIH is, on its face, a very narrow opinion resting entirely on the distinction between "prepayment" and "redemption". Its import, however, is much broader. Prior to *EFIH*, lower court opinions had effectively imposed a "rule of explicitness" standard on makewhole premiums in bankruptcy – the loan agreement or indenture had to specifically provide for payment of the makewhole upon acceleration or after acceleration. The Third Circuit's opinion reversed the burden:

EFIH answers that the Noteholders should have taken note of bankruptcy courts' novel application of *Northwestern* and insisted on clearer language in the Indenture. . . . But this puts the burden backward; if EFIH wanted its duty to pay

[41] *Id*. at 255.

> the make-whole on optional redemption to terminate on acceleration of its debt, it needed to make clear that § 6.02 trumps § 3.07. . . . The burden to make that showing is with EFIH. To place it on the Noteholders for EFIH's decision to redeem the Notes is a bridge too far.[42]

Judge Ambro's opinion is, essentially, a command to follow relevant state law as if the bankruptcy had not occurred where the redemption is truly optional.

EFIH is also a holding that the filing of a bankruptcy, standing alone, does not preclude a redemption from being optional – as Judge Ambro noted, section 1124(2) would have allowed EFIH avoid redemption by reinstating the maturity of its notes under a plan.[43] Thus redemption under a plan could still trigger a makewhole. It is true that a plan redemption was not before the court – EFIH had fully redeemed its 1st Lien notes and partially redeemed its 2nd Lien notes during the case. However, the Third Circuit rendered its opinion knowing that EFIH was in the middle of its second plan confirmation proceeding."[44]

EFIH's facts were extreme – the redemption was clearly optional. The debtors made no serious argument that their financial distress would preclude paying the 1st and 2nd lien notes at maturity. The entire fight was waged to flow value to EFIH's unsecured noteholders and EFIH's parent company. EFIH is, in a sense, a companion to the numerous cases which will not allow an obligor to escape a prepayment premium by manufacturing a default.[45] *Northwestern Mutual* itself had cited such cases. In *Sharon Steel*, the Second Circuit held that a solvent issuer could not avoid a redemption premium by engineering a default and acceleration.[46] *EFIH* held that a

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[42] Id. at 261 (citations omitted).
[43] Id. at
[44] The remand to Judge Sontchi provides: "Any further appeals shall return to this panel."*Id*. at 261.
[45] "In the event that a court concludes that the borrower has defaulted intentionally in order to trigger acceleration and thereby avoid or evade a prepayment premium, the prepayment clause may be enforced, notwithstanding substantial authority which requires an explicit agreement to allow a premium after acceleration." *Northwestern Mutual*, 11 Misc. 3d 980; 987, 816 N.Y.S.2d 831, 836 (Sup. Ct. Nassau Cty. 2006) (numerous citations omitted)..
[46] Sharon Steel v. Chase Manhattan Bank, 691 F.2d 1031, 1052 (2d Cir. 1982):

debtor could not avoid a makewhole it could otherwise pay by choosing to redeem after bankruptcy.

Thus EFIH can be read as a warning not to use bankruptcy to reallocate value legitimately owed to a ***secured creditor*** under an otherwise ***payable*** makewhole.

Less examined is the converse of this problem – the use of bankruptcy to reallocate value legitimately owed to ***unsecured creditors*** under an otherwise ***avoidable*** makewhole.

Assume a makewhole premium is enormous, which is quite common given the structure of a standard makewhole clause such as those in EFIH and Momentive. Assume the coupon is 12% and the Treasury rate is about 2% -- the makewhole is roughly 10% of principal for each year remaining under the loan agreement. If the original maturity is 10 years and the issuer files for chapter 11 two years after issuance, the makewhole is about 80% of principal. Assume a makewhole is payable by its terms upon ***acceleration*** – I'd call that a "super makewhole". The super makewhole would allow the secured lender to almost double its claim and thereby absorb an enormous fraction of the value of the debtor.

The unsecured creditors (or the debtor, in the unlikely event the debtor picks a fight with its secured creditor) have very few weapons against a "super makewhole".

Makewhole premiums look like unmatured interest. If the makewhole was an unsecured claim for unmatured interest, it would be disallowed under Section 502(b)(2). If the makewhole premium was a secured unmatured interest, it would presumptively be allowed as provided in the

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> We see no bar, therefore, to the Indenture Trustees seeking specific performance of the redemption provisions where the debtor causes the debentures to become due and payable by its voluntary actions.
>
> This is not a case in which a debtor finds itself unable to make required payments. The default here stemmed from the plan of voluntary liquidation . . . . We hold, therefore, that the redemption premium must be paid.

agreement but remain subject to equitable considerations.[47] The courts, however, have held that a makewhole is a "fee" or "charge" which will be "reasonable" and thus allowed under Section 506(b) so long as it is enforceable, under applicable non-bankruptcy law, as "liquidated damages".[48]

Two super makewholes were specifically upheld as liquidated damages in the first court of appeals case on makewholes: *In re United Merchants & Manufacturers*[49] – where, however, such fees were only 8% and 7% of outstanding principal, respectively.

Debtors have argued that the makewhole formula appearing in the EFIH and Momentive indentures – the present value of foregoing interest, discounted at a U.S. Treasury-based rate – is not reasonable because the rate is too low: the loan was not made to a U.S. Treasury credit. If the borrower was a B-rated credit at the inception of the loan, debtors have argued that the present value of the future interest payments should be discounted at rates appropriate to B-rated credits, not the risk-free Treasury rate. Thus a Treasury-based discount rate did not measure actual damages. This argument had some success a decade ago.[50] However it has largely been rejected by recent decisions[51] and was not even advanced in *Momentive* or *EFIH*.

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[47] "Interest" under Section 506(b) is not governed by the agreement under which it arose, United States v. Ron Pair Enters., 489 U.S. 235, 241 (1989). *See* Urban Communicators Pcs Limited Partnership v. Gabriel Capital, L.P.,, 394 B.R. 325; 338 (S.D.N.Y. 2008): "The great majority of courts to have considered the issue since Ron Pair have concluded that post-petition interest should be computed at the rate provided in the agreement, or other applicable law, under which the claim arose -- the so-called 'contract rate' of interest." 4 COLLIER ON BANKRUPTCY ¶ 506.04[2][b][I] (rev. 15th ed. 2008) (collecting cases). The courts adopt a presumption in favor of applying a contractual default rate of interest, "subject to equitable considerations." *In re Vanderveer Estates Holdings, Inc., 283 B.R. 122, 134 (Bankr. E.D.N.Y. 2002)*; *In re Vest Assocs., 217 B.R. 696, 702 (Bankr. S.D.N.Y. 1998).* See also *In re Terry Ltd. P'ship, 27 F.3d 241, 243 (7th Cir. 1994)* ("What emerges from the post-*Ron Pair* decisions is a presumption in favor of the contract rate subject to rebuttal based upon equitable considerations.").

[48] Charles & Kleinhaus, *Prepayment Premiums in Bankruptcy*, 15 AM. BANKR. INST. L. REV. 537, 557 & n.61 (2007)

[49] 674 F.2d 134 (2nd Cir. 1982)

[50] *Id.*, at 560 & nn.72-76.

[51] River E. Plaza, LLC v Variable Annuity Life Ins. Co., 498 F.3rd 718 (7th Cir. 2007); UIP Ltd. LLC v. Lincoln Nat'l Life Ins. Co., 2009 U.S. Dist. LEXIS 111052 (D. Az. Nov. 30, 2009); In re Hidden Lake Ltd. Partnership, 24 Bankr. 722 (Bankr. S.D. Ohio 2000). *See also* In re Fin. Ctr. Assocs., 140 Bankr 829, 839 (Bankr. E.DN.Y. 1992), rejecting the argument that the treasury rate was an unenforceably low discount rate.

Analyzing super makewholes as liquidated damages ignores the enormity of the premium in the early years of the credit. In the example given above, the 1,000 basis point spread between Treasuries and coupon produced an 80% premium two years after issuance. This is a premium no borrower would voluntarily pay. It will be triggered only in bankruptcy.

Indeed, a loan with a super makewhole that is oversecured by a first lien on substantially all assets of the debtor, and engineered to default within a short period of time, can be used as a cheap way for the secured creditor to buy the debtor.

This is the converse of the *EFIH* case – instead of the debtors (or unsecured creditors) using bankruptcy to avoid an otherwise payable makewhole, the debtor (or secured creditor) uses bankruptcy to trigger an otherwise avoidable makewhole.

The one avenue of recourse against a super makewhole is reinstatement under Section 1124(2), as Judge Ambro suggested. To reinstate, all defaults must be cured other than the "ipso facto" defaults listed in Section 365(b)(2)[52] – which the other covenants in the agreement may make impossible.

Even if all defaults may be cured, Section 1124(2)(C) requires the plan to "compensate[] the holder of such claim . . . for any damages incurred as a result of any reasonable reliance by such holder on such contractual provision . . . "and Section 1123(d) provides that the amount necessary to cure a default under a plan "shall be determined in accordance with the underlying agreement and applicable non-bankruptcy law."

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[52] Under Section 1124(2)'s incorporation of Section 365(b)(2), the plan need to cure "any default that is a breach of a provision relating to –

(A) the insolvency or financial condition of the debtor at any time before the closing of the case;
(B) the commencement of a case under this title; [or]
(C) the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement, or
(D) the satisfaction of any penalty rate or penalty provision relating to a default arising from any failure by the debtor to perform nonmonetary obligations under the executory contract or unexpired lease."

One would hope that de-acceleration under Section 1124(2) would preclude liquidated damages for "foregone interest" under state law (and hence, Section 1123(d)) when the plan proposes to pay the interest. That result would be consistent with the Third Circuit's *EFIH* decision, which effectively imposes a result as if the bankruptcy had not occurred – that is, if a debtor cannot plead acceleration as "forcing" a redemption which is otherwise voluntary, a creditor should not be able to plead acceleration as triggering a makewhole when the acceleration is actually not occurring.

But what if the creditor had entered into a swap agreement in which it had sold the future 10% interest rate payments in return for a LIBOR-based payment? The creditor might well terminate the swap upon the filing of the bankruptcy to fix its exposure based on the acceleration of the loan and the assertion of the makewhole payment. Would swap damages be "damages incurred as a result of reasonable reliance" on acceleration?

III. Resistance is Futile: Swap Claims

Instead of a bonds with a makewhole premium, assume the debtor has obtained a 10-year LIBOR+400 basis point term loan from a bank, with a companion interest rate swap under which the borrower paid the swap counterparty 10% per annum and the swap counterparty paid the borrower LIBOR+400 basis points.

Now assume the borrower files a bankruptcy petition. The swap counterparty has the absolute right to terminate the swap under Section 560. The termination gives rise to a claim. The claim is determined in accordance with the swap agreement, which almost always is in the form adopted by the International Swaps and Derivatives Association ("ISDA"). The swap counterparty typically determines the claim under the ISDA form by soliciting quotations from other swap dealers of how much each would want to pay the swap counterparty 10% fixed, in return for payment from the swap counterparty of LIBOR+400.

The floating rate loan swapped out to a 10% fixed rate is economically equivalent to a 10% fixed rate loan. The termination claim is economically equivalent to a claim for the value of unpaid 10% interest over the value of unpaid LIBOR+400 interest. However, the Ninth Circuit held in *Thrifty Oil* that a swap claim was not a claim for interest and thus was not subject to disallowance as "unmatured interest" under Section 502(b)(2).[53] No later opinion has challenged that conclusion.[54]

[53] Thrifty Oil Co. v. Bank of America National Trust and Savings Association, 322 F.3d 1039 (9th Cir. 2003). The Ninth Circuit reasoned that interest is compensation for the loan of money. The swap counterparty could be completely independent of the lender and have made no loan – in which case the swap payments could not be compensation for the loan and thus not interest.

[54] *Cf. In re* Tribune Company, 464 B.R. 126, 194-95 (Bankr. D. Del. 2011) (Banks' swap claim would be classified separately from claims for principal and interest), *aff'd in part, rev'd in part, in each case on other grounds*, 799 F.3rd 272 (3rd Cir. 2015).

Just as the EFIH and Momentive makewholes increased as interest rates fell and the spread between the Treasury-based rate and the coupon rate grew larger, so the swap claim increases as interest rates fall and the spread between the LIBOR-based rate and the fixed (coupon) rate grows larger.

And there is nothing the debtor (or the unsecured creditors) can do to avoid the swap claim: as noted, Section 560 gives the swap counterparty the absolute right to terminate the swap. The most that can be said is that the swap claim represents the difference between fixed and floating legs, which at inception is zero.

CONCLUSION

Interest has a checkered history.

In medieval Europe, the Catholic Church condemned interest as usury. Clever Italian financiers responded with contracts that provided for an advance in one currency and repayment in another, with interest buried in the exchange rate. In the Islamic world, Sharia law likewise prohibits interest – and similar tactics are used to charge interest in "Sharia" compliant finance. We are seeing similar developments in chapter 11 – and even chapter 13.

Chapter 13 cases do not feature "makewhole premiums" – but a careful look at *Till* discloses that the subprime auto loan in that case was structured as the equivalent of a makewhole. The Tills made a $300 down payment on their truck and financed the balance of the purchase price by entering into a retail installment purchase contract under which their initial indebtedness was $8,254.24 – the $6,395 balance of the price of the truck, plus $330.75 in fees and taxes, plus a finance charge of 21% per year for 136 weeks, or $1,859.49. The contract provided for the Tills to pay the indebtedness in 68 equal bi-weekly payments.

Thus the Till's debt represented principal and all interest under the life of the loan capitalized into one lump sum at incurrence – in corporate parlance, we would refer to the Tills' retail installment purchase contract as a zero-coupon bond, with 21% interest accreting from issuance to maturity. Section 502(b)(2) would disallow unaccreted interest after the petition date except to the extent allowed as a secured claim under Section 506(b) – but the 2005 amendments to Section 1325(a) may preclude such disallowance for auto loans incurred within a year of bankruptcy. The increased principal amount by definition increases the true cramdown interest rate.[55]

Interest as an economic, not legal, concept is protean – it comes in the form of coupon, of loans incurred at a discount, as makewhole premiums or as swap claims. Fighting interest as interest is a losing game because there are too many ways to pay interest and the Bankruptcy Code does not and probably cannot address them all.

But the fight against "gaming the system" is worth waging because it goes to the integrity and fairness of the system. Parties should not be able to use the bankruptcy process to reallocate value in ways that are not "reasonable" under Section 506(b) or "fair and equitable" under Section 1129(b)(1) – not because "gaming the system" "increases the cost of credit" or has other economic implications, but because it's wrong.

[55] The Tills filed a year and 23 days after taking out their loan, so the amended Section 1325(a) would not have applied to them. If it had, however, they would have had to pay $894.94 more to retain their truck – over their three year plan, that would have been about $200 per year, equal to an additional 5% annual interest on the $4,000 allowed amount of their secured debt.

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Cramdown Interest Rates: Disarray Dominates *Till*…?

If ever there were an unresolved issue that needs to be settled once and for all, it is determining the appropriate interest rate to be paid to secured creditors for purposes of confirming a cramdown plan, especially in Chapter 13 cases. The diversity of approaches (and resulting interest rates) endorsed by the lower courts is daunting. The Supreme Court had a marvelous opportunity to impose some much-needed order and predictability on these determinations with its decision in *Till v. SCS Credit Corp.*, 124 S. Ct. 1951, 43 Bankr. Ct. Dec. (CRR) 2, Bankr. L. Rep. (CCH) ¶ 80099 (U.S. 2004). None of the various methodologies employed by the lower courts, however, (and no one opinion) garnered the support of a majority of the Court. The most guidance that lower courts can glean from *Till* is that certain methodologies were rejected (explicitly or implicitly) by a majority of the Court. Within the realm of remaining contenders, though, there is little in *Till* to guide and constrain the lower courts, aside from pre-*Till* circuit precedent not inconsistent with *Till*.

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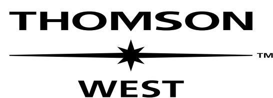
The Tills' Truck Loan Travels Into Chapter 13

In 1998, Lee and Amy Till purchased a used truck for $6,725, paying $330 in cash and promising to repay the $6,425 balance (plus 21% interest) through 68 biweekly payments. This promissory note, secured by a purchase money security interest in the Tills' used truck, was immediately assigned by the seller of the truck to SCS Credit Corporation. One year later, after having defaulted on their payment obligations under the note, the Tills filed a Chapter 13 petition, at which time they owed SCS $4,900, but their truck was worth (as stipulated by the parties) only $4,000. Pursuant to Code § 506(a), then, SCS had an "allowed secured claim" of $4,000 and an "allowed unsecured claim" of $900.

The Tills proposed a repayment plan that would pay SCS's allowed secured claim, plus 9.5% interest, from the Tills' monthly plan payments, contemplating payment in full of SCS's allowed secured claim in approximately two years. The 9.5% interest rate was derived by adding a 1.5% risk premium to the prevailing national prime rate (a composite of the rate banks charge on low-risk loans)—a so-called "formula" approach to setting cramdown interest rates. The bankruptcy court confirmed the Tills' plan, overruling SCS's objection to the 9.5% interest rate.

The bankruptcy court's confirmation order, however, was reversed on appeal to the district court, which held that "bankruptcy courts [must] set cram down interest rates at the level the creditor could have obtained if it had foreclosed on the loan, sold the collateral, and reinvested the proceeds in loans of equivalent duration and risk"—the so-called "coerced loan" approach to cramdown interest. *Till*, 124 S. Ct. 1951, at 1957. Based upon unrebutted evidence adduced in the bankruptcy court that SCS "received 21% interest on all of its loans because borrowers like



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the Tills are poor credit risks," "the district court concluded that 21% was the proper rate." *In re Till*, 301 F.3d 583, 585, 586, 40 Bankr. Ct. Dec. (CRR) 13, 48 Collier Bankr. Cas. 2d (MB) 1781, Bankr. L. Rep. (CCH) ¶ 78715 (7th Cir. 2002), cert. granted, 539 U.S. 925, 123 S. Ct. 2572, 156 L. Ed. 2d 601 (2003) and rev'd and remanded, 124 S. Ct. 1951, 43 Bankr. Ct. Dec. (CRR) 2, Bankr. L. Rep. (CCH) ¶ 80099 (U.S. 2004) [Bankr. Serv., L Ed § 50:290].

On further appeal, the Seventh Circuit agreed with the district court that, in theory, a "coerced loan" rate is the proper cramdown interest rate to pay secured creditors. But the court also held that the interest rate specified in the parties' original contract should "serve as the presumptive rate," in the absence of a showing by the creditor or the debtor that the interest rate should be higher or lower—the so-called "contract rate" methodology for determining a cramdown interest rate. *Till*, 301 F.3d 583, at 592. A lengthy dissent, however, took issue with both the coerced loan theory and its presumptive contract-rate corollary, advocating instead a purposefully modest formula rate such as that embraced by the bankruptcy court. *Till*, 301 F.3d 583, at 593-599 (Rovner, C.J., dissenting).

In an odd voting alignment, the Supreme Court reversed the Seventh Circuit's decision, but did not repudiate either the coerced loan theory or the contract-rate methodology. Moreover, the Court's holding essentially affirmed the bankruptcy court's 9.5% formula rate, but the Court did not adopt the formula method. A four-justice plurality opinion (authored by Justice Stevens) endorsed the formula method. A four-justice dissenting opinion (authored by Justice Scalia) endorsed the contract-rate methodology. Justice Thomas wrote separately to voice his disagreement with both the formula and contract-rate methodologies, arguing that a secured creditor is entitled to no more than the risk-free rate of interest. Because the Tills' plan proposed an interest rate in excess of the risk-free rate, Justice Thomas concurred in the judgment reversing the Seventh Circuit (and, thus, essentially affirming the bankruptcy court's confirmation of the debtors' plan). Although Justice Thomas cast the deciding vote, an eight-justice majority of the Court rejected the risk-free rate advocated by Justice Thomas as inappropriately undercompensatory.

The Statutory Present Value Requirement

Cramdown interest is implicated by the Code's provisions for confirmation of a plan over the objection of a secured creditor. Thus, in Chapter 13, in the absence of the secured creditor's approval of the plan or a surrender of collateral to the secured creditor, a bankruptcy court can confirm a debtor's plan only if:

> (i) the plan provides that the holder of such [allowed secured] claim retain the lien securing such claim; and
>
> (ii) the *value, as of the effective date of the plan*, of property to be distributed under the plan on account of such [allowed secured] claim is not less than the allowed amount of such claim….

Bankruptcy Code § 1325(a)(5)(B) (emphasis added).

The above-italicized language, as well as identical language in comparable provisions of Chapters 11 and 12 (see Bankruptcy Code §§ 1129(b)(2)(A)(i), 1225(a)(5)(B)), "contemplates a present value analysis that will discount value to be received in the future," "thus recognizing the time-value of money." H.R. Rep. No. 95-595, at 414, 413 (1978).

> Under the cram down option, the debtor is permitted to keep the property over the objection of the creditor; the creditor retains the lien securing the claim, and the debtor is required to provide the creditor with payments, over the life of the plan, that will total the *present value* of the allowed secured claim….

Associates Commercial Corp. v. Rash, 520 U.S. 953, 957, 117 S. Ct. 1879, 138 L. Ed. 2d 148, 30 Bankr. Ct. Dec. (CRR) 1254, 37 Collier Bankr. Cas. 2d (MB) 744, Bankr. L. Rep. (CCH) ¶ 77409 (1997) (emphasis added and citations omitted) [Norton Bankr. L. & Prac. 2d § 43:2; Bankr. Serv., L Ed §§ 24:253, 24:255, 24:264].

Determining the present value of future payments is a straightforward mathematical calculation once one selects "an appropriate discount rate [for] a discounting of the

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stream of deferred payments back to the present dollar value of the claim at confirmation." *Rake v. Wade*, 508 U.S. 464, 472 n.8, 113 S. Ct. 2187, 124 L. Ed. 2d 424, 24 Bankr. Ct. Dec. (CRR) 533, 28 Collier Bankr. Cas. 2d (MB) 983, Bankr. L. Rep. (CCH) ¶ 75275 (1993) [Norton Bankr. L. & Prac. 2d §§ 121:8, 122:8, 123:12; Bankr. Serv., L Ed §§ 50:269, 50:306]. Because the present value of plan payments on a creditor's secured claim, "as of the effective date of the plan," must equal or exceed the amount of the allowed secured claim, this requirement can be met through deferred payment of the face amount of the allowed secured claim, *plus interest payments* calculated using an interest rate equal to the appropriate discount rate. See H.R. REP. NO. 95-595, at 414 (1978) (noting that, "of course, if the interest rate paid is equivalent to the discount rate used, the present value and face future value will be identical"). "When a claim is paid off pursuant to a stream of future payments, a creditor receives the 'present value' of its claim only if the total amount of the deferred payments includes the amount of the underlying claim plus an appropriate amount of interest to compensate the creditor for the decreased value of the claim caused by the delayed payments." *Rake v. Wade*, 508 U.S. 464, at 472 n.8. Nothing in the Code or its legislative history, however, indicates what the appropriate interest or discount rate should be.

Interest and Discount Rates: Herein of Opportunity Cost

Time value of money concepts revolve around the elementary proposition that "a specified amount of money available to you today is worth more than a claim to the same amount of money in the future." WILLIAM A. KLEIN & JOHN C. COFFEE, JR., BUSINESS ORGANIZATION AND FINANCE: LEGAL AND ECONOMIC PRINCIPLES 318 (9th ed. 2004). Interest rates are the means by which we determine, very precisely, how much more valuable present money is than future money. Interest is, essentially, the price of money, and the price of money is determined in the same manner as the price of goods and services—by supply and demand in various markets for money. Interest as the price of money simply reflects the very intuitive idea that people generally prefer to receive money sooner rather than later. This is true for several reasons, each of which contributes to the amount of interest *demanded* in order to forego present receipt and enjoyment of money in favor of future receipt and enjoyment (*and*, conversely, *paid* in order to have money now rather than in the future).

The most straightforward component of interest is inflation compensation. In periods of positive inflation, money becomes less valuable over time and, thus, interest compensates those who forego present receipt and enjoyment of money for the devaluation of that money expected to occur over time. Over and above simple inflation compensation, though, interest rates are a reflection of the basic economic concept of opportunity cost. Devoting any resource to a particular use necessarily means abandoning other possible uses. So one of the "costs" of using the resource in that particular manner is that which is given up in terms of other opportunities.

Foregoing present receipt and enjoyment of money obviously involves opportunity cost in terms of other possible uses of that money. In terms of measuring the foregone return from other possible uses of money, at a minimum, one could always invest money in U.S. Treasury obligations, which are considered risk free (or as close to a risk-free investment as there is). The interest rate on U.S. Treasury obligations, therefore, is known as the risk-free rate, which contains compensation for inflation and so-called "pure" interest—compensation for the time value of money and nothing else. The risk-free rate, however, does not fully capture the opportunity cost of most uses of money, as most uses of money are not risk free, and the best measure of opportunity cost "is the lost return on the next best alternative." KLEIN & COFFEE, BUSINESS ORGANIZATION AND FINANCE, at 329. Interest rates above the risk-free rate, thus, contain an additional measure of compensation—a so-called risk premium—to account for the risk inherent in the future receipts of money.

The same principles apply when we translate the concept of interest into present value analysis. "Opportunity cost can be expressed as a rate of return; and that rate of return is the discount rate used" in the present value analysis. KLEIN & COFFEE, BUSINESS ORGANIZATION AND FINANCE, at 330. The opportunity cost captured by an appropriate discount rate is the "rate of return offered by *equivalent*... alternatives." RICHARD A. BREALEY & STEWART C. MYERS, PRINCIPLES OF CORPORATE FINANCE 17 (6th ed. 2000). In that regard, "the concepts of present value and... opportunity cost... still make sense for risky investments. It is still proper to discount the payoff by the rate of return offered by an equivalent [risky] investment." BREALEY & MYERS, CORPORATE FINANCE, at 18. Since risky future cash receipts carry a higher opportunity cost than risk-free future cash receipts, this implies that risky future cash receipts must be discounted at a higher rate than is appropriate for risk-free future cash receipts. In present value computations, then, all else being equal, a higher discount rate results in a lower present value. Thus, the most basic principles of time value of money reveal not only that "*a dollar today is*

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worth more than a dollar tomorrow," but also that "*[a] safe dollar is worth more than a risky one*." BREALEY & MYERS, CORPORATE FINANCE, at 16, 18.

Cramdown Interest Rates Repudiated by *Till*

Although *Till* does not definitively resolve the appropriate method for setting a cramdown interest rate, it does seem to foreclose application of certain approaches.

A Risk-Free Rate

All of the opinions in *Till* acknowledged the three distinct components comprising interest rates: "pure" risk-free interest, inflation, and a risk premium. Thus, "[b]oth the plurality and dissent agree[d] that '[a] debtor's promise of future payments is worth less than an immediate payment of the same total amount because the creditor cannot use the money right away, inflation may cause the value of the dollar to decline before the debtor pays, and there is always some risk of nonpayment.'" *Till*, 124 S. Ct. 1951, at 1965 (Thomas, J., concurring).

In his separate concurrence, though, Justice Thomas argued that the text of Code § 1325(a)(5)(B) does not require inclusion of a risk premium in a cramdown interest rate:

> I agree that a "*promise* of future payments is worth less than an immediate payment" of the same amount, in part because of the risk of nonpayment. But this fact is irrelevant. The statute does not require that the value of the *promise* to distribute property under the plan be no less than the allowed amount of the secured creditor's claim. It requires only that "the value... of *property* to be distributed under the plan," at the time of the effective date of the plan, be no less than the amount of the secured creditor's claim. 11 U.S.C. § 1325(a)(5)(B)(ii) (emphasis added). Both the plurality and the dissent ignore the clear text of the statute in an apparent rush to ensure that secured creditors are not undercompensated in bankruptcy proceedings. But the statute that Congress enacted does not require a debtor-specific risk adjustment that would put secured creditors in the same position as if they had made another loan.

Till, 124 S. Ct. 1951, at 1965 (Thomas, J., concurring).

According to Justice Thomas's reading, then, by speaking in terms of the value of "property" to be distributed under the plan, rather than the value of a "promise" to distribute that property, the statute effectively eliminates any consideration of risk in determining the present value of that property: "[I]t is nonsensical to speak of a debtor's risk of default being inherent in the value of 'property' unless that property is a promise or a debt." *Till*, 124 S. Ct. 1951, at 1966 (Thomas, J., concurring). Justice Thomas's sharp dichotomy between the "property" to be distributed under a plan and a "promise" to distribute that property, however, does not necessarily follow from the language of the statute.

In Chapter 13, "a confirmed plan acts more or less like a court-approved contract… that binds both the debtor and all the creditors," *In re Harvey*, 213 F.3d 318, 321, 36 Bankr. Ct. Dec. (CRR) 21, Bankr. L. Rep. (CCH) ¶ 78181 (7th Cir. 2000) [Norton Bankr. L. & Prac. 2d § 121:8], and the essence of a contract, of course, is as a set of enforceable promises. RESTATEMENT (SECOND) OF CONTRACTS § 1. Implicit in the plan itself, then, is the debtor's enforceable promise to make future plan distributions to the secured creditor, and accepted understandings of the concept of property can easily encompass this enforceable promise within the "property" distributed to the secured creditor under the plan. As Justice Scalia noted, "[b]oth the promise to make payments and the proposed payments themselves are property rights, the former 'to be distributed under the plan' immediately upon confirmation, and the latter over the life of the plan." *Till*, 124 S. Ct. 1951, at 1976 (Scalia, J., dissenting). Indeed, the Supreme Court has recognized as much in a similar context. Together, the Court's decisions in *Ahlers* and *203 North LaSalle* hold that not only is purchase or retention of an equity interest in the debtor's property itself "property" distributed under the plan, but the exclusive *right* to purchase such an equity interest, merely implicit in the structure of the plan, also "should… be treated as an item of property in its own right." *Bank of America Nat. Trust and Sav. Ass'n v. 203 North LaSalle Street Partnership*, 526 U.S. 434, 455, 119 S. Ct. 1411, 143 L. Ed. 2d 607, 34 Bankr. Ct. Dec. (CRR) 329, 41 Collier Bankr. Cas. 2d (MB) 526, Bankr. L. Rep. (CCH) ¶ 77924 (1999)). See also *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 209, 108 S. Ct. 963, 99 L. Ed. 2d 169, 17 Bankr. Ct. Dec. (CRR) 201, 18 Collier Bankr. Cas. 2d (MB) 262, Bankr. L. Rep. (CCH) ¶ 72186 (1988) [Norton Bankr. L. & Prac. 2d § 93:13; Bankr. Serv., L Ed § 45:22].

Even Justice Thomas acknowledged that the "property" distributed under a plan might include a "promise" to distribute property in the future "if the 'property to be distributed' under a Chapter 13 plan is a note (*i.e.*, a promise to pay)." *Till*, 124 S. Ct. 1951, at 1967 (Thomas, J., concurring). "But there is no practical difference between obligating the debtor to make deferred payments under a plan and obligating the debtor to sign a note that requires those same payments." *Till*, 124 S. Ct. 1951, at 1976 (Scalia, J., dissenting). In each case, the secured creditor

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receives the debtor's promise to make the payments (either explicitly or implicitly). If such a promise is "property" distributed under the plan in one case, it also seems to be "property" distributed under the plan in the other.

Even more fundamentally, though, contrasting valuation of a *promise* to distribute property in the future and valuation of the *property* to be distributed in the future is a distinction entirely without a difference, given the operative valuation language of the Code. When the plan calls for future property distributions (e.g., future cash payments), the statute requires those future distributions to be valued "as of the effective date of the plan." Bankruptcy Code § 1325(a)(5)(B)(ii). The "property" to be distributed, thus, cannot be valued in the abstract or at face value; delayed distribution requires discounting future distributions to present value, which simply begs the question of the appropriate discount rate (or interest to be paid with the future distributions) and whether that rate should include a risk premium.

As Justice Thomas acknowledged, the plan must "propose an interest rate that will compensate a creditor for the fact that if he had received the property immediately rather than at a future date, he could have immediately made use of that property." *Till*, 124 S. Ct. 1951, at 1967 (Thomas, J., concurring). This correctly recognizes the concept of opportunity cost, which is the essence of interest, but Justice Thomas inappropriately assumes that "[i]n most, if not all, cases, where the plan proposes simply a stream of cash payments, the appropriate risk-free rate should suffice" to compensate the creditor for his opportunity cost. *Till*, 124 S. Ct. 1951, at 1966 (Thomas, J., concurring). As our above primer on interest demonstrates, though, a risk-free rate is an appropriate measure of the opportunity cost of deferring payment only if those deferred payments are risk free. If the deferred payments are risky, the opportunity cost of the deferral is higher than the risk-free rate of interest. Opportunity cost cannot be determined in the abstract either; the opportunity cost of a future receipt can be determined only by reference to the nature of that future receipt. This concept is embedded in and cannot be severed from the statutory mandate to determine "value, as of the effective date of the plan." Bankruptcy Code § 1325(a)(5)(B)(ii). If future distributions of "property" under a plan are uncertain, then the "value" of those future distributions of property, "as of the effective date of the plan," is lower than if receipt of that "property" carries no risk.

A risk-free rate of cramdown interest, then, is not compelled by the language of the Code and, indeed, seems inconsistent with the very nature of determining the present "value, as of the effective date of the plan," of proposed plan distributions. Little wonder, then, that use of a risk-free cramdown interest rate has had virtually no following in the lower courts. "Circuit authority uniformly rejects the risk-free approach," and "Justice THOMAS identifie[d] no decision adopting his view." *Till*, 124 S. Ct. 1951, at 1976-77 (Scalia, J., dissenting). It was this conspicuous dearth of any substantial support in a quite voluminous body of case law that ultimately convinced the *Till* plurality to join the four dissenters in rejecting Justice Thomas's reading of the statute:

> [B]ecause so many judges who have considered the issue (including the authors of the four earlier opinions in this case) have rejected the risk-free approach, we think it too late in the day to endorse that approach now. Of course, if the text of the statute required such an approach, that would be the end of the matter. We think, however, that § 1325(a)(5)(B)(ii)'s reference to "value, as of the effective date of the plan, of property to be distributed under the plan" is better read to incorporate all of the commonly understood components of "present value," including any risk of nonpayment.

Till, 124 S. Ct. 1951, at 1964 (Stevens, J., plurality opinion).

The Cost of Funds Approach

Another approach to cramdown interest rates that seems untenable after *Till* is the so-called cost of funds approach. Although no circuit court has adopted the cost of funds approach, several bankruptcy courts have. See, e.g., *Matter of Jordan*, 130 B.R. 185, 21 Bankr. Ct. Dec. (CRR) 1579, Bankr. L. Rep. (CCH) ¶ 74087 (Bankr. D. N.J. 1991) [Norton Bankr. L. & Prac. 2d § 122:8; Bankr. Serv., L Ed §§ 50:292, 50:294, 50:295]. Moreover, the Second Circuit (while ultimately rejecting the cost of funds approach as impractical) opined that, in theory, "an interest rate based on a 'cost of funds' approach… appropriately reflects the present value of a creditor's allowed [secured] claim." *In re Valenti*, 105 F.3d 55, 64, 30 Bankr. Ct. Dec. (CRR) 210, Bankr. L. Rep. (CCH) ¶ 77251 (2d Cir. 1997) [Norton Bankr. L. & Prac. 2d §§ 43:2, 122:8] (abrogated in part by, Associates Commercial Corp. v. Rash, 520 U.S. 953, 117 S. Ct. 1879, 138 L. Ed. 2d 148, 30 Bankr. Ct. Dec. (CRR) 1254, 37 Collier Bankr. Cas. 2d (MB) 744, Bankr. L. Rep. (CCH) ¶ 77409 (1997) [Bankr. Serv., L Ed §§ 24:251, 24:253, 24:255, 24:264]) and (holding modified by, In re Marquez, 270 B.R. 761 (Norton Bankr. L. & Prac. 2d § 43:2; Bankr. D. Ariz. 2001)). Likewise, the Seventh Circuit dissenter in *Till* thought that "the cost of funds approach comes closer to recognizing the economic consequences of the debtor's decision to keep the collateral." *Till*, 301 F.3d 583, at 595 (Rovner, C.J., dissenting).

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> Strictly speaking, the debtor's retention of collateral does not preclude the creditor from making a new loan, it simply deprives the creditor of an asset that the creditor could convert into money and use to fund the new loan. A straightforward way to account for that deprivation is to ask what it would cost the creditor to obtain the cash equivalent of the collateral from an alternative source.

Till, 301 F.3d 583, at 595 (Rovner, C.J., dissenting). The cost of funds approach, however, has a number of problems, which led to its rejection by both the *Till* plurality (explicitly) and the *Till* dissenters (implicitly).

First of all, the notion of simply "replacing" the funds tied up in the debtor's retention of the secured creditor's collateral is not necessarily a realistic depiction of the economic consequences to the secured creditor. "The cost of funds method presupposes that a creditor will opt to exhaust some of its own credit in order to replace the liquid capital it would have received after foreclosure and sale." *Till*, 301 F.3d 583, at 590.

> A major difficulty with this approach… is its underlying [and unstated] assumption that the secured creditor has an unlimited supply of credit. When 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.

United Carolina Bank v. Hall, 993 F.2d 1126, 1130, 24 Bankr. Ct. Dec. (CRR) 508, 28 Collier Bankr. Cas. 2d (MB) 1388 (4th Cir. 1993) [Norton Bankr. L. & Prac. 2d § 122:8; Bankr. Serv., L Ed §§ 50:293, 50:302].

In addition, by focusing upon the secured creditor's marginal cost of capital, this "approach… is difficult for bankruptcy courts to apply efficiently and inexpensively. Because individual creditors borrow funds at different rates, bankruptcy courts would have to conduct evidentiary hearings to determine a creditor's cost of funds on a case-by-case basis." *Valenti*, 105 F.3d 55, at 64. Moreover, this information is not readily available to the debtor, which "imposes a significant evidentiary burden" for any "debtor seeking to rebut a creditor's asserted cost of borrowing." *Till*, 124 S. Ct. 1951, at 1961 (Stevens, J., plurality opinion). And determining a secured creditor's cost of capital introduces its own theoretical and methodological ambiguities and complexities. See, e.g., *In re Cassell*, 119 B.R. 89, 91 (W.D. Va. 1990) [Norton Bankr. L. & Prac. 2d § 122:8; Bankr. Serv., L Ed § 50:292] (noting that the assumption "that the proper measure of a creditor's cost of funds is its incremental borrowing cost… contains a basic error" in light of "the fact that firms finance their activities through equity as well as debt" and, thus, the creditor's "cost of capital for those needs is more properly reflected by its weighted average cost of capital rather than its marginal cost" of borrowing).

Most significantly, however, the cost of funds approach does not seem at all responsive to the inquiry mandated by the statute: determining the present "value, as of the effective date of the plan," of a stream of future payments *from the debtor*. Bankruptcy Code § 1325(a)(5)(B)(ii). Thus, the cost of funds approach "mistakenly focuses on the creditworthiness of the *creditor* rather than the debtor. *Till*, 124 S. Ct. 1951, at 1961 (Stevens, J., plurality opinion). This shift in focus, and its premise that the creditor is made whole by simply "replacing" the funds at issue—while obligating the debtor to pay the creditor those funds over time plus the creditor's cost of obtaining those funds—ignores altogether the risk that the debtor will not pay. See, e.g., *Jordan*, 130 B.R. 185, at 192 (acknowledging that any estimate of the creditor's cost of funds "does not include the risk to the secured creditor inherent in the Chapter 13 deferral of payments process"). Thus, the cost of funds approach is a close cousin to Justice Thomas's proposed risk-free cramdown rate and, therefore, cannot survive *Till*, given that an eight-justice majority of the Court "agree[d] that any deferred payments to a secured creditor must fully compensate it for the risk that such a failure [to pay] will occur." *Till*, 124 S. Ct. 1951, at 1968 (Scalia, J., dissenting).

Cramdown Interest Rates Consistent with *Till*

Given that no circuit court of appeals pre-*Till* had adopted either a risk-free cramdown interest rate or a cost of funds approach to cramdown interest rates, *Till*'s repudiation of those measures changes the legal landscape very little. And when it comes to choosing among the other competing approaches to determining a cramdown interest rate (presumably the impetus for the Court's grant of certiorari), *Till* does absolutely nothing. Indeed, in some senses *Till* introduces even more conceptual ambiguity into the inquiry.

The Coerced Loan Theory

Pre-*Till*, the lower courts would choose a cramdown interest rate methodology only after first envisioning what Professor Carlson has aptly described as the most convincing "subjunctive" scenario. "What would have happened if…?" David Gray Carlson, *Car Wars: Valuation Standards in Chapter 13 Bankruptcy Cases*, 13 Bankr.

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DEV. J. 1, 18 (1996). The pre-*Till* courts had largely rejected the subjunctive scenario posited by the cost of funds approach in favor of the alternative subjunctive scenario of a new loan to the debtor.

> [W]e conclude that it is fairer to treat the value of the collateral retained by the debtor under the "cram down" provision of Chapter 13 as a new loan and to match its rate of return to the secured creditor with that which the creditor would otherwise be able to obtain in its lending market.

Hall, 993 F.2d 1126, at 1130. Accord *General Motors Acceptance Corp. v. Jones*, 999 F.2d 63, 24 Bankr. Ct. Dec. (CRR) 800, 29 Collier Bankr. Cas. 2d (MB) 381, Bankr. L. Rep. (CCH) ¶ 75352 (3d Cir. 1993) [Bankr. Serv., L Ed §§ 50:286, 50:292, 50:293, 50:295, 50:297, 50:298, 50:301; Norton Bankr. L. & Prac. 2d § 122:8]; *Matter of Smithwick*, 121 F.3d 211 (5th Cir. 1997); *Memphis Bank & Trust Co. v. Whitman*, 692 F.2d 427, 9 Bankr. Ct. Dec. (CRR) 1140, 7 Collier Bankr. Cas. 2d (MB) 727, Bankr. L. Rep. (CCH) ¶ 68901, Bankr. L. Rep. (CCH) ¶ 68946 (6th Cir. 1982); *Koopmans v. Farm Credit Services of Mid-America, ACA*, 102 F.3d 874, 30 Bankr. Ct. Dec. (CRR) 21, Bankr. L. Rep. (CCH) ¶ 77190 (7th Cir. 1996) [Bankr. Serv., L Ed §§ 47:226, 47:243, 47:246, 47:248, 47:251, 47:253]; *In re Hardzog*, 901 F.2d 858, 20 Bankr. Ct. Dec. (CRR) 640, 22 Collier Bankr. Cas. 2d (MB) 1253, Bankr. L. Rep. (CCH) ¶ 73340 (10th Cir. 1990) [Norton Bankr. L. & Prac. 2d § 93:5, Bankr. Serv., L Ed §§ 47:246, 47:248]; *Matter of Southern States Motor Inns, Inc.*, 709 F.2d 647, 10 Bankr. Ct. Dec. (CRR) 1470, 8 Collier Bankr. Cas. 2d (MB) 1283, Bankr. L. Rep. (CCH) ¶ 69332 (11th Cir. 1983) [Norton Bankr. L. & Prac. 2d § 93:5].

Of course, cramdown is not really a "new loan" in that it is imposed on the creditor over its objection—thus, the notion becomes one of a forced or coerced loan. "Because every cram down is imposed by a court over the objection of the secured creditor, there is no free market of willing cram down lenders." *Till*, 124 S. Ct. 1951, at 1959 n.13 (Stevens, J., plurality opinion). See Todd J. Zywicki, *Cramdown and the Code: Calculating Cramdown Interest Rates Under the Bankruptcy Code*, 19 THURGOOD MARSHALL L. REV. 241, 265-67 (1994) (explaining that cramdown is, nonetheless, necessary to counter a secured creditor's "hold up" power). Thus, "the coerced loan approach requires bankruptcy courts to consider evidence about the market for comparable loans to similar (though nonbankrupt) debtors." *Till*, 124 S. Ct. 1951, at 1960 (Stevens, J., plurality opinion). As Professor Carlson points out, though, while "[s]ubjunctive claims are designed to have normative purchase," "[t]hey have *rhetorical* force, not scientific integrity." Carlson, *Car Wars*, 13 BANKR. DEV. J. 1, at 18. And the forced loan theory receives much less overt emphasis in the *Till* opinions.

The *Till* plurality purports to reject the coerced loan theory, opting instead for "an objective economic analysis [that] would suggest the debtor's interest payments will adequately compensate all such creditors for the time value of their money and the risk of default." *Till*, 124 S. Ct. 1951, at 1960 & n.14 (Stevens, J., plurality opinion) ("courts [should] look to first principles and ask only what rate will fairly compensate a creditor for its exposure"). While much of the reasoning of *Till*'s four-justice dissent is consistent with the forced loan theory, nowhere does that opinion expressly invoke the new loan analogy. Rather, like the plurality, the dissent favored an objective inquiry whose aim is full compensation of the secured creditor: "For a [cramdown interest rate] to be adequate, a *hypothetical, rational* creditor must be indifferent between accepting (1) the proposed risky stream of payments over time and (2) immediate payment of its present value in a lump sum." *Till*, 124 S. Ct. 1951, at 1974 (Scalia, J., dissenting) (emphasis added). Accord *Till*, 124 S. Ct. 1951, at 1959 (Stevens, J., plurality opinion) (noting that the statute does *not* "require that the cram down terms make the creditor *subjectively* indifferent between present foreclosure and future payment. Indeed, the very idea of a 'cram down' loan *precludes* the latter result." (emphasis added)).

As the fundamentals of present value analysis demonstrate, though, full compensation is determined by opportunity cost—"the lost return on the next best alternative whose rate of return is known." KLEIN & COFFEE, BUSINESS ORGANIZATION AND FINANCE, at 329. See also BREALEY & MYERS, CORPORATE FINANCE, at 17 (noting that the opportunity cost captured by an appropriate discount rate is "the rate of return offered by *equivalent*… alternatives" (emphasis added)). Nothing in the ultimate reasoning of either the plurality or the dissent, then, is inconsistent with the coerced loan theory. The rate of interest on a comparable loan to a similar debtor is simply one measure of the secured creditor's opportunity cost. The *Till* plurality and dissent simply proposed alternative measures of the secured creditor's opportunity cost, neither of which attracted the support of a majority of the Court.

The only differences between the alternative measures lie in presumptions about the most reliable estimates of the secured creditor's opportunity cost, burdens of proof, and other such methodological details. In theory, though, all of these approaches (including the coerced loan approach) are attempting to measure the same thing. As the *Till* plurality acknowledged:

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> [I]f all relevant information about the debtor's circumstances, the creditor's circumstances, the nature of the collateral, and the market for comparable loans were equally available to both debtor and creditor, then in theory the formula and presumptive contract rate approaches would yield the same final interest rate. Thus, we principally differ with the dissent not over what final rate courts should adopt but over which party (creditor or debtor) should bear the burden of rebutting the presumptive rate (prime or contract, respectively).

Till, 124 S. Ct. 1951, at 1964 (Stevens, J., plurality opinion). Likewise, the *Till* dissent agreed that "[o]ur only disagreement is over what procedure will more often produce accurate estimates of the appropriate interest rate." *Till*, 124 S. Ct. 1951, at 1968.

The *Till* Court's failure to specify a methodology for determining the appropriate interest rate means that (depending on existing circuit precedent) not only are both a formula rate and a presumptive contract rate still viable, so too is a coerced loan approach. Nothing in *Till* seems to preclude a bankruptcy court from fixing a cramdown interest rate based upon direct evidence of the market interest rate that would be charged on a comparable loan to a similar debtor—that is, to the extent such evidence is available. See Hon. John K. Pearson, et al., *Ending the Judicial Snipe Hunt: The Search for the Cramdown Interest Rate*, 4 AM. BANKR. INST. L. REV. 35, 44-48 (1996) (discussing the absence in many circumstances of any market for loans on the same terms as the cramdown, especially when the creditor is undersecured and, thus, the debtor has no equity in the collateral).

A Formula Rate

Several circuit courts have approved use of the formula method for estimating an appropriate cramdown interest rate, and this is the methodology favored by the four-justice plurality in *Till*. The formula approach attempts to quantify the various components of interest ("pure" risk-free interest, an inflation adjustment, and a risk premium) discussed above:

> Taking its cue from ordinary lending practices, the approach begins by looking to the national prime market, reported daily in the press, which reflects the financial market's estimate of the amount a commercial bank should charge a creditworthy commercial borrower to compensate for the opportunity costs of the loan, the risk of inflation, and the relatively slight risk of default. Because bankrupt debtors typically pose a greater risk of nonpayment than solvent commercial borrowers, the approach then requires a bankruptcy court to adjust the prime rate accordingly. The appropriate size of the risk adjustment depends, of course, on such factors as the circumstances of the estate, the nature of the security, and the duration and feasibility of the reorganization plan. The court must therefore hold a hearing at which the debtor and any creditors may present evidence about the appropriate risk adjustment.

Till, 124 S. Ct. 1951, at 1961 (Stevens, J., plurality opinion). Accord *Valenti*, 105 F.3d 55 (U.S. Treasury rate plus risk premium); *Koopmans*, 102 F.3d 874 (prime rate plus risk premium); *U.S. v. Doud*, 869 F.2d 1144, 19 Bankr. Ct. Dec. (CRR) 325, 20 Collier Bankr. Cas. 2d (MB) 1156, Bankr. L. Rep. (CCH) ¶ 72809 (8th Cir. 1989) [Norton Bankr. L. & Prac. 2d § 93:5; Bankr. Serv., L Ed §§ 47:241, 47:244, 47:248, 47:254, 47:255] (U.S. Treasury rate plus risk premium); *In re Fowler*, 903 F.2d 694, 22 Collier Bankr. Cas. 2d (MB) 1659, Bankr. L. Rep. (CCH) ¶ 73390 (9th Cir. 1990) [Norton Bankr. L. & Prac. 2d § 93:5; Bankr. Serv., L Ed §§ 47:239, 47:240, 47:241, 47:248, 47:253, 47:255] (prime rate plus risk premium).

Under the formula approach, then, the pivotal issue is, of course, determining an adequate risk premium in light of the repayment risks of the particular debtor's plan. The need to take evidence on this issue in each case, though, did not unduly trouble the plurality, because "starting from a concededly *low* estimate and adjusting *upward* places the evidentiary burden squarely on the creditors, who are likely to have readier access to any [relevant] information," and "many of the factors relevant to the adjustment fall squarely within the bankruptcy court's area of expertise." *Till*, 124 S. Ct. 1951, at 1961 (Stevens, J., plurality opinion).

Moreover, in Chapter 13 cases, many courts have adopted (often by local rule) a fixed risk premium or default risk premium, thus, narrowing (or eliminating entirely) the risk premium inquiry. See, e.g., *In re Wilmsmeyer*, 171 B.R. 61, 63 (Bankr. E.D. Mo. 1994) [Bankr. Serv., L Ed § 50:299] (confirming Chapter 13 plan with cramdown interest rate of prime plus 3.5% set by local rule, "[a]bsent proof to the contrary"). The *Till* plurality did not comment upon the propriety of this practice nor "decide the proper scale for the risk adjustment," but did implicitly sanction informal guideposts for a risk premium by noting (with apparent approval): "The Bankruptcy Court in this case approved a risk adjustment of 1.5%, and other courts have generally approved adjustments of 1% to 3%." *Till*, 124 S. Ct. 1951, at 1962 (Stevens, J., plurality opinion) (citations omitted).

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The Presumptive Contract Rate

The four-justice *Till* dissent favored the approach of those courts (including the Seventh Circuit panel in *Till*) holding that, in the absence of evidence to the contrary, the parties' original contract rate should serve as the presumptive cramdown rate of interest. See *Jones*, 999 F.2d 63; *Smithwick*, 121 F.3d 211. The *Till* dissenters had in mind the same general objectives as the plurality: adequate risk compensation for the secured creditor and ease of administration. Yet, the dissenters believed a presumptive contract rate far superior on both scores:

> The plurality would use the prime lending rate—a rate we *know* is too low—and require the judge in every case to determine an amount by which to increase it. I believe that, in practice, this approach will systematically undercompensate secured creditors for the true risk of default. I would instead adopt the contract rate—*i.e.*, the rate at which the creditor actually loaned funds to the debtor—as a presumption that the bankruptcy judge could revise on motion of either party. Since that rate is generally a good indicator of actual risk, disputes should be infrequent, and it will provide a quick and reasonably accurate standard.

Till, 124 S. Ct. 1951, at 1968 (Scalia, J., dissenting).

Efficient Markets, Transaction Costs, and "Profits." The dissent's willingness to rely on the parties' contract rate as the proper starting point is essentially an attempt to objectify, to the greatest degree possible, the determination of a cramdown interest rate and thus take the decision away from individual bankruptcy judges:

> [T]he most relevant factors bearing on risk premium are (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. Under the formula approach, a risk premium must be computed in every case, so judges will invariably grapple with these imponderables. Under the contract-rate approach, by contrast, the task of assessing all these risk factors is entrusted to the entity most capable of undertaking it: the market. All the risk factors are reflected (assuming market efficiency) in the debtor's contract rate—a number readily found in the loan document. If neither party disputes it, the bankruptcy judge's task is at an end. There are straightforward ways a debtor *could* dispute it—for example, by showing that the creditor is now substantially oversecured, or that some other lender is willing to extend credit at a lower rate. But unlike the formula approach, which requires difficult estimation in every case, the contract-rate approach requires it only when the parties choose to contest the issue.

Till, 124 S.Ct. 1951, at 1973 (Scalia, J., dissenting) (citation omitted).

This approach, of course, "assumes that subprime lending markets are competitive and therefore largely efficient. If so, the high interest rates lenders charge reflect. . . the actual risks of default that subprime borrowers present." *Till*, 124 S.Ct. 1951, at 1969 (Scalia, J., dissenting). The plurality, however, was not prepared to indulge the assumption "that subprime loans are negotiated between fully informed buyers and sellers in a classic free market," and was more inclined to believe that "subprime lenders. . . exploit borrowers' ignorance and charge rates above what a competitive market would allow." *Till*, 124 S.Ct. 1951, at 1962-63 (Stevens, J., plurality opinion).

The plurality also thought that the parties' contract rate systematically "overcompensates secured creditors because the market lending rate must be high enough to cover factors, like lenders' transaction costs and overall profits, that are no longer relevant in the context of court-administered and court-supervised cram down loans." *Till*, 124 S.Ct. 1951, at 1960 (Stevens, J., plurality opinion). As the dissent points out, though, so-called accounting "profits," as long as they do not exceed the return available from other comparable uses of the creditor's money, are not economic "profits" but are merely the opportunity cost of deferring payment to the creditor—the essence of determining an appropriate interest rate. "[O]verhead and profits. . . are necessary components of *any* commercial lending rate, since creditors will not lend money if they cannot cover their costs and return a level of profit sufficient to prevent their investors from going elsewhere." *Till*, 124 S.Ct. 1951, at 1972 (Scalia, J., dissenting).

The fact that a cramdown is not really a "new loan" means that "[s]ome transaction costs are avoided by the creditor in bankruptcy—for example loan-origination costs." But the creditor also incurs additional costs in conjunction with the debtor's bankruptcy proceedings that would not be incurred with a "new loan". Thus, the creditor's costs are not necessarily lower for a cramdown "loan," and it may well be the case that "[a]ny transaction costs the creditor avoids in bankruptcy are. . . far less than the additional ones he incurs." *Till*, 124 S.Ct. 1951, at 1972 n.6 (Scalia, J., dissenting).

Risk Premium and Plan Feasibility. The plurality also took issue with the dissent's second operative assumption "that the expected costs of default in Chapter 13 are

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normally no less than those at the time of lending" because "Chapter 13 plans often fail" and, thus, "[t]he better assumption is that bankrupt debtors are riskier than other subprime debtors—or, at the very least, not systematically *less* risky." *Till*, 124 S.Ct. 1951, at 1969-70 & n.1 (Scalia, J., dissenting) (citing Scott F. Norberg, *Consumer Bankruptcy's New Clothes: An Empirical Study of Discharge and Debt Collection in Chapter 13*, 7 AM. BANKR. INST. L. REV. 415, 440-41 (1999), finding a 60% postconfirmation failure rate). This, of course, is the central issue in determining an appropriate level of compensation for the risk of plan failure, but the plurality essentially sidestepped the issue.

> There is some dispute about the true scale of that risk. . . . It is sufficient for our purposes to note that, under 11 U.S.C. § 1325(a)(6), a court may not approve a plan unless. . . "the debtor will be able to make all payments under the plan and to comply with the plan." Together with the cram down provision, this requirement obligates the court to select a rate high enough to compensate the creditor for its risk but not so high as to doom the plan. If the court determines that the likelihood of default is so high as to necessitate an "eye-popping" interest rate, the plan probably should not be confirmed.
>
> . . . .
>
> In our view, . . . Congress intended to create a program under which plans that qualify for confirmation have a high probability of success. Perhaps bankruptcy judges currently confirm too many risky plans, but the solution is to confirm fewer such risky plans, not to set default cram down rates at absurdly high levels, thereby increasing the risk of default.

Till, 124 S.Ct. 1951, at 1962-63 (Stevens, J., plurality opinion) (citations omitted).

The plurality's reliance on the feasibility requirement is very interesting, because it is rather unclear what role feasibility plays under the formula approach. Is the feasibility requirement a mandate to deny confirmation if the risk of default (and thus, the cram down interest rate) is too high, or is it a justification for purposefully modest cram down interest rates that will enhance the feasibility of Chapter 13 plans? Although the plurality's opinion seems to imply the former, the practice of the lower courts suggests the latter.

> There is no better demonstration of the inadequacies of the formula approach than the proceedings in this case. Petititioners' economics expert testified that the 1.5% risk premium was "very reasonable" because Chapter 13 plans are "supposed to be financially feasible" and "the borrowers are under the supervision of the court." Nothing in the record shows how these two platitudes were somehow manipulated to arrive at a figure of 1.5%. It bears repeating that feasibility determinations. . . do not prevent. . . confirmed Chapter 13 plans from failing. On cross-examination, the expert admitted that he had only limited familiarity with the subprime auto lending market and that he was not familiar with the default rates or the costs of collection in that market. In light of these devastating concessions, it is impossible to view the 1.5% figure as anything other than a smallish number picked out of a hat.
>
> . . . .
>
> . . . . That result is not unusual, see, *e.g., In re Valenti*, 105 F.3d 55, 64 (C.A.2 1997) (recommending a 1%-3% premium over the *treasury* rate—*i.e.*, approximately a 0% premium over prime); it is the entirely predictable consequence of a methodology that tells bankruptcy judges to set interest rates based on highly imponderable factors. Given the inherent uncertainty of the enterprise, what heartless bankruptcy judge can be expected to demand that the unfortunate debtor pay *triple* the prime rate as a condition of keeping his sole means of transportation? It challenges human nature.

Till, 124 S. Ct. 1951, at 1968 (Scalia, J., dissenting). See also Jack Friedman, *What Courts Do to Secured Creditors in Chapter 11 Cram Down*, 14 CARDOZO L. REV. 1495, 1521 (1993) ("Not one of the reported decisions, discussing what 'risk factor' should be added to a base rate, has even analyzed the probability and magnitude of actual risk. Decisions may generally discuss the condition of the debtor or the collateral . . ., but an objective basis for quantifying the risk factor is rarely developed.").

Compensating for a *Rash* Decision

The *Till* dissent is probably correct that the formula approach. "in practice, will systematically undercompensate secured creditors for the true risks of default," and "the 1.5% premium adopted in this case is far below anything approaching fair compensation." *Till*, 124 S. Ct. 1951, at 1968, 1976 (Scalia, J., dissenting). The true opportunity cost of deferring payment of SCS's "allowed secured claim" was likely much closer to the parties' 21% contract rate than the 9.5%

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formula rate approved by the bankruptcy court. The plurality made noises about the need "to ensure that an objective economic analysis would suggest the debtor's interest payments will adequately compensate all such creditors for . . . the risk of default." *Till*, 124 S.Ct. 1951, at 1962-63 (Stevens, J., plurality opinion) (citations omitted). But one comes away from the *Till* decision with the distinct impression that the plurality was much closer to Justice Thomas's concurrence on this issue than they were willing to admit, and the plurality didn't really care whether the cramdown interest rate fully compensates the secured creditor for the true risks of default. Why? Justice Stevens' *Till* plurality did not elaborate in a coherent fashion, but Justice Thomas's concurrence (which openly questioned the legitimacy of any risk premium) may contain the answer: "[R]espondent overlooks the fact that secured creditors are already compensated in part for the risk of nonpayment through the valuation of the secured claim." *Till*, 124 S.Ct. 1951, at 1967 (Thomas, J., concurring).

To understand this comment, let's return to the subjunctive scenario that seems most powerful with respect to cramdown: the forced loan analogy. There are, however, alternative versions of the forced loan analogy. If we focus exclusively on the language of Code § 1325(a)(5)(B)(ii), the loan at issue in cramdown is a forced loan in the amount of the creditor's "allowed secured claim." This, however, has not been the dominant version of the forced loan scenario. Viewing § 1325(a)(5) in its entirety—casting cramdown as an alternative to surrender of the collateral to the creditor—cramdown is a forced loan in the amount of the proceeds the creditor would realize upon surrender of the collateral. As the Seventh Circuit majority in *Till* put it:

> Given these two alternative modes of protection afforded by the statute, it is logical to conclude that the interest rate under the cramdown provision must put the creditor in a position reasonably equivalent to the position it would be in . . . had it received and then sold the collateral.

Till, 301 F.3d 583, at 588-89.

These alternative versions of the forced loan analogy differ because the Supreme Court's *Rash* decision held that a creditor's "allowed secured claim" is *not* measured by the proceeds the secured creditor would realize "had it received and then sold the collateral"—a so-called foreclosure-value standard. Rather, the *Rash* decision held that the creditor's "allowed secured claim" must be measured by the higher replacement-value standard—"the cost the debtor would incur to obtain a like asset." *Associates Commercial Corp. v. Rash*, 520 U.S. 953, 965 117 S.Ct. 1879 (1997). One could, then, hypothesize the subjunctive "forced loan" at issue in cramdown as follows: "What would be the cost to this debtor to replace this collateral *and this lender?*" *In re Segura*, 218 B.R. 166, 174 (Bankr. N.D. Okla. 1998).

> Hypothetically, if the debtor desires to retain the collateral but does not believe the existing lender's current interest rate is fair, the debtor has another option not contained in Section 1325. The debtor simply can look elsewhere for a more favorable rate. For instance, the debtor may surrender the collateral to the creditor and purchase a replacement for the collateral (at replacement value, consistent with the *Rash* rationale) *and* obtain replacement financing for such replacement collateral after negotiating lending terms, including an interest rate, with other lenders in the open market.

Segura, 218 B.R. 166, at 174.

But the *Rash* Court justified the higher replacement-value standard for valuing the creditor's collateral, inter alia, by pointing to the risks imposed on the creditor by the debtor's retention of the collateral and deferred payment to the creditor:

> From the creditor's perspective . . ., surrender and retention are not equivalent acts.
>
> When a debtor surrenders the property, a creditor obtains it immediately, and is free to sell it and reinvest the proceeds. We recall here that [the creditor] sought that very advantage. If a debtor keeps the property and continues to use it, the creditor obtains at once neither the property nor its value and is exposed to double risks: The debtor may again default and the property may deteriorate from extended use.

Rash, 520 U.S. 953, at 962. Justice Stevens' dissent in *Rash* pointed out that the statutory design is evidently to compensate the secured creditor for this risk through the risk premium component of a cramdown interest rate and *not* through a cushion in the collateral valuation. See *Rash*, 520 U.S. 953, at 966 n.* (Stevens, J., dissenting). Hence, "*Rash* shifted compensation for the risk of default from the 'interest' component of [present] 'value' to the valuation component" of determining the creditor's "allowed secured claim." *In re Goodyear*, 218 B.R. 718, 721 (Bankr. D.Vt. 1998) [Bankr. Serv., L Ed § 47:239, 47:254]. Thus, there is an entirely understandable tendency (bound up with the intuitive appeal of the dominant version of the forced loan analogy) to believe that "a contract rate of interest cannot be applied to that claim

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without *over*compensating the secured creditor." *In re Scott*, 248 B.R. 786, 792 (Bankr. N.D. Ill. 2000) (emphasis added).

Indeed, Justice Scalia's dissent conducted an extensive numerical analysis to demonstrate how the 1.5% risk premium adopted by the bankruptcy court did not adequately compensate SCS for default risk. One of the "costs of default" implicated by that risk, according to the dissent, "involves liquidation":

> The $4,000 to which respondent would be entitled if paid in a lump sum reflects the *replacement* value of the vehicle, *i.e.*, the amount it would cost the debtor to purchase a similar used truck. See *Associates Commercial Corp. v. Rash*, 520 U.S. 953, 965, 117 S.Ct. 1879, 138 L.Ed.2d 148 (1997). If the debtor defaults, the creditor cannot sell the truck for that amount; it receives only a lesser *foreclosure* value . . . .

Till, 124 S.Ct. 1951, at 1975 (Scalia, J., dissenting). This, "cost," however, is not a product of the *deferred payment* to the secured creditor—the *only* concern of the statutory present value requirement. This is a "cost" only in the sense that *Rash* requires a cramdown valuation of the creditor's collateral that exceeds (*from Day 1*) the foreclosure value the creditor could realize upon surrender of the collateral. There is a compelling argument, therefore, that this is not a "cost" for which the creditor is entitled to *any* compensation. And when one removes this "cost" from the present value calculus, the "modest" cramdown interest rates produced by the formula approach no longer seem undercompensatory and, in fact, appear quite generous. See, e.g., *Scott*, 248 B.R. 786, at 792-93 [Bankr. Serv., L Ed §§ 50:275, 50:286, 50:295, 50:302] (on facts of the case, 9% prime rate plus 0% risk premium on replacement value gave secured creditor a greater return than 24% contract rate on foreclosure value).

Systematic overcompensation of secured creditors is every bit as legitimate a concern as systematic undercompensation of secured creditors. This not only implicates feasibility of Chapter 13 plans, but also the returns that unsecured creditors will receive in Chapter 13 plans. Since Chapter 13 plans are largely fixed-income, fixed-duration repayment schemes, every plan dollar that goes into the pocket of a secured creditor is a dollar taken out of the collective pockets of unsecured creditors. And *Till* illustrates that there are two critical components of the secured creditor's cramdown compensation: collateral valuation *and* interest rate, which must be considered in tandem. The failure to do so, as demonstrated by the disconnect between *Rash* and *Till*, leaves us without any principled means for assessing whether secured creditors are being overcompensated or undercompensated in cramdown.

Research References: See Norton Bankr. L. & Prac. 2d § 43:2; Bankr. Serv., L Ed §§ 50:285 to 50:302; West's Key Number Digest, Bankruptcy 3708(5), 3708(6).

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FAIR EQUIVALENTS AND MARKET PRICES: BANKRUPTCY CRAMDOWN INTEREST RATES

Bruce A. Markell[*]

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INTRODUCTION

Cramdown[1] is messy. It pits a chapter 11 debtor's stakeholders against each other, in a match in which the main issue is the value of what each is to receive under a plan of reorganization. Because cramdown is nonconsensual, any judicial decision involving cramdown must reconcile deeply-held and diverse views as to the value being offered.

Valuation in bankruptcy, in turn, is also messy. Courts are often placed in the position of assigning a monetary value to an asset for which there is either no seller or no buyer, and often no market. To complicate matters, these assets are often nothing more than intangible promises of a reorganized debtor;

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[1] By "cramdown," I mean the nonconsensual confirmation of a chapter 11 plan of reorganization achieved under 11 U.S.C. § 1129(b). I thus use it as a noun. In contrast, I use the two words "cram down" as a verb to describe the action or process of implementing a cramdown. As I have noted before, albeit in a different context:

> Courts use "cramdown" and "cram down" and "cram-down" interchangeably. Indeed, Justice Douglas once combined different forms in the same paragraph. Blanchette v. Conn. Gen. Ins. Corps., 419 U.S. 102, 167 (1974) (Douglas, J., dissenting). The hyphenated version appears to have been the first locution used by a court. New Eng. Coal & Coke Co. v. Rutland R.R. Co., 143 F.2d 179, 189 n.36 (2d Cir. 1944).
>
> The earliest print references to the term use either the two-word or the hyphenated form. *Compare* Robert T. Swaine, *Present Status of Railroad Reorganizations Legislation Affecting Them*, AM. BAR ASS'N, PROCEEDINGS OF THE SECTION ON COMM. LAW 15, 15 (1940) (two-word form) *and* Warner Fuller, *The Background and Techniques of Equity and Bankruptcy Railroad Reorganizations—A Survey*, 7 LAW & CONTEMP. PROBS. 377, 389, 390 (1940) (hyphenated form).

In re Shat, 424 B.R. 854, 858 n.7 (Bankr. D. Nev. 2010) (Markell, J.).

promises from an entity that has already broken most of its past promises to its creditors.

Outside of bankruptcy, such promises are routinely valued in the world of finance. In many cases, markets exist in which such promises are traded. Bond markets, for example, exist to trade the promises of bond issuers to pay sums borrowed. Value in these markets is the prices traders are willing to acquire or release these promises.

In bankruptcy reorganization, plan proponents often craft plans of reorganization that compel creditors to trade a promise made before bankruptcy for a promise forged under the plan. The terms may be quite different. Short-term construction loans can transform into medium- and long-term investments; obligations may become collateralized (and vice versa); and debt instruments may morph into equity interests.

In many cases, these transformations are consensual. Section 1129(a) of the Bankruptcy Code (the "Code") provides the plan proponent[2] with the ability to confirm a plan by persuading classes of stakeholders to vote to adopt the plan. The plan proponent need not convince every creditor or stakeholder; § 1129(a)(8) requires only unanimity of class acceptance, not unanimity of creditor acceptance.[3] As a result, if a plan proponent can obtain the positive votes of more than one-half of those creditors voting in a class, and those creditors hold at least two-thirds of the debt voting in that class, the class accepts.[4] Outvoted creditors in any class, so long as they will receive at least as much in reorganization as they would have in a liquidation,[5] must accept the plan's treatment, as plan confirmation will discharge their claims in excess of what they receive under the confirmed plan.[6]

This voting process, however, is not cramdown as it is classically understood. Cramdown in the historic sense consists of confirmation over the dissent of an *entire* class.[7] To engage in over-generalization, the Code permits such confirmation only if the dissenting class receives payment in full (but not

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[2] I use the term "plan proponent" instead of debtor or debtor in possession, as any party in interest can, after the expiration of the exclusivity period, propose a plan of reorganization. *See* 11 U.S.C. § 1121(c) (2012).

[3] *Id.* § 1129(a)(8).

[4] *Id.* § 1126(c).

[5] This requirement flows from § 1129(a)(7), the so-called "best interest of creditors" test.

[6] 11 U.S.C. § 1141.

[7] *See* 7 COLLIER ON BANKRUPTCY ¶ 1129.03 (Alan N. Resnick & Henry J. Sommer eds., 16th ed.).

more than in full), or if no class junior in priority receives anything.[8] The deck is stacked in favor of plan proponents, however, because "payment in full" does not have to be payment in cash. It can consist of any sort of "property," including the types of intangible promises that banks, investors, and markets value on a daily basis.[9]

Whether this daily experience can precisely be transferred to cramdown has vexed many. This Article looks not at the policies behind cramdown—that is for another time and place. Instead, this Article looks at the history and legislative policies behind the current state of cramdown, as well as recent attempts to value the promises of a reorganizing debtor. Along the way, it examines *Till v. SCS Corp.*,[10] a 2004 Supreme Court case of major contention in this area, and *Till*'s recent application in the cramdown confirmation in *Momentive Performance Materials Inc.* ("*Momentive*"),[11] a large, public-company chapter 11 case.[12]

This examination reveals a gap between (1) the purposes and policies of cramdown as historically understood, and the current contentions; and (2) expectations of hedge funds and other financial players that cramdown rates should be determined by the market—the rates an actual lender would accept in extending credit to the reorganized debtor. Given the history and precedents in the cramdown area, this Article takes the position that *Momentive* was correct, and that courts should resist using such market-based discount rates in cramdown calculations.

I. THE CONCEPT AND EXCHANGE ANTICIPATED BY § 1129(B)(1)

Section 1129 of the Code governs confirmation of chapter 11 plans of reorganization. Section 1129(a) sets forth sixteen requirements for

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[8] *See id.* ¶ 1129.03[4][a][ii].

[9] *See id.* ¶ 1129.03[4][a][i][A],[C].

[10] 541 U.S. 465 (2004).

[11] Momentive was an affiliate of the lead debtor, MPM Silicones, LLC. As a consequence, the case is reported under the name of the affiliate. *See In re* MPM Silicones, LLC (*Momentive*), 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), *appeal docketed*, No. 15-1771 (2d Cir. filed June 1, 2015).

[12] *Momentive* was not the first case to adopt *Till* in chapter 11, but it well may be the most notorious, given the billions of dollars at issue. *See In re* Pamplico Highway Dev., LLC, 468 B.R. 783, 795 (Bankr. D.S.C. 2012) (collecting cases); *In re* SW Boston Hotel Venture, LLC, 460 B.R. 38, 55 (Bankr. D. Mass. 2011) (collecting cases); *see also* Gary W. Marsh & Matthew M. Weiss, *Chapter 11 Interest Rates After* Till, 84 AM. BANKR. L.J. 209, 221 (2010) ("*Till*'s formula approach, which adds the prime rate to a debtor–specific risk adjustment, should now be considered the default interest rate for a Chapter 11 cramdown.").

confirmation,[13] including the consent of each class of creditors or interest holders under the plan. Confirmation of a plan without the consent of all classes is possible, but heavily circumscribed. Section 1129(b)(1) sets forth the requirements. While paragraph (1) relaxes the requirement of unanimous class consent, all other requirements of § 1129(a) remain in place.[14] Thus, to cram down a nonconsensual plan, the plan proponent must, among other things, still propose the plan in good faith;[15] still pay each impaired creditor at least as much as it would receive in a liquidation;[16] still pay all administrative claims in full;[17] and still establish that the plan is economically feasible.[18]

In addition, § 1129(b)(1) requires the plan proponent to show that the plan does not discriminate unfairly against the dissenting class, and is fair and equitable as to that class.[19] Unfair discrimination is a horizontal equity test; it ensures that a plan does not unduly favor a class having similar priority to the dissenting class simply because the favored class voted for the plan, and the dissenting class did not.[20] Although valuation issues can and do arise in the unfair discrimination analysis, those issues are for another time.

This Article focuses on the vertical equity test of § 1129(b)(1): whether a plan is "fair and equitable" as to the dissenting class. That is, it examines how the concept of "fair and equitable" polices the distribution of reorganization value among stakeholders with different nonbankruptcy priorities.

A. *The History of "Fair and Equitable"*

Undoubtedly, "fair and equitable" is not a crisp, well-defined standard. An examination of its provenance demonstrates, however, that this vagueness was intentional from the beginning. While the statutory origins of the phrase lie in

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[13] 11 U.S.C. § 1129(a)(1)–(16) (2012). In individual chapter 11 cases, there is a seventeenth, uncodified requirement regarding the provision of current tax returns. 7 COLLIER ON BANKRUPTCY, *supra* note 7, ¶ 1129.02[17].

[14] *See* 11 U.S.C. § 1129(b)(1).

[15] *Id.* § 1129(a)(3).

[16] *Id.* § 1129(a)(7).

[17] *Id.* § 1129(a)(9).

[18] *Id.* § 1129(a)(11).

[19] *Id.* § 1129(b)(1).

[20] I have explored this relationship elsewhere, see Bruce A. Markell, *A New Perspective on Unfair Discrimination in Chapter 11*, 72 AM. BANKR. L.J. 227 (1998). This article was the subject of an interchange between the Association of the Bar of the City of New York and myself. *See* Steven M. Abramowitz et al., *Making the Test for Unfair Discrimination More "Fair": A Proposal*, 58 BUS. LAW. 83 (2002); Bruce A. Markell, *Slouching Toward Fairness: A Reply to the ABCNY's Proposal on Unfair Discrimination*, 58 BUS. LAW. 109 (2002).

the 1933 and 1934 additions of §§ 77[21] and 77B[22] to the Bankruptcy Act of 1898,[23] the genesis of the phrase lies in early equity receiverships.

1. The Statutory Origins: §§ 77 and 77B

Sections 77 and 77B each required judicial findings as to the fairness of any reorganization. Section 77, as originally enacted in 1933, did not, however, use the words "fair and equitable."[24] Rather, it simply stated that the plan had to be "equitable."[25] It was not until 1935, after the adoption of § 77B, that the words "fair and" were inserted before "equitable" in both sections.[26]

The first indication that statutory reorganization law would mirror prior receivership practice came early. In 1936 the Supreme Court decided *In re 620 Church Street Building Corp.*[27] In that case, the Court held that a reorganization plan, which dealt with multiple secured creditors secured by the same collateral, could eliminate the junior secured creditors' property interests if the common collateral's value was insufficient to pay the senior creditor's debt in full.[28] As the Court stated, allocation of all the collateral's value to a senior lienholder extinguished "whatever interest petitioners may have [had] as junior lienors under the Illinois law" if the senior lien holder's debt was not fully discharged.[29]

Other questions over the meaning of "fair and equitable" quickly made their way to the Court. In 1939, in *Case v. Los Angeles Lumber Products Co.*, the Court construed § 77B's use of "fair and equitable."[30] The Court held that "[t]he words 'fair and equitable' . . . are words of art which prior to the advent of s 77B had acquired a fixed meaning through judicial interpretations in the field of equity receivership reorganizations."[31]

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21 Section 77 provided for relief for railroad corporations. Act of Mar. 3, 1933, ch. 204, § 77, 47 Stat. 1467, 1474–82 (1933).

22 Section 77B, enacted a year after § 77, extended the reorganization provisions of § 77 to other types of corporations. Act of June 7, 1934, ch. 424, § 77B, 48 Stat. 911, 914 (1934).

23 Pub. L. No. 55-171, ch. 541, 30 Stat. 544 (repealed 1978).

24 *See* § 77(g), 47 Stat. at 1479.

25 *Id.*

26 Act of Aug. 27, 1935, ch. 774, § 77(e)(1), 49 Stat. 911, 918 (1935).

27 299 U.S. 24 (1936).

28 *Id.* at 27.

29 *Id.*

30 308 U.S. 106 (1939).

31 *Id.* at 115.

2. *Incorporation of Prior Equity Receivership Practice*

What was Justice Douglas's "fixed meaning"? Adhering "to the familiar rule that where words are employed in an act which had at the time a well known meaning in the law,"[32] he explained it as follows:

> If the value of the [debtor] justified the issuance of stock in exchange for old shares, the creditors were entitled to the benefit of that value, whether it was present or prospective, for dividends or only for purposes of control. In either event it was a right of property out of which the creditors were entitled to be paid before the stockholders could retain it for any purpose whatever.[33]

In short, secured creditors were to be paid from their collateral before unsecured creditors share in collateral proceeds, and all creditors, secured or unsecured, were to be paid in full before any equity holder receives anything.

The Supreme Court, in a series of cases in the early 1940s,[34] quickly confirmed that *Case*'s interpretation of "fair and equitable" governed § 77 railroad reorganization cases[35] and chapter X[36] reorganizations.

These cases dealt primarily with the vertical adjustment of rights between creditors and equity owners. Questions soon arose about the proper treatment when the debtor was insolvent, and the issue was division of value among creditor groups with different priorities. Did absolute priority apply among creditor classes? The Court answered yes.

3. *"Fair Equivalents" of Value Under the Statute*

After *In re 620 Church Street* and *Case*, the Court continued to confirm the primacy of nonbankruptcy priorities, but also acknowledged the practicalities of reorganization. In *Group of Institutional Investors v. Chicago, Milwaukee, St. Paul & Pacific Railroad*, the Court reviewed a plan's allocation of value

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32 *Id.*

33 *Id.* at 116 (quoting N. Pac. Ry. Co. v. Boyd, 228 U.S. 482, 508 (1912)); *see also* Kan. City Terminal Ry. v. Cent. Union Tr. Co., 271 U.S. 445, 455 (1926) ("Unsecured creditors of insolvent corporations are entitled to the benefit of the values which remain after lienholders are satisfied, whether this is present or prospective, for dividends or only for purposes of control.").

34 *See* Grp. Of Inst. Inv'rs v. Chi., Milwaukee, Saint Paul & Pac. R.R., 318 U.S. 523 (1943); Marine Harbor Props., Inc. v. Mfr.'s Tr. Co., 317 U.S. 78 (1942); Consol. Rock Prods. Co. v. Du Bois, 312 U.S. 510 (1941).

35 *See Grp. Of Inst. Inv'rs*, 318 U.S. at 542.

36 *See Marine Harbor Props.*, 317 U.S. at 85.

among creditors.[37] The Court stated that, among classes of creditors, absolute priority was satisfied if "each security holder in the order of his priority receives from that which is available for the satisfaction of his claim the *equitable equivalent* of the rights surrendered."[38]

This statement requires some explanation. Payment in full in reorganization is not necessarily payment in cash. As *Case* recognized, it was

> clear that [the absolute priority] rule did not "require the impossible, and make it necessary to pay an unsecured creditor in cash as a condition of stockholders retaining an interest in the reorganized company. His interest can be preserved by the issuance, on equitable terms, of income bonds or preferred stock."[39]

In this light, the "equitable equivalent" of *Group of Institutional Investors* can be understood to require the valuation of what a plan proposed to exchange for the old, soon–to–be–discharged debt. But equitable equivalence is a slippery concept. It lacks mathematical certainty and admits of a wide range of possible satisfying answers.

The Court acknowledged this fuzziness, but took it as part of the system. This can be seen from the Court's 1943 embrace of the woolliness of the concept in *Group of Institutional Investors*.[40] Speaking through Justice Douglas again, the Court had this to say:

> And in discussing the method by which creditors should receive "full compensatory treatment" for their rights, we emphasized, as already noted, that "Practical adjustments, rather than a rigid formula, are necessary." . . . Certainly those standards do not suggest any mathematical formula. We recently stated in another connection that, whatever may be "the pretenses of exactitude" in determining a dollar valuation for a railroad property, "to claim for it 'scientific' validity, is to employ the term in its loosest sense." . . . That is equally true here. A requirement that dollar values be placed on what each security holder surrenders and on what he receives would create an

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[37] 318 U.S. at 558. The owners had been already excluded through a lack of sufficient reorganization value. *See id.* at 542 (noting the Seventh Circuit's holding in *In re* Chi., Milwaukee, Saint Paul & Pac. R.R., 124 F.2d 754 (7th Cir. 1941), *aff'd in part, rev'd in part sub nom.* Grp. of Inst. Inv'rs, v. Chi., Milwaukee, Saint Paul & Pac. R.R., 318 U.S. 523 (1943)).

[38] *Id.* at 565 (emphasis added).

[39] Case v. L.A. Lumber Prods. Co., 308 U.S. 106, 117 (1939) (quoting N. Pac. Ry. Co. v. Boyd, 228 U.S. 482, 508 (1912)).

[40] 318 U.S. at 564.

> illusion of certainty where none exists and would place an impracticable burden on the whole reorganization process.[41]

So what is to be used? Earlier cases indicated that courts must take into account all aspects of a debtor's business:

> Since its application requires a prediction as to what will occur in the future, an estimate, as distinguished from mathematical certitude, is all that can be made. But that estimate must be based on an informed judgment which embraces all facts relevant to future earning capacity and hence to present worth, including, of course, the nature and condition of the properties, the past earnings record, and all circumstances which indicate whether or not that record is a reliable criterion of future performance.[42]

In short, the Court required a facts and circumstances inquiry, based around the reorganized debtor's future earning capacity. The reluctance to use information from the market was deliberate: "The criterion of earning capacity is the essential one if the enterprise is to be freed from the heavy hand of past errors, miscalculations or disaster, and if the allocation of securities among the various claimants is to be fair and equitable."[43]

Justice Douglas then worked the foundational concept of earning capacity into an equitable equivalence test:

> It is sufficient that each security holder in the order of his priority receives from that which is available for the satisfaction of his claim *the equitable equivalent of the rights surrendered*. That requires a comparison of the new securities allotted to him with the old securities which he exchanges to determine whether the new are the equitable equivalent of the old. But that determination cannot be made by the use of any mathematical formula.[44]

So we look at the "equitable equivalent," a determination that "the use of any mathematical formula" cannot make.

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[41] *Id.* at 565.

[42] Consol. Rock Prods. Co. v. Du Bois, 312 U.S. 510, 526 (1941).

[43] *Id.* This discount can be significant. At least one recent study suggests undervaluation in bankruptcy, due, in part, to just the debtor's status as having commenced a case, to be as much as 12%–20%. Michael T. Roberts, *The Bankruptcy Discount: Profiting at the Expense of others In Chapter 11*, 21 AM. BANKR. INST. L. REV. 157, 187 (2013).

[44] *Grp. of Inst. Inv'rs*, 318 U.S. at 565–66 (emphasis added).

4. The 1978 Code

A fair question is whether these Supreme Court holdings retain any current vitality. After all, they were made under a prior statute and referred to valuation methodologies that most would consider quaint today. An examination of the history and drafting of current § 1129(b), however, illustrates that these cases retain their relevance.

The history of § 1129(b) is a history of compromise. One of the largest compromises was the relaxation of absolute priority as an individual creditor right, re-characterizing it instead as a class right only (and thus allowing a majority of creditors to waive the benefit of the rule over the dissent of a minority).[45]

Other issues remained, such as whether to replace or rework the "fair and equitable" standard found in the Act. The Bankruptcy Review Commission, formed in 1968, knew of the squishiness of the "fair and equitable" standard. This can be seen from the Commission's report, which stated that "[a]lthough market values, liquidation values, and past earnings records may be relevant, they are not determinative."[46] The report justified this statement by quoting from *Consolidated Rock Products Co. v. DuBois*: "'[A]n estimate, as distinguished from mathematical certitude, is all that can be made.'"[47] Against this background, the report made no new suggestions; it merely acknowledged the problems this lack of precision caused: "'Inequities are inevitable' and any conception about 'clear-cut rules about legal priorities is an unrealistic one.'"[48]

H.R. 6, the first bankruptcy bill introduced after the compromise on absolute priority referred to above, essentially opted for simple retention.[49] It

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[45] *See* Bruce A. Markell, *Owners, Auctions, and Absolute Priority in Bankruptcy Reorganizations*, 44 STAN. L. REV. 69, 88–90 (1991).

[46] EXEC. DIR., COMM'N ON THE BANKR. LAWS OF THE U.S., REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. NO. 93-137, pt. II, at 256 (1973).

[47] *Id.* at 257 (quoting Consol. Rock Prods. Co. v. Du Bois, 312 U.S. 510, 526 (1941)).

[48] *Id.* (quoting Hubert L. Will, *Railroad Reorganization—The Long and The Short of It*, 41 ILL. L. REV. 608, 626 (1947)).

[49] As initially introduced on January 4, 1977, § 1129(b) of H.R. 6 read as follows:

> (b) If all of the requirements of subsection (a) of this section other than paragraph (8) are met with respect to a plan, the court, on request of the proponent of such plan, shall confirm such plan notwithstanding such paragraph if such plan is fair and equitable with respect to all classes except any class that has accepted the plan and that is comprised of claims or interests on account of which the holders of such claims or interests will receive or retain under the plan not more than would be so received or retained under a plan that is fair and equitable with respect to all classes.

contained a simple statement of the confirmation standard: a court would confirm a plan "if such plan were fair and equitable with respect to all classes except any class that has accepted the plan."[50]

Two and one-half months later, the House amended the bill to eliminate the simple injunction that the plan be "fair and equitable." In its stead, the amended bill attempted to define fair and equitable treatment, but without using the words "fair and equitable."[51] Successive bills added to the statement of the rule.[52] The House Report on the final bill reflected these changes, but categorized them as a "partial codification" of the absolute priority rule.[53]

After some procedural wrangling with the Senate, the House's version of the bankruptcy bill prevailed.[54] But the bill that emerged from the negotiations between the House and Senate contained a drastically different treatment of nonconsensual reorganizations. Whereas the House bill described in the House Report contained only one subsection on nonconsensual confirmation that did not use the words "fair and equitable,"[55] the new bill included two subsections on the topic, and explicitly incorporated the phrase "fair and equitable."[56]

The first subsection harkened back to H.R. 6 by providing that a court could cram down a non-consensual plan over the dissent of any class only if

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H.R. 6, 95th Cong. § 1129(b) (Jan. 4, 1977).

[50] *Id.*

[51] H.R. 6, 95th Cong. § 1129(b) (Mar. 21, 1977). This bill was the first to create different categories of fair and equitable treatment for different types of claims.

[52] *See* H.R. 7330, 95th Cong. § 1129(b) (May 23, 1977); *see also* H.R. 8200, 95th Cong. § 1129(b) (July 11, 1977); H.R. 8200, 95th Cong. § 1129(b) (Sept. 8, 1977).

[53] H.R. REP. NO. 95-595, at 414 (Sept. 8, 1977). The report also confirmed the rule's focus on returning only the reorganization value to creditors. It stated that "creditors are entitled to be paid according to the going-concern value of the business." *Id.* at 223.

[54] The Senate attempted to substitute a bill sponsored by the Securities and Exchange Commission in place of the House bill. *See* S. 2266, 95th Cong. (Oct. 29, 1977). This bill proposed preserving a two-track reorganization system and required a mandatory trustee for debtors whose equity interests were publicly held. *Id.* § 1130. Under this substitute bill, private companies would have been exempt from the fair and equitable rule. *Id.* § 1130.

[55] H.R. 8200, 95th Cong. § 1129(b) (Sept. 8, 1977).

[56] H.R. 8200, 95th Cong. § 1129(b), *as reprinted in* 124 CONG. REC. 32,350, 32,376 (1978) (enacted). Due to these changes, the statements on absolute priority contained in H.R. Rep. No. 595 are not as authoritative as they might otherwise be. Congress recognized this issue, and in lieu of a Conference Report, members of Congress read virtually identical statements into both the House and Senate records on the bill. 124 CONG. REC. at 32,391 (statement of Rep. Rousselot). As noted at the time, Congress believed that this procedure imbued such remarks with "the effect of being a conference report." *Id.* The Supreme Court has concurred. *See* Begier v. IRS, 496 U.S. 53, 64 n.5 (1990) ("Because of the absence of a conference and the key roles played by Representative Edwards and his counterpart floor manager Senator DeConcini, we have treated their floor statements on the Bankruptcy Reform Act of 1978 as persuasive evidence of congressional intent.").

the plan were, among other things, "fair and equitable."[57] Although the bill continued past practice and did not attempt to define this concept explicitly, Congress's prior efforts to define it were not lost. The second subsection on cramdown retained the various treatments developed in earlier bills as *examples* of fair and equitable treatment.[58]

These examples were placed in subparagraphs of paragraph (2) of § 1129(b).[59] In structure, paragraph (2) has three subparagraphs. In order of priority, these subparagraphs give examples of fair and equitable treatment of secured claims, unsecured claims, and equity interests. Although a more detailed examination is reserved for later, the basic thrust of each of these subparagraphs is that "fair and equitable" treatment includes situations in which a stakeholder receives property equal in value to the amount of its prepetition claim or interest. In short, "fair and equitable" treatment includes satisfaction of the claim.[60]

These subparagraphs also speak to when the claim is not fully satisfied. In those circumstances, "fair and equitable" treatment is present if senior interests are not satisfied only when the plan excludes junior interests from the reorganization. If unsecured creditors are not paid in full, shareholders cannot participate.[61]

As the floor remarks made clear, the list of illustrations was not exhaustive; courts were not to exclude other components and interpretations.[62] The scope of these unmentioned, yet nonexcluded items, was broad. These included the

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[57] H.R. 8200 § 1129(b)(1), *as reprinted in* 124 CONG. REC. at 32,376.

[58] Technically, the bill stated that the fair and equitable treatment "included" the examples. *Id.* § 1129(b)(2).

[59] 11 U.S.C. § 1129(b)(2)(A)–(C) (2012).

[60] Or, in the context of an equity interest, delivery of property equal in value to the interest.
There is a somewhat tautological treatment of secured creditors involved in this formulation. Under the Bankruptcy Code, a creditor holds a secured claim only to the extent of the value of its collateral. *See id.* § 506(a). If the debt exceeds the collateral's value, the creditor holds two claims: a secured claim equal to the value of the collateral, and an unsecured claim for the balance. *See id.* In light of this bifurcation, and because the proceeds of collateral cannot be allocated to other creditors without compensation to the secured creditor, § 1129(b)(2)(A) does not address less than full payment on a secured claim. *See id.* § 1129(b)(2)(A).

[61] Obviously, there are exceptions. If the class of senior interests consents, then shareholders can participate even if all members of the class are not paid in full. In addition, many courts have recognized that junior creditors can contribute new value to the reorganization, and obtain interests in the reorganized debtor commensurate with their contributions. *See* 7 COLLIER ON BANKRUPTCY, *supra* note 7, ¶ 1129.03[4][c].

[62] *See* 124 CONG. REC. at 32,407 (statement of Rep. Edwards); *id.* at 34,006 (statement of Sen. DeConcini) (noting "many of the factors interpreting 'fair and equitable'. . . , which were explicated in the description of section 1129(b) in the House report, were omitted from the House amendment . . . . [T]he deletion is intended to be one of style and not one of substance").

various components of the rule that: provided step-ups to compensate for loss of priority; compensated junior creditors with better or more quickly amortizing securities; and increased the amount of the claim protected by the amount of post-petition interest.[63]

The most obvious omission, however, was the fundamental idea that no stakeholder should receive more than its nonbankruptcy entitlement. Put another way, no creditor should be paid more than what it is owed. This concept was included in the bill the House originally passed;[64] Congress, however, dropped it in the final bill that became current law. The managers of the final bill were at pains to point out that this omission did not mean they were eliminating the requirement: "While that requirement [of no overpayment] was explicitly included in the House bill, deletion is intended to be one of style and not one of substance."[65] The floor managers went on to characterize the no-overpayment rule as a "safeguard" for junior classes.[66]

Courts have honored this component even though not explicitly incorporated: "'It's undisputed that the "fair and equitable" requirement encompasses a rule that a senior class cannot receive more than full compensation for its claims.'"[67]

B. Summary: Of "Fair Equivalents" and § 1129(b)(2)'s Examples

To summarize, the standard for assessing nonconsensual confirmation is whether the plan is "fair and equitable" as to each dissenting class. That standard is found in paragraph (1) of § 1129(b). Congress used "fair and equitable," admittedly a vague phrase, to capture reorganization practice in equity receiverships, and the statutory phrase has guided courts for over 80 years. For purposes of this Article, three short apothegms can synthesize the history and doctrine under this phrase: "don't pay too little"; "don't pay too much"; and "don't expect precision."

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63 *See* 7 COLLIER ON BANKRUPTCY, *supra* note 7, ¶ 1129.03[4][b][i][A]–[C].

64 *See, e.g.*, H.R. 6, 95th Cong., 1st Sess. § 1129(b) (Mar. 21, 1977).

65 124 CONG. REC. at 32,407 (statement of Rep. Edwards); *id.* at 34,006 (statement of Sen. DeConcini).

66 124 CONG. REC. at 32,408 (statement of Rep. Edwards); *id.* at 34,007 (statement of Sen. DeConcini).

67 *In re* Genco Shipping & Trading Ltd, 513 B.R. 233, 242–43 (Bankr. S.D.N.Y. 2014) (quoting *In re* Chemtura Corp., 439 B.R. 561, 592 (Bankr. S.D.N.Y. 2010)); *see also In re* Exide Techs., 303 B.R. 48, 61, 66 (Bankr. D. Del. 2003); *In re* MCorp Fin., Inc., 137 B.R. 219, 235 (Bankr. S.D. Tex. 1992); *In re* Future Energy Corp., 83 B.R. 470, 495 n.39 (Bankr. S.D.N.Y. 1988); 7 COLLIER ON BANKRUPTCY, *supra* note 7, ¶ 1129.03[4][a][ii]. *See generally In re* Walat Farms, Inc., 70 B.R. 330, 335 (Bankr. E.D. Mich. 1987).

1. *Don't Pay Too Little*

The first apothegm, "don't pay too little," stems from the examples in paragraph (2) of § 1129(b). They illustrate that payment in full is "fair and equitable" treatment. That proposition alone is hardly surprising; you would not need a bankruptcy law for that proposition. What bankruptcy law provides is that the payment need not be in cash, but only in "property." That concept raises issues of valuation.

2. *Don't Pay Too Much*

The second apothegm, "don't pay too much," stems from the uncodified concept of absolute priority that a creditor should not receive more than it is due. Again, one would not need a bankruptcy law for this proposition; the law of restitution would otherwise cover it. But again, since noncash property can constitute payment, the issue remains as to the valuation of the property being distributed under the plan.

3. *Don't Expect Precision*

Finally, the history of reorganization and the Supreme Court's interpretations of "fair and equitable" justify the final apothegm: "don't expect precision." As Justice Douglas stated, valuation "requires a prediction as to what will occur in the future, [and thus] an estimate, as distinguished from mathematical certitude, is all that can be made."[68] He continued this theme two years later. When valuing the property a party is receiving in satisfaction of its claim, "[a] requirement that dollar values be placed on what each security holder surrenders and on what he receives would create an illusion of certainty where none exists and would place an impracticable burden on the whole reorganization process."[69] More recently, finance literature has echoed these insights: "It is unrealistic to expect or demand absolute certainty in valuation, since cash flows and discount rates are estimated. This also means that analysts

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[68] Consol. Rock Prods. Co. v. Du Bois, 312 U.S. 510, 526 (1941).

[69] Grp. of Inst. Inv'rs v. Chi., Milwaukee, Saint Paul & Pac. R.R., 318 U.S. 523, 565 (1943); *see also* Lippe v. Bairnco Corp., 288 B.R. 678, 690 (S.D.N.Y. 2003) ("Common sense and the authorities in the area suggest that an opinion as to the value of a business should be expressed as a range of values rather than as a single number."), *aff'd*, 99 F. App'x 274 (2d Cir. 2004); Harris Tr. & Sav. Bank v. Ellis, 810 F.2d 700, 706 (7th Cir. 1987) (Easterbrook, J.) ("'Fairness' is a range, not a point.").

have to give themselves a reasonable margin for error in making recommendations on the basis of valuations."[70]

All of this uncertainty leads back to Justice Douglas's standard for assessing whether the value of property offered in a reorganization satisfies stakeholders' interests: "It is sufficient that each security holder in the order of his priority receives from that which is available for the satisfaction of his claim *the equitable equivalent* of the rights surrendered."[71] In passing on whether the plan proponent's evidence meets this standard of "equitable equivalence," Justice Douglas, speaking for the Court, stated that the process "requires a comparison of the new securities allotted to [the stakeholder] with the old securities which he exchanges to determine whether the new are the equitable equivalent of the old."[72] Reiterating what he had said in *Consolidated Rock Products*, he continued: "But that determination cannot be made by the use of any mathematical formula."[73]

II. The Process of Property Valuation in Nonconsensual Confirmation

At one level, it is all well and good to say that stakeholders are entitled to a "fair equivalent" when surrendering their prepetition interests. But any assessment of equivalence requires two other determinations: (1) the value of the prepetition interest; and (2) the value of the property proposed to be transferred in reorganization.

The value of the prepetition interest, in the case of unsecured debt, is rather ministerial. It simply involves calculation of the debt as of the petition date.[74] Matters get complicated, however, if the debt is secured, because then the value of the creditor's prepetition entitlement includes the value of the collateral.[75] A limit to this complication exists. If the creditor is oversecured—that is, if its collateral is worth more than the amount of its debt—then the

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70 Aswath Damodaran, Investment Valuation: Tools & Techniques for Determining the Value of Any Asset 4 (3d ed. 2012); *see also* Arthur Keown et al., Financial Management: Principles & Applications 751 (6th ed. 2012) ("[N]o single dollar value exists for a company.").

71 *Grp. of Inst. Inv'rs*, 318 U.S. at 565 (emphasis added).

72 *Id.*

73 *Id.*

74 *See* 11 U.S.C. § 502(a) (2012).

75 *See id.* § 506(a).

value of the creditor's interest is simply the face amount of the debt.[76] That result is the legacy of the "don't pay too much" line of cases.

But even if a creditor is oversecured, and the value of its prepetition entitlement can be stated with certainty, there is a further wrinkle. There must be a valuation of the property the plan proponent proposes to transfer under the plan in satisfaction of the agreed prepetition entitlement. This property will rarely be cash (although it could be).[77] More often, the property will be a promise of future payments, such as a promissory note or bond or some other income-producing security. Such promises are fairly standard in finance, as is their valuation.

A. Valuing Income Producing Property

Income producing property involves a promise today to make a payment tomorrow, or at some point in the future. But such a promise is rarely worth the amount of the promised payment.[78] Put simply, a promise to pay $1 tomorrow is not worth $1 today.

That insight is fairly standard, but it leaves an open question: given that $1 payable tomorrow is not worth $1 today, what is it worth? The study of finance can and does quantify the difference. It does so under present value analysis.

1. Present Value Analysis

What is "present value"? Start first with an extended example. If you pay $100 today to a bank for a one-year certificate of deposit, what would you expect the bank to pay you in a year? The common sense response would be: it depends on the interest rate being offered by the bank. If 10%, the amount would be $110; if 5%, the amount drops to $105.[79] The bank's promise to pay you an amount in the future depends on the interest rate it offers upon deposit.

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[76] H.R. REP. NO. 95-595, 416 (1977) ("It is important to note that under section 506(a), the allowed amount of the secured claim will not include any extent to which the amount of such claim exceeds the value of the property securing such claim.").

[77] *Id.* at 415 ("For example, consider an allowed secured claim of $1,000 in a class by itself. One plan could propose to pay $1,000 on account of this claim as of the effective date of the plan . . . [This] plan clearly meets the requirements of subparagraph (A) [of § 1129(b)(2)] because the amount received on account of the second claim has an equivalent present value as of the effective date of the plan equal to the allowed amount of such claim."). *See* 11 U.S.C. § 1129(b)(2).

[78] Five years ago, I would have said "never" instead of "rarely," but the advent of negative interest rates opens up unexplored areas.

[79] These examples use simple, and not compounded, interest rates.

So the bank could sell you a certificate of deposit—a promise to pay an amount in the future—by promising to pay $110 for every $100 invested. Simple math would allow the investor assessing this promise to calculate that the inherent interest rate on this promise would be 10%. Another way to look at this analysis is to take the promise of future payment and reduce it or discount it to today's value. This process is referred to as calculating present value.[80]

In this context, present value is the concept that reduces the face or notional amount of a stream of projected future payments to adjust for the common sense insight that $1 a year from now is not worth $1 today. The factor used to discount the stream is the "discount rate," usually expressed as a percentage amount.[81]

So if a payment of $110 a year from now has a present value today of $100, the discount rate is 10%. Higher discount rates mean lower present value; were the discount rate 20% in the prior example, the present value of $110 a year from now would be $91.67.[82] These numbers work in reverse as well.

2. Present Value Analysis and § 1129(b)

What do discount rates have to do with cramdown? There are two separate explanations. The first has to do with the text of § 1129(b)(2); the second with finance.

As a matter of statutory interpretation, § 1129(b)(2) requires, in three places, that a creditor or interest holder receive property "of a value, as of the effective date of the plan" equal to some amount, usually the allowed amount of the participant's claim.[83] Congress intended that these words incorporate present value analysis. As stated in the report accompanying the House bill, "[t]his [language] contemplates a present value analysis that will discount

80 Present value is represented by the formula $PV = P/(1+i)^n$, where *P* is the future amount, *i* is the discount rate expressed as a decimal, and *n* is the number of periods discounted.

81 ASWATH DAMODARAN, THE DARK SIDE OF VALUATION: VALUING YOUNG, DISTRESSED AND COMPLEX BUSINESSES 30 (2d ed. 2010) ("When valuing these cash flows, we have to consider risk somewhere, and the discount rate is usually the vehicle that we use to convey the concerns that we may have about uncertainty in the future. In practical terms, we use higher discount rates to discount riskier cash flows and thus give them a lower value than more predictable cash flows."). *See In re* Union Meeting Partners, 165 B.R. 553, 572–73 (Bankr. E.D. Pa. 1994), *aff'd*, 52 F.3d 317 (3d Cir. 1995).

82 *See* H.R. REP. NO. 95–595, 415 (1977) ("[T]he higher the discount rate, the less present value the note will have.").

83 11 U.S.C. § 1129(b)(2)(A)(i)(II), (B)(i), (C)(i) (2012).

value to be received in the future."[84] Despite the changes to § 1129(b) after the conference, this form remained the intended construction: "The House report accompanying the House bill described what is meant by present value."[85]

3. *Present Value and Finance*

Finance theory also adopts a present value analysis. When comparing the value of two different streams of income—whether they are the net cash flow of a business or of a bond—value is expressed in present value terms. In this analysis, the discount rate is key: it is a single number that represents different components of risk and reward. In particular, the discount rate will have among its elements: the risk-free rate of return (traditionally expressed in terms of United States governmental obligations); a component for inflation; and a component that measures the risk of repayment. This last component is often referred to as the risk premium involved in the transaction.[86]

This risk premium is typically calculated by the obligor's risk profile, taken from either its existing financial instruments, or the profiles of similar firms.[87] If the whole firm is being valued, the discount rate is typically the firm's weighted average cost of capital ("WACC"), which is the cost of the different components of financing (debt and equity) used by the firm, weighted by their market value proportions.[88] If a bond issue is being valued, the cost of equity would not be factored in (there is no equity in the equation).[89]

B. *Valuing Debt Issued in Reorganizations*

As seen above, the Code requires a present value analysis, and finance theory offers a relatively simple method of computing the present value of debt instruments. A quick and facile analysis might indicate that a court should just

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[84] H.R. REP. NO. 95-595, 414 (1977); *see id.* at 413 ("The property is to be valued as of the effective date of the plan, thus recognizing the time-value of money.").

[85] 124 CONG. REC. 32,407 (1978) (statement of Rep. Edwards); 124 CONG. REC. 34,007 (1978) (statement of Sen. DeConcini).

[86] *See generally* DAMODARAN, *supra* note 81, at 35–38. For solvent companies, valuation also factors in the marginal tax rate of the company being valued. *Id.*

[87] *Id.* at 36.

[88] *See In re* Genco Shipping & Trading Ltd, 513 B.R. 233, 242–43 (Bankr. S.D.N.Y. 2014).

[89] If the debt is secured by all assets of the company, and the relationship between the debt and the collateral essentially means that the lender would have to take over the business if it foreclosed on its collateral, WACC might be appropriate, as the promise inherent in the debt instruments is that the debtor will yield its business if it defaults.

yield to finance experts to value reorganization debt when assessing compliance with the absolute priority rule.

At one level, such an analysis likely works. A reorganized debtor will have cash flow, and that cash flow will stand as security for the reorganization debt issued. All that remains to be done to value the reorganization debt is to employ a present value analysis on the cash flow.

Present value analysis, however, requires selecting an appropriate discount rate. As set forth above, an appropriate discount rate will reflect what is traditionally thought to be represented in such a rate: (i) a risk-free rate of return; (ii) compensation for inflation; and (iii) a risk premium.[90] Courts, however, did not uniformly combine or assess these factors in the first twenty-five years under the Code.

III. *TILL* AND DISCOUNT RATES

Before 2004, courts were all over the map on how to select an appropriate discount rate.[91] Some courts used the contract rate, some attempted to calculate a creditor's cost in lending money, and still others tried to craft a debtor-specific interest rate.[92] Confusion was common, both in chapter 11 cases and in chapter 13 cases, in which § 1325(b)(5)(A) uses the same touchstone language invoking present value.[93]

A. Till v. SCS Credit

In 2004, however, the Supreme Court addressed the crucial question of how to select an appropriate discount rate for cramdown, at least in the context of a chapter 13 case. In *Till v. SCS Credit Corp.*, the discrete issue was the appropriate cramdown interest rate in chapter 13.[94] The Court ultimately decided to use a formula based approach, beginning with the prime rate of interest, enhanced by a factor based on the debtor's riskiness. In particular, the Court noted the benefits this approach would have:

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[90] *See generally* DAMODARAN, *supra* note 81, at 35–38.

[91] *See generally* 7 COLLIER ON BANKRUPTCY, *supra* note 7, ¶ 1129.05[2][c][ii].

[92] *Id.* ¶ 1129.05[2][c][ii][A]–[C].

[93] In chapter 13, creditors do not vote on the debtor's plan. The Code provides that the debtor may confirm the plan if the creditor retains its lien, and if "the value, as of the effective date of the plan, of property to be distributed under the plan on account of such claim is not less than the allowed amount of such [secured creditor's] claim." 11 U.S.C. § 1325(a)(5)(B)(ii) (2012). This language closely tracks the language of section § 1129(b)(2)(A)(ii). *See id.* § 1129(b)(2)(A)(ii).

[94] 541 U.S. 465 (2004).

> [T]he formula approach entails a straightforward, familiar, and objective inquiry, and minimizes the need for potentially costly additional evidentiary proceedings. Moreover, the resulting "prime-plus" rate of interest depends only on the state of financial markets, the circumstances of the bankruptcy estate, and the characteristics of the loan, not on the creditor's circumstances or its prior interactions with the debtor. For these reasons, the prime-plus or formula rate best comports with the purposes of the Bankruptcy Code.[95]

The Court was clear, however, that it believed its analysis of chapter 13's language had broader application. As the Court saw it:

> [T]he Bankruptcy Code includes numerous provisions that, like the [Chapter 13] cram down provision, require a court to "discoun[t] . . . [a] stream of deferred payments back to the[ir] present dollar value," . . . to ensure that a creditor receives at least the value of its claim. We think it likely that Congress intended bankruptcy judges and trustees to follow essentially the same approach when choosing an appropriate interest rate under any of these provisions.[96]

Till indicated that a formula approach based upon the prime rate best carries out the intentions of Congress for those sections which require discounting to present value.[97] The formula approach starts with the prime rate, and then adjusts the applicable rate upward based on the particular risks presented by the reorganized debtor.

What is the amount of the increase to be added to the prime rate? The Court did not directly decide the proper scale for this risk adjustment factor. It did note, however, that other courts had approved adjustments of one to three percent (or 100 to 300 basis points), and seemed to suggest that large adjustments would not be appropriate because a plan cannot be confirmed unless the bankruptcy court finds that the plan is feasible.

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95 *Id.* at 479–80.

96 *Id.* at 474 (internal citations omitted). In a footnote to this passage, the Court identified those sections of the Code it saw as incorporating similar language requiring use of present value analysis. *See id.* at 474 n.10 (listing §§ 1129(a)(7)(A)(ii), 1129(a)(7)(B), 1129(a)(9)(B)(i), 1129(a)(9)(C), 1129(b)(2)(A)(ii), 1129(b)(2)(B)(i), 1129(b)(2)(C)(i), 1173(a)(2), 1225(a)(4), 1225(a)(5)(B)(ii), 1228(b)(2), 1325(a)(4), and 1228(b)(2) as sections of the Code requiring courts to discount future payments back to their present dollar value).

97 *Id.* at 479. Although no opinion commanded a majority of five Justices, the plurality opinion of Justice Stevens, speaking for four Justices, entered a judgment that reversed the decision and ordered further proceedings consistent with that plurality opinion. *Id.* at 468. Justice Thomas concurred in that judgment, but he expressed his view, based upon the language of the statute, that the appropriate rate should be lower, including no amount to compensate the creditor for risk. *Id.* at 487 (Thomas, J., concurring).

B. Till *and Chapter 11*

Courts have consistently been reluctant to apply *Till* to chapter 11 cases. Initially, *Till* seems directed at minimizing costs in chapter 13 cases, which can ill afford to host costly disputes. That rationale, while not absent from chapter 11 cases, is certainly minimized in larger chapter 11 cases. In addition, the Court seemed to be answering a question they would rather have seen the market answer—what is the appropriate rate to compensate lenders in bankruptcy? As noted by the Court, "there is no readily apparent chapter 13 'cram down market rate of interest': because every cram down loan is imposed by a court over the objection of the secured creditor, there is no free market of willing cram down lenders."[98]

The Court, however, went on to note that in certain situations bankruptcy courts can look to market rates. In now-notorious footnote 14, the Court said:

> Interestingly, the same is not true in the Chapter 11 context, as numerous lenders advertise financing for Chapter 11 debtors in possession . . . . Thus, when picking a cram down rate in a Chapter 11 case, it might make sense to ask what rate an efficient market would produce. In the Chapter 13 context, by contrast, the absence of any such market obligates courts to look to first principles and ask only what rate will fairly compensate a creditor for its exposure.[99]

This footnote 14 has led some courts to apply *Till* only when it appears that no efficient market exists for the type of loan at issue.[100] One commonality in these cases has been a tendency to equate the fact that some chapter 11 debtors can obtain exit financing with the presence of an efficient market. Other courts have simply treated the method employed as a factual matter and

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[98] *Id.* at 476 n.14 (plurality opinion).

[99] *Id.* (citations omitted).

[100] *See* Bank of Montreal v. Official Comm. of Unsecured Creditors (*In re* Am. Homepatient, Inc.), 420 F.3d 559, 568 (6th Cir. 2005) ("[Footnote 14] means that the market rate should be applied in Chapter 11 cases where there exists an efficient market. But where no efficient market exists for a Chapter 11 debtor, then the bankruptcy court should employ the formula approach endorsed by the *Till* plurality. This nuanced approach should obviate the concern of commentators who argue that, even in the Chapter 11 context, there are instances where no efficient market exists."); *see also* Gen. Elec. Credit Equities, Inc. v. Brice Rd. Devs., L.L.C. (*In re* Brice Rd. Devs., L.L.C.), 392 B.R. 274, 280 (B.A.P. 6th Cir. 2008); *In re* DBSD N. Am., Inc., 419 B.R. 179 (Bankr. S.D.N.Y. 2009), *aff'd*, 2010 WL 1223109 (S.D.N.Y Mar. 24, 2010), *aff'd in part*, *rev'd in part*, 627 F.3d 496 (2d Cir. 2010); *In re* Good, 413 B.R. 552 (Bankr. E.D. Tex. 2009), *aff'd sub nom.* Good v. RMR Invs., Inc., 428 B.R. 249 (E.D. Tex. 2010); *In re* Winn-Dixie Stores, 356 B.R. 239 (Bankr. M.D. Fla. 2006).

affirmed reasonable efforts by bankruptcy courts to puzzle out the appropriate discount rate.[101]

The trend, however, is to the contrary. As recently summarized by the Fifth Circuit: "[T]he vast majority of bankruptcy courts have taken the *Till* plurality's invitation to apply the prime-plus formula under Chapter 11."[102]

When a creditor argued that the *Till* process produced a rate no lender would use, and thus was absurd, the Fifth Circuit responded:

> While [the lender] is undoubtedly correct that no willing lender would have extended credit on the terms it was forced to accept under the § 1129(b) cramdown plan, this "absurd result" is the natural consequence of the prime-plus method, which sacrifices market realities in favor of simple and feasible bankruptcy reorganizations.[103]

C. Till*'s Reference to Efficient Markets*

Given this odd policy result, a fair question exists as to whether a court may ever use market–derived interest rates as the discount factor under § 1129(b). That is where footnote 14 comes in. To repeat, it states in relevant part:

> Because every cram down loan is imposed by a court over the objection of the secured creditor, there is no free market of willing cram down lenders. Interestingly, the same is *not* true in the Chapter 11 context, as numerous lenders advertise financing for Chapter 11 debtors in possession . . . . Thus, when picking a cram down rate in a Chapter 11 case, it might make sense to ask what rate an efficient market would produce. In the Chapter 13 context, by contrast, the absence of any such market obligates courts to look to first principles

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[101] *See* Wells Fargo Bank N.A. v. Tex. Grand Prairie Hotel Realty, L.L.C. (*In re* Tex. Grand Prairie Hotel Realty, L.L.C.), 710 F.3d 324, 331 (5th Cir. 2013) ("We will not tie bankruptcy courts to a specific methodology as they assess the appropriate Chapter 11 cramdown rate of interest; rather, we continue to review a bankruptcy court's entire cramdown-rate analysis only for clear error.").

[102] *Id.* at 333.

[103] *Id.* at 336. Indeed, Justice Thomas essentially took this position in *Till*: "The dissent might be correct that the use of the prime rate, even with a small risk adjustment, 'will systematically undercompensate secured creditors for the true risks of default.' This systematic undercompensation might seem problematic as a matter of policy. But, it raises no problem as a matter of statutory interpretation." 541 U.S. at 488 (Thomas, J., concurring).

> and ask only what rate will fairly compensate a creditor for its exposure.[104]

This passage has been correctly criticized for confusing debtor in possession financing with exit financing.[105] The argument runs that if the Court used a supporting premise unrelated to its conclusion (that debtor in possession financing is available), then its conclusion (that the use of market rates "might make sense"), does not follow. That logical misstep might be enough to raise questions regarding the propriety of the use of market rates. But the use of false premises does not necessarily doom a conclusion to the scrapheap. It might be right for other reasons.

So if we ignore the logical error, what is the rule in chapter 11? All the Court gives us is a very short and cryptic dicta: "[I]t might make sense to ask what rate an efficient market would produce."[106]

Two points are worth making here. First, as a matter of statutory interpretation, the phrase "it might make sense to ask" is not all that strong an indication courts *must* use market rates when the reorganization debt's market is efficient, especially if the selection of a discount rate is a matter of fact.[107] In addition, the Court's words do not mandate use of market rates; they only require the bankruptcy court "to ask" what rate an efficient market would yield.[108] If § 1129(b)(2) mandates the use of market rates, that rule will have to be clarified in further cases.

The second point is more nuanced. Even the strongest advocates for market-based discount rates must concede that the Court's dicta states that if there is no efficient market, prevailing rates are not automatically adopted. In these circumstances "courts . . . look to first principles and ask only what rate will fairly compensate a creditor for its exposure."[109] As indicated above, *Till* refers to the consideration of market rates in chapter 11 only if there is an "efficient" market for cram down loans. Is there?

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[104] *Till*, 541 U.S. at 476 n.14 (plurality opinion) (citation omitted).

[105] *See* 7 COLLIER ON BANKRUPTCY, *supra* note 7, ¶ 1129.05[2][c][i].

[106] *Till*, 541 U.S. at 476 n.14 (plurality opinion).

[107] As a determination of fact, review would be controlled by the clearly erroneous standard of review. *See infra* Section VI.B.

[108] *Till*, 541 U.S. at 476 n.14.

[109] *Id.*

1. *Is There a Market for Cramdown Debt?*

To determine whether there is an efficient market for chapter 11 cramdown loans, the first question to ask is whether there is even a market. This requires reflection on what a market is. Markets are not necessarily physical; they are mediums or processes that clear and establish prices on goods or services. At issue in cramdown situations is the value of a promise. That promise is to repay certain borrowed sums at a set rate of interest. A facile argument would run that such promises are brokered every day: car loans, home loans, corporate bonds, and the like all represent promises for which there appear to be established markets. Consumers know where and how to shop consumer loans such as car loans and mortgages; corporations know to go to the capital markets for floating bonds or issuing other debt securities.

But there are strong commonalities among these types of loans. They each rely on standard forms. Standard forms pervade consumer loans and bond indentures.[110] Individuals and entities that buy and trade these loans after their origination thus know their terms, their covenants, and their provisions.

Such may not be the case with cramdown loans. As *Till* observed in footnote 14: "Because every cram down loan is imposed by a court over the objection of the secured creditor, there is no free market of willing cram down lenders."[111] The Court also noted that the Code

> does not require that the terms of the cram down loan match the terms to which the debtor and creditor agreed prebankruptcy, nor does it require that the cram down terms make the creditor subjectively indifferent between present foreclosure and future payment. Indeed, the very idea of a "cram down" loan *precludes* the latter result: By definition, a creditor forced to accept such a loan would prefer instead to foreclose.[112]

In short, the nonconsensual nature of reorganization debt issued in a cramdown may very well exclude it from markets for loans of similar amount or duration made by non-debtor entities.

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[110] Standard forms dominate consumer transactions, as every law student who tries to independently draft a car loan or a mortgage soon finds out. In the world of corporate bond indentures, efforts such as those of the American Bar Association ensure similarity, if not uniformity, in most bond indenture provisions. *See* Tr. Indentures & Indenture Trs. Comm., American Bar Ass'n, *Annotated Trust Indenture Act*, 67 BUS. LAW. 977 (2012).

[111] *Till*, 541 U.S. at 476 n.14 (2004).

[112] *Id.* at 476.

But plan proponents may intend to float reorganization debt or other securities to the public; thus, the reorganized debt or securities may be designed to be traded on a public market. That reality raises questions about whether the public markets can fairly price the reorganization debt.

2. *If There Is a Market, Is it Efficient?*

In *Till*, Justice Scalia dissented in part because he was willing to assume that the subprime debt markets that produced the contract at issue were "competitive and therefore largely efficient."[113] The plurality responded that "several considerations suggest that the subprime market is not, in fact, perfectly competitive."[114] These considerations included a disparity of power between the normal participants, which leads to informational asymmetry, a condition the *Till* plurality noted that tends to preclude economic efficiency.[115]

This raises the question of whether any market in cramdown loans for a corporate bankruptcy debtor is, or can be, "efficient."[116] Initially, it is unclear exactly what the Court thought was an "efficient" market. There are many views on this, but for purposes of this Article, I will discuss two: the lay view and the economist's view.

a. *"Efficient" as Understood by Non-Economists: The Lay View*

The lay view[117] likely takes the position that an efficient market is one that works without much effort because the standard terms and conditions are set, and only a few points need to be dickered to complete a deal. It is efficient because people use it in hundreds if not thousands of transactions every day. The process moves quickly, without any time spent on decisions that do not seem to matter. Put crudely, an efficient market does not waste anyone's time.

Car loans, such as the one present in *Till*, might be thought to represent such a market. Cars are bought and sold on long, fourteen-inch forms, densely filled with small type. But the parties typically focus only on several terms,

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[113] *Id.* at 492 (Scalia, J., dissenting).

[114] *Id.* at 481 (plurality opinion).

[115] *Id.* at 478 (plurality opinion).

[116] For purposes of this discussion, I assume that *Till* referred to notions from economics and finance in using the term "efficient," although as indicated below, that may not be an unobjectionable assumption.

[117] The concept of a "lay" understanding is my own construct. "Efficient" as used in everyday conversation has a much different meaning than "efficient" as used by economists. This section tries to capture the sense non-economists understand when they first hear of the concept of an "efficient" market.

such as price, trade-in value, and other terms that seemingly have a more direct and immediate impact on the consumer and the seller. So too with most consumer loans and mortgages: the forms are standardized so that the debt obligation can be freely sold and traded in the secondary market.

The abundance of such loans gives some comfort that there is a rate set without necessary reference to a particular debtor involved. The "market" of consumer loans determines the general risk for such loans. All a consumer has to do is to meet the minimum credit score requirements. The Court's use of the "prime rate" in *Till*—a generalized rate offered to banks' "best customers"—supports the view that the Court was looking for something extrinsic to the debtor to validate the discount rate chosen.[118]

But this method ultimately is unsatisfactory for purposes of chapter 11. Although there is a market for loans to corporate debtors, it does not exist on the scale, and with the standardization of, consumer loans. There is more reason to believe that the terms of a particular loan are set with reference to subjective evaluations of the creditworthiness of the debtor, rather than with reference to an objective market place able to assess and price such corporate loans.

Given the Court's efforts in *Till* to arrive at a general rate that compensates creditors but does not require extensive proof of the debtor's loan qualifications, this concept of efficiency is not likely the one *Till* contemplated in footnote 14. There is a concept of efficiency, however, in economics and finance literature, and it is worth looking at.

b. "Efficient" as Understood by Economists

The economists' view is that prices in an economically efficient market should, in theory, reflect all relevant information about a business or asset.[119] *Till* recognized this view: "[I]f all relevant information about the debtor's circumstances, the creditor's circumstances, the nature of the collateral, and the market for comparable loans were equally available to both debtor and creditor, then in theory the formula and presumptive contract rate approaches would yield the same final interest rate."[120] In such cases, market prices will

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[118] *Till*, 541 U.S. 479–80.

[119] *See, e.g.*, Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. (PAPERS & PROC.) 383, 383 (1970).

[120] *Till*, 541 U.S. at 484.

approximate the value estimated by cash flow and other non-market measures—sometimes called "intrinsic value."[121] When markets are not efficient, prices trend away from intrinsic value, a fact that reorganization cases of the last seventy-five years have recognized.

In the world of finance, the efficient market hypothesis holds that an efficient market is one in which prices fully reflect all known or available information about the asset being traded.[122] There are several versions of the efficient market hypothesis: a weak version, in which market prices reflect all past price patterns; a "semi-strong" version, in which market prices reflect past price patterns and all other publically available information; and a "strong" version, in which market prices reflect not only all publicly-available information, but also all private information held by insiders.[123] One consequence of an efficient market is that no investor can consistently beat the market and enjoy above-average returns without incurring above-average risks; the efficiency of the market in absorbing information and reflecting that information in price changes would defeat any strategy. This notion is captured by a standard joke:

> A well-known story tells of a finance professor and a student who come across a $100 bill lying on the ground. As the student stops to pick it up, the professor says, "Don't bother—if it were really a $100 bill, it wouldn't be there."[124]

Efficiency is treated as having two "flavors": informational efficiency and fundamental value efficiency.[125] Informational efficiency reflects the market's ability to assimilate and distribute new information, and to reflect the consequence of the information in the asset's trading price. Fundamental value efficiency, in turn, is a correlative concept that reflects the market's ability to

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[121] DAMODARAN, *supra* note 81, at 23 ("What is intrinsic value? Consider it the value that would be attached to an asset by an all-knowing analyst with access to all information available right now and a perfect valuation model. No such analyst exists, of course, but we all aspire to be as close as we can to this perfect analyst.").

[122] *See, e.g.*, Fama, *supra* note 119, at 383 ("A market in which prices always 'fully reflect' available information is called 'efficient.'"); Lynn A. Stout, *The Mechanisms of Market Inefficiency: An Introduction to the New Finance*, 28 J. CORP. L. 635, 639 (2003) ("According to the most common definition, a market is 'efficient' when prices always fully reflect available information.").

[123] These distinctions were first developed in Eugene F. Fama, *supra* note 119, at 383.

[124] Burton G. Malkiel, *The Efficient Market Hypothesis and Its Critics*, 17 J. ECON. PERSP. 59, 60 (2003). As the author notes, this "story well illustrates what financial economists usually mean when they say markets are efficient." *Id.*

[125] J. Alex Milburn, *The Relationship Between Fair Value, Market Value, and Efficient Markets*, 7 ACCT. PERSP. 293, 298–99 (2008).

impound or incorporate the new information in a way that reflects fundamental or intrinsic value.[126]

There are problems with each form of efficiency. Informational efficiency has been criticized for its bias towards short-term, easily digestible information:

> Information that is easy to understand and that is trumpeted in the business media—for example, merger announcements or news of a stock split—may be incorporated into market prices almost instantaneously. But information that is "public" but difficult to get hold of, or information that is complex or requires a specialist's knowledge to comprehend, may take weeks or months to be fully incorporated into prices. Indeed it may never be fully incorporated at all.[127]

Fundamental value efficiency examines bias in interpreting and incorporating public information into prices. As noted by J. Alex Milburn, "[t]here is much discussion in the literature of potential fundamental value biases in capital market prices. These include the effects of regulation and transaction costs and limitations of arbitrage in linking markets and in limiting short selling . . . ; and cognitive limitations and irrational behavior."[128] Added to this is a fundamental problem with value efficiency: it cannot be tested. It assumes the mistake in valuation that it tries to prove the market made. As one author has observed, "[f]undamental value is not a falsifiable number."[129]

There are many reasons to believe that markets in the debt of bankruptcy debtors are not efficient markets capable of reflecting all relevant information about a bankruptcy debtor.[130] A critique of a pure market valuation perspective recently stated:

> To them, the market appears as their *deus ex machina*. . . . But the authors' preference for market evidence, to the exclusion of expert opinion, dictates exposure to market ambiguities and inefficiencies. These include (i) the vague definition of the term "markets"; (ii) the

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[126] *Id.* at 298–300.

[127] Stout, *supra* note 122, at 656.

[128] Milburn, *supra* note 125, at 299.

[129] William T. Allen, *Securities Markets As Social Products: The Pretty Efficient Capital Markets Hypothesis*, 28 J. CORP. L. 551, 558 (2003).

[130] This lack of information and other uncertainties can drive up the discount rate. In one study, for example, the authors found that creditors in bankruptcy often use an implicit discount rate of over 75%. Fabrice Barthélémy, Timothy C.G. Fisher & Jocelyn Martel, *What Discount Rate Should Bankruptcy Judges Use? Estimates from Canadian Reorganization Data*, 29 INT'L REV. L. & ECON. 67, 68 (2009).

> challenges particular to valuing a business in distress compared to a stable company; (iii) the inefficiency of trading distressed securities, including lack of research coverage and delisting; and (iv) a presumption that federal judges, schooled in law and not necessarily in market theory and operation, can intuitively sense distortions and errors.[131]

If these cracks in the efficiency market hypothesis generally were not enough to question its applicability to reorganization securities, then other concerns might be. Debt securities markets have not been the focus of most of the efficient market hypothesis literature; equity securities have.[132] Courts have noticed this lacuna; a common observation was made in *Newby v. Enron Corp. (In re Enron Corp. Securities Derivative & "ERISA" Litigation)*: "No standard at all appears to have been established for measuring market efficiency for debt securities. Adding to that difficulty, thus far there is little scholarly literature about, and only a few courts have addressed, market efficiency for bonds."[133] This uncertainty reflects a continuing debate over efficiency in debt markets in the academic field as well.[134]

And although there is very little discussion regarding markets in bankruptcy, it appears that most studies just assume a lack of any efficient

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[131] Robert J. Stark, Jack F. Williams & Anders J. Maxwell, *Market Evidence, Expert Opinion, and the Adjudicated Value of Distressed Businesses*, 68 BUS. LAW. 1039, 1059–60 (2013).

[132] *See, e.g.*, Hui-Ju Tsai, *The Informational Efficiency of Bonds and Stocks: The Role of Institutional Sized Bond Trades*, 31 INT'L REV. ECON. & FIN. 34, 34 (2014) ("Although there is extensive research on the informational efficiency of stock markets, the studies on the informational efficiency of bond markets were quite limited until . . . 2002.").

[133] 529 F. Supp. 2d 644, 748 (S.D. Tex. 2006); *see also* Thomas S. Green, Comment, *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, 1172–75 (2016).

[134] *See, e.g.*, Aurelio Fernández Bariviera, M. Belén Guercio & Lisana B. Martinez, *Informational Efficiency in Distressed Markets: The Case of European Corporate Bonds*, 45 ECON. & SOC. REV. 349, 351 (2014) ("Corporate bond markets are some of the least studied markets in the financial literature."); Chris Downing, Shane Underwood & Yuhang Xing, *The Relative Informational Efficiency of Stocks and Bonds: An Intraday Analysis*, 44 J. FIN. & QUANTITATIVE ANALYSIS 1081, 1081–82 (2009) (noting that because the "market for corporate bonds has long been relatively opaque[,] . . . previous studies of the relation between stock and bond returns have drawn conflicting conclusions from dealer quotes of uncertain quality, or narrow datasets that leave the generality of the results open to question"); Umit G. Gurun, Rick Johnston & Stanimir Markov, *Sell-Side Debt Analysts and Debt Market Efficiency*, 62 MGMT. SCI. 682, 682 (2015) ("[T]he public debt market is on average larger than the equity market . . . , but it is also less liquid and less efficient . . . ."); Konstantinos Tolikas, *The Relative Informational Efficiency of Corporate Retail Bonds: Evidence from the London Stock Exchange*, 46 INT'L REV. FIN. ANALYSIS. 191, 192 (2016) ("[C]orporate bonds usually trade in a rather opaque environment with only a few market professionals that have access to information such as the prices at which dealers are willing to transact and the actual prices of completed bond trades. As a result, the literature on various aspects of the corporate bond markets is quite limited and rather inconclusive.").

market given the individualized negotiations that occur in bankruptcy when reaching terms on reorganization debt. As was summarized by Professor Gilson and others:

> The factors that lead to a reliable estimate of value in a market process are absent in bankruptcy. There is no active market for control of the assets of the bankrupt firm because it is strongly discouraged by the structure of Chapter 11. There is no oversight from the capital markets because management has access to debtor-in-possession financing. The securities of bankrupt firms often trade infrequently. . . . Perhaps as a result, there is very limited analyst coverage. This absence of market forces makes valuation more complex and less precise.[135]

All of these doubts lend credence to the Court's dubiety over an efficient market in car loans expressed in *Till*.[136]

These ambiguities and inefficiencies have caused some judges to rely upon matters related to intrinsic valuations. The reason is simple. As stated by Judge Sontchi: "In the majority of instances in Chapter 11 in which valuation is implicated, . . . market data will be unavailable or inapplicable."[137]

Even if there were efficient debt markets, it is not clear that the price obtained in such a market will provide the type of value required by the historic reorganization cases and § 1129(b)(2). First, rates for new loans have components not appropriate for a cramdown, such as initiation costs and profit components.[138] This fact points to two possible conclusions. First, any court dealing with so-called market evaluations must reduce the "market" rate to negate such profit elements. Second, the court should conclude that the market for bonds or loans generally is not the same market as reorganization debt, given that reorganization debt has at least an implicit assumption that the debt

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[135] Stuart C. Gilson, Edith S. Hotchkiss & Richard S. Ruback, *Valuation of Bankrupt Firms*, 13 REV. FIN. STUD. 43, 43–44 (2000) (internal citations omitted).

[136] Till v. SCS Credit Corp., 541 U.S. 465, 481 (2004) ("Moreover, several considerations suggest that the subprime market is not, in fact, perfectly competitive.").

[137] Christopher S. Sontchi, *Valuation Methodologies: A Judge's View*, 20 AM. BANKR. INST. L. REV. 1, 14 (2012).

[138] *See* GMAC v. Valenti (*In re* Valenti), 105 F.3d 55, 63–64 (2d Cir. 1997), (stating that cramdown is intended to "put the creditor in the same economic position that it would have been in had it received the value of its allowed claim immediately. . . . [T]he value of a creditor's allowed claim does not include any degree of profit. The purpose is not to put the creditor in the same position that it would have been in had it arranged a 'new' loan").

will be held to term and not traded. Either one of these conclusions is inconsistent with an efficient market.

Second, a related notion is that just because there are willing buyers and sellers of such debt does not mean that there are willing buyers and sellers of cramdown loans generally—indeed, the whole structure of cramdown seeks to relieve the debtor and its other creditors of the lack of a seamless market in reorganization debt. The full and precise payment of secured creditors is a lesser value than the reorganization of a viable company—so long as the secured creditor receives the equitable equivalent of the value of its prepetition debt.

Finally, an efficient market typically assumes that all past and present relevant information is known to the market participants. While this may be arguable for general debt securities, it is not tenable for reorganization debt. Such debt is typically the subject of litigation and negotiation between and among the relevant parties—with the motives and the offers and counteroffers remaining private. A debtor in possession, for example, may offer or accept an interest rate not because it bears some symbiotic relationship to a market rate, but because it is a compromise for give and take on other issues.

An example might be a lender's acceptance of a lower rate in return for an agreement not to pursue preferences or fraudulent transfers—price decisions particular to the holders of the debt but irrelevant to any market participant who might buy the debt instrument down the way. Put another way, the rates the parties demand or offer are not rates designed for a market trade or necessarily connected to the risks and rewards of the debt to which they are attached. As Professor Gilson has noted: "U.S. bankruptcy law resolves valuation through negotiation."[139]

IV. *MOMENTIVE* AND CHAPTER 11

The debate over *Till*'s application in chapter 11 came to a flash point in August of 2014 when Bankruptcy Judge Robert Drain of the Southern District of New York issued a decision confirming a chapter 11 plan for Momentive Performance Materials Inc. ("Momentive").[140] As chapter 11 plans go, the broad structure of Momentive's plan was fairly vanilla financial restructuring:

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[139] Gilson, Hotchkiss & Ruback, *supra* note 135, at 44.

[140] *Momentive*, 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), *appeal docketed*, No. 15-1771 (2d Cir. filed June 1, 2015).

junior levels of debt agreed to cancel their interests, contribute cash, and receive all the equity interests in the reorganized debtor.[141] All interests, debt or equity, junior to them would be eliminated.[142] General unsecured creditors would be undisturbed and paid in full.[143] Secured creditors would be paid in accordance with the Code.[144]

This last point, however, proved contentious. There was no agreement on what the secured creditors were due, or what constituted permissible treatment of their claims. For their part, the secured creditors, who were oversecured, believed that they were owed not only their principal and accrued interest, but also a “make whole” premium—a sum of cash calculated to compensate a lender for prepayment of an above-market loan. The debtors countered that such make whole premiums were not payable under the loan documents, and in any event ran contrary to the Code’s disallowance of unmatured interest.

As an alternative to litigating the dispute, the debtor proposed a plan with a so-called “death trap” voting provision[145]: if the class of secured creditors voted for the plan, the class members would receive a cash payment equal to their principal and accrued interest, albeit without any payment of a contested make whole premium.[146]

If, however, the secured creditor class rejected the plan, the cash payment was off the table. Instead, the debtor would cram down the secured creditors’ claims over approximately seven years at an interest rate of 4.1% to 4.85%,[147] a rate not only below that stated in the original debt instruments, but also below what Momentive had agreed to pay to obtain a loan facility to take out the lenders had they accepted the plan. Indeed, when Momentive filed its Form 10-K after consummating its plan, it estimated that the rate ultimately imposed

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[141] *See* Disclosure Statement for Joint Chapter 11 Plan of Reorganization for Momentive Performance Materials Inc. & Its Affiliated Debtors at 28–54, *Momentive*, No. 14-22503-rdd (Bankr. S.D.N.Y. Sept. 9, 2014), ECF No. 516, 2014 WL 4255110, at *28–54.

[142] *Id.*

[143] *Id.*

[144] *Id.*

[145] *Momentive*, 2014 WL 4436335, at *11. These provisions are often called “toggle provisions,” or “fish-or-cut-bait” provisions.

[146] Disclosure Statement for Joint Chapter 11 Plan of Reorganization for Momentive Performance Materials Inc. & Its Affiliated Debtors, *supra* note 141, at 35–36. Make whole premiums are amounts payable upon payment of a loan before maturity that are designed to compensate a lender for the interest that will not accrue due to early payment.

[147] *Id.* The rate in the plan was even lower; Judge Drain increased the risk premium by 50 basis points, or 0.5% overall. *Momentive*, 2014 WL 4436335, at *32.

was approximately 87% of what a market rate would be.[148] Some commentators have estimated that this discount cost the secured creditors $200 million.[149]

Intense debate has followed Judge Drain's decision.[150] This Article takes the position that his decision was correct, and should be affirmed, even though it was not the only correct decision that could have been made.

A. The Debtor

Momentive was in the silicone business. It had over $2.1 billion in sales in the year before bankruptcy and employed over 4,500 people. It also had been the subject of a leveraged buyout from Apollo Global Management in 2006.[151] It also had a lot of debt—more than 16 times its annual cash flow before taxes and depreciation.[152]

B. The Secured Parties

Much of Momentive's debt was incurred in 2012, when Momentive had issued two classes of senior secured notes. The first series, in the amount of $1.1 billion, was issued at an interest rate of 8.875% ("First Lien Notes").[153] The second series, in the amount of $250 million, was issued at an interest rate of 10% ("1.5 Lien Notes").[154] Both the First Lien Notes and the 1.5 Lien Notes matured in 2020.[155] Both series were secured by all or virtually all of Momentive's assets.

Momentive issued a third series of secured notes in 2010. These notes were in the aggregate principal amount of $1.161 billion, and were secured by the same assets, but were contractually junior in priority to the First Lien Notes

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[148] Momentive Performance Materials, Inc., Annual Report (Form 10-K), at 51 (Mar. 30, 2015).

[149] Michael Vitti, *Taking a Deeper Look into* Momentive*, Part 1*, QUICKREAD (Dec. 22, 2015), http://quickreadbuzz.com /2015/12/22/taking-a-deeper-look-into-momentive-part-1/.

[150] *See, e.g.*, Alec P. Ostrow, *Chapter 11 Cramdown Interest Rates: The Momentum Tilts Toward Chapter 13*, *in* 2015 NORTON ANN. SURV. BANKR. L. 3; Mark J. Thompson & Katie M. McDonough, *Lost in Translation:* Till v. SCS Credit Corp. *and the Mistaken Transfer of a Consumer Bankruptcy Repayment Formula to Chapter 11 Reorganizations*, 20 FORDHAM J. CORP. & FIN. L. 893, 923 (2015).

[151] Disclosure Statement for Joint Chapter 11 Plan of Reorganization for Momentive Performance Materials Inc. & Its Affiliated Debtors, *supra* note 141, at 17–23.

[152] *Id.* at 28.

[153] *Id.* at 24.

[154] *Id.* at 25.

[155] *Id.* at 24–25.

and the 1.5 Lien Notes.[156] They were set to mature in 2021.[157] Apollo, who had engineered Momentive's leveraged buyout, held most of the notes. It also beneficially held most of the equity in the debtor.[158]

C. Confirmation and Cramdown

Momentive's disclosure statement indicated that it had a debt-free value of somewhere between $2 billion and $2.4 billion.[159] No party seriously challenged this entity valuation,[160] even though this valuation put Apollo's Second Lien Notes at risk of being at least partially undersecured while confirming that the First Lien Notes and the 1.5 Notes were oversecured. At the same time, the prepetition debt service on all Momentive's debt was approximately $288 million per year, some $200 million more than its earnings before taxes and depreciation.[161]

To reduce this debt service, Momentive sought to take advantage of the fact that the market had changed from 2012 when it had issued the First and 1.5 Lien Notes—interest rates had dropped significantly. In such circumstances, it is textbook bankruptcy law that a debtor can cram down a secured creditor's claim by giving it a continuing lien on its collateral and a stream of payments that has a present value equal to the allowed amount of its claim.[162] This treatment favors debtors because the interest rate necessary to discount the stream of payments will track interest rates extant at the time of the bankruptcy filing. Using these reduced rates, a debtor can essentially unilaterally refinance its existing debt at lower rates.

But the lenders had anticipated this strategy. Their loan documents required Momentive to pay make whole premiums in the case of any prepayment.[163] Essentially, a make whole premium is an amount equal to the lost interest

[156] *Id.* at 25.
[157] *Id.*
[158] *Id.* at 27 (noting Apollo owned a "significant portion of the Second Lien Notes").
[159] Notice of Filing of Certain Exhibits to Disclosure Statement for Joint Chapter 11 Plan of Reorganization for Momentive Performance Materials Inc. & Its Affiliated Debtors at 43, Exhibit C, *In re* MPM Silicones, LLC (*Momentive*), No. 14-22503-rdd, 2014 WL 4436335 (Bankr. S.D.N.Y. June 11, 2014), *aff'd*, 531 B.R. 321 (S.D.N.Y. 2015), *appeal docketed*, No. 15-1771 (2d Cir. filed June 1, 2015), 2014 WL 2917134, at *43.
[160] *See Momentive*, 2014 WL 4436335, at *10.
[161] Disclosure Statement for Joint Chapter 11 Plan of Reorganization for Momentive Performance Materials Inc. & Its Affiliated Debtors, *supra* note 141, at 26–28.
[162] *See* 7 COLLIER ON BANKRUPTCY, *supra* note 7, ¶ 1129.04[2][a].
[163] *See Momentive*, 2014 WL 4637175, at *10.

between (1) what was originally agreed to be paid if the loan were held to maturity; and (2) the interest paid to the date of the prepayment. In the end, the goal is to put the secured creditor in the same position as if the loan had not been repaid.[164]

Momentive, understandably, did not want to pay that much. So it proposed a plan under which, if the noteholder classes accepted, Momentive would pay cash to the First Lien Notes and the 1.5 Lien Notes in an amount equal to their face amount, along with accrued interest.[165] The amounts to be paid, however, did not include any amount allocable to the make whole premiums.[166] Momentive would finance this payment by borrowing money under a facility previously obtained at the time of the bankruptcy filing.[167]

If the noteholders rejected this proposed treatment, Momentive created a "death trap": a different and less favorable treatment if it had to confirm the plan over the note holders' objections. The less favorable treatment still purported to pay the note holders in full, without payment of the make whole premium.[168] Momentive no longer, however, would pay cash.[169] Rather, it proposed to give a note that would pay the claims over time at an interest rate crafted according to *Till*.

This crafted interest rate, to no one's surprise, was low—the debtor keyed the rate payable to the seven-year Treasury note rate plus 1.5% for the First Lien Notes, and the same Treasury note rate plus 2% for the 1.5 Lien Notes.[170] These rates worked out initially to be 3.6% on the First Lien Notes and 4.1% on the 1.5 Lien Notes.[171] In short, they went for broke in suggesting *Till* controlled. Judge Drain gave reasoned support to their position.

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[164] See Bruce A. Markell, *"Shoot the. . .": Holes in Make Whole Premiums,* 36 BANKR. L. LETTER No. 5 (Thomson Reuters, St. Paul, Minn.), May 2016, at 1, 2–3, 4, for my discussion of the make-whole premiums issues in *Momentive*.

[165] Disclosure Statement for Joint Chapter 11 Plan of Reorganization for Momentive Performance Materials Inc. & Its Affiliated Debtors, *supra* note 141, at 35–36.

[166] *Id.*

[167] *Id.* at 40. The interest rate payable on this facility was more than the proposed interest rate on the replacement notes.

[168] *Id.* at 35–36.

[169] *Id.*

[170] *Momentive*, No. 14-22503-rdd, 2014 WL 4436335, at *24 (Bankr. S.D.N.Y. Sept. 9, 2014), *aff'd*, 531 B.R. 321 (S.D.N.Y 2015), *appeal docketed*, No. 15-1771 (2d Cir. filed June 1, 2015).

[171] *Id.*

D. Till *Adopted; Market Spurned*

Judge Drain started his analysis by restating *Till*: in chapter 13, the applicable statute does not require a market-based analysis, but rather permits a discount rate tied to the prime rate.[172] He then assessed whether the Court's interpretation of chapter 13's provision, § 1325(a)(5), had relevance in chapter 11. He found it did, quoting the Supreme Court to the effect that: "Congress likely intended bankruptcy judges and trustees to follow essentially the same approach when choosing an appropriate interest rate under any of the many Code provisions requiring a court to discount a stream of deferred payments back to their present dollar value."[173]

From this perspective, he compared §§ 1325(a)(5) and 1129(b)(2)(A)(i)(II) and concluded that "there is no sufficiently contrary basis to distinguish the chapter 13 and chapter 11 plan contexts in light of the similarity of the language of the two provisions and the underlying present value concept that *Till* recognized should be applied uniformly throughout the Code."[174] Judge Drain then categorized and dismissed, as did the Court in *Till*, various market-based discount rates produced by the coerced loan and presumptive contract rate. These methods sought to give the secured creditor in essence a refinanced new loan by using a discount rate provided by the market and the individual costs of the creditor.

As the bankruptcy court stated, "[t]he purpose is *not* to put the creditor in the same position that it would have been in had it arranged a 'new' loan."[175]

So what was the goal? As Judge Drain noted:

> *Till* distinguished the cramdown rate from market loans; the former does not require the lender to be indifferent compared to the result in a foreclosure, where the creditor could then re-lend the proceeds in the marketplace, and should not "overcompensate[] creditors because the market lending rate must be high enough to cover factors, like lenders' transaction costs and overall profits, that are no longer relevant in the context of court-administered and court-supervised cramdown loans."[176]

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[172] *Id.* at *23–24.
[173] *Id.* at *24 (quoting Till v. SCS Credit Corp., 541 U.S. 465, 474 (2004)).
[174] *Id.* at *24.
[175] *Id.* at *25 (quoting *In re* Valenti, 105 F.3d 55, 63–64 (2d Cir. 1997)).
[176] *Id*. (quoting *Till*, 541 U.S. at 476–77).

The cramdown rate analysis, therefore, should focus on a rate that does not take market factors into account but, rather, starts with the riskless rate applicable to all obligations to be paid over time, adjusted for the risks unique to the debtor in actually completing such payment.[177]

Judge Drain then restated how to apply a *Till* formula-based rate:

> Under the formula approach, the proper rate for secured lenders' cramdown notes begins with a risk-free base rate, such as the prime rate used in *Till*, or the Treasury rate used in *GMAC v. Valenti (In re Valenti)*, which is then adjusted by a percentage reflecting a risk factor based on the circumstances of the debtor's estate, the nature of the collateral security and the terms of the cramdown note itself, and the duration and feasibility of the plan.[178]

The risk factor adjustment then concerned the court. After noting that *Till* stated that "no adjustment whatsoever to the risk-free rate would be required if the Court found that the debtors were certain to perform their obligations under the replacement notes,"[179] the court concluded that market-based assessments of a discount rate particular to Momentive were not to be considered. As Judge Drain summarized:

> Therefore, as a first principle, the cramdown interest rate, under section 1129(b)(2)(A)(i)(II) of the Code, should not contain any profit or cost element, which were rejected by *Till* and the Second Circuit in *Valenti* as inconsistent with the present-value approach for cramdown purposes. In addition, market-based evidence should not be considered, except, arguably and, if so secondarily, when setting a proper risk premium in the formula approach taken by *Till* and *Valenti*.[180]

But what about footnote 14 and its suggestion of possibly different treatment for chapter 11 debtors? Judge Drain dismissed these arguments. First, he noted that the Supreme Court meant footnote 14 to acknowledge the involuntary nature of cramdown. The purpose of cramdown is not to provide property to creditors under terms that they would voluntarily make; it is to deliver to creditors a fair equivalent of their entitlements, even though the

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[177] *Id.* (quoting *Till*, 541 U.S. at 477–78) (citations omitted).

[178] *Id*. at *26.

[179] *Id.* The court quoted the Supreme Court: "We note that if 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." *Id.* (quoting *Till*, 541 U.S. at 479 n.18).

[180] *Id.*

creditor may not agree.[181] Second, he noted the inapplicability of the Court's reference in footnote 14 to debtor in possession financing to cramdown discount rates; the two types of loans operate on completely different assumptions.[182] Finally, Judge Drain rejected the creditor's argument that market rates should control when the market is efficient. The creditors argued that this criterion was satisfied if, as was the case with Momentive, there was trading in the debt.[183] Judge Drain rejected this argument, pointing out that the Court itself in *Till* was not convinced that the market for auto loans—ubiquitous and numerous as they may be—was an efficient market.[184]

The bankruptcy court then argued that *Till* was inconsistent with a two-step process taken by other courts—that is, figure out if a market is efficient, and then, only if it is not, apply *Till*.[185] The disconnect is that reorganization discount values are not market substitutes; it is simply not the case that the goal is to give the creditor property that the creditor can immediately turn around and sell and receive 100% of its claim.

The creditors next made a superficially appealing argument. The debtor had negotiated and obtained a take-out facility of over $1 billion to pay the note holders in case they accepted the plan.[186] That facility carried a higher rate than the cramdown rate proposed, a rate closer to 6% than to the 4% offered.[187] Since the loan facility was specific to Momentive, the creditors contended its interest rate should be used as the discount rate.

Judge Drain rejected this argument.[188]

> [I]t is clear to me that no private lender, including the lenders who the debtors have obtained backup takeout commitments from, would lend without a built-in profit element, let alone recovery for costs and fees, which also, as discussed above, is contrary to *Till* and *Valenti*'s first principles and the purpose of section 1129(b)(2)(A)(i)(II).[189]

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181 *Id.*

182 *Id.* at *27.

183 The creditors believed such a market existed for the reorganizations debt. The creditors' opening brief on appeal to the district court contained a graph of the market trading in the First Lien and 1.5 Lien notes. Reply Brief for Appellants at 4, BOKF, NA v. Momentive Performance Materials, Inc. (*In re* MPM Silicones, LLC), 531 B.R. 321 (S.D.N.Y. 2015) (Nos. 14 CV 7471(VB), et al.), ECF No. 17.

184 *Momentive*, 2014 WL 4436335, at * 27.

185 *Id.* at *28.

186 *Id.* at *29.

187 *Id.*

188 *Id.*

189 *Id.*

The creditors then engaged in a battle of the experts over the relative risk factors—the "plus" factor *Till* requires to be added to the base rate chosen.[190] In this regard, the court was performing the time-honored function of a trial court in assessing the credibility and veracity of witnesses. In this case, the debtor's witnesses won.[191] The court found that "a risk premium of 1.5 and 2 percent, respectively, for the two series of replacement notes is appropriate."[192] The court did, however, change the base rate used.[193] In *In re Valenti*, a Second Circuit case under chapter 13, the court had used the United States Treasury note rate as its base rate.[194] As the court noted in *Momentive*, the Treasury note rate "is often used as a base rate for longer-term corporate debt such as the replacement notes."[195] There is a difference between the prime rate and the rate for Treasury notes: the Treasury rate is assumed to be riskless, while the prime rate has some risk built into it.

As a result, the court thought that "there should be an additional amount added to the risk premium in light of the fact that the debtors used Treasury rates as the base rate."[196] The court added an additional increment of 0.5% for the first lien replacement notes, and an additional 0.75% for the 1.5 lien replacement notes.[197] Given that the seven-year Treasury rate was 2.1%, the court thus assigned a reorganization discount rate of 4.1% and 4.85% for the reorganization notes.[198]

The final rate contrasts with the then-prime rate of 3.25%, the exit financing rate of approximately 5% to 6%,[199] and the fact that these rates were almost a third of the 11% WACC that Momentive's own advisors had used in calculating reorganization value.[200] Momentive would later estimate that these

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190 *Id.* at *30.

191 *Id.* at *31.

192 *Id.* at *30. The court had noted that "the debt under the replacement notes is approximately 50 to 75 percent less than the value of the collateral therefor, and closer to 50 percent than 75 percent. Gross debt leverage also will substantially decrease under the plan, from 17.8 percent to 5.6 percent, or from $4.4 billion in debt down to $1.3 billion." *Id.*

193 *Id.* at *31–32.

194 105 F.3d 55, 64–65 (2d Cir. 1997).

195 *Momentive*, 2014 WL 4436335, at *32.

196 *Id.*

197 *Id.*

198 *Id.*

199 *Id.* at *34.

200 Momentive Performance Materials, Inc., Annual Report (Form 10-K), *supra* note 148, at 51.

reorganization discount rates were approximately 87% of what market rates would have been.[201]

V. POLICY CONSIDERATIONS IN SELECTING A DISCOUNT RATE

Any analysis of the application of *Till*'s formula rate in chapter 11 cases analysis must start with an examination and specification of the role and purpose of discount rates in cramdown. Creditors urge that § 1129(b)(2)(A)(i)(II) requires them to receive property that has 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."[202] They contend that the proper value is market value; their debt should be worth on the petition date what a third party would be willing to pay for it. Put another way, "the value of [the creditor's] interest" in its collateral is the value the market ascribed to that note. If conceded, then the hunt for a discount rate the market would assign is very relevant.

A. The Rejection of a Market Rate as Constituting Irrebuttable Evidence of a Proper Cramdown Interest Rate

But doctrine and history belie this argument. Initially, the starting point is *not* § 1129(b)(2)(A)(i)(II). It is § 1129(b)(1). Paragraph (1) sets the standard for cramdown—that the plan be "fair and equitable" as to the dissenting class; the treatments listed in paragraph (2) are but examples of that treatment. As shown above,[203] and as relevant to cramdown, there are three principles involved: "don't pay too little"; "don't pay too much"; and "don't expect precision."

With respect to the minimum payment under the "fair and equitable" standard, the Supreme Court has been clear for almost seventy-five years that the standard is one of a "fair equivalent" exchange. That is, the property the plan offers offered must be the "fair equivalent" of the property surrendered; the reorganization debt received must be the fair equivalent of the pre-petition debt discharged. This much may not be objectionable at a high level of abstraction: who can argue against a "fair equivalent"?

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[201] *Id.*
[202] 11 U.S.C. § 1129(b)(2)(A)(i)(II) (2012).
[203] *See supra* section II.B.

1. *Evidence That Congress Does Not Always Adopt Market Rates in Reorganization*

What does rankle secured creditors is that "fair equivalents" under *Till* and its progeny may leave them with property they cannot sell for the amount of the debt discharged. This result was not unanticipated. When Congress adopted the 1978 Code, it left in place the "fair and equitable" standard. The 1973 Commission explicitly decided to continue the standard,[204] although it made the standard "more flexible."[205] As to the application of the "fair and equitable" standard to reorganizations, the Commission made no new suggestions. It merely acknowledged the problems this lack of precision in the term could cause: "'Inequities are inevitable' and any conception about 'clear-cut rules about legal priorities is an unrealistic one.'"[206]

Indeed, the Code itself has several provisions that skew values in reorganization away from a market-based result. Section 1129(a)(7), for example, accepts the fact that a creditor with a debt bearing a below-market interest rate may receive less in reorganization than in liquidation.[207] Section 511 mandates an interest rate set by non-bankruptcy law for governmental entities.[208]

These exceptions lead away from pure market results. As a more recent court has phrased it,

> [w]hile [the lender] is undoubtedly correct that no willing lender would have extended credit on the terms it was forced to accept under the § 1129(b) cramdown plan, this "absurd result" is the natural consequence of the prime-plus method, which sacrifices market realities in favor of simple and feasible bankruptcy reorganizations.[209]

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[204] THE COMM'N ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. NO. 93-137, pt. 2 (1973).

[205] *Id.* cmt. 6.

[206] *Id.* pt. 1 (quoting Will, *supra* note 48, at 626).

[207] *See* 11 U.S.C. § 1129(a)(7). The best interest test applies only to impaired creditors. *Id.* § 1129(a)(7)(A)(ii). If a creditor with a below market rate of interest is left unimpaired under § 1124, then the value of the property received will be less than they would have received in liquidation.

[208] *See id.* § 511 (specifying that non-bankruptcy rates of interest should be used for certain types of claims held by governmental entities).

[209] *In re* Tex. Grand Prairie Hotel Realty, L.L.C., 710 F.3d 324, 336 (5th Cir. 2013).

2. *Protecting Restrictions on Potential Overpayment*

To put it in simple terms, the full and precise payment of secured creditors is a lesser value than the reorganization of a viable company—so long as the secured creditor receives the equitable equivalent of the value of its pre-petition debt.[210]

Why tolerate this less-than-full market-based compensation? It is a version of the "don't pay too much" argument. Lower valuations of collateral (and of businesses) result in reduced or eliminated participation for junior interests.[211] If the lower valuation results from the use of a metric that factors in a bankruptcy taint, there is a policy position that such reduction or elimination is improper and unfair. As stated in *In re New York, New Haven and Hartford R.R.*, "[t]he stigma of bankruptcy alone is a factor that will seriously depress the market value of a company's securities."[212] After all, reorganization is supposed to result in a rescue based on future prospects; and the use of a tainted discount rate would then set the participation in that future venture at values at odds with the goal.

On this point, the American Bankruptcy Institute's recent chapter 11 study goes astray.[213] The Commission's Report recommended market-based interest

[210] There is a relationship between risk factors under *Till* and the feasibility requirement of § 1129(a)(11). Paragraph (11) only requires that the court find it more likely than not that a plan is feasible; the risk factors contemplated by *Till* would seem to involve assessing success above the simple more likely-than-not stage. *Accord* Till v. SCS Credit Corp., 541 U.S. 465, 466 (2004); *see* 11 U.S.C. § 1129(a)(11).

[211] *See In re* 620 Church St. Corp., 299 U.S. 24, 27 (1936).

[212] 4 B.R. 758, 791 (D. Conn. 1980). The Third Circuit echoed this concern in *In re Penn Central Transportation Co.*:

> [The parties have argued that] the market can be expected irrationally to undervalue the securities of a once-distressed company emerging from a lengthy reorganization. In re Missouri Pac. R. R., 39 F. Supp. 436, 446 (E.D.Mo.1941); See also Blum, The Law and Language of Corporate Reorganization, 17 U.Chi.L.Rev. 565, 566–69 (1950). That argument has considerable force when the securities in issue represent equity in, or long term interest bearing obligations of, a reorganized debtor. In such cases, the market value of the security will depend upon the investing public's perception of the future prospects of the enterprise. That perception may well be unduly distorted by the recently concluded reorganization and the prospect of lean years for the enterprise in the immediate future. Use of a substitute "reorganization value" may under the circumstances be the only fair means of determining the value of the securities distributed.

596 F.2d 1102, 1115–16 (3d Cir. 1979).

[213] COMM'N TO STUDY THE REFORM OF CHAPTER 11, AM. BANKR. INST., FINAL REPORT AND RECOMMENDATIONS 234–37 (2014).

rates be used in cramdown situations.[214] Specifically, the Report stated that courts should look at many factors and reject a straight application of *Till*:

> In selecting the appropriate discount rate, the court should consider the evidence presented by the parties at the confirmation hearing and, if practicable, use the cost of capital for similar debt issued to companies comparable to the debtor as a reorganized entity, taking into account the size and creditworthiness of the debtor and the nature and condition of the collateral, among other factors. If such a market rate is not available or the court determines that an efficient market does not exist, the court should use an appropriate risk-adjusted rate that reflects the actual risk posed in the case of the reorganized debtor, considering factors such as the debtor's industry, projections, leverage, revised capital structure, and obligations under the plan. The court should not apply the "prime plus" formula adopted by the Supreme Court in *Till v. SCS Credit Corp.*, 541 U.S. 465 (2004) in the chapter 11 context.[215]

As stated in the Report, "[t]he objective is to make sure payments received by the secured creditor in the future represent the value of its secured claim on the effective date."[216] To achieve this goal, the Report further states that § 1129(b)(2)(A) should provide creditors with deferred cash payments that reflect economic realities. Section 1129(b)(2)(A), the Report contends,

> was intended to provide the secured creditor with the value of its allowed secured claim as of the effective date of the plan, even if that amount would be paid over an extended period of time. In other words, the secured creditor should receive the same return, regardless of whether the debtor elects to pay the allowed secured claim in cash on the effective date or through deferred cash payments over several years. Accordingly, the discount rate applied to the deferred cash payments should reflect the economic realities of the case, including the rate of interest available on similar debt and risks associated with the future income stream available to fund the payments.[217]

This discussion is odd for several reasons. First, the Commission read § 1129(b)(2)(A) without any acknowledgment that it constitutes an example of the more general and controlling standard of "fair and equitable" as used in § 1129(b)(1). Second, the Commission did not consider the history and doctrine of the "fair and equitable" doctrine, nor any discussion of any

[214] *Id.* at 234–37.
[215] *Id.* at 234.
[216] *Id.* at 235.
[217] *Id.* at 236–37.

Supreme Court decision before *Till* discussing the "fair and equitable" standard. Finally, there is no hint that valuation methods might be imprecise, and that this imprecision could hurt, as well as help, both debtors and creditors. In short, it is a one-sided discussion, focusing on what I have called the "don't pay too little" question, while ignoring the "don't pay too much" and "don't expect precision" inquiries.

Not surprisingly, the Commission rejected *Till*, but it is unclear exactly on what grounds. The Commission's Report states that "the discount rate used in that prime plus formula is not based on the economic realities of the particular case. Consequently, this interpretation likely undercompensates creditors for the risk present in the post-confirmation credit."[218]

This statement is also odd in that it ignores legitimate interests of plan proponents by focusing solely on the creditor's interest in compensation. By trying to ensure secured creditors receive "at least" the amount of their secured claim,[219] the Commission's Report fails to appreciate that anything over that amount, caused by errors in inputs or methodologies, is overcompensation that deprives participation for holders of junior interests. The Commission's Report appears to believe that precise values can be placed on reorganization securities (or that any market for these new securities would reliably price them), thus ignoring my final apothegm, "don't expect precision."

The Commission's Report also does not address one of Judge Drain's other concerns from *Momentive*. As he noted, rates for loans priced by the market have components not appropriate for a cramdown, such as initiation costs and profit components.[220] Allowing valuations methodologies that include this component decreases valuation at the expense of junior creditors—a further example that would violate the general principle of "don't pay too much."

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[218] *Id.* at 237.

[219] *Id.* at 234.

[220] Judge Drain quoted *In re Valenti* in stating that cramdown is intended to "put the creditor in the same economic position it would have been in had it received the value of its allowed claim immediately . . . the value of a creditor's allowed claim does not include any degree of profit. The purpose is not to put the creditor in the same position that it would have been in had it arranged a 'new' loan." *Momentive*, No. 14-22503-rdd, 2014 WL 4436335, at *25 (Bankr. S.D.N.Y. Sept. 9, 2014), *aff'd*, 531 B.R. 321 (S.D.N.Y. 2015), *appeal docketed*, No. 15-1771 (2d Cir. filed June 1, 2015) (quoting 105 F.3d 55, 63–64 (2d Cir. 1997)).

3. The Role of Precision and Expectations

The rejection of a pure market-based method also borrows from the "don't expect precision" argument. As the Supreme Court stated early on in *Group of Institutional Investors v. Chicago, Milwaukee, Saint Paul & Pacific R. R. Co.*: "[W]hatever may be 'the pretenses of exactitude' in determining a dollar valuation for a railroad property, 'to claim for it "scientific" validity, is to employ the term in its loosest sense.'"[221] Indeed, some inaccuracy is to be expected. To be efficient, markets need information, and that relevant information may be scarce or conflicting in a chapter 11 case, either because of uncertainty over the legal issues involved,[222] omnibus deals made that only incidentally affect the rationality of the discount rate,[223] or just the mass of information disseminated in the chapter 11 case.[224]

The history of valuation in bankruptcy supports the Supreme Court's wariness. Courts have shifted among valuation methodologies over time, from capitalized earnings to discounted cash flow to beta analysis.[225] Indeed, new methods may be on the horizon in terms of the use of credit derivatives.[226] Reducing or eliminating a stakeholder's rights and participation on the basis of the latest product of financial wizardry may be unfair to those holding junior interests, especially when Congress has not specified any particular interest rate to be used, which it has done in other areas.[227]

B. Not Irrebuttable, But Not Irrelevant Either

Does this mean that market rates are irrelevant? The answer is no, but that answer has more to do with valuation procedure and how courts view valuation methodologies than anything else. Start first with the nature of the decision the bankruptcy court has to make. The statute requires the court to determine the

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221 318 U.S. 523, 565 (1943) (quoting Nashville, Chattanooga & Saint Louis Ry. v. Browning, 310 U.S. 362, 370 (1940)).

222 In *Momentive*, in addition to the ultimate decisions on whether the inter-creditor agreements allowed Apollo to sponsor Momentive's plan, the resolution of the issues of the validity of make whole premiums, and of the applicable discount rate were unknown before Judge Drain's ruling. *See Momentive*, 2014 WL 4436335, at *19–20.

223 *Id.* at *11.

224 *See, e.g.*, *In re* N.Y., New Haven & Hartford R.R. Co., 4 B.R. 758, 791 (D. Conn. 1980).

225 *See generally* Michael Simkovic, *The Evolution of Valuation in Bankruptcy*, AM. BANKR. L.J. (forthcoming 2016) (manuscript at 1), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2810622.

226 *Id.* at 5–6.

227 *See, e.g.*, 11 U.S.C. § 511 (2012) (specifying interest rate to be used in plan for certain types of debt owed to government entities).

present value of the reorganization debt, which will usually be the valuation of a promise. How is that done? As the Supreme Court determined, speaking through Justice Douglas: "Whether in a given case senior creditors have been made whole or received 'full compensatory treatment' rests in the informed judgment of the [the trier of facts] on consideration of all relevant facts."[228] Does this mean that the selection of an appropriate discount rate is an issue of fact or an issue of law?[229]

The characterization matters. If an issue of fact, then the bankruptcy court could be reversed only if the selection of a particular method of valuation was clearly erroneous. This could happen, for example, if the bankruptcy court spurned the use of future earnings in conducting its valuation and focused only on past offers to buy the business.[230] If an issue of law, however, then a de novo standard of review applies, with the appellate court in a position to choose the appropriate valuation method.

Courts are somewhat conflicted over the appropriate characterization.[231] As recently stated in *Alberts v. HCA, Inc.*, however, the authorities "stating that a bankruptcy court's valuation determinations are issues of fact" are in fact "more persuasive and appear to represent the majority view."[232] If followed, this characterization gives bankruptcy courts, as the initial trier of fact, great latitude to adopt and adapt valuation methodologies—so long as they adhere to the general guidelines that they must look to the future, not to the past.

Might a bankruptcy court consider market rates in its determination of an appropriate discount rate? The answer is yes, if done cautiously. If the rates

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[228] Grp. Of Inst. Inv'rs v. Chi., Milwaukee, Saint Paul & Pac. R.R., 318 U.S. 523, 565 (1943).

[229] For an excellent article that touches on many of this issues in this section, see Anthony J. Casey & Julia Simon-Kerr, *A Simple Theory of Complex Valuation*, 113 MICH. L. REV. 1175 (2015).

[230] *See, e.g.*, Protective Comm. for Indep. Stockholders of TMT Trailer Ferry, Inc. v. Anderson, 390 U.S. 414, 442 n.20 (1968) (reversing the lower court because it had not looked to future earnings in an absolute priority valuation).

[231] Cases favoring a clearly erroneous standard include: Alberts v. HCA, Inc., 496 B.R. 1, 14 n.6 (D.D.C. 2013); Estate of Godley v. Comm'r, 286 F.3d 210, 212 (4th Cir. 2002) (finding valuation methodology is "part of the larger factual question of valuation" and this issue is reviewed for clear error); Gross v. Comm'r, 272 F.3d 333, 343 (6th Cir. 2001) ("The choice of the appropriate valuation methodology for a particular stock is, in itself, a question of fact.") (citations omitted); Sammons v. Comm'r, 838 F.2d 330, 334 (9th Cir. 1988) (determining whether the Tax Court appropriately selected cost method of valuing art collection is question of fact reviewed for clear error). Cases favoring a de novo standard include: McGarey v. Midfirst Bank (*In re* McGarey), 529 B.R. 277, 282 (D. Ariz. 2015); Nat'l Rural Utils. Coop. Fin. Corp. v. Wabash Valley Power Ass'n, 111 B.R. 752, 767 (Bankr. S.D. Ind. 1990) ("The bankruptcy court's selection and application of valuation methodology is primarily a legal matter.").

[232] 496 B.R. at 13.

found in the market are shown to be sufficiently reflective of the risks inherent in the plan of reorganization, then market rates may influence the increase to the risk-free rate used in *Till*.[233] Judge Drain recognized this point: "[M]arket-based evidence should not be considered, *except*, arguably and, if so secondarily, when setting a proper risk premium in the formula approach taken by *Till* and *Valenti*."[234]

This point is underscored by the statutory analysis employed in *Till*. In footnote 14, the Supreme Court provided a very short and cryptic dicta when interpreting what the appropriate discount rate might be: "[I]t might make sense to ask what rate an efficient market would produce."[235]

This approach makes prosecuting and proving cramdown cases perilous for lawyers. It means that value, and the discount rate used to obtain value, are factual matters subject to a deferential standard of review. But given the history of the "fair and equitable" rule, the goal of this inquiry is not to reach a "conclusion [that] correspond[s] to the valuation that the relevant community believes to be accurate"[236] Rather, the goal is to make

> a prediction as to what will occur in the future, an estimate, as distinguished from mathematical certitude. . . . But that estimate must be based on an informed judgment which embraces all facts relevant to future earning capacity and hence to present worth, including, of course, the nature and condition of the properties, the past earnings record, and all circumstances which indicate whether or not that record is a reliable criterion of future performance.[237]

As the Third Circuit noted:

> [T]he market can be expected irrationally to undervalue the securities of a once-distressed company emerging from a lengthy reorganization. . . . That argument has considerable force when the securities in issue represent equity in, or long term interest bearing obligations of, a reorganized debtor. . . . In such cases, the market value of the security will depend upon the investing public's

233 Casey & Simon-Kerr, *supra* note 229, at 1206 ("[W]hat judges are required and competent to do, in addition to excluding unqualified experts, is to question the assumptions that the experts make, to insist that experts persuade them that theirs is the best methodology, to be meticulous in questioning the pieces that make up that methodology, and to enforce the burden of proof.").

234 *Momentive*, No. 14-22503-rdd, 2014 WL 4436335, at *26 (Bankr. S.D.N.Y. 2014), *aff'd*, 531 B.R. 321 (S.D.N.Y. 2015), *appeal docketed*, No. 15-1771 (2d Cir. filed June 1, 2015) (emphasis added).

235 Till v. SCS Credit Corp., 541 U.S. 465, 476 n.14 (2004).

236 Casey & Simon-Kerr, *supra* note 229, at 1206.

237 Consol. Rock Prods. Co. v. Du Bois, 312 U.S. 510, 526 (1941).

> perception of the future prospects of the enterprise. That perception may well be unduly distorted by the recently concluded reorganization and the prospect of lean years for the enterprise in the immediate future. Use of a substitute "reorganization value" may under the circumstances be the only fair means of determining the value of the securities distributed.[238]

This policy of excising components of bankruptcy "taint" raises the stakes in "getting it right" at confirmation, and underscores the need for persuasive presentation of valuation evidence. Tied up in this analysis are two propositions: (1) "value" in § 1129(b)(2) can encompass a formula-based approach; and (2) determining the components of the formula need not turn a blind eye to market evidence to the extent that such evidence bears on the formula's risk factors (or to the extent that some other method of valuation exists that does not penalize the debtor for its status and focuses on future cash flow). Given the wide scope of "relevance" under the Federal Rules of Evidence,[239] this policy opens a wide door for market-based evidence. What it does not do, however, is change the formula into which such evidence is inserted.

CONCLUSION

I began with the assertion that valuation in reorganization is messy. This untidiness is exemplified by the process of selecting an appropriate discount rate to use to value a stream of payments under a plan of reorganization, and by the lack of indisputably accurate valuations. There is a natural tendency to factor in that the debtor, as the obligor on such payments, has already broken all its previous promises.

To counteract this gloomy perspective, reorganization doctrine and policy have always indicated that intrinsic value, not market-based prices, should have primacy in determining the value of a debtor or reorganization debt. But the inputs necessary to produce intrinsic value are flexible; a bankruptcy court can admit any evidence that tends to make a valuation opinion more or less likely. Thus, valuation can and usually is shown by whatever forward-looking relevant evidence can be adduced.

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[238] *In re* Penn Cent. Transp. Co., 596 F.2d 1102, 1115–16 (3d Cir. 1979) (citing *In re* Mo. Pac. R.R., 39 F. Supp. 436, 446 (E.D. Mo. 1941)). *Accord* Walter J. Blum, *The Law and Language of Corporate Reorganization*, 17 U. CHI. L. REV. 565, 566–69 (1950)).

[239] Under Federal Rule of Evidence 401, a fact is relevant if it is of consequence, and if it has "*any* tendency to make a fact more or less probable." FED. R. EVID. 401 (emphasis added).

There are, of course, limitations. Through a series of cases decided soon after the adoption of the current "fair and equitable" standard, the Supreme Court indicated a broad preference for evidence of future earning capacity over past values, for "fair equivalents" of value rather than mathematically precise determinations. This process is designed to produce property the value of which is the "fair equivalent" of the debt discharged in the reorganization, an exhortation to not pay too little to creditors.

At the same time, courts have indicated that the valuation evidence adduced needs to be stripped of components related to the taint of past failures; valuations are to be based upon reasonable future prospects, not on past or perceived present failures. This protects junior creditors and is an embodiment of the "don't pay too much" concept.

Against this background, *Till*'s formula-based approach provides a rough and ready "fair equivalent" of value as *Consolidated Rock* and its progeny require. The use of the *Till* formula is devoid of reliance on factors incorporating the debtor's past errors and does not treat the debtor as riskier just because of its bankruptcy filing.

Market-based rates, in contrast, inevitably incorporate elements that history and doctrine have tried to scrub from the reorganization process. They also imbue their results with far more precision than the facts in most reorganizations can justify, or the policy behind reorganization can tolerate. Until valuation practice produces better methodologies that fit within the boundaries of the "fair and equitable" standard set early on by the Supreme Court, or until Congress changes confirmation standards, *Till*'s formula-based discount rates will be unassailable in chapter 11.

BANKRUPTCY'S ENDOWMENT EFFECT

Anthony J. Casey[*]

ABSTRACT

In this Essay, I respond to Professor Markell's analysis of the recent controversy over the cramdown interest rate applied in corporate bankruptcies. I argue that the main source of controversy is a misperception that pervades much of bankruptcy law and scholarship. Namely, courts and scholars commonly assign undue importance to preserving creditors' nonbankruptcy endowments, which is inconsistent with foundational bankruptcy policy.

I make the case here that the guiding principle for optimal bankruptcy design should not be the preservation of nonbankruptcy rights but rather should be the minimization of opportunistic behavior that reduces the net value of a firm. Applying this principle to the question of the cramdown interest rate, I show that an optimal rule—properly focused on the minimization of opportunistic behavior—supports a cramdown interest rate based on the prevailing market rates for similar loans. Along the way I also show that this approach is consistent with the Bankruptcy Code and the theoretical principles (although not the ultimate conclusion) that Professor Markell has advocated.

INTRODUCTION

The endowment effect runs strong in corporate bankruptcy scholarship. Scholars commonly make the mistake of assuming that because a creditor is endowed with a right outside bankruptcy, that creditor must therefore be entitled to maintain the same right inside bankruptcy.[1] These scholars often

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[1] *See, e.g.*, OLIVER HART, FIRMS, CONTRACTS, AND FINANCIAL STRUCTURE 160 (Oxford 1995); Barry E. Adler & Ian Ayres, *A Dilution Mechanism for Valuing Corporations in Bankruptcy*, 111 YALE L.J. 83, 88–90 (2001); Barry E. Adler & George Triantis, Debt Priority and Options in Bankruptcy (Mar. 2, 2016) (unpublished manuscript) (on file with authors); Walter J. Blum, Commentary, *The "New Directions" for Priority Rights in Bankruptcy Reorganizations*, 67 HARV. L. REV. 1367, 1374 (1982) [hereinafter Blum, *New Directions*]; Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, 91 YALE L.J. 857, 857–58 (1982).

assert that this result is required by the foundational theory of bankruptcy—it is not—and then defend policy proposals as scrupulously protecting creditors' entitlements.[2]

Despite its popularity in academic scholarship, this idea of sacred endowments is an untenable position that misunderstands the fundamental principles of bankruptcy. Corporate bankruptcy is, at its core, a system that *alters* nonbankruptcy endowments according to a hypothetical bargain—hypothetical because it is not the one the parties actually entered into—that we assume all creditors of a firm would have entered into if bargaining were costless.[3] The entire point of that hypothetical bargain is to suspend and alter some nonbankruptcy endowments to protect other endowments that maximize the value of the bankruptcy estate[4] and the firm as a whole.[5] Indeed, if every party retained every nonbankruptcy endowment, the Bankruptcy Code (the "Code") would have no provisions at all.

Of course, altering nonbankruptcy endowments can impose costs. Foremost among those costs is the risk of opportunistic behavior.[6] We do not want to create incentives for parties to pursue (or avoid) a bankruptcy filing for the sole purpose of transferring (or avoiding the transfer of) value between stakeholders. Such opportunistic maneuvering is costly for the estate as a whole. Thus, optimal bankruptcy policy will be designed to achieve its estate-maximizing purpose in part by minimizing opportunistic bankruptcy behavior that destroys firm value. Protecting nonbankruptcy endowments can, in many cases, be a means to that end. But protecting those endowments is not, as many scholars appear to believe, an end in and of itself.[7]

The unwarranted focus on nonbankruptcy endowments is a mistake that bankruptcy law scholars commonly make, including scholars arguing for

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[2] *See* Adler & Ayres, *supra* note 1, at 88–90; Adler & Triantis, *supra* note 1; Jackson, *supra* note 1, at 857–58.

[3] Jackson, *supra* note 1, at 860.

[4] I use the term "estate" in a nontechnical sense throughout this Article to refer to the collective interests of all stakeholders, not just one class of creditors.

[5] Anthony J. Casey & Aziz Z. Huq, *The Article III Problem in Bankruptcy*, 82 U. CHI. L. REV. 1155, 1194 (2014) ("Bankruptcy's proper goal is rather best understood as one of limiting certain private rights to protect others.").

[6] *See* Jackson, *supra* note 1, at 869.

[7] I have made this point elsewhere. *See* Anthony J. Casey & Edward R. Morrison, Beyond Options (2016) (unpublished manuscript) (on file with authors); *see also* Douglas G. Baird, *Priority Matters*, 165 U. PA. L. Rev. (forthcoming 2016) (manuscript at 47–48) (on file with the University of Pennsylvania Law Review) [hereinafter Baird, *Priority Matters*].

absolute priority[8] as well as scholars arguing against it.[9] Courts and lawyers are no different. The recent and ongoing dispute over cramdown in *In re MPM Silicones, LLC* ("*Momentive*") provides a salient example.[10] The dispute in *Momentive* was about what interest rate the senior creditors would get in a chapter 11 cramdown.[11] The bankruptcy court ultimately decided the case by importing a creditor-endowment framework from consumer bankruptcy law.[12] That framework—the "*Till* formula" or "*Till* interest rate"—comes from the plurality opinion in *Till v. SCS Credit Corp*.[13] Eight of the nine Supreme Court Justices framed *Till* as an endowment case.[14] Indeed, the plurality and dissenting opinions in *Till* focused almost exclusively on ex ante endowments. The same was true of the bankruptcy court's opinion in *Momentive*. In each case, considerations about a properly designed bankruptcy system were conspicuously absent from the discussion.[15]

The result of all of this focus on endowments is that corporate bankruptcy scholarship and precedent are often bogged down in a back-and-forth about who is entitled to what, when the relevant question is what rule makes the most sense. The first part of Professor Markell's article on *Till* and *Momentive* provides a refreshing alternative. Instead of focusing on senior creditors'

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[8] Baird, *Priority Matters*, *supra* note 7, manuscript at 47–48; Casey & Morrison, *supra* note 7.

[9] Including me. Anthony J. Casey, *The Creditors' Bargain and Option-Preservation Priority in Chapter 11*, 78 U. CHI. L. REV. 759, 778 (2011); *see also* Melissa Jacoby & Edward Janger, *Ice Cube Bonds: Allocating the Price of Process in Chapter 11 Bankruptcy*, 123 YALE L.J. 862, 916, 918, 922 (2013); *cf.* Omer Tene, *Revisiting the Creditors' Bargain: The Entitlement to the Going-Concern Surplus in Corporate Bankruptcy*, 19 BANKR. DEV. J. 287, 396 (2003).

[10] *See In re* MPM Silicones, LLC (*Momentive*), 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), *appeal docketed*, No. 15–1771 (2d Cir. June 1, 2015).

[11] There was a separate dispute about make-whole payments that also focused on creditor entitlements, but the outcome there turned in large part on whether the state-law entitlements existed in the first place. *See* Bruce A. Markell, *"Shoot the. . .": Holes in Make-Whole Premiums*, 36 BANKR. L. LETTER No. 6 (Thomson Reuters, Saint Paul, Minn.), May 2016, at 3–4 [hereinafter Markell, *Make-Whole Premiums*].

[12] *Momentive*, 2014 WL 4436335, at *23–32.

[13] 541 U.S. 465, 478–80 (2004).

[14] Justice Thomas is the exception. *See Till*, 541 U.S. at 473–74, 489, 491–92 (Thomas, J., concurring) (focusing on statutory language rather than nonbankruptcy entitlements).

[15] The purpose of chapter 13 may be different enough to justify this approach in *Till*, but not in chapter 11 cases like *Momentive*. I discuss this briefly below, *infra* note 94. But my primary inquiry here is into the bankruptcy court's move to import *Till*'s analysis into chapter 11 corporate bankruptcies. *Momentive*, 2014 WL 4436335, at *23–32. In chapter 13 cases, we might worry about different things for policy reasons unrelated to corporate reorganization. Chapter 13 deals with individuals' and society's interest in providing opportunities for a fresh start. *See* H.R. REP. NO. 95-595, at 117 (1977). Chapter 13 also exists in a nonmarket environment—there is no going-concern sale, no DIP lender, and no market for exit financing. For individuals, there is simply the break-up of the assets (chapter 7) or the option to cram down a loan (chapter 13). Conditional upon being in chapter 13, the debtor is trying to keep things together without market support. We might not want to require an interest rate that makes it impossible to do that.

nonbankruptcy entitlements, Professor Markell marshals history and precedent to suggest three basic doctrinal principles that courts should follow in applying priority rules in chapter 11 cases: (1) "don't pay too little"; (2) "don't pay too much"; and (3) "don't expect precision." In doing so, he exposes the fallacies in commonly held notions (partially embraced by the *Till* dissent) that a creditor is somehow entitled to get exactly what it had before bankruptcy or to be made "subjectively indifferent between present foreclosure and future payment."[16] Professor Markell shows that there are no statutory or historical grounds for such arguments.

The Markell principles (as I will call them) not only have the support of history and caselaw, but they also make for good bankruptcy policy. But when Professor Markell attempts to operationalize his principles, bankruptcy's endowment effect sneaks back in. "Too much" and "too little" are defined for Professor Markell—just as they were for eight Justices on the *Till* Court—by reference to what the creditors are entitled to outside of bankruptcy. Here I must part ways with his analysis. Neither the history that Professor Markell presents[17] nor the statute that controls cramdown[18] requires this definition. Rather, Professor Markell convincingly shows us that the history leaves doubt about (and creates wiggle room for) how one should define entitlements. And the statute—as well as recent precedent interpreting it—suggests an altogether different inquiry, which has little to do with nonbankruptcy entitlements and much to do with implementing a coherent foundational theory of corporate reorganization. As such, I suggest a fourth and preeminent guiding principle that is supported by the statute and history: "do what makes sense." And on that front, the court in *Momentive* got things exactly wrong.

I proceed in four parts. In Part I, I briefly review the applicable statutory provisions, Professor Markell's historical insights on those statutes, and the import of recent Supreme Court cases interpreting them. I suggest, similarly to Professor Markell, that these foundations provide only general and uncertain guidance. But that guidance does foreclose certain forms of cramdown, including that which was used in *Till* (and imported to *Momentive*). I show, therefore, that, on the one hand, the application of the *Till* formula in *Momentive* is inconsistent with the Markell principles. On the other hand, the

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[16] Bruce A. Markell, *Fair Equivalents and Market Prices: Bankruptcy Cramdown Interest Rates*, 33 EMORY BANKR. DEV. J. 91, 114 (2016) [hereinafter Markell, *Fair Equivalents*] (quoting *Till*, 541 U.S. at 476 n.14 (2004)).

[17] *Id.* at 95–103.

[18] 11 U.S.C. § 1129(b) (2012).

foundational guidance does not foreclose a cramdown system that is consistent with and advances general policies of a properly functioning corporate bankruptcy system. The inferences one can, and should, draw support embracing a method and framework of cramdown that best advance the foundational theory of corporate bankruptcy and reorganization.

In Part II, I review and examine that foundational theory and explain how it relates to the cramdown process. The real question that emerges from the analysis is not who is entitled to what, but rather, how should one design a bankruptcy system that produces a coherent set of incentives and outcomes. I suggest that while properly designed bankruptcy law should not, and does not, require any special attention to senior creditor entitlements or to making a senior creditor subjectively indifferent between foreclosure and cramdown, the law does require a system that minimizes opportunistic behavior that would destroy firm value. That is, the bankruptcy system should minimize the extent to which it creates value-destroying opportunities for stakeholders to exploit the bankruptcy process to capture value from other stakeholders.

In Part III, I derive the optimal cramdown rule. A coherent cramdown system will not only prevent creditors from destroying value by opportunistically *opposing* a plan, but it will also prevent debtors from destroying value by opportunistically *proposing* cramdown. If a creditor can insist on foreclosing on an asset that has going concern value, it will make threats to extract rents. Those threats can lead to bargaining failures that destroy estate value. Similarly, if debtors get consistently better rates of interest in cramdown, they will flood courts with chapter 11 cases that never should have been filed. Moreover, debtors who otherwise would have filed will be artificially drawn toward proposing inefficient cramdown plans. They will even, as the debtors in *Momentive* did, make threats of or propose inefficient plans for the sole purpose of extracting rents from creditors.[19]

[19] According to the debtor's plan in *Momentive*, Momentive would pay cash to the First Lien Notes and the 1.5 Lien Notes in an amount equal to their face value, including accrued interest, if they agreed to the plan and dropped certain objections. Disclosure Statement for Joint Chapter 11 Plan of Reorganization for Momentive Performance Materials Inc. & Its Affiliated Debtors at 35–36, *In re* MPM Silicones, LLC, No. 14-22503-rdd (Bankr. S.D.N.Y. Sept. 9, 2014), ECF No. 516, 2014 WL 4255110, at *35–36. If the note holders rejected this proposed treatment, however, Momentive would pay the note holders over time at an interest rate crafted according to *Till*. *Id.* *See generally* Markell, *Fair Equivalents*, *supra* note 16, at 125 (discussing the ramifications of Momentive's proposed plan). The result was that the noteholders would receive lower value if they objected to the plan. *Id.*

Neither of these outcomes serves any valid purpose for corporate reorganization. Both can be avoided by a system that allows cramdown but tests its rate against the market alternatives that face a debtor at that time in the real world. I show that a focus on real-world market rates—and not intrinsic values—is necessary to properly align the incentives of those making the decision to pursue the cramdown option rather than the other options available in the market. In Part IV, I present examples and apply this framework to the specific facts of *Momentive*, showing how the focus on real-world market rates better aligns incentives and is more consistent with bankruptcy's fundamental purpose.

I. HISTORY, PRECEDENT, AND STATUTORY AUTHORITY

Many of the debates about entitlements are beyond the scope of this Article. There is no question that the absolute priority rule, in some form, is the current law of the land.[20] It is codified in chapter 11 through the words "fair and equitable."[21] That much is uncontroversial.[22] Accordingly, Professor Markell opens his discussion about cramdown with an informative and persuasive history of the statutory requirement that a plan be "fair and equitable."[23] From this history, he abstracts three general principles that form the core of absolute priority (and therefore govern cramdown): "don't pay too little"; "don't pay too much"; and "don't expect precision."[24]

These principles combine, Professor Markell tells us, into a standard of "fair equivalence."[25] So for cramdown, a creditor is entitled to a fair equivalent of its prepetition interest. That standard, of course, requires valuation of both the interest rate and the thing that purports to be its fair equivalent. The former is usually easy; the latter is often difficult. Recognizing this difficulty, Professor Markell invokes the "don't expect precision" principle to justify application of the *Till* formula. This is a mistake.

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[20] The absolute priority rule prevents equity holders from retaining or realizing any value in a reorganized debtor company unless creditors consent or are paid in full. *See* 11 U.S.C. § 1129(b); Bruce A. Markell, *Owners, Auctions, and Absolute Priority in Bankruptcy*, 44 STAN. L. REV. 69, 72 & n.17 (1991).

[21] 11 U.S.C. § 1129(b)(1).

[22] *See generally* Baird, *Priority Matters*, *supra* note 7, manuscript at 4.

[23] Markell, *Fair Equivalents*, *supra* note 16, at 95–103 (outlining the caselaw and legislative history behind the "fair and equitable" standard).

[24] *Id.* at 103–04.

[25] *Id.* at 104.

The *Till* formula applied to chapter 11 ironically gets everything backward. It is a formula that provides a precise but inequivalent payout, thus violating the Markell principles, while also violating the clear directives of the statute and distorting the bankruptcy process. Thus, while the Markell principles are sound in theory, the application here is not. To show this, I first examine the relevant statute and then turn to the Markell principles.

A. The Statutory Provisions: § 1129(b)(1) and § 1129(b)(2)

The statutory language is as good a place to start as any. The relevant provisions for cramming down a secured creditor are §§ 1129(b)(1) and 1129(b)(2)(A) of the Code. The first of these provisions requires that any cramdown plan must be "fair and equitable" with respect to the objecting class.[26] The second provision adds that the words "fair and equitable"—whatever else they may mean—at least include a specific set of requirements, which the provision lists.[27]

Professor Markell notes that the list of requirements in § 1129(b)(2) is not exhaustive.[28] Other things might also be required for a plan to be fair and equitable.[29] The non-exhaustive nature of § 1129(b)(2) is a crucial point that courts and scholars often ignore. It is not enough that a plan meet the requirements of § 1129(b)(2). It must also meet all other requirements that are implied by § 1129(b)(1)'s invocation of the words "fair and equitable."[30] Because that phrase has a long history, the list of implied requirements can be identified by looking at the application of § 1129(b) over the last century. Thus, for example, a plan cannot be fair and equitable if it overpays a class of creditors.[31]

But this analysis does not mean we can ignore § 1129(b)(2). In a sense, though, that is what *Momentive* does. Professor Markell seems to justify this

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[26] 11 U.S.C. § 1129(b)(1).

[27] The specific language states: "[T]he condition that a plan be fair and equitable with respect to a class includes the following requirements . . . ." *Id.* § 1129(b)(2). For cramming down a secured creditor, the plan is required to provide the creditor with one of these three things: (1) retention of its liens along with deferred cash payments "of a value, as of the effective date of the plan, of at least the value" of the creditor's interest in the property subject to the lien; (2) the right to credit bid in a sale of the property subject to the lien; or (3) the "indubitable equivalent" of the creditor's claims. *See id.* § 1129(b)(2)(A).

[28] Markell, *Fair Equivalents*, *supra* note 16, at 130.

[29] *Id.*

[30] *See In re* Castleton Plaza, LP, 707 F.3d 821, 823 (7th Cir. 2013) (noting that compliance with § 1129(b)(2) was not all that was required to satisfy absolute priority).

[31] Markell, *Fair Equivalents*, *supra* note 16, at 131.

outcome in *Momentive* by calling the requirements "examples."[32] But such justification cannot withstand scrutiny. The statute plainly calls them "requirements" for a plan to qualify as "fair and equitable."[33]

Moreover, the Supreme Court has made it clear that it does, in fact, view the provisions of § 1129(b)(2) as requirements—most recently in *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*.[34] In that case, a unanimous Court stated, "A Chapter 11 plan confirmed over the objection of a 'class of secured claims' must meet one of the three requirements in order to be deemed 'fair and equitable' with respect to the nonconsenting creditor's claim. The plan must provide [one of (i), (ii), or (iii)]."[35]

Prior to *RadLax*, the Court's opinion in *Bank of America National Trust & Savings Association v. 203 North LaSalle Street Partnership* expressed the same premise,[36] noting that a plan can be "fair and equitable" only if it complies with § 1129(b)(2).[37] The Court then went even further, suggesting that compliance with the requirements of § 1129(b)(2) was not only mandatory, but the validity of such compliance also must be *market tested*.[38] A mere judicial sense that the statute was being followed was not enough; a market test showing it to be true was required.[39]

These interpretations are consistent with the Court's general tendency—for better or worse—to restrict the discretion of bankruptcy judges in altering the rights of creditors.[40] To be sure, bankruptcy judges can alter those rights, but only according to very specific rules. This lesson has been repeated often in the Court's bankruptcy jurisprudence.[41]

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[32] *Id.* at 130.

[33] 11 U.S.C. § 1129(b)(2) ("[T]he condition that a plan be fair and equitable with respect to a class includes the following requirements . . . .").

[34] 132 S. Ct. 2065, 2069–70 (2012).

[35] *Id.* This interpretation is consistent with the statutory language. It is also consistent with the history of the Code and the concerns of the drafters. River East Plaza, LLC v. Geneva Leasing Ass'n (*In re* River East Plaza, LLC), 669 F.3d 826, 828–29 (7th Cir. 2012); *see also* Douglas G. Baird, *Remembering Pine Gate*, 38 J. MARSHALL L. REV. 5, 9 (2004) [hereinafter Baird, *Pine Gate*].

[36] 526 U.S. 434, 437–38 (1999).

[37] *Id.* at 441.

[38] *Id.* at 458.

[39] *Id.* at 436.

[40] *See* Douglas G. Baird & Anthony J. Casey, *Bankruptcy Step Zero*, 2012 SUP. CT. REV. 203, 220.

[41] I have explored these lessons more fully elsewhere:

> Together these cases start to form a pattern. On certain questions, the market and Congress are the only competent arbiters. To the extent Congress is unclear in addressing those questions, the

The best way to understand § 1129(b)(2), then, is as a floor for what will qualify as fair and equitable. That floor cannot be ignored.

None of the analysis so far contradicts the Markell principles. Indeed, to say that § 1129(b)(2) sets a floor for payment merely restates the first principle: "don't pay too little." The long-recognized implied ceiling in § 1129(b)(1) provides the second principle: "don't pay too much."[42] And Professor Markell's historical analysis of "fair and equitable" suggests the third principle: "don't expect precision." But if we want to use the principles in an actual case, we are still left to decipher what exactly is "too little" or "too much."

B. History and the Markell Principles

The statute cannot get us much further. For cramming down a secured creditor, the relevant language merely reframes the too-little question as one of whether "a deferred cash payment [is] . . . of a value, as of the . . . date of the plan of at least the value of" the creditor's interest.[43] But how does one answer that question?

We might turn to caselaw, but Supreme Court precedent does not provide controlling authority on how to answer the question. This is true, despite *Till*, for two reasons. First, *Till* did not garner a majority opinion. It was a four-member plurality not joined by Justice Thomas.[44] Second, *Till* was construing § 1325 and not § 1129, and the footnotes in the plurality opinion provide conflicting guidance as to whether the reasoning of the case is applicable to chapter 11 cases.[45] It is also worth pausing to note that Justice Thomas's

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> Court will view it as providing as narrow a rule as is reasonably consistent with the Code's language.

Id. at 221; *see also* Casey & Huq, *supra* note 5, at 1215–16.

[42] Markell, *Fair Equivalents*, *supra* note 16, at 104.

[43] 11 U.S.C. § 1129(b)(2)(A)(i)(II) (2012) ("[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.").

[44] 541 U.S. 465 (2004) (plurality opinion). This point was somewhat irrelevant for the bankruptcy court in *Momentive*. *See Momentive*, No. 14-22503-rdd, 2014 WL 4436335, at *24 (Bankr. S.D.N.Y. Sept. 9, 2014), *aff'd*, 531 B.R. 321 (S.D.N.Y. 2015), *appeal docketed*, No. 15-1771 (2d Cir. June 1, 2015). It was obviously bound by decisions of the Second Circuit, and the Second Circuit had adopted a similar approach to the *Till* plurality in an earlier case. *Id.* (citing GMAC v. Valenti (*In re* Valenti), 105 F.3d 55, 63 (2d Cir. 1997)). Thus, statutory text and first principles aside, the bankruptcy court was bound to at least apply the *Till* rule to *chapter 13 cases. Id.*

[45] *See* 541 U.S. at 476 n.14; Markell, *Fair Equivalents*, *supra* note 16, at 110–13.

concurrence was based on a close reading of the statutory text of § 1325(a)(5)(B)(ii) that is not easily imported to § 1129(b)(2)(A)(i)(II).[46]

Next, we can turn to history and apply the Markell principles.[47] Through those principles, we can accept errors as long as we try to get things right. The problem with the *Till* formula is that it does not even try to get things right.

To see why, we must first note that concepts like "too little" and "too much" must be anchored to some baseline concept. The baseline for the Justices in *Till* (and for Professor Markell and the judge in *Momentive*) was nonbankruptcy entitlements. For them, the debate about too much and too little was about comparing what the creditors and other stakeholders would have received outside of bankruptcy. Interestingly, in *Till*, each side succeeded in showing that the other side was getting the entitlements wrong. Everyone was achieving a form of false precision at the expense of paying too little or too much. Thus, everyone was violating at least two of the Markell principles.

The dissent in *Till*, in search of precision, suggested that the creditors should receive a stream of payments subject to the prebankruptcy interest rate.[48] But that rate will generally overpay creditors. True, if the creditors had foreclosed and liquidated the assets outside of bankruptcy, they would have been able to reinvest the cash proceeds in a new loan. But the sale and reinvestment would have imposed significant transaction costs in the form of finding a buyer for the assets and finding a new borrower. And the market rate for such a loan may have changed since the time of the original transaction.

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[46] Section 1325 deals with "the value, as of the effective date of the plan, of property to be distributed under the plan." 11 U.S.C. § 1325(a)(4). Justice Thomas notes that the value of the cash to be distributed was its face value, regardless of the risk of nondistribution. *Till*, 541 U.S. at 485–86 (Thomas, J., concurring). He went on to note that if the "property distributed" was "a note (i.e., a promise to pay)," then the value of that note "necessarily includes" a risk premium. *Id.* at 488–89. Section 1129(b)(2)(A)(i)(II) talks of "deferred cash payments . . . 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." The question for Justice Thomas, then, is whether "of a value" modifies "payments" or "deferred cash payments." The former would make the provision analogous to the case in *Till*; the latter would look more like Justice Thomas's hypothetical "notes." Put another way, "deferred cash payments" are promises to pay, and valuing them today (like valuing notes) implies a risk adjustment in a way that valuing payments or property (that happen to be coming in the future) does not. For my eye, the natural and plain reading is that "value" modifies the entire clause, "deferred cash payments." In short, even if the plurality reasoning in *Till* applied to § 1129(b)(2)(A)(i)(II), it is likely that Justice Thomas's reasoning does not. So for chapter 11, that would give a fifth vote to the dissent. Does that matter? Probably not. But it does make the case that *Till* somehow provides binding authority even more dubious.

[47] The historical support for the reasoning is set forth in Professor Markell's piece. Markell, *Fair Equivalents*, *supra* note 16, at 95–103. I do not restate it here.

[48] *Till*, 541 U.S. at 491 (Scalia, J., dissenting).

Moreover, a firm coming out of a successful bankruptcy (if the system works at all) should be less risky than a firm that has just defaulted and is on the brink of filing bankruptcy. That reduced risk should justify a lower interest rate.

That being said, the plurality's approach in *Till* performs no better. Following the plurality view does not produce imprecise but fairly equivalent payouts. Instead, the *Till* plurality directs a court to use a formula that produces a fairly precise rate (prime plus one to three percent is a relatively narrow range) with a payout that is, in most cases, certainly *not* equivalent to creditors' prepetition entitlements.[49] Indeed, because the formula starts with the prime rate and allows for limited deviations, it will underestimate the value of creditors' entitlements by significant margins.[50]

As a result, neither of these precise methods[51] is consistent with the Markell principles. They do not produce a fair equivalent of creditors' prepetition interests in the estate. As Professor Markell shows, a fair equivalent "cannot be made by the use of any mathematical formula."[52] Rather, the Markell principles call for an "estimate" that does not have "mathematical certitude."[53] Fair equivalence does not imply "an illusion of certainty," but instead requires "equitable equivalence."[54] The takeaway from all of this analysis is that the law requires the creditor to be given something that is a fair estimate of its prepetition interest. A fair estimate, by definition, can deviate from actual value, but it cannot deviate in a biased (i.e., unfair) way. Thus, an estimate that precisely and consistently understates creditors' prepetition interests would not be a fair estimate.

That is, however, exactly what the *Till* interest rate does. And so *Momentive*, in adopting the *Till* formula for chapter 11, violates the Markell principles. It pays too little, and not because it is imprecise. Rather, the

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[49] *Id.* at 491–92 (Thomas, J., concurring) (noting that the plurality started with "a rate we know is too low" and that the formula "will systematically undercompensate").

[50] *Id.* at 504 (Scalia, J., dissenting) (noting that the plurality's rate in *Till* was off by an order of magnitude).

[51] Markell, *Fair Equivalents*, *supra* note 16, at 103–04. Precision implies both exactness and accuracy. The *Till* rate is precise in the sense that it achieves relative certainty and accurately underestimates the interest rate. The three Markell principles, taken together, suggest that "don't expect precision" means you do not need exactness, and unbiased inaccuracy is okay. We should not sacrifice fairness by introducing bias in the name of exactitude or mathematical certainty. Inaccurate equivalency is better than accurate inequivalency.

[52] *Id.* at 105 (quoting Grp. of Inst. Inv'rs, v. Chi., Milwaukee, Saint Paul & Pac. R.R., 318 U.S. 523, 565–66 (1943)).

[53] *Id.* at 98 (quoting Consol. Rock Prods. Co. v. Du Bois, 312 U.S. 510, 526 (1941)).

[54] *Id.* at 98–99 (quoting *Grp. of Inst. Inv'rs*, at 565).

underpayment is a direct result of the attempt for precision. The rate paid is precise and *precisely too low*.

II. OF ENTITLEMENTS AND OPPORTUNISTIC BEHAVIOR

The story so far is that the law requires fair equivalence and not precision, but the *Till* rate gives us the opposite. The disconnect stems directly from the *Till* Court's misguided focus on entitlements. The law's tolerance for less-than-precise valuation (as the Markell principles demonstrate) provides a signal that the bankruptcy purpose behind the cramdown rules is not to ensure that entitlements are protected and treated like property rights—that would require precision—but rather to create a system that facilitates appropriate incentives. In this Part, I argue that such a system is not only appropriate from a policy perspective, but also consistent with the statute and the Markell principles.

To do so, I first review the foundational theory of bankruptcy to show that a well-designed bankruptcy system need not focus on the full preservation of nonbankruptcy entitlements. Then, I explain the key features of a system focused on minimizing opportunistic behavior and discuss how that approach is consistent with the statute and the principles behind it.

A. *The Creditors' Bargain Theory and the Lure of Creditor Entitlements*

The academic focus on preserving nonbankruptcy entitlements goes at least as far back as Thomas Jackson's seminal 1982 article on the matter.[55] These entitlements were central to Jackson's discussion and model of his creditors' bargain theory.[56] But today, it has become clear that the theory does not itself require the preservation of these entitlements.

The core of the creditors' bargain theory justifies the existence of corporate bankruptcy based on the assumption that creditors cannot collectively reach an ex ante agreement over how to deal with financial distress.[57] Without that agreement, they cannot bind themselves to refrain from behavior that might destroy (or fail to maximize) the value of an estate. The result is a collective-

[55] *See* Jackson, *supra* note 1, at 857. It perhaps goes further back. *See* Walter J. Blum, *Full Priority and Full Compensation in Corporate Reorganizations: A Reappraisal*, 25 U. CHI. L. REV. 417, 437–39 (1958); Blum, *New Directions*, *supra* note 1, at 1368–69.

[56] *See* Jackson, *supra* note 1, at 858.

[57] *See id.* at 862–63.

action problem that cannot be solved by private contracting and, therefore, justifies a mandatory bankruptcy regime.[58]

That regime, the theory suggests, should be the one that mimics the bargain that creditors would have entered into if they were capable of doing so.[59] As a result, we should expect the bargain to be the one that maximizes the value of the estate in bankruptcy. Of course, that alone is not enough. There are many ways to maximize the value of a bankruptcy estate that might have side effects that hinder other goals. Strictly speaking, we should expect the parties in a hypothetical costless bargain to enter an agreement that maximizes the average expected value of the estate across *all states of the world*.[60] Because parties are generally allowed (and assumed) to contract for efficient outcomes, this is usually translated into the principle that bankruptcy law should tinker with nonbankruptcy rights as little as possible.

An important nuance, however, lies buried in this translation. We can confidently say that the contracts that parties enter into outside of bankruptcy indicate their contracting preferences in those states of the world. These contracts do not, however, tell us anything about what the parties would contract for with regard to their rights and entitlements *in* bankruptcy. In the world we live in—with its mandatory bankruptcy rules—we have no idea what bankruptcy terms the parties would freely choose in the absence of those rules. Moreover, in a world where bankruptcy law is necessary because we have assumed that no efficient contract can be drafted to govern in the bankruptcy state of the world, it would be strange to determine the bankruptcy rules by looking to the inefficient-by-assumption contracts that a subset of the relevant parties did in fact draft.

What is left, then, of the respect for nonbankruptcy entitlements? The answer lies in the dynamic effect that rules can have across different states of the world. We should be wary of rules in bankruptcy that either destroy value for firms not in bankruptcy or that create incentives for parties to opportunistically shift from one state to another.

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[58] *Id.* at 862.

[59] *See id.* at 867–68.

[60] By "all states of the world," I mean to encompass the various contingencies that might play out both in and out of bankruptcy. The parties, ex ante, will desire to maximize the overall expected value of the firm based on their probabilistic expectations about which state of the world will ultimately result. If a rule produces a benefit in one state of the world, the value of the benefit must be discounted for any costs imposed in another state of the world (weighted by the probabilities that each state will actually come to exist).

For example, a rule that converts all loans to an interest-free regime in bankruptcy would have two deleterious effects. First, it would cause healthy debtors to feign distress and file for bankruptcy when there is no value to be gained from the filing. Second, it would reduce the willingness of creditors to make loans to even healthy firms with low bankruptcy risk. Contrast that outcome with a bankruptcy rule that guarantees a creditor its foreclosure value but awards all additional value created by the bankruptcy process to the debtor.[61] Such a rule only encourages the debtor to file for bankruptcy when there is value to be created by the bankruptcy, and it has no impact on the rights the creditor enjoys *in other states of the world.*

The takeaway is that bankruptcy law should minimize its *interference* with entitlements *outside bankruptcy*. That principle is much different from the idea that bankruptcy law must *preserve* entitlements *inside bankruptcy*. This distinction is often lost. The original exposition of the creditors' bargain theory itself makes the explicit assumption that the absolute priority of secured creditors' rights brings aggregate efficiencies to the estate and should therefore be respected. But nothing about the underlying theory justifies that assumption. Neither does any real world evidence.[62] Indeed, all one can really say about the market for (and aggregate efficiencies of) secured creditors' rights is that parties view them as valuable in the states of the world that do not trigger bankruptcy law.[63]

B. The Creditors' Bargain and Minimizing Opportunistic Behavior

Despite the lack of theoretical or empirical grounding, the assumption that the creditors' bargain theory requires the protection of nonbankruptcy entitlements has spawned a vast literature championing the protection of creditors' nonbankruptcy entitlements in bankruptcy for its own sake. This detour is unfortunate and unnecessary, and it leads to unhinged debates about entitlements—debates that lack a strong connection to considerations of the proper design of bankruptcy policy.

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[61] Casey, *supra* note 9, at 796; *see also* COMM'N TO STUDY THE REFORM OF CHAPTER 11, AM. BANKR. INST., FINAL REPORT AND RECOMMENDATIONS 75 (2014).

[62] Baird, *Priority Matters*, *supra* note 7, manuscript at 32 ("It is also worth noting that we do not see anything as simple as the absolute priority rule in an analogous environment in which free contracting is permitted.").

[63] I have stressed this point in prior articles. Casey, *supra* note 9, at 772–73; Casey & Morrison, *supra* note 7; *see also* Baird, *Priority Matters*, *supra* note 7, manuscript at 22 ("The debate about relative and absolute priority must therefore take place in an empirical vacuum.").

Much clarity can be gained going forward by dropping the entitlement framework altogether and focusing instead on the incentives and distortions to incentives that bankruptcy law creates when it assigns rights to stakeholders. Thus, the goal should not be to preserve or protect entitlements, but instead to minimize opportunistic behavior.[64]

All of this is to say that we want bankruptcy rules to be efficient in operation and in effect. Deviations from entitlements are only relevant to the extent that they distort behavior and create inefficiencies within the bankruptcy system. Lots of parties are over- or undercompensated in bankruptcy (depending on your baseline). There is no question about that. The question is whether they are over- or undercompensated in a way that distorts the process or distorts behavior in other contexts outside of bankruptcy.

This framing is consistent with the structure of § 1129(b), with its creditor bidding and indubitable equivalent requirements, and with the cases interpreting that section.[65] For example, § 1129(b)(2)(A)(ii)—as interpreted by the Supreme Court in *RadLAX*—requires that a debtor wanting to sell an asset that is subject to a lien must provide the creditor the opportunity to credit bid in the sale.[66] This framing of § 1129(b) limits the debtor's ability to opportunistically sell the good into a depressed market. The result is that if a debtor attempts to sell into a depressed market, the creditor will take the asset by credit bid. The creditor, on the other hand, has limited opportunities to extract value because it cannot demand the right to buy the asset under any circumstances.

Note that neither the Code nor the Court requires any proof about efficiencies in the market or about intrinsic values. Instead, they force the debtor to make (and the creditors to live with) a choice that is cabined by the realities of the market for the assets. The debtor can give the creditor a cash

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[64] The idea that bankruptcy law can and should change nonbankruptcy endowments is consistent with the Supreme Court's holding in *United States v. Butner*. 440 U.S. 48, 54 (1979). *Butner* is sometimes cited for the principle that bankruptcy law should leave state law undisturbed. That application is not quite right. The case merely says that in the absence of a bankruptcy statute, courts should look to state law. *Id.* at 57–58. But here, there is a statute (11 U.S.C. § 1129) and so we look to it and not to state law. Indeed, in *Butner* the Court explicitly said that the constitutional bankruptcy power "would clearly encompass a federal statute" defining a creditor's interest in estate property. *Id.* at 54. The Court also noted that a nonbankruptcy state interest could be altered by bankruptcy law if a federal (that is, bankruptcy) interest required that result. *Id.* at 55.

[65] *See, e.g.*, RadLAX Gateway Hotel, LLC v. Amalgamated Bank, 132 S. Ct. 2065, 2069−70 (2012); Bank of Am. Nat'l Tr. & Sav. Ass'n v. 203 N. LaSalle St. P'ship, 526 U.S. 434, 457–58 (1999). *See generally* Baird & Casey, *supra* note 39, at 208–10.

[66] 132 S. Ct. at 2069−70.

equivalent, a cramdown payment plan (which I have suggested must be equal to market loans), or the ability to buy the asset in a market sale. The effect is that the debtor is choosing between cash and the things that cash can buy on the market. Faced with that choice, the debtor has no incentive to act opportunistically.[67]

Similarly, § 1129(b)(2)(A)(iii) provides that when a debtor wants to give the creditor something other than a cramdown loan or cash, it must meet the highest standard of "indubitable equivalence."[68] This limit is set at a very high level because the debtor's rejection of the market-tested options is highly suspect. As Judge Posner noted in a recent case, "[t]he debtor's only motive for substitution of collateral in such a case is that the substitute collateral is likely to be worth less than the existing collateral."[69] And so the Code requires a high burden of equivalence to limit the debtor's ability to opportunistically choose alternative compensation.[70]

Finally, the Court's opinion in *203 North LaSalle*, with its implied new-value exception, also prevents debtors from opportunistically buying into the equity of a reorganized firm without a market test.[71] That market test goes a long way toward eliminating a debtor's ability to use the inside investment (or threat of an inside investment) to opportunistically extract value from a creditor. Again, there is no suggestion that the test is secondary to nonmarket evidence about intrinsic entitlements.

The opportunistic-behavior framework is also consistent with other core provisions of the Code. In many instances, the Code alters nonbankruptcy rights with the goal of minimizing opportunistic behavior. In others, the Code preserves nonbankruptcy rights with that same goal. For example, the automatic stay broadly prohibits most creditors from exercising their nonbankruptcy enforcement rights.[72] This alteration of rights is intended to prohibit creditors from using those rights to gain advantage over other creditors

[67] These rules are also consistent with historical cases of opportunistic behavior that were on the minds of the drafters of the Code. *See In re* Pine Gate Assocs., Ltd., No. B75-4345A, 1976 U.S. Dist. LEXIS 17366 (N.D. Ga. Oct. 14, 1976); *In re* Pine Gate Assocs., Ltd., 12 Collier Bankr. Cas. (MB) 607 (Bankr. N.D. Ga. Mar. 4, 1977); Baird, *Pine Gate*, *supra* note 34, at 5.

[68] 11 U.S.C. § 1129(b)(2)(A)(iii) (2012).

[69] *In re* River East Plaza, LLC, 669 F.3d 826, 831–32 (7th Cir. 2012).

[70] *See id.* at 832 ("[B]ecause of the different risk profiles of the two forms of collateral, they are not equivalents, and there is no reason why the choice between them should be made for the creditor by the debtor.").

[71] *See* 526 U.S. 434, 457–58 (1999).

[72] *See* 11 U.S.C. § 362(a).

in a way that destroys estate value.[73] The rule also prevents creditors from using threats of opportunistic enforcement to extract rents.[74] It is an alteration of nonbankruptcy rights for the purpose of maximizing estate value.[75]

The automatic stay, without more, however, would create an opportunity for the debtor to use stalling tactics to extract value from creditors. The ability to stop enforcement when time is of the essence can be a powerful threat.[76] To partially alleviate that concern, bankruptcy law provides for things like adequate protection and other safety valves that allow the judge to lift the automatic stay for cause.[77]

To be sure, none of these provisions is precise. There is a lot of fudging, and the Code and the courts will get things wrong in many close cases. But the goal is clear: to provide a system that maximizes the estate value while minimizing the instances of opportunistic behavior. Sometimes this will require the protection of nonbankruptcy entitlements; sometimes it will require the destruction of those entitlements.

In the abstract, this theory tells us two things: we should (1) view as more suspect rules that *transfer* value in bankruptcy that otherwise would not have been transferred; and (2) view as less suspect rules that *distribute* value that would not otherwise have existed. Thus, the creditors' bargain theory has little to tell us about distributions of the going concern value that bankruptcy has created or saved (the bankruptcy surplus), but it has much to tell us about making sure parties receive at least the value they would have received in nonbankruptcy proceedings. The former has only a small impact on nonbankruptcy values and the decision to enter bankruptcy,[78] while the latter has an enormous impact on those things.[79]

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73 3 COLLIER ON BANKRUPTCY ¶ 362.03 (Alan N. Resnick & Henry J. Sommer eds. 16th ed.) ("[T]he stay provides creditors with protection by preventing the dismemberment of a debtor's assets by individual creditors levying on the property. This promotes the bankruptcy goal of equality of distribution.").

74 *Id.* ("[The stay] protects property that may be necessary for the debtor's fresh start and . . . provides breathing space to permit the debtor to focus on rehabilitation or reorganization.").

75 *Id.* ¶ 362.03[2] ("The stay prevents this piecemeal liquidation, offering the chance to maximize the value of the business.").

76 *See generally* Chrysler LLC v. Plastech Engineered Prods., Inc. (*In re* Plastech Engineered Prods., Inc.), 382 B.R. 90, 107–08 (Bankr. E.D. Mich. 2008) (struggling with competing claims about whether the invocation of, or the motion to lift, the automatic stay was opportunistic). A more general example would be when a debtor uses the automatic stay to hold seasonal or perishable goods hostage.

77 *See* 11 U.S.C § 362(d).

78 It may be wise to give at least some of the bankruptcy surplus to the person or entity that makes the filing decision to ensure that value-creating filings do occur. But beyond that, the distributional implications are unclear. *See* Alan Schwartz, *A Normative Theory of Business Bankruptcy*, 91 VA. L. REV. 1199, 1239

In the next part, I will show that for cramdown, this approach demands the use of the actual market rates (net of transaction cost) for similar exit loans as they exist at the time of confirmation.

III. CRAMDOWN

Moving from the abstract to the concrete, we can now derive the optimal rule for cramdown using the Markell principles viewed in connection with our goal of minimizing opportunistic behavior.

A. "Don't Pay Too Much"

An obvious question from the above is whether cramdown, or some form of it, is reconcilable with the fundamental theory that bankruptcy should maximize the value of the estate while minimizing instances of opportunistic behavior. It is.[80] Without cramdown, in fact, the collective-action problem would be insurmountable. A secured creditor might, in the absence of a Coasean bargain[81] with the debtor, seek to foreclose on an asset even when doing so destroys estate value. There are three primary explanations for why this bargaining failure might occur: (1) irrational or idiosyncratic preferences;[82] (2) asymmetric information (the creditor does not know the true value of the

(2005). *Compare* Barry E. Adler, *Illinois ABI Symposium on Chapter 11 Reform: Priority in Going-Concern Surplus*, 2015 U. ILL. L. REV. ONLINE 811, 814 (2015), *and* Adler & Triantis, *supra* note 1, at 19–20, *with* Douglas G. Baird & Donald S. Bernstein, *Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain*, 115 YALE L.J. 1930, 1937 (2006), *and* Casey, *supra* note 9, at 778, *with* Jacoby & Janger, *supra* note 9, at 916, 918, 922, *and* Tene, *supra* note 9, at 395–96, *with* Baird, *Priority Matters*, *supra* note 7.

[79] Allowing debtors (or junior creditors) to capture foreclosure value from senior creditors by entering bankruptcy would have at least three major effects: (1) debtors will spend resources to enter bankruptcy even where it is not value maximizing; (2) creditors will spend resources to prevent bankruptcy even when the bankruptcy would be value maximizing; and (3) the cost and availability of capital for debtors outside of bankruptcy will be adversely impacted because the risk for creditors will be higher.

[80] *See* George G. Triantis, *Mitigating the Collective Action Problem of Debt Enforcement Through Bankruptcy Law: Bill C-22 and Its Shadow*, 20 CAN. BUS. L. REV. 242, 252 (1992) ("The cram down is one way to address the problem of holdouts by classes of secured lenders.").

[81] The Coase Theorem posits that where there are completely competitive markets with no transaction costs, parties in a transaction will always reach the most efficient outcome, regardless of how property rights are allocated. *See generally* R.H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960).

[82] The creditor may also have artificial reasons for foreclosing on assets even when doing so destroys value. Such reasons often stem from external forces such as regulatory pressure from tax and accounting rules. *See, e.g.*, *In re* RTJJ, Inc., No. 11-32050, 2013 WL 462003, at *15 (Bankr. W.D.N.C. Feb. 6, 2013) ("First National recognizes this. Community One does not seem to care. Under pressure from federal regulators, Community One seeks to rid itself of this nonperforming loan, at any cost. Its aims are noneconomic—at least as to this Debtor—and are destructive.").

estate as reorganized but the debtor does); or (3) opportunistic posturing (the creditor may be threatening foreclosure in hopes of extracting more value).

The bargaining problem is important regardless of which reason is driving it. And the dynamics of the negotiations are likely to be such that a debtor cannot distinguish between them anyway. The creditor who is posturing might want to appear irrational or idiosyncratic to make the threat of foreclosure credible. In any event, if the debtor and creditor cannot reach a bargain, the debtor will have two remaining options: (1) go to the market to refinance the asset (and give cash to the secured creditor); or (2) allow the foreclosure.

There is a risk that significant value will be destroyed if transaction costs for the first option are high, which is likely to be the case. Providing the market with clear information may be prohibitively costly or impossible, and the bargaining with outside lenders might fail for the same reasons as the bargaining with the secured creditor. The outsiders will have even less information about the loan than the insider. And if, as is often true in these cases, it is only feasible to provide full information to one potential lender, that lender may try to extract rents by posturing, or it may have its own irrational or idiosyncratic preferences. The final result is that if these transaction costs are high enough, resorting to the market might not be worth it at all.

To correct for these problems, the Code allows the debtor to choose whether the creditor will (1) get the right to foreclose on the property;[83] (2) get paid in cash; or (3) get a note or some other property that is of an equivalent value.[84] Giving this choice to the debtor prevents bargaining failure. Chiefly, the creditor can no longer opportunistically demand a higher interest rate simply because the debtor would incur transaction costs if it tried to go to the market to get a new loan. The creditor cannot idiosyncratically raise its interest rate above market and then demand that the debtor pay the higher rate or risk foreclosure. And the creditor cannot demand the right to take its asset away simply because it has bad information and overestimates the risk of leaving the asset with the debtor.

Instead, the debtor has the choice to keep the asset within the estate if the asset is more valuable there. Moreover, the debtor can force the creditor to

[83] The debtor could also sell the asset subject to credit bidding. But, assuming the creditor is undersecured, that alternative amounts to the same thing as foreclosure.

[84] *See* 11 U.S.C. § 1129(b)(2) (2012); *In re* River East Plaza, LLC, 669 F.3d 826, 828–33 (7th Cir. 2012) (summarizing the options).

continue to finance the asset at a market rate, thereby avoiding any transaction costs that it might otherwise incur on the market. This option of the debtor prevents the creditor from opportunistically profiting from the mere existence of these transaction costs.[85]

Going back to the creditors' bargain theory, we would expect a creditor, ex ante, to enter into a pact to accept cramdown when that cramdown is expected to give the creditor something of the same market value as the cash value of its foreclosure rights. If the debtor with going-concern value has to choose between (a) giving the creditor $100 in cash (or allowing a foreclosure, which amounts to almost the same thing) and destroying the firm, or (b) giving the creditor $100 in a promise and saving the firm, we want the debtor to choose (b) every time. And this choice is likely to arise quite often. If the debtor has to pay off the creditor, there are (as Professor Markell and the judge in *Momentive* point out)[86] transaction costs associated with going out into the market to obtain financing. The debtor and the lender have to find each other. The debtor has to convince the lender that it is viable and has a good business plan. Then the debtor has to bargain with the lender (in a market that might be imperfect) to achieve the best rate. And all of this has to be done quickly. The costs of doing so might deplete the cash of the debtor. As those costs add up, the outside loan might end up costing $110 rather than $100.

Everyone is better off if the estate keeps the cash, saves the transaction costs, and gives the old creditor a promise of $100. At that point, we have created a surplus (in savings) of $10 that can be divided among the stakeholders. Bankruptcy law does not trust the parties to reach this outcome on their own. The senior creditor might, as we have suggested, have idiosyncratic preferences or, more likely, it might play a hard bargaining game to try to extract the surplus for itself. And while the law should not really be concerned with who gets the surplus, it should be concerned about whether bargaining failure destroys value of the estate. And so we allow cramdown, which is merely the "don't pay too much" principle.

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[85] It also prevents the creditor from incidentally profiting from those costs. But that is not the rule's primary purpose.

[86] *See Momentive*, No. 14-22503-rdd, 2014 WL 4436335, at *25–29 (Bankr. S.D.N.Y. Sept. 9, 2014), *aff'd*, 531 B.R. 321 (S.D.N.Y. 2015), *appeal pending*, No. 15-1771 (2d Cir. June 1, 2015); Markell, *Fair Equivalents*, *supra* note 16, at 120.

B. "Don't Pay Too Little"

There is, however, a flipside to all of this. If debtors get a consistently better rate in cramdown than they would on the market, the rate would function as a subsidy for cramdowns that artificially moves demand to those loans, even though market loans are better. This subsidy creates two particular distortions that destroy firm value. The first among these distortions is to filing incentives. If debtors can lower interest rates below market simply by filing bankruptcy, all firms will have an incentive to go through bankruptcy after taking on a loan, and whenever they are considering refinancing. Conversely, creditors will have an incentive to expend resources to prevent such bankruptcies. The second distortion is to the decision a debtor must make while in bankruptcy between cramming down a loan, allowing foreclosure, or refinancing. If cramming down a loan produces a below-market rate, a debtor will favor doing so when the market forces would otherwise suggest refinancing or submitting to foreclosure.

These distortions from normal market forces are not justified by any theory of corporate reorganization. To solve these problems, bankruptcy law should (and does) place the debtor in a position of choosing between options based on how those options benefit the stakeholders as a whole rather than based on opportunities to capture value from one stakeholder. Bankruptcy law, therefore, seeks to limit the instances of, and incentives for, a debtor to engage in opportunistic behavior by requiring the debtor to pay market rates when it opts to cram down a loan. This only works if the market rate is taken from the real market. If the court allows an intrinsic value that is below market, or a rough estimate of a below-market rate (like the *Till* rate), the debtor will still act opportunistically.

This is merely the "don't pay too little" principle.

C. "Don't Expect Precision"

Of course, determining the market rate for any exit loan is difficult. There will be noise and inaccuracy. Evidence can be hard to find and expert testimony can be unreliable. But that inaccuracy does not mean we should give up. An imprecise estimate is better than no estimate or one known to be wrong. As the saying goes, don't let the perfect be the enemy of the good. This is merely the "don't expect precision" principle.

Oddly, the market-rate approach is, nonetheless, rejected (by Professor Markell and the judge in *Momentive*) in part because it is too imprecise. Professor Markell provides a lengthy discussion about why inefficient markets will not reflect intrinsic values.[87] The judge in *Momentive* focused specifically on the fact that market rates might include transaction costs or profits that are not reflective of actual intrinsic values.[88] If these arguments are about precision and error, we can reject them outright; Markell's principles establish that precision is not required.

A more nuanced argument can, however, be built around this point and on the foundations of bankruptcy's endowment effect: the absence of an efficient market means that the market rate is not estimating the intrinsic value of the asset (here the stream of payments) at all. The lack of equivalence with intrinsic value is problematic from an endowment perspective—creditors are not getting exactly what they are entitled to. And so, if the point of equitable equivalence is to preserve nonbankruptcy rights just for the sake of preserving them, we might have to give a creditor a payment with the same intrinsic value as its prepetition interest in the estate. And inefficient market rates do not do that. At its core, then, an endowment view of bankruptcy requires that fair equivalence means equivalence "of intrinsic value," which requires that any market estimate be an efficient-market estimate.

But these problems only exist for the endowment perspective. If, as I have argued above, the purpose of fair equivalence is not to protect endowments but to align incentives, then fair equivalence only requires that creditors get (or more accurately, that debtors pay) the actual market rate for the cramdown loan, regardless of whether that rate is efficient. Incentives are set and altered by actual (and imperfect) markets that exist in the real world and not by perfectly efficient markets that exist in economic models. We therefore need only concern ourselves with those actual markets.

The inefficient-market critique is, in this way, a red herring. To give the creditor a fair equivalent of its interest in the cramdown context—to not pay too much or too little—is to require the debtor to pay a rate equal to the prevailing market rate (net of transaction costs) for similar exit loans. Payments on those terms will, by definition, also be equivalent to the stream of payments that the creditor could buy on the real market (not the market we wished existed) with the cash value of its interest (ignoring transaction costs).

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[87] Markell, *Fair Equivalents*, *supra* note 16, at 117–20.

[88] *Momentive*, 2014 WL 4436335, at *29.

As a final objection to the inefficient-market critique, it is odd to suggest (as Professor Markell and the judge in *Momentive* do) that cash is worth anything less than what it can buy on the market. After all, the value of money is entirely based on what it can buy (in the real world). If $100 in cash can buy a stream of payments secured by an asset with certain terms at a 10% interest rate, then regardless of the market inefficiencies (indeed, because of the market efficiencies) that cash is worth exactly that stream of payments. Giving someone a stream of payments with the same exact terms but a less-than-10% interest rate is not equivalent in any sense. This would be true even if the 10% being paid on the market were all supracompetitive "profit" (which seems to be the concern of the judge in *Momentive*).[89]

The counterargument is hard to grasp. The judge in *Momentive* seems to argue that if the market is mispricing the loan, the stream of payments with a 10% interest rate is a better deal than the cash because the market is mispriced.[90] The lender who makes a market loan is, therefore, being overpaid and getting a windfall, and the crammed-down lender would also get a windfall if that rate were used. That logic is not obviously correct. At best, it would only be true if the crammed-down secured creditor could not access the inefficient market with its cash (again, cash is worth what it can buy).

But even so, let us say there really is overpayment here. It still does not matter. The reality is that giving (or not giving) the creditor the exact equivalent of the cash is not the thing that should concern bankruptcy law. It is only the incentive effects on the debtor that the law should care about for cramdown. And from that perspective it is only the actual market rate—not the intrinsic value of the investment—that has any importance.

D. "Do What Makes Sense"

To summarize, if a cramdown loan from the secured creditor would be cheaper than a market loan—because of transaction costs—we want the debtor to choose to keep that loan. If, however, the debtor can get a better rate from a well-informed outsider, then it should take that loan and pay off the creditor. And if the cost of a market loan—excluding transaction costs—is still greater than the value of the collateral to the enterprise, then we want the debtor to allow for foreclosure.

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[89] *Id.* at *26.

[90] *Id.* at *29.

While the *Till* formula does not achieve this outcome, a cramdown rule that requires the debtor to pay the secured creditor the actual market rate, net of transaction costs, does. Such a rule is not, and need not be, the same as requiring the debtor to give the creditor the intrinsic value of the creditor's interest.

For cramdown to work, the debtor needs to be in a position where it cannot gain opportunistic advantage by choosing a less-efficient reorganization plan. We want the debtor to choose the efficient outcome and then force it upon the creditor. The law limits opportunistic creditor behavior by prohibiting it from demanding too much—that is, so much that it would destroy value of the estate. The law limits opportunistic debtor behavior by prohibiting it from paying too little—that is, so little that it would destroy value of the estate.

And the law should not worry about getting intrinsic value wrong as long as it sets the incentives well enough to produce a sensible set of bankruptcy decisions.

IV. EXAMPLES & *MOMENTIVE*

A. *Examples*

Some examples can add clarity to the insights set forth above.

1. *An Example without Cramdown*

Imagine a debtor in bankruptcy has an asset that is subject to a lien. The asset is more valuable in the hands of the debtor than it is when put to other uses. In other words, the debtor in possession of the asset has going-concern value. The secured creditor has threatened foreclosure, which led to the debtor's bankruptcy filing. The debtor is considering cramming down a loan or looking for financing on the market to preserve its going-concern value.

Assume also that the loan is a good business decision if the interest rate is 10%. But if it costs anything more than 10%, the loan is not worth it; the debtor would be better off selling the asset or letting the creditor foreclose. The loan is worth the price of 10%, but not a penny more.

Now let us assume that the actual market rate for that loan would be 10% if transaction costs were zero. That means the debtor will not be able to find financing in a world where there are any transaction costs. Those transaction

costs will either be borne directly by the debtor or show up as a higher interest rate for the loan. Either way, the debtor will not borrow the money. Finally, assume that the secured creditor is like any other lender and would also make the loan at 10% if it had full information and bargaining did not break down.

With those assumptions, bargaining failure between the secured creditor and the debtor will mean that the debtor loses the asset and the going-concern value is destroyed. Without cramdown, there is nothing the debtor can do. The secured creditor acting with bad information or bluffing refuses to offer 10% financing, and the asset is taken out of the estate.

2. *An Example with Cramdown at the Market Rate*

With these assumptions, cramdown at the market rate fixes things. The best outcome occurs if the debtor can cram down a loan on the secured creditor at 10%. As long as the secured creditor has the same cost of capital as the market lenders who would loan at 10%, then it should welcome the chance to have the 10% loan imposed upon it without incurring transaction costs.[91] The debtor, in contrast, is choosing between the market rate (10% plus transaction costs) and the cramdown rate (10%), and has every incentive to choose the efficient rate.

Of course, sometimes the market loan will be better than the one the secured creditor can offer. Cramdown at market rate gets those cases right as well. Assume that the secured creditor cannot lend at the market rate. The secured creditor is, itself, in distress, and is no longer competitive with the market.[92] The secured creditor will lose value if it is forced to make a loan at 10%. Here, the secured creditor can settle with the debtor and offer to pay the debtor money not to cram down the loan. If that settlement process does not break down, it will produce the optimal bankruptcy outcome.[93] If the transaction costs of going to the market are lower than the harm to the secured creditor, then the debtor will take the offer. If the transaction costs are higher, it will not. The debtor will only choose cramdown to avoid the transaction costs that hurt the estate as a whole.

[91] There is the issue of legal fees associated with the bankruptcy. But those are sunk costs to the creditor at this point.

[92] This is also assuming that the secured creditor cannot easily sell the loan after the reorganization. But this is a consistent assumption because we have already assumed high market transaction costs.

[93] If the market rate and the transaction costs are common knowledge, then the bargaining process should be smooth. But those might be bold assumptions.

Note that when the creditor pays to avoid cramdown, the creditor is getting less than its prebankruptcy entitlement. It is paying to avoid being forced to make an unprofitable loan. From an entitlement perspective, therefore, this outcome is bad. But from an opportunistic-behavior perspective, it is a good outcome. Because the debtor cannot get better than the market rate in cramdown, it does not have an incentive to use cramdown to extract rents. Rather, the parties are just bargaining over who pays the transaction costs.

To be sure, this outcome is imprecise. Sometimes the secured creditor will be forced to make an inefficient loan. For example, if the secured creditor has a higher cost of capital and would charge 11% for the loan, but the market charges 10% (plus transaction costs that are less than 1%), it is not, strictly speaking, the right allocation of capital for the secured creditor to be loaning at 10%.

In a perfect world, we want a rule that does not cram down the loan in this instance. But there is no perfect way to distinguish between, on the one hand, an actual high-cost inside lender and, on the other hand, a lender that is either pretending to be, or taking measures to become, a high-cost lender to gain bargaining leverage or avoid cramdown in other instances. Cramdown, then, is a little overbroad. But, if the rate gets things right in most cases, allowing for a little imprecision is nonetheless consistent with maximizing the value of the bankruptcy estate in general. And we should expect that creditors *will* be close to market-rate lenders in most cases.

3. *An Example with Cramdown at a Non-Market Rate*

Things look very different if the debtor can cram down the secured creditor at a below-market rate. Keeping the market rate at 10%, let us now assume a cramdown rate of 5%. To be concrete, the parties have full information that a willing and able market lender would charge 10% to provide a new loan secured by the same collateral and under the same terms, but the debtor is able to cram down the loan on the secured creditor at 5%.[94]

The debtor stands to gain 5% over the market (on top of saving transaction costs) by cramming down the secured creditor. That gives the debtor an incentive to opt for cramdown even in cases where the secured creditor's cost

[94] This scenario is essentially what happened in *Momentive*. 2014 WL 4436335, at *29. There, the market lender was willing to make the loan at around 6.25%, and the cramdown rate ended up being around 4%. *Id.* at *32.

of capital is greatly in excess of the market. But the problems go deeper than that. Imagine that the debtor's going-concern value is such that the loan is not profitable for the debtor at any rate higher than 6%. Now we have a firm that would never survive in the market, forcing its creditors to subsidize its existence with a below-market loan. This produces a reallocation of capital in the economy unsupported by any bankruptcy purpose.[95] Even if capital markets are inefficient, it would be a drastic move (not supported by any history of, or any provision in, the Code) to enlist bankruptcy as the means of compelling banks to subsidize reorganized firms to correct for a perceived inefficiency in market-wide lending rates.

Moreover, the below-market cramdown rate creates an incentive for healthy and failed firms alike to file for bankruptcy to refinance their existing loans. And those incentives of debtors, in turn, create incentives for lenders to account for the risk on the front end by charging large origination fees, raising interest rates, or simply refraining from making loans in the first place.

Finally, the below-market cramdown rates provide the debtor with the incentive and opportunity to hold up creditors and use the threat of cramdown to extract value. In our example, a cramdown at 5% is a below-cost loan from the secured creditor. The debtor may offer a choice to the creditor: pay me your cost or accept the cramdown. With a market cramdown rate, the most the debtor can extract from the creditor is the difference between the creditor's cost of capital and the general cost of capital on the market. And that difference will be zero in expectation. In our below-market example, the difference is the 5% interest rate in expectation. This number can be significant. In *Momentive*, it was a difference that amounted to potentially $200 million.[96] And in *Momentive*, the debtors did, in fact, use a threat of

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[95] There might be reasons to support such a reallocation in chapter 13, where we might want to make sure that lenders are not earning supracompetitive profits on the backs of individuals who are denied a fresh start. We might think that bankruptcy is the entry point of last resort to protect against a lending market that is taking advantage of unsophisticated borrowers. Or, we might simply not want to doom individual debtors to failure with interest rates that cannot possibly be paid.

But none of those concerns is present in chapter 11. Chapter 11 is intended to maximize the value of the estate. *See* 7 COLLIER ON BANKRUPTCY, *supra* note 73, ¶ 1100.01. The way to accomplish that goal is to make sure that viable firms are reorganized and nonviable firms are liquidated. *See id.* ("Chapter 11 of the Bankruptcy Code provides an opportunity for a debtor to reorganize its business or financial affairs or to engage in an orderly liquidation of its property either as a going concern or otherwise."). And along the way, we want to make sure the process does not create avenues for stakeholders to opportunistically transfer value from one stakeholder to another.

[96] Markell, *Fair Equivalents*, *supra* note 16, at 123 (noting that some estimates put the differential in value in *Momentive* at $200 million).

cramdown to extract value from the secured creditors.[97] Through their "death-trap" voting provisions, they offered cash payment in exchange for the creditors waiving their right to object to the plan.[98] The particular objection there had to do with make-whole payments, which are controversial.[99] But if *Momentive* is affirmed, there is no reason to think that the use of threats in the future will be limited to demands to waive controversial objections, as opposed to broader demands to waive standard procedural rights.

These examples demonstrate that cramdown equivalence geared to actual markets focuses debtors' choices away from opportunistic behavior, while below-market cramdown rates provide opportunities for value extraction. Of course, these examples do assume that the market rate can be ascertained. And that is a big assumption. But here, the Markell principles can do a great deal of work. The market rate need not be known with mathematical certainty for it to serve its purpose. As long as it is fairly equivalent to the actual market in expectation, it will cabin the spectrum of opportunistic behavior. A rough, unbiased estimate is neither too low nor too high. What *is* too low is a rate that is known with certainty to be $200 million below the market rate.

B. Momentive

The outcome and application of *Till* to *Momentive* is, therefore, puzzling. The bankruptcy court was essentially throwing away information.[100] The difficulty of estimating the market was not an issue at all because there existed two objective measures of the market for exit loans. The first was the rate of the loan commitment the debtor had lined up to fund the potential cash-out of the senior creditors if they took the offer in the death-trap agreement.[101] The second was the market price of the notes when the court approved the cramdown rate.[102] This evidence suggested that the cramdown rate was significantly below the market rate for that type of exit loan.

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[97] Disclosure Statement for Joint Chapter 11 Plan of Reorganization for Momentive Performance Materials Inc. & Its Affiliated Debtors, *supra* note 19, at 35–36.

[98] *See id.*

[99] For further discussion of make-whole premiums, see generally Markell, *Make-Whole Premiums*, *supra* note 11, at 3–4 (providing background information on how make-whole premiums operate, and how courts, including the court in *Momentive*, have either allowed or disallowed them).

[100] *Momentive*, No. 14-22503-rdd, 2014 WL 4436335, at *25–29 (Bankr. S.D.N.Y. Sept. 9, 2014), *aff'd*, 531 B.R. 321 (S.D.N.Y. 2015), *appeal pending*, No. 15-1771 (2d Cir. June 1, 2015).

[101] *Id.* at *11.

[102] *See* Reply Brief of Appellant Wilmington Trust, N.A., as Indenture Trustee for the 1.5 Lien Notes at 17, Momentive Performance Materials, Inc. v. BOKF, NA (*In re* MPM Silicones, L.L.C.), Nos. 15-1682, 15-1824 (2d Cir. Mar. 30, 2016), 2016 WL 1380968, at *17.

Despite this clear evidence of the market value of an exit loan, the court applied the *Till* formula to justify a much lower rate based on a theory that the market rate might improperly include profit and transaction costs, to which the secured creditor was not entitled.[103] Implicit in my analysis above is the point that the court was right about transaction costs. But there is no way the transaction costs for a loan come anywhere near the underpayment discount in *Momentive*, which by some evidence was 14% of the entire loan value, and by other evidence was nearly $200 million.[104]

As for profits, the court was wrong to exclude them.[105] The idea that part of the market rate included profits is only relevant for entitlement frameworks. From an opportunistic behavior framework, however, the amount of profit is irrelevant. The debtor simply compares the cramdown rate with the market rate in choosing whether to act opportunistically. It does not care whether those rates include profits; it only cares which rate is lower.

As noted, the court's discounted rate opens the door to attempts by the debtor to extract value by demanding procedural waivers. It also will likely change the ex ante bargain in the general market between senior creditors on the one hand and debtors and junior creditors on the other.

The ability of senior creditors to adjust ex ante rates in future loans means that the direct wealth transfers created by the *Momentive* ruling will be unimportant.[106] But the *procedural* distortions cannot be so easily erased. Every estate, as a whole, will be worse off because the stakeholders cannot commit ex ante to refrain from this opportunistic behavior. The best they can do is pay each other in advance for the option to act opportunistically even when everyone is made worse off by the existence of that option. This inability to commit to optimal behavior is precisely the type of ex ante contracting problem that bankruptcy law is designed to prevent and why *Momentive* is inconsistent with fundamental bankruptcy principles, with the statute, and with the Markell principles.

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103 *Momentive*, 2014 WL 4436335, at *25.

104 *See* Reply Brief of Appellant Wilmington Trust, N.A., as Indenture Trustee for the 1.5 Lien Notes, *supra* note 102, at 6 (stating loan value was reduced by over 14% by court's ruling); Markell, *Fair Equivalents*, *supra* note 16, at 123 (finding estimates at $200 million).

105 *Momentive*, 2014 WL 4436335, at *29.

106 Justice Thomas noted this in his *Till* concurrence. 541 U.S. 465, 488 (2004) (Thomas, J., concurring).

CONCLUSION

Professor Markell moves the analysis of cramdown, absolute priority, and corporate bankruptcy forward a great deal with his insightful analysis and three simple principles. But, as I suggested at the beginning, there is a fourth principle that should also govern in these matters: "do what makes sense." That is to say, the rules should further good bankruptcy policy.

Of course, courts are not supposed to simply make up new rules just to achieve pragmatic ends. Fortunately, though, sense and good policy require nothing of the sort here. The statute and the history are well crafted. They require equivalence, and equivalence, properly defined, gets the right result.

The *Till* rate, however, is not the equivalent of anything. It is not a market rate. Nor does it have anything to do with intrinsic value. The *Till* rate, therefore, fails both the endowment and the opportunistic-behavior approaches. In contrast, the market rate—while certainly imprecise—is consistent with the statute and is, by any metric that considers the proper purpose of corporate bankruptcy, a fair equivalent that aligns incentives and reduces opportunistic behavior. It is, therefore, neither too high nor too low to achieve bankruptcy's proper purpose.

The market rate also frees courts from unnecessary concerns about market efficiency. While market rates may incidentally include profits that exist because of inefficient markets, there is nothing wrong with that from a policy or statutory perspective. There is no reason for courts to attempt to estimate intrinsic value in perfect markets when imperfect-market equivalence satisfies both the statute and the purpose behind it. Those attempts, after all, led the *Momentive* court to stretch the notion of equivalence so far as to allow for a rate that is known to be tens or hundreds of millions of dollars below market value. Courts should instead focus on ensuring that debtors pay actual market rates to reduce the risk of opportunistic behavior. Doing so furthers the ultimate purpose of maximizing the value of the estate in a way that intrinsic-value methods do not.

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Default Rates of Interest and Cure of a Defaulted Debt in a Chapter 11 Plan of Reorganization (Part I): *Entz-White*'s Overlooked Choice of Law Dimension

By Ralph Brubaker

The congeries of confusing Code provisions in Code §§ 365(b)(2)(D), 1124(2)(A), and 1123(d) produces an important and very difficult question: when a debtor's Chapter 11 plan of reorganization proposes to cure a defaulted promissory note and "de-accelerate" and reinstate the original repayment schedule pursuant to Code § 1124(2), what rate of interest must the debtor pay on the debt from the date of default through the date of cure—the contractual rate of interest, a market rate, or some other (e.g., formula) rate? And if the contract rate is to be used, is the appropriate contract rate the nondefault rate of interest or the higher default rate set by the parties' contract?

In the 1983 Ninth Circuit decision of *In re Entz-White Lumber and Supply, Inc.*,[1] the court held that the appropriate rate of interest for the cure payment is the nondefault contract rate of interest. In the subsequent Supreme Court decision of *Rake v. Wade*,[2] though, by holding that the interest necessary to cure defaults is governed by Code § 506(b), the Court decoupled cure interest from the contract rate of interest, given the *Ron Pair* interpretation of § 506(b).[3] But in 1994 Congress enacted Code § 1123(d) to overrule *Rake v. Wade* and mandate that cure amounts be determined in accordance with the parties' contractual agreement and applicable state law.

Last month, in the case of *In re New Investments, Inc.*,[4] the Ninth Circuit held that § 1123(d) has also legislatively overruled *Entz-White* and requires payment of cure interest at the default rate of interest contained in the parties' contract, and the Eleventh Circuit similarly construed the effect of § 1123(d) last year in a nonprecedential opinion in the case of *In re Sagamore Partners, Ltd.* [5] There was a vigorous dissenting opinion in *New Investments*, though. Moreover, both the *New Investments* and *Sagamore Partners* decisions wholly failed to address the implications of Code § 365(b)(2)(D), also enacted in 1994 and incorporated by reference into Code § 1124(2), and there are very credible indications that § 365(b)(2)(D) codified

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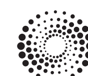
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the *Entz-White* holding. Given the immense complexity (intensified by perplexing ambiguity) of the Code provisions at issue, as well as the large dollar amounts that can be at stake, we may not have heard the last of *Entz-White*.

This Part I will analyze those courts' decisions that the "plain meaning" of Code § 1123(d) repudiates the *Entz-White* conception of cure. Part II in next month's issue of *Bankruptcy Law Letter* will address the implications of the statutory provision those courts neglected to even mention, Code § 365(b)(2)(D), which not only further undermines the facile conclusion that the 1994 Code amendments legislatively overruled *Entz-White*, but also indicates that, in fact, the 1994 amendments *codified* *Entz-White*.

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Acceleration and Code § 1124(2) "De-acceleration"

Full understanding of the Bankruptcy Code's cure provisions requires some background knowledge of the common-law contract principles of which the Code's cure right is simply a modification and, in some senses, an extension.

A material breach of a contractual obligation not only entitles the other party to the contract to cease further performance, it also gives that injured party the right to sue immediately for a "total" breach: "[a] claim for damages . . . based on all of the injured party's remaining rights to performance."[6] The holder of a promissory note to be repaid in periodic installments, however, has no general right to sue for the entire unpaid balance of the debt upon default in the payment of an individual installment.

> There is an important exception to the general rule that a breach by nonperformance, if sufficiently serious, gives the injured party a claim for damages for total breach. If, at the time of the breach, the injured party has fully performed and the only remaining duty of performance of the party in breach is to pay money in independent installments, the failure to pay one or more installments does not amount to a total breach that will accelerate the time for payment of the balance of the debt. The injured party may maintain successive actions for partial breach as successive installments fall due.[7]

It is in response to this rule that installment notes nearly universally contain acceleration clauses "under which the remaining installments become due, either automatically or at the option of the injured party, on a breach as to one installment, so that such nonperformance gives rise to a claim for damages for total breach."[8]

In a Chapter 11 case, though, a debtor's plan can provide for cure of payment defaults and "de-acceleration" of a note pursuant to Code §§ 1123(a)(5)(G) and 1124(2). Code § 1123(a)(5)(G) provides a general authorization for the "curing or waiving of any default" under a plan of reorganization. Code § 1124(2) specifies the condi-

tions under which a cure and reinstatement leaves a class unimpaired, with the consequence that the unimpaired class, "and each holder of a claim . . . of such class, are conclusively presumed to have accepted the plan, and solicitation of acceptances with respect to such class from the holders of claims or interests of such class is not required."[9] Section 1124(2) provides (in relevant part) as follows:

> [A] class of claims or interests is impaired under a plan, unless, with respect to each claim or interest of such class, the plan—
>
> . . . .
>
> (2) notwithstanding any contractual provision or applicable law that entitles the holder of such claim or interest to demand or receive accelerated payment of such claim or interest after the occurrence of a default—
>
> (A) cures any such default that occurred before or after the commencement of the case under this title, other than a default of a kind specified in section 365(b)(2) of this title or of a kind that section 365(b)(2) expressly does not require to be cured;
>
> (B) reinstates the maturity of such claim or interest as such maturity existed before such default;
>
> (C) compensates the holder of such claim or interest for any damages incurred as a result of any reasonable reliance by such holder on such contractual provision or such applicable law;
>
> . . . and
>
> (E) does not otherwise alter the legal, equitable, or contractual rights to which such claim or interest entitles the holder of such claim or interest.

Because such a cure and "de-acceleration" under Code § 1124(2) does not impair the noteholder's claim, the debtor's plan can be confirmed even over the dissent of the noteholder, who is entitled to neither (1) the § 1129(b) "cram down" protections afforded only to "each class of claims or interests *that is impaired* under, and has not accepted, the plan," nor (2) the § 1129(a)(7) "best interests" protection reserved for "each *impaired* class of claims or interests."[10] Cure and reinstatement under Code § 1124(2), therefore, is a kind of super-cramdown that is even more powerful than a § 1129(b) cramdown (since impaired creditors crammed down under § 1129(b) are entitled to best-interests protection under § 1129(a)(7)).[11]

Such a cure and reinstatement is often an advantageous (from the debtor's perspective) means of dealing with certain secured claims (which typically are each a class unto themselves), particularly those of oversecured creditors and/or those for which the rate of interest necessary to cram down a plan over the secured creditor's dissent[12] greatly exceeds the nondefault contractual rate of interest set in the creditor's note. As the Seventh Circuit explained in an early seminal decision, the entire utility of the Chapter 11 cure and reinstatement provisions lies in "retention of advantageous contract terms," for example, by "allowing the Chapter 11 debtor to reinstate the original terms of an accelerated long-term loan at [a] lower interest rate."[13]

Cure: The Common Law of Contracts and Code § 1124(2)

Although the concept of cure of defaults is employed in various Code provisions, nowhere does the Code illuminate what "cure" of a default is.[14] Indeed, the popular myth of the incurable "historical fact" default[15] starkly demonstrates that "curing" a default is by no means an entirely self-evident self-defining concept. Cure, though, is a concept integral to the background common-law contract principles, against which Code § 1124(2) is a palliative.

Acceleration of a debt is a means by which an individual periodic payment default "gives rise to a claim for damages for total breach" of all remaining payment obligations.[16] Cure is a concept familiar to the common law of contracts and which occupies the space between a default and a consequent termination of the contract giving rise to a claim for damages for a total breach. "Courts . . . encourage the parties to keep the deal together by allowing the injured party to terminate the contract only after an appropriate length of time has passed,"[17] and "the purpose of requiring a period of time before termination is to give the party in breach an opportunity to cure."[18] "[T]he injured party has a claim for damages for total breach if, but only if," the "breach is not cured in time."[19]

Courts will typically give effect to contractual provisions explicitly limiting the time within which defaults can be cured (and thus forestall contract termination and total breach),[20] and, of course, this is from whence comes the general validity of a contractual acceleration of a debt post-default. Code

§ 1124(2), though, essentially extends the otherwise-available nonbankruptcy right to cure payment defaults *beyond* the date specified in the parties' contract (via the acceleration clause), permitting cure of all individual payment defaults predating confirmation of the debtor's plan of reorganization. This bankruptcy cure, then, has the same effect as would a nonbankruptcy cure of payment defaults; it prevents contract termination and the creditor's resulting claim for damages for total breach by undoing the pre-bankruptcy acceleration and "reinstat[ing] the maturity of such claim . . . as such maturity existed before such default."[21]

Payment of Interest as a Component of Cure of Payment Defaults

What, then, is necessary to "cure" pre-confirmation defaults? As a general matter, a "party in breach. . . can 'cure' the breach by correcting the deficiency in performance."[22] On "the question of what is required for cure" (i.e., correcting the deficiency in performance) "[f]or missed payments, the answer is easy—make up the payments."[23] When the default is a debtor's failure to make payments on a debt that is accruing interest, though, failure to repay principal amounts when agreed means that those principal amounts will continue to accrue interest until those principal amounts are actually repaid through a cure payment. Correcting the deficiency in performance, therefore, would seem to require payment of not only (1) the agreed (but missed) periodic amounts called for by the parties' agreement, but also payment of (2) additional accrued interest on the principal portion of that sum for the period that those funds remained delinquent.

Recognizing (a) that agreed periodic payments are often composed of both principal repayment and accrued interest on the entire unpaid principal balance and (b) that the principal amount of the debt will continue to accrue interest until repaid, an alternative way to describe that required cure amount when the debtor has stopped making payments would be payment of (1) the principal portion of all missed payments, plus (2) accrued interest on the entire unpaid principal balance of the debt to the date of cure. Under either formulation, though, interest seems to be an inescapable component of "cure" of defaulted payments on an interest-bearing debt.

The Interest Rate for Curing a Payment Default

If one takes such a "contractual" view of the "cure" required by Code § 1124(2), then the concept of "cure" of a defaulted payment on an interest-bearing debt seems to ineluctably include payment of interest at the rate specified in the parties' contractual agreement. But if the parties' agreement provides that the debt will bear interest at a higher rate after a default (which is common), then what rate is appropriate for calculating the required cure payment—the pre-default contract rate or the higher post-default contract rate?

Entz-White: The Pre-Default Contract Rate of Interest

In *Entz-White*, the most famous decision on this issue, the Ninth Circuit reasoned as follows:

> The Code does not define "cure." In *In re Tadeo*, 685 F.2d 24, 26-27 (2d Cir. 1982), the Second Circuit said, "A default is an event in the debtor-creditor relationship which triggers certain consequences. . . . Curing a default commonly means taking care of the triggering event and returning to pre-default conditions. The consequences are thus nullified. This is the concept of "cure" used throughout the Bankruptcy Code.". . .
>
> * * * *
>
> And, by curing the default, [the debtor] is entitled to avoid all consequences of the default—including higher post-default interest rates. . . . It is clear that the power to cure under the Bankruptcy Code authorizes a plan to nullify all consequences of default, including avoidance of default penalties such as higher interest.[24]

The Ninth Circuit, therefore, held that any cure payment need only include interest calculated at the nondefault contract rate of interest.

This conclusion, however, is far from clear. Even if one accepts the premise that the concept of "cure" implies nullifying all of the consequences of the cured default, all that necessarily follows is that *post-cure* the debt should accrue interest at the

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lower nondefault contract rate of interest (as if the now-cured default had never occurred).[25] However, nothing in the notion of "cure" as nullifying the consequences of default necessarily tells us the rate at which interest should accrue post-default and *pre-cure* (before the consequences of default have been nullified by the cure).

Arguably, when the parties' agreement contains a post-default interest rate, they have tacitly agreed[26] that, until all of the consequences of default are nullified (by payment in full or otherwise), the debt will accrue interest at the higher default rate—implying that the consequences of default can be nullified through "cure" of the default only if the cure amount is calculated at the higher default rate of interest. In other words, part and parcel of the "default" that must be cured is the debtor's failure to pay (as agreed) default-rate interest accruing until the date of cure. As one bankruptcy court put it:

> I agree that a cure must take care of the triggering event and that cure can nullify consequences. . . . One consequence of default may be, as here, an increase in the interest rate. But it seems to me that that consequence must be, under the notes, part of the cure.[27]

Nonetheless, *Entz-White*, as well as an earlier decision from Bankruptcy Judge Lifland,[28] represented the dominant early view that cure under Code § 1124(2)(A) only requires payment of interest at the nondefault contract rate, notwithstanding a higher default rate in the parties' agreement,[29] and the Ninth Circuit's subsequent decisions confirmed *Entz-White*'s conception of "cure" as *retroactively* nullifying the consequences of default as regards a post-default interest rate.[30] So while the concept of "cure" as nullifying all consequences of the default, in and of itself, cannot and does not tell us whether that cure is retroactive or prospective,[31] *Entz-White* clearly held that a bankruptcy "cure" is *retroactive*, at least as concerns the applicable contractual rate of interest.

The Supreme Court's subsequent *Rake v. Wade* decision conceptualized cure interest in an entirely different, non-contractual manner. The 1994 amendments to the Code overruled *Rake v. Wade* and mandated a "contractual" conception of the required cure amount, but the effect of that amendment on the issue of whether payment of post-default contract interest is part of the required cure payment is hardly definitive.

Rake v. Wade: Interest on Cure Amounts Is Governed by Code § 506(b)

Rake v. Wade involved a Chapter 13 debtor whose plan proposed cure and reinstatement of an oversecured home mortgage debt, as authorized by Code § 1322(b)(3) & (5). The Supreme Court's opinion conceptualized the cure payment required for reinstatement of the mortgage debt—i.e., the missed mortgage payments—as simply a subcomponent of the petition-date mortgage "debt" itself (within the meaning of Code § 101(12)), with a corresponding "claim" (under Code § 101(5)(A)) by the mortgage "creditor" (under Code § 101(10)(A)) to be repaid the missed payment amounts. The right to interest as part of the post-petition cure payment, therefore, according to Justice Thomas's opinion for the unanimous *Rake v. Wade* Court, should be determined by the Code's general provisions regarding post-petition interest on pre-petition claims. Since the mortgage creditor in that case was oversecured, then, that oversecured creditor was entitled to receive post-petition interest as part of the required cure payment under Code § 506(b).[32]

The theory of *Rake v. Wade* was a distinct departure from the contractual conception of cure interest (explored above) that is implicit in *both* the *Entz-White* reasoning *and* the reasoning that challenges *Entz-White* as *contrary* to the terms of the parties' contract. Indeed, the Court's prior *Ron Pair* decision had completely decoupled the entitlement to post-petition interest under § 506(b) from the parties' agreement regarding payment of interest.[33] The theory of *Rake v. Wade* was subject to several potential objections, but the one that led to its ultimate demise was the fact that it required payment of interest on interest, even when the note at issue did not provide for payment of such compound interest and, indeed, even if such compound interest would be prohibited by applicable nonbankruptcy state law.

To understand this interest-on-interest objection, recall that many periodic payments on installment

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obligations contain both (1) a repayment of some portion of the principal amount of the debt, and (2) all accrued interest on the entire unpaid principal balance. For example, consider an oversecured debt bearing 12% simple annual interest (1% per month) that requires monthly payments of $200 of principal plus all accrued interest since the last monthly payment. Debtor does not make the monthly payment owing when the principal balance of the debt is $10,000, which monthly payment is in the amount of $300, comprised of a $200 payment of principal plus $100 of accrued interest (1% of $10,000). Debtor files Chapter 11 on the date that the $300 monthly payment was due, and then proposes to cure and reinstate that defaulted oversecured installment debt under Debtor's Chapter 11 plan that has an effective date of one month after the petition date.

Assuming for the sake of simplification that the required § 506(b) post-petition interest rate is also 12% simple annual interest (1% per month), under the theory of *Rake v. Wade*, the effective-date payment required to cure the $300 missed payment would be the petition-date amount owing (the "debt"/"claim") for that missed payment ($300), *plus* one month of interest on that amount ($3), for a total cure payment of $303. If we were to honor the parties' agreement, though, that unpaid principal bears only simple (noncompounded) interest (i.e., no interest on interest), the required cure interest would be only one month's interest ($2) on the principal portion of the missed payment ($200), for a total cure payment of $302.[34] The *Rake v. Wade* cure payment is larger because it includes interest on the interest component of the missed payment.

Post-petition interest on interest is a hot-button issue in bankruptcy jurisprudence. Indeed, in the venerable case of *Vanston Bondholders Protective Committee v. Green*, the Supreme Court held that post-petition interest on interest could *not* be allowed to an oversecured creditor because "an allowance of interest on interest . . . would not be in accord with the equitable principles governing bankruptcy distributions."[35] In legislatively overruling *Rake v. Wade*, then, the House Report accompanying the 1994 amendments explained as follows:

> Section 305. Interest on Interest.
>
> This section will have the effect of overruling the decision of the Supreme Court in *Rake v. Wade*. In that case, the Court held that the Bankruptcy Code required that interest be paid on mortgage arrearages paid by debtors curing defaults on their mortgages. Notwithstanding State law, this case has had the effect of providing a windfall to secured creditors . . . . This had the effect of giving secured creditors interest on interest payments, and interest on late charges and other fees, even where applicable laws prohibit such interest and even when it was something not contemplated by either party in the original transaction.[36]

The 1994 Enactment of Code § 1123(d) and a Contractual Theory of Cure

In overruling *Rake v. Wade*, Congress simply repudiated its theory that cure interest is governed by Code § 506(b). Thus, the 1994 Code amendments enacted a new § 1123(d), applicable to loan agreements entered into after the effective date of the 1994 amendments (October 22, 1994), as follows:

> (d) Notwithstanding . . . sections 506(b), 1129(a)(7), and 1129(b) of this title, if it is proposed in a plan to cure a default the amount necessary to cure the default shall be determined in accordance with the underlying agreement and applicable nonbankruptcy law.[37]

This amendment, therefore, mandates a "contractual" conception of the necessary cure amount, which means that cure interest must be computed at the contract rate. The *New Investments* majority was of the opinion that § 1123(d) also necessarily overrules *Entz-White* and requires cure interest to be computed at the contractual *default* rate:

> § 1123(d) renders void *Entz-White*'s rule that a debtor who proposes to cure a default may avoid a higher, post-default interest rate in a loan agreement. . . . The underlying agreement—here, the promissory note—requires the payment of a higher interest rate upon default. And "applicable nonbankruptcy law"—here, Washington state law—allows for a higher interest rate upon default when provided for in the loan agreement. . . .
>
> The plain language of § 1123(d) compels the holding that a debtor cannot nullify a preexisting obligation in a loan agreement to pay post-default interest solely by proposing a cure. . . .
>
> * * * *
>
> . . . [T]he debtor must cure the default but may

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> not "otherwise alter the legal, equitable, or contractual rights" of the creditor, 11 U.S.C. § 1124(2)(E). Here, one of those rights is post-default interest, and New Investments's [sic] cure may not alter that right.
>
> Consistent with § 1124(2), the debtor can return to pre-default conditions, which can include a lower, pre-default interest rate, only by fulfilling the obligations of the underlying loan agreement and applicable state law. 11 U.S.C. § 1123(d). By its terms, § 1123(d) requires that we look to the "underlying agreement," not only to the "pre-default interest provisions" of the underlying agreement.[38]

§ 1123(d) Does Not Specify the Effects of Cure

The reasoning of the Eleventh Circuit panel in *Sagamore Partners* was identical to that of the *New Investments* majority, and the *Sagamore Partners* panel even went so far as to state that § 1123(d) "provide[s] the previously missing definition of 'cure.' "[39] That, however, attributes much more content to § 1123(d) than its "plain language" can carry.

At most, § 1123(d), by its terms, merely specifies a general methodology for determining the "*amount*" that must be paid to cure a *payment default*, and it mandates a "contractual" approach to that payment-amount issue consistent with the "contractual" conception of cure discussed above. Equally (if not more) significant to a complete understanding (i.e., definition) of cure, though, is determining the *effects* of a cure, and § 1123(d), by its terms, says *absolutely nothing* about the *effects* of a cure. Indeed, the *New Investments* majority acknowledged that "§ 1123(d) has *not altered or attempted to define*" the "concept of cure generally" as regards its effects of "put[ting] the debtor in the same position as if the default had never occurred" and "returning to pre-default conditions."[40]

For example, one of the effects of cure, provided for explicitly by § 1124(2)(B), is that cure of defaults permits the plan, in true cram-down fashion (i.e., over the creditor's objection via lack of "impairment" of the creditor's claim), to "reinstate[] the maturity of such claim . . . as such maturity existed before such [cured] default[s]." Nowhere, however, does the Code expressly state that cure of defaults permits the plan (without "impairment" of the creditor's claim) to "provide[] for future [post-cure] interest payments at the pre-default [interest] rate, rather than the post-default [interest] rate."[41] Nonetheless, courts (including the *New Investments* majority in the above-quoted passage) generally assume that such is indeed an effect of "cure" that will *not* "impair" the creditor's claim, by leaning upon the entirely non-statutory "definition" of "cure" set forth in *Entz-White* and that the drafters of the 1994 amendments also endorsed in the House Report explaining § 1123(d): "It is the Committee's intention that a cure pursuant to a plan should operate to put the debtor in the same position as if the default had never occurred."[42]

The Parties' Contract and Applicable Nonbankruptcy Law Cannot Specify the Effects of a Bankruptcy Cure

Code § 1123(d), then, does not speak to the *effects* of cure. Indeed, because § 1123(d) adopts a "contractual" theory of cure, § 1123(d) *cannot* speak to the *effects* of cure, which are purely federal bankruptcy law effects that *contravene* "the underlying agreement" of the parties "and applicable nonbankruptcy law" referenced in § 1123(d).

For example, the § 1124(2)(B) "de-acceleration" of a defaulted note after a § 1124(2)(A) cure of defaults is manifestly in contravention of any pre-bankruptcy acceleration of the indebtedness provided for "in accordance with the underlying agreement," which acceleration is fully enforceable under "applicable nonbankruptcy law."[43] Moreover, the same is true of all other *effects* of a bankruptcy "cure" of defaults, such as reinstating the nondefault rate of interest for all *future*, *post-cure* debt payments: all such *effects* of a bankruptcy cure are *necessarily* a matter of federal bankruptcy law that simply *cannot* be determined by looking to "the underlying agreement and applicable nonbankruptcy law" referenced in § 1123(d). As the Tenth Circuit stated in construing the contours of a bankruptcy "cure" and the rights afforded thereby, "this issue is as much one of federal law . . . as is the determination that [a bankruptcy "cure"] gives the debtor the right to reverse contractual acceleration of a mortgage in default."[44]

Because the *effects* of a "cure," de-acceleration, and reinstatement in bankruptcy necessarily *con-*

travene the terms of the parties' agreement and otherwise applicable state law, we simply cannot (and thus should not even try to) derive those *effects* by looking to the parties' agreement and applicable state law.

The *Entz-White* Decision Was a Holding Regarding the Retroactive Effect of a Bankruptcy Cure

As discussed above, in mandating a contractual conception of required cure amounts, Code § 1123(d) overturned the *Rake v. Wade* non-contractual (§ 506(b)) theory of cure interest. *Entz-White*, though, is *not* inconsistent with a contractual conception of required cure amounts. Indeed, as discussed above, both *Entz-White* and cases rejecting *Entz-White* reason from a contractual theory of cure.

The issue to which *Entz-White* was directed was solely one of the *effects* of a bankruptcy cure in nullifying a particular consequence of default (the default rate of interest): *is the nullification of the default rate of interest prospective only or retroactive* (such that cure interest is also paid at the nondefault rate of interest specified in the parties' contract)? As with all other questions regarding the *effects* of a bankruptcy cure, *necessarily* that is purely a question of federal bankruptcy law that *cannot* be determined "in accordance with the underlying agreement and applicable nonbankruptcy law" referenced in § 1123(d).

This is what Judge Berzon was getting at in her dissent in *New Investments*. Code § 1123(d) tells us that cure interest must be computed at a contract rate of interest "in accordance with the underlying agreement" (as long as that interest rate is enforceable under "applicable nonbankruptcy law"), but it tells us nothing about whether the nondefault or default rate of interest is the appropriate contract rate[45] because § 1123(d) does not tell us whether cure is prospective or retroactive in nullifying the default rate of interest. Merely adopting a contractual theory of the required "cure" amount (as mandated in § 1123(d)), in and of itself, cannot and does not resolve the question of whether that cure is prospective or retroactive.

Indeed, there is *nothing* in the terms of the Code itself and (as discussed above) *nothing* in the general (non-statututory) concept of "cure" as nullifying the consequences of default that resolves the question of whether that nullifying of consequences is prospective or retroactive.[46] The *New Investments* majority simply *assumed* that a bankruptcy "cure" must operate purely *prospectively*. That is certainly a plausible construction and application of the concept of "cure" as nullifying the consequences of default, if the *New Investments* court were considering the matter as one of first impression, writing on a clean slate. The *New Investments* court, however, was *not* writing on a clean slate; *Entz-White* clearly held that a bankruptcy "cure" is *retroactive* as concerns the applicable contractual rate of interest.[47]

Judge Berzon, in dissent, thus was absolutely correct that the *New Investments* panel was bound by the existing Ninth Circuit precedent of *Entz-White* as regards the retroactive effect of "cure" in nullifying default rates of interest. "The majority's conclusion that § 1123(d) overruled *Entz-White* has no basis in the text of the statute,"[48] particularly given the majority's admission that "§ 1123(d) has *not* altered or attempted to define" the "concept of cure generally" in "returning [a loan] to pre-default conditions."[49]

The Washington Deed of Trust Statute Cannot Determine the Effects of a Bankruptcy Cure

Understanding that the *effects* of a bankruptcy "cure" of defaults can *only* be determined by federal bankruptcy law also helps us see why the *New Investments* majority's reliance on the Washington deed of trust statute was badly misguided. That state statue permits a debtor to halt a nonjudicial foreclosure sale by making a statutorily specified cure of payment defaults, and that statue seems to require that the interest component of the cure payment required to halt the foreclosure be computed using any contractual default rate of interest.[50] The effect of that state statute, however, is to halt a foreclosure sale (which is utterly immaterial for purposes of a bankruptcy "cure"), and that state statute obviously cannot determine the effects of a bankruptcy "cure" of defaults as retroactive or prospective.

For example, nothing in that Washington statute

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purports to nullify default rates of interest *at all*, either retroactively or prospectively.[51] Yet, the Ninth Circuit has squarely held[52] and the *New Investments* majority reaffirmed that a bankruptcy "cure" of defaults *does prospectively* "return[a loan] to pre-default conditions, which can include returning to a lower, pre-default interest rate."[53] That is because the *prospective* nullification of a default interest rate through a bankruptcy "cure" of defaults necessarily is a question of federal bankruptcy law that cannot be determined by the Washington deed of trust statute. Likewise, whether the nullification of default interest through a bankruptcy "cure" is *retroactive* is also exclusively a question of federal bankruptcy law that cannot be determined by the Washington deed of trust statute.

Entz-White, as a matter of the *federal bankruptcy law* effects of a § 1124(2)(A) "cure" of defaults, clearly held that such a cure is *retroactive* in nullifying a default rate of interest, and Washington state law cannot somehow "preempt" that decision. The *New Investments* majority's conclusion to the contrary turns the Supremacy Clause on its head.

Not only did the *New Investments* majority err in concluding that Code § 1123(d) legislatively overruled *Entz-White*, the majority opinion also wholly failed to address another provision in the 1994 amendments, enacted concurrently with § 1123(d), that may well have <u>*codified*</u> *Entz-White*. Part II of this article, in next month's *Bankruptcy Law Letter* will address the implications of Code § 365(b)(2)(D), which are incorporated by explicit statutory reference into (and thus govern the cure required by) § 1124(2)(A).

ENDNOTES:

[1]In re Entz-White Lumber and Supply, Inc., 850 F.2d 1338, 18 Bankr. Ct. Dec. (CRR) 83, Bankr. L. Rep. (CCH) P 72380, 98 A.L.R. Fed. 831 (9th Cir. 1988).

[2]Rake v. Wade, 508 U.S. 464, 113 S. Ct. 2187, 124 L. Ed. 2d 424, 24 Bankr. Ct. Dec. (CRR) 533, 28 Collier Bankr. Cas. 2d (MB) 983, Bankr. L. Rep. (CCH) P 75275 (1993).

[3]U.S. v. Ron Pair Enterprises, Inc., 489 U.S. 235, 109 S. Ct. 1026, 103 L. Ed. 2d 290, 18 Bankr. Ct. Dec. (CRR) 1150, Bankr. L. Rep. (CCH) P 72575, 89-1 U.S. Tax Cas. (CCH) P 9179, 63 A.F.T.R.2d 89-652 (1989).

[4]In re New Investments, Inc, 840 F.3d 1137, 63 Bankr. Ct. Dec. (CRR) 97, Bankr. L. Rep. (CCH) P 83029 (9th Cir. 2016).

[5]In re Sagamore Partners, Ltd., 620 Fed. Appx. 864, 868-69 (11th Cir. 2015).

[6]Restatement (Second) of Contracts § 236(1) (1981).

[7]E. Allan Farnsworth, Contracts § 8.18, at 575 (4th ed. 2004) (footnotes omitted). See Restatement (Second) of Contracts § 243(3).

[8]Restatement (Second) of Contracts § 243 comment d.

[9]11 U.S.C.A. § 1126(f).

[10]11 U.S.C.A. § 1129(b)(1) & (a)(7).

[11]The repeated emphasis of the court in the *Moody National* case, therefore, to the effect that § 1124(2) is "merely definitional" and thus provides no "basis for the granting of substantive relief" is not only extremely curious, but more importantly, is simply incorrect. In re Moody Nat. SHS Houston H, LLC, 426 B.R. 667, 672, 52 Bankr. Ct. Dec. (CRR) 262 (Bankr. S.D. Tex. 2010). "A major purpose of reinstatement in Chapter 11 is for the [terms of loan] agreements to stand as an alternative to cram down rights under § 1129(b)." David Gray Carlson, Rake's Progress: Cure and Reinstatement of Secured Claims in Bankruptcy Reorganization, 13 Emory Bankr. Dev. J. 273, 286 (1997).

[12]Just what that rate is or should be is still subject to considerable uncertainty and debate. See generally Ralph Brubaker, Cramdown Interest Rates: Disarray Dominates Till . . . ?, 24 Bankr. L. Letter No. 8, at 1 (Aug. 2004); Anthony J. Casey, Bankruptcy's Endowment Effect, 33 Emory Bankr. Dev. J. 141 (2016); Bruce A. Markell, Fair Equivalents and Market Prices: Bankruptcy Cramdown Interest Rates, 33 Emory Bankr. Dev. J. 91 (2016); Bruce A. Markell, To Market, To Market: Momentive and Secured Creditor Cram Down Interest Rates, 36 Bankr. L. Letter No. 2, at 1 (Feb. 2016).

[13]Matter of Madison Hotel Associates, 749 F.2d 410, 419-20, 12 Bankr. Ct. Dec. (CRR) 616, 11 Collier Bankr. Cas. 2d (MB) 771 (7th Cir. 1984).

[14]"The Code does not define 'cure.' " Entz-White, 850 F.2d at 1340.

[15]See generally Ralph Brubaker, Cure of Nonmonetary Defaults as a Prerequisite to Assumption of Executory Contracts and Unexpired Leases: A Lesson in the Nature and Function of the Cure Requirement, 24 Bankr. L. Letter No.12, at 1, 7-8 (Dec. 2004); Ward Benson, Nonmonetary "Historical" Defaults Should Not Always Prevent Assumption of Executory Contracts: State Contract Law as the Standard for the Cure Requirement in § 365(b) of the Bankruptcy Code, 23 J. Bankr. L. & Prac.

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No. 4, at 413 (Aug. 2014); Andrea Coles-Bjerre, Ipso Facto: The Pattern of Assumable Contracts in Bankruptcy, 40 N.M. L. Rev. 77, 101 & n.101 (2010); David G. Epstein & Lisa Normand, "Real World" and "Academic" Questions About "Nonmonetary Obligations" Under the 2005 Version of 365(b), 13 Am. Bankr. Inst. L. Rev. 617, 623 & n.25 (2005).

[16]Restatement (Second) of Contracts § 243 comment d.

[17]Farnsworth, Contracts § 8.15, at 562.

[18]Farnsworth, Contracts § 8.18, at 572.

[19]Restatement (Second) of Contracts § 243 comment a.

[20]See Farnsworth, Contracts § 8.18, at 572-74.

[21]11 U.S.C.A. § 1124(2)(B). If the debtor had not defaulted on the debt pre-petition, the bankruptcy filing itself operates to accelerate the debt, by virtue of Code § 502(b)'s provisions (1) that the amount of a creditor's claim is to be allowed "as of the date of the filing of the petition" and (2) disallowing any "claim for unmatured interest." 11 U.S.C.A. § 502(b) & (b)(2). "Section 502(b) thus contains t[he] principle[]" that "bankruptcy operates as the acceleration of the principal amount of all claims against the debtor." S. Rep. No. 95-989, at 63 (1978); H.R. Rep. No. 95-595, at 353 (1977).

In such a case, if there were also no defaults on the debt post-petition, that debt could be reinstated without impairment thereof, under Code § 1124(1), if the plan "leaves unaltered the legal, equitable, and contractual rights to which such claim . . . entitles the holder of such claim." More likely in such a case, though, is the scenario under which post-petition payments on that debt are not made during the pendency of the automatic stay, and thus, cure of those post-petition payment defaults would be necessary to reinstate the debt without impairment thereof, under Code § 1124(2).

[22]Farnsworth, Contracts § 8.17, at 569.

[23]In re Garcia, 276 B.R. 627, 639 (Bankr. D. Ariz. 2002).

[24]Entz-White, 850 F.2d at 1340, 1342.

[25]That is the holding of In re Southeast Co., 868 F.2d 335, 337-38, 18 Bankr. Ct. Dec. (CRR) 1519, 20 Collier Bankr. Cas. 2d (MB) 1348, Bankr. L. Rep. (CCH) P 72698 (9th Cir. 1989).

[26]The Southeast Co. case provides a rarer example where this agreement was explicit. The note in that case provided that acceleration (at the creditor's option upon default) was independent of and cumulative to default interest (triggered automatically upon default). The debtor could "cure" any payment default before (and thus prevent) acceleration, and "[p]ayment of any interest that had accrued at the default rate was required by the note's terms as a condition precedent to curing default." 868 F.2d at 336.

[27]In re Johnston, 2004 WL 3019472, at *7 (Bankr. N.D. Iowa 2004). See also Carlson, 13 Emory Bankr. Dev. J. at 333 (characterizing the *Entz-White* reasoning as "[p]retending the contract is not in default (when it is) and thereby invoking the predefault rate in violation of the contract"). Cf. In re Countrywood Inv. Group, Ltd., 117 B.R. 338 (Bankr. M.D. Tenn. 1990) (plan provided for interest at default rate as part of cure payment; court holds that payment of that cure amount reinstates pre-default contract rate of interest).

[28]In re Forest Hills Associates, 40 B.R. 410, 11 Bankr. Ct. Dec. (CRR) 1145, Bankr. L. Rep. (CCH) P 69876 (Bankr. S.D. N.Y. 1984).

[29]See also In re Udhus, 218 B.R. 513, 32 Bankr. Ct. Dec. (CRR) 376, 39 Collier Bankr. Cas. 2d (MB) 1139 (B.A.P. 9th Cir. 1998); In re Johnson, 184 B.R. 570, 27 Bankr. Ct. Dec. (CRR) 723, 34 Collier Bankr. Cas. 2d (MB) 72 (Bankr. D. Minn. 1995); In re PCH Associates, 122 B.R. 181 (Bankr. S.D. N.Y. 1990); In re Singer Island Hotel, Ltd., 95 B.R. 845, 20 Collier Bankr. Cas. 2d (MB) 436 (Bankr. S.D. Fla. 1989).

[30]See, e.g., In re Sylmar Plaza, L.P., 314 F.3d 1070, 40 Bankr. Ct. Dec. (CRR) 172, 49 Collier Bankr. Cas. 2d (MB) 1413, Bankr. L. Rep. (CCH) P 78768 (9th Cir. 2002).

[31]As Professor Carlson nicely illustrated, the logical exercise of reasoning from a purely counterfactual subjunctive ("what if") scenario is entirely indeterminate:

> Indeed, subjunctive work of this sort (reimagining the world "as if" the contract were never breached) [could even] produce a cure price of zero. That is, if we can pretend the debtor never defaulted for the purpose of triggering postdefault interest, we can pretend no default for other reasons as well. Namely, we can pretend that the secured party was paid all amounts due and owing under the contract, plus attorney's fees. If we unleash subjunctive imagination, there is no limit, save that which imagination chooses to impose upon itself, in reordering the contractual rights of the parties.

Carlson, 13 Emory Bankr. Dev. J. at 333-34.

[32]And since Code § 1322(b)(5) authorizes payment of cure amounts over "a reasonable time" post-confirmation, that secured creditor would also be entitled to received post-confirmation interest on the confirmation-date cure amount (including all post-petition interest that had accrued under § 506(b)) pursuant to Code § 1325(a)(5).

Unlike Chapter 13, Chapter 11 seems to contemplate immediate effective-date payment of cure amounts under § 1124(2), thus mooting any inquiry regarding post-confirmation interest. See Moody National, 426 B.R. at 671 & n.4; Carlson, 13 Emory Bankr. Dev. J. at 339-40.

[33]*Ron Pair* held that even a nonconsensual oversecured creditor, who thus has no agreement with the debtor regarding payment of interest on the debt, is entitled to post-petition interest under

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Code § 506(b).

[34]Under either approach, the debtor would also make the regular monthly periodic payment due on the effective date of the plan in the amount set under the parties' original payment schedule (i.e., as if the $300 monthly payment had been made when due). If you want to check your math, that payment would be in the amount of $298.

[35]Vanston Bondholders Protective Committee v. Green, 329 U.S. 156, 163, 67 S. Ct. 237, 91 L. Ed. 162 (1946). As regards interest on interest, then, the *Rake v. Wade* holding was, therefore, precisely the opposite of the *Vanston* holding. *Vanston* assumed that interest on interest *was* to be paid under the terms of the parties' agreement and applicable state law, but nonetheless held that it could *not* be allowed to an oversecured creditor post-petition. *Rake* assumed that interest on arrearages (including interest on interest) was *not* permissible under the terms of the parties' agreement or applicable state law, but nonetheless held that such interest (including interest on interest) *must* be allowed to the oversecured creditor post-petition.

[36]H.R. Rep. No. 103-835, at 55 (1994), reprinted in 1994 U.S.C.C.A.N. 3340, 3364 (citation omitted). See also 140 Cong. Rec. H10,770 (daily ed. Oct. 4, 1994) (same).

[37]Substantially identical provisions were also added to Chapters 12 and 13, in §§ 1222(d) and 1322(e), respectively.

[38]New Investments, 840 F.3d at 1140-42. Accord In re 1 Ashbury Court Partners, L.L.C., 2011 WL 4712010, at *4-5 (Bankr. D. Kan. 2011); Moody National, 426 B.R. at 672-73, 674-76; In re K & J Properties, Inc., 338 B.R. 450, 461, 44 Bankr. Ct. Dec. (CRR) 208 (Bankr. D. Colo. 2005); Johnston, 2004 WL 3019472, at *7.

[39]Sagamore Partners, 620 Fed. Appx. at 869.

[40]New Investments, 840 F.3d at 1141 (emphasis added).

[41]Southeast Co., 868 F.2d at 337.

[42]H.R. Rep. No. 103-835, at 55, reprinted in 1994 U.S.C.C.A.N. at 3364. Accord 140 Cong. Rec. H10,770 (daily ed. Oct. 4, 1994) (same).

[43]11 U.S.C.A. § 1123(d).

[44]In re Thompson, 894 F.2d 1227, 1230, 20 Bankr. Ct. Dec. (CRR) 213, 22 Collier Bankr. Cas. 2d (MB) 250, Bankr. L. Rep. (CCH) P 73225 (10th Cir. 1990).

[45]As Judge Berzon put it: "In short, the text of § 1123(d) makes clear that New Investments' cure will be based on the terms of the promissory note, but offers no guidance on which of the note's provisions governs here." New Investments, 840 F.3d at 1144 (Berzon, C.J., dissenting).

[46]Again, Judge Berzon was absolutely correct: "Neither § 1123(d) nor any other provision of the Bankruptcy Code explains *where* in the underlying agreement to look for the provisions that apply in the event of a cure." New Investments, 840 F.3d at 1144 (Berzon, C.J., dissenting).

[47]As Judge Berzon put it, "the text of § 1123(d) makes clear that New Investments' cure will be based on the terms of the promissory note, but offers no guidance on which of the note's provisions governs here. *Entz-White* provides that guidance," though. New Investments, 840 F.3d at 1144 (Berzon, C.J., dissenting).

[48]New Investments, 840 F.3d at 1144 (Berzon, C.J., dissenting).

[49]New Investments, 840 F.3d at 1141 (emphasis added).

[50]See Wash. Rev. Code Ann. § 61.24.090(1)(a).

[51]See Meyers Way Development Ltd. Partnership v. University Sav. Bank, 80 Wash. App. 655, 910 P.2d 1308, 1317 (Div. 1 1996) (nothing in the statute nullifies default interest provisions); Wash. Code Ann. § 61.24.090(3) (providing that upon cure of defaults, "the deed of trust shall be reinstated and the obligation shall remain as though no *acceleration* had taken place," *not* as though no *default* had taken place (emphasis added)).

[52]See Southeast Co., 868 F.2d at 337-38.

[53]New Investments, 840 F.3d at 1142.

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Default Rates of Interest and Cure of a Defaulted Debt in a Chapter 11 Plan of Reorganization (Part II): *Entz-White* and the "Penalty Rate" Amendments

By Ralph Brubaker

The congeries of confusing Code provisions in Code §§ 365(b)(2)(D), 1124(2)(A), and 1123(d) produces an important and very difficult question: when a debtor's Chapter 11 plan of reorganization proposes to cure a defaulted promissory note and "de-accelerate" and reinstate the original repayment schedule pursuant to Code § 1124(2), what rate of interest must the debtor pay on the debt from the date of default through the date of cure—the contractual rate of interest, a market rate, or some other (e.g., formula) rate? And if the contract rate is to be used, is the appropriate contract rate the nondefault rate of interest or the higher default rate set by the parties' contract?

In the 1983 Ninth Circuit decision of *In re Entz-White Lumber and Supply, Inc.*,[1] the court held that the appropriate rate of interest for the cure payment is the nondefault contract rate of interest. In the subsequent Supreme Court decision of *Rake v. Wade*,[2] though, by holding that the interest necessary to cure defaults is governed by Code § 506(b), the Court decoupled cure interest from the contract rate of interest, given the *Ron Pair* interpretation of § 506(b).[3] But in 1994 Congress enacted Code § 1123(d) to overrule *Rake v. Wade* and mandate that cure amounts be determined in accordance with the parties' contractual agreement and applicable state law.

In the case of *In re New Investments, Inc.*,[4] the Ninth Circuit held that § 1123(d) has also legislatively overruled *Entz-White* and requires payment of cure interest at the default rate of interest contained in the parties' contract, and the Eleventh Circuit similarly construed the effect of § 1123(d) in a nonprecedential opinion in the case of *In re Sagamore Partners, Ltd.*[5] There was a vigorous dissenting opinion in *New Investments*, though.

Part I of this two-part article, in last month's issue of *Bankruptcy Law Letter*, analyzed those courts' decisions that the "plain meaning" of Code § 1123(d) repudiates the *Entz-White* conception of cure.

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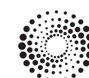

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Entz-White, though, was a decision regarding the *effects* of a § 1124(2)(A) "cure" of defaults (holding that such a "cure" is *retroactive* in nullifying a default interest rate), and the *effects* of a § 1124(2)(A) "cure" of defaults (as either retroactive or purely prospective) is exclusively an issue of *federal bankruptcy law* that simply *cannot* be determined by looking to "the underlying agreement" of the parties or "applicable nonbankruptcy law" referenced in Code § 1123(d). Indeed, the *New Investmtents* majority fully acknowledged that "§ 1123(d) has *not* altered or attempted to define" the "concept of cure generally" in "returning [a loan] to pre-default conditions, which can include a lower, pre-default interest rate."[6] Nothing in § 1123(d) even purports to tell us whether the nullification of default interest rates effected by "cure" is retroactive or prospective, so § 1123(d) by its terms did *not* (and could *not*) overrule the *Entz-White* holding that a "cure" is retroactive in that regard.

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This Part II analyzes an even more curious (and potentially more significant) aspect of the *New Investments* decision. Not only was *New Investments* wrongly decided, it may also have absolutely *no* precedential force, even within the Ninth Circuit. That is because the *New Investments* opinion (both majority and dissent), like the *Sagamore Partners* panel, wholly failed to address another provision in the 1994 amendments, enacted concurrently with § 1123(d), that may well have codified *Entz-White*. This Part II analyzes the implications of Code § 365(b)(2)(D), which is incorporated by explicit statutory reference into (and thus governs the cure required by) § 1124(a)(2)(A).

Given the immense complexity (intensified by perplexing ambiguity) of the Code provisions at issue, as well as the large dollar amounts that can be at stake, we may not have heard the last of *Entz-White*.

The 1994 Enactment of Code § 365(b)(2)(D): Codification of *Entz-White*?

Note that the "cure" required by § 1124(2)(A) in order to "de-accelerate" and reinstate a debt under § 1124(2)(B) is cure of any "default that occurred before or after commencement of the case. . ., *other than a default of a kind specified in section 365(b)(2)*." Code § 365(b)(2) was originally enacted as part of the Code's general invalidation of *ipso facto* default provisions, providing that the cure, compensation, and adequate assurance requisites to assumption of a defaulted executory contract are not required with respect to *ipso facto* defaults.

Of course, default rates and other default fees and charges present similar *ipso facto* concerns.[7] Enforcement of such provisions, triggered by an effective proxy for or predictor of a bankruptcy filing (a default), would enable individual creditors to improve their position in bankruptcy relative to other creditors or to "extort" a windfall distribution from the debtor's going-concern surplus that a

Chapter 11 proceeding preserves. Thus, Code § 365(b)(2) was subsequently amended in 1994 to add a new sub-subsection 365(b)(2)(D), which itself was amended in the 2005 BAPCPA amendments (adding the italicized language below) to read as follows:

> (2) Paragraph (1) of this subsection [default cure, compensation, and adequate assurance of future performance] does not apply to a default that is a breach of a provision relating to—
>
> * * * *
>
> (D) the satisfaction of any penalty rate or *penalty* provision relating to a default arising from any failure by the debtor to perform nonmonetary obligations under the executory contract or unexpired lease.

The 2005 amendments to § 365(b)(2) (along with a parallel amendment to § 365(b)(1)(A)) was primarily directed at resolving ambiguity regarding the necessity of curing nonmonetary defaults.[8] The pre-2005 version of § 365(b)(2)(D), though, contained another interpretive ambiguity, relevant to the default-interest inquiry at hand,[9] that the 2005 amendment also seems to have clarified: Is the debtor excused from all penalty rates or only those relating to nonmonetary defaults? That interpretive uncertainty is raised by the difficult disjunctive "or" in § 365(b)(2)(D), which can plausibly be read two alternative ways:

> (1) "satisfaction of any [(i)] penalty rate [relating to a default arising from any failure by the debtor to perform nonmonetary obligations] or [(ii)] penalty provision relating to a default arising from any failure by the debtor to perform nonmonetary obligations"; or
>
> (2) "satisfaction of any [(i)] penalty rate or [(ii)] penalty provision relating to a default arising from any failure by the debtor to perform nonmonetary obligations."

Dialing this into the required "cure" under § 1124(2)(A) for "de-acceleration" and reinstatement of a defaulted note under § 1124(2)(B), interpretation (1) excuses a debtor from paying (as part of its cure) only those penalty interest rates triggered by a nonmonetary default, while interpretation (2) excuses a debtor from paying (as part of its cure) all penalty interest rates. Moreover, as applied to the default interest-rate issue, interpretation (2) excusing a debtor from paying (as part of its cure) any penalty interest rate can be seen as simply a codification of the Ninth Circuit holding in *Entz-White*, which reasoned that "the power to cure under the Bankruptcy Code authorizes a plan to nullify all consequences of default, including avoidance of default penalties such as higher interest."[10] Indeed, Ken Klee made precisely that point in a law review article published shortly after the 1994 amendments.[11] And there are several indications that that is, indeed, the appropriate interpretation of § 365(b)(2)(D).

Interpretive Canons

Canons of statutory construction, in particular series-qualifier canons, suggest that interpretation (2) above, excusing satisfaction of all penalty rates, is the meaning of § 365(b)(2)(D). The general rule regarding a series qualifier, such as the "relating to . . ." clause in § 365(b)(2)(D), is that "[w]hen there is a straightforward, parallel construction that involves all nouns or verbs in a series, a prepositive or postpositive modifier normally applies to the entire series."[12] That general series-qualifier canon, therefore, would point to interpretation (1), excusing from cure only those penalty rates triggered by a nonmonetary default.

There is an exception, however, to the general series-qualifier canon; when a determiner (such as the word "penalty" in § 365(b)(2)(D)) is "repeated before the second element" in the series ("penalty provision" in the § 365(b)(2)(D) series), this "syntax would suggest no carryover modification" to other terms in the series ("penalty rate" in § 365(b)(2)(D)).[13] "With postpositive modifiers, the insertion of a determiner before the second item tends to cut off the modifying phrase so that its backward reach is limited."[14] This particular series-qualifier canon, then, seems to speak directly to the 2005 amendment inserting and repeating the "penalty" determiner before the word "provision" and suggests that the meaning of § 365(b)(2)(D) is that of interpretation (2) above, excusing cure of any and all "penalty rates." Thus, even if interpretation (1) was a reasonable construction of the effect of § 365(b)(2)(D) on a § 1124(2) "cure" before 2005,[15] the 2005 amendment indicates that interpretation (2), excusing satisfaction of any and all "penalty rates," is the meaning of § 365(b)(2)(D).

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Legislative History and Statutory Affirmation of the Claremont Acquisition *Decision*

Interpretation (2), excusing satisfaction of any and all "penalty rates," is also supported by the legislative history surrounding the original 1994 enactment of § 365(b)(2)(D), which suggests that codification of *Entz-White* is precisely what Congress intended with the original version of § 365(b)(2)(D), and thus, the 2005 amendment simply clarified that intention. Both the House Report accompanying the originally proposed § 365(b)(2)(D),[16] as well as floor statements accompanying House passage of the legislation ultimately enacted,[17] described the new § 365(b)(2)(D) as providing that cures can be effected "at a nondefault rate (i.e., [the debtor] would not need to pay penalty rates)."[18]

The Ninth Circuit itself, in its *Claremont Acquisition* decision, clearly indicated that this was indeed the meaning of § 365(b)(2)(D) as originally enacted:

> Congress intended subsection (D) to address a single issue: the payment of penalties. . . . The first clause addresses penalty rates which are commonly imposed where a debtor's breach was monetary in nature. The second clause addresses the payment of penalties under liquidated damages provisions where the debtor's breach was nonmonetary in nature.[19]

Inserting and repeating the word "penalty" before the second clause in 2005 leaves little doubt that this is now the meaning of § 365(b)(2)(D); the 2005 amendment to § 365(b)(2)(D) "expressly adopt[s] the Ninth Circuit's *Claremont* decision," as regards its interpretation of § 365(b)(2)(D).[20] And, of course, part-and-parcel of the 2005 affirmation of the *Claremont Acquisition* interpretation of § 365(b)(2)(D) is a more emphatic codification of *Entz-White*: "The first clause [of § 365(b)(2)(D)] addresses penalty rates which are commonly imposed where a debtor's breach was monetary in nature"[21] and excuses "the satisfaction of any [such] penalty rate."[22]

§ 365(b)(2)(D)'s Specific Directive Negating Penalty Rates Trumps § 1123(d)'s General Directive Regarding Contractual Cure Amounts

The leading decision interpreting the effect of *both* of the 1994 "cure" amendments—*both* § 1123(d) *and* § 365(b)(2)(D)—as regards their effect on the continuing validity of *Entz-White* is Bankruptcy Judge Case's opinion in *In re Phoenix Business Park Ltd. Partnership*, holding that the 1994 amendments did *not* overrule and indeed codified *Entz-White*.[23] Judge Case's analysis of the implications of § 365(b)(2)(D), based upon the *Claremont Acquisition* interpretation of § 365(b)(2)(D), is even more compelling now that the 2005 amendment to § 365(b)(2)(D) has explicitly affirmed the *Claremont Acquisition* interpretation of § 365(b)(2)(D).

Both the Ninth Circuit in *New Investments* and the Eleventh Circuit in *Sagamore Partners* reached a contrary conclusion by completely ignoring the implications of § 365(b)(2)(D) and focusing exclusively upon the supposed "plain language" of § 1123(d). As demonstrated in Part I of this article, though, by its terms § 1123(d) says absolutely *nothing* about the *Entz-White* default interest-rate issue. Code § 365(b)(2)(D), therefore, is the *only* statutory provision that explicitly addresses the *Entz-White* default interest issue.

Even if there were a conflict between § 1123(d) and § 365(b)(2)(D) as regards default interest, though,[24] Judge Case rightly pointed out that § 1123(d)'s failure to specifically trump §§ 365(b)(2)(D) and 1124(2)(A), in its introductory "notwithstanding" clause, means that those provisions (which are more specific with respect to the default rate issue[25]) trump any contrary implications in § 1123(d) as regards payment of default interest in curing defaults. If Congress's "intent was to overrule, rather than codify, the *Entz-White* line of cases," then "one would expect the limiting preliminary language of section 1123(d) to include reference to one or both of" sections 365(b)(2)(D) and 1124(2)(A), but "[n]o such reference exists."[26]

> The foregoing analysis compels the conclusion that Congress did not legislatively overrule *Entz-White* [through Code § 1123(d)], that *Entz-White* remains good law [pursuant to Code § 365(b)(2)(D)] and that, therefore, a debtor need pay interest only at the contract rate, and not the default rate, . . . in order to effectuate a cure under section 1124(2).[27]

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Evisceration of the § 1124(2)(A) Cross-Reference to § 365(b)(2)

One court resisted the implications of § 365(b)(2)(D) by simply refusing to apply § 365(b)(2)(D) to a § 1124(2)(A) "cure" of defaults. In the case of *In re Moody National SHS Houston H, LLC*, the court reasoned as follows:

> Although it is true that § 1124(2)(A) references defaults "of a kind" described in § 365(b)(2), the defaults described in § 365(b)(2) are defaults under leases or executory contracts. A mortgage note is neither a lease nor an executory contract.
>
> It would stretch the language of § 1124(2)(A) far beyond its plain meaning to believe that it refers to any default rate of interest on any type of agreement. . . .
>
> This Court declines to apply the § 365(b)(2) exception that is contained in § 1124(2)(A) to determine whether the holder of a claim secured by a garden variety real estate mortgage is unimpaired.[28]

If accepted, though, this reasoning would render § 1124(2) a nullity. The *only* kinds of debts for which § 1124(2) has any utility at all are debts that are *not* associated with executory contracts and unexpired leases subject to § 365. A debtor does not need § 1124(2) to reinstate a defaulted executory contract or unexpired lease via a plan of reorganization. Code § 365 assumption, in and of itself, authorizes cure and reinstatement of such a defaulted executory contract or unexpired lease, and § 1123(b)(2) expressly provides that "a plan may, subject to section 365 . . ., provide for the assumption . . . of any executory contract or unexpired lease of the debtor." The entire purpose and function of § 1124(2), therefore, is to permit a debtor's plan "to cure and reinstate certain *executed* contracts—loan agreements—in reorganization cases."[29]

Hence, the "of a kind" reference in § 1124(2)(A), if it is to have any meaning at all, must be referring to the particular kind of *contract provisions* set forth in the referenced subsection, § 365(b)(2), rather than the kinds of contracts and leases governed by § 365 generally. Indeed, the language of that cross-reference refers only and specifically to a "*default* of a kind specified in section 365(b)(2)," i.e., an *ipso facto* default.

If § 1124(2)(A) were only excusing cure of *ipso facto* defaults in executory contracts and unexpired leases subject to § 365—since § 1124(2) *only* has utility for debts *not* associated with an executory contract or unexpired lease subject to § 365—then § 1124(2)(A) would *never* excuse cure of *ipso facto* defaults. I.e., a debtor could cure, "de-acclerate," and reinstate a defaulted debt under § 1124(2) *only* by also curing *all* ipso facto defaults, such as financial condition defaults or even a bankruptcy filing default. This, of course, would make it impossible to ever cure, "de-accelerate," and reinstate (through a Chapter 11 plan in a *bankruptcy* case) a defaulted debt contract that contains a bankruptcy default clause. Given that debt contracts invariably *do* contain such a bankruptcy default clause (and inevitably *would* if *Moody National* were good law), the *Moody National* interpretation of the "of a kind" reference in § 1124(2)(A) would render § 1124(2) a dead letter. Consequently, it is hard to accept the *Moody National* interpretation as even a plausible (much less "plain") meaning of the statutory text at issue.[30]

Strictly Construing the Effects of a Bankruptcy "Cure"

The bankruptcy court and district court (affirming) in the case of *In re 139-141 Owners Corp.*[31] refused to follow *Entz-White* via an entirely different chain of logic—one that implicitly and properly recognizes that *Entz-White* is a decision about the federal law *effects* of a § 1124(2)(A) "cure" of defaults. Reasoning from that premise, those courts challenged the notion that a § 1124(2)(A) "cure" has any effects other than the one explicitly specified in § 1124(2)(B)—"de-acceleration" of a defaulted debt. As the bankruptcy court in *139-141 Owners Corp.* reasoned:

> Subsection (2) of Section 1124 is concerned only with a secured creditor's contractual right "to demand or receive accelerated payment . . . after the occurrence of a default." Subsection (2) does no more than permit a debtor to avoid the consequences of an accelerated payment provision if the plan meets all four of the conditions specified in the subdivisions of Subsection (2):
>
> (A) the plan must "cure" any default that occurred before or after commencement of the case;
> (B) the plan must "reinstate[ ] the maturity of such claim" as it existed before the default;

(C) the plan must compensate the creditor for any damages incurred; and
(D) the plan must not "otherwise alter the legal, equitable, or contractual rights to which" the creditor is contractually entitled.

Nothing in the statute provides expressly or by implication that a debtor has the power to avoid or vitiate a secured creditor's contractual right to default interest by complying with the four subdivisions of Subsection (2). Subsection (2) on its face is concerned only with a contract provision requiring "accelerated payment" upon a default, and the statute permits the debtor to de-accelerate and reinstate the pre-default maturity of the loan only if the plan (D) "does not otherwise alter" the secured creditor's contractual rights.

* * * *

Denial of a mortgagee's contractual right to interest at a default rate undoubtedly does "alter" the secured creditor's contractual rights within the meaning of subsection (D) of Section 1124(2). Thus, Section 1124(2), dealing as it does solely with the concept of impairment in the context of an acceleration clause, does not provide a statutory basis for judicial nullification of a contract right to default rate interest.[32]

There are two major difficulties with this reasoning, though. First, and like the decisions in *New Investements* and *Sagamore Parnters*, it completely overlooks the implications of § 365(b)(2)(D), which explicitly limits the "cure" required by § 1124(2)(A). If § 365(b)(2)(D) codifies *Entz-White*'s retroactive nullification of default interest rates, then that *is* an additional effect of a § 1124(2)(A) "cure" expressly provided for by statute.

Second, and potentially even more significantly, the reasoning of *139-141 Owners Corp.* goes well beyond the *Entz-White* notion of *retroactive* nullification of default interest rates; it also denies that a § 1124(2)(A) "cure" can effect a *prospective*, *post-cure* nullification of default interest rates. Indeed, if § 365(b)(2)(D) codifies *Entz-White*'s retroactive nullification of default interest rates, then the *139-141 Owners Corp.* reasoning would *only* prevent nullification of default interest rates *prospectively* for future *post-cure* payments on the "de-accelerated" debt.

That result is the precise opposite of the *New Investments* holding (that "cure" *does* nullify default interest *prospectively*, but not retroactively), and it is at odds with the longstanding, conventional understanding of the effects of a bankruptcy "cure," which Congress also endorsed in the legislative history for both the original codification of § 1124(2)[33] and the 1994 cure amendments, "that a cure pursuant to a plan should operate to put the debtor in the same position as if the default had never occurred."[34] If that is a proper conception of the effect of a bankruptcy "cure" of defaults (and nearly all courts assume that it is, at least prospectively), then the general reasoning of *139-141 Owners Corp.* must be rejected. And if § 365(b)(2)(D) codifies *Entz-White*, then the holding of *139-141 Owners Corp.* (which involved only a *retroactive* nullification of default interest) must also be rejected.

Distinguishing "Penalty" Rates From Compensatory Rates

Another means by which some courts have refused to follow *Entz-White*, even in the face of § 1124(2)(A)'s express incorporation of § 365(b)(2)(D), is by noting that § 365(b)(2)(D) only excuses "the satisfaction of any *penalty* rate," and these courts thus posit that not all *default* rates of interest should be considered "*penalty*" rates.[35] This interpretation of § 365(b)(2)(D), though, is also not free of difficulties. Moreover, properly applied, this interpretation will virtually *never* require payment of default interest.

Initially, it is not at all clear that the "penalty rate" language means anything other than a default rate; i.e., a default rate *is* a "penalty rate" within the meaning of § 365(b)(2)(D). Indeed, *both* the *Entz-White* opinion[36] *and* the legislative history explaining § 365(b)(2)(D)[37] (which was arguably enacted to codify *Entz-White*) expressly assume and state that *all* default rates are and should be considered "penalty" rates.

Moreover, if not all default rates should be considered "penalty" rates, then we need more elucidation of just what a "penalty" rate is, but the case law is unclear as to what is meant by a "penalty" rate. Some cases seem to assume that if a default rate is enforceable under applicable non-bankruptcy law, then it is *not* a "penalty" rate, and thus, § 365(b)(2)(D) does not excuse payment of default interest as part of a cure payment.[38] That,

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however, would make the § 365(b)(2)(D) nullification of a "penalty rate" entirely redundant with § 1123(d), which already expressly requires determination of cure amounts "in accordance with . . . applicable nonbankruptcy law." The surplusage canon, therefore, counsels against interpreting "penalty rate" to mean unenforceable under applicable nonbankuptcy law.[39]

If "penalty rate" means something other than all default rates, it is much more likely that § 365(b)(2)(D) is using the term "penalty" to connote the meaning that term carries under the common law of contracts,[40] where "penalty" refers to an unenforceable liquidated damages provision. Some states do not scrutinize default interest using the penalty/liquidated damages standard of general contract law, but rather provide that default interest is enforceable as long as it is not usurious (i.e., in excess of statutorily prescribed maximum interest rates).[41] This, then, would provide a rationale for imposition of an independent federal bankruptcy prohibition (in § 365(b)(2)(D)) against "penalty rates," that may well be enforceable under applicable nonbankruptcy law, but that nonetheless constitute a "penalty" under the common law understanding of that concept. Indeed, there is a strong tradition that the extent to which bankruptcy courts will allow interest charges "against debtors' estates being administered by them has long been decided by federal law" in accordance with "equitable principles governing bankruptcy distributions."[42] Code § 365(b)(2)(D), therefore, (as incorporated into a § 1124(2)(A) "cure" of defaults) may well simply codify just such an equitable limitation on default interest.

The common law meaning of an unenforceable "penalty" provision is one that "disregard[s] the principle of compensation" by requiring payment of an unreasonably large amount "in light of the anticipated or actual loss caused" by a default "and the difficulties of proof of loss."[43] The Code § 365(b)(2)(D) negation of "penalty" provisions, therefore, operates in tandem with the Code provisions (in both § 365(b)(1) and § 1124(2)) requiring that the debtor, as a condition of reinstatement, not only "cures" defaults but also "compensates" for damages caused thereby.[44] A default interest rate, therefore, should be struck down under § 365(b)(2)(D) (as incorporated into § 1124(2)(A)) as a "penalty rate" if it is not a reasonable approximation of loss caused by the debtor's default.

Thus, the bankruptcy court in the case of *In re Zamani* was on the right track when it held:

> [A]n interest rate providing more than appropriate compensation is a penalty against the debtor and should not be allowed. As a result, it is not enough for a creditor to show that the default rate of interest is within a generally accepted range of interest rates. Rather, the creditor must provide tangible proof of loss; "formulaic or hypothetical" statements are insufficient. If the creditor fails to satisfy this evidentiary burden, the court will only allow the basic contract rate of interest.[45]

Even this approach, though, is incomplete to the extent that it fails to specify what kinds of creditor losses are appropriately compensable. And in that regard, it is particularly noteworthy that the compensation requirement in conjunction with cure and reinstatement of a defaulted debt under Code § 1124(2) is markedly different (and much more limited) than the compensation requirement in conjunction with cure and reinstatement of an executory contract or unexpired lease under Code § 365(b)(1). The counter-party to an assumed executory contract or unexpired lease is entitled to compensation (under § 365(b)(1)(B)) "for any actual pecuniary loss to such party from such [cured] default," which seems to provide full expectation damages consistent with general principles of nonbankruptcy contract law.[46] For defaulted debt reinstated under Code § 1124(2), though, the only compensation required (under § 1124(2)(C)) is "for any damages incurred as a result of any reasonable *reliance* by [the creditor] on such contractual provision or applicable law," which is obviously referring to the "contractual provision or applicable law that entitles the [creditor] to demand or receive accelerated payment . . . after an event of default."[47]

The only losses a creditor is entitled to recover under § 1124(2)(C), therefore, are *reliance* damages incurred in accelerating the debt, which acceleration is being reversed and undone with the cure and reinstatement, as provided for in § 1124(2)(B). "The logic behind § 1124(2)(C) is to protect an accelerating creditor from out-of-pocket losses in-

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curred when a debtor files bankruptcy and undoes the acceleration."[48] Thus, "[t]his section entitles the [creditor] to be compensated for damages incurred in reliance upon [an] acceleration clause and attendant efforts to enforce its rights as a result of such acceleration," "such as legal fees, foreclosure notice fees, court costs, and the like."[49]

Default interest rates do not provide (because they are not designed to provide) a reasonable approximation of such out-of-pocket reliance losses; indeed, compensation for such expenses typically is specifically provided for (separate and apart from, and in addition to, default interest) under most loan agreements. Instead, a commonly advanced justification for default interest is "that charging relatively high default rates of interest provides an incentive for borrowers not to default."[50] Such a provision, though, that produces "an *in terrorem* effect on the other party" in order to "deter breach by compelling performance," is a conspicuous "red flag" sign of a noncompensatory penalty.[51] As the *Zamani* court rightly recognized, then, "[d]efault rates that are meant to be an enforcement mechanism [that coerces performance] go beyond compensation and are unacceptable penalties."[52]

There are compensatory reasons for charging a higher interest rate upon default, as default may provide a creditor more and better information regarding the risk of nonpayment and relevant opportunity cost associated with the unpaid debt. Even if the default rate were a reasonable approximation of the increased risk and opportunity cost, though (which would be a case-by-case evidentiary issue), that is *not* the kind of *reliance* loss compensable under § 1124(2)(C) in connection with a debt reinstated under Code § 1124(2).[53] In the context of a § 1124(2) cure and reinstatement, therefore, it seems reasonable to conclude that default interest rate provisions should routinely (and even presumptively) be considered noncompensatory "penalty" rates that need not be paid as part of a § 1124(2)(A) "cure" of defaults.

The Precedential Force of *New Investments* (or Lack Thereof)

The most perplexing aspect of the *New Investments* decision is its exclusive (and, as explored in Part I, inapt) reliance upon Code § 1123(d), without any mention whatsoever of the implications of Code § 365(b)(2)(D), which explicitly limits the "cure" required by § 1124(2)(A). The most plausible explanation for the court's failure to address the implications of § 365(b)(2)(D) is that the parties did not address § 365(b)(2)(D) in their briefs, and of course, an appellate court has no obligation to address arguments not timely raised by the parties themselves.

The *New Investments* panel, though, was certainly aware of the argument that § 365(b)(2)(D) codifies *Entz-White*, because the court issued an order, in advance of oral argument, instructing counsel to "be prepared at oral argument to discuss the reasoning of the opinions in *In re Pheonix Business Park Ltd. Partnership* and *In re Moody National SHS Houston H, LLC*, particularly as they relate to the relationship between 11 U.S.C. §§ 1123(a)(5)(G), 1123(d), 1124(2)(A), and 365(b)(2)(D)."[54] Yet, in deciding the case, the panel obviously decided not to go beyond the issues and arguments briefed by the parties (which were limited to the effect of Code § 1123(d) upon the required cure payment), as was their prerogative.

The holding of *New Investments*, therefore, speaks *solely* to the implications of § 1123(d) and does *not* address the implications of § 365(b)(2)(D). *New Investments*, therefore, is of extremely limited precedential value, even within the Ninth Circuit. Nothing in *New Investments* prevents any party in any case other than the *New Investments* case itself from raising § 365(b)(2)(D) as excusing payment of default interest as part of a § 1124(2)(A) "cure" of defaults.

We may not have heard the last of *Entz-White*!

Reviving Bankruptcy Courts' Discretion: Cure Without Reinstatement?

The context in which courts seem most receptive to side-stepping *Entz-White* and § 365(b)(2)(D) is when the debtor's estate is solvent and, thus, the nullification of default interest as part of the cure of a defaulted debt inures to the benefit of the debtor's equity holders rather than unsecured creditors.[55] No such distinction (and corresponding

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flexibility), however, appears on the face of the statute itself, nor in the prevailing conception "that a cure pursuant to a plan . . . operate[s] to put the debtor in the same position as if the default had never occurred,"[56] whether or not the debtor's estate is insolvent.

If Code § 365(b)(2)(D) does, indeed, codify *Entz-White*, then it is equally protective of the interests of both unsecured creditors and debtor's equity holders. Indeed, many aspects of the Chapter 11 reorganization process inevitably operate to permit equity holders to preserve an equity interest that would be forfeited or much less valuable were the Chapter 11 process unavailable. The cure and reinstatement provisions of Code § 1124(2), therefore, seem to be yet another indication that "leveling the playing field for the debtor in negotiating a restructuring of secured debt *is* one of the principal functions of Chapter 11 reorganizations,"[57] wholly independent of any benefit for unsecured creditors.

Even if Code § 365(b)(2)(D) codifies *Entz-White*, though, bankruptcy courts nonetheless may be able to reclaim some of the flexibility that super-cramdown via a § 1124(2) cure seems to deny them. That is because another aspect of the *Entz-White* decision may give § 1124(2) cure an exceedingly broad sphere of operation.

Pursuant to Code § 1124(2), the provision for cure of defaults is the means to the further end of "de-accelerating" the defaulted debt ("notwithstanding any contractual provision or applicable law" permitting acceleration[58]), "reinstat[ing] the maturity of" the defaulted debt "as such maturity existed before such default,"[59] and otherwise "returning to [the] pre-default conditions" and terms governing the defaulted debt.[60] In *Entz-White*, though, the debtor did not seek to de-accelerate and reinstate pre-default terms and conditions of the defaulted debt. Indeed, the debtor could not de-accelerate the debt at issue because maturity had not been accelerated; rather, the entire debt had become due pursuant to its original terms.[61] Thus, the "cure" the debtor sought to effectuate in *Entz-White* was payment in full of the entire unpaid balance of the debt (*without* payment of post-default interest at the contractual default rate).

If "cure" can include payment in full of the entire debt, then there is no de-acceleration and reinstatement of the original terms and conditions governing the debt because there is no more debt once it is paid in full via "cure." If this is a permissible "cure" of a defaulted debt, then "cure" is an end unto itself rather than a means to reinstatement. The Ninth Circuit, in *Entz-White*, though, held that payment in full of a defaulted debt (without default interest) was a permissible "cure" of that defaulted debt that the debtor could impose on the creditor under § 1124(2)(A).[62]

That conception of "cure" of defaults as an end unto itself is, however, completely at odds with the common law of contracts, from which the Bankrputcy Code's cure provisions are obviously derived (as discussed in Part I). The purpose and function of "cure" of defaults, under the common law of contracts, is to prevent contract termination and the creditor's resulting claim for damages for total breach, i.e., *prevent* the creditor from demanding immediate payment in full of the entire balance of the debt. By holding that "cure" *includes* immediate payment in full of the entire balance of the debt, then, *Entz-White* turns "cure" upside down, emptying it of its reinstatement essence. Other courts, therefore, have disagreed with *Entz-White* and have held that payment in full of the entire balance owing on the debt is not a § 1124(2) "cure" of that debt because "cure require[s] some degree of reinstatement."[63]

Another compelling reason to conclude that immediate payment in full of the entire balance of a debt is not a permissible super-cramdown (via § 1124(2) "cure") is because cramdown via payment in full is fully accommodated by the conventional cramdown provisions of Code § 1129(b). Of course, with respect to cramdown of an oversecured debt (the kind of debt for which § 1124(2) is typically invoked), that payment-in-full cramdown must include post-petition interest under Code § 506(b). And § 506(b) does afford bankruptcy courts the discretion and flexibility to determine whether "the payment of default interest in solvent debtor cases, when considered with other equitable factors, makes the award of default interest appropriate."[64]

It is noteworthy that *New Investments* was also a solvent debtor case involving a "cure" effectuated

via payment in full of the entire balance owing on an oversecured debt. In such cases (outside of the Ninth Circuit), creditors have an alternative (and seemingly sounder) means by which to seek payment of post-default interest at the contractual default rate—via § 506(b), on the theory that immediate effective-date payment in full of the entire debt is not a permissible "cure" under Code § 1124(2). Instead, effective-date payment-in-full cramdown must be effectuated under Code § 1129(b).

ENDNOTES:

[1]In re Entz-White Lumber and Supply, Inc., 850 F.2d 1338, 18 Bankr. Ct. Dec. (CRR) 83, Bankr. L. Rep. (CCH) P 72380, 98 A.L.R. Fed. 831 (9th Cir. 1988).

[2]Rake v. Wade, 508 U.S. 464, 113 S. Ct. 2187, 124 L. Ed. 2d 424, 24 Bankr. Ct. Dec. (CRR) 533, 28 Collier Bankr. Cas. 2d (MB) 983, Bankr. L. Rep. (CCH) P 75275 (1993).

[3]U.S. v. Ron Pair Enterprises, Inc., 489 U.S. 235, 109 S. Ct. 1026, 103 L. Ed. 2d 290, 18 Bankr. Ct. Dec. (CRR) 1150, Bankr. L. Rep. (CCH) P 72575, 89-1 U.S. Tax Cas. (CCH) P 9179, 63 A.F.T.R.2d 89-652 (1989).

[4]In re New Investments, Inc, 840 F.3d 1137, 63 Bankr. Ct. Dec. (CRR) 97, Bankr. L. Rep. (CCH) P 83029 (9th Cir. 2016).

[5]In re Sagamore Partners, Ltd., 620 Fed. Appx. 864, 868-69 (11th Cir. 2015).

[6]New Investments, 840 F.3d at 1140 (emphasis added).

[7]See David Gray Carlson, Rake's Progress: Cure and Reinstatement of Secured Claims in Bankruptcy Reorganization, 13 Emory Bankr. Dev. J. 273, 324-25 (1997); Ralph Brubaker, Cure of Nonmonetary Defaults as a Prerequisite to Assumption of Executory Contracts and Unexpired Leases: A Lesson in the Nature and Function of the Cure Requirement, 24 Bankr. L. Letter No.12, at 1, 7 (Dec. 2004); Charles J. Tabb & Ralph Brubaker, Teacher's Manual for Bankruptcy Law: Principles, Policies, and Practice 479 n.9, 484 (4th ed. 2015). See generally Ralph Brubaker, Option Agreements, the Bargained-For Exchange, and Unenforceable Ipso Facto Provisions, 21 Bankr. L. Letter No. 10, at 1, 1-2, 5 (Oct. 2001).

[8]See generally Brubaker, 24 Bankr. L. Letter No. 12; Ward Benson, Nonmonetary "Historical" Defaults Should Not Always Prevent Assumption of Executory Contracts: State Contract Law as the Standard for the Cure Requirement in § 365(b) of the Bankruptcy Code, 23 J. Bankr. L. & Prac. No. 4, at 413 (Aug. 2014); Andrea Coles-Bjerre, Ipso Facto: The Pattern of Assumable Contracts in Bankruptcy, 40 N.M. L. Rev. 77, 101-05 (2010); David G. Epstein & Lisa Normand, "Real World" and "Academic" Questions About "Nonmonetary Obligations" Under the 2005 Version of 365(b), 13 Am. Bankr. Inst. L. Rev. 617 (2005).

[9]See Brubaker, 24 Bankr. L. Letter No. 12, at 2-3.

[10]Entz-White, 850 F.2d at 1342.

[11]Kenneth N. Klee, Adjusting Chapter 11: Fine Tuning the Plan Process, 69 Am. Bankr. L.J. 551, 558 & n.38 (1995) (stating that "the congressional amendment appears to codify applicable Ninth Circuit precedent that construed the Code as not requiring a default or penalty rate to be paid when a plan reversed the acceleration and reinstated the terms of an obligation," citing *Entz-White*).

[12]Antonin Scalia & Bryan Garner, Reading Law: The Interpretation of Legal Texts 147 (2012).

[13]Scalia & Garner, Reading Law, at 148.

[14]Scalia & Garner, Reading Law, at 149.

[15]That was the pre-2005 interpretation proffered by Grant T. Stein & Ralph S. Wheatly, The Impact of Cure and Reinstatement on Default Interest, 16 Am. Bankr. Inst. J. 7, 8, 33 (Jul.-Aug. 1997).

[16]H.R. Rep. No. 103-835, at 17, 50 (1994).

[17]140 Cong. Rec. H10,758, H10,769 (daily ed. Oct. 4, 1994).

[18]H.R. Rep No. 103-835, at 50; 140 Cong. Rec. H10,769 (daily ed. Oct. 4, 1994).

[19]In re Claremont Acquisition Corp., 113 F.3d 1029, 1034 (9th Cir. 1997). The court also noted that the "legislative history of § 365(b)(2)(D) supports [this] construction of the section and suggests that Congress intended only to relieve debtors of the obligation to pay penalties." Id.

[20]In re 2712 Mission Partners, L.P., 52 Bankr. Ct. Dec. (CRR) 193, 2010 WL 431738, at *3 (Bankr. N.D. Cal. 2010).

[21]Claremont Acquisition, 113 F.3d at 1034

[22]11 U.S.C.A. § 365(b)(2)(D).

[23]In re Phoenix Business Park Ltd. Partnership, 257 B.R. 517, 37 Bankr. Ct. Dec. (CRR) 81 (Bankr. D. Ariz. 2001). Accord Brody v. Geared Equity, LLC, 2014 WL 4090549, at *3 (D. Ariz. 2014), appeal dismissed, (9th Cir. 14-16631) (Jan. 5, 2015); In re DSBC Investments, L.L.C., 2009 WL 2998940, at *2-3 (Bankr. D. Ariz. 2009); In re Zamani, 390 B.R. 680, 685-87, 60 Collier Bankr. Cas. 2d (MB) 117 (Bankr. N.D. Cal. 2008); In re Admiralty RV Resort, LLC, 2002 WL 1285504, at *1 (Bankr. C.D. Cal. 2002).

[24]Such an interpretation is disfavored, however, because "there can be no justification for needlessly

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rendering provisions in conflict if they can be interpreted harmoniously." Scalia & Garner, Reading Law, at 180 (discussing the harmonious-reading canon).

[25]See Scalia & Garner, Reading Law, at 183-89 (discussing the general/specific canon).

[26]Phoenix Business Park, 257 B.R. at 522.

[27]Phoenix Business Park, 257 B.R. at 522.

[28]Moody National, 426 B.R. at 673-74 (citations omitted).

[29]Carlson, 13 Emory Bankr. Dev. J. at 274.

[30]See Scalia & Garner, at 63 (discussing the interpretive "presumption against ineffectiveness," which "ensures that a text's manifest purpose is furthered, not hindered," and which "follows inevitably from the facts that (1) interpretation always depends on context, (2) context always includes evident purpose, and (3) evident purpose always includes effectiveness").

[31]In re 139-141 Owners Corp., 306 B.R. 763, 767-73, 42 Bankr. Ct. Dec. (CRR) 148, 52 Collier Bankr. Cas. 2d (MB) 705 (Bankr. S.D. N.Y. 2004), aff'd in relevant part, 313 B.R. 364, 368-69 (S.D.N.Y. 2004).

[32]139-141 Owners Corp., 306 B.R. at 768.

[33]The Senate Report explained § 1124(2) as follows:

> [A] claim . . . is unimpaired by curing the effect of a default and *reinstating the original terms* of an obligation when maturity was brought on or accelerated by the default. The intervention of bankruptcy and the defaults represent a temporary crisis which the plan of reorganization is intended to clear away. The holder of a claim . . . who under the plan is *restored to his original position*, when others receive less or get nothing at all, is fortunate indeed and has no cause to complain. Curing of the default and the *assumption of the debt in accordance with its [original] terms* is an important reorganization technique for dealing with a particular class of claims, especially secured claims.

S. Rep. No. 95-989, at 120 (1978) (emphasis added).

[34]140 Cong. Rec. H10,770 (daily ed. Oct. 4, 1994); H.R. Rep. No. 103-835, at 55 (same).

[35]See, e.g., In re Sweet, 369 B.R. 644, 650, 48 Bankr. Ct. Dec. (CRR) 109, 57 Collier Bankr. Cas. 2d (MB) 155 (Bankr. D. Colo. 2007) ("This language is significant because it suggests that . . . if a default rate is not considered a penalty, default interest may nevertheless be appropriate to effectuate a § 1124(2)(A) cure."); Phoenix Business Park, 257 B.R. at 521 ("Thus, if a default interest rate is a 'penalty rate,' then it does not need to be paid as part of a section 1124(2) cure.").

[36]See Entz-White, 850 F.2d at 1342 ("the power to cure under the Bankruptcy Code authorizes a plan to nullify all consequences of default, including avoidance of default *penalties* such as *higher interest*" (emphasis added)).

[37]See 140 Cong. Rec. H10,769 (daily ed. Oct. 4, 1994) ("section 365(b) is clarified to provide that" a default "can be cured at a *nondefault rate* (i.e., [the debtor] would *not* need to pay *penalty rates*) (emphasis added)); H.R. Rep. No. 103-835, at 50 (same).

[38]See, e.g., Sweet, 369 B.R. at 650-51 & n.11.

[39]See Scalia & Garner, Reading Law, at 174-79 (discussing the surplusage canon).

[40]See Brubaker, 24 Bankr. L. Letter No. 12, at 7. See generally Scalia & Garner, Reading Law, at 320-21 (discussing the canon of imputed common-law meaning).

[41]See, e.g., Sweet, 369 B.R. at 650 n.11 (discussing Colorado law).

[42]Vanston Bondholders Protective Committee v. Green, 329 U.S. 156, 163, 67 S. Ct. 237, 91 L. Ed. 162 (1946).

[43]Restatement (Second) of Contracts § 356(1) & cmt. a, at 157 (1981) ("The central objective behind the system of contract remedies is compensatory, not punitive.").

[44]See 11 U.S.C.A, §§ 365(b)(1)(A) & (B), 1124(2)(A) & (C). The common law of contracts, similarly, distinguishes between "cure" of defaults and any other damages caused by the default. Cure of a contract breach is not the equivalent of never having breached at all. Thus, a breaching party's subsequent "cure does not wipe out its liability for its breach." E. Allan Farnsworth, Contracts § 8.17, at 589 (4th ed. 2004). "[A] party who has cured a material breach has still committed a breach . . . for which he is liable in damages." Restatement (Second) of Contracts § 242 cmt. a, at 244.

[45]In re Zamani, 390 B.R. 680, 688 (Bankr. N.D. Cal. 2008),

[46]The cure, compensation, and adequate assurance features codified in § 365(b)(1) were first introduced in the 1973 Commission's proposed bankruptcy bill, which indicated that those requirements were borrowed from nonbankruptcy contract law. See Report of the Commission on the Bankruptcy Laws of the United States, H.R. Doc. No. 93-137, pt. I, § 4–602(b)(2) & note 11, at 153, 156-57 (1973). Thus, Code § 365(b)(1)(B) "simply codifies the nondebtor party's nonbankruptcy right to compensation" for breach damages. Brubaker, 24 Bankr. L. Letter No. 12, at 6.

[47]11 U.S.C.A. § 1124(2).

[48]Phoenix Business Park, 257 B.R. at 523.

[49]Phoenix Business Park, 257 B.R. at 522-23.

[50]In re K & J Properties, Inc., 338 B.R. 450, 457 n.6, 44 Bankr. Ct. Dec. (CRR) 208 (Bankr. D. Colo. 2005). See also In re Hassen Imports Partnership, 256 B.R. 916, 918, 45 Collier Bankr. Cas. 2d (MB) 679 (B.A.P. 9th Cir. 2000); Zamani, 390 B.R. at 688.

[51]Farnsworth, Contracts, § 12.18, at 811.

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[52]Zamani, 390 B.R. at 688.

[53]See In re Southeast Co., 81 B.R. 587, 591-92, 18 Collier Bankr. Cas. 2d (MB) 359 (B.A.P. 9th Cir. 1987), decision aff'd, 868 F.2d 335, 18 Bankr. Ct. Dec. (CRR) 1519, 20 Collier Bankr. Cas. 2d (MB) 1348, Bankr. L. Rep. (CCH) P 72698 (9th Cir. 1989); In re Hein, 60 B.R. 769 (Bankr. S.D. Cal. 1986); In re Kizzac Management Corp., 44 B.R. 496, 501, 11 Collier Bankr. Cas. 2d (MB) 1106, Bankr. L. Rep. (CCH) P 70149 (Bankr. S.D. N.Y. 1984); In re Manville Forest Products Corp., 43 B.R. 293, 11 Collier Bankr. Cas. 2d (MB) 735, Bankr. L. Rep. (CCH) P 70062 (Bankr. S.D. N.Y. 1984); In re Forest Hills Associates, 40 B.R. 410, 11 Bankr. Ct. Dec. (CRR) 1145, Bankr. L. Rep. (CCH) P 69876 (Bankr. S.D. N.Y. 1984); Matter of Rainbow Forest Apartments, 33 B.R. 576, 11 Bankr. Ct. Dec. (CRR) 149 (Bankr. N.D. Ga. 1983); In re Masnorth Corp., 28 B.R. 892, 10 Bankr. Ct. Dec. (CRR) 553 (Bankr. N.D. Ga. 1983).

[54]Order, In re New Investments, Inc., No. 13-36194 (9th Cir. Apr. 26, 2016), Docket Entry 33, Doc. ID 9953910 (case citations omitted).

[55]See, for example, Bankruptcy Judge Gropper's frank acknowledgment of the influence of that circumstance on courts' decisions in his *General Growth Properties* opinion. In re General Growth Properties, Inc., 451 B.R. 323, 328-29, 55 Bankr. Ct. Dec. (CRR) 6, 65 Collier Bankr. Cas. 2d (MB) 1351 (Bankr. S.D. N.Y. 2011).

[56]140 Cong. Rec. H10,770 (daily ed. Oct. 4, 1994); H.R. Rep. No. 103-835, at 55 (same).

[57]Ralph Brubaker, Artificial Impairment and the Single-Asset Real Estate Debtor, 33 Bankr. L. Letter No. 4, at 1, 8 (Apr. 2013) (noting that the means by which Chapter 11 does so is, "[i]f the secured creditor will not agree to a restructuring of the [secured] debt, then the debtor may be able to impose a restructuring on the secured creditor through Chapter 11, as long as that restructuring complies with the Code's cramdown provisions," such as the cure and reinstatement super-cramdown provision of § 1124(2)).

[58]11 U.S.C.A. § 1124(2).

[59]11 U.S.C.A. § 1124(2)(B).

[60]New Investments, 840 F.3d at 1141.

[61]"The note was due by its own terms on June 1, 1984. Entz-White did not pay the amount due, and filed a Chapter 11 bankruptcy petition on August 17, 1984." Entz-White, 850 F.2d at 1339.

[62]See Entz-White, 850 F.2d at 1341-42.

[63]Carlson, 13 Emory Bankr. Dev. J. at 347. See, e.g., In re Etienne Estates at Washington LLC, 2016 WL 1254739, at *10 (Bankr. E.D. N.Y. 2016), order corrected, 2016 WL 7377055 (Bankr. E.D. N.Y. 2016); In re General Growth Properties, Inc., 2011 WL 2974305, at *2 (Bankr. S.D. N.Y. 2011); In re Route One West Windsor Ltd. Partnership, 225 B.R. 76, 81-85, 40 Collier Bankr. Cas. 2d (MB) 1069 (Bankr. D. N.J. 1998); In re Liberty Warehouse Associates Ltd. Partnership, 220 B.R. 546, 54-50 (Bankr. S.D. N.Y. 1998); In re Ace-Texas, Inc., 217 B.R. 719, 726-27, 32 Bankr. Ct. Dec. (CRR) 459 (Bankr. D. Del. 1998); In re Chateaugay Corp., 150 B.R. 529, 542-43, 23 Bankr. Ct. Dec. (CRR) 1579, Bankr. L. Rep. (CCH) P 75121 (Bankr. S.D. N.Y. 1993), order aff'd, 170 B.R. 551, Bankr. L. Rep. (CCH) P 76087 (S.D. N.Y. 1994).

[64]In re Dow Corning Corp., 456 F.3d 668, 680, 46 Bankr. Ct. Dec. (CRR) 222, Bankr. L. Rep. (CCH) P 80664, 2006 FED App. 0260P (6th Cir. 2006). See generally Christopher W. Frost, A Rare Glimpse at Priority Issues in a Solvent Estate: *In re Dow Corning*, 26 Bankr. L. Letter No.12, at 1 (Dec. 2006).

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// Bankruptcy Law Letter

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"Shoot the. . .": Holes in Make Whole Premiums

By Bruce A. Markell

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Introduction

There's a famous scene in *Raiders of the Lost Ark*[1] in which Indiana Jones, played by Harrison Ford, confronts an adversary dressed in all black, wielding a long and sharp scimitar. The adversary flashes his sword and twirls it with fancy moves, all with apparent evil intent. This display interrupts Indiana who is searching the bazaar frantically for Marion, his once and future girlfriend. After watching the display of swordsmanship, Indiana pulls his revolver out and nonchalantly shoots the swordsman. The adversary drops and the crowd goes wild.[2]

Legal arguments can be like that. One side thinks its theory, deeply researched, painstakingly planned, and meticulous implemented, beats all comers. It then runs into an overlooked and vastly superior force, and is defeated.

I think the current kurfuffle over make whole premiums (MWPs)[3] is destined for a similar fate. Corporate lawyers have mined state law to develop rock-solid nonbankruptcy theories, in an effort to provide legal justifications for such premiums.

What they seem to have forgotten, to paraphrase another of my favorite movies, is that "It's bankruptcy, Jake."[4] Within the Code are theories that simply eviscerate state law verities, in much the same way that Indiana Jones dispatched the black-clad swordsman.

In this issue of the *Bankruptcy Law Letter*, I want to look at MWPs and the case law interpreting them. This inquiry will look at the recent efforts to understand such clauses under nonbankruptcy law, but my main point is something simpler: there is no way MWPs are not substitutes or proxies for unmatured interest. As such, there is no way, despite all their corporate finery, that they can withstand the fatal bullet of Section 502(b)(2).[5]

Make Whole Premiums (MWPs)

MWPs seek to protect lenders from drops in interest rates. They

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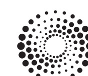

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are clauses in debt instruments which typically require borrowers to pay a premium or fee for the privilege of early payment, as might be the case if a borrower could obtain a loan at a lower rate in order to pay off the original, higher-interest rate loan. A borrower with an outstanding loan bearing an interest rate of 15%, for example, would love to pay off that loan if rates drop and if the borrower can now borrow a similar amount of money at 5%. But the borrower's boon is in the lender's doom; upon repayment, the lender can no longer lend out the money at the higher rate.

To protect against this loss of a high interest rate stream, lenders have insisted on MWPs. The typical MWP allows for early payment of a loan, but only if the payment is accompanied by a fee. The fee, in turn, is set in the original loan documents, and often requires payment of an amount equal to the present value of the interest that would have been paid if there were no payoff.

The Cases

Two recent bankruptcy court cases have explored MWPs. Their analyses of the issue are illuminating. The first is Judge Drain's decision in September 2014 in *In re MPM Silicones, LLC,*[6] better known as "*Momentive*." The next case is *Energy Future Holding Corp*. (EFHC).[7] In both cases, the courts disallowed the MWP because they found that the MWP would not be enforceable under nonbankruptcy law.[8]

Momentive

Momentive was in the silicone business.[9] It had over $4.1 billion in sales in the year before bankruptcy, and employed over 4,500 people. It also had been the subject of a leveraged buyout from Apollo in 2006. It also had a lot of debt—more than 16 times its annual cash flow before taxes and depreciation.

Part of this large amount of debt was incurred in 2012, when Momentive issued two classes of senior secured notes. The first series, in the amount of $1.1 billion, was issued at an interest rate of 8.875%. The second series, in the amount of $250 million, was issued at an interest rate of 10%. Both series of notes matured in 2020, and both were secured by all or virtually all of Momentive's assets.

Momentive's disclosure statement indicated that it had a debt-free value of somewhere between $2 billion and $2.4 billion. This valuation confirmed that both series of notes were over secured. At the same time, the debt service on Momentive's debt was approximately $288 million per year, some $200 million more than its earnings before taxes and depreciation. It needed to do something.

So it filed Chapter 11. When it filed in 2014, the market had changed from 2012 when it had issued the notes—interest rates had dropped significantly. In such circumstances, it is textbook bankruptcy

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law that a debtor can "cram down" a secured creditor's claim by giving it a continuing lien on its collateral and a stream of payments that has a present value equal to the allowed amount of its claim. This treatment favors debtors because the interest rate necessary to discount the stream of payments will track interest rates extant at the time of the bankruptcy filing or at confirmation. Using these reduced rates, a debtor can essentially unilaterally refinance its existing debt at lower rates.

But the lenders had anticipated this. Their loan documents required Momentive to pay a MWP. The governing documents defined the MWP as follows:

> the greater of: (1) 1% of the then outstanding principal amount of such Note and (2) the excess of: (a) the present value at such redemption date of (i) the redemption price of such Note, at October 15, 2015 (such redemption price being set forth in paragraph 5 of the applicable Note) plus (ii) all required interest payments due on such Note through October 15, 2015 (excluding accrued but unpaid interest), computed using a discount rate equal to the Treasury Rate as of such redemption date plus 50 basis points; over (b) the then outstanding principal amount of such Note.[10]

Ultimately, Judge Drain disallowed the MWP, but we'll get to that. First, let's look at the other recent MWP case.

Energy Future Holdings Corp. (EFHC)

Energy Future Holdings Corp. is a Texas-based holding company. It owned TXU Energy, a retail electricity provider with more than 2 million customers in Texas, and Luminant, which is engaged largely in power generation and related mining activities and energy trading. It filed chapter 11 in April 2014 with the goal of restructuring $42 billion in debt. It is one of the largest chapter 11 cases ever.

In *EFHC*, Judge Sontchi has issued several rulings regarding several different series of notes, each of which contain MWPs.[11] At issue were three different series of notes: a first lien series of notes, a second liens series of notes, and a series of "payment-in-kind" notes. The first lien notes were issued in 2010 in the aggregate amount of $2.1 billion, and bore an interest rate of 10%. They were due in 2020. The second lien notes were issued in two series, one bearing an 11% interest rate and due in 2021, and a second bearing an 11.75% interest rate and also due in 2021. In the aggregate, the principal amount of the second lien notes was over $2.1 billion. Finally, the "payment-in-kind" notes were unsecured notes issued in two series. The first series was $2 billion in notes bearing an interest rate of 10.875%, and the second consisted of $2.5 billion in notes bearing rates ranging from 11.250% to 12.000%. Both series of notes were due in 2017.

All of the notes had MWPs. The following language was representative:

> "Applicable Premium" means, with respect to any Note on any Redemption Date, the greater of: (1) 1.0% of the principal amount of such Note; and (2) the excess, if any, of (a) the present value at such Redemption Date of (i) the redemption price of such Note at December 1, 2014 (such redemption price as set forth in the table appearing under Section 3.07(d) hereof), plus (ii) all required interest payments (calculated based on the Cash Interest rate payable on the Notes) due on such Note through December 1, 2014 (excluding accrued and unpaid interest, if any, to the redemption Date), computed using a discount rate equal to the Treasury Rate as of such Redemption Date plus 50 basis points; over (b) the principal amount of such Note.

The MWP in each of *Momentive* and *EFHC* thus incorporated as an essential element the amount interest not paid. In *Momentive*, the MWP includes the discounted value of "all required interest payments due on such Note through October 15, 2015. . . ." In *EFHC*, the MWP similarly includes the discounted value of "all required interest payments. . . due on such Note through December 1, 2014." The key feature of each MWP clause was the selection of an appropriate discount rate (based on the Treasury Rate in both cases), but the base against which the agreed discount rate was to be applied was nothing other than the aggregate amount of interest that would not be paid due to the early payment of the notes involved.

MWPs: History and Validity Under State Law

MWPs are a product of the common law rule that a borrower has no independent right to pay a loan before its stated maturity.[12] This rule, often dubbed the "perfect tender rule" then leads to negotiation, either at origination or at proposed prepayment, of

the terms under which a lender will accept an early payment.[13] To insolvency and restructuring lawyers, this may sound odd: you always take the money. But outside of bankruptcy, things are different. Solvent borrowers pay a price for the privilege of paying early. This, however, begs the question as to whether the other creditors of an insolvent chapter 11 debtor should pay the same price.[14]

Under the general rule that contracts are to be enforced according to their terms, courts generally uphold MWPs between solvent parties.[15] Proffered payment before scheduled maturity need only be accepted if accompanied by the amount specified in the MWP clause.

Case law, however, has developed an exception, an exception to that exception, and an interpretive gloss on the exception to the exception.

The exception is not really an exception; it is simply an interpretation of how MWP clauses work. If the lender seeks to exercise its rights to accelerate the maturity date, such as would be practically required before a foreclosure of any security or suit on the entire amount of principal, there is no obligation to pay a MWP since it is not the borrower, but the lender, who seeks payment before scheduled maturity.[16] "By accelerating the loan, the lender elects 'to give up [its] future income stream in favor of having an immediate right to collect [its] entire debt.' "[17] Accordingly, no payment on the MWP is due.[18]

The exception to this exception is that a lender may still collect a MWP after its election to accelerate (or after any automatic acceleration) if the loan documents so provide.[19]

The interpretive gloss on this exception is that because it is an exception to an exception, the enforceability of a MWP after a lender's voluntary or automatic acceleration requires clear and explicit contractual language.[20]

Disallowance of MWPs under Section 502(b)(1)

It is on this last point that the efforts to collect MWPs in *Momentive* and *EFHC* foundered. As Judge Drain in *Momentive* saw it, the MWP had to contain "either an explicit recognition that the make-whole would be payable notwithstanding the acceleration of the loan or . . . a provision that requires the borrower to pay a make-whole whenever debt is repaid prior to its original maturity . . . ."[21] The indenture at issue in *Momentive* didn't pass this test.

In *EFHC*, Judge Sontchi found the indentures there had similar language to the indentures in *Momentive*, and thus applied the same reasoning. As a result, both *Momentive* and *EFHC* disallowed the MWP under Section 502(b)(1). In short, they found the clauses unenforceable under nonbankruptcy law.

Disallowance of MWPs under Section 502(b)(2)

As shown above, the recent trend seems to be to disallow MWPs on state law grounds under § 502(b)(1). In the long run, however, reliance on state law contract interpretation theories just encourages lenders' counsel to try and craft more specific language because existing MWPs are not specific enough. Which in turn will require more litigation in bankruptcy courts with uncertain results. To return to the opening metaphor, it just encourages the swordsman to develop more elaborate moves.

But why work that hard to dispense with MWPs in bankruptcy? Disallowance under § 502(b)(2) is easier and simpler.

Section 502(b)(2) disallows a claim to the extent that it is for unmatured interest. Paragraph (2) thus has two components: interest, and a lack of maturity of that interest.

"Interest"

Take interest first. The Bankruptcy Code does not define "interest." To start with the basics, however, *Black's Law Dictionary* defines interest as:

> The compensation fixed by agreement or allowed by law for the use or detention of money, or for the loss of money by one who is entitled to its use; esp., the amount owed to a lender in return for the use of borrowed money. Also termed finance charge.[22]

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Those courts that have looked specifically at what "interest" is under Section 502(b)(1) use a similar definition. "Interest is money 'paid to compensate for the delay and risk involved in the ultimate repayment of monies loaned.' "[23] Or, as indicated by the Second Circuit, "The word 'interest' [is what is] to be paid to compensate for the delay an risk involved in the ultimate repayment of monies loaned."[24]

Outside of Section 502(b)(2), "interest" has been similarly broadly defined. In reviewing the proposed definition of interest under federal banking law in *Smiley v. Citibank*, for example, the Supreme Court had the following definition before it:

> The term 'interest' as used in 12 U.S.C. § 85 includes any payment compensating a creditor or prospective creditor for an extension of credit, making available of a line of credit, or any default or breach by a borrower of a condition upon which credit was extended. It includes, among other things, the following fees connected with credit extension or availability: numerical periodic rates, late fees, not sufficient funds (NSF) fees, overlimit fees, annual fees, cash advance fees, and membership fees. It does not ordinarily include appraisal fees, premiums and commissions attributable to insurance guaranteeing repayment of any extension of credit, finders' fees, fees for document preparation or notarization, or fees incurred to obtain credit reports." 61 Fed.Reg. 4869 (to be codified in 12 CFR § 7.4001(a)).[25]

In reviewing this language, the Court said that "[a]s an analytical matter, it seems to us perfectly possible to draw a line, as the regulation does, between (1) 'payment compensating a creditor or prospective creditor for an extension of credit, making available of a line of credit, or any default or breach by a borrower of a condition upon which credit was extended,' and (2) all other payments."[26]

State law, especially when examining usury claims, is similarly broad. As an example, when summarizing Texas usury law, a Texas federal District Court has said:

> The Texas Supreme Court has stated that "amounts charged or received in connection with a loan are not interest if they are not for the use, forbearance, or detention of money." First USA Management Inc. v. Esmond, 960 S.W.2d 625, 627 (Tex. 1997). To determine this, the Court has held that "fees which are an additional charge supported by a distinctly separate rate and additional consideration, other than the simple lending of money, are not interest and thus do not violate the usury laws." [First Bank v. Tony's Tortilla Factory, Inc., 877 S.W.2d 285, 287 (Tex.1994)] . Furthermore, Courts may look past the label assigned to the fee in order to determine if the fee is a service charge or disguised interest. Id.[27]

In the context of similar usury determinations, state courts have not hesitated to recharacterize parties' labels to find that charges and fees should be treated as interest despite the different label used by the parties.[28] Charges as diverse as broker's fees,[29] mandatory repurchase prices,[30] and even attorneys' fees[31] have been recharacterized as interest.

The common element among these definitions is that fees and charges by the lender which represent bona fide payments to third parties will not be interest; payments which the lender collects for itself will be. And, as emphasized in *Mims*, the contractual characterization is not binding. Courts floor substantive not formalist standards. Indeed, in *Mims*, the court held that the lender's charges for attorney's fees would be split: those fees that went to outside counsel were not counted as interest, while those fees allocable to in-house counsel were counted as interest.[32]

The allocation of payments into principal and interest components has a long history, especially in usury cases. The general policy which emerges is that payments denominated or treated as interest are not due and cannot be payable unless there is money or funds (that is, principal) outstanding. Put another way, when a borrower takes out a loan, he or she is bound to repay the principal and only that interest which accrues while any principal is outstanding. You don't pay interest if the principal amount of the debt is repaid.

The point is substantive. Regardless of how the parties characterize a payment, the law will recharacterize it according to its substance.[33] The classic example is zero coupon bonds. With such bonds, no interest is specified. A borrower receives a certain sum—say, for example, $100—and then signs a note or bond that obligates the borrower to repay a larger sum later—say $120, to complete the example. No interest is mentioned. On its face,

such a transaction looks to be interest free. But courts (and Congress, for that matter) have no problem recharacterizing the difference between what is received and what is to be paid back as interest—and thus in the example, the $20 difference between value received and obligation incurred would be characterized as interest.

The legislative history of Section 502(b)(2) confirms this. It states that:

> For example, a claim on a $1,000 note issued the day before bankruptcy would only be allowed to the extent of the case actually advanced. If the original discount was 10% so that the cash advanced was only $900, then notwithstanding the face amount of note, only $900 would be allowed. If $900 was advanced under the note some time before bankruptcy, the interest component of the note would have to be pro-rated and disallowed to the extent it was for interest after the commencement of the case.[34]

Under this standard, MWPs should count as interest. They are charges collected by the lenders related to the use of the money lent or, in the language of the federal regulation discussed in *Smiley*, to the "default or breach by a borrower of a condition [here, no prepayment] upon which credit was extended." Indeed, as can be seen from the clauses used in *Momentive* and in *EFHC*, such charges are by agreement calculated with reference to interest foregone by reason of the debtor's early payment of the entire amount of principal.

The primary problem with this characterization was stated by Scott K. Charles and Emil A. Kleinhaus:

> Treating all prepayment fees (including fixed fees) as "interest" would have the benefit of treating all compensation resulting from prepayment clauses in the same way, thus avoiding any need to draw subtle (and, in the view of some, illusory) distinctions between "true options," on the one hand, and liquidated damages, on the other. The downside of such an approach, however, is that fees that bear no necessary relation to future interest—and that are even called "charges" or "fees"—would be treated no differently from damages for breach of a no call and formulas intended to estimate such damages. One relatively crude approach, under which prepayment clauses necessarily yield "charges," would be replaced with another, under which the clauses yield "interest" no matter their form.[35]

Given the definitions of interest above, this objection suffers from a constricted view of interest. In areas as diverse as usury and consumer protection, state law picks up and uses a broad definition of "interest" including all claims by the lender for fees, charges and other remittances paid directly to the lender for the lender's benefit. To the charge that such a broad interpretation of interest is not applicable to contractual clauses bargained for at arm's length by sophisticated parties, the response is one that usury law has long provided: public policy trumps individual agreements.

In addition, whatever arguments used to sustain MWPs for solvent debtors, in bankruptcy the debtor is not the party paying. Rather, the payments will come, in cases in which the debtor is insolvent, from other creditors. In such circumstances, lenders' claims of loss of a bargained for right fall in line with other creditors' similar claims—all creditors wish for continuous interest. Lenders with MWPs should not have their claims increased simply because of lenders' crafty drafting.[36]

"Unmatured"

The second element of Section 502(b)(2) is that the claim for interest be "unmatured." Although the Bankruptcy Code mentions this classification in Section 101(5)'s definition of "claim," it is not a separately defined term. The legislative history gives some hint as to meaning. It states that "interest disallowed under this paragraph includes postpetition interest that is not yet due and payable, and any portion of prepaid interest that represents an original discounting of the claim, yet that would not have been earned on the date of bankruptcy."[37]

Case law has followed this suggestion. While "[t]he Bankruptcy Code does not define 'unmatured interest,' . . . case law has determined that unmatured interest includes interest that is not yet due and payable at the time of a bankruptcy filing, or is not yet earned."[38]

The legislative history also indicates that the bankruptcy filing cannot be the trigger that brings about the maturity of the obligation to pay interest. It states that "[w]hether interest is matured or

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unmatured on the date of bankruptcy is to be determined without reference to any ipso facto or bankruptcy clause in the agreement creating the claim."[39] This leads directly to the conclusion that MWPs are "unmatured," regardless of any automatic acceleration of the maturity date caused by the filing of the bankruptcy case.

Liquidated Damages?

Many cases, including leading cases from Delaware, reject this analysis. Instead of viewing MWPs as substitutes for interest yet to be paid, they view them as liquidated damages, and thus a separate class of claims. In *In re Trico Marine Servs., Inc*.,[40] Judge Shannon stated that:

> Research reveals that the substantial majority of courts considering this issue have concluded that make-whole or prepayment obligations are in the nature of liquidated damages rather than unmatured interest, whereas courts taking a contrary approach are distinctly in the minority. . .This Court is persuaded by the soundness of the majority's interpretation of make-whole obligations, and therefore finds that the Indenture Trustee's claim on account of the Make-Whole Premium is akin to a claim for liquidated damages, not a claim for unmatured interest.[41]

Judge Carey soon agreed.[42]

There are two fatal objections to this reasoning. First, simply calling something liquidated damages doesn't change the character of the damages liquidated. If a MWP is a liquidated damages clause, then there must be some damages that required advance calculation. The damages represented by a MWP, however, are the present value of unpaid and unearned interest, which would be disallowed under Section 502(b)(2). If you call the clause a "liquidated interest" provision, you lose no meaning, but reveal the true character of the clause. As a result, characterizing MWP as liquidated damages is true but trivial; even when liquidated, the damages are still damages inextricably tied to and calculated by the amount of interest avoided by an early payment. Indeed, this has rightly been called a "false dichotomy."[43]

The second argument is more subtle. For a liquidated damages clause to exist, there must be some breach that leads to damages being liquidated.[44] But there is no breach outside of bankruptcy when a borrower seeks to repay a loan which is subject to a MWP. Rather, the borrower is simply electing to exercising its bargained-for option to pay early.[45] Put another way, paying early and paying the MWP is *performance*, not breach.[46] Without breach, there can be no liquidated damages. This analysis leads back to the characterization of the MWP as interest, and its status as of a bankruptcy filing as unmatured.

Conclusion

The swordsman scene in Indiana Jones was born of a rethinking the movie's story, and necessity. As related on a fan-based website, the idea originally was to have Harrison Ford's character engage in an extended fight with the swordsman. But that had certain costs. As stated by Harrison Ford:

> I was in my fifth week of dysentery. I'm riding up to the set at 5.30am and can't wait to storm up to Steven with this idea. We could save four days on this lousy location this way! Besides which, it was right and important—what is more vital in the character's mind is finding Marion; he doesn't have the time for another five-minute fight. But as was very often the case when I suggested it to Steve—"Let's just shoot the [person]"—he said he'd thought the same thing that morning.[47]

Just as it was time to rethink the scene in *Raiders*, the time has come to rethink MWPs in bankruptcy. No matter how they are sliced and diced, they are compensation for unpaid interest. As such, and regardless of their status under non-bankruptcy law, they are "unmatured interest" under the Bankruptcy Code. They should be shot and summarily disallowed.

ENDNOTES:

[1]Raiders of the Lost Ark (Paramount Pictures 1981).

[2]You can see the scene at: https://www.youtube.com/watch?v=7YyBtMxZgQs.

[3]Such clauses are often called "yield maintenance provisions" or something similar. I do not make distinctions because I do not believe that there are any substantive differences under bankruptcy law.

[4]Chinatown (Paramount Pictures 1974). The

actual line is: "Forget it, Jake. It's Chinatown."

[5]For a shorter piece advocating the same position, see Matthew I. Knepper, Lipstick On A Pig: Disallowing Make-Whole Clauses As Unmatured Interest, Am. Bankr. Inst. J., at 40 (Dec. 2012/Jan. 2013).

[6]In re MPM Silicones, LLC, 2014 WL 4436335 at *16-17 (Bankr. S.D.N.Y. 2014), order aff'd, 531 B.R. 321 (S.D.N.Y. 2015).

[7]Judge Sontchi's rulings are contained in a series of cases. In re Energy Future Holdings Corp., 513 B.R. 651, 59 Bankr. Ct. Dec. (CRR) 265 (Bankr. D. Del. 2014); In re Energy Future Holdings Corp., 527 B.R. 178 (Bankr. D. Del. 2015), order aff'd, 2016 WL 627343 (D. Del. 2016); In re Energy Future Holdings Corp., 533 B.R. 106 (Bankr. D. Del. 2015), order aff'd, 2016 WL 627343 (D. Del. 2016); In re Energy Future Holdings Corp., 539 B.R. 723, 61 Bankr. Ct. Dec. (CRR) 200 (Bankr. D. Del. 2015), order aff'd, 2016 WL 1451045 (D. Del. 2016); In re Energy Future Holdings Corp., 540 B.R. 96 (Bankr. D. Del. 2015); and In re Energy Future Holdings Corp., 540 B.R. 109 (Bankr. D. Del. 2015).

[8]For a more detailed background on the cases, see Greg M. Zipes & Gerard DiConza, Make Wholes: Have Bankruptcy Courts Identified the Yellow Brick Road Language that Leads to Creditor Oz?, 25 No. 1 J. Bankr. L. & Prac. NL Art. 4 (2016).

[9]This summary is taken from my examination of *Momentive*'s use of a cram down interest rate based on Till v. SCS Credit Corp. *See* To Market, To Market: Momentive and Secured Creditor Cram Down Interest Rates, Bankruptcy Law Letter, Vol. 36, No. 2 (Feb. 2016).

[10]In re MPM Silicones, LLC, Case No. 14-22503-rdd, 2014 WL 4436335, at *12 (Bankr. S.D.N.Y., Sept. 9, 2014), aff'd, 531 B.R. 321, (S.D.N.Y 2015), appeal pending, Dkt. No. 15-1771 (2d Cir.).

[11]In re Energy Future Holdings Corp., 513 B.R. 651, 59 Bankr. Ct. Dec. (CRR) 265 (Bankr. D. Del. 2014); In re Energy Future Holdings Corp., 527 B.R. 178 (Bankr. D. Del. 2015), order aff'd, 2016 WL 627343 (D. Del. 2016); In re Energy Future Holdings Corp., 533 B.R. 106 (Bankr. D. Del. 2015), order aff'd, 2016 WL 627343 (D. Del. 2016); In re Energy Future Holdings Corp., 539 B.R. 723, 61 Bankr. Ct. Dec. (CRR) 200 (Bankr. D. Del. 2015), order aff'd, 2016 WL 1451045 (D. Del. 2016); In re Energy Future Holdings Corp., 540 B.R. 96 (Bankr. D. Del. 2015); and In re Energy Future Holdings Corp., 540 B.R. 109 (Bankr. D. Del. 2015).

[12]See. e.g., Abbe v. Goodwin, 7 Conn. 377, 1829 WL 36 (1829); Brown v. Cole, 14 L.J.-Ch. 167 (1845). There is some doubt as to how well established this rule was before the Nineteenth Century. Frank S. Alexander, Mortgage Prepayment: The Trial of Commonsense, 72 Cornell. L. Rev. 288, 304 (1986-1987) ("There is little evidence to support a rule prohibiting mortgage prepayment until the beginning of the nineteenth century.").

For a more comprehensive examination of the history and details of make-whole premiums, see Patrick M. Birney Toward Understanding Make-Whole Premiums in Bankruptcy, 24 No. 4 J. Bankr. L. & Prac. NL Art. 7 (2015).

[13]The history and nomenclature is more richly examined in the most compete examination of the subject to date, Scott K. Charles & Emil A. Kleinhaus, Prepayment Clauses in Bankruptcy, 15 Am. Bankr. L. Rev. 537, 541 (2007).

[14]Considerations may be quite different with solvent chapter 11 debtors. See In re Chemtura Corp., 439 B.R. 561 (Bankr. S.D. N.Y. 2010).

[15]See, e.g., Poughkeepsie Galleria Co. v. Aetna Life Ins. Co., 178 Misc. 2d 646, 648, 680 N.Y.S.2d 420 (Sup 1998).

[16]There is a corollary to this point. If the lender's acceleration is caused by the bad faith conduct of the borrower or other conduct seeking to evade the operation of the MWP, then the MWP must still be paid. In such cases, even though the lender is the one seeking early payment through acceleration of the maturity date, the MWP is still due since the cause of the lender's action was the borrower's bad faith. See Sharon Steel Corp. v. Chase Manhattan Bank, N.A., 691 F.2d 1039, 1053 (2d Cir. 1982).

[17]In re South Side House, LLC, 451 B.R. 248, 268, 55 Bankr. Ct. Dec. (CRR) 26 (Bankr. E.D. N.Y. 2011), order aff'd, Bankr. L. Rep. (CCH) P 82170, 2012 WL 273119 (E.D. N.Y. 2012) (quoting In re Solutia Inc., 379 B.R. 473, 488, 49 Bankr. Ct. Dec. (CRR) 38 (Bankr. S.D. N.Y. 2007)).

[18]George H. Nutman, Inc. v. Aetna Business Credit, Inc., 115 Misc. 2d 168, 169, 453 N.Y.S.2d 586 (Sup 1982) (citing Kilpatrick v. Germania Life Ins. Co., 183 N.Y. 163, 168-69, 75 N.E. 1124 (1905)).

[19]Northwestern Mut. Life Ins. Co. v. Uniondale Realty Associates, 11 Misc. 3d 980, 985, 816 N.Y.S.2d 831, 836 (Sup 2006) ("When a clear and unambiguous clause which calls for payment of the prepayment premium or a sum equal thereto, at any time after default and acceleration is included in the loan agreement, such clause is analyzed as liquidated damages and is generally enforceable").

[20]In re South Side House, LLC, 451 B.R. 248, 268, 55 Bankr. Ct. Dec. (CRR) 26 (Bankr. E.D. N.Y. 2011), order aff'd, Bankr. L. Rep. (CCH) P 82170, 2012 WL 273119 (E.D. N.Y. 2012) (citing In re Granite Broadcasting Corp., 369 B.R. 120, 144, 48 Bankr. Ct. Dec. (CRR) 81 (Bankr. S.D. N.Y. 2007) ("As a general rule, a lender is not entitled to prepayment consideration after a default unless the parties' agreement expressly requires it."); In re Solutia Inc., 379 B.R. 473, 488, 49 Bankr. Ct. Dec. (CRR) 38 (Bankr. S.D. N.Y. 2007) (declining to award a claim for loss of expected interest stream absent explicit language in the indenture so enti-

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tling the lender); HSBC Bank USA, Nat'l Ass'n. v. Calpine Corp., 2010 WL 3835200, at *5 (S.D.N.Y. Sept. 10, 2010) (declining to allow premiums in respect of secured notes where the notes did not "specifically require a payment in the event of acceleration").

[21]In re MPM Silicones, LLC, Case No. 14-22503-rdd, 2014 WL 4436335, at *14 (Bankr. S.D.N.Y., Sept. 9, 2014), aff'd, 531 B.R. 321, (S.D.N.Y 2015), appeal pending, Dkt. No. 15-1771 (2d Cir.). Judge Drain referred to Scott K. Charles & Emil A. Kleinhaus, Prepayment Clauses In Bankruptcy, 15 Am. Bankr. Inst. L. Rev. 537, 556 (2007) and U.S. Bank National Association v. South Side House, LLC, 2012 U.S. Dist. LEXIS, 10824, at *21-24, and In re LaGuardia Associates, L.P., 2012 Bankr. LEXIS 5612, at *14-16 for examples of the level of explicitness or specificity required.

[22]Black's Law Dictionary 935 (10th ed. 2014).

[23]Thrifty Oil Co. v. Bank of America Nat. Trust and Sav. Ass'n, 322 F.3d 1039, 1046 (9th Cir. 2003) (quoting Matter of Pengo Industries, Inc., 962 F.2d 543, 546, 27 Collier Bankr. Cas. 2d (MB) 119 (5th Cir. 1992)).

[24]In re Chateaugay Corp., 961 F.2d 378, 381, 22 Bankr. Ct. Dec. (CRR) 1347, 26 Collier Bankr. Cas. 2d (MB) 1174, Bankr. L. Rep. (CCH) P 74550 (2d Cir. 1992) (quoting In re Public Service Co. of New Hampshire, 114 B.R. 800, 803, 20 Bankr. Ct. Dec. (CRR) 850, Bankr. L. Rep. (CCH) P 73424 (Bankr. D. N.H. 1990)).

[25]Smiley v. Citibank (S. Dakota), N.A., 517 U.S. 735, 740, 116 S. Ct. 1730, 1733 (1996).

[26]Smiley v. Citibank (South Dakota), N.A., 517 U.S. 735, 740, 116 S. Ct. 1730, 1733, 135 L. Ed. 2d 25 (1996).

[27]Mims v. Fidelity Funding, Inc., 307 B.R. 809, 856 (N.D. Tex. 2002). See also Parker v. Brinson Constr. Co., 78 So.2d 873 (Fla. 1955) ("Interest" generally is defined as compensation allowed by law or fixed by agreement between the parties to a loan for the use or detention of money or the forbearance to collect money that is due.).

[28]See, e.g., Pease v. Taylor, 88 Nev. 287, 291, 496 P.2d 757, 760 (1972); Durst v. Abrash, 22 A.D.2d 39, 40, 253 N.Y.S.2d 351, 352 (1st Dep't 1964), order aff'd, 17 N.Y.2d 445, 266 N.Y.S.2d 806, 213 N.E.2d 887 (1965); Taylor v. Budd, 217 Cal. 262, 265–66, 18 P.2d 333 (1933).

[29]See, e.g., Wheeler v. Superior Mortg. Co., 196 Cal. App. 2d 822, 828–29, 17 Cal. Rptr. 291, 295 (2d Dist. 1961).

[30]See, e.g., Durst v. Abrash, 22 A.D.2d 39, 40, 253 N.Y.S.2d 351, 352 (1st Dep't 1964), order aff'd, 17 N.Y.2d 445, 266 N.Y.S.2d 806, 213 N.E.2d 887 (1965).

[31]Mims v. Fidelity Funding, Inc., 307 B.R. 849, 857 (N.D. Tex. 2002).

[32]Mims v. Fidelity Funding, Inc., 307 B.R. 849, 857 (N.D. Tex. 2002).

[33]See, e.g., Thrifty Oil Co. v. Bank of America Nat. Trust and Sav. Ass'n, 322 F.3d 1039, 1047 (9th Cir. 2003) ("In deciding whether a claim includes unmatured interest, federal courts generally focus on the substance of the claim, not its form, and may rely on evidence outside the parties' agreement.").

[34]H.R.Rep. No. 95-595, 95th Cong., 1st Sess. 352-53 (1977); S.Rep. No. 95-989. 95th Cong., 2d Sess. 62 (1978).

[35]Scott K. Charles & Emil A. Kleinhaus, Prepayment Clauses In Bankruptcy, 15 Am. Bankr. Inst. L. Rev. 537, 574 (2007).

[36]"[T]he venerable principle that a bankruptcy court can refuse to award interest that accrues on a creditor's claim after the petition for bankruptcy is filed . . . is designed for cases where there is not enough money to pay all the creditors—so that there is a question whether one creditor should get interest while another doesn't even recover principal." Matter of Chicago, Milwaukee, St. Paul and Pacific R. Co., 791 F.2d 524, 529 (7th Cir. 1986).

[37]H.R.Rep. No. 95-595, 95th Cong., 1st Sess. 352 (1977); S.Rep. No. 95-989. 95th Cong., 2d Sess. 62 (1978).

[38]In re South Side House, LLC, 451 B.R. 248, 261, 55 Bankr. Ct. Dec. (CRR) 26 (Bankr. E.D. N.Y. 2011), order aff'd, Bankr. L. Rep. (CCH) P 82170, 2012 WL 273119 (E.D. N.Y. 2012). See also In re Doctors Hosp. of Hyde Park, Inc., 508 B.R. 697, 706 (Bankr. N.D. Ill. 2014) (Unmatured interest is "interest which was not yet due and payable at the time the petition was filed.") (quoting In re X-Cel, Inc., 75 B.R. 781, 788-89 (N.D. Ill. 1987)).

[39]H.R.Rep. No. 95-595, 95th Cong., 1st Sess. 352-53 (1977); S.Rep. No. 95-989. 95th Cong., 2d Sess. 62 (1978).

[40]In re Trico Marine Services, Inc., 450 B.R. 474 (Bankr. D. Del. 2011).

[41]In re Trico Marine Servs., Inc., 450 B.R. 474, 480-81 (Bankr. D. Del. 2011) (citing Noonan v. Fremont Fin. (In re Lappin Elec. Co.), 245 B.R. 326, 330 (Bankr. E.D. Wis. 2000) ("[T]his court is in agreement with a majority of courts that view a prepayment charge as liquidated damages, not as unmatured interest or an alternative means of paying under the contract.") (citations omitted); see also In re Outdoor Sports Headquarters, Inc., 161 B.R. 414, 424 (Bankr. S.D. Ohio 1993) ("Prepayment amounts, although often computed as being interest that would have been received through the life of a loan, do not constitute unmatured interest because they fully mature pursuant to the provisions of the contract.") (citations omitted); In re Skyler Ridge, 80 B.R. 500, 508 (Bankr. C.D. Cal.

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1987) ("Liquidated damages, including prepayment premiums, fully mature at the time of breach, and do not represent unmatured interest.") (citation omitted)).

[42]In re Sch. Specialty, Inc., No. 13-10125 KJC, 2013 WL 1838513, at *5 (Bankr. D. Del. Apr. 22, 2013).

[43]In re Doctors Hosp. of Hyde Park, Inc., 508 B.R. 697, 706 (Bankr. N.D. Ill. 2014).

[44]See, e.g., Restatement (Second) of Contracts § 356(1) (1981), which indicates that liquidated damages are available after "breach."

[45]See West Raleigh Group v. Massachusetts Mut. Life Ins. Co., 809 F. Supp. 384, 391 (E.D. N.C. 1992) (noting that the borrower's premise that prepayment is a liquidated-damages provision "ignores the fact that there has been no breach of contract . . . [where the borrower] is attempting to voluntarily invoke a contract term—the privilege and option of prepayment," and therefore "to invoke that option it must abide by the terms of its agreement"); Carlyle Apartments Joint Venture v. AIG Life Ins. Co., 333 Md. 265, 635 A.2d 366, 373 (1994) (noting that prepayment was in accordance with the contract and not a breach); Lazzareschi Inv. Co. v. San Francisco Fed. Sav. & Loan Assn., 22 Cal. App. 3d 303, 99 Cal. Rptr. 417, 420 (1st Dist. 1971) (Prepayment is the "opposite of default.").

[46]See Megan W. Murray, Prepayment Premiums: Contracting for Future Financial Stability in the Commercial Lending Market, 96 Iowa L. Rev. 1037, 1051-53 (2011). See also River East Plaza, L.L.C. v. Variable Annuity Life Ins. Co., 498 F.3d 718 (7th Cir. 2007).

[47] http://web.archive.org/web/20080604184141/http://www.indy-net.co.uk/articles.php?article_id=4. The unexpurgated version of "[person]" is a vulgar personal description that rhymes with "trucker." Webster's Unabridged Dictionary dates the term actually used by Ford to 1598, and defines it as "an offensive or disagreeable person."

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