AMERICAN BANKRUPTCY INSTITUTE

2018 Bankruptcy Battleground West

Writs of Certiorari: Pros and Cons

Hon. Scott H. Yun, Moderator
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WRITS OF *CERTIORARI*: PROS AND CONS

I. FALSE ORAL STATEMENTS: GROUNDS FOR DENIAL OF DISCHARGE?

A. **Case**: *Appling v. Lamar, Archer & Cofrin, LLP (In re Appling)*, 848 F.3d 953 (11th Cir. 2017), *cert. granted*, 2018 WL 386562 (U.S. Jan. 12, 2018) (No. 16-1215)

B. **Question Presented**: "The question presented is whether (and, if so, when) a statement concerning a specific asset can be a "statement respecting the debtor's ... financial condition" within Section 523(a)(2)."

C. **Status**: The Supreme Court of the United States granted *Certiorari* on January 12, 2018.

D. **Relevant Documents**:

1. Petition, *Appling*, 2017 WL 1338561 (U.S. Apr. 11, 2017) (No. 16-1215) **[ATTACHED WITHOUT APPENDIX]**
2. Brief in Opposition, *Appling*, 2017 WL 2333828 (U.S. May 25, 2017) (No. 16-1215)
3. Reply in Support of Petition for a Writ of Certiorari, *Appling*, 2017 WL 2391510 (U.S. May 31, 2017) (No. 16-1215)
4. Brief for the United States as Amicus Curae, *Appling*, 2017 WL 5256223 (U.S. Nov. 9, 2017) (No. 16-1215)
5. Supplemental Brief of Respondent, *Appling*, 2017 WL 6018208 (U.S. Dec. 1, 2017) (No. 16-1215)
6. Second Supplemental Brief of Respondent, *Appling*, No. 16-1215 (U.S. Jan. 2, 2018) (no Westlaw cite available)

II. RECHARACTERIZATION OF DEBT: STATE LAW OR FEDERAL COMMON LAW

A. **Cases:**

1. *Pem Entities LLC v. Levin (In re Province Grande Olde Liberty, LLC)*, 86 U.S.L.W. 3065 (U.S. Aug. 10, 2017)
2. *Leslie v. Hancock Park Capital II, L.P. (In re Fitness Holdings Int'l, Inc.)*, 86 U.S.L.W. 4420 (U.S. Oct. 2, 2017)

B. **Question Presented**: "The question presented by this petition addresses a split among the Circuit Courts as to whether a bankruptcy court's authority to recharacterize putative debt as equity arises from the bankruptcy court's general equitable powers under 11 U.S.C. § 105(a) as announced in *Pepper v. Litton* (as five Circuits have held) or arises under 11 U.S.C. § 502(b), thus restricting the bankruptcy court's equitable powers to applicable state law (as two Circuits have held)."

C. **Status**: The United States Supreme Court denied *certiorari* on the Petition for Writ of Certiorari in *Pem Entities LLC v. Levin, et. al.*, United States Supreme Court, No. 16-492 and the Petition for Writ of *Certiorari* in *Sam Leslie, Chapter 7 Trustee of the Estate of Fitness Holdings International, Inc. v. Hancock Park Capital II, L.P., et. al.,* United States Supreme Court, No. 16-1136.

D. **Relevant Documents**:

1. Petition for Writ of Certiorari, *Pem Entities*, 2016 WL 5956659 (U.S. Oct. 11, 2016) (No. 16-492)
2. Petition for Writ of Certiorari, *Fitness Holdings*, 2017 WL 1057403 (U.S. Mar. 15, 2017) (No. 16-1136) **[ATTACHED WITHOUT APPENDIX]**
3. Brief of Respondents Hancock Park Capital II, L.P., et al in Opposition, *Hancock Park*, 2017 WL 2223306 (U.S. May 19, 2017) (No. 16-1136)
4. Reply Brief of Petitioner, *Fitness Holdings*, 2017 WL 2472066 (U.S. June 7, 2017) (No. 16-1136)

III. CRAMDOWN INTEREST RATE: FORMULA V. MARKET RATE UNDER *TILL*

A. **Issue:** There is currently a Circuit split regarding the appropriate cramdown interest rate in a Chapter 11 case (with the Second and Sixth Circuits using the "market" approach where a market exists, and other Circuits continuing to apply *Till's* "formula" approach across the board).

B. **Status**: There are no pending petitions for *certiorari*.

C. **Relevant Cases**:

1. *Momentive Performance Materials, Inc. v. BOKF, NA (In re MPM Silicones, L.L.C.)*, 874 F.3d 787 (2d Cir. 2017) **[ATTACHED]**
2. *First S. Nat'l Bank v. Sunnyslope Housing Ltd. P'ship (In re Sunnyslope Housing Ltd. P'ship)*, 859 F.3d 637 (9th Cir. 2017) **[ATTACHED]**

3. *Wells Fargo Nat'l Ass'n v. Texas Grand Prairie Hotel Realty, L.L.C. (In re Texas Grand Prairie Hotel Realty, L.L.C.)*, 710 F.3d 324, 337 (5th Cir. 2013) **[ATTACHED]**
4. *Bank of Montreal v. Official Comm. Of Unsecured Creditors (In re Am. HomePatient, Inc.)*, 420 F.3d 559, 568 (6th Cir. 2005) **[ATTACHED]**
5. *Till v. SCS Credit Corp*. *(In re Till)*, 541 U.S. 465 (2004) **[ATTACHED]**

No.

In the Supreme Court of the United States

LAMAR, ARCHER & COFRIN, LLP,
Petitioner,

v.

R. SCOTT APPLING,
Respondent.

ON PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE ELEVENTH CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

The Bankruptcy Code prohibits the discharge of "any debt . . . for money, property, [or] services . . . to the extent obtained by . . . false pretenses, a false representation, or actual fraud, other than a statement respecting the debtor's . . . financial condition." 11 U.S.C. § 523(a)(2). Three Circuits have held that a statement concerning a specific asset of the debtor cannot be a "statement respecting the debtor's . . . financial condition." Two Circuits, including the Eleventh Circuit below, have held that it can be. Based on that interpretation, the Eleventh Circuit here reversed the bankruptcy court's conclusion that the debt at issue "is nondischargeable," App. 14a, even though it is based on a fraudulent statement.

The question presented is whether (and, if so, when) a statement concerning a specific asset can be a "statement respecting the debtor's . . . financial condition" within Section 523(a)(2).

RULE 29.6 STATEMENT

Petitioner Lamar, Archer & Cofrin, LLP, is a limited liability partnership. Petitioner has no parent corporation, and no publicly held company owns 10% or more interest in the partnership.

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PETITION FOR A WRIT OF CERTIORARI

Lamar, Archer & Cofrin, LLP (Lamar) respectfully petitions this Court for a writ of certiorari to review the judgment of the United States Court of Appeals for the Eleventh Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals (App. 1a-19a) is reported at 848 F.3d 953. The opinion of the district court (App. 20a-44a) is unreported. The order of the bankruptcy court denying respondent's motion to dismiss (App. 67a-81a) is reported at 500 B.R. 246. The bankruptcy court's findings of fact and conclusions of law (App. 45a-66a) are reported at 527 B.R. 545.

JURISDICTION

The court of appeals entered judgment on February 15, 2017. App. 1a-2a. This Court has jurisdiction under 28 U.S.C. § 1254(1).

STATUTORY PROVISION INVOLVED

Section 523 of the Bankruptcy Code, 11 U.S.C. § 523, provides in relevant part:

> (a) A discharge under section 727, 1141, 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual debtor from any debt—
>
> . . .
>
> (2) for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by—
>
> (A) false pretenses, a false representation, or actual fraud, other than a statement respecting the debtor's or an insider's financial condition; [or]
>
> (B) use of a statement in writing—

> (i) that is materially false;
>
> (ii) respecting the debtor's or an insider's financial condition;
>
> (iii) on which the creditor to whom the debtor is liable for such money, property, services, or credit reasonably relied; and
>
> (iv) that the debtor caused to be made or published with intent to deceive . . . .

STATEMENT

This case concerns an expressly acknowledged and now entrenched circuit conflict over the meaning of a provision of the Bankruptcy Code dealing with the dischargeability of a commonly recurring type of debt. One of the time-honored rules of bankruptcy is that it is intended to provide a fresh start for the "honest but unfortunate debtor." *Cohen v. de la Cruz*, 523 U.S. 213, 217 (1998) (citation omitted). In keeping with that objective, the Bankruptcy Code provides broad relief for individual debtors, but prohibits the discharge of debts that result from dishonest or fraudulent conduct. This case concerns whether Congress intended to drive a truck through that general policy, or just tweak it to address a particular situation that had arisen, when it amended Section 523(a)(2)(A) of the Bankruptcy Code.

Section 523(a)(2)(A) of the Code generally bars the discharge in bankruptcy—whether under Chapter 7, 11, 12, or 13—of debts obtained by "false pretenses, a false representation, or actual fraud," with one exception: a debt obtained by fraudulent means where the fraud consists of a false "statement respecting the debtor's . . . financial condition." This "financial condition" exception was added to the Code in 1960 to address the practice among certain consumer finance companies of coaxing loan applicants into submitting

false or misleading financial statements in order to insulate (or arguably insulate) the resulting debts to the bank from any future discharge in bankruptcy. *See Field v. Mans*, 516 U.S. 59, 76-77 & n.13 (1995).[1] In response, Congress singled out such debts and subjected them to additional rules before they could be exempted from discharge. *See* 11 U.S.C. § 523(a)(2)(B).

The question presented in this case is whether a false statement that concerns a *specific* asset—as opposed to a debtor's financial health more generally, as is typically required, for example, by an application for credit—is a "statement respecting the debtor's . . . financial condition," such that a debt obtained on that basis is dischargeable unless it meets the heightened standard in Section 523(a)(2)(B). In this case, the debtor (respondent) intentionally made a false statement to the creditor (petitioner) about an "anticipated tax refund"—a single asset—in order to receive an extension of credit on services that he had secured and hoped to continue to receive. App. 6a. The bankruptcy court and district court held that this was *not* a statement respecting the debtor's financial condition; the Eleventh Circuit held otherwise.

As the Eleventh Circuit below recognized, "[t]he circuits and other federal courts are split on this question." *Id.* The Fourth Circuit has held that a statement about a single asset can be a statement

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[1] In *Field*, this Court considered "the level of a creditor's reliance on a fraudulent misrepresentation necessary to place a debt . . . beyond release" under Section 523(a)(2)(A), 516 U.S. at 61—a different issue than the one presented here. But in deciding that question, the Court discussed the history of the "financial condition" exception. *See id.* at 64-66, 76-77 & n.13.

respecting the debtor's financial condition, while the Fifth, Eighth, and Tenth Circuits have all held that it is not. In the decision below, the Eleventh Circuit sided with the Fourth, deepening the split and removing any doubt that it is here to stay until resolved by this Court. Particularly given the importance of uniformity in bankruptcy, there is no reason why this Court should tolerate the result where a common class of debts is dischargeable in some parts of the country but not others. The question presented warrants review, and this case presents an ideal vehicle to resolve it.

A. Factual Background

Petitioner Lamar, Archer & Cofrin, LLP (Lamar), is a law firm located in Atlanta, Georgia. In 2004, respondent R. Scott Appling hired Lamar and Walter Gordon to represent Appling in litigation against the former owners of a business he had recently purchased. App. 21a. Appling agreed to pay Lamar and Gordon on an hourly basis with fees due monthly. *Id.* As the litigation proceeded, Appling fell behind in his payments for the services he received. *Id.*

By March 2005, Appling owed Lamar more than $60,000 and Gordon $18,000 in unpaid legal fees. *Id.* Lamar informed Appling that if he were unable to bring fees current, Lamar would be forced to terminate its representation in an appropriate manner. *Id.* at 21a-22a. The parties met in Gordon's office on March 18, 2005, to discuss the situation. *Id.* at 22a.

At the meeting, Appling told Lamar and Gordon that he had consulted an accountant, and that he would soon be filing an amended tax return, entitling him to a tax refund of approximately $100,000—enough to cover current and future legal fees. *Id.* at 22a, 54a. Based on

that representation, Lamar and Gordon agreed to continue their representation of Appling. *Id.* at 41a, 62a.

In November 2005, Lamar and Appling met again to discuss the outstanding legal fees and Lamar's continued representation. In the November meeting, Appling informed Lamar that his accountant had improperly handled the amended return. *Id.* at 22a-23a, 57a-60a. As a result, Appling claimed, he had been forced to refile the return himself, and so had not yet received his refund. *Id.* at 23a, 57a-60a. Appling assured Lamar, however, that he still expected to receive an amount sufficient to cover all of his mounting legal fees. *Id.* at 22a. Once again, Lamar continued its representation of Appling on the basis of his assurances. *Id.* at 41a, 61a-62a.

Lamar and Gordon continued to represent Appling for approximately a year following the initial March meeting, eventually negotiating a settlement that drastically lowered Appling's remaining financial obligations to the former owners of his business, but generating additional legal fees as a result of their efforts. *Id.* at 48a-49a.

Appling's representations about his tax return were false. In June 2005, Appling did sign and submit an amended tax return. *Id.* at 22a, 48a. But that return sought a refund of only $60,718 (which was further reduced by the IRS to $59,851), not the approximately $100,000 he had represented. *Id.* Moreover, Appling received the refund in October 2005—prior to the November meeting when he claimed to have not yet received it. *Id.* at 22a, 48a-49a. And, contrary to his stated intent, Appling never paid any of the refund

money he did receive to Lamar or Gordon, but instead used it to pay other business expenses. *Id.*

When Lamar learned the truth in June 2006 that Appling had received the refund and invested it in his business, rather than paying his outstanding legal fees, Lamar demanded payment of all outstanding fees within 14 days. *Id.* at 23a. When Appling failed to satisfy Lamar's demand, Lamar sued Appling in Georgia state court, obtaining a judgment in the amount of $104,179.60 in October 2012. *Id.* Three months later, Appling and his wife filed for bankruptcy under Chapter 7, seeking to discharge all of their personal debts, including Lamar's judgment. *Id.*

B. Procedural History

1. Lamar initiated an adversary proceeding in the bankruptcy court for the Middle District of Georgia, seeking a determination that Appling's debt to Lamar was not dischargeable under 11 U.S.C. § 523(a)(2)(A) because it was obtained by fraud. Appling moved to dismiss the complaint, arguing among other things that the prohibition on discharging such debts did not apply because the alleged false statements about his tax refund were "statement[s] respecting [his] . . . financial condition." App. 70a (quoting § 523(a)(2)(A)).

In September 2013, the bankruptcy court denied Appling's motion. *Id.* at 67a-81a. "Two views have emerged on the proper interpretation of the phrase 'respecting the debtor's . . . financial condition,'" the court explained. *Id.* at 71a (citation omitted). Under the one view, the phrase includes "any communication that has a bearing on the debtor's financial position," including statements about a "single asset or liability." *Id.* (citation omitted). Under the other, the phrase

includes only "communications that purport to state the debtor's overall net worth, overall financial health, or equation of assets and liabilities." *Id.* (citation omitted). Adopting the latter view, the court held that the alleged misrepresentations about "a single asset, the tax refund," were not representations as to his "overall financial condition or net worth," and therefore refused to dismiss Lamar's complaint. *Id.* at 73a, 76a.

2. Following a two-day trial, the bankruptcy court issued its findings of fact and conclusions of law resolving the adversarial proceeding. *Id.* at 45a-66a. Among other things, the court found that Appling had indeed "knowingly made a false representation with intent to deceive when he represented" that his tax refund would be "approximately $100,000" and, later, that "he had not yet received the refund." *Id.* at 54a, 58a. The court further found that Lamar relied on Appling's representations regarding the tax refund, that it was justified in so doing, and that it was harmed thereby. *Id.* at 62a-66a. Accordingly, it held that Lamar's claim against Appling is not dischargeable under Section 523(a)(2)(A). *Id.* at 66a.

3. On appeal, the district court affirmed the bankruptcy court in all respects. *Id.* at 20a-44a. As to the meaning of Section 523(a)(2)(A), the district court recognized that "[c]ourts disagree whether to construe the phrase 'respecting the debtor's . . . financial condition' broadly or strictly," and then canvassed the conflict in courts across the country. *Id.* at 25a-27a. "Finding the reasoning of the Fifth Circuit persuasive," the district court agreed with the bankruptcy court's interpretation and thus concluded that "[a] statement pertaining to a single asset is not a statement of financial condition." *Id.* at 27a-29a.

Because Appling's false statements concerned a "single asset" rather than his "financial condition" (i.e., his "net worth, overall financial heath, or equation of assets and liabilities"), the court affirmed. *Id.* at 30a.

4. The court of appeals reversed and remanded. *Id.* at 1a-19a. Like the courts before it, the court of appeals recognized that "[t]his appeal presents a question that has divided the federal courts"—namely, "Can a statement about a single asset be a 'statement respecting the debtor's . . . financial condition.'" *Id.* at 1a-2a (citation omitted). The court noted that the Fourth Circuit and several bankruptcy courts had held that "a debtor's assertion that he owns certain property free and clear of other liens" or similar statements *are* "statement[s] respecting his financial condition," the court observed. *Id.* at 6a (citation omitted). On the other hand, the court observed, the Fifth, Eighth, and Tenth Circuits, as well as several other bankruptcy courts, have held that "a statement about a single asset *does not* respect a debtor's financial condition." *Id.* at 6a-7a (emphasis added).

The court of appeals sided with the Fourth Circuit's interpretation of Section 523(a)(2)(A). "Whether by its ordinary meaning or as a term of art [in the Bankruptcy Code]," the court conceded, "'financial condition' likely refers to the sum of all assets and liabilities," or "one's overall financial status." *Id.* at 7a-8a. But even so, the court continued, "it does not follow that the phrase 'statement *respecting* the debtor's . . . financial condition' covers only statements that encompass the entirety of a debtor's financial condition at once." *Id.* at 8a (citation omitted). The term "respecting" is "defined broadly," the court said,

pointing to the *Webster's New International Dictionary* definition of the word. *Id.*

The court rejected Lamar's argument that such an interpretation of the phrase was inconsistent with the provision's targeted objective—as reflected in the legislative history—of preventing fraud while protecting debtors from creditors who sought to mislead debtors into submitting false or misleading financial statements, such as an application for credit, for the very purpose of insulating the creditors' claims from discharge. *See Field v. Mans*, 516 U.S. 59, 76-77 (1995). If Congress wanted to limit the provision to such "financial statements," the court of appeals observed, Congress could have said so. App. 10a. Because it did not, the court concluded that by "statement" Congress meant only to distinguish a debt obtained by an affirmative misstatement from one obtained by "a nonactionable omission." *Id.* at 11a.

In the end, the court of appeals concluded that the "text is not ambiguous." *Id.* at 12a. "[A] statement about a single asset can be a 'statement respecting the debtor's . . . financial condition.'" *Id.* at 14a. And, because Appling's statement did not meet all the requirements for nondischargeability in Section 523(a)(2)(B)—namely, the requirement that the false statement be in writing—the court held that Appling's liability to Lamar based on a fraudulent statement "can be discharged." *Id.* The court therefore reversed the bankruptcy court's and district court's ruling that "Appling's debt to Lamar is nondischargeable" and remanded. *Id.*

Judge Rosenbaum concurred, but disagreed with the panel's conclusion that the text was clear-cut. *Id.* at 14a-19a. Contrary to what "the panel seems to

think," she explained, "[s]tanding alone" "the words of the phrase 'statement respecting ... the debtor's financial condition' are *not* unambiguous." *Id.* at 15a (emphasis added). Indeed, as she noted, several other courts, including this Court and "[t]hree other circuits," "have understood the phrase to mean the opposite of what we conclude today." *Id.* at 15a-16a (citing *Field*). Nevertheless, based on her view of whether false statements were more likely to be made orally or in writing, she concluded that a "broad" interpretation was more consistent with Congress's intent. *Id.* at 19a.

REASONS FOR GRANTING THE WRIT

All the core criteria for certiorari are met. In its decision below, the Eleventh Circuit expressly recognized that it was deepening an existing circuit conflict on whether a false statement about a single asset can be a "statement respecting a debtor's ... financial condition," within the meaning of 11 U.S.C. § 523(a)(2)(A). Five Circuits have now decided that question. Three have held that a statement about a single asset is *not* a statement respecting a debtor's financial condition, while two others (including the Eleventh Circuit below) have held that it can be. The issue arises in bankruptcy courts across the country with remarkably frequency and is important to debtors and creditors alike. This case presents a clean vehicle for resolving this question. Moreover, the decision below is wrong and should not be allowed to stand. The petition for a writ of certiorari should be granted.

A. The Decision Below Deepens An Acknowledged Circuit Conflict

The circuit conflict presented by this case is as clear as can be. The Eleventh Circuit expressly recognized

that its decision deepens an existing conflict among the courts of appeals on whether a false statement about a specific asset can be a "statement respecting the debtor's . . . financial condition" within the meaning of 11 U.S.C. § 523(a)(2)(A). App. 6a-7a. Several other courts of appeals have recognized this conflict. *See, e.g.*, *In re Bandi*, 683 F.3d 671, 677 (5th Cir. 2012), *cert. denied*, 133 S. Ct. 845 (2013); *In re Joelson*, 427 F.3d 700, 710 (10th Cir. 2005), *cert. denied*, 547 U.S. 1163 (2006); *In re Lauer*, 371 F.3d 406, 413 (8th Cir. 2004). So has the leading bankruptcy treatise. *See* 4 Alan N. Resnick, Collier on Bankruptcy ¶ 523.08[2][c] (16th ed. 2017 online) ("Courts are sharply divided on the proper scope of the term."). And, indeed, so has Appling himself. *See* Appling CA11 Reply Br. 10 ("This case requires the Court to wade into an active circuit split."). Certiorari is warranted to resolve that conflict.

The majority position. Three courts of appeals have squarely held that a statement about a specific asset is not a "statement respecting the debtor's . . . financial condition." *See* App. 6a-7a.

The Eighth Circuit led the way in *In re Lauer*, 371 F.3d 406 (2004). The false statement in that case concerned a Missouri limited partnership's purported ownership interest in a nursing home. *Id.* at 409-10. The Eighth Circuit initially acknowledged that lower "[c]ourts ha[d] disagreed" on whether the phrase "respecting the debtor's or an insider's financial condition" in 11 U.S.C. § 523(a)(2) could include "misrepresentations concerning specific assets" like the false statement at issue in that case. *Id.* at 413. Then the Eighth Circuit held it did not. *Id.* at 413-14.

In Section 523(a)(2)(A) and (B), the Eighth Circuit reasoned, Congress had sought to address "'the

peculiar potential of financial statements to be misused . . . by creditors' such as 'consumer finance companies, which sometimes have encouraged [false financial statements] by their borrowers for the very purpose of insulating their own claims from discharge.'" *Id.* at 413 (second alteration in original) (citation omitted). Because the false statement about Crossroads' interest in a specific asset (the nursing home) was not analogous to the "financial statements" "routinely required" by such creditors, the Eighth Circuit held that it was not a statement "respecting [Crossroads'] financial condition," and therefore the debtor's fraud liability was nondischargeable. *Id.* at 413-14.[2]

A year later, the Tenth Circuit considered the issue in *In re Joelson*, 427 F.3d 700 (2005). There, the debtor made false statements about specific real properties in order to secure a $50,000 loan. *Id.* at 703. Like the Eighth Circuit, the Tenth Circuit recognized at the outset that "[c]ases interpreting the phrase 'respecting the debtor's . . . financial condition' have split." *Id.* at 710. Under what the court of appeals called the "strict interpretation," statements "respecting the debtor's . . .

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[2] In *Lauer*, the debtor misrepresented the limited partnership Crossroads' interest in the nursing home, not his own. "The Bankruptcy Code defines 'insider' to include a partnership in which an individual debtor is a general partner." 371 F.3d at 413. Accordingly, the Eighth Circuit considered whether the misrepresentation about Crossroad's interest was a "statement respecting . . . an insider's financial condition," instead of a "debtor's . . . financial condition." *Id.* The court gave no indication that the distinction made any difference to its analysis, and no other court of appeals has distinguished *Lauer* on that basis. *See* App. 6a-7a (including the Eighth Circuit among the courts of appeals to have held that "a statement about a single asset does not respect a *debtor's* financial condition" (emphasis added)).

financial condition" are only those that "present[] an overall picture of the debtor's financial position." *Id.* at 705. By contrast, the court noted, under the "broad interpretation" even a communication "addressing the status of a single asset or liability qualifies." *Id.*

After extensive analysis of the text, structure, and policy of the Bankruptcy Code, *id.* at 706-07; the legislative history of Section 523(a)(2), *id.* at 707-10; and case law from this Court and others interpreting the provision, *id.* at 710-14, the Tenth Circuit agreed with the former interpretation. *Id.* at 714. Accordingly, the court held that statements "respecting the debtor's . . . financial condition" are "those that purport to present a picture of the debtor's overall financial health." *Id.* The debtor's false statements concerning only her purported ownership of "certain assets" were not. *Id.* at 714-15.

The Fifth Circuit next addressed the issue in *In re Bandi*, 683 F.3d 671 (2012). The false statements again concerned the debtor's (or, in that case, debtors') purported ownership of certain real properties in order to secure a loan. *Id.* at 673. The Fifth Circuit likewise acknowledged that "there is a split among the various courts as to the correct interpretation of § 523(a)(2)." *Id.* at 677. After carefully examining the text and other indicia of Congress's intent, the Fifth Circuit sided with the Tenth and Eighth Circuits: "We conclude that the phrase 'a statement respecting the debtor's or an insider's financial condition' as used in § 523(a)(2) was meant to embody terms commonly understood in commercial usage rather than a broadly descriptive phrase intended to capture any and all misrepresentations that pertain in some way to specific assets or liabilities of the debtor." *Id.* at 676. As such,

the debtors' false statements about specific properties were not "respecting [their] financial condition," and thus the debt was nondischargeable. *Id.* at 679.[3]

The minority view. Before the Eleventh Circuit's decision in this case, the Fourth Circuit was the only court of appeals to have reached a contrary conclusion, and the Fourth Circuit did so more than three decades ago, in a one-page decision. *See* App. 6a.

In *Engler v. Van Steinburg*, the debtor made a false statement that certain collateral was not subject to a superior lien in order to obtain a loan. 744 F.2d 1060, 1060 (1984). The Fourth Circuit"[c]onceded[]" that "a statement that one's assets are not encumbered is not a formal financial statement." *Id.* at 1060-61. But, it held, Section 523(a)(2)(A) did not "speak in terms of financial statements." *Id.* It referred instead to "a much broader class of statements—those 'respecting the debtor's . . . financial condition.'" *Id.* at 1061. An assertion that one owns a certain property "free and clear," it reasoned, "may be the most significant information about his financial condition." *Id.* And, thus, a debt incurred on that basis could be discharged, unless it met the higher standards for nondischargeability in 11 U.S.C. § 523(a)(2)(B). *Id.* at 1060-61. Because the statement at issue did not meet those standards—namely, it was not made in writing—the court held that it could be discharged. *Id.* at 1060.

As the first court of appeals to address the question, the Fourth Circuit's analysis was brief. Unlike all of the courts of appeals to address the issue since, the Fourth Circuit did not recognize that courts

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[3] As discussed *infra* at 14-15, the debtors petitioned this Court for certiorari in *Bandi*. This Court denied review.

had adopted conflicting interpretations of Section 523(a)(2)(A). The court also failed to consider whether its interpretation was consistent with the purpose of the provision—as reflected in the legislative history and described in *Field*, *see supra* at 3 & n.1—or with the policies behind the Bankruptcy Code as a whole.

For that reason, the last time certiorari was sought on the question presented—in 2012, following the Fifth Circuit's decision in *Bandi*—the respondent argued that the split did not merit review because it was "stale" (given that it was based on 1984 decision), "lopsided" (given that the line up, then, was 3-1), and thin (given that the Fourth Circuit's analysis of the issue was brief). *In re Bandi* Opp. at 5-7, 2012 WL 6019371. The respondent also pointed to the "emerging consensus" among the courts of appeals, and speculated that the Fourth Circuit might eventually revisit the issue and restore uniformity to the law. *Id.* at 7.

Whether or not that was a fair assessment then, it is certainly not now. By acknowledging the conflict among the courts of appeals and siding with the Fourth Circuit in an extensively reasoned (even if ultimately erroneous) published decision, the Eleventh Circuit has eliminated any element of staleness, any realistic chance that the conflict would sort itself out on its own, and any argument that the conflict is not fully vetted, thus necessitating the intervention of this Court to restore uniformity among the circuits on this important issue. The question presented is ripe for review.

B. The Question Presented Is Important And This Case Presents An Excellent Vehicle

The clear and deepening split over the question presented is a compelling, and frequently sufficient,

basis to grant certiorari in itself. But the case for certiorari here is further bolstered by the fact that the question presented is undeniably important—to countless debtors and creditors, and the bankruptcy system alike. It recurs frequently in bankruptcy courts throughout the country. And this case offers a clean vehicle in which to resolve the conflict.

Ensuring the uniformity of federal law is always important, but it is fundamental to the proper administration of the bankruptcy system in particular. The Constitution itself acknowledges as much by granting Congress power "[t]o establish . . . uniform Laws on the subject of Bankruptcies throughout the United States." U.S. Const. art. I, § 8, cl. 4. This Court thus routinely grants certiorari to resolve disagreements between just *two* courts of appeals concerning the interpretation or application of the Bankruptcy Code. *See, e.g.*, *Harris v. Viegelahn*, 135 S. Ct. 1829, 1836 (2015) (certiorari was granted to resolve a 1-1 circuit split); *Clark v. Rameker*, 134 S. Ct. 2242, 2246 (2014) (same); *Hall v. United States*, 132 S. Ct. 1882, 1886 & n.1 (2012) (same). Here, the Eleventh Circuit has deepened a circuit conflict that now involves at least *five* circuits. Such disuniformity in the "uniform Laws" of bankruptcy is untenable.

The untenability of allowing this circuit split to stand is underscored by the fact that the question recurs so frequently in the lower courts. In addition to the five circuits that have now issued published opinions addressing the question, at least two others have been presented with it, but resolved the appeals without adopting a definitive answer. *See In re Gulevsky*, 362 F.3d 961, 962 (7th Cir. 2004); *In re Bogdanovich*, 292 F.3d 104, 112 (2d Cir. 2002).

Perhaps more important, as the Eleventh Circuit noted, the question regularly arises in bankruptcy courts around the country, where the answers are similarly inconsistent. *Compare*, *e.g.*, *In re Feldman*, 500 B.R. 431, 437 (Bankr. E.D. Pa. 2013) (adopting majority position); *In re Banayan*, 468 B.R. 542, 575-76 (Bankr. N.D.N.Y. 2012) (same); *In re Campbell*, 448 B.R. 876, 886 (Bankr. W.D. Pa. 2011) (same),[4] *with In re Carless*, No. 10-42988 (DHS), 2012 WL 32700, at *3-4 (Bankr. D.N.J. Jan. 6, 2012) (adopting the minority position); *In re Aman*, 492 B.R. 550, 565 & n.47 (Bankr. M.D. Fla. 2010) (same); *In re Nicolai*, No. 05-29876, 2007 WL 405851, at *1 (Bankr. D.N.J. Jan. 31, 2007) (same).[5] The citations here represent just the tip of

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[4] *See also In re Alicea*, 230 B.R. 492, 503-04 (Bankr. S.D.N.Y. 1999) (majority position); *In re Soderlund*, 197 B.R. 742, 746 (Bankr. D. Mass. 1996) (same); *In re Peterson*, 182 B.R. 877, 880 (Bankr. N.D. Okla. 1995) (same); *In re Olinger*, 160 B.R. 1004, 1010–11 (Bankr. S.D. Ind. 1993) (same); *In re Oliver*, 145 B.R. 303, 305-06 (Bankr. E.D. Mo. 1992) (same); *In re Mercado*, 144 B.R. 879, 883-85 (Bankr. C.D. Cal. 1992) (same); *In re Sansoucy*, 136 B.R. 20, 23 (Bankr. D.N.H. 1992) (same); *In re Price*, 123 B.R. 42, 45 (Bankr. N.D. Ill. 1991) (same); *In re Seaborne*, 106 B.R. 711, 714 (Bankr. M.D. Fla. 1989) (same); *In re Pollina*, 31 B.R. 975, 977-78 (D.N.J. 1983) (same).

[5] *See also In re Hambley*, 329 B.R. 382, 399 (Bankr. E.D.N.Y. 2005) (minority position); *In re Priestley*, 201 B.R. 875, 882 (Bankr. D. Del. 1996) (same); *In re Kolbfleisch*, 97 B.R. 351, 353 (Bankr. N.D. Ohio 1989) (same); *In re Richey*, 103 B.R. 25, 29 (Bankr. D. Conn. 1989) (same); *In re Rhodes*, 93 B.R. 622, 624 (Bankr. S.D. Ill. 1988) (same); *In re Howard*, 73 B.R. 694, 702 (Bankr. N.D. Ind. 1987) (same); *In re Panaia*, 61 B.R. 959, 960-61 (Bankr. D. Mass. 1986) (same); *In re Prestridge*, 45 B.R. 681, 683 (Bankr. W.D. Tenn. 1985) (same).

the iceberg given that many if not most bankruptcy court rulings on the issue are oral and unreported.

This case presents the ideal vehicle for resolving the conflict. The relevant facts are undisputed (or have been resolved by a finder or fact), and the resolution of the question presented is dispositive of the dischargeability of the debt. After a two-day trial, the bankruptcy court found that every other element of nondischargeability under Section 523(a)(2)(A) was met. App. 62a-66a. Its findings were affirmed by the district court, *see id.* at 30a-44a, and left untouched by the court of appeals, *see id.* at 4a. Appling himself acknowledged that the "case require[d] the court to wade into an active circuit split." Appling CA11 Reply Br. 10. The question presented was raised and passed upon by each court below—the bankruptcy court (App. 70a-76a), district court (*id.* at 24a-30a), and court of appeals (*id.* at 4a-14a). The court of appeals passed upon the question in a published opinion after thorough analysis, and chose a side. There is no impediment to this Court's resolving the question in this case, and therefore no reason to wait to decide this issue.

C. The Decision Below Is Wrong

Finally, the case for certiorari is strengthened by the fact that the court of appeals erred. The court of appeals thought the text of Section 523(a)(2)(A) unambiguously compelled its conclusion, despite the contrary holdings from three courts of appeals and myriad bankruptcy courts. That was error. The text and structure of the statute, as well as the purpose of Section 523(a)(2)(A) and the origins of the "financial condition" exception in particular, weigh decisively against the Eleventh Circuit's conclusion.

Most fundamentally, the Eleventh Circuit's interpretation fails to give effect to the text of Section 523(a)(2)(A). "Financial condition" is different than "finances" generally. When the Bankruptcy Code uses the term "financial condition," it refers to the debtor's financial health generally—*i.e.*, the balance of all of the debtor's assets and liabilities. The Code defines "insolvent"—the lynchpin of the bankruptcy system—as, among other things, the "*financial condition* such that the sum of such entity's debts is greater than all of such entity's property." 11 U.S.C. § 101(32)(A) (emphasis added). This meaning is also consistent with both the ordinary and commercial usage of "financial condition." *See, e.g.*, *Balance sheet*, Webster's Third New International Dictionary 165 (1993) (defining "balance sheet" as a "statement of the *financial condition* (as of a corporation) at a given date showing the equality of total assets to total liabilities plus net worth or of total liabilities to total assets plus deficit" (emphasis added)); *In re Bandi*, 683 F.3d at 676.

Accordingly, before the court of appeals, Appling "accept[ed] the premise that 'financial condition'" in Section 523(a)(2)(A) means "*overall* financial condition." Appling CA11 Br. 16. The court of appeals did the same. *See* App. 8a ("Whether by its ordinary meaning or as a term of art, 'financial condition' likely refers to the sum of all assets and liabilities."); *see id.* at 9a ("statement *of* the debtor's financial condition" would likely include only those statements that "express[] a debtor's overall financial condition").

Instead, the Eleventh Circuit focused on Congress's use of "respecting." In the court of appeals' view, "statement[s] *respecting* the debtor's . . . financial condition" must include statements concerning a single

asset because the word "respecting" is "defined broadly as '[w]ith regard or relation to; regarding; concerning.'" App. 8a (quoting *Respecting*, Webster's New International Dictionary 2123 (2d ed. 1961)). That interpretation uses the word "respecting" to effectively override or change the meaning of "financial condition."

Of course, "financial condition" has to be considered in context. And it is no doubt true that "respecting," like the similar "related to" or "in connection with" phrases Congress uses from time to time, has breadth in the abstract. Indeed, this Court has observed that such phrases are "essentially 'indeterminat[e].'" *Maracich v. Spears*, 133 S. Ct. 2191, 2200 (2013) (alteration in original) (citation omitted). As such, "one might be excused for wondering, at first blush," when Congress uses them, "whether [its] words of limitation . . . do much limiting" at all. *New York State Conference of Blue Cross & Blue Shield Plans v. Travelers Ins. Co.*, 514 U.S. 645, 655 (1995). But, for that very reason, the Court has cautioned against interpreting such phrases "to extend to the furthest stretch of its indeterminacy." *Id.*

That is precisely what the Eleventh Circuit has done here. While (as discussed) "financial condition" is a phrase of unquestioned limitation, under the Eleventh Circuit's interpretation the exception in Section 523(a)(2)(A) essentially applies to any statement about anything concerning one's finances—a vastly broader class. The court's reading of "respecting" thus renders Congress's use of "financial condition" largely meaningless. If Congress had meant that result, the far more natural way to achieve it would have been to say a "statement respecting the debtor's finances" or the like—not "financial condition."

Moreover, this interpretation was not necessary. A court can give effect to Congress's use of "respecting" without overriding the limitations inherent in Congress's use of "financial condition."

The Eleventh Circuit's interpretation is also irreconcilable with the purpose of Section 523(a)(2)(A) as a whole. Section 523(a)(2)(A) is a prohibition on the discharge of debts incurred by fraudulent means, dating back in one form or another to at least the Bankruptcy Act of 1898. *See Husky Int'l Elecs., Inc. v. Ritz*, 136 S. Ct. 1581, 1585 (2016); *In re Joelson*, 427 F.3d at 707. It gives effect to the fundamental bankruptcy policy that the bankruptcy courts will not provide safe haven for the perpetrators of fraud. As this Court has stressed, the Code seeks to protect the "honest but unfortunate debtor." *Cohen v. de la Cruz*, 523 U.S. 213, 217 (1998) (citation omitted).

The "financial condition" exception carves out of that longstanding prohibition debts obtained by a particular kind of fraud, based on "statements respecting the debtor's . . . financial condition." As this Court has repeatedly recognized, "[i]n construing provisions . . . in which a general statement of policy is qualified by an exception," the Court's typical practice is "[to] read the exception narrowly in order to preserve the primary operation of the provision." *Knight v. Commissioner*, 552 U.S. 181, 190 (2008) (alterations in original) (citation omitted). The Eleventh Circuit's interpretation, by contrast, undermines the primary operation of Section 523(a)(2)(A) by creating a loophole through which dishonest debtors might relieve themselves, at honest creditors' expense, of liabilities incurred through fraud.

As the Tenth Circuit observed, the minority view of the "financial condition" exception could "eliminate coverage for many misrepresentations" at the very "heart" of Section 523(a)(2)(A), because "'virtually every statement by a debtor that induces the delivery of goods or services on credit relates to his ability to pay.'" *In re Joelson*, 427 F.3d at 710, 713 (citation omitted). Even the most ardent textualists would endeavor to avoid that problematic result. *See* Antonin Scalia & Bryan A. Garner, *Reading Law: The Interpretation of Legal Texts* 63-65 (2012) ("A textually permissible interpretation that furthers rather than obstructs a document's purpose should be favored.").

Finally, the Eleventh Circuit's interpretation also fails to account for the genesis of the "financial condition" exception. As this Court recognized in *Field*, Congress added the "financial condition" exception because it was concerned that certain consumer-finance companies were deliberately encouraging their customers to "submit[] false financial statements . . . for the very purpose of insulating [the creditors'] own claims from discharge." 516 U.S. at 76-77. These creditors accomplished this by misleading loan applicants into making inaccurate statements about their "complete list of debts." *Id.* at 77 n.13 (quoting H.R. Rep. No. 95-595 at 130 (1977), *as reprinted in* 1978 U.S.C.C.A.N. 5963, 6091). Thus, Congress crafted an exception for debts arising from "statement[s] respecting the debtor's financial condition," while heightening the rules for discharging such a debt to protect against the problem it was addressing. *See id.* at 65.

The Eleventh Circuit's decision expands the scope of the "financial condition" exception far beyond the

particular problem targeted by Congress when it amended the provision. Indeed, it turns Congress's intent on its head. If a statement "respecting the debtor's . . . financial condition" includes a statement regarding a single asset, then in an effort to protect the honest but unwary debtor from dishonest creditors, Congress has in fact made a huge category of debts incurred by fraud dischargeable in bankruptcy *unless* the honest creditor can meet the heightened standards of Section 523(a)(2)(B), including among others proving that the statement be in writing and that the creditor reasonably (as opposed to justifiably) relied on it.

The Eleventh Circuit erred in concluding that the "financial condition" exception contained in Section 523(a)(2)(A) demands these strange results, much less *unambiguously* demands these results. The flaws in the Eleventh Circuit's interpretation provide all the more reason for this Court to grant review.

CONCLUSION

The petition for certiorari should be granted.

Respectfully submitted,

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April 11, 2017

No. _____

In The
Supreme Court of the United States

SAM LESLIE, Chapter 7 Trustee of the estate of Fitness Holdings International, Inc.,

Petitioner,

v.

HANCOCK PARK CAPITAL II, L.P., a Delaware Limited Partnership, et al.,

Respondents.

On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

The question presented by this petition addresses a split among the Circuit Courts as to whether a bankruptcy court's authority to recharacterize putative debt as equity arises from the bankruptcy court's general equitable powers under 11 U.S.C. § 105(a) as announced in *Pepper v. Litton*[1] (as five Circuits have held) or arises under 11 U.S.C. § 502(b), thus restricting the bankruptcy court's equitable powers to applicable state law (as two Circuits have held).[2]

[1] 308 U.S. 295, 304, 60 S.Ct. 238, 244, 84 L.Ed. 281 (1939).

[2] The Question Presented above is similar to the Question Presented in the Petition For a Writ of Certiorari currently pending and filed in the case entitled *PEM Entities LLC v. Eric M. Levin & Howard Shareff*, United States Supreme Court, Case No. 16-492.

PARTIES TO THE PROCEEDINGS BELOW AND RULE 29.6 STATEMENT

The following list provides the names of all of the parties to the proceedings below:

1. Petitioner Sam Leslie, Chapter 7 Trustee of the estate of Fitness Holdings International, Inc.

2. Hancock Park Capital II, L.P., a Delaware Limited Partnership

3. Pacific Western Bank, a California state chartered bank (f/k/a Pacific Western National Bank).

4. Kenton Van Harten, an individual.

5. Michael Fourticq, Sr., an individual.

6. Hancock Park Associates, III, LLC, a Delaware limited liability company.

7. Hancock Park Associates, a California limited partnership.

Pursuant to Rule 29.6, the Appellant represents that there is no parent or publicly held company owning 10% or more of the Debtors' corporate stock.

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PETITION FOR A WRIT OF CERTIORARI

Petitioner Sam Leslie, chapter 7 trustee for Fitness Holdings International, Inc., respectfully petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Ninth Circuit.

OPINIONS BELOW

The opinion of the Ninth Circuit Court of Appeals, *In re Fitness Holdings International, Inc.*, United States Court of Appeals, Ninth Circuit, November 8, 2016, 660 Fed.Appx. 546, is unreported ("*Fitness Holdings II*"). App., *infra*, 1-5.

The opinion of the District Court Central District of California is unreported. App., *infra*, 6-24.

The order of the Ninth Circuit Court of Appeals denying the petition for panel rehearing and the petition for rehearing *en banc* entered on December 15, 2016. App., *infra*, 75-76.

The opinion of the Ninth Circuit Court of Appeals, *Official Committee of Unsecured Creditors v. Hancock Park Capital II, L.P.* (*In re Fitness Holdings International, Inc.*), 714 F.3d 1141 (9th Cir. 2013) ("*Fitness Holdings I*"). App., *infra*, 35-52.

The opinion of the Ninth Circuit Court of Appeals, *In re Fitness Holdings Intern., Inc.*, 529 Fed. Appx. 871

(9th Cir. 2013), and Amended Memorandum. App., *infra*, 28-34.

The opinion of the District Court, Central District of California*, In re Fitness Holdings Intern., Inc.*, United States District Court, C.D. California. August 31, 2011, 2011 WL 7763674. App., *infra*, 54-74.

JURISDICTION

The judgment of the court of appeals, denying petitioner's motion for rehearing *en banc* was entered on December 15, 2016. App., *infra*, 75-76. This Court has jurisdiction under 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS INVOLVED

Sections 105(a) and 502 of Title 11 of the United States Code are reproduced in full in an appendix attached hereto. App., *infra*, 77-79.

STATEMENT OF THE CASE

Sam Leslie, chapter 7 trustee ("Trustee") for the bankruptcy estate of Fitness Holdings International ("Debtor"), sought to recover a pre-bankruptcy transfer of approximately $12 million (the "Transfer") that the Debtor made to its sole shareholder, Hancock Park Capital II, LP ("Hancock Park"). App., *infra*, 2. The Transfer was made a little over one year before the

Debtor filed for bankruptcy protection in October 2008. *Fitness Holdings I*, 714 F.3d at 1143-44. App., *infra*, 38; App., *infra*, 55-56.

The Debtor, a home fitness company, was acquired in 2003 by its sole shareholder, Hancock Park in a leveraged buyout, a portion of which was funded by Pacific Western Bank ("PWB"). *In re Fitness Holdings Int'l, Inc*. ("*Fitness Holdings*"), No. CV 10-0647 AG, 2011 WL 7763674, *2-3 (C.D. Cal. Aug. 31, 2011). App., *infra*, 56-57; App., *infra*, 7.

From September 30, 2003 thru November 5, 2006, Hancock Park financed the Debtor's business operations by advancing $24,276,065.74 to the Debtor. *Fitness Holdings I*, at p. 1143-44, App., *infra*, 37; App., *infra*, 7-8, 56-57. These financings were documented by a series of *self-described* unsecured subordinated promissory notes. *Id*.

Most of the Hancock Park notes had a maturity date of November 5, 2006, and required interest to be paid quarterly. However, the interest payments were never made, and the principal wasn't paid when due. No demand for payment of either principal or interest was ever made. App., *infra*, 37.

In June 2007, the Debtor obtained a $25,000,000 secured loan from PWB (the "Refinancing"), in the form of a Term Loan in the amount of $17,000,000 and a line of credit for $8,000,000. App., *infra*, 8, 38. The proceeds from the Refinancing went, *inter alia*, to pay off PWB's prior loans, with $11,995,500 going to Hancock Park, as a reduction of its indebtedness. From

the Refinancing the Debtor received approximately $1 million. *Id.* In addition, Hancock Park's partners obtained releases of their personal guaranties. *Id.* At the time of the advances from Hancock Park and the Refinancing, the Debtor had substantial amounts due and owing to its unsecured vendor creditors, and was not paying its obligations when due.

Based upon the foregoing, the Trustee sought through the First Amended Complaint ("Complaint") a declaration from the bankruptcy court that Hancock Park's unsecured advances be recharacterized as equity contributions. The Trustee also asserted claims for equitable subordination (claim allowance/determination) as to Hancock Park's general unsecured claim, for avoidance of the Transfer as a fraudulent transfer and for breach of fiduciary duty. App., *infra*, 2, 8, 38-39.

The bankruptcy court dismissed all claims against Hancock Park with prejudice. The Trustee appealed to the District Court, which affirmed the bankruptcy court and dismissed the case for failure to state a claim. *Fitness Holdings*, 2011 WL 7763674, *1, App., *infra*, 54. The District Court held that, under longstanding precedent of the Ninth Circuit Bankruptcy Appellate Panel, Hancock Park's advances were loans and, as a matter of law, it was barred from recharacterizing such loans as equity investments. *Id.* at *5 (citing *In re Pacific Express*, 69 B.R. 112, 115 (B.A.P. 9th Cir. 1986)).

Upon appeal, the Ninth Circuit disapproved *In re Pacific Express*, finding that bankruptcy courts may

recharacterize debt as equity. *In re Fitness Holdings I*, 714 F.3d at 1148-49. App., *infra*, 47 and App., *infra*, 9. The Ninth Circuit vacated and remanded the matter so that the lower court could determine through the application of California State law[3] whether the transactions at issue were debt or equity. *Id.*

Fitness Holdings I departed from the majority of the Circuits and lower courts that followed the teachings of *Pepper v. Litton* and employed the equitable powers of the bankruptcy court under 11 U.S.C. § 105(a), to fashion a multi-point test to determine whether an alleged shareholder debt should be recharacterized as equity, *Fitness Holdings I*, 714 F.3d at 1148-49. App., *infra*, 45, 50, 52; App., *infra*, 9, 13. In so doing the Ninth Circuit took the road less traveled, adopting the approach taken by the Fifth Circuit in *Grossman v. Lothian Oil Inc*., (*In re Lothian Oil)*, 650 F.3d 539, 542-43 (5th Cir. 2011), which determined that the issue of recharacterization was a request to disallow the lender's claim under 11 U.S.C. § 502, thus mandating the court to limit its review to state law.[4] *Fitness Holdings I*, 714 F.3d at 1148-49. The Ninth Circuit came to this conclusion despite the fact that Hancock Park's claim was addressed separately in the Complaint through an equitable subordination claim and

[3] There exists no California cases or statutory law that directly address the equitable bankruptcy concept of recharacterization.

[4] Despite this finding, the *Lothian Oil Court* ultimately relied upon a federal multi-factor test which Texas courts imported from federal tax law. *In re Lothian Oil*, 650 F.3d at 542-44.

that recharacterization was presented to support the elements of the Trustee's claims for avoidance of fraudulent transfer and breach of fiduciary duty. App., *infra*, 28-34, 36, 53.

On remand, the District Court again dismissed the complaint.[5] Unlike *Lothian Oil*, it did not use the factors identified in federal tax cases through the guise of determining "applicable" state law. Instead, it created its own test that focused on California contract law and placed form over substance by looking only to the four corners of the documents. App., *infra*, 6-24. Thus, while *Lothian Oil's* result created a false conflict because it effectively aped the majority Circuits' analysis, it invited the potential for a conflict (through application of state law) that materialized in *Fitness Holdings II*.

Upon review, the Ninth Circuit adopted the findings and conclusions of the District Court and determined that the Hancock Park notes gave Hancock Park a 'right to payment' under state law. *Fitness Holdings II*. App., *infra*, 1-5. In so doing, contrary to every other circuit court in the country, the Ninth Circuit rejected an equitable analysis regarding the bona fides of Hancock Park's advances to the Debtor (a substance over form test) applying California state contract law,

[5] The District Court addressed the Complaint after the bankruptcy court granted the defendants' motions to dismiss filed after the *Fitness Holdings I* decision. App., *infra*, 6. On remand, the bankruptcy court dismissed Claims 1, 3, 4, 5, 6, 9 and 10 with prejudice. App., *infra*, 25-26. The Trustee appealed this decision to the District Court.

instead of the equitable principles that are necessary to address a recharacterization determination.

REASONS FOR GRANTING THE PETITION

This Petition should be granted to resolve the split of authorities existing in the Circuit Courts as to the proper basis for determining whether a corporate debtor's debt to its shareholder should be recharacterized as equity as part of the claim analysis process.

Five Circuits apply the equitable powers of the bankruptcy court as authorized under 11 U.S.C. § 105(a) as described in *Pepper v. Litton*. Two Circuits limit review to state law, based upon their determination that recharacterization is a claim adjudication process and subject to 11 U.S.C. § 502(b). Thus, the question presented is whether the analysis employed in determining whether to recharacterize debt as a capital contribution is rooted in 11 U.S.C. § 105(a) and subject to broad equitable considerations, or rooted in 11 U.S.C. § 502(b) and subject to varying state law.

Adoption of a single uniform equitable analysis under the principles presented in *Pepper v. Litto*n, for recharacterization will provide certainty and uniformity in bankruptcy cases. Recharacterization of debt to equity is an equitable remedy essential to bankruptcy cases. Requiring bankruptcy courts to ascertain state law to determine whether the transactions at issue should be recharacterized as equity could result in a patchwork of up to 50 state law based rules

for recharacterization or, in the case of *Fitness Holdings II*, state-based recharacterization rules that place form over substance.

Given the split of authorities among the Circuits, the Supreme Court should establish a uniform standard to be used in addressing the issue of recharacterization in the context of a bankruptcy proceeding.

I. THERE IS A CIRCUIT CONFLICT REGARDING WHETHER STATE LAW OR FEDERAL LAW PROVIDES THE RULE OF DECISION FOR BANKRUPTCY COURTS RECHARACTERIZING CLAIMS AS EQUITY

The weight of federal authority holds that bankruptcy courts are vested with authority to recharacterize debt as equity. At least seven Circuits [3rd, 4th, 5th, 6th, 9th, 10th, and 11th] have embraced this concept and district courts within two other Circuits [2nd and 7th], likewise, have affirmatively adopted this concept. The Circuits embracing recharacterization do so on the theory that the substance of a transaction, rather than its form, should control the transaction's characterization in the first instance. *See In re SubMicron Systems Corp.*, 432 F.3d 448, 454 (3d Cir. 2006) (finding recharacterization "grounded in bankruptcy courts' equitable authority to ensure 'that substance will not give way to form'") (footnote omitted) quoting *Pepper v. Litton*, 308 U.S. 295, 305-06, 60 S.Ct. 238, 84 L.Ed 281 (1939). But, while the guiding principles appear to be the same, the analytical framework for application of recharacterization falls into two distinct camps.

The five-circuit majority's equity considerations flow from the bankruptcy court's "general equitable powers under 11 U.S.C. § 105(a)".[6] Rooted in the equitable powers provided under 11 U.S.C. § 105(a), as described in *Pepper v. Litton*, the Third, Fourth, Sixth, and Tenth Circuits employ variations of a multi-factor test as the analytical framework to determine whether recharacterization is warranted. *Fairchild Dornier GMBH v. Official Committee of Unsecured Creditors (In re Dornier Aviation)*, 453 F.3d 225, 231 (4th Cir. 2006) (focused on five factors); *In re AutoStyle Plastics, Inc.*, 269 F.2d 726 (6th Cir. 2001) (focused on eleven factors); *In re Hedged-Investments*, 380 F.3d 1292, 1298 (10th Cir. 2004) (applying thirteen factors). The Eleventh Circuit, while applying a federal rule of decision, focused on only two of the many factors that have been advanced by the jurisdictions in the majority. *See N&D Properties, Inc.*, 799 F.2d 726, 733 (11th Cir. 1986). The Third Circuit, while acknowledging the various multi-factor test "include pertinent factors," applies an "overarching inquiry" designed to determine "whether the parties called an instrument one thing when in fact

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[6] The lower courts in the Second and Seventh Circuits also have embraced Section 105(a) as the statutory authority for recharacterization. *See In re Outboard Marine Corp.*, 2003 WL 21697357 (N.D. Ill. July 22, 2003) (embracing Sixth Circuit's reliance on Section 105(a)); *In re Emerald Casino, Inc.*, 2015 WL 1843271 (N.D. Ill. Apr. 21, 2015) ("Though the Seventh Circuit has not explicitly adopted the majority approach, this court finds the reasoning supporting that approach persuasive."); *In re Franklin Indus. Complex, Inc.*, 2007 WL 2509709 (N.D.N.Y. Aug. 30, 2007) (recognizing bankruptcy court's authority to recharacterize debt as equity pursuant to Section 105).

they intended it as something else." *SubMicron Systems*, 432 F.3d at 455-56.

While stated differently, the majority analysis focusing on some or all of the specific factors identified, see discussion *infra*, share a common thread: "These factors all speak to whether the transaction 'appears to reflect the characteristics of . . . an arm's length negotiation.' This test is a highly fact-dependent inquiry." *Dornier Aviation*, 453 F.3d at 234 *quoting AutoStyle Plastics*, 269 F.3d at 750 *quoting In re Cold Harbor Assocs.*, 204 B.R. 904, 915 (Bankr. E.D. Va. 1997) (amendment in original; footnote omitted).

Eschewing the application of 11 U.S.C. § 105(a) as the predicate for recharacterization, the Fifth and Ninth Circuits, instead, hold that bankruptcy courts are vested with the power to recharacterize debt as equity pursuant to 11 U.S.C. § 502(b). *See Lothian Oil*, 650 F.3d at 543; *Fitness Holdings I*, 714 F.3d at 1148-49. Under this statutory provision, these Circuits require recharacterization to be determined based on applicable state law. Coincidentally, the decisions in these two minority Circuits did not actually identify state law specific factors to apply. The Fifth Circuit circuitously applied federal law insofar as the Texas state law it relied upon aped the federal multi-part test and, in fact, was similarly founded in federal tax cases. *See Lothian Oil*, 650 F.3d at 544.

The Ninth Circuit in this case, while requiring the application of a state law test, in accord with 11 U.S.C. § 502(b), did not identify any specific California state

law to apply, remanding the case to the District Court for a determination of the appropriate California state law to apply to recharacterization of debt to equity. *Fitness Holdings I*, 714 F.3d at 1148-49. In turn, the District Court did not identify a set of factors *per se*, but defaulted instead to basic rules of California state contract interpretation.

Thus, on the one hand, there are five Circuits (and lower courts in two other Circuits) in the majority that have based their analysis of recharacterization claims employing the equitable powers of the bankruptcy courts as vested under Section 105(a). Four of these Circuits (and the two lower courts in the Second and Seventh Circuits) set forth a substantially similar multi-factor test that provides uniformity to bankruptcy courts in assessing whether, in the first instance, purported debt should be recharacterized as equity. On the other hand, there are two Circuits that have found recharacterization rooted in Section 502(b) requiring an analysis of state law that, in the case of the Fifth Circuit, borrows wholesale from federal authority or, in the case of the Ninth Circuit, identifies no factors and provides no guidance at all and utilized California contract interpretation law as the basis for its "equitable decision."

This conflict presents this Court with an opportunity to weigh in and clarify the proper source of the standards governing recharacterization. Ultimately, the reconciliation of these competing tests will rest in whether recharacterization finds its footing in Section 105(a) or, alternatively, Section 502(b).

Adoption of a single uniform methodolgy for recharacterization will provide certainty and consistency in bankruptcy cases. Recharacterization of debt to equity is an equitable remedy unique to bankruptcy (and federal tax) cases and looking to state law to ascertain whether the transactions at issue should be recharacterized as equity will result in a chaotic patchwork of disparate state law based rules.

Given the split among the Circuits, only this Court is able to provide a uniform approach to this important question. Accordingly, the Court should accept review to:

1. Resolve the split in authorities as between the Circuits;

2. Rectify the Ninth Circuit's adoption of an erroneous legal standard for recharacterization cases so that future bankruptcy estates may proceed to address recharacterization appropriately and avoid years of needless litigation contesting the bona fides of the *Fitness Holdings* rulings.

3. Eliminate jurisdictional "forum shopping" in cases where the claim will have a major impact on the administration of the bankruptcy estate and the debtor seeks to avoid the standard of recharacterization as established by the Ninth and Fifth Circuits – looking solely to state law regarding recharacterization of a debt obligation.

II. RECHARACTERIZATION IS ROOTED IN THE EQUITABLE POWERS OF THE BANKRUPTCY COURTS [11 U.S.C. § 105(a)]

A. The Genesis of Recharacterization

The equitable jurisdiction of the bankruptcy court is a certainty as is its "power to sift the circumstances surrounding any claim to see that injustice or unfairness is not done in the administration of the bankrupt estate." *Pepper v. Litton*, 308 U.S. at 308. That is particularly true "when the claim seeking allowance accrues to the benefit of an officer, director, or stockholder." *Id.*

Although the issue of recharacterization is just being addressed by the Ninth Circuit, the "doctrine" and the legal standards applicable to the same are not without historical perspective. Recharacterization, as a concept in bankruptcy, has its genesis in tax cases. *See Roth Steel Tube Co. v. Comm'r*, 800 F.2d 625 (6th Cir. 1986); *see also Fin Hay Realty Co. v. United States*, 398 F.2d 694, 696 (3d Cir. 1968).

In *Roth Steel*, the Sixth Circuit was faced with ascertaining whether a transaction should be classified as debt or equity for income tax liability purposes. As posited by the *Roth Steel* court:

> The determination of whether advances to a corporation are loans or capital contributions depends on whether the objective facts establish an intention to create an unconditional obligation to repay the advances. *Raymond*, 511 F.2d at 190. "Advances between a parent

> corporation and a subsidiary . . . are subject to particular scrutiny 'because the control element suggests the opportunity to contrive a fictional debt'." *United States v. Uneco, Inc.*, 532 F.2d 1204, 1207 (8th Cir. 1976) (quoting *Cuyuna Realty Co. v. United States*, 382 F.2d 298, 300-01 (Ct.Cl. 1967)).

Roth Steel, 800 F.2d at 629-30.

Having posited the question for determining classification of a transaction, the *Roth Steel* court identified the following eleven factors to assist in reaching the answer:

> This court has identified a number of factors to be used in making the capital contribution versus loan determination: (1) the names given to the instruments, if any, evidencing the indebtedness; (2) the presence or absence of a fixed maturity date and schedule of payments; (3) the presence or absence of a fixed rate of interest and interest payments; (4) the source of repayments; (5) the adequacy or inadequacy of capitalization; (6) the identity of interest between the creditor and the stockholder; (7) the security, if any, for the advances; (8) the corporation's ability to obtain financing from outside lending institutions; (9) the extent to which the advances were subordinated to the claims of outside creditors; (10) the extent to which the advances were used to acquire capital assets; and (11) the presence or absence of a sinking fund to provide repayments. See *Raymond*, 511 F.2d at 190-91; *Austin Village, Inc. v. United States*,

> 432 F.2d 741, 745 (6th Cir. 1970); *Berthold v. Commissioner*, 404 F.2d 119, 122 (6th Cir. 1968); *Smith*, 370 F.2d at 180. No one factor is controlling or decisive, and the court must look to the particular circumstances of each case. *Smith*, 370 F.2d at 180.

Id. at 630.

The Circuits in the majority, seizing on the debt or equity analysis in tax cases, embrace both the concept of recharacterization, as well as the test (with variations) referenced above. *See, e.g., Alternative Fuels*, 789 F.3d at 1149; *see also Dornier Aviation*, 453 F.3d at 233; *AutoStyle Plastics*, 269 F.3d at 748. Even the Fifth Circuit, while purportedly deferring to Texas state law, recognized that the applicable Texas state law, consistent with the Circuits adopting the majority approach,

> imported a multi-factor test from federal tax law. *Arch Petroleum, Inc. v. Sharp*, 958 S.W.2d 475, 477 n. 3 (Tex. Ct. App. 1997) ("For an oft-cited discussion of the distinction between debt and equity, including a list of sixteen distinguishing factors, see *Fin Hay Realty Co. v. United States*, 398 F.2d 694, 696 (3d Cir. 1968)."). Other courts that have permitted recharacterization have also borrowed tests from federal tax cases. *See, e.g.*, *Hedged-Invs.*, 380 F.3d at 1298. In the tax context, this court has employed several multi-factor tests. *See Estate of Mixon v. United States*, 464 F.2d 394, 402 (5th Cir. 1972) (13-factor test); *Jones v.*

> *United States*, 659 F.2d 618, 622 n. 12 (5th Cir. 1981) (11-factor test).

In re Lothian Oil, 650 F.3d at 544.

Indeed, while some courts have questioned generally the application of the recharacterization concept in tax cases to bankruptcy cases on the basis that they are purportedly focused on distinct policy considerations, the jurisdictions in the majority continue to employ this analysis. As explained in *Outboard Marine*,

> No court, however, has identified what those different policy considerations are, let alone why those differences should preclude a bankruptcy court that is determining whether recharacterization is appropriate from relying on the factors that tax courts employ in conducting the same type of analysis. These factors serve their purpose; they enable the finder of fact to assess the true nature of a transaction. The Court will not jettison this effective set of factors simply because the factual inquiry occurs in a bankruptcy setting.

Outboard Marine, 2003 WL 21697357 *5.

B. Section 105(a), Not Section 502(b), Vests Equitable Power In Bankruptcy Courts To Analyze Transactions And Determine The True Nature Of A Transaction

Petitioner submits that recharacterization is separate and distinct from claim allowance [11 U.S.C. § 502(b)] or, for that matter, equitable subordination

[11 U.S.C. § 510(c)]. Recharacterization does not focus on whether a valid claim should otherwise be disallowed or subordinated, but on the preliminary issue of what was the true nature of the transaction. *See Dornier Aviation*, 453 F.3d at 231 ("recharacterization requires a different inquiry and serves a different function" than disallowance or equitable subordination).

As recently explained by the Tenth Circuit:

> Although related, disallowance and recharacterization require different inquiries and serve different functions. Under § 502(b), disallowance of a claim is appropriate "when the claimant has no rights vis-à-vis the bankrupt, i.e., when there is 'no basis in fact or law' for any recovery from the debtor." *In re Official Comm. of Unsecured Creditors for Dornier Aviation (N. Am.), Inc.*, 453 F.3d 225, 232 (4th Cir. 2006). Recharacterization, on the other hand, is not an inquiry into the enforceability of a claim; instead, it is an inquiry into the true nature of a transaction underlying a claim. In this way, recharacterization is part of a long tradition of courts applying the "substance over form" doctrine. *Id.* at 233; see also *Pepper v. Litton*, 308 U.S. 295, 305-06, 60 S.Ct. 238, 84 L.Ed. 281 (1939) ("[Courts] have been invoked to the end that fraud will not prevail, that substance will not give way to form, that technical considerations will not prevent substantial justice from being done."). Unlike disallowance of a claim, recharacterization of a loan as equity does not ultimately relieve a

> debtor from his obligation to repay the claimant. Although the claimant may not proceed in bankruptcy – since he no longer holds an allowed "claim" – he may still hold a valid interest in equity to be paid upon satisfaction of the debtor's other outstanding obligations.
>
> Because disallowance and recharacterization are distinct inquiries, "[e]ven if a claimant is able to meet § 502's minimal threshold for allowance of the claim," a court must still "determine the claim's proper priority" by scrutinizing the true substance of a contested transaction. *In re Dornier Aviation*, 453 F.3d at 232. We therefore reject Mr. Jenkins' contention that a court's power to recharacterize arises solely from the disallowance provision of § 502(b), rather than from § 105(a).

In re Alternate Fuels, Inc., 789 F.3d 1139, 1148 (10th Cir. 2015) (*"Alternate Fuels")*; *see also In re AutoStyle Plastics, Inc*. 269 F.3d at 748 (recognizing that "[b]ankruptcy courts that have applied a recharacterization analysis have stated that their power to do so stems from the authority vested in the bankruptcy courts to use their equitable powers to test the validity of debts"); *Dornier Aviation*, 453 F.3d 225 at 231 ("recharacterization is well within the broad powers afforded a bankruptcy court in § 105(a) and facilitates the application of the priority scheme laid out in § 726").

In so holding, the Tenth Circuit acknowledged the holdings in *Fitness Holdings I* and *Lothian Oil*, but demonstrated why their reliance on Section 502(b) was

misplaced. The Tenth Circuit also reconciled its holding with this Court's holdings in *Travelers Casualty & Surety Co. of America v. Pacific Gas & Electric Co.*, 549 U.S. 443, 127 S.Ct. 1199, 167 L.Ed.2d 178 (2007) ("*Travelers*"), and *Law v. Siegel*, 571 U.S. ___, 134 S.Ct. 1188, 188 L.Ed.2d 146 (2014). As the Tenth Circuit noted, neither of these cases dealt with the concept of recharacterization and reliance thereon served only to conflate the distinct concepts of disallowance and recharacterization. *Alternate Fuels, Inc.*, 789 F.3d at 1147-48.

While related, those concepts are not the same. Therein lies the deficiency in the analysis of those minority Circuits that have relied upon Section 502(b) for recharacterization authority and, in turn, state law. Specifically, in *Lothian Oil*, the Fifth Circuit noted that other circuits allowing recharacterization found that such authority rested in Section 105(a). Nevertheless, *Lothian Oil* dismissed this analysis out of hand apparently premised on the Fifth Circuit's "cautious view" of Section 105(a). *Lothian Oil*, 650 F.3d at 543. Based thereon, the *Lothian Oil* court defaulted to Section 502(b) without actually conducting any reasoned analysis as between the two bankruptcy provisions and why the other Circuits were incorrect in their reliance on Section 105(b).

Indeed, *Lothian Oil* quotes Section 502(b) for the proposition that "the court, after notice and a hearing, shall determine the amount of such claim . . . and shall allow such claim in such amount, except to the extent that – (1) such claim is unenforceable against the

debtor and property of the debtor, under any agreement or applicable law. . . ." *Lothian Oil*, 650 F.3d at 543. But, it never connects the dots between this passage and the act of recharacterizing a transaction. Once *Lothian Oil* summarily adopted Section 502(b) as the source for recharacterization, it had no choice but to apply state law. *Id., citing Butner v. United States*, 440 U.S. 48, 54, 99 S.Ct. 914, 918, 59 L.Ed.2d 136 (1979).

The flaw, of course, is that the *Lothian Oil* court never performed any rigorous analysis and merely defaulted to Section 502(b). Thus, its application of state law was preordained by its initial decision to rely upon Section 502(b), and was not grounded in any sound analysis that recharacterization of debt to equity should be treated the same as disallowance of a claim. Moreover, its reliance on *Butner* is suspect given that *Butner* did not implicate recharacterization. The issues addressed in *Butner* – whether the petitioner had a security interest in rent from property owned by the debtor or whether such income should be distributed in the same fashion as an unsecured claim – provides no guidance with respect to the distinct concept of recharacterization.

Ultimately, the Fifth Circuit ended up applying the same equitable factors enunciated by the majority Circuits insofar as it relied upon a Texas state court decision that, in turn, adopted its factors from a federal tax decision. Thus, the Fifth Circuit applied the correct equitable factors, but for the wrong reason. *Lothian Oil*, 650 F.3d at 544.

This Court need not give Section 105(a) a broad interpretation to conclude that recharacterization is appropriate under this Section and that federal equitable principals should apply. As recently articulated by a Connecticut bankruptcy court, this Court's interpretation of Section 105 supports the conclusion that recharacterization is appropriate under this statutory framework:

> When warranted by the facts and circumstances of the case, a bankruptcy court's exercise of its equitable powers under 11 U.S.C. § 105(a) to recharacterize purported debt as equity is both necessary and appropriate to carry out the provisions of the Bankruptcy Code. *See, Law v. Siegel*, ___ U.S. ___, 134 S.Ct. 1188, 1194, 188 L.Ed.2d 146 (2014). The equitable remedy of recharacterization is necessary to ensure that the substance of a party's rights is not determined by its form. *See, Pepper v. Litton*, 308 U.S. 295, 305-06, 60 S.Ct. 238, 84 L.Ed. 281 (1939) ("[Courts] have been invoked to the end that fraud will not prevail, that substance will not give way to form, that technical considerations will not prevent substantial justice from being done."). Whether a party is a creditor with a claim against the bankruptcy estate or an equity security holder with an interest in the debtor-in-possession significantly affects the rights and remedies available to such a party under the Bankruptcy Code.

In re Eternal Enterprise, Inc., 557 B.R. 277, 286-287 (Bankr. D. Conn. 2016) (footnotes omitted). The Connecticut bankruptcy court recognized the difference in the priority and distribution scheme depending on the classification of a claim. Thus, the court concluded that recharacterization under Section 105(a) "is an essential remedy the bankruptcy court has the power and authority to use to preserve the distributional priorities of the Code and encourage the use of chapter 11 reorganization as a platform for reinvestment." *Id.* at 287; *see also Dornier Aviation*, 453 F.3d at 231 ("implementation of the Code's priority scheme requires a determination of whether a particular obligation is debt or equity. Where, as here, the question is in dispute, the bankruptcy court must have the authority to make this determination in order to preserve the Code's priority scheme.").

III. THE *FITNESS HOLDINGS II* DECISION EXEMPLIFIES THE DOWNSIDE OF A NON-UNIFORM APPROACH TO RECHARACTERIZATION

In *Fitness Holdings I*, the Ninth Circuit embraced the concept of recharacterization holding that a bankruptcy court "may recharacterize an obligation that does not constitute 'debt' under state law" in bankruptcy proceedings, thus "join[ing] sister circuits, which have reached the same conclusion." *Fitness Holdings I*, 714 F.3d at 1147, 1148. In doing so, the *Fitness Holdings I* court reversed the District Court's

determination that it could not look past the operative transaction documents:

> The district court did not view the trustee's constructively fraudulent transfer claim through this lens. Because the court erroneously concluded that it was barred from considering whether the complaint plausibly alleged that the promissory notes could be recharacterized as creating equity interests rather than debt, it failed to apply the correct standard in considering whether the trustee's allegation that Fitness Holdings did not receive reasonably equivalent value for its transfer of $11,995,500 . . .

Id. at 1149.

Although *Fitness Holdings I* brought the Ninth Circuit in line with six other Circuits that recognized recharacterization, it followed the Fifth Circuit's lead as presented in *Lothian Oil*, and determined that 11 U.S.C. § 502(b) was the beginning and end of the recharacterization analysis. Like *Lothian Oil*, *Fitness Holdings I* also relied on this Court's decision in *Travelers* for the proposition that "courts may not rely on 11 U.S.C. § 105(a) and federal common law rules 'of their own creation' to determine whether recharacterization is warranted." *Id*. at 1148-49.

Travelers, however, says no such thing. In *Travelers*, this Court was presented with the question of whether an unsecured creditor could recover attorney's fees under a pre-petition contract that were incurred post-petition. In this context, where Section

502(b) was directly implicated, this Court held that "we generally presume that claims enforceable under applicable state law will be allowed in bankruptcy unless they are expressly disallowed." *Travelers*, 549 U.S. at 452.

As recognized by the Tenth Circuit in *Alternate Fuels, Travelers* did not present a recharacterization analysis. *Alternate Fuels*, 789 F.3d at 1148. It does not mention recharacterization or discuss it in any context, and it does not expressly overrule *Hedged-Investments* or any recharacterization case from any other circuit. *Id.* The Ninth Circuit's reliance on *Travelers* was unwarranted and certain error. This error infected its decision to reject Section 105(a) in deference to Section 502(b).

The Ninth Circuit's decision to animate recharacterization through Section 502(b) and, thus, have state law apply to the exclusion of the federal rule of law led to a series of events that resulted in a holding that applies no factors whatsoever and completely ignores the equitable concept of recharacterization. First, rather than enunciating what those factors were or referencing state law that addresses recharacterization, the Ninth Circuit remanded to the District Court to establish this criteria. *Fitness Holdings I*, 714 F.3d at 1149.

Second, on remand, no such findings were made by the District Court. Instead, the District Court applied basic state court contract principles and never looked beyond the form of the transaction – *i.e.*, the four corners of the transaction documents – an analysis

directly at odds with the fundamental equitable purpose of recharacterization insofar as the District Court elevated form over substance. App., *infra*, 6.

The District Court, had it been guided by the federal equitable common law principals and the multipart tests employed by the majority of Circuits that have adopted recharacterization, would have been required to conduct a fulsome analysis of the transaction in question and look beyond the paper form of the transaction. While the District Court abdicated its obligation to elucidate the factors to consider in determining whether to recharacterize debt to equity, its failings were brought on, in part, by the Ninth Circuit's determination that state law, not federal law, should apply.

Third, the Ninth Circuit compounded its reliance on 502(b) by affirming the District Court's approach that provided no state-based factors and, instead, effectively placed form over substance by applying contract rules that eliminated the possibility of a recharacterization claim unless there was shown first to be an ambiguity on the face of the Hancock Park notes,

> The district court correctly applied California law in concluding that the notes were contracts that created a right to payment. *See Poseidon Dev., Inc. v. Woodland Lane Estates, LLC*, 62 Cal. Rptr. 3d 59, 63 (Cal. Ct. App. 2007). The Trustee did not allege any ambiguity in the promissory notes and did not offer any extrinsic evidence that could have

> triggered application of the parol evidence rule. *See Miller v. Glenn Miller Prods., Inc.*, 454 F.3d 975, 989-90 (9th Cir. 2006) ("Because California law recognizes that the words of a written instrument often lack a clear meaning apart from the context in which the words were written, courts may preliminarily consider any extrinsic evidence offered by the parties.") (citing *Pacific Gas & Elec. Co. v. G.W. Thomas Drayage & Rigging Co.*, 442 P.2d 641, 644-46 (Cal. 1968)) (applying California parol evidence rule).
>
> We see no basis under California law to ignore basic contract law and to adopt the Trustee's proposed usury law approach to determine whether the promissory notes at issue here were "real" or "sham" transactions.

App., *infra*, 3-4.

The Ninth Circuit decision in *Fitness Holdings II*, if left to stand, renders the entire concept of recharacterization a nullity in this jurisdiction, insofar as courts will, absent an ambiguity, never look past the four corners of a document even if the substance of the transaction bears no resemblance to the unambiguous form.[7] *Hedged-Investments*, 380 F.3d at 1297

[7] Petitioner concurs with respondent in its Opposition to Petition for Writ of Certiorari in the current petition pending before this Court styled *PEM Entities LLC v. Eric M. Levin & Howard Shareff*, United States Supreme Court, Case No. 16-492 (filed on February 28, 2017) in its view that *Fitness Holdings II* provided the appropriate vehicle for this Court's review of a state-based alternative to the federal rule of decision on recharacterization. *Id.* at p.12 ("*Fitness Holdings II* is the only circuit case that has even

(recharacterization "effectively ignore[s] the label attached to the transaction at issue and instead recognize[s] its true substance").

While purporting to follow *Lothian Oil*, the Ninth Circuit's lack of any enumerated factors serves merely to demonstrate the fundamental problem in defaulting to state law in determining the equitable issue of recharacterization. The Ninth Circuit decision ignores altogether the equitable principles used by all of the other Circuits, including the Fifth Circuit, to address a claim for recharacterization. In doing so, the Ninth Circuit even refused to consider analogous California state law claims that used an equity type pronged test regarding the legality of a contract. *See* App., *infra*, 4.

Fitness Holdings II reflects the extreme downside of a non-uniform approach to applying recharacterization and the attempt to apply disparate state law concepts to this inquiry. While even its companion, *Lothian Oil*, ultimately applied the same factors as those set out in the majority Circuits, *Fitness Holdings I* embraces recharacterization under state-based rules, but the analysis subsequently adopted by *Fitness Holdings II* places form over substance, further reflecting the conflict with the federal rule of law.

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considered what a state-based rule would look like when the state has not adopted the *AutoStyle* factors. Because that case directly addresses the issue of a proposed 'state law rule,' *Fitness Holdings II* . . . would offer a more appropriate vehicle for this Court to consider this unformed doctrine.").

If left to stand, *Fitness Holdings II* serves to cement the conflict between the majority and minority jurisdictions on the issue of recharacterization and whether Section 105(a) and the federal rule of decision or Section 502(b) and state law govern this inquiry. The *Fitness Holdings II* ruling compels review by this Court to address the split between the Circuits, and establish Section 105(a) as the vehicle for a recharacterization analysis.

CONCLUSION

For the reasons expressed herein, this Court should grant the petition and issue a writ of certiorari to resolve the conflict that exists among the Circuits with respect to the proper rule of decision for recharacterizing debt to equity in bankruptcy proceedings.

Respectfully submitted,

Date: March 15, 2017

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874 F.3d 787
United States Court of Appeals,
Second Circuit.

In the MATTER OF: MPM SILICONES, L.L.C.
Momentive Performance Materials
Incorporated, Apollo Global ManagemenT,
LLC, Ad Hoc Committee of Second
Lien Holders, Plaintiffs-Appellees,
v.
BOKF, NA, as First Lien Trustee, Wilmington Trust,
N.A., as 1.5 Lien Trustee, Defendants-Appellants.
U.S. Bank National Association, as
Indenture Trustee, Plaintiff-Appellant,
v.
Wilmington Savings Fund Society, FSB, as
Successor Indenture Trustee, Momentive
Performance Materials Incorporated, Ad
Hoc Committee of Second Lien Noteholders,
Apollo Management, LLC, and Certain of
its Affiliated Funds, Defendants-Appellees.

Nos. 15-1682 (L)
|
15-1824 (CON)
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No. 15-1771
|
August Term, 2016
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Submitted: November 9, 2016
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Decided: October 20, 2017

Synopsis

Background: Order was entered by the United States Bankruptcy Court for the Southern District of New York, Robert D. Drain, J., 2014 WL 4436335, confirming debtor's proposed Chapter 11 plan, and noteholders appealed on theory that the plan violated the "absolute priority" rule, that Chapter 11 "cramdown" interest rate was inadequate, and that the lower court had erroneously denied their request for make-whole premium. The District Court, Briccetti, J., 531 B.R. 321, affirmed, and noteholders appealed.

Holdings: The Court of Appeals, Barrington D. Parker, Circuit Judge, held that:

[1] proposed Chapter 11 plan did not violate "absolute priority" rule, by providing a partial distribution to second lien noteholders on their claims but none to holders of subordinated notes;

[2] to determine appropriate Chapter 11 "cramdown" rate of interest, bankruptcy court should have engaged in two-stage process and first determined whether there existed an efficient market for loans of type that secured creditors would be required to make under plan;

[3] senior lien noteholders were not entitled to make-whole premium on notes which had been accelerated automatically upon debtors' Chapter 11 filing; and

[4] appeal from district court's affirmance of bankruptcy court's Chapter 11 plan confirmation order was not equitably moot.

Affirmed in part, reversed in part, and remanded.

West Headnotes (16)

[1] **Bankruptcy**
Conclusions of law;de novo review
Bankruptcy
Clear error

Court of Appeals exercises plenary review over district court's affirmance of bankruptcy court's decision, reviewing de novo the bankruptcy court's conclusions of law, and reviewing its findings of facts for clear error. Fed. R. Bankr. P. 8013.

Cases that cite this headnote

[2] **Contracts**
Intention of Parties

Under New York law, fundamental objective of contract interpretation is to give effect to the expressed intention of the parties.

Cases that cite this headnote

[3] **Contracts**
Existence of ambiguity

Under New York law, contract language is "ambiguous" if it is capable of more than one meaning.

Cases that cite this headnote

[4] **Bankruptcy**
Preservation of priority

Proposed Chapter 11 plan did not violate "absolute priority" rule, by providing a partial distribution to second lien noteholders on their claims but none to holders of subordinated notes; ambiguity in trust indenture as to whether second lien notes were "senior indebtedness," to which these subordinated notes had been subordinated, had to be resolved in favor of finding such subordination, not only because this was consistent with debtors' repeated representations to the Securities and Exchange Commission (SEC) and to financial community, but because contrary interpretation led to irrational results. 11 U.S.C.A. § 1129(b)(2)(B)(ii).

Cases that cite this headnote

[5] **Contracts**
Application to Contracts in General
Evidence
Showing Intent of Parties as to Subject-Matter

When contract term is ambiguous, New York courts look to extrinsic evidence to determine the intention of the parties, including evidence of parties' apparent intention, evidence of what would be commercially reasonable, and the parties' interpretation of the contract in practice, prior to litigation.

Cases that cite this headnote

[6] **Bankruptcy**
Secured creditors, protection of

To determine appropriate Chapter 11 "cramdown" rate of interest to ensure that objecting secured class receives stream of payments under proposed plan with present value that is at least equal to amount of class members' allowed secured claims, bankruptcy court should engage in two-stage process and first determine whether there exists efficient market for loans of type that secured creditors will be required to make under plan; only if there is no efficient market for such loans should courts proceed to second stage of process and use "formula" or prime-plus approach to calculate appropriate "cramdown" rate by starting with largely risk-free interest rate and applying appropriate risk adjustments. 11 U.S.C.A. § 1129(b)(2)(A)(i)(II).

Cases that cite this headnote

[7] **Bankruptcy**
Secured creditors, protection of

To determine appropriate Chapter 11 "cramdown" rate of interest to ensure that objecting secured class received stream of payments under proposed plan with present value that was at least equal to amount of class members' allowed secured claims, bankruptcy court should not have categorically rejected the probative value of evidence as to market rates of interest, but should have considered such evidence to determine whether an efficient market existed for loans of type that objecting secured creditors would be required to make under proposed plan. 11 U.S.C.A. § 1129(b)(2)(A)(i)(II).

Cases that cite this headnote

[8] **Bills and Notes**
Mode and Sufficiency of Payment

"Make-whole premium" is a contractual substitute for interest lost on promissory notes redeemed before their expected due date, and is meant to ensure that lender is compensated,

if paid earlier than the original maturity of loan, for the interest that it will not receive.

Cases that cite this headnote

[9] **Bills and Notes**
Mode and Sufficiency of Payment

Senior lien noteholders were not entitled to make-whole premium on notes which had been accelerated automatically upon debtors' Chapter 11 filing, an event of default under senior notes; while notes required payment of make-whole premium in event that they were redeemed early, repayment of notes that had been accelerated automatically due to debtors' bankruptcy filing was not a voluntary early "redemption" of notes prior to their due date, but a repayment contractually required on notes that had become due, pursuant to their terms, due to commencement of jointly administered bankruptcy cases.

Cases that cite this headnote

[10] **Bankruptcy**
Proceedings, Acts, or Persons Affected

Any attempt by senior noteholders to rescind the automatic acceleration of their notes that occurred due to debtors' Chapter 11 filing, in attempt to preserve their right to make-whole premium, would be a postpetition attempt to modify their contractual rights, and was barred by automatic stay. 11 U.S.C.A. § 362(a).

Cases that cite this headnote

[11] **Bankruptcy**
Moot questions

Equitable mootness is a prudential doctrine that is invoked to avoid disturbing a reorganization plan once implemented.

Cases that cite this headnote

[12] **Bankruptcy**
Moot questions

Equitable mootness doctrine allows appellate courts to dismiss bankruptcy appeals when, during pendency of appeal, events occur such that, while appellate court may conceivably be able to fashion effective relief, implementation of that relief would be inequitable.

Cases that cite this headnote

[13] **Bankruptcy**
Moot questions

Equitable mootness doctrine requires a bankruptcy appellate court to carefully balance importance of finality in bankruptcy proceedings against appellant's right to review and relief.

Cases that cite this headnote

[14] **Bankruptcy**
Moot questions

When reorganization plan has been substantially consummated, bankruptcy appellate court presumes that appeal from plan confirmation order is equitably moot; that presumption, however, will give way upon showing of presence of the five *Chateaugay* factors: (1) that effective relief can be ordered; (2) that such relief will not affect debtor's re-emergence from bankruptcy; (3) that such relief will not unravel intricate transactions; (4) that affected third parties were notified and able to participate in appeal; and (5) that appellant diligently sought stay of reorganization plan.

Cases that cite this headnote

[15] **Bankruptcy**
Moot questions

While each of the five *Chateaugay* factors must be satisfied in order to overcome presumption that substantial consummation of Chapter 11 reorganization plan will equitably moot an appeal from plan confirmation order, bankruptcy appellate courts place significant weight on fifth factor, i.e., on whether appellant diligently sought a

stay of reorganization plan; if stay was sought, then courts will provide relief if it is at all feasible, that is, unless relief would knock the props out from under the authorization for every transaction that has taken place and create an unmanageable, uncontrollable situation for bankruptcy court.

Cases that cite this headnote

[16] Bankruptcy
Moot questions

Appeal from district court's affirmance of bankruptcy court's Chapter 11 plan confirmation order, on ground that bankruptcy court had improperly relied solely on a "formula," or prime-plus approach, to calculate appropriate "cramdown" interest rate and had not considered whether there was efficient market for loans of type that objecting secured creditors would be required to make under proposed plan, was not rendered equitably moot by substantial consummation of plan, where creditors had diligently sought stay pending appeal from multiple courts, and where requiring debtors to pay additional interest to objecting secured creditors would not unravel the plan, threaten debtors' re-emergence from bankruptcy, or otherwise materially implicate *Chateaugay* concerns. 11 U.S.C.A. § 1129(b)(2)(A)(i)(II).

Cases that cite this headnote

***790** Appeals from the United States District Court for the Southern District of New York. Vincent L. Briccetti, *Judge*.

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Before: Cabranes, Pooler, and Parker, Circuit Judges.

Opinion

Barrington D. Parker, Circuit Judge:

Three groups of creditors separately appeal a judgment of the United States District Court of the Southern District of New ***791** York (Briccetti, *J.*) affirming the confirmation of Debtors' Chapter 11 reorganization plan by the U.S. Bankruptcy Court (Drain, *J.*). The creditors argue that the plan improperly eliminated or reduced the value of notes they held. Debtors argue that the plan was properly confirmed and that these

appeals should be dismissed as equitably moot. With one exception, we conclude that the plan confirmed by the bankruptcy court and affirmed by the district court comports with the provisions of Chapter 11. We remand so that the bankruptcy court can address the single deficiency we identify with the proceedings below which is the process for determining the proper interest rate under the cramdown provision of Chapter 11. We decline to dismiss these appeals as equitably moot.

These appeals by three groups of creditors challenge various aspects of Appellee Momentive Performance Materials, Inc.'s ("MPM,") substantially consummated plan of reorganization under Chapter 11 of the U.S. Bankruptcy Code.[1] With one exception, we conclude that the reorganization plan (the "Plan") confirmed by the bankruptcy court and affirmed by the district court comports with Chapter 11. We remand so that the bankruptcy court can address the single deficiency we identify in the proceedings below, which is the process for determining the proper interest rate under the cramdown provision of Chapter 11.

I

MPM, a leading producer of silicone, faced serious financial problems after it took on significant new debt obligations beginning in the mid-2000s.[2] *See* 15-1771 JA 286-88; 15-1682 JA 1605-06.[3] Following these debt issuances, MPM was substantially overleveraged, and ultimately filed a petition under Chapter 11. The four relevant classes of notes issued by MPM are as follows:

Subordinated Notes. In 2006, MPM issued $500 million in subordinated unsecured notes (the "Subordinated Notes") pursuant to an indenture (the "2006 Indenture"). 15-1771 JA 303. Appellant U.S. Bank is the indenture trustee for the Subordinated Notes. In 2009 MPM issued secured second-lien notes and offered the Subordinated Notes holders the option of exchanging their notes for the newly-issued second-lien notes. The second-lien notes were offered at a 60% discount but were secured. 15-1771 JA 2241. Holders of $118 million of the Subordinated Notes accepted the offer, leaving $382 million in unsecured Subordinated Notes outstanding. 15-1771 JA 2241.

Second-Lien Notes. In 2010, MPM issued approximately $1 billion in "springing" ***792** second-lien notes (the "Second-Lien Notes"). 15-1682 JA 1616; 15-1771 JA 476. The Second-Lien Notes were to be unsecured until the $118 million of previously exchanged Subordinated Notes were redeemed, at which point the "spring" in the lien would be triggered. 15-1771 JA 517, 580-81. Once triggered, the Second-Lien Notes would then (but only then) obtain a security interest in the Debtor's collateral. The exchanged Subordinated Notes were redeemed in November 2012, 15-1771 JA 721, at which point the trigger occurred and the Second-Lien Notes became secured with second-priority liens junior to other pre-existing liens on the Debtors' collateral. A primary issue on this appeal is whether the Second-Lien Notes have priority over the Subordinated Notes.

Senior-Lien Notes. In 2012, MPM again issued more debt, this time in the form of two classes of senior secured notes. Specifically, MPM issued $1.1 billion in first-lien secured notes (the "First-Lien Notes"), and $250 million in 1.5-lien secured notes (the "1.5-Lien Notes," and, with the First-Lien Notes, the "Senior-Lien Notes"). 15-1682 JA 1615. Appellants BOKF and Wilmington Trust are the indenture trustees for the First-Lien Notes and 1.5-Lien Notes, respectively. Pursuant to the governing indentures (the "2012 Indentures"), the Senior-Lien Notes were to be repaid in full by their maturity date of October 15, 2020. They carried fixed interest rates of 8.875% and 10%, respectively. The 2012 Indentures also called for the recovery of a "make-whole" premium if MPM opted to redeem the notes prior to maturity. Because the Second-Lien Notes and the Senior-Lien Notes are secured by the same collateral, the holders of those notes executed an intercreditor agreement (the "Intercreditor Agreement"), which provided that the Senior-Lien Notes stood in priority to the Second-Lien Notes as to their respective liens, but that each was junior to pre-existing liens on MPM's collateral. 15-1771 JA 691-718. Other primary issues on this appeal are whether the Senior-Lien Note holders are entitled to the make-whole adjustment and the cramdown interest rate they are entitled to if their Notes are replaced under the Plan.

II

After these notes were issued, MPM experienced significant financial problems. *See* 15-1771 JA 284-88.

In April 2014, MPM filed a petition under Chapter 11 and ultimately submitted a reorganization plan to the bankruptcy court. 15-1682 JA 3841-912. Several elements of that Plan are at issue on these appeals. The Plan provided for (i) a 100% cash recovery of the principal balance and accrued interest on the Senior-Lien Notes; (ii) an estimated 12.8%-28.1% recovery on the Second-Lien Notes in the form of equity in the reorganized Debtors; but (iii) no recovery on the Subordinated Notes. 15-1771 JA 271-74.

The Plan also gave the Senior-Lien Notes holders the option of (i) accepting the Plan and immediately receiving a cash payment of the outstanding principal and interest due on their Notes (without a make-whole premium), or (ii) rejecting the Plan, receiving replacement notes "with a present value equal to the Allowed amount of such holder's [claim]," and then litigating in the bankruptcy court issues including whether they were entitled to the make-whole premium and the interest rate on the replacement notes. 15-1771 JA 271-72; 15-1682 JA 3873-75. The Senior-Lien Notes holders rejected the Plan, and, thus, elected the latter option.

The appellants here—the Subordinated Notes holders and the Senior-Lien Notes holders—opposed the Plan. (The Second-Lien Notes holders unanimously accepted ***793** it.) The Subordinated Notes holders, who were to receive nothing, contended that, under relevant indenture provisions, their Notes were not subordinate to the Second-Lien Notes holders and, consequently, they were entitled to some recovery. The Senior-Lien Notes holders opposed the Plan on the ground that the replacement notes they received did not provide for the make-whole premium, and carried a largely risk-free interest rate that failed to comply with the Code because it was well below ascertainable market rates for similar debt obligations and thus was not fair and equitable because it failed to give them the present value of their claim.

Despite these objections, the bankruptcy court confirmed the Plan following a four-day hearing. *In re MPM Silicones, LLC*, 2014 WL 4436335 (Bankr. S.D.N.Y. Sept. 9, 2014), *aff'd*, 531 B.R. 321 (S.D.N.Y. 2015). Confirmation was facilitated by Chapter 11's "cramdown" provision, which allows a bankruptcy court to confirm a reorganization plan notwithstanding non-accepting classes if the plan "does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan." 11 U.S.C. § 1129(b)(1).

The bankruptcy court concluded that the Plan was fair to the Subordinated Notes holders, despite no recovery, because the 2006 Indenture called for their subordination to the Second-Lien Notes. *In re MPM Silicones, LLC*, 2014 WL 4436335, at *2-*11. It held the plan was fair to the Senior-Lien Notes holders because the 2012 Indentures did not require payment of the make-whole premium in the bankruptcy context and because the interest rate on the proposed replacement notes, even though well below a "market" rate, was determined by a formula that complied with the Code's cramdown provision. *Id.* at *11-*32.

The bankruptcy court's confirmation order triggered an automatic 14-day stay during which Debtors could not consummate the Plan. *See* Fed. R. Bankr. P. 3020(e). Appellants aggressively took advantage of this period and attempted to block the implementation of the Plan. Specifically, prior to the expiration of the automatic stay, appellants moved in the bankruptcy court to extend the stay pending their appeal of the confirmation order, which the court denied. *See* 15-1682 JA 4099, 4173. They then promptly moved the district court for a stay, which was also denied. *See* 15-1682 JA 183, 185. Appellants then appealed the denial of the stay to this Court, and we dismissed the appeal for lack of jurisdiction. 15-1682 JA 4872-73. Despite these efforts, the Debtors contend this appeal is equitably moot, a contention with which we do not agree.

The appellants appealed the confirmation order to the district court which affirmed the bankruptcy court's confirmation order. 531 B.R. 321. The district court essentially agreed with the bankruptcy court, concluding that: (i) the relevant indentures unambiguously prioritize the Second-Lien Notes over the Subordinated Notes, *id.* at 326-31; (ii) the below market interest rate selected by the bankruptcy court complied with the Code, *id.* at 331-34; and (iii) under their indentures, the Senior-Lien Notes holders are not entitled to the make-whole premium in the context of a bankruptcy, *id.* at 335-38. The Subordinated Notes holders, the First-Lien Notes holders, and the 1.5-Lien Notes holders separately appealed. [4]

*794 III

[1] "We exercise plenary review over a district court's affirmance of a bankruptcy court's decisions, reviewing *de novo* the bankruptcy court's conclusions of law, and reviewing its findings of facts for clear error." *In re Lehman Bros., Inc.*, 808 F.3d 942, 946 (2d Cir. 2015) (internal quotation marks omitted).

IV

These appeals raise four issues. First, the Subordinated Notes holders challenge the lower courts' conclusions that their claims are subordinate to the Second-Lien Notes holders' claims. Second, the Senior-Lien Notes holders contend that the lower courts erroneously applied a below-market interest rate to their replacement notes. Third, the Senior-Lien Notes holders challenge the lower courts' rulings that they are not entitled to a make-whole premium. Finally, Debtors argue that we should dismiss these appeals as equitably moot. We find merit only in the Senior-Lien Notes holders' contention with respect to the method of calculating the appropriate interest rate for the replacement notes. We reject the others.

A

The lower courts concluded that the Plan, which provided no distribution to the Subordinated Notes holders, complied with the governing 2006 Indenture. The Subordinated Notes holders argue this conclusion was erroneous because, under the terms of the 2006 Indenture, their claims are not subordinate to the Second-Lien Notes, whose holders recovered under the plan. The Debtors, on the other hand, contend that the 2006 Indenture gives the Second-Lien Notes priority over the Subordinated Notes. We agree with the Debtors, although for somewhat different reasons from the lower courts which found the relevant indenture provisions unambiguous. We find them to be ambiguous, but resolve the ambiguities in favor of the Debtors.

The Subordinated Notes holders' argument begins with Section 10.01 of the 2006 Indenture, which states that the Subordinated Notes are "subordinated in right of payment ... to the prior payment in full of all existing and future Senior Indebtedness of the Company," and that "only Indebtedness of the Company that is Senior Indebtedness of the Company shall rank senior to the Securities in accordance with the provisions set forth herein." 15-1771 JA 404. Accordingly, the Second-Lien Notes stand in priority to the Subordinated Notes only if they constitute "Senior Indebtedness."

"Senior Indebtedness" in the 2006 Indenture begins with what the parties refer to as the "Baseline Definition," which defines Senior Indebtedness as:

> all Indebtedness ... unless the instrument creating or evidencing the same or pursuant to which the same is outstanding expressly provides that such obligations are subordinated in right of payment to any other Indebtedness of the Company ...

15-1771 JA 341.

It is undisputed that the Second-Lien Notes are not subordinated in right of payment to any other indebtedness and that therefore they satisfy the Baseline Definition of Senior Indebtedness. However, the Baseline Definition is then subject to six enumerated exceptions, the fourth of which (the "Fourth Proviso") excepts from Senior Indebtedness:

> ***795** any Indebtedness or obligation of the Company ... that by its terms is subordinate or junior *in any respect* to any other Indebtedness or obligation of the Company ... including any Pari Passu Indebtedness.

15-1771 JA 342 (emphasis added).

The Subordinated Notes holders argue that the Fourth Proviso carves out the Second-Lien Notes from the Baseline Definition, *i.e.*, that the Second-Lien Notes are an "[i]ndebtedness or obligation of the Company ... that by its terms is subordinate or junior in any respect to any other Indebtedness of the Company." The Subordinated Notes holders rely heavily on the "in any respect" language. They argue that the Second-Lien Notes are subordinate to, for example, the First-Lien Notes—

because, pursuant to the Intercreditor Agreement, the liens supporting the Second-Lien Notes are junior to the liens supporting the First-Lien Notes—and that they are therefore subordinate to other Indebtedness of the company.

The lower courts rejected this argument, and concluded that the Second-Lien Notes unambiguously constitute Senior Indebtedness despite the Fourth Proviso. They did so in reliance on a distinction between "lien subordination" and "payment (or debt) subordination," concluding that the Fourth Proviso unambiguously carves out from the Baseline Definition only the latter and not the former.[5] Because the Second-Lien Notes are not subordinate in *payment* to other note classes—but rather, the *liens* supporting their notes are subordinate—the lower courts concluded that the Second-Lien Notes are not covered by the Fourth Proviso.

We do not agree with the lower courts that the Fourth Proviso unambiguously incorporates a distinction between lien subordination and payment subordination. Rather, we conclude that the Fourth Proviso renders the definition of Senior Indebtedness ambiguous as to whether it includes the Second-Lien Notes. Nevertheless, we conclude that this ambiguity should be resolved in Debtors' favor given the plethora of evidence in the record that the parties intended the Second-Lien Notes to be Senior Indebtedness.

1

[2] **[3]** As discussed, the lower courts concluded that the Second-Lien Notes are unambiguously Senior Indebtedness. Under New York law, which governs the Indenture, a fundamental objective of contract interpretation is to give effect to the expressed intention of the parties. The initial inquiry is whether the contractual language, without reference to sources outside the text of the contract, is ambiguous. Contract language is ambiguous if it is capable of more than one meaning.

[4] We are not persuaded by the Debtors' (and lower courts') conclusion that the Fourth Proviso's reference to "subordinate ... in any respect" unambiguously refers only to payment subordination and not to lien subordination. The Debtors read the Fourth Proviso as if it states "subordinate ... *in right of payment*," which of course it does not. In so doing, the Debtors disregard the breadth of the term "in any respect," a term which is generally thought ***796** to be as broadly encompassing as possible.[6] And, as a practical matter, it seems to us illogical to believe that a second-lien holder does not possess an obligation that is meaningfully subordinate in some respect to a first-lien holder. These sophisticated parties knew how to cabin the type of subordination to which they refer; the indenture uses the term "subordinate ... in right of payment" many times, including in the Baseline Definition itself.

Moreover, the Debtors' interpretation renders language in the indenture superfluous, which is a common sign of ambiguity. *See RJE Corp. v. Northville Indus. Corp.*, 329 F.3d 310, 314 (2d Cir. 2003) (in assessing ambiguity, courts consider the entire contract "to safeguard against adopting an interpretation that would render any individual provision superfluous" (internal quotation marks omitted)); *see also Lawyers' Fund for Client Protection of State of N.Y. v. Bank Leumi Trust Co. of New York*, 94 N.Y.2d 398, 404, 706 N.Y.S.2d 66, 727 N.E.2d 563 (N.Y. 2000) (concluding that an interpretation that renders a portion of a contract superfluous is "unsupportable: under standard principles of contract interpretation"). Specifically, if the Fourth Proviso only excepts debt subordinate in right of payment, there is no purpose for the "in right of payment" carve-out in the Baseline Definition. We disagree with the lower courts' attempts to interpret away this superfluity by finding a distinction between "expressly" (in the Baseline Definition) and "by its terms" (in the Fourth Proviso). We see no meaningful distinction between those terms.

Nevertheless, we also conclude that the Subordinated Notes holders' interpretation, that the Fourth Proviso unambiguously excludes the Second-Line Notes from the definition of Senior Indebtedness, is incorrect. As the lower courts correctly concluded, the Subordinated Notes holders' interpretation renders key parts of the Baseline Definition superfluous. Under their reading, that definition excludes from Senior Indebtedness only obligations subordinate "in right of payment," but the Fourth Proviso excludes all obligations that stand behind any type of other obligation. If so, the Baseline Definition's more limited carve-out for debt subordinate "in right of payment" would be unnecessary, because all such debt would be carved out from the definition of Senior Indebtedness by the Fourth Proviso.

As the Subordinated Notes holders correctly acknowledge, "[f]or this indenture, it simply is *not* possible to avoid superfluity." 15-1771 Br. of Appellant 54 (internal quotation marks omitted). Where, as here, varying interpretations render contractual language superfluous, we are not obligated to arbitrarily select one as opposed to another. Because the 2006 Indenture is open to differing reasonable interpretations as to whether the Second-Lien Notes constitute Senior Indebtedness, we conclude that it is ambiguous as a matter of law.

2

[5] Where a contract term is ambiguous, we look to extrinsic evidence to determine the intention of the parties. That evidence can include the parties' apparent intention, *Walk-In Medical Centers, Inc. v. Breuer Capital Corp.*, 818 F.2d 260, 264 (2d Cir. 1987), what would be commercially reasonable, *Fundamental Long Term Care Holdings, LLC v. Cammeby's Funding LLC*, 20 N.Y.3d 438, 445, 962 N.Y.S.2d 583, 985 N.E.2d 893 (2013), and the "parties' ***797** interpretation of the contract in practice, prior to litigation," *Ocean Transp., Inc. v. American Philippine Fiber Indus., Inc.*, 743 F.2d 85, 91 (2d Cir. 1984). Applying these tools, we conclude, as did the district court, that the parties understood that the Second-Lien Notes constituted Senior Indebtedness. *See* 531 B.R. at 331 n.7.

First, MPM repeatedly represented to the Securities Exchange Commission and to the financial community that the Second-Lien Notes were Senior Indebtedness. It did so in its prospectuses, 8-Ks and 10-Ks. For example, it disclosed in a November 2010 8-K that the Second-Lien Notes are "senior indebtedness of the Company ... and will rank ... senior in right of payment to all existing and future subordinated indebtedness." 15-1771 JA 3057; *see also* 15-1771 JA 2231. It went further when it subsequently resold certain Subordinated Notes. In a May 2013 prospectus, MPM restated that the Subordinated Notes "are subordinated to all our existing and future senior debt, including the ... Second-Priority Springing-Lien Notes." MPM also specifically identified as the first risk related to the Subordinated Notes that those holders' "right to receive payments on the Notes is junior to those lenders who have a security interest in our assets." 15-1771 JA 3007, 3010. MPM further asserted that in the event it were to file for bankruptcy and were unable to repay its secured debt, "it is possible that there would be no assets remaining from which your claims could be satisfied." 15-1771 JA 3010. The Subordinated Note holders knew all of this because the Debtors were contractually obligated, pursuant to Section 4.02 of the 2006 Indenture, to provide copies of its 10-Ks, 10-Qs, 8-Ks, and all other required disclosures both to the Subordinated Note holders as well as to their Trustee—a highly sophisticated group of investors. 15-1771 JA 357. There is no dispute that these disclosures occurred. Consequently, it was widely understood in the investment community that the Second-Lien Notes had priority.

Second, the Subordinated Notes holders' interpretation generates the irrational outcome that the springing of the Second-Lien Notes' security interest, which was meant to enhance the note holders' protection, would actually strip those notes of their status as Senior Indebtedness and therefore their priority over the Subordinated Notes. As the bankruptcy court concluded, "[t]here is no logical reason for such a distinction, notwithstanding the subordinated noteholders' attempt to find one." 2014 WL 4436335, at *9.

Third, the Subordinated Notes holders' proposed interpretation that "in any respect" covers all junior liens would mean that no senior note classes would qualify as Senior Indebtedness because each was secured in some respect by a junior lien. For example, the First-Lien Notes were secured in part by a second priority lien on collateral securing a prepetition revolving credit facility. *See* 15-1771 JA 2425-26. We think it highly improbable that anyone understood this interpretation to be correct. Certainly MPM did not. For example, in a December 2012 prospectus MPM represented to the SEC that the Senior-Lien Notes were Senior Indebtedness. 15-1771 JA 3725. Because those note classes are subordinate to pre-existing liens as to the Debtors' collateral, they, too, would seemingly not qualify as Senior Indebtedness under the Subordinated Notes holders' interpretation. In light of these factors, we have little trouble concluding that the extrinsic evidence establishes that the most reasonable interpretation of the Indenture is that the Second-Lien Notes are Senior Indebtedness. The judgment of the district court on that issue is, therefore, affirmed.

***798 B**

As a consequence of rejecting the Plan, the Senior-Lien Notes holders received replacement notes which pay out their claim over time. The Code permits debtors to make such "deferred cash payments" to secured creditors (*i.e.*, to "cramdown"). 11 U.S.C. § 1129(b)(2)(A)(i)(II). However, those payments must ultimately amount to the full value of the secured creditors' claims. *Id.* To ensure the creditor receives the full present value of its secured claim, the deferred payments must carry an appropriate rate of interest. *See Rake v. Wade*, 508 U.S. 464, 472 n.8, 113 S.Ct. 2187, 124 L.Ed.2d 424 (1993).

The rate selected by the lower courts for the Senior-Lien Note holders' replacement notes was based on the "formula" rate. The bankruptcy court selected interest rates of 4.1% and 4.85%, respectively, which were largely risk-free rates slightly adjusted for appropriate risk factors. It is not disputed that this rate is below market in comparison with rates associated with comparable debt obligations. The Debtors defend the application of the "formula" method on the ground that it is required by the plurality opinion in the Chapter 13 case of *Till v. SCS Credit Corp.*, **541 U.S. 465**, 124 S.Ct. 1951, 158 L.Ed.2d 787 (2004).

The Senior-Lien Notes holders contend that because this rate is too low, the Plan is not "fair and equitable" as required by § 1129(b). They argue that the lower courts should have applied a market rate of interest which is the rate MPM would pay to a contemporaneous sophisticated arms-length lender in the open market. The Senior-Lien Notes holders argued in the bankruptcy court that such a market exists and would generate interest in the 5-6+% range. *See* 15-1682 JA 464, 1941. [7]

The bankruptcy court rejected this approach, and concluded that a cramdown interest rate should "not take market factors into account." 2014 WL 4436335, at *25. Viewing itself as "largely governed by the principles enunciated by the plurality opinion in *Till v. SCS Credit Corp.*, **541 U.S. 465**, 124 S.Ct. 1951, 158 L.Ed.2d 787 (2004)," it concluded that the proper rate was what the plurality in *Till* referred to as the "formula" or "prime-plus" rate (discussed more fully below). *Id.* at *24, *26. The district court agreed. 531 B.R. at 332-34. The Senior-Lien Notes holders argue on appeal that the lower courts erred in concluding that the *Till* plurality opinion is wholly applicable to this Chapter 11 proceeding. In substantial part, we agree.

At issue in *Till* was a Chapter 13 debtor's sub-prime auto loan, carrying an interest rate of 21% and providing the creditor with a $4,000 secured claim. As with Chapter 11, Chapter 13 allows debtors to provide secured creditors with future property distributions (such as deferred cash payments) whose total "value, as of the effective date of the plan, ... is not less than the allowed amount of such claim." 11 U.S.C. § 1325(a)(5)(B)(ii). The question became, as here, how to calculate the interest on the deferred payments such that the creditor would receive the full value of its claim. No single interest-calculation method secured a majority vote on the Court, ***799** resulting in a plurality opinion endorsing the "formula" method.

The "formula" approach endorsed by the *Till* plurality instructs the bankruptcy court to begin with a largely risk-free interest rate, specifically, the "national prime rate ... which reflects the financial market's estimate of the amount a commercial bank should charge a creditworthy commercial borrower to compensate for the opportunity costs of the loan, the risk of inflation, and the relatively slight risk of default." 541 U.S. at 479, 124 S.Ct. 1951. The bankruptcy court should then hold a hearing to determine a proper plan-specific risk adjustment to that prime rate "at which the debtor and any creditors may present evidence." *Id.* Using this approach, "courts have generally approved adjustments [above the prime rate] of 1% to 3%." *Id.* at 480, 124 S.Ct. 1951. [8]

The *Till* plurality arrived at the "formula" rate after rejecting a number of alternative methods relied on by the lower courts. Significantly, it rejected methods relying on purported "market" rates of interest because those rates "must be high enough to cover factors, like lenders' transactions costs and overall profits, that are no longer relevant in the context of court-administered and court-supervised cramdown loans." 541 U.S. at 477, 124 S.Ct. 1951. The plurality then identified the only factors it viewed as relevant in properly ensuring that the sum of deferred payments equals present value: (i) the time-value of money; (ii) inflation; and (iii) the risk of non-payment. *Id.* at 474, 124 S.Ct. 1951. The plurality concluded that the "formula" or "prime-plus" method best reflects those considerations.

Although *Till* involved a Chapter 13 petition, the plurality intimated that the "formula" method might be applicable to rate calculations made pursuant to other similarly worded Code provisions. In fact, it cited the Chapter 11 cramdown provision, 11 U.S.C. § 1129(b)(2)(A)(i)(II), among many other provisions, when it noted that "[w]e 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 [Code] provisions." *Id.* at 474 & n.10, 124 S.Ct. 1951.

Despite that language, however, the plurality made no conclusive statement as to whether the "formula" rate was generally required in Chapter 11 cases. And, notably, the plurality went on to state, in the opinion's much-discussed footnote 14, that the approach it felt best applied in the Chapter 13 context may *not* be suited to Chapter 11. Specifically, in that footnote, the Court stated that in Chapter 13 cramdowns "there is no free market of willing cramdown lenders." 541 U.S. at 476 n.14, 124 S.Ct. 1951. It continued: "[i]nterestingly, 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 cramdown rate in a Chapter 11 case, it might make sense to ask what rate an efficient market would produce." *Id.* (internal citations omitted) (emphasis in original). [9]

[6] ***800** Many courts have relied on footnote 14 to conclude that efficient market rates for cramdown loans cannot be ignored in Chapter 11 cases. Most notably, the Sixth Circuit, "tak[ing] [its] cue from Footnote 14" of the *Till* plurality, adopted a two-part process for selecting an interest rate in Chapter 11 cramdowns:

> [T]he 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.

In re American HomePatient, Inc., 420 F.3d 559, 568 (6th Cir. 2005). In applying this rule, courts have held that markets for financing are 'efficient' where, for example, "they offer a loan with a term, size, and collateral comparable to the forced loan contemplated under the cramdown plan." *In re Texas Grand Prairie Hotel Realty, L.L.C.*, 710 F.3d 324, 337 (5th Cir. 2013). [10]

We adopt the Sixth Circuit's two-step approach, which, in our view, best aligns with the Code and relevant precedent. We do not read the *Till* plurality as stating that efficient market rates are irrelevant in determining value in the Chapter 11 cramdown context. And, disregarding available efficient market rates would be a major departure from long-standing precedent dictating that "the best way to determine value is exposure to a market." *Bank of Am. Nat'l Trust and Sav. Ass'n v. 203 N. LaSalle St. P'ship*, 526 U.S. 434, 457, 119 S.Ct. 1411, 143 L.Ed.2d 607 (1999) (assessing a Chapter 11 cramdown); *see also United States v. 50 Acres of Land*, 469 U.S. 24, 25 & n.1, 105 S.Ct. 451, 83 L.Ed.2d 376 (1984) ("fair market value" is "what a willing buyer would pay in cash to a willing seller" (internal quotation marks omitted)). In *Bank of America*, the Court noted that "one of the Code's innovations [was] to narrow the occasions for courts to make valuation judgments," and expressed a "disfavor for decisions untested by competitive choice ... when some form of market valuation may be available." *Bank of America*, 526 U.S. at 457-58, 119 S.Ct. 1411.

The Senior-Lien Notes holders presented expert testimony in the bankruptcy court that, if credited, would have established a market rate. This evidence showed that if the Senior-Lien Noteholders were to have approved the Plan and accepted a cash-out payment for their notes, MPM would have had to secure exit financing to cover the lump-sum payment. In preparation for that possible eventuality (which did not come to pass in light of the Senior-Lien Notes holders' rejection of the Plan), MPM went out into the market seeking lenders to provide that financing. Those lenders quoted MPM rates of interest ranging between 5 and 6+%. *See In re MPM Silicones, LLC*, 2014 WL 4436335, at *29.

At these rates, the First-Lien Note holders contend that they would have received around $150 million more than the Plan offered, Br. of First-Lien Appellant 25, 33. The 1.5-Lien Note holders claim that the interest rate chosen by the lower courts led them to receive notes "valued by the market at *less than 93 cents* on the value of the secured claims," Br. of 1.5-Lien Appellant 20. [11] The Plan was objectionable ***801** to the Senior-Lien Notes holders because, in essence, it required them to lend Debtors a significant sum of money and receive a much lower rate

of interest than any other lender would have received for offering the same loan to MPM on the open market.

When dealing with a sub-prime loan in the Chapter 13 context, "value" can be elusive because the market is not necessarily efficient and the borrower is typically unsophisticated. However, where, as here, an efficient market may exist that generates an interest rate that is apparently acceptable to sophisticated parties dealing at arms-length, we conclude, consistent with footnote 14, that such a rate is preferable to a formula improvised by a court. *See Bank of America*, 526 U.S. at 457, 119 S.Ct. 1411; *see also In re Valenti*, 105 F.3d 55, 63 (2d Cir. 1997) (the goal of the cramdown rate "is 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"); *see also* 15-1682 JA 3428 (First-Lien Notes holders' expert testifying that because the First-Lien Notes holders "are pricing it at the market ... they're being compensated for the underlying risk that they are taking," and not for any "imbedded profit").

We understand that the complexity of the task of determining an appropriate market rate will vary from case to case. In some cases the task will be straightforward, in others it will be more complex. But, at the end of the day, we have no reason to believe the task varies materially in difficulty from the myriad tasks which we regularly rely on the expertise of our bankruptcy courts to resolve.

[7] We therefore conclude that the lower courts erred in categorically dismissing the probative value of market rates of interest. We remand so that the bankruptcy court can ascertain if an efficient market rate exists and, if so, apply that rate, instead of the formula rate. [12] We arrive at no conclusion with regard to the outcome of this inquiry.

C

[8] The 2012 Indentures governing the Senior-Lien Notes contain Optional Redemption Clauses, which provide for the payment of a make-whole premium [13] (referred to as the "Applicable Premium" in the indentures) if MPM were to "redeem the Notes at its option" prior to October 15, 2015. 15-1682 JA 2322. [14] The make- ***802** whole premium was intended to ensure that the Senior-Lien Notes holders received additional compensation to make up for the interest they would not receive if the Notes were redeemed prior to their maturity date.

[9] In October 2014, the Debtors, pursuant to the Plan, issued replacement notes to the Senior-Lien Notes holders, which did not account for the make-whole premium. These holders contended that the failure to include that premium violated the 2012 Indentures. The bankruptcy court concluded that the Senior-Lien Notes holders were not entitled to the premium. It reasoned that under the 2012 Indentures the make-whole premium would be due only in the case of an "optional redemption" and not in the case of an acceleration brought about by a bankruptcy filing. 2014 WL 4436335, at *11-*15. The district court agreed. 531 B.R. at 335-38. We too agree.

The Senior-Lien Notes holders claim entitlement to the make-whole premium for essentially three reasons: (i) they are entitled to the make-whole under the 2012 Indentures' Optional Redemption Clauses; (ii) they are entitled to it under the 2012 Indentures' Acceleration Clauses; and (iii) even if the indentures did not allow for a make-whole premium upon acceleration, they should not have been permanently barred from exercising their contractual right to rescind acceleration and thereby obtain the make-whole premium.

1

The Senior-Lien Notes holders' principal argument is that they are entitled to the make-whole premium because when MPM issued the replacement notes under the Plan, it "redeemed" the Notes "at its option" prior to maturity. This argument fails for the same reasons we rejected nearly identical arguments in *In re AMR Corp.*, 730 F.3d 88 (2d Cir. 2013). There we rejected the note holders' argument that they were entitled to a make-whole premium following a debtor's bankruptcy filing. We concluded that:

> American's bankruptcy petition triggered a default, and this default automatically accelerated the debt. That acceleration changed the date of maturity from some point in the future ... to an earlier date based on the debtor's default under the contract. ... When the event

> of default occurred and the debt accelerated, the new maturity for the debt was November 29, 2011 [the date of the bankruptcy petition]. Consequently, American's attempt to repay the debt in October 2012 was not a voluntary prepayment because [p]repayment can only occur *prior* to the maturity date.

Id. at 103 (internal citations and quotation marks omitted).

The Senior-Lien Notes holders argue *AMR* is inapplicable because it spoke only to "prepayment" rather than "redemption." As the district court noted, the principle of *AMR* does not turn on the distinction between "prepayment" and "redemption." 531 B.R. at 336-37. In fact, in *AMR* we stated that because "American's debt was accelerated ... upon its bankruptcy filing [it] is not now voluntarily redeeming the notes." *AMR*, 730 F.3d at 109.

We also held in *AMR* that acceleration brought about by a bankruptcy filing changes the date of maturity of the accelerated notes to the date of the petition. 730 F.3d at 103. Therefore, any payment on the accelerated notes following a bankruptcy filing would be a *post*-maturity payment. And, as the First-Lien Notes holders ***803** concede, the "plain meaning of the term 'redeem' is to 'repay[ ] ... a debt security ... *at or before* maturity.' " 15-1682 Br. of First-Lien Appellant 39 (emphasis added). Here, Debtors' payment was *post*-maturity, not "at or before" maturity. *But see In re Energy Future Holdings Corp.*, 842 F.3d 247, 255 (3d Cir. 2016). Moreover, even assuming MPM's issuance of the replacement notes was a "redemption," it would not have been "at [*MPM's*] option," as required to trigger the Optional Redemption Clauses. Rather, the obligation to issue the replacement notes came about automatically by operation of separate indenture provisions, the Automatic Acceleration Clauses. A payment made mandatory by operation of an automatic acceleration clause is not one made at MPM's option. *See AMR*, 730 F.3d at 100B01.

2

As discussed, the 2012 Indentures each contain an Acceleration Clause, which calls for the acceleration of payment of the Senior-Lien Notes under certain conditions constituting an Event of Default. Pursuant to Section 6.01(g), one such event is MPM's filing of a voluntary bankruptcy petition. Although most Events of Default allow the Senior-Lien Notes holders the *option* of accelerating payment, a default brought about by MPM's voluntary bankruptcy petition leads to an *automatic* acceleration under Section 6.02. [15]

The Senior-Lien Notes holders argue that the term "premium, if any" in the Acceleration Clauses requires that the make-whole premium is due upon an automatic acceleration. This argument fails in light of our conclusion that the Senior-Lien Notes holders are not entitled to the make-whole premium under the Optional Redemption Clauses. In other words, the make-whole premium is not due pursuant to the Acceleration Clauses' reference to "premium, if any," for the simple reason that the more specific Optional Redemption Clauses which grant the make-whole are not triggered and thus no premium has been generated. *See Aramony v. United Way of Am.*, 254 F.3d 403, 413 (2d Cir. 2001) (noting that "it is a fundamental rule of contract construction that specific terms and exact terms are given greater weight than general language" (internal quotation marks omitted)).

3

[10] Finally, the Senior-Lien Notes holders argue that the lower courts erred in disregarding their contractual right to rescind acceleration, [16] a right that if invoked would have reinstated the original maturity date and thereby kept the Optional Redemption Clauses (and therefore the make-whole premium) in effect.

AMR forecloses this argument as well. There, considering nearly identical indenture language, we concluded that a creditor's post-petition invocation of a contractual right to rescind an acceleration triggered automatically by a bankruptcy filing is barred because it would be "an attempt to modify contract rights and would therefore be subject to the automatic ***804** stay." 730 F.3d at 102; *see also id.* at 102-03 ("any attempt by U.S. Bank to rescind acceleration now—after the automatic stay has taken effect—is an effort to affect American's contract rights, and thus the property of the estate").

The Senior-Lien Notes holders again attempt to distinguish *AMR* by relying on the fact that the acceleration provision there, unlike the one here, expressly disavowed the make-whole premium. According to the 1.5-Lien Notes holders, our concern in *AMR* was therefore with not allowing the creditors "an end-run around their bargain by rescission." 15-1682 Br. of 1.5-Lien Appellant 45. This argument fails because, although the provisions at issue here do not expressly disallow the make-whole premium, the Optional Redemption Clauses, as we have seen, achieve this result. Therefore, just as in *AMR*, because the right to rescind acceleration here would serve as "an end-run around their bargain by rescission," the lower courts correctly concluded that the automatic stay barred rescission of the acceleration of the Notes.

V

[11] **[12]** **[13]** Debtors seek dismissal of these appeals under the principle of equitable mootness, a "prudential doctrine that is invoked to avoid disturbing a reorganization plan once implemented." *In re Metromedia Fiber Network, Inc.*, 416 F.3d 136, 144 (2d Cir. 2005). [17] The doctrine "allows appellate courts to dismiss bankruptcy appeals 'when, during the pendency of an appeal, events occur' such that 'even though effective relief could conceivably be fashioned, implementation of that relief would be inequitable.' " *In re Motors Liquidation Co.*, 829 F.3d 135, 167 (2d Cir. 2016) (quoting *In re Chateaugay Corp.*, 988 F.2d 322, 325 (2d Cir. 1993) ("*Chateaugay II*")). The doctrine requires us to "carefully balance the importance of finality in bankruptcy proceedings against the appellant's right to review and relief." *In re Charter Commc'ns. Inc.*, 691 F.3d 476, 481 (2d Cir. 2012). With these principles in mind, we decline to dismiss any of these appeals as equitably moot.

[14] Where, as here, a reorganization plan has been substantially consummated, we presume that an appeal of that plan is equitably moot. *In re BGI, Inc.*, 772 F.3d 102, 104 (2d Cir. 2014). That presumption, however, gives way where five factors first identified in *Chateaugay II* are met. They are, where: (i) effective relief can be ordered; (ii) relief will not affect the debtor's re-emergence; (iii) relief "will not unravel intricate transactions"; (iv) affected third-parties are notified and able to participate in the appeal; and (v) appellant diligently sought a stay of the reorganization plan. *In re Charter*, 691 F.3d at 482.

[15] Although we require satisfaction of each *Chateaugay II* factor to overcome a mootness presumption, we have placed significant reliance on the fifth factor, concluding that a "chief consideration under *Chateaugay II* is whether the appellant sought a stay of confirmation." *In re Metromedia*, 416 F.3d at 144. Along these lines, we concluded that "[i]f a stay was sought, we will provide relief if it is at all ***805** feasible, that is, unless relief would 'knock the props out from under the authorization for every transaction that has taken place and create an unmanageable, uncontrollable situation for the Bankruptcy Court.' " *Id.* (quoting *Chateaugay II*, 10 F.3d 944, 953 (2d Cir. 1993)).

A special emphasis on this factor is sound. Equitable mootness issues only arise in earnest following a judicial determination that some facet of a reorganization plan violates the Code. It is generally considered inappropriately harsh to deny relief to which one is entitled on the purportedly equitable ground that the unfair (or illegal) plan has been put into effect, especially where a creditor took all appropriate steps to secure judicial relief. In such a case, we have held that it is proper to "provide relief if it is at all feasible." *Id.*

[16] Here, the appellants immediately objected to various provisions of the Plan and promptly and consistently sought a stay in three different courts. Thus their diligence is not in question. Debtors nevertheless argue that these appeals should be dismissed as moot because of the cascading effects of rewriting the plan were the appellants to prevail. Specifically, they argue that "granting the Noteholders' relief would alter a critical piece of the Plan resulting from the intense-multi-party negotiation, thereby impact[ing] other terms of the agreement and throw[ing] into doubt the viability of the Plan," and that according such relief "would cause debilitating financial uncertainty" to the emergent Debtor. 15-1682 Br. of Appellees 69, 71 (internal quotation marks omitted).

In light of the limited nature of the remand we order, we do not believe these concerns will materialize. On remand, the bankruptcy court will only be called on to re-evaluate the interest to be received on the replacement notes held by the Senior-Lien Notes holders. The Debtors acknowledge that this might require, at most, $32 million of additional annual payments over seven years. 15-1682 Br. of Appellees 69. The Debtors will not have to

pay out the nearly $200 million they assert would be required to pay the Senior-Lien Notes holders' make-whole premium, nor will any redistribution be required to the Subordinated Notes holders, as to which the plan is fair. In fact, our judgment allows for no redistribution other than that from the Debtors to the Senior-Lien Notes holders.

Given the scale of Debtors' reorganization, we are not persuaded that a payment of, perhaps, $32 million in annual payments over seven years, with no other redistribution from other creditors or third parties, would unravel the plan, threaten Debtors' emergence, or otherwise materially implicate the concerns identified in *Chateaugay II*.

Our conclusion is supported by the findings of the lower courts, which had intimate familiarity with the Debtors' financial condition and the transactions that will arise from the reorganization. Although it made no determinative ruling as to equitable mootness, the bankruptcy court opined that "the risk of equitable mootness is not strong here *for either set of movants* ... the senior secured lender set of movants and the senior subordinated noteholder movants." 15-1682 JA 4165 (emphasis added). The district court agreed. 15-1682 JA 4837 ("I agree with Judge Drain that the risk of equitable mootness here is not very great ..."). Debtors' request that we dismiss these appeals as equitably moot is denied.

VI

To summarize, we conclude as follows:

1. The Second-Lien Notes stand in priority to the Subordinated Notes.

***806** 2. The Senior-Lien Notes holders are not entitled to the make-whole premium.

3. The lower court erred in the process it used to calculate the interest rate applicable to the replacement notes received by the Senior-Lien Notes holders. On remand, the bankruptcy court should assess whether an efficient market rate can be ascertained, and, if so, apply it to the replacement notes.

4. We decline to dismiss any of these appeals as equitably moot.

For the foregoing reasons, we **AFFIRM** the District Court's order in part, with respect to the priority of the Subordinated Notes and the Senior-Lien Notes holders' entitlement to a make-whole premium; **REVERSE** the order in part, with respect to the method of calculating the interest rate on the Senior-Lien Notes holders' replacement notes; and **REMAND** the matter for further proceedings consistent with this opinion.

All Citations

874 F.3d 787, Bankr. L. Rep. P 83,176

Footnotes

1 Momentive Performance Materials, Inc.'s "MPM," and with affiliated debtors, "Debtors".

2 The facts recounted herein derive principally from the bankruptcy court's decision confirming Debtors' reorganization plan, *In re MPM Silicones, LLC*, 2014 WL 4436335 (Bankr. S.D.N.Y. Sept. 9, 2014), *aff'd* 531 B.R. 321 (S.D.N.Y. 2015), as well as the public disclosures made part of the record. We rely on the facts recounted in the bankruptcy court's ruling in light of our "oblig[ation] to accept the bankruptcy court's undisturbed findings of fact unless they are clearly erroneous." *Brunner v. New York State Higher Educ. Servs. Corp.*, 831 F.2d 395, 396 (2d Cir. 1987).

3 As discussed, *infra* note 4, we resolve with this opinion three separate appeals. Our citations to the respective records will begin with the relevant docket number on appeal, and references to "JA" are to the respective joint appendices filed with that appeal. For example, our citation to "15-1771 JA 286-88" is to pages 286-88 of the joint appendix filed in the appeal brought by U.S. Bank, docketed No. 15-1771.

4 The appeals by the First-Lien Notes holders (No. 15-1682) and 1.5-Lien Notes holders (No. 15-1824) were consolidated and heard in tandem with the appeal by the Subordinated Notes holders (No. 15-1771).

5 The district court discussed in some detail the distinction between lien subordination and payment/debt subordination. 531 B.R. at 328. In short, "[l]ien subordination involves two senior creditors with security interests in the same collateral,

one of which has lien priority over the other. ... By contrast, in payment subordination, the senior lender enjoys the right to be paid first from all assets of the borrower or any applicable guarantor, whether or not constituting collateral security for the senior or subordinated lenders." *Id.*

6 Debtors' attempt to downplay the significance of the term "in any respect" in this context is unconvincing given that the term appears nowhere else in the indenture other than in the Fourth Proviso.

7 Debtors' reorganization plan proposed interest rates of 3.6% and 4.09%. *See* 2014 WL 4436335, at *24. However, the bankruptcy court concluded that those rates should be increased by 0.5% and 0.75%, respectively, in light of the fact that the base interest rate was pegged to the Treasury rate, rather than the prime rate (which reflects additional risk). *Id.* at *32. On appeal to the district court, the Senior-Lien Notes holders argued the bankruptcy court erred in not requiring the prime rate, an argument the district court rejected. 531 B.R. at 334-35. The Senior-Lien Notes holders do not press this argument here.

8 Here, the bankruptcy court applied risk adjustments of 2.0% and 2.75%, which it added to the Treasury rate of 2.1% to arrive at interest rates of 4.1% and 4.85%, respectively. 2014 WL 4436335, at *32. Debtors assert in their briefing that the Treasury rate dropped by approximately 0.2% between the confirmation date and the plan's effective date, which thereby further lowered their notes' interest rate. 15-1682 Br. of Appellee at 11 n.3.

9 The Supreme Court has not subsequently spoken about the interest-calculation method to be applied in a Chapter 11 case. Nor have we.

10 Numerous courts, included in this Circuit, have followed the *American HomePatient* approach. *See, e.g.*, *In re 20 Bayard Views, LLC*, 445 B.R. 83, 108-09 (E.D.N.Y. 2011) (collecting cases and deciding to "follow the majority approach" first outlined in *American HomePatient*).

11 The Senior-Lien Notes holders offered evidence that the market price for their notes dropped, respectively, from 101.375% and 104.000% six days prior to the bankruptcy court's oral decision, to 94.375% and 92.563% nine days after that decision. 15-1682 JA 3991 ¶¶ 5-6, 8-9.

12 We acknowledge that the lower courts grappled with the Senior-Lien Notes holders' evidence regarding MPM's quoted exit financing, and made express their view that the rate produced by that process may not in fact have been produced by an efficient market. 2014 WL 4436335, at *26, *29; 531 B.R. at 334 n.9. Nevertheless, Judge Drain left no ambiguity that he applied the "formula" approach for Chapter 13 individual bankruptcy cases as dictated by the *Till* plurality and, in so doing, explicitly declined to consider market forces. *See* 2014 WL 4436335, at *25-*26; *see also id.* at *28 ("I conclude that [the *American HomePatient*] two-step method, generally speaking, misinterprets *Till*"). Judge Briccetti agreed with this approach. 531 B.R. at 334. As discussed, this was in error. The bankruptcy court should have the opportunity to engage the *American HomePatient* analysis in earnest.

13 A make-whole premium is a "contractual substitute for interest lost on Notes redeemed before their expected due date." *In re Energy Future Holdings Corp.*, 842 F.3d 247, 251 (3d Cir. 2016) ("*EFH*"). As stated by the bankruptcy court, its purpose "is to ensure that the lender is compensated for being paid earlier than the original maturity of the loan for the interest it will not receive ...." 2014 WL 4436335, at *15.

14 We cite in this section to the indenture for the First-Lien Notes; the indenture for the 1.5-Lien Notes is identical for relevant purposes.

15 Section 6.02 provides: "If an Event of Default specified in Section 6.01(f) or (g) with respect to MPM occurs, the principal of, premium, if any, and interest on all the Notes shall ipso facto become and be immediately due and payable without any declaration or other act on the part of the Trustee or any Holders." 15-1682 JA 2260.

16 "Holders of a majority in principal amount of outstanding Notes by notice to the Trustee may rescind any such acceleration with respect to the Notes and its consequences." 15-1682 JA 2260.

17 Debtors filed with the district court a motion to dismiss the appeal of the bankruptcy court's confirmation order on the basis of equitable mootness. 15-1771 JA 4570-88. The district court made no ruling on the motion, concluding it was "mooted by this Court's decision to affirm the Orders of the Bankruptcy Court." 531 B.R. at 338 n.14. Debtors then filed motions to dismiss on equitable mootness grounds with this Court, 15-1682 Doc. 58; 15-1771 Doc. 62, which we summarily denied without prejudice to Debtors "rais[ing] the issue ... in their merits brief," 15-1682 Doc. 159; 15-1771 Doc. 102.

859 F.3d 637
United States Court of Appeals,
Ninth Circuit.

IN RE SUNNYSLOPE HOUSING LIMITED PARTNERSHIP, Debtor.
First Southern National Bank, Plaintiff-Appellant,
v.
Sunnyslope Housing Limited Partnership, Defendant-Appellee.
In re Sunnyslope Housing Limited Partnership, Debtor.
Sunnyslope Housing Limited Partnership, Plaintiff-Appellant,
v.
First Southern National Bank, Defendant-Appellee.
In re Sunnyslope Housing Limited Partnership, Debtor.
First Southern National Bank, Plaintiff-Appellant,
v.
Sunnyslope Housing LP, Defendant-Appellee.
In re Sunnyslope Housing Limited Partnership, Debtor.
Sunnyslope Housing LP, Plaintiff-Appellant,
v.
First Southern National Bank, Defendant-Appellee.

No. 12-17241, No. 12-17327,
No. 13-16164, No. 13-16180
|
Argued and Submitted En Banc January 17, 2017 San Francisco, California
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Filed May 26, 2017
|
Amended June 23, 2017

Synopsis

Background: Creditor appealed from bankruptcy court order valuing its allowed secured claim, for Chapter 11 plan confirmation purposes, at $3.9 million and sought a stay. The United States District Court for the District of Arizona, H. Russel Holland, Senior District Judge, 2012 WL 12949503, affirmed the bankruptcy court's determinations and declined to grant creditor a stay. Creditor appealed, and debtor cross-appealed and moved to dismiss on the ground of equitable mootness. The Court of Appeals, Clifton, Circuit Judge, 818 F.3d 937, reversed and remanded. Rehearing en banc was granted.

Holdings: The Court of Appeals, Hurwitz, Circuit Judge, held that:

[1] while low-income housing restrictions on deed of trust property that debtor sought to retain in its proposed Chapter 11 plan would be cut off by hypothetical foreclosure, bankruptcy court, in calculating replacement value of this property, for purpose of determining what payments debtor had to make to deed of trust creditor to obtain confirmation of plan that it did not accept, had to value property subject to these restrictions;

[2] bankruptcy court did not clearly err in setting Chapter 11 "cram down" rate of interest at 4.4%;

[3] bankruptcy court did not abuse its discretion in finding Chapter 11 debtor's 40-year, balloon-payment plan was feasible, as required for confirmation; and

[4] bankruptcy court did not abuse its discretion in declining to modify its scheduling order, in order to give creditor a second opportunity to elect whether to be treated as holding a fully secured claim.

Affirmed.

Kozinski, Circuit Judge, filed dissenting opinion, in which O'Scannlain and Friedland, Circuit Judges, joined.

West Headnotes (14)

[1] Bankruptcy
Secured creditors, protection of

Bankruptcy
Valuation;periodic payments

When a Chapter 11 or Chapter 13 debtor intends to retain liened property by making series of payments to secured creditor whose present value is equal to amount of creditor's allowed secured claim, purpose of a valuation of creditor's collateral is not

to determine amount that creditor would receive if it hypothetically had to foreclose and to sell collateral; foreclosure value is not relevant because creditor is not foreclosing. 11 U.S.C.A. §§ 506(a)(1), 1129(a)(7)(B), 1325(a)(5)(B)(ii).

Cases that cite this headnote

[2] **Bankruptcy**
Secured creditors, protection of
Bankruptcy
Valuation;periodic payments

When a Chapter 11 or Chapter 13 debtor intends to retain liened property by making series of payments to secured creditor whose present value is equal to amount of creditor's allowed secured claim, court should value creditor's collateral using replacement-value standard, based on cost that debtor would incur to obtain a like asset for same proposed use. 11 U.S.C.A. §§ 506(a)(1), 1129(a)(7)(B), 1325(a)(5)(B)(ii).

Cases that cite this headnote

[3] **Bankruptcy**
Particular cases and issues

Determination of replacement value of property that secures a creditor's claim, and that debtor proposes to retain, is factual finding, which bankruptcy appellate court reviews for clear error. 11 U.S.C.A. §§ 506(a)(1), 1129(a)(7)(B), 1325(a)(5)(B)(ii).

Cases that cite this headnote

[4] **Bankruptcy**
Secured creditors, protection of

While low-income housing restrictions on deed of trust property that debtor sought to retain in its proposed Chapter 11 plan would be cut off by hypothetical foreclosure and permit property to be devoted to its highest and best use, bankruptcy court, in calculating replacement value of this property, for purpose of determining what payments debtor had to make to deed of trust creditor to obtain confirmation of plan that it did not accept, had to value property subject to these restrictions. 11 U.S.C.A. §§ 506(a)(1), 1129(a)(7)(B).

Cases that cite this headnote

[5] **Bankruptcy**
In general;nature and purpose

While the protection of creditors' interests is important purpose under Chapter 11, successful debtor reorganization and maximization of value of estate are the primary purposes.

Cases that cite this headnote

[6] **Bankruptcy**
Particular cases and issues

Whether proposed Chapter 11 plan is fair and equitable is factual determination, as required for "cram down," is reviewed for clear error. 11 U.S.C.A. § 1129(b).

Cases that cite this headnote

[7] **Bankruptcy**
Secured creditors, protection of

"Cram down" interest rate must ensure that secured creditor receives the present value of its secured claim through the payments contemplated by plan of reorganization. 11 U.S.C.A. § 1129(b)(2)(A)(i)(II).

Cases that cite this headnote

[8] **Bankruptcy**
Secured creditors, protection of
Bankruptcy
Confirmation;Objections

In calculating appropriate "cram down" interest rate, courts apply "formula approach," which begins with the national prime rate and adjusts up or down according to the risk of plan's success, and secured creditor bears burden of showing that the prime rate does not adequately account for

riskiness of debtor. 11 U.S.C.A. § 1129(b)(2)(A)(i)(II).

Cases that cite this headnote

[9] Bankruptcy
Secured creditors, protection of

Bankruptcy court did not clearly err in setting Chapter 11 "cram down" rate of interest at 4.4%, though this was lower than original contract rate of interest on deed of trust loan, where interest rates had decreased significantly since original deed of trust loan was made, where relevant national prime rate was 3.25%, and where bankruptcy court adjusted that rate upward to account for risk of non-payment after hearing testimony that market loan rate for similar properties was 4.18%. 11 U.S.C.A. § 1129(b)(2)(A)(i)(II).

Cases that cite this headnote

[10] Bankruptcy
Feasibility in general

To obtain confirmation of proposed Chapter 11 plan, debtor, as plan proponent, must demonstrate that the plan has reasonable probability of success. 11 U.S.C.A. § 1129(a)(11).

Cases that cite this headnote

[11] Bankruptcy
Discretion

Bankruptcy court's finding as to feasibility of proposed Chapter 11 plan is reviewed for abuse of discretion. 11 U.S.C.A. § 1129(a)(11).

Cases that cite this headnote

[12] Bankruptcy
Feasibility in general

Bankruptcy court did not abuse its discretion in finding Chapter 11 debtor's 40-year, balloon-payment plan was feasible, as required for confirmation, where debtor's projections showed that debtor could make plan payments, and expert testimony confirmed that real property which collateralized objecting creditor's secured claim would remain useful for full term of plan. 11 U.S.C.A. § 1129(a)(11).

Cases that cite this headnote

[13] Bankruptcy
Extension of time

Bankruptcy
Discretion

Bankruptcy court may modify a scheduling order for "cause," and bankruptcy appellate court will review its decision whether to do so for abuse of discretion. Fed. R. Bankr. P. 9006(b)(1).

1 Cases that cite this headnote

[14] Bankruptcy
Acceptance

Bankruptcy court did not abuse its discretion in declining to modify its scheduling order, in order to give creditor a second opportunity to elect whether to be treated as holding a fully secured claim, following modification of debtor's Chapter 11 plan to increase valuation of collateral that secured creditor's claim; alteration was not material to election decision, as creditor's treatment under modified plan remained the same, amended plan did not alter treatment of unsecured claims, and allowing second election would give creditor a second chance to object to plan, this time both as a secured and unsecured creditor, and might prevent approval of reorganization plan. 11 U.S.C.A. § 1111(b); Fed. R. Bankr. P. 9006(b)(1).

1 Cases that cite this headnote

***640** Appeals from the United States District Court for the District of Arizona, H. Russel Holland, District Judge, Presiding, D.C. No. 2:11-cv-02579-HRH, D.C. No. 2:11-cv-02579-HRH, D.C. No. 2:12-cv-02700-HRH, D.C. No. 2:12-cv-02700-HRH

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Before: Sidney R. Thomas, Chief Judge, and Alex Kozinski, Diarmuid F. O'Scannlain, Susan P. Graber, Ronald M. Gould, Richard C. Tallman, Carlos T. Bea, Jacqueline H. Nguyen, Andrew D. Hurwitz, John B. Owens, and Michelle T. Friedland, Circuit Judges.

Dissent by Judge Kozinski

OPINION

HURWITZ, Circuit Judge:

When a debtor, over a secured creditor's objection, seeks to retain and use the creditor's collateral in a Chapter 11 plan of reorganization through a "cram down," the Bankruptcy Code treats the creditor's claim as secured "to the extent of the value of such creditor's interest." 11 U.S.C § 506(a)(1). That value is to "be determined in light of the purpose of the valuation and of the proposed disposition or use of such property." *Id.*

In *Associates Commercial Corp. v. Rash*, the Supreme Court adopted a "replacement-value standard" for § 506(a)(1) cram-down valuations. 520 U.S. 953, 956, 117 S.Ct. 1879, 138 L.Ed.2d 148 (1997). The Court held that replacement value, "rather than a foreclosure sale that will not take place, is the proper guide under a prescription hinged to the property's 'disposition or use.' " *Id.* at 963, 117 S.Ct. 1879 (quoting *In re Winthrop Old Farm Nurseries, Inc.*, 50 F.3d 72, 75 (1st Cir. 1995)).

In rejecting a "foreclosure-value standard," the Court also noted that foreclosure value was "typically lower" than replacement value. *Id.* at 960, 117 S.Ct. 1879. Today, however, we confront the atypical case. Because foreclosure would vitiate covenants requiring that the secured property—an apartment complex—be used for low-income housing, foreclosure value in this case exceeds replacement value, which is tied to the debtor's "actual use" of the property in the proposed reorganization. *Id.* at 963, 117 S.Ct. 1879. But we take the Supreme Court at its word and hold, as *Rash* teaches, that § 506(a)(1) requires the use of replacement value rather than a hypothetical value derived from the very foreclosure that the reorganization is designed to avoid. Thus, the bankruptcy court did not err in this case in approving Sunnyslope's plan of reorganization and valuing the collateral assuming its continued use after reorganization as low-income housing.

BACKGROUND

I. The Sunnyslope Project

Sunnyslope Housing Limited Partnership ("Sunnyslope") owns an apartment ***641** complex in Phoenix, Arizona. Construction funding came from three loans. Capstone Realty Advisors, LLC, provided the bulk of the funding through an $8.5 million loan with an interest rate of 5.35%, secured by a first-priority deed of trust. The Capstone loan was guaranteed by the United States Department of Housing and Urban Development ("HUD"), and funded through bonds issued by the Phoenix Industrial Development Authority. The City of Phoenix and the State of Arizona provided the balance of the funding. The City loan was secured by a second-position deed of trust, and the State loan by a third-position deed of trust.

A. The Covenants

To secure financing and tax benefits, Sunnyslope entered into five agreements:

1. To obtain the HUD guarantee, Sunnyslope signed a Regulatory Agreement requiring that the apartment complex be used for affordable housing.

2. Sunnyslope also entered into a Regulatory Agreement with the Phoenix Industrial Development Authority, requiring Sunnyslope to "preserve the tax-exempt status" of the project, and use 40% of the units for low-income housing. The agreement provided that its covenants "shall run with the land and shall bind the Owner, and its successors and assigns and all subsequent owners or operators of the Project or any interest therein." The restrictions, however, terminated on "foreclosure of the lien of the Mortgage or delivery of a deed in lieu of foreclosure."

3. The City of Phoenix required Sunnyslope to sign a Declaration of Affirmative Land Use Restrictive Covenants, mandating that 23 units be set aside for low-income families. The restriction ran with the land and bound "all future owners and operators" but, similarly, would be vitiated by foreclosure.

4. The Arizona Department of Housing required Sunnyslope to enter into a Declaration of Covenants, Conditions, and Restrictions. That 40-year agreement set aside five units for low-income residents. The agreement ran with the land and bound future owners, terminated upon foreclosure, and was expressly subordinate to the HUD Regulatory Agreement.

5. Finally, in order to receive federal tax credits, Sunnyslope agreed with the Arizona Department of Housing to use the entire complex as low-income housing. The tax credits, and restriction on use, would terminate on foreclosure.

B. The Default and its Aftermath

In 2009, Sunnyslope defaulted on the Capstone loan. As guarantor, HUD took over the loan and sold it to First Southern National Bank ("First Southern") for $5.05 million. In connection with the sale, HUD released its Regulatory Agreement. The Loan Sale Agreement confirmed, however, that the property remained subject to the other "covenants, conditions and restrictions."

First Southern began foreclosure proceedings, and an Arizona state court appointed a receiver. In December 2010, the receiver agreed to sell the complex to a third party for $7.65 million.

II. The Bankruptcy Proceedings

Before the sale could close, Sunnyslope filed a Chapter 11 petition. Over First Southern's objection, Sunnyslope sought to retain the complex in its proposed plan of reorganization, exercising the "cram- ***642** down" option in 11 U.S.C. § 1129(b)(2)(A). A successful cram down allows the reorganized debtor to retain collateral over a secured creditor's objection, subject to the requirement in § 506(a)(1) that the debt be treated as secured "to the extent of the value of such creditor's interest" in the collateral.

The central issue in the reorganization proceedings was the valuation of First Southern's collateral, the apartment complex. Sunnyslope asserted that the complex should be valued as low-income housing, while First Southern contended that the complex should instead be valued without regard to Sunnyslope's contractual obligations to use it as low-income housing, which would terminate upon foreclosure.

In that regard, First Southern's expert valued the complex at $7.74 million, making the "extraordinary assumption" that a foreclosure would remove any low-income housing requirements. First Southern's expert also opined, however, that the value of the property was only $4,885,000 if those requirements remained in place. Sunnyslope's expert valued the property at $2.6 million with the low-income housing restrictions in place, and at $7 million without.

During its original proceeding, the bankruptcy court held that, under § 506(a)(1), the value of the property was $2.6 million because Sunnyslope's plan of reorganization called for continued use of the complex as low-income housing. The court also declined to include in the valuation of the complex the tax credits available to Sunnyslope. First Southern then elected to treat its claim as fully secured under 11 U.S.C. § 1111(b).

The bankruptcy court subsequently confirmed the plan of reorganization, which provided for payment in full of the First Southern claim over 40 years, at an interest rate of 4.4%, with a balloon payment at the end without interest. The reorganization plan required the City and State to relinquish their liens, but provided for payment of their unsecured claims in full, albeit without interest, at the end of the 40 years.

The bankruptcy court found the plan fair and equitable under 11 U.S.C. § 1129(b)(1) because First Southern retained its lien, would receive an interest rate equivalent to the prevailing market rate, and could foreclose (and, therefore, obtain the property without the restrictive covenants) should Sunnyslope default. The court also found the plan feasible under 11 U.S.C. § 1129(a)(11), citing Sunnyslope's financial projections, and noting that "the Creditor has come in with no evidence of a lack of feasibility." The court concluded that it was more likely than not that Sunnyslope could make plan payments based on the history of comparable properties. The court also noted that, when the balloon payment came due, the property would be free of the low-income housing restrictions, making the collateral an even more valuable asset.

After confirmation, First Southern obtained a stay of the plan of reorganization from the district court pending appeal. The district court denied First Southern's request for a stay. Cornerstone at Camelback LLC invested $1.2 million in the complex, and the plan was funded. The district court affirmed the reorganization plan as modified. Both parties appealed.

After First Southern unsuccessfully sought a writ from this court prohibiting the bankruptcy court from considering the district court's remand pending resolution of the appeals, the bankruptcy court valued the tax credits at $1.3 million, added that amount to its previous valuation, and re-confirmed the plan of reorganization. First Southern attempted to withdraw its ***643** § 1111(b) election, but the bankruptcy court denied the request.

First Southern again appealed. The district court denied First Southern's request for a stay and affirmed the reorganization plan as modified. First Southern timely appealed to this court, and Sunnyslope cross-appealed.

III. Panel Opinion

After the various appeals were consolidated, a divided panel of this court reversed the bankruptcy court's order approving the plan of reorganization, holding that the court should have valued the apartment complex without regard to the affordable housing requirements. *In re Sunnyslope Hous. Ltd. P'ship*, 818 F.3d 937, 940 (9th Cir. 2016). The majority held that, under § 506(a)(1), replacement cost "is a measure of what it would cost to produce or acquire an equivalent piece of property" and that "the replacement value of a 150-unit apartment complex does not take into account the fact that there is a restriction on the use of the complex." *Id.* at 948 n.5. The dissenting opinion, in contrast, argued that "a straightforward application" of *Rash* "compels valuing First Southern's collateral ... in light of Sunnyslope's proposed use of the property in its plan of reorganization as affordable housing." *Id.* at 950 (Paez, J., dissenting). [1]

A majority of the active judges of this court voted to grant Sunnyslope's petition for rehearing en banc, and the panel opinion was vacated. *In re Sunnyslope Hous. Ltd. P'ship*, 838 F.3d 975 (9th Cir. 2016); *see* Fed. R. App. P. 35.

DISCUSSION

The critical issue for decision is whether the bankruptcy court erred by valuing the apartment complex assuming its continued use after reorganization as low-income housing. In addition, First Southern contends that the plan of reorganization is neither fair and equitable nor feasible, and that the district court erred in not allowing it to withdraw its § 1111(b) election.

I. Valuation

[1] When a Chapter 11 debtor opts for a cram down, a creditor's claim is secured "to the extent of the value of such creditor's interest in the estate's interest in [the secured] property." 11 U.S.C. § 506(a)(1). The value of that claim is "determined in light of the purpose of the valuation and of the proposed disposition or use of such property." *Id.* We established long ago that, "[w]hen a Chapter 11 debtor or a Chapter 13 debtor intends to retain property subject to a lien, the purpose of a valuation under section 506(a) is not to determine the amount the creditor would receive if it hypothetically had to foreclose and sell the collateral." *In re Taffi*, 96 F.3d 1190, 1192 (9th Cir. 1996) (en banc). The debtor is "in, not outside of, bankruptcy," so "[t]he foreclosure value is not relevant" because the creditor "is not foreclosing." *Id.*

In *Taffi*, we noted that our decision was consistent with the approach of all but one circuit—the Fifth—which had adopted a foreclosure-value standard in *In re Rash*, 90 F.3d 1036 (5th Cir. 1996) (en banc). *See* 96 F.3d at 1193. There, the Rashes owed $41,171 on a freight-hauler truck loan when they filed a Chapter 13 petition. ***644** *Rash*,

520 U.S. at 956, 117 S.Ct. 1879. They sought to retain the truck through a cram down, proposing a reorganization plan paying the creditor for the foreclosure value of the truck, which they contended was $28,500. *Id.* at 957, 117 S.Ct. 1879. In contrast, the creditor argued the truck should be valued at "the price the Rashes would have to pay to purchase a like vehicle," estimated at $41,000. *Id.* But the Fifth Circuit disagreed and held that § 506(a)(1) required the use of foreclosure value. *Rash*, 90 F.3d at 1060–61.

[2] One year after we decided *Taffi*, the Supreme Court reversed the Fifth Circuit. The Court held, consistent with *Taffi*, that "§ 506(a) directs application of the replacement-value standard," rather than foreclosure value. *Rash*, 520 U.S. at 956, 117 S.Ct. 1879.[2] The Court stated that the value of collateral under § 506(a)(1) is "the cost the debtor would incur to obtain a like asset for the same 'proposed ... use.' " *Id.* at 965, 117 S.Ct. 1879 (alteration in original).

Rash stressed the instruction in § 506(a)(1) to value the collateral based on its "proposed disposition or use" in the plan of reorganization. *Id.* at 962, 117 S.Ct. 1879. The Court emphasized that, in a reorganization involving a cram down, the debtor will continue to use the collateral, and valuation must therefore occur "in light of the proposed repayment plan reality: no foreclosure sale." *Id.* at 963, 117 S.Ct. 1879 (alteration omitted) (quoting *Winthrop Old Farm Nurseries*, 50 F.3d at 75). The "actual use," the Court held, "is the proper guide," *id.*, and replacement value is therefore "the price a willing buyer in the debtor's trade, business, or situation would pay to obtain like property from a willing seller," *id.* at 960, 117 S.Ct. 1879.

[3] *Rash* also teaches that the determination of replacement value by the bankruptcy court is a factual finding. *Id.* at 965 n.6, 117 S.Ct. 1879. We therefore review the valuation determination in this case for clear error. *In re JTS Corp.*, 617 F.3d 1102, 1109 (9th Cir. 2010). We find none.

[4] The essential inquiry under *Rash* is to determine the price that a debtor in Sunnyslope's position would pay to obtain an asset like the collateral for the particular use proposed in the plan of reorganization. 520 U.S. at 965, 117 S.Ct. 1879. First Southern does not dispute that there was substantial evidence before the bankruptcy court that it would cost Sunnyslope $3.9 million to acquire a property like the apartment complex (including the tax-credits) with similar restrictive covenants requiring that it be devoted to low-income housing.

Despite this, First Southern argues that the property should instead be valued at its "highest and best use"—housing without any low-income restrictions. But § 506(a)(1) speaks expressly of the reorganization plan's "proposed disposition or use." Absent foreclosure, the very event that the Chapter 11 plan sought to avoid, Sunnyslope cannot use the property except as affordable housing, nor could anyone else. *Rash* expressly instructs that a § 506(a)(1) valuation cannot consider what would happen after a hypothetical foreclosure—the valuation must instead reflect the property's "actual use." 520 U.S. at 963, 117 S.Ct. 1879.

First Southern attempts to distinguish *Rash* by noting that foreclosure value is greater than replacement value in this case. But *Rash* implicitly acknowledged ***645** that this outcome might occasionally be the case, and nonetheless adopted a replacement-value standard. *See* 520 U.S. at 960, 117 S.Ct. 1879. We cannot depart from that standard without doing precisely what *Rash* instructed bankruptcy courts to avoid—assuming a foreclosure that the Chapter 11 petition prevented. *See id.* at 963, 117 S.Ct. 1879.

To be sure, a creditor is better off whenever the highest possible value for its collateral is chosen, and *Rash* did in fact recognize that when "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." *Id.* at 962, 117 S.Ct. 1879. But *Rash* did not adopt a rule requiring that the bankruptcy court value the collateral at the higher of its foreclosure value or replacement value. Rather, it expressly rejected the use of foreclosure value, and instead stressed the requirement in § 506(a)(1) that the property be valued in light of its "proposed disposition or use." 520 U.S. at 960, 962, 117 S.Ct. 1879. Here, the proposed disposition and use is for low-income housing; indeed, no other use is possible without foreclosure. First Southern may be exposed to an increased risk under the cram down, but that does not allow us to ignore the command of *Rash*.

First Southern also argues that the low-income housing requirements do not apply to its security because HUD released its Regulatory Agreement, and all other

covenants are junior to its lien. Although the State and City liens may be subordinate to First Southern's, it is undisputed the restrictions they impose continue to run with the land absent foreclosure. Thus, they were properly considered in determining the value of the collateral.

[5] Finally, First Southern's amici argue that valuing the collateral with the low-income restrictions in place would discourage future lending on like projects. We disagree. "[W]hile the protection of creditors' interests is an important purpose under Chapter 11, the Supreme Court has made clear that successful debtor reorganization and maximization of the value of the estate are the primary purposes." *In re Bonner Mall P'ship*, 2 F.3d 899, 916 (9th Cir. 1993) (footnote omitted), *abrogated on other grounds by Bullard v. Blue Hills Bank*, —— U.S. ——, 135 S.Ct. 1686, 191 L.Ed.2d 621 (2015). Allowing the debtor to "rehabilitate the business" generally maximizes the value of the estate. *Id.* And, in this case, First Southern bought the Sunnyslope loan at a substantial discount, knowing of the risk that the property would remain subject to the low-income housing requirements. Valuing First Southern's collateral with those restrictions in mind subjects the lender to no more risk than it consciously undertook. *See Rash*, 520 U.S. at 962–63, 117 S.Ct. 1879.

Accordingly, we hold that the bankruptcy court did not err in valuing First Southern's collateral in the plan of reorganization assuming its continued use as affordable housing. [3]

***646 II. Plan Fairness**

[6] The cram-down provision in 11 U.S.C. § 1129(b) requires that the reorganization plan be "fair and equitable." The secured creditor must retain its lien, § 1129(b)(2)(A)(i)(I), and receive payments over time equaling the present value of the secured claim, § 1129(b)(2)(A)(i)(II). Whether a plan is fair and equitable is a factual determination reviewed for clear error. *In re Acequia, Inc.*, 787 F.2d 1352, 1358 (9th Cir. 1986).

The bankruptcy court found the Sunnyslope plan fair and equitable because First Southern retained its lien and received the present value of its allowed claim over the term of the plan. There is no dispute that First Southern retained its lien, and our discussion above disposes of any contention that its secured claim was undervalued. Thus, the only remaining question is whether the bankruptcy court erred in concluding that the plan provides for payments equal to the present value of the secured claim.

[7] **[8]** The interest rate chosen must ensure that the creditor receives the present value of its secured claim through the payments contemplated by the plan of reorganization. *Till v. SCS Credit Corp.*, **541 U.S. 465**, 469, 124 S.Ct. 1951, 158 L.Ed.2d 787 (2004). In *Till*, a plurality endorsed the "formula approach" for calculating the appropriate interest rate, which begins with the national prime rate and adjusts up or down according to the risk of the plan's success. *Id.* at 478–79, 124 S.Ct. 1951. The creditor bears the burden of showing that the prime rate does not adequately account for the riskiness of the debtor. *Id.*

[9] First Southern argues that it is not receiving the present value of its secured claim because the interest rate adopted in the plan, 4.4%, is lower than the original rate on its loan. But we find no clear error in the bankruptcy court's determination. The bankruptcy court conducted a hearing at which it heard expert testimony, applied the *Till* test, and found that the 4.4% interest rate on the plan payments would result in First Southern's receiving the present value of its $3.9 million security over the term of the reorganization plan. The relevant national prime rate was 3.25%, and the bankruptcy court adjusted that rate upward to account for the risk of non-payment. The court also heard testimony that the market loan rate for similar properties was 4.18%. In setting the 4.4% rate, the bankruptcy court carefully explained its reasoning, noting that interest rates had decreased significantly since the Capstone loan was made. The bankruptcy court also noted that the risk to the lender had similarly decreased since then because, when the loan was made, the apartment complex had not yet been built. [4]

The bankruptcy court did not clearly err, and we affirm its determination.

III. Plan Feasibility

[10] **[11]** Plan confirmation also requires a finding that the debtor will not require further reorganization. 11 U.S.C. § 1129(a)(11). It therefore requires the debtor to demonstrate that the plan "has a ***647** reasonable probability of success." *Acequia*, 787 F.2d at 1364. A bankruptcy court's finding of feasibility is reviewed for abuse of discretion. *Id.* at 1365.

[12] The bankruptcy court did not abuse its discretion in finding the Sunnyslope plan feasible. A projection showed that Sunnyslope would be able to make plan payments, and expert testimony confirmed that the collateral would remain useful for 40 years (the term of the plan). The court also found the balloon payment feasible because it was secured by property whose value exceeded the value of the remaining First Southern claim. And the court noted that First Southern had "come in with no evidence of a lack of feasibility." It was therefore well within the bankruptcy court's discretion to find that the plan of reorganization was feasible.

IV. The § 1111(b) Election

Finally, § 1111(b) of the Bankruptcy Code allows a secured creditor to elect to have its claim treated as either fully or partially secured. An election affects the treatment of the unsecured portion of the claim under the plan and the procedural protections afforded to the creditor. *See, e.g.*, 11 U.S.C. § 1129(a)(7)(B). In the absence of a contrary order by the bankruptcy court, the creditor must make this election before the end of the disclosure statement hearing. Fed. R. Bankr. P. 3014.

In this case, the bankruptcy court ordered that First Southern make its § 1111(b) election "7 calendar days after the court issues a ruling on valuation." First Southern timely did so, choosing to treat its entire claim as secured.

[13] **[14]** First Southern now argues that the bankruptcy court erred in not allowing it to make a second election after the district court remanded and required the tax credits be added to the valuation. In effect, First Southern contends that the bankruptcy court erred by not amending its scheduling order to allow the creditor a second bite at the apple. A bankruptcy court may modify a scheduling order "for cause," Fed. R. Bankr. P. 9006(b)(1), and we review its decision whether to do so for abuse of discretion, *see In re Zilog, Inc.*, 450 F.3d 996, 1006–07 (9th Cir. 2006). We assume without deciding that a court should modify a scheduling order to allow a creditor to change its § 1111(b) election after a material alteration to the original plan. *See In re Scarsdale Realty Partners, L.P.*, 232 B.R. 300, 300 (Bankr. S.D.N.Y. 1999); *see also In re Keller*, 47 B.R. 725, 730 (Bankr. N.D. Iowa 1985). But, in this case, we agree with the district court that the only alteration in the plan—the increased valuation of the collateral—was not material to the election decision.

When First Southern made its election, the plan provided for 40 years of payments of principal and interest providing the creditor with the present value of its $2.6 million secured claim, with a final balloon payment covering the remainder of the debt. After remand, as the district court noted, "First Southern's treatment under the plan as modified remains the same; the only difference is that its annual payments will be more and the balloon payment at the end of the 40 years will be less."

Significantly, the amended plan of reorganization did not alter the treatment of unsecured claims, which are to be paid without interest in 40 years, or immediately at five cents on the dollar. Thus, First Southern knew at the time of the initial election "the prospects of its treatment under the plan," *Keller*, 47 B.R. at 729 (quoting Fed. R. Bankr. P. 3014 advisory committee note), yet it opted to treat its entire claim as secured.

***648** Allowing a second election would give First Southern a second chance to object to the plan, this time both as a secured and unsecured creditor and, given the potential size of the unsecured claim, the ability to prevent approval of the reorganization plan. *See* 11 U.S.C. § 1129(a)(7)(A)(ii). But this is precisely the option First Southern had at the time of its first election, when it chose to forgo having any portion of its claim treated as unsecured, instead seeking to increase the valuation of its secured claim through appeal. That gambit failed, and the bankruptcy court did not err when it rejected First Southern's attempt to turn back the clock and torpedo the plan of reorganization.

CONCLUSION

We **AFFIRM** the judgment of the district court. [5]

KOZINSKI, Circuit Judge, with whom Circuit Judges O'SCANNLAIN and FRIEDLAND join, dissenting:

Today's opinion claims to "take the Supreme Court at its word," but it fetishizes a selection of the Court's words at the expense of its logic. This cramped formalism produces a strange result: Even though the Court has told us that cramdown valuations are supposed to limit a secured creditor's risk, we've adopted a new valuation

standard that turns entirely on the debtor's desires—creditors be damned. Instead of holding the valuation hostage to the debtor's "particular use," I would hold that the appropriate value is the market price of the building without restrictive covenants. [1]

The majority purports to rely on *Associates Commercial Corp. v. Rash*, 520 U.S. 953, 117 S.Ct. 1879, 138 L.Ed.2d 148 (1997), but *Rash* never adopted today's strict "particular use" interpretation of replacement value. The Court was more flexible: "Whether replacement value is the equivalent of retail value, wholesale value, or some other value will depend on the type of debtor and the nature of the property." *Id.* at 965 n.6, 117 S.Ct. 1879. After all, the bare notion of "replacement value" isn't self-interpreting. A conservation-minded owner may prefer to see his lands stay wild. He may adopt an easement to keep them that way, and may not care that this drastically reduces the commercial value of the property. But the owner's preferences don't shape the market value of an undeveloped acre—which is what the owner who actually *did* buy new replacement property would have to pay.

What interpretation of "replacement value" should we use? Unhelpfully, *Rash* offers few specifics on how the nature of the property and the debtor should affect valuation. [2] But *Rash* expressly notes that replacement value shouldn't include certain warranties and modifications that drive a ***649** wedge between private value and market value. *See id.* And *Rash* was unambiguously motivated by a desire to reduce what it saw as the "double risks" that cramdowns pose for creditors: "The debtor may again default and the property may deteriorate from extended use." *Id.* at 962, 117 S.Ct. 1879. With these risks in mind, the *Rash* Court adopted a broad standard—the typically higher replacement value over the typically lower foreclosure value—that would give secured creditors their due protection. *See also Till* v. *SCS Credit Corp.*, **541 U.S. 465**, 489, 124 S.Ct. 1951, 158 L.Ed.2d 787 (2004) (Thomas, J., concurring) (noting that creditors are "compensated in part for the risk of nonpayment through the valuation of the secured claim" because *Rash* used a "secured-creditor-friendly replacement-value standard rather than the lower foreclosure-value standard"). A moment's reflection reveals why today's holding is at odds with these motivations: The majority's valuation falls well below what the secured creditor would obtain from an immediate sale. [3]

In short, the majority has adopted a test that is not dictated by the letter of *Rash* and is contradicted by its reasoning. For these reasons, and those offered by Judge Clifton in his panel opinion, *In re Sunnyslope Hous. Ltd. P'ship*, 818 F.3d 937 (9th Cir. 2016), I dissent.

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Footnotes

1 The panel unanimously rejected Sunnyslope's contention that the appeal was equitably moot because the plan of reorganization had gone into effect during the appeal. *Sunnyslope*, 818 F.3d at 945 (majority); *id.* at 950 n.1 (dissent). And, because the panel reversed the order approving the reorganization plan on the valuation issue, it pretermitted the other issues raised by the parties. *See id.* at 949 n.6 (majority).

2 *Rash* used the term "replacement" value, but noted that the term is consistent with the "fair-market" valuation nomenclature that we used in *Taffi*. *Rash*, 520 U.S. at 959 n.2, 117 S.Ct. 1879.

3 The dissent correctly notes the statement in *Rash* that "[w]hether replacement value is the equivalent of retail value, wholesale value, or some other value will depend on the type of debtor and the nature of the property." 520 U.S. at 965 n.6, 117 S.Ct. 1879. But the very footnote in which that language appears stresses "that the replacement-value standard, not the foreclosure-value standard, governs in cram down cases." *Id.* Given the Court's plain injunction that "actual use, not a foreclosure sale that will not take place, is the proper guide" to determining replacement value, *id.* at 963, 117 S.Ct. 1879, a bankruptcy court surely cannot premise a § 506(a) valuation on a hypothetical foreclosure. And, First Southern had no ability to sell the property free and clear of the low-income restrictions absent such a foreclosure.

4 First Southern contends that the bankruptcy court erred by considering the chance of a second default as a credit enhancement. But if Sunnyslope defaults a second time, First Southern can foreclose and obtain a property worth more

than the court's § 506(a)(1) valuation. *See Till*, 541 U.S. at 479, 124 S.Ct. 1951 (noting that risk can be evaluated in light of "the nature of the security").

5 Sunnyslope's cross-appeal argues that the tax credits should not have been included in the valuation of the security. At oral argument, counsel for Sunnyslope stated that this argument would be withdrawn if the bankruptcy court's valuation were otherwise affirmed. Given our conclusions above, we do not address the tax credit issue. In the exercise of our discretion, we also decline to address Sunnyslope's argument that the appeal is equitably moot. *See In re Transwest Resort Props., Inc.*, 801 F.3d 1161, 1167 (9th Cir. 2015) (noting that "[e]quitable mootness is a prudential doctrine").

1 In this case, the price a buyer would have to pay on the market for like property may be closely approximated by "foreclosure value." That coincidence drives the majority's analysis, but it does nothing to answer the real question presented by this case: Whether the market valuation commanded by *Rash* turns on a debtor's idiosyncratic use of the particular property. It does not.

2 The fact that *Rash* does not adopt a strict definition of "replacement value" and offers little guidance on how to apply it has been widely appreciated by other courts and commentators. *See, e.g.*, Charles Jordan Tabb, *Law of Bankruptcy* 741 (4th ed. 2016) (describing footnote 6 of *Rash* as a "substantial opening" that has allowed a wide variety of valuation standards to flourish). I make no effort to defend *Rash*, which has been subject to abundant criticism along these lines. But I also see no reason to step beyond it, as today's majority does.

3 In my view, much of this risk will be passed on to borrowers in the form of higher interest rates—in which case, the joke's on future Sunnyslopes. Regardless, the Supreme Court expressly held that "[a]djustments in the interest rate and secured creditor demands for more 'adequate protection' do not fully offset" the risks of cramdowns. 520 U.S. at 962–63, 117 S.Ct. 1879 (quoting 11 U.S.C. § 361). Of course, one reason for ex-post credit risk might be *Rash* itself: It's hard for parties to bargain in the shadow of an unclear rule.

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KeyCite Yellow Flag - Negative Treatment
Distinguished by In re Couture Hotel Corporation, Bankr.N.D.Tex., September 2, 2015

710 F.3d 324
United States Court of Appeals,
Fifth Circuit.

In the Matter of TEXAS GRAND PRAIRIE HOTEL REALTY, L.L.C., Debtor.
Wells Fargo Bank National Association, as Trustee for the Morgan Stanley Capital I Incorporated, Commercial Mortgage Pass–Through Certificates Trust, Series 2007–XLF9, acting by and through its Special Servicer, Berkadia Commercial Mortgage, L.L.C., Appellant
v.
Texas Grand Prairie Hotel Realty, L.L.C.; Texas Austin Hotel Realty, L.L.C.; Texas Houston Hotel Realty, L.L.C.; Texas San Antonio Hotel Realty, L.L.C., Appellees.

No. 11–11109.
|
March 1, 2013.

Synopsis

Background: Debtors sought confirmation of proposed Chapter 11 "cramdown" plan over secured creditor's objection. Secured creditor moved to strike testimony of debtors' expert regarding appropriate cramdown rate of interest. The United States Bankruptcy Court for the Northern District of Texas denied the motion to strike, adopted expert's analysis as correct, and confirmed the plan. Secured creditor appealed. The District Court, John H. McBryde, J., 2011 WL 5429087, affirmed, and secured creditor appealed. Debtors moved to dismiss appeal as equitably moot.

Holdings: The Court of Appeals, Patrick E. Higginbotham, Circuit Judge, held that:

[1] the appeal was not equitably moot;

[2] the Court of Appeals reviews a bankruptcy court's entire cramdown-rate analysis only for clear error; and

[3] the bankruptcy court did not clearly err in approving a 5% cramdown rate of interest.

Affirmed.

West Headnotes (16)

[1] **Bankruptcy**
Moot questions

Doctrine of equitable mootness is unique to bankruptcy proceedings, responsive to the reality that there is a point beyond which a court cannot order fundamental changes in reorganization actions.

Cases that cite this headnote

[2] **Bankruptcy**
Effect of want of stay;conclusiveness of sale

Bankruptcy
Moot questions

To establish the equitable mootness of an appeal, Chapter 11 debtor-appellee must show that (1) the plan of reorganization has not been stayed, (2) the plan has been "substantially consummated," and (3) the relief requested by the appellant would affect either the rights of parties not before the court or the success of the plan.

1 Cases that cite this headnote

[3] **Bankruptcy**
Moot questions

Fifth Circuit has taken a narrow view of equitable mootness, particularly where pleaded against a secured creditor.

Cases that cite this headnote

[4] **Bankruptcy**
Effect of want of stay;conclusiveness of sale

Bankruptcy

Moot questions

Secured creditor's appeal from district court decision affirming bankruptcy court's confirmation of Chapter 11 debtors' "cramdown" plan was not equitably moot; although secured creditor conceded that plan had not been stayed and that plan had been "substantially consummated," debtors' concerns that granting relief to secured creditor would result in a "cataclysmic unwinding" of the plan, jeopardizing nearly $8 million in distributions made under the plan as well as numerous transactions with third parties, need not have been realized, as Court of Appeals could grant partial relief to secured creditor without disturbing the reorganization, such as by awarding a slightly higher cramdown interest rate or granting a small money judgment, and debtors did not present compelling evidence that granting fractional relief would unduly burden the rights of third parties not before the court. 11 U.S.C.A. § 1129(b).

1 Cases that cite this headnote

[5] **Bankruptcy**

Moot questions

Equitable mootness protects only the rights of parties not before the court.

Cases that cite this headnote

[6] **Bankruptcy**

Discretion

Court of Appeals reviews a trial court's decision to admit expert testimony for abuse of discretion.

1 Cases that cite this headnote

[7] **Evidence**

Matters involving scientific or other special knowledge in general

Evidence

Necessity and sufficiency

Rule governing expert testimony requires trial courts to ensure that proffered expert testimony is not only relevant, but reliable. Fed.Rules Evid.Rule 702, 28 U.S.C.A.

Cases that cite this headnote

[8] **Evidence**

Necessity and sufficiency

To determine reliability of proffered expert testimony, trial court must make a preliminary assessment of whether the reasoning or methodology underlying the testimony is scientifically valid and of whether that reasoning or methodology can properly be applied to the facts in issue. Fed.Rules Evid.Rule 702, 28 U.S.C.A.

2 Cases that cite this headnote

[9] **Evidence**

Necessity and sufficiency

Trial court ought not transform a *Daubert* hearing into a trial on the merits. Fed.Rules Evid.Rule 702, 28 U.S.C.A.

1 Cases that cite this headnote

[10] **Evidence**

Necessity and sufficiency

Most of the safeguards provided for in *Daubert* are not as essential in a case where a district judge sits as the trier of fact in place of a jury. Fed.Rules Evid.Rule 702, 28 U.S.C.A.

2 Cases that cite this headnote

[11] **Bankruptcy**

Confirmation;Objections

Where secured creditor, in moving to strike the testimony of Chapter 11 debtors' expert regarding the appropriate "cramdown" rate of interest for its secured claim, did not challenge expert's factual findings, calculations, or financial projections but, rather, argued that expert's analysis as a whole rested on a flawed understanding of governing Supreme Court precedent, such that secured creditor's *Daubert* motion was indistinguishable from its argument on the

merits, bankruptcy judge reasonably deferred secured creditor's *Daubert* argument to the plan confirmation hearing instead of deciding it before the hearing. Fed.Rules Evid.Rule 702, 28 U.S.C.A.

Cases that cite this headnote

[12] Bankruptcy
Secured creditors, protection of

Chapter 11 debtor may "cram down" a reorganization plan over the dissent of a secured creditor only if the plan provides the creditor with deferred payments of a "value" at least equal to the "allowed amount" of the secured claim as of the effective date of the plan; in other words, the deferred payments, discounted to present value by applying an appropriate interest rate, that is, the "cramdown rate," must equal the allowed amount of the secured creditor's claim. 11 U.S.C.A. § 1129(b).

10 Cases that cite this headnote

[13] Bankruptcy
Particular cases and issues

Fifth Circuit reviews a bankruptcy court's entire cramdown-rate analysis in Chapter 11, including both its factual findings and its choice of methodology, only for clear error. 11 U.S.C.A. § 1129(b).

4 Cases that cite this headnote

[14] Courts
Number of judges concurring in opinion, and opinion by divided court

Panel of the Fifth Circuit may only overrule a prior panel decision if such overruling is unequivocally directed by controlling Supreme Court precedent.

5 Cases that cite this headnote

[15] Interest
Computation of rate in general

Under the *Till* plurality's "prime-plus" formula method for calculating the Chapter 13 cramdown rate of interest on a secured claim, bankruptcy court should begin its cramdown rate analysis with the national prime rate, that is, the rate charged by banks to creditworthy commercial borrowers, and then add a supplemental "risk adjustment" to account for such factors as the circumstances of the estate, the nature of the security, and the duration and feasibility of the reorganization plan. 11 U.S.C.A. § 1129(b).

16 Cases that cite this headnote

[16] Interest
Computation of rate in general

Bankruptcy court did not clearly err in confirming Chapter 11 plan that contained 5% "cramdown" rate of interest for creditor's secured claim; cramdown rate determination of debtors' expert, on which court relied, rested on uncontroversial application of *Till* plurality's "prime-plus" formula method for calculating Chapter 13 cramdown interest, expert engaged in holistic evaluation of debtors, concluding that quality of estate was sterling, that debtors' revenues were exceeding projections, that creditor's collateral, primarily real estate, was liquid and stable or appreciating in value, and that reorganization plan would be tight but feasible, based on these findings, which were independently verified by creditor's expert, debtors' expert assessed risk adjustment of 1.75% over prime, which fell squarely within range of adjustments that other courts had assessed in similar circumstances, and creditor's expert predicated his 8.8% rate on analysis rejected by *Till* plurality. 11 U.S.C.A. § 1129(b).

13 Cases that cite this headnote

Attorneys and Law Firms

***326** Brian Christopher Walsh, Bryan Cave, L.L.P., Saint Louis, MO, Keith Miles Aurzada, Bryan Cave, L.L.P., Dallas, TX, for Appellant.

Davor Rukavina, Munsch, Hardt, Kopf & Harr, P.C., Dallas, TX, for Appellees.

Appeal from the United States District Court for the Northern District of Texas.

Before HIGGINBOTHAM, ELROD, and HAYNES, Circuit Judges.

Opinion

PATRICK E. HIGGINBOTHAM, Circuit Judge:

Wells Fargo Bank National Association ("Wells Fargo") appeals from a district court decision affirming confirmation of a Chapter 11 cramdown plan. Finding no error in the bankruptcy court's judgment, [1] we affirm.

***327 I.**

In 2007, Texas Grand Prairie Hotel Realty, LLC, Texas Austin Hotel Realty, LLC, Texas Houston Hotel Realty, LLC, and Texas San Antonio Hotel Realty, LLC (collectively, "Debtors") obtained a $49,000,000 loan from Morgan Stanley Mortgage Capital, Inc., applying the proceeds to acquire and renovate four hotel properties in Texas. Morgan Stanley—not a party to this case—took a security interest in the hotel properties and in substantially all of the Debtors' other assets. Wells Fargo eventually acquired the loan from Morgan Stanley.

In 2009, the Debtors' hotel business soured. Unable to pay Wells Fargo's loan as payment came due, the Debtors filed for Chapter 11 protection and proposed a plan of reorganization. When Wells Fargo rejected the proposed reorganization, the Debtors sought to cram down their plan under 11 U.S.C. § 1129(b). The plan valued Wells Fargo's secured claim at roughly $39,080,000, in accordance with Wells Fargo's own appraisal. Under the plan, the Debtors proposed to pay off Wells Fargo's secured claim over a term of ten years, with interest accruing at 5%—1.75% above the prime rate on the date of the confirmation hearing. [2]

The bankruptcy court held a two-day evidentiary hearing to assess whether it could confirm the Debtors' plan under § 1129(b) over Wells Fargo's objection. Among other things, Wells Fargo challenged the Debtors' proposed 5% interest rate on its secured claim. Both parties stipulated that the applicable rate should be determined by applying the "prime-plus" formula endorsed by a plurality of the Supreme Court in *Till v. SCS Credit Corp.* [3] However, the parties' experts disagreed on the application of that formula: whereas the Debtors' expert—Mr. Louis Robichaux—testified that it supported a 5% rate, Wells Fargo's expert insisted that it mandated a rate of at least 8.8%.

Wells Fargo filed a *Daubert* motion seeking to strike Robichaux's testimony under Rule 702, insisting that "Robichaux's ... failure to correctly apply *Till* and its progeny show[s] that his methodology is flawed, does not comport with applicable law, and is unreliable." The bankruptcy court denied Wells Fargo's motion to strike, adopted Robichaux's analysis as correct, and confirmed the Debtors' cramdown plan.

Wells Fargo appealed to the district court, challenging the bankruptcy court's decision to admit Robichaux's testimony as well as the court's adoption of Robichaux's § 1129(b) interest-rate analysis. The district court affirmed and this appeal followed. The Debtors have moved to dismiss the appeal as equitably moot.

II.

[1] **[2]** We begin by reviewing *de novo* the Debtors' equitable mootness defense. [4] The doctrine of equitable mootness is unique to bankruptcy proceedings, responsive to the reality that "there is a point beyond which a court cannot order fundamental changes in reorganization actions." [5] To establish equitable mootness, a debtor must show that (i) the plan of reorganization has not been stayed, (ii) the plan has been "substantially consummated," and (iii) the relief requested by the ***328** appellant would "affect either the rights of parties not before the court or the success of the plan." [6] Wells Fargo here stipulates that the first two elements are satisfied.

[3] This Circuit has taken a narrow view of equitable mootness, particularly where pleaded against a secured creditor.[7] Reasoning that "the possibility of partial recovery obviates the need for equitable mootness,"[8] we have permitted appeals to go forward even where granting full relief "could have imposed a very significant liability on the estate, to the great detriment of both the success of the reorganization and third parties."[9] For example, in *Matter of Scopac,* we permitted secured creditors to appeal a bankruptcy court valuation order whose reversal had the potential to—and ultimately *did*—impose millions of dollars in liability on a cash-starved entity just emerging from bankruptcy.[10] In *Matter of Pacific Lumber Co.,* we allowed a secured creditor to appeal under similar circumstances.[11]

[4] The Debtors insist that granting relief to Wells Fargo could result in a cataclysmic unwinding of the reorganization plan. According to the Debtors, "all of the nearly $8 million in distributions made under the Plan, and all of the other actions taken in furtherance and implementation of the Plan—including transactions with third parties—will be in jeopardy of needing to be undone, clawed back, or otherwise abrogated." Moreover, the Debtors contend, any money judgment against them would come out of the pockets of unsecured creditors, as "[t]here is just one 'pot' of funds to distribute." Finally, the Debtors aver, a judgment in favor of Wells Fargo would affect the rights and expectations of the "Equity Purchaser"—that is, the Debtors themselves—who paid a substantial sum to acquire equity in the bankrupt entities pursuant to the reorganization plan.

While the Debtors' concerns might be realized, they need not be. This Court could grant partial relief to Wells Fargo without disturbing the reorganization, by, for example, awarding a slightly higher § 1129(b) cramdown interest rate or granting a small money judgment. The Debtors present no credible evidence that granting such fractional relief would require unwinding any of the transactions undertaken pursuant to the reorganization plan; indeed, by the Debtors' own account, they are *not* cash starved like the debtors in *Pacific Lumber* or *Scopac,* having enjoyed a substantial improvement in their revenues and cash position after filing for bankruptcy.

Nor do the Debtors present compelling evidence that granting fractional relief ***329** would unduly burden the rights of third parties not before the court. Though the reorganization plan ties the unsecured creditors' recovery to the Debtors' projected net operating income through 2015, the Debtors' *actual* net operating income may be higher. Moreover, in fiscal years 2016 and 2017—after the Debtors' payment obligations to unsecured creditors have ended—the Debtors' own projections show a net operating income of approximately $3,200,000. In other words, the possibility exists that the Debtors could afford a fractional payout without reducing distributions to third-party claimants.

[5] As for the Debtors' assertion that a fractional award to Wells Fargo would affect their interest as equity holders in the reorganized bankrupt, perhaps they are correct. But equitable mootness protects only "the rights of *parties not before the court.*"[12] The fact "that a judgment might have adverse consequences [to the equity holders of the reorganized bankrupt] is not only a natural result of any appeal ... but [should have been] foreseeable to them as sophisticated investors."[13]

Unpersuaded by the Debtors' motion to dismiss this appeal as equitably moot, we proceed to the merits, turning first to Wells Fargo's claim that the bankruptcy court erred in admitting the testimony of the Debtors' restructuring expert—Mr. Louis Robichaux—regarding the appropriate § 1129(b) cramdown rate of interest.

III.

According to Wells Fargo, Robichaux's testimony is inadmissible under Rule 702 because his "purely subjective approach to interest-rate setting" violates the Supreme Court's decision in *Till,* which "call[s] for an objective inquiry."

[6] **[7]** **[8]** **[9]** **[10]** We review a trial court's decision to admit expert testimony for abuse of discretion.[14] As read by *Daubert,* Rule 702 requires trial courts to ensure that proffered expert testimony is "not only relevant, but reliable."[15] To determine reliability, the trial court must make a "preliminary assessment of whether the reasoning or methodology underlying the testimony is scientifically valid and of whether that reasoning or methodology can properly be applied to the facts in issue."[16] Two cautions signify: the trial court ought not "transform a *Daubert*

hearing into a trial on the merits," [17] and "most of the safeguards provided for in *Daubert* are not as essential in a case ... where a district judge sits as the trier of fact in place of a jury." [18]

[11] Here, Wells Fargo does not challenge Robichaux's factual findings, calculations, or financial projections, but rather argues that Robichaux's analysis as a whole rested on a flawed understanding of *Till.* As we read it, Wells Fargo's *Daubert* motion is indistinguishable from its argument on the merits. It follows that the bankruptcy judge reasonably deferred Wells Fargo's *Daubert* argument to the ***330** confirmation hearing instead of deciding it before the hearing. [19] We pursue the same path and proceed to the merits.

IV.

Wells Fargo claims that the bankruptcy court erred in setting a 5% cramdown rate. We turn first to the standard under which this Court reviews a Chapter 11 cramdown rate determination, then to its application.

A.

[12] Under 11 U.S.C. § 1129(b), a debtor can "cram down" a reorganization plan over the dissent of a secured creditor only if the plan provides the creditor—in this case Wells Fargo—with deferred payments of a "value" at least equal to the "allowed amount" of the secured claim as of the effective date of the plan. [20] In other words, the deferred payments, discounted to present value by applying an appropriate interest rate (the "cramdown rate"), must equal the allowed amount of the secured creditor's claim. [21]

[13] Wells Fargo contends that though a bankruptcy court's factual findings under § 1129(b) are reviewed only for clear error, a bankruptcy court's choice of *methodology* for calculating the § 1129(b) cramdown rate is a question of law subject to *de novo* review. Wells Fargo suggests that the Supreme Court's decision in *Till* supports its position, reasoning that *Till* is "controlling authority" that requires bankruptcy courts to apply the prime-plus formula to calculate the Chapter 11 cramdown rate.

We disagree. In *T–H New Orleans,* we "[declined] to establish a particular formula for determining an appropriate cramdown interest rate" under Chapter 11, reviewing the bankruptcy court's entire § 1129(b) analysis for clear error. [22] We reasoned that it would be imprudent to "tie the hands of the lower courts as they make the factual determination involved in establishing an appropriate interest rate." [23] Though Wells Fargo contends that we overruled *T–H New Orleans* in our subsequent decision in *Matter of Smithwick,* [24] this reading of *Smithwick* is untenable. In *Smithwick*, we held that bankruptcy courts must calculate the Chapter 13 cramdown rate using the "presumptive contract rate" approach. [25] However, we reaffirmed that "[t]his court has declined to establish a particular formula ***331** for the cramdown interest rate in Chapter 11 cases." [26] We justified our departure from *T–H New Orleans* in the Chapter 13 context on the ground that the need for judicial guidance is more acute in the case of individual bankruptcies, given the "greater need to reduce litigation expenses associated with an individualized discount rate determination." [27] *Smithwick* is not in tension with *T–H New Orleans* 's application in Chapter 11 proceedings.

[14] Nor is *Till.* In *Till,* a plurality of the Supreme Court ruled that bankruptcy courts must calculate the Chapter 13 cramdown rate by applying the prime-plus formula. [28] While the plurality suggested that this approach should also govern under Chapter 11, [29] we have held that "[a] Supreme Court decision must be more than merely illuminating with respect to the case before us, because a panel of this court can only overrule a prior panel decision if such overruling is unequivocally directed by controlling Supreme Court precedent." [30] As we recognized in *Drive Financial Services, L.P. v. Jordan,* [31] *Till* was a splintered decision whose precedential value is limited even in the Chapter 13 context. [32] While many courts have chosen to apply the *Till* plurality's formula method under Chapter 11, they have done so because they were *persuaded* by the plurality's reasoning, not because they considered *Till* binding. [33] Ultimately, the plurality's suggestion that its analysis also governs in the Chapter 11 context—which would be dictum even in a majority opinion—is not "controlling ... precedent." [34]

Today, we reaffirm our decision in *T–H New Orleans.* 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.

B.

At length, we turn to address whether the bankruptcy court clearly erred in assessing a 5% cramdown rate under § 1129(b). While both parties stipulate that the *Till* plurality's formula approach governs the applicable cramdown rate, they disagree on what that approach requires.

***332 1.**

[15] Under the *Till* plurality's formula method, a bankruptcy court should begin its cramdown rate analysis with the national prime rate—the rate charged by banks to creditworthy commercial borrowers—and then add a supplemental "risk adjustment" to account for "such factors as the circumstances of the estate, the nature of the security, and the duration and feasibility of the reorganization plan." [35] Though the plurality "d [id] not decide the proper scale for the risk adjustment," it observed that "other courts have generally approved adjustments of 1% to 3%." [36]

In ruling that the formula method governs under Chapter 13, the *Till* plurality was motivated primarily by what it viewed as the method's simplicity and objectivity. [37] First, the plurality reasoned, the method minimizes the need for costly evidentiary hearings, as the prime rate is reported daily, and as "many of the factors relevant to the [risk] adjustment fall squarely within the bankruptcy court's area of expertise." [38] Second, the plurality observed, the approach varies only in "the state of financial markets, the circumstances of the bankruptcy estate, and the characteristics of the loan" instead of inquiring into a particular creditor's cost of funds or prior contractual relations with the debtor. [39]

For these same reasons, the plurality "reject[ed] the coerced loan, presumptive contract rate, and cost of funds approaches," as "[e]ach of these approaches is complicated, imposes significant evidentiary costs, and aims to make each individual creditor whole rather than to ensure the debtor's payments have the required present value." [40] The plurality was particularly critical of the coerced loan approach applied by the Seventh Circuit below, noting that it "requires bankruptcy courts to consider evidence about the market for comparable loans to similar (though nonbankrupt) debtors—an inquiry far removed from such courts' usual task of evaluating debtors' financial circumstances and the feasibility of their debt adjustment plans." [41]

Having explained its prime-plus formula, the plurality applied it to the case before the Court, in which the secured creditor—an auto-financing company—objected to the bankruptcy court's assessment of a cramdown rate at 1.5% over prime. [42] The creditor claimed that this cramdown rate was woefully inadequate to compensate it for the risk that the debtor would default on its restructured obligations, presenting evidence that the subprime financing market would demand a rate of at least prime plus 13% for a comparable loan. [43] The plurality rejected the creditor's arguments and affirmed the bankruptcy court's 1.5% risk adjustment, observing that the debtor's expert had testified that the rate was "very reasonable given that Chapter 13 plans are supposed to be feasible." [44]

In a spirited dissent, Justice Scalia warned that the plurality's approach would "systematically undercompensate" creditors. ***333** [45] Justice Scalia observed that "based on even a rudimentary financial analysis of the facts of this case, the 1.5% [risk adjustment assessed by the plurality] is obviously wrong—not just off by a couple percent, but probably by roughly an order of magnitude." [46] As for the plurality's reference to the testimony of the debtors' economics expert, Justice Scalia noted that "[n]othing in the record shows how [the expert's] platitudes were somehow manipulated to arrive at a figure of 1.5 percent." [47] Justice Scalia concluded that it was "impossible to view the 1.5% figure as anything other than a smallish number picked out of a hat." [48]

While *Till* was an appeal from a Chapter 13 proceeding, the plurality observed that "Congress [likely] intended bankruptcy judges and trustees to follow essentially the same [formula] approach when choosing an appropriate

interest rate under [Chapters 11],” reasoning that the applicable statutory language was functionally identical in both contexts.[49] However, in Footnote 14, the plurality appeared to qualify its extension of the prime-plus formula to Chapter 11, observing that as “efficient markets” for exit financing often exist in business bankruptcies, a “market rate” approach might be more suitable for making the cramdown rate determination under § 1129(b).[50]

In spite of Justice Scalia's warning, the vast majority of bankruptcy courts have taken the *Till* plurality's invitation to apply the prime-plus formula under Chapter 11.[51] While courts often acknowledge that *Till* 's Footnote 14 appears to endorse a “market rate” approach under Chapter 11 *if* an “efficient market” for a loan substantially identical to the cramdown loan exists, courts almost invariably conclude that such markets are absent.[52] Among the courts that follow *Till* 's formula method in the Chapter 11 context, “risk adjustment” calculations have generally hewed to the plurality's suggested range of 1% to 3%.[53] ***334** Within that range, courts typically select a rate on the basis of a holistic assessment of the risk of the debtor's default on its restructured obligations,[54] evaluating factors including the quality of the debtor's management, the commitment of the debtor's owners, the health and future prospects of the debtor's business, the quality of the lender's collateral, and the feasibility and duration of the plan.[55]

2.

Returning to the proceedings in this case, both Wells Fargo and the Debtors presented the bankruptcy court with expert testimony on the appropriate prime-plus cramdown rate. Mr. Louis Robichaux, the Debtors' expert, began his analysis by quoting the prime rate at 3.25%. He then proceeded to assess a risk adjustment by evaluating the factors enumerated by the *Till* plurality, looking to “the circumstances of the [D]ebtors' estate, the nature of the security, and the duration and feasibility of the plan.” Robichaux concluded that the Debtors' hotel properties were well maintained and excellently managed, that the Debtors' owners were committed to the business, that the Debtors' revenues exceeded their projections in the months prior to the hearing, that Wells Fargo's collateral was stable or appreciating, and that the Debtors' proposed cramdown plan would be tight but feasible. On the basis of these findings, Robichaux assessed the risk of default “just to the left of the middle of the risk scale.” As *Till* had suggested that risk adjustments generally fall between 1% and 3%, Robichaux reasoned that a 1.75% risk adjustment would be appropriate.

Wells Fargo's expert, Mr. Richard Ferrell, corroborated virtually all of Robichaux's findings with respect to Debtors' properties, management, ownership, and projected earnings. Ferrell also agreed that the applicable prime rate was 3.25%. However, Ferrell devoted the vast majority of his cramdown rate analysis to determining the rate of interest that the market would charge to finance an amount of principal equal to the cramdown loan. Because Ferrell concluded that there was no market for single, secured loans comparable to the forced loan contemplated under the cramdown plan, he calculated the market rate by taking the weighted average of the interest rates the market would charge for a multi-tiered exit financing package comprised of senior debt, mezzanine debt, and equity. Ferrell's calculations yielded a “blended” market rate of 9.3%.[56]

***335** To bring his “market influenced” analysis within the form of *Till* ' s prime-plus method, Ferrell purported to “utilize the [3.25%] Prime Rate as the Base Rate,” making an upward “adjustment” of 6.05% to account for “the nature of the security interest.” This calculation yielded Ferrell's 9.3% blended market rate.[57] Mr. Ferrell then adjusted the blended rate in accordance with the remaining *Till* factors, making a downward adjustment of 1.5% to account for the sterling “circumstances of the bankruptcy estate” and an upward adjustment of 1% to account for the plan's tight feasibility. Ultimately, Mr. Ferrell concluded that Wells Fargo was entitled to a cramdown rate of 8.8%.

The bankruptcy court agreed with the parties that *Till* was “instructive, if not controlling” under Chapter 11. Turning to Mr. Robichaux's analysis, the court concluded that “Mr. Robichaux properly interpreted *Till* and properly applied it,” and that his “assessment of the circumstances of the estate, the nature of the security, and the feasibility of the plan ... [were] credible and persuasive.” As for Mr. Ferrell's analysis, the court rejected it as inconsistent with *Till* 's prime-plus method:

> I disagree with [Mr. Ferrell's] approach because it establishes a benchmark before adjustment that I just view to be completely inconsistent with *Till*. *Till* set that benchmark at national prime, but according to Mr. Ferrell, you first determine what level any portion of a loan would be financeable, and then you begin to work from there.... The Court finds no support for that type of analysis in *Till*. If anything this strikes the Court as more in the nature of a forced loan approach that the majority in *Till* expressly rejected.

Ultimately, the court determined, "[Robichaux's] risk adjustment rate of 1.75% is defensible, ... especially ... in light of the modifications to the plan which render, in the Court's opinion, the plan feasible." Consequently, the court concluded that Wells Fargo was entitled to a 5% cramdown rate.

3.

[16] We agree with the bankruptcy court that Robichaux's § 1129(b) cramdown rate determination rests on an uncontroversial application of the *Till* plurality's formula method. As the plurality instructed, Robichaux engaged in a holistic evaluation of the Debtors, concluding that the quality of the bankruptcy estate was sterling, that the Debtors' revenues were exceeding projections, that Wells Fargo's collateral—primarily real estate—was liquid and stable or appreciating in value, and that the reorganization plan would be tight but feasible. On the basis of these findings—which were all independently verified by Ferrell—Robichaux assessed a risk adjustment of 1.75% over prime. This risk adjustment falls squarely within the range of adjustments other bankruptcy courts have assessed in similar ***336** circumstances. [58]

We also agree that Ferrell predicated his 8.8% cramdown rate on the sort of comparable loans analysis rejected by the *Till* plurality. Wells Fargo's briefs repeatedly aver that the plurality characterized "the market for comparable loans" as "relevant," complaining that Ferrell's analysis can "hardly be consigned to the dustbin for considering relevant information." However, aside from the fact that Wells Fargo takes the quoted language out of context, the plurality expressly rejected methodologies that "require[ ] the bankruptcy courts to consider evidence about the market for comparable loans," noting that such approaches "require an inquiry far removed from such courts' usual task of evaluating debtors' financial circumstances and the feasibility of their debt-adjustment plans." [59]

Wells Fargo complains that Robichaux's analysis produces "absurd results," pointing to the undisputed fact that on the date of plan confirmation, the market was charging rates in excess of 5% on smaller, over-collateralized loans to comparable hotel owners. While Wells Fargo 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. [60] Stated differently, while it may be "impossible to view" Robichaux's 1.75% risk adjustment as "anything other than a smallish number picked out of a hat," [61] the *Till* plurality's formula approach—not Justice Scalia's dissent—has become the default rule in Chapter 11 bankruptcies.

Notably, Wells Fargo makes no attempt to predicate Ferrell's "market-influenced" blended rate calculation on the *Till* plurality's Footnote 14, which suggests that a "market rate" approach should apply in Chapter 11 cases where "efficient markets" for exit financing exist. [62] Footnote ***337** 14 has been criticized by commentators, who observe that it rests on the untenable assumption that the voluntary market for forced cramdown loans is somehow less illusory in the Chapter 11 context than it is in the Chapter 13 context. [63] Nevertheless, many courts—including the Sixth Circuit—have found Footnote 14 persuasive, concluding that a "market rate" approach should be used to calculate the Chapter 11 cramdown rate in circumstances where "efficient markets" for exit financing exist. [64]

Even assuming, however, that Footnote 14 has some persuasive value, it does not suggest that the bankruptcy court here committed any error. Among the courts that

adhere to Footnote 14, most have held that markets for exit financing are "efficient" only if they offer a loan with a term, size, and collateral comparable to the forced loan contemplated under the cramdown plan. [65] In the present case, Ferrell himself acknowledged that "there's no one in this market today that would loan this loan to the debtors—one to one loan-to-value ratio, 39 million dollars, secured by these properties." While Ferrell concluded that exit financing could be cobbled together through a combination of senior debt, mezzanine debt, and equity financing, courts including the Sixth Circuit have rejected the argument that the existence of such tiered financing establishes "efficient markets," observing that it bears no resemblance to the single, secured loan contemplated under a cramdown plan. [66]

The bankruptcy court in this case calculated the disputed 5% cramdown rate on the basis of a straightforward application of the prime-plus approach—an approach that has been endorsed by a plurality of the Supreme Court, adopted by the vast majority of bankruptcy courts, and, perhaps most importantly, accepted as governing by both parties to this appeal. On this record, we cannot conclude that the bankruptcy court's cramdown rate calculation is clearly erroneous. However, we do not suggest that the prime-plus formula is the only—or even the optimal—method for calculating the Chapter 11 cramdown rate.

V.

The judgment of the district court is AFFIRMED.

All Citations

710 F.3d 324, 57 Bankr.Ct.Dec. 177, Bankr. L. Rep. P 82,438

Footnotes

1 *See In re Berryman Prods., Inc.,* 159 F.3d 941, 943 (5th Cir.1998) ("In the bankruptcy appellate process, we perform the same function as did the district court: Fact findings of the bankruptcy court are reviewed under a clearly erroneous standard and issues of law are reviewed *de novo*.").

2 The Debtors later agreed to reduce the repayment term to seven years.

3 **541 U.S. 465**, 124 S.Ct. 1951, 158 L.Ed.2d 787 (2004).

4 *See In re GWI PCS 1, Inc.,* 230 F.3d 788, 799–800 (5th Cir.2000).

5 *In re Scopac,* 624 F.3d 274, 281 (5th Cir.2010) (*Scopac I*).

6 *Id.*

7 *See In re Pacific Lumber Co.,* 584 F.3d 229, 243 (5th Cir.2009) ("Secured credit represents property rights that ultimately find a minimum level of protection in the takings and due process clauses of the Constitution.... Federal courts should proceed with caution before declining appellate review of the adjudication of these rights under a judge-created abstention doctrine.").

8 *In re Scopac,* 649 F.3d 320, 322 (5th Cir.2011) (*Scopac II*).

9 *Scopac I,* 624 F.3d at 282.

10 *See id.* at 286 (awarding judgment of $29,700,000 to appellants). *But see Scopac II,* 649 F.3d at 322 (clarifying that bankruptcy court had discretion to award less than the full judgment if necessary to avoid "jeopardiz[ing] the reorganized debtor's financial health").

11 *See Pacific Lumber,* 584 F.3d at 243–50 (allowing secured creditors to appeal valuation order whose reversal could have imposed up to $90,000,000 on a cash-poor entity just emerging from bankruptcy).

12 *In re Manges,* 29 F.3d 1034, 1039 (5th Cir.1994) (emphasis added).

13 *Pacific Lumber,* 584 F.3d at 244.

14 *Moore v. Ashland Chem. Inc.,* 151 F.3d 269, 274 (5th Cir.1998).

15 *Daubert v. Merrell Dow Pharmaceuticals, Inc.,* 509 U.S. 579, 589, 113 S.Ct. 2786, 125 L.Ed.2d 469 (1993).

16 *Id.* at 590–91, 113 S.Ct. 2786.

17 *Pipitone v. Biomatrix Inc.,* 288 F.3d 239, 250 (5th Cir.2002).

18 *Gibbs v. Gibbs,* 210 F.3d 491, 500 (5th Cir.2000).

19 As the bankruptcy court observed, "[Wells Fargo's] objections to Mr. Robichaux's testimony really go to its disagreement to the merits of his opinion, and so that disagreement is really properly voiced as a response to the opinion itself."

20 *See* 11 U.S.C. § 1129(b)(1)(A)(i)(II) ("[E]ach holder of a [secured claim must] 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.").

21 *E.g., In re T–H New Orleans Ltd. P'ship,* 116 F.3d 790, 800 (5th Cir.1997) ("[The Chapter 11 cramdown provision] has been interpreted to require that the total deferred payments have a present value equal to the amount of the secured claim.").

22 *See T–H New Orleans,* 116 F.3d at 800; *see also In re Briscoe Enters., Ltd., II,* 994 F.2d 1160, 1169 (5th Cir.1993) ("We review a bankruptcy court's calculation of an appropriate interest rate for clear error. Courts have used a wide variety of different rates as benchmarks in computing the appropriate interest rate (or discount rate as it is frequently termed) for the specific risk level in their cases.").

23 *T–H New Orleans,* 116 F.3d at 800.

24 121 F.3d 211 (5th Cir.1997).

25 *Id.* at 214–15.

26 *Id.*

27 *Id.*

28 **541 U.S.** 465, 479–81, 124 S.Ct. 1951, 158 L.Ed.2d 787 (2004).

29 *See id.* at 474–75, 124 S.Ct. 1951.

30 *Reed v. Fla. Metro. Univ., Inc.,* 681 F.3d 630, 648 (5th Cir.2012) (quoting *Martin v. Medtronic, Inc.,* 254 F.3d 573, 577 (5th Cir.2001) (quoting *United States v. Zuniga–Salinas,* 945 F.2d 1302, 1306 (5th Cir.1991))).

31 521 F.3d 343 (5th Cir.2008).

32 *Id.* at 350 ("[W]e hold that the *Till* plurality's adoption of the prime-plus interest rate approach is binding precedent in cases presenting an essentially indistinguishable factual scenario."); *see also Good v. RMR Invs., Inc.,* 428 B.R. 249, 255 (E.D.Tex.2010) ("In *Drive* [*Financial*], the Fifth Circuit only narrowly adopted the formula approach for Chapter 13 cases.... Therefore, in the Fifth Circuit, bankruptcy courts still enjoy some latitude in determining which method should be applied to determine the cramdown interest rate in Chapter 11 cases.").

33 *See, e.g., In re Am. HomePatient, Inc.,* 420 F.3d 559, 567 (6th Cir.2005) (adopting *Till* plurality approach as persuasive); *In re Prussia Assocs.,* 322 B.R. 572, 585, 589 (Bankr.E.D.Pa.2005) (same); *In re Cantwell,* 336 B.R. 688, 692 (Bankr.D.N.J.2006) (same).

34 *Reed,* 681 F.3d at 648 (quoting *Martin,* 254 F.3d at 577 (quoting *Zuniga–Salinas,* 945 F.2d at 1306)).

35 **541 U.S.** 465, 479, 124 S.Ct. 1951, 158 L.Ed.2d 787 (2004).

36 *Id.* at 480, 124 S.Ct. 1951.

37 *Id.* at 474–76, 124 S.Ct. 1951.

38 *Id.* at 479, 124 S.Ct. 1951.

39 *Id.* at 479–80, 124 S.Ct. 1951.

40 *Id.* at 477, 124 S.Ct. 1951.

41 *Id.*

42 *Id.* at 471–72, 124 S.Ct. 1951.

43 *Id.*

44 *Id.*

45 *Id.* at 492, 124 S.Ct. 1951 (Scalia, J., dissenting).

46 *Id.* at 501, 124 S.Ct. 1951.

47 *Id.* at 500, 124 S.Ct. 1951.

48 *Id.* at 501, 124 S.Ct. 1951.

49 *Id.* at 474–75, 124 S.Ct. 1951 (plurality opinion).

50 *See id.* at 477 n. 14, 124 S.Ct. 1951.

51 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."); *see In re Mirant Corp.,* 334 B.R. 800, 821 (Bankr.N.D.Tex.2005) (concluding that *Till* is "clearly relevant" in the Chapter 11 context, and that "*Till* makes clear that the market in fact does not properly measure the [cramdown rate]."); *see also In re Pamplico Highway Dev., LLC,* 468 B.R. 783, 795 (Bankr.D.S.C.2012) (collecting cases); *In re SW Boston Hotel Venture,* 460 B.R. 38, 55 (Bankr.D.Mass.2011) (collecting cases).

52 *See, e.g., In re Nw. Timberline Enters.,* 348 B.R. 412, 432, 435 (Bankr.N.D.Tex.2006) (applying prime-plus formula after concluding that the evidence was insufficient to establish the existence of an efficient market); *Pamplico,* 468 B.R. at 793 (same); *In re Walkabout Creek Ltd. Dividend Hous. Ass'n Ltd.,* 460 B.R. 567, 574 (Bankr.D.D.C.2011) (same); *In re 20 Bayard Views, LLC,* 445 B.R. 83 (Bankr.E.D.N.Y.2011) (same); *SW Boston Hotel,* 460 B.R. at 55 (same); *In re Hockenberry,* 457 B.R. 646, 657 (Bankr.S.D.Ohio 2011) (same); *In re Riverbend Leasing LLC,* 458 B.R. 520, 536 (Bankr.S.D.Iowa 2011) (same); *In re Bryant,* 439 B.R. 724, 742–43 (Bankr.E.D.Ark.2010) (same).

53 *E.g., In re Prussia Assocs.,* 322 B.R. 572, 591 (Bankr.E.D.Pa.2005) ("The risk premium, per *Till,* will normally fluctuate between 1% and 3%."); *Riverbend Leasing,* 458 B.R. at 535 ("[T]he general consensus that has emerged provides that a one to three percent adjustment to the prime rate as of the effective date is appropriate."); *see also Pamplico,* 468 B.R. at 795 (collecting cases).

54 Marsh & Weiss, *supra* note 51, at 221; *see also Pamplico,* 468 B.R. at 794 ("[T]he general consensus among courts is that a one to three percent adjustment to the prime rate is appropriate, with a 1.00% adjustment representing the low risk debtor and a 3.00% adjustment representing a high risk debtor"); *In re Lilo Props., LLC,* 2011 WL 5509401 at *2 (Bankr.D.Vt.2011) ("The Court starts with the premise that the lowest-risk debtors would pay prime plus 1% and the highest-risk debtors would pay prime plus 3%.").

55 *See, e.g., SW Boston Hotel,* 460 B.R. at 57 (examining quality of management); *Prussia Assocs.,* 322 B.R. at 593 (examining commitment of owner); *Riverbend Leasing,* 458 B.R. at 536 (examining health and future prospects of business); *Walkabout Creek,* 460 B.R. at 574 (examining quality of collateral); *Bryant,* 439 B.R. at 743 (examining repayment term).

56 More precisely, Mr. Ferrell determined that the market could finance the first $23,448,000 of the cramdown loan at a rate of 6.25%, in exchange for a first mortgage on the Debtors' hotel properties. He then determined that the balance of the cramdown loan could be financed through a combination of mezzanine debt, at a rate of 11%, and equity, at a constructive rate of 22%. The weighted average of the interest rates on these three financing tranches was 9.3%.

57 As Wells Fargo's briefs on appeal implicitly concede, Mr. Ferrell thus effectively chose the *market* rate, and not the prime rate, as the starting point of his cramdown rate analysis. *Cf.* C.B. Reehl & Stephen P. Milner, *Chapter 11 Real Estate Cram–Down Plans: The Legacy of* Till, 30 CAL. BANKR. J. 405, 410 ("[I]f the risk adjustment could take on any value, *Till* would have no relevance since cram-down interest rates could be determined reverse engineered through application of other methodologies.... In other words, the same market factors used to develop cram-down interest rates before *Till,* could now be used to determine the value of the risk adjustment.").

58 *See SW Boston Hotel,* 460 B.R. at 57 (assessing risk adjustment of 1.0% over prime for a Chapter 11 cramdown loan secured by hotel properties); *In re Indus. W. Commerce Ctr., LLC,* 2011 WL 3300187 (9th Cir.BAP 2011) (assessing risk adjustment of 1.70% over prime for Chapter 11 cramdown loan secured by commercial real property); *Prussia Assocs.,* 322 B.R. at 591 (assessing risk adjustment of 1.5% above prime where "the risks attendant to the proposed loan [were] neither negligible nor extreme"); *see also Pamplico,* 468 B.R. at 795 (collecting cases).

59 *Till,* 541 U.S. at 477, 124 S.Ct. 1951. Wells Fargo also urges that *Till* characterized the formula approach as an "objective inquiry," apparently viewing this language as a ringing endorsement of the type of quantitative market analysis performed by Ferrell. In fact, the plurality was merely suggesting that its prime-plus approach incorporated an objective baseline —the prime rate—and did not depend on a complicated market analysis of any specific creditor's cost of funds. *See id.* at 466–67, 124 S.Ct. 1951.

60 *See Till,* 541 U.S. at 479, 124 S.Ct. 1951 ("[U]nlike the coerced loan, presumptive contract rate, and cost of funds approaches, the formula approach entails a straightforward, familiar, and objective inquiry, and minimizes the need for potentially costly additional evidentiary proceedings"); *id.* at 504, 124 S.Ct. 1951 (Scalia, J. dissenting) ("[T]he 1.5% premium adopted in this case is far below anything approaching fair compensation. That result ... is the entirely predictable consequence of a methodology that tells bankruptcy judges to set interest rates based on highly imponderable factors.").

61 *Id.* at 501, 124 S.Ct. 1951 (Scalia, J., dissenting).

62 *Till,* 541 U.S. at 477 n. 14, 124 S.Ct. 1951. Footnote 14 demonstrates that the *Till* plurality itself drew a clear distinction between its "prime-plus" approach on the one hand, and a "market rate" approach on the other.

63 COLLIER ON BANKRUPTCY ¶ 1129.05[2][c][i] (16th ed. rev. 2012) ("The problem with [Footnote 14] is that the relevant market for involuntary loans in chapter 11 may be just as illusory as in chapter 13."); Thomas J. Yerbich, *How Do You Count the Votes—or did* Till *tilt the Game?,* AM. BANKR. INST. J., July/Aug. 2004, at 10 ("There is no more of a 'free market of willing cramdown lenders' in a chapter 11 ... than in a chapter 13.").

64 *See In re Am. HomePatient, Inc.,* 420 F.3d 559, 568 (6th Cir.2005) ("[W]e opt to take our cue from Footnote 14 of the [plurality] opinion, which offered the guiding principle that 'when picking a cram down rate in a Chapter 11 case, it might

make sense to ask what rate an efficient market would produce.' "); *see also* Marsh & Weiss, *supra* note 51, at 213 ("Since *American HomePatient* ... [a] majority of courts hold that, where an efficient market exists, the market rate should be applied, but where no efficient market can be established, the court should apply the prime-plus formula adopted in *Till.*").

65 *E.g., In re 20 Bayard Views, LLC,* 445 B.R. 83, 110–11 (Bankr.E.D.N.Y.2011); *In re SW Boston Hotel Venture,* 460 B.R. 38, 55 (Bankr.D.Mass.2011).

66 *Am. HomePatient,* 420 F.3d at 568–69; *20 Bayard Views,* 445 B.R. at 110–11; *SW Boston Hotel,* 460 B.R. at 55–58; *see also* Marsh & Weiss, *supra* note 51, at 221 ("[C]ourts have generally been unreceptive to the use of tiered financing as a basis for establishing a market interest rate.").

* * *

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KeyCite Yellow Flag - Negative Treatment
Disagreed With by In re Northwest Timberline Enterprises, Inc., Bankr.N.D.Tex., August 24, 2006

420 F.3d 559
United States Court of Appeals,
Sixth Circuit.

In re: AMERICAN HOMEPATIENT, INC., Debtor.
Bank of Montreal et al., Appellants/Cross-Appellees,
v.
Official Committee of Unsecured Creditors
et al., Appellees/Cross-Appellants.

Nos. 03-6500, 03-6501.
|
Argued: July 20, 2005.
|
Decided and Filed: Aug. 16, 2005.
|
Rehearing and Rehearing En
Banc Denied Feb. 1, 2006.

Synopsis

Background: Following the confirmation by the United States Bankruptcy Court, George C. Paine, II, Chief Judge, 298 B.R. 152, of a Chapter 11 bankruptcy reorganization plan, creditors appealed. The United States District Court for the Middle District of Tennessee at Nashville, Thomas A. Wiseman, Jr., J., denied debtor's motion to dismiss the appeal on grounds of equitable mootness, and affirmed. Debtor and creditors appealed.

Holdings: The Court of Appeals, Gilman, Circuit Judge, held that:

[1] creditors' appeal was not equitably moot;

[2] bankruptcy court's utilization of 6.785 percent for the cramdown interest rate was warranted; and

[3] evidence supported bankruptcy court's determination that collateral value of creditors' secured interest in debtor's assets was $250 million.

Affirmed.

West Headnotes (14)

[1] **Bankruptcy**
Conclusions of Law;De Novo Review
Bankruptcy
Clear Error

In appeals from the decision of a district court on appeal from the bankruptcy court, the Court of Appeals independently reviews the bankruptcy court's decision, applying the clearly erroneous standard to findings of fact and de novo review to conclusions of law.

10 Cases that cite this headnote

[2] **Bankruptcy**
Questions of Law or Fact

When a question in the bankruptcy context involves a mixed question of law and fact, the Court of Appeals must break it down into its constituent parts and apply the appropriate standard of review for each part.

9 Cases that cite this headnote

[3] **Bankruptcy**
Moot Questions

In bankruptcy proceedings, a case that is equitably moot is not technically moot, but rather "equitable mootness" occurs where the Chapter 11 plan of reorganization is substantially consummated, and where it is no longer prudent to upset the plan of reorganization. Bankr.Code, 11 U.S.C.A. § 1129.

3 Cases that cite this headnote

[4] **Bankruptcy**
Moot Questions

Generally when determining the equitable mootness of an appeal of a Chapter 11 reorganization order, a reviewing court inquires as to whether the plan has been substantially consummated at the

time of the appeal, and, if so, whether piecemeal modification of the bankruptcy reorganization plan is possible or desirable.

5 Cases that cite this headnote

[5] **Bankruptcy**
Effect of Want of Stay;Conclusiveness of Sale
Bankruptcy
Moot Questions

In determining whether equitable mootness bars an appeal of an order confirming a Chapter 11 reorganization plan, a reviewing court examines (1) whether a stay has been obtained, (2) whether the plan has been substantially consummated, and (3) whether the relief requested would affect either the rights of parties not before the court or the success of the plan. Bankr.Code, 11 U.S.C.A. § 1129.

16 Cases that cite this headnote

[6] **Bankruptcy**
Effect of Want of Stay;Conclusiveness of Sale
Bankruptcy
Moot Questions

Creditors' appeal of an order confirming a Chapter 11 reorganization plan was not "equitably moot," although creditors did not pursue a stay of the confirmation order, and the plan had been consummated, where creditors' appeal, if successful, might not require reversal of the actions already undertaken with respect to consummation of the plan. Bankr.Code, 11 U.S.C.A. § 1129.

7 Cases that cite this headnote

[7] **Bankruptcy**
Fairness and Equity;"Cram Down."

A judicial cramdown is an available option when one or more classes of creditors refuse to accept the Chapter 11 reorganization plan. Bankr.Code, 11 U.S.C.A. § 1129(b).

2 Cases that cite this headnote

[8] **Bankruptcy**
Fairness and Equity;"Cram Down."

The cramdown provisions of the Bankruptcy Code allow courts, despite objections, to confirm a Chapter 11 reorganization plan if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan. Bankr.Code, 11 U.S.C.A. § 1129(b).

7 Cases that cite this headnote

[9] **Interest**
Computation of Rate in General

Under the coerced loan theory for determining cramdown interest rates for a Chapter 11 reorganization plan, courts treat any deferred payment of an obligation under a plan as a coerced loan, and the rate of return with respect to such loan must correspond to the rate that would be charged or obtained by the creditor making a loan to a third party with similar terms, duration, collateral, and risk. Bankr.Code, 11 U.S.C.A. § 1129(b).

4 Cases that cite this headnote

[10] **Interest**
Computation of Rate in General

Under the coerced loan theory for determining cramdown interest rates for a Chapter 11 reorganization plan, courts must use the current market rate of interest used for similar loans in the region.

15 Cases that cite this headnote

[11] **Interest**
Computation of Rate in General

Bankruptcy court's utilization of 6.785 percent for the cramdown interest rate for a Chapter 11 reorganization plan, rather than the 12.16 percent rate proposed by the creditors, was warranted; even

though bankruptcy court relied on the coerced loan theory, which was subsequently criticized by Supreme Court decision in *Till*, the bankruptcy court properly determined interest rate by using rate for six-year Treasury Bill plus 350 basis points, and determining what an efficient market allowed for the type of loans, involving senior secured debt, that the creditors provided, and creditors' proposed interest rate would have resulted in windfall to creditors. Bankr.Code, 11 U.S.C.A. § 1129(b).

29 Cases that cite this headnote

[12] Interest

Computation of Rate in General

The market rate should be applied for determining the cramdown interest rate for a reorganization plan in Chapter 11 cases only where there exists an efficient market. Bankr.Code, 11 U.S.C.A. § 1129(b).

31 Cases that cite this headnote

[13] Bankruptcy

Confirmation;Objections

Evidence was sufficient to support bankruptcy court's determination that collateral value of creditors' secured interest in Chapter 11 debtor's assets was $250 million, for purpose of determining creditors' allowed claim in reorganization plan; expert testified that the collateral value was between $235 million and $275 million, and his estimate included the debtor's current liabilities and excess cash. Bankr.Code, 11 U.S.C.A. § 1129(b).

1 Cases that cite this headnote

[14] Bankruptcy

Confirmation;Objections

The appropriate valuation of creditors' secured interest in Chapter 11 debtor's assets should be viewed as a question of fact rather than a question of law. Bankr.Code, 11 U.S.C.A. § 1129.

2 Cases that cite this headnote

Attorneys and Law Firms

***561 ARGUED:** Robin E. Phelan, Haynes & Boone, Dallas, Texas, for Appellants. Frank J. Wright, Hance, Scarborough, Wright, Ginsburg & Brusilow, Dallas, Texas, for Appellees. **ON BRIEF:** Robin E. Phelan, Alan Wright, Haynes & Boone, Dallas, Texas, James R. Kelley, Neal & Harwell, Nashville, Tennessee, for Appellants. Frank J. Wright, C. Ashley Ellis, Hance, Scarborough, Wright, Ginsburg & Brusilow, Dallas, Texas, Michael R. Paslay, Waller, Lansden, Dortch & Davis, Nashville, Tennessee, Robert J. Mendes, Robert J. Gonzales, Jr., Mendes & Gonzales, Nashville, Tennessee, for Appellees.

Before: CLAY, GILMAN, and COOK, Circuit Judges.

OPINION

GILMAN, Circuit Judge.

In July of 2002, American HomePatient, Inc. (American) filed for relief under Chapter 11 of the Bankruptcy Code. Despite objections by a group of secured lenders to American's proposed plan of reorganization, the bankruptcy court imposed the plan on the lenders pursuant to the Bankruptcy Code's so-called "cramdown" provisions set forth in 11 U.S.C. § 1129(b). The bankruptcy court further concluded that the appropriate cramdown interest rate for the lenders was 6.785%, and it fixed their collateral value at $250 million.

Displeased with these rulings, the lenders appealed the order of confirmation to the district court. American responded by filing a motion to dismiss the lenders' appeal on the grounds of equitable mootness. ***562** The district court denied American's motion, but then concluded on the merits that the bankruptcy court had properly determined both the cramdown interest rate and the collateral value. Both parties appealed. For the reasons set forth below, we **AFFIRM** the judgment of the district court.

I. BACKGROUND

American is a publicly-held company based in Brentwood, Tennessee. It specializes in providing home healthcare services and products and has more than 280 affiliates and subsidiaries in 35 states. Over the course of its operations, American borrowed a significant amount of money. Most of this debt was incurred between 1994 and 1998, when American invested in dozens of new branch offices. The lenders in this case are 24 entities that loaned money to American during this time frame. Although the parties disagree as to the exact total owed to the lenders, both sides acknowledge that the principal balance is in the range of $278 to $290 million.

Following American's voluntary filing for bankruptcy protection under Chapter 11 of the Bankruptcy Code in July of 2002, the company and its affiliates filed a Joint Plan of Reorganization. American filed a Second Amended Joint Plan of Reorganization in January of 2003. This amended plan was approved by all but the lenders in the present case. American then sought to have the plan confirmed pursuant to the Bankruptcy Code's cramdown provisions set forth in 11 U.S.C. § 1129(b), which allow a reorganization plan to go into effect notwithstanding the fact that it has not been accepted by all of the impaired classes.

The bankruptcy court held a five-day hearing on the lenders' claims. During this hearing, the court heard from various witnesses who testified as to the appropriate cramdown interest rate to be applied to the lenders' allowed secured claim. The bankruptcy court was ultimately persuaded by the testimony of American's expert witness David Rosen, who opined that the appropriate cramdown interest rate was 6.785%, which was equal to the interest rate on a six-year Treasury note plus 3.5%. It determined that the lenders' proposed interest rate of 12.16% was inappropriate because it would result in a windfall to the lenders.

The bankruptcy court also heard testimony regarding the lenders' collateral value in order to determine the amount of the lenders' allowed secured claim. Patrick Hurst, another of American's expert witnesses, testified that the value of this collateral was between $235 and $275 million. The lenders' expert witness, Gerald Benjamin, opined that the correct valuation was between $300 and $320 million. After weighing this conflicting evidence, the bankruptcy court found that Hurst's testimony was significantly more credible. It then fixed the lenders' collateral value, and thus their allowed secured claim, at $250 million.

On May 14, 2003, the bankruptcy court overruled the lenders' objections and directed American to submit a proposed order confirming the amended reorganization plan. This confirmation order was entered by the bankruptcy court on May 27, 2003. The lenders subsequently appealed to the district court and petitioned first the bankruptcy court and then the district court for a stay of the confirmation order. This request was denied by both courts, and the lenders did not seek a stay from this court. As a result, the amended reorganization plan became effective on July 1, 2003.

On August 15, 2003, American filed a motion to dismiss the lenders' appeal before ***563** the district court on the basis of equitable mootness. The district court denied the motion, but affirmed the bankruptcy court's decision to confirm the plan on the merits. This appeal by the lenders and cross-appeal by American followed.

II. ANALYSIS

A. Standard of review

[1] **[2]** "In appeals from the decision of a district court on appeal from the bankruptcy court, the court of appeals independently reviews the bankruptcy court's decision, applying the clearly erroneous standard to findings of fact and *de novo* review to conclusions of law." *Zirnhelt v. Madaj (In re Madaj)*, 149 F.3d 467, 468 (6th Cir.1998) (citations and quotation marks omitted). Furthermore, when a question in the bankruptcy context involves a mixed question of law and fact, "we must break it down into its constituent parts and apply the appropriate standard of review for each part." *Wesbanco Bank Barnesville v. Rafoth (In re Baker & Getty Fin. Servs., Inc.)*, 106 F.3d 1255, 1259 (6th Cir.1997) (citation and quotation marks omitted).

B. American's motion to dismiss on equitable mootness grounds

[3] American argues in its cross-appeal that the lenders are equitably estopped from pursuing this appeal. In bankruptcy proceedings, a "case that is equitably moot

is not technically moot, but rather equitable mootness occurs where the plan of reorganization is substantially consummated, and where it is no longer 'prudent to upset the plan of reorganization.' " *Guardian Sav. & Loan Ass'n v. Arbors of Houston Assocs. Ltd. P'shp.* (*In re Arbors of Houston Assocs. Ltd. P'shp.*), No. 97-2099, 1999 WL 17649, at *2 (6th Cir. Jan.4, 1999) (unpublished) (citation omitted).

[4] This court has yet to delineate with clarity the appropriate standard for addressing claims of equitable mootness. Generally, "[w]hen determining the mootness of an appeal of a bankruptcy reorganization order, this Court inquires as to whether the plan has been substantially consummated at the time of the appeal, and, if so, whether piecemeal modification of the bankruptcy reorganization plan is possible or desirable." *Unofficial Comm. of Co-Defendants v. Eagle-Picher Indus., Inc.* (*In re Eagle Picher Indus., Inc.*), Nos. 96-4309 & 97-4260, 1998 WL 939869, at *4 (6th Cir. Dec.21, 1998) (unpublished) (citation and quotation marks omitted). This court in *City of Covington v. Covington Landing Ltd. Partnership,* 71 F.3d 1221, 1225 (6th Cir.1995), on the other hand, cited with approval two other formulations of the governing standard. One is employed by the Seventh Circuit, in which the reviewing court "asks whether it is 'prudent to upset the plan of reorganization at this late date,' " *id.* (quoting *In re UNR Indus., Inc.,* 20 F.3d 766, 769 (7th Cir.1994)), and the other is utilized by the Fifth Circuit, in which the court examines "(1) whether a stay has been obtained; (2) whether the plan has been 'substantially consummated'; and (3) whether the relief requested would affect either the rights of parties not before the court or the success of the plan." *Id.* (citing *Manges v. Seattle-First Nat'l Bank* (*In re Manges*), 29 F.3d 1034, 1039 (5th Cir.1994)). The court in *City of Covington,* however, concluded that the record before it was inadequate to support equitable estoppel, 71 F.3d at 1226, so it "did not explicitly adopt a formula for this equitable doctrine." *Arbors of Houston Assocs. Ltd. P'shp.,* 1999 WL 17649 at *2.

[5] **[6]** We are now squarely faced with the issue. After due consideration, we ***564** adopt the Fifth Circuit's standard quoted above, which we believe presents the clearest synthesis of the relevant factors. Under this standard, the first factor to consider is whether a stay has been obtained. The lenders concede that they did not pursue a stay of the confirmation order in this court. American argues that this fact establishes that "the Lenders assumed the risk that the Appeal would be equitably mooted." The lenders, for their part, argue that to pursue a stay before the Sixth Circuit would have been futile because of the high burden required for injunctive relief. From a strategic perspective, they argue, pursuing such a stay made little sense.

This court has in the past acknowledged that "[t]he failure to seek a stay ... is not necessarily fatal to the appellant's ability to proceed." *City of Covington,* 71 F.3d at 1225-26; *see also UNR Indus., Inc.,* 20 F.3d 766, 769 (7th Cir.1994)("[R]equesting a stay is not a mandatory step comparable to filing a timely notice of appeal."). In sum, while this first factor weighs somewhat against the lenders, their failure to seek a stay before this court is not fatal.

The next factor to be considered is whether the plan has been substantially consummated. *City of Covington,* 71 F.3d at 1225. Again, the lenders have conceded that "the Plan is likely already consummated." This second factor thus weighs unequivocally against the lenders.

The last, and most important factor, is whether the relief requested would affect either the rights of parties not before the court or the success of the plan. *See id.* Here, the parties disagree. American argues that the lenders' appeal, if successful, will unravel the entire reorganization plan. But the lenders argue that "none of the actions undertaken with the consummation of the Plan needs to be reversed for this Court to grant the relief that the Lenders seek."

The bankruptcy court disagreed, commenting that

> [t]he Lenders do not quibble with the attainability of the financial projections of the debtor. Instead, they contend, that given the highly leveraged nature of the debtor's operations, and the $290,000,000 owed to the senior secured debt holders, that the debtor cannot generate enough cash to service the debt or pay down the principal. *On these financial projections, the Lenders are correct if it is assumed that the Lenders secured debt is $290,000,000 and the interest rate is to be paid in excess of 12%.* However, on the financial projections of the

> debtor in light of a $250,000,000 secured debt, at an approximately 6.85% interest rate, the debtor's plan is not only feasible, but reasonable.

(Emphasis added.) This comment indicates that the bankruptcy court was of the opinion that accepting both the lenders' suggested collateral valuation and their cramdown interest rate would result in an infeasible reorganization plan.

The problem, however, with finding this statement conclusive on the equitable mootness issue is that the bankruptcy court did not find that the lenders' claims taken individually would unravel the entire confirmed plan. Moreover, other observations made by the bankruptcy court arguably support the lenders' position. For example, when reviewing the lenders' claims about an investment-band cramdown interest rate, the bankruptcy court simply noted that "[a]n interest rate of 12.16% results in a windfall to the Lenders." It did not comment either way on the feasibility of such a proposal. Likewise, when addressing the lenders' collateral-valuation argument, the bankruptcy court found American's expert to be more ***565** persuasive and credible. But it again did not comment on the feasibility of adopting the lenders' higher valuation.

The lenders further observe that "[t]he Houlihan Lokey financial projections clearly show the ability to pay $290,000,000 at a 12.16% interest rate in deferred payments over time." This argument relies heavily on complex accounting procedures that strain the brain. Essentially, however, the lenders argue that American's objections to the proposal by the lenders are based on a static analysis of the debtor's revenue and obligations. The lenders, by contrast, maintain that taking into account future projections combined with an increasing interest rate would enable American to pay $290,000,000 at a 12.16% interest rate without thwarting the plan's other terms or affecting American's obligations to third parties. American, for its part, did not directly counter the complex accounting presented by the lenders. It suggests only that accepting the lenders' position would unravel the entire confirmed reorganization plan.

In sum, although the lenders did not seek a stay before this court, and although the reorganization plan has been substantially consummated, the lenders have presented a plausible argument that American might be able to pay $290,000,000 at a 12.16% interest rate without affecting the success of the confirmed plan. We will therefore err on the side of caution and deny America's motion to dismiss the appeal on the grounds of equitable mootness. This brings us to the merits of the lenders' appeal.

C. The cramdown interest rate

The lenders' first substantive argument is that the district court erred in applying the "coerced loan theory" to determine the appropriate cramdown interest rate. They further contend that the cramdown interest rate of 6.785% is too low. Instead, they submit that the bankruptcy court should have applied a blended interest rate of 12.16%. This complex issue is further complicated by the recent Supreme Court case of *Till v. SCS Credit Corp.,* 541 U.S. 465, 124 S.Ct. 1951, 158 L.Ed.2d 787 (2004) (plurality opinion).

[7] **[8]** As an initial matter, a judicial cramdown is an available option when "one or more classes refuse to accept the plan." 7 Collier on Bankruptcy ¶ 1129.04 (15th ed.2005). The cramdown provisions set forth in 11 U.S.C. § 1129(b) allow courts, despite objections, to confirm a reorganization plan if "the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan." This statutory provision, however, does not specify how bankruptcy courts are to calculate the appropriate cramdown interest rate for lenders. *Cf. Till,* 541 U.S. at 473, 124 S.Ct. 1951 ("[Chapter 13] provides little guidance as to which of the rates of interest ... Congress had in mind when it adopted the cram down provision.").

[9] **[10]** In its pre-*Till* assessment, the bankruptcy court relied on several Sixth Circuit cases calling for the application of the coerced loan theory in determining cramdown interest rates. *See Household Auto. Fin. Corp. v. Burden* (*In re Kidd*), 315 F.3d 671 (6th Cir.2003) (applying the coerced loan theory in a Chapter 13 context); *Memphis Bank & Trust Co. v. Whitman,* 692 F.2d 427 (6th Cir.1982) (same). Under the coerced loan theory, courts "treat any deferred payment of an obligation under a plan as a coerced loan and the rate of return with respect to such loan must correspond to the rate that would be charged or obtained by the creditor making a loan to a third party with similar terms, duration, collateral and ***566** risk." 7 Collier on Bankruptcy ¶ 1129.06[1][c][ii][B]. Courts must therefore "use the current market

rate of interest used for similar loans in the region." *Memphis Bank & Trust Co.,* 692 F.2d at 431. This court has concluded that "[b]ankruptcy courts are generally familiar with the current conventional rates on various types of consumer loans. And where parties dispute the question, proof can easily be adduced." *Id.*

[11] The bankruptcy court therefore proceeded to determine, "based on its assessment of the credibility and reliability of the expert witnesses, what best accomplishes the market rate under the ... coerced loan theory." In this analysis, it was most persuaded by David Rosen, one of American's expert witnesses. Rosen testified that, "under the 'coerced loan' theory, the appropriate level of interest to provide the Lenders with the present value of their claim is the six-year Treasury Bill [interest rate] plus 350 basis points." This resulted in the appropriate interest rate under the coerced loan theory being fixed by the bankruptcy court at 6.785% per annum.

The lenders, however, contend that application of the coerced loan theory was improper in light of *Till,* 541 U.S. 465, 124 S.Ct. 1951, 158 L.Ed.2d 787. In that Chapter 13 case, the Supreme Court evaluated the four widely used methods of calculating the cramdown interest rate (the coerced loan, presumptive contract rate, formula rate, and cost of funds approaches) and found that all but the formula rate suffered from serious flaws:

> These considerations lead us to reject the coerced loan, presumptive contract rate, and cost of funds approaches. Each of these approaches is complicated, imposes significant evidentiary costs, and aims to make each individual creditor whole rather than to ensure the debtor's payments have the required present value. For example, the coerced loan approach requires bankruptcy courts to consider evidence about the market for comparable loans to similar (though nonbankrupt) debtors-an inquiry far removed from such courts' usual task of evaluating debtors' financial circumstances and the feasibility of their debt adjustment plans. In addition, the approach overcompensates creditors because the market lending rate must be high enough to cover factors, like lenders' transaction costs and overall profits, that are no longer relevant in the context of court-administered and court-supervised cram down loans.

Id. at 477, 124 S.Ct. 1951.

Instead, the Court endorsed the use of the formula approach. Under this approach, the bankruptcy court

> begins by looking to the national prime rate, reported daily in the press, which reflects the financial market's estimate of the amount a commercial bank should charge a creditworthy commercial borrower to compensate for the opportunity costs of the loan, the risk of inflation, and the relatively slight risk of default. 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.

Id. at 478-79, 124 S.Ct. 1951. The Court further observed that adopting "the formula approach entails a straightforward, familiar, and objective inquiry, and minimizes the need for potentially costly additional evidentiary proceedings." *Id.* at 479, 124 S.Ct. 1951.

Till, however, was a Chapter 13 bankruptcy case. So even though the plurality is clear that the formula approach is the preferable method for Chapter 13 cases, ***567** the opinion is less clear about cases in the Chapter 11 context. On the one hand, the plurality noted that "the 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." *Id.* at 474, 124 S.Ct. 1951 (quoting *Rake v. Wade,* 508 U.S. 464, 472 n. 8, 113 S.Ct. 2187, 124 L.Ed.2d 424 (1993)) (alterations in original). It further commented that "[w]e 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." *Id.* Some commentators have taken this to mean that *Till* 's analysis of Chapter 13 cramdown interest rates might be applicable to Chapter 11 cramdowns as well. *See* 7 Collier on Bankruptcy ¶ 1129.06[1][c][i].

In a footnote, however, the plurality noted that "there is no readily apparent Chapter 13 'cram down market rate of interest.' " *Id.* at 476 n. 14, 124 S.Ct. 1951. This follows from the fact that "[b]ecause 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." *Id.* But

> [i]nterestingly, 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.

Id. (emphasis added). This footnote suggests that a formula approach like the one adopted by the plurality is not required in the Chapter 11 context.

At least one court that has examined cramdown interest rates post-*Till* has concluded that *Till* does not apply in a Chapter 11 context. *See In re Prussia Assocs.,* 322 B.R. 572, 585, 589 (Bankr.E.D.Pa.2005) (holding that "*Till* is instructive, but it is not controlling, insofar as mandating the use of the 'formula' approach described in *Till* in every Chapter 11 case," and noting that "[*Till* 's] dicta implies that the Bankruptcy Court in such circumstances (i.e., efficient markets) should exercise discretion in evaluating an appropriate cramdown interest rate by considering the availability of market financing").

Several outside commentators, however, have argued that *Till* 's formula approach should apply to Chapter 11 cases as well as to Chapter 13 cases, noting that the two are not all that dissimilar. *See* 7 Collier on Bankruptcy ¶ 1129.06[1][c][i] ("[T]he relevant market for involuntary loans in chapter 11 may be just as illusory as in chapter 13."); Ronald F. Greenspan & Cynthia Nelson, *'Un* Till' *We Meet Again: Why the* Till *Decision Might Not Be the Last Word on Cramdown Interest Rates,* Am. Bankr.Inst. J., Dec.-Jan.2004, at 48 ("So we are left to wonder if footnote 14 nullifies *Till* in a chapter 11 context (or at least where efficient markets exist), modifies its application or is merely an irrelevant musing."); Thomas J. Yerbich, *How Do You Count the Votes-or Did* Till *Tilt the Game?,* Am. Bankr.Inst. J., July-Aug.2004, at 10 ("There is no more of a 'free market of willing cramdown lenders' in a chapter 11 (or a chapter 12, for that matter) than in a chapter 13."). And at least one court has concluded that *Till* does apply in a Chapter 11 context. *See Official Unsecured Creditor's Comm. of LWD, Inc. v. K & B Capital, LLC* (*In re LWD, Inc.*), 2005 WL 567460 (Bankr.W.D.Ky. Feb.10, 2005).

***568** **[12]** Taking all of this into account, we decline to blindly adopt *Till* ' s endorsement of the formula approach for Chapter 13 cases in the Chapter 11 context. Rather, we opt to take our cue from Footnote 14 of the opinion, which offered the guiding principle that "when picking a cram down rate in a Chapter 11 case, it might make sense to ask what rate an efficient market would produce." *Till,* 541 U.S. at 476 n. 14, 124 S.Ct. 1951. This 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.

While we accept Footnote 14's recommendation that the appropriate rate here is the one that "an efficient market would produce," we must still reconcile this principle with the coerced loan theory employed by the bankruptcy court. Indeed, the lenders make two related arguments against the bankruptcy court's determination of the appropriate interest rate, which they contend demonstrate that the court did not apply the rate that an efficient market would produce. They first claim that the 6.785% rate fixed by the bankruptcy court is not a realistic measure of what an efficient market would provide. According to the lenders' experts, an efficient market would have produced a rate of approximately 12%. One of their experts opined that this is because

> [i]t is not feasible, using conventional funding sources, to provide the $309 million in financing needed by the Company with 100% debt. There is, however, an established market that can provide financing of $309 million to the Company. This market would provide a combination of senior debt, mezzanine debt, and equity, with resulting yields priced in response to the inherent risks assumed by the holders of such instruments.

This dovetails with the lenders' second point of contention, which is that the bankruptcy court should have taken "loan-specific" criteria into account when adjusting the appropriate cramdown rate. In support of this argument, they cite to language in *Till* suggesting that the Supreme Court would look favorably on an analysis incorporating debtor-specific risks.

Our understanding of the bankruptcy court's methodology, however, is that it in fact sought to determine what an efficient market would have produced for the loan that the lenders provided, albeit under the rubric of the coerced loan theory. In its assessment of the coerced loan theory, the bankruptcy court court accepted Rosen's testimony to the effect that the loan in question was "senior debt loan in the health care field ... under a normalized capital structure." Rosen then proceeded to analyze the standard market rate for such a loan. The lenders' argument, on the other hand, is centered on the composite interest rate that a new loan (including "mezzanine" debt and equity) would command in the market, not what their loan to American (which was all senior debt) would require. But as the bankruptcy court properly noted:

> The Lenders' argument that the debtor could not obtain a "new loan" in the market place so highly leveraged might be so, but in actuality no new loan is being made here at all. Instead, the court is sanctioning the workout between the debtor and the Lenders. ***569** New funds are not being advanced without the consent of the claimants.

Indeed, the only type of debt contemplated by American's reorganization plan was senior secured debt. The inclusion of other types of financing-mezzanine debt and equity-is a pure hypothetical suggested by the lenders.

In addition, the bankruptcy court commented that, in its opinion, the 12.16% interest rate called for by the lenders would result in a "windfall." The court observed that

> [t]he lenders are not entitled to a premium on their return because the debtor filed for bankruptcy. The blended rate suggested by the Lenders goes beyond protecting the value of its claim from dilution caused by the delay in payment.... Any windfall because of bankruptcy is neither contemplated nor required under the Code. The court's role is not to reward the creditor for the "new loan" to a bankrupt debtor, but instead only to provide the creditor with the present value of its claim.

This observation, that the lenders' request would result in a windfall, is further highlighted by *Till.* In *Till,* the plurality acknowledged that lenders ought to be compensated for their risk. The opinion, however, cited with approval the fact that other courts starting from the prime rate "have generally approved adjustments of 1% to 3%." *Till,* 541 U.S. at 480, 124 S.Ct. 1951. It also commented that if a bankruptcy 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." *Id.* at 480-81, 124 S.Ct. 1951 (citation omitted). The interest rate demanded by the lenders here-12.16%-is nearly eight percentage points higher than the 4.25% prime rate in effect on May 27, 2003, the date that the confirmation order was entered by the district court. *See* http:// www.federalreserve.gov/releases/h15/ data/d/prime.txt. As such, the 12.16% rate appears to fall under the "eye-popping" category described unfavorably by *Till.*

In sum, *Till* provides the lower courts with the guiding principle that "when picking a cram down rate in a

Chapter 11 case, it might make sense to ask what rate an efficient market would produce." *Till,* 541 U.S. at 476 n. 14, 124 S.Ct. 1951. Although the lenders argue that the rate chosen by the bankruptcy court was not the rate produced by an efficient market, this is a question that was fully considered by that court. Its conclusion that the appropriate market rate would be 6.785% was reached only after carefully evaluating the testimony of various expert witnesses. The fact that the bankruptcy court utilized the rubric of the "coerced loan theory" that was criticized in *Till* provides no basis to reverse the bankruptcy court's decision because *Till* pointed out that, if anything, the coerced loan theory "*overcompensates* creditors ...." *Till,* 541 U.S. at 477, 124 S.Ct. 1951 (emphasis added). We therefore concur in the result reached by both the bankruptcy court and the district court on this issue.

D. The lenders' collateral value

[13] The lenders' final argument is that the bankruptcy court erred in determining the collateral value of their secured interest in American's assets. Specifically, the lenders assert that the witness upon whom the bankruptcy court relied, Patrick Hurst, "testified to the 'enterprise value' of the Debtors, but he did not testify that the Lenders' collateral value was the same thing as the enterprise value." They further claim that his evaluation did not take into account American's current liabilities or excess cash reserves.

***570 [14]** There are two weaknesses with the lenders' argument. First, they maintain that the failure to include current liabilities in calculating American's enterprise value constitutes an error as a matter of law. But they fail to cite any caselaw or authority supporting the proposition that current liabilities must, as a matter of law, be added to the enterprise value in order for that value to be the appropriate collateral value in a cramdown proceeding. In the absence of any authority to the contrary, we believe that the appropriate valuation should be viewed as a question of fact rather than a question of law.

That the valuation of the lenders' collateral is a question of fact is bolstered by the extensive "number crunching" performed by the bankruptcy court. In the course of the confirmation proceedings, the court perused hundreds of pages of supporting documents and heard two expert witnesses, Hurst and Benjamin, testify at length about the appropriate valuation. It also examined the results based upon three different valuation methodologies discussed by the two experts. The bankruptcy court had thus considered an extensive factual record by the time it fixed the lenders' collateral value at $250 million.

Second, the record indicates that Hurst did in fact take current liabilities and excess cash into account when calculating American's enterprise value. At one point during the confirmation hearing, Hurst was explicitly asked if he had included these items in his enterprise valuation:

> Q. And [with regard to the] selected enterprise value, you said you've added the excess cash to get to a final enterprise value?
>
> A. Correct.
>
> Q. Okay. Let's see. In calculating your enterprise value, have you assumed that a purchaser would assume the current liabilities?
>
> A. Yes.
>
> Q. And why is that?
>
> A. Because when we talked about it before-remember at the very beginning we said that the business enterprise valuation assumes that a buyer (inaudible) insufficient level of working capital. Working capital is current assets minus current liabilities. And so, therefore, they're getting all the assets and they're getting the current liabilities.

Hurst's calculations therefore did take these items into account. So even accepting the lenders' argument that the bankruptcy court was legally required to take into account excess cash and current liabilities in the overall valuation, the court's reliance on Hurst's testimony establishes that it did exactly that.

The lenders' argument essentially calls on this court to recalculate the collateral value of their claim on the basis of the testimony and documents already thoroughly reviewed by the bankruptcy court. We decline to do so because we find no error, much less clear error, in the bankruptcy court's evaluation of the lenders' collateral value.

III. CONCLUSION

For all of the reasons set forth above, we **AFFIRM** the judgment of the district court.

All Citations

420 F.3d 559, 45 Bankr.Ct.Dec. 47, Bankr. L. Rep. P 80,341, 2005 Fed.App. 0345P

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Superseded by Statute as Stated in In re Jones, Bankr.S.D.Tex., April 18, 2007

124 S.Ct. 1951
Supreme Court of the United States

Lee M. TILL, et ux., Petitioners,
v.
SCS CREDIT CORPORATION.

No. 02-1016.
|
Argued Dec. 2, 2003.
|
Decided May 17, 2004.

Synopsis

Background: Secured creditor objected to interest rate on payments to creditor on cram down loan under debtors' proposed Chapter 13 payment plan. The United States Bankruptcy Court for the Southern District of Indiana overruled objection, and creditor appealed. The District Court, Larry J. McKinney, Chief Judge, reversed. Debtors appealed, and the United States Court of Appeals for the Seventh Circuit, Ripple, Circuit Judge, 301 F.3d 583, vacated and remanded. Certiorari was granted.

[Holding:] The Supreme Court, Justice Stevens, held that formula approach, requiring adjustment of prime national interest rate based on risk of nonpayment, was appropriate method for determining adequate rate of interest on cram down loan.

Reversed and remanded.

Justice Thomas filed opinion concurring in judgment.

Justice Scalia filed dissenting opinion, in which Chief Justice Rehnquist, Justice O'Connor, and Justice Kennedy joined.

West Headnotes (4)

[1] Interest
Computation of Rate in General

Coerced loan approach was not appropriate method for determining adequate rate of interest on cram down loan pursuant to Chapter 13 payment plan; method required bankruptcy court to consider evidence about market for comparable loans to similar debtors, an inquiry far removed from court's usual task of evaluating debtors' financial circumstances and feasibility of their debt adjustment plan, and it overcompensated creditor. (Per Justice Stevens, with three Justices concurring, and one Justice concurring in judgment). Bankr.Code, 11 U.S.C.A. § 1325(a)(5)(B).

243 Cases that cite this headnote

[2] Interest
Computation of Rate in General

Presumptive contract rate approach was not appropriate method for determining adequate rate of interest on cram down loan pursuant to Chapter 13 payment plan; approach improperly focused on creditor's potential use of proceeds of foreclosure sale, it required debtor to obtain information about creditor's costs of overhead, financial circumstances, and lending practices to rebut presumptive contract rate, it could have produced absurd results, entitling inefficient, poorly managed lenders with lower profit margins to obtain higher cram down rates than well managed, better capitalized lenders, and similarly situated creditors could have ended up with vastly different cram down rates. (Per Justice Stevens, with three Justices concurring, and one Justice concurring in judgment). Bankr.Code, 11 U.S.C.A. § 1325(a)(5)(B).

107 Cases that cite this headnote

[3] Interest
Computation of Rate in General

Cost of funds approach was not appropriate method for determining adequate rate of interest on cram down loan pursuant

to Chapter 13 payment plan; approach mistakenly focused on creditworthiness of creditor rather than debtor, it imposed significant evidentiary burden, as debtor seeking to rebut creditor's asserted cost of borrowing had to introduce expert testimony about creditor's financial condition, and creditworthy lender with low cost of borrowing could have obtained lower cram down rate than financially unsound lender. (Per Justice Stevens, with three Justices concurring, and one Justice concurring in judgment). Bankr.Code, 11 U.S.C.A. § 1325(a)(5)(B).

136 Cases that cite this headnote

[4] Interest

Computation of Rate in General

Formula approach, requiring adjustment of prime national interest rate based on risk of nonpayment, was appropriate method for determining adequate rate of interest on cram down loan pursuant to Chapter 13 payment plan; approach entailed straightforward, familiar, and objective inquiry, and minimized need for potentially costly additional evidentiary proceedings, and resulting "prime-plus" rate of interest depended only on state of financial markets, circumstances of bankruptcy estate, and characteristics of loan, not on creditor's circumstances or its prior interactions with debtor. (Per Justice Stevens, with three Justices concurring, and one Justice concurring in judgment). Bankr.Code, 11 U.S.C.A. § 1325(a)(5)(B).

341 Cases that cite this headnote

**1952 *Syllabus* *

Under the so-called "cramdown option" permitted by the Bankruptcy Code, a Chapter 13 debtor's proposed debt adjustment plan must provide each allowed, secured creditor both a lien securing the claim and a promise of future property disbursements whose total value, as of the plan's date, "is not less than the [claim's] allowed amount," 11 U.S.C. § 1325(a)(5)(B)(ii). When such plans provide for installment payments, each installment must be calibrated to ensure that the **1953 creditor receives disbursements whose total present value equals or exceeds that of the allowed claim. Respondent's retail installment contract on petitioners' truck had a secured value of $4,000 at the time petitioners filed a Chapter 13 petition. Petitioners' proposed debt adjustment plan provided the amount that would be distributed to creditors each month and that petitioners would pay an annual 9.5% interest rate on respondent's secured claim. This "prime-plus" or "formula rate" was reached by augmenting the national prime rate of 8% to account for the nonpayment risk posed by borrowers in petitioners' financial position. In confirming the plan, the Bankruptcy Court overruled respondent's objection that it was entitled to its contract interest rate of 21%. The District Court reversed, ruling that the 21% "coerced loan rate" was appropriate because cramdown rates must be set at the level the creditor could have obtained had it foreclosed on the loan, sold the collateral, and reinvested the proceeds in equivalent loans. The Seventh Circuit modified that approach, holding that the original contract rate was a "presumptive rate" that could be challenged with evidence that a higher or lower rate should apply, and remanding the case to the Bankruptcy Court to afford the parties an opportunity to rebut the presumptive 21% rate. The dissent proposed adoption of the formula approach rejecting a "cost of funds rate" that would simply ask what it would cost the creditor to obtain the cash equivalent of the collateral from another source.

Held: The judgment is reversed, and the case is remanded.

301 F.3d 583, reversed and remanded.

Justice STEVENS, joined by Justice SOUTER, Justice GINSBURG, and Justice BREYER, concluded that the prime-plus or formula rate best meets the purposes of the Bankruptcy Code. Pp. 1958-1964.

*466 a) The Code gives little guidance as to which of the four interest rates advocated by opinions in this case Congress intended when it adopted the cramdown provision. A debtor's promise of future payments is worth less than an immediate lump-sum payment because the creditor cannot use the money right away, inflation may

cause the dollar's value to decline before the debtor pays, and there is a nonpayment risk. In choosing an interest rate sufficient to compensate the creditor for such concerns, bankruptcy courts must consider that: (1) 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; (2) Chapter 13 expressly authorizes a bankruptcy court to modify the rights of a creditor whose claim is secured by an interest in anything other than the debtor's principal residence; and (3) from a creditor's point of view, the cramdown provision mandates an objective rather than a subjective inquiry. Pp. 1958-1960.

(b) These considerations lead to the conclusion that the coerced loan, presumptive contract rate, and cost of funds approaches should be rejected, since they are complicated, impose significant evidentiary costs, and aim to make each individual creditor whole rather than to ensure that a debtor's payments have the required present value. Pp. 1960-1961.

(c) The formula approach has none of these defects. Taking its cue from ordinary lending practices, it looks to the national prime rate, which reflects the financial market's estimate of the amount a commercial bank should charge a creditworthy commercial borrower to compensate **1954 for the loan's opportunity costs, the inflation risk, and the relatively slight default risk. A bankruptcy court is then required to adjust the prime rate to account for the greater nonpayment risk that bankrupt debtors typically pose. Because that adjustment depends on such factors as the estate's circumstances, the security's nature, and the reorganization plan's duration and feasibility, the court must hold a hearing to permit the debtor and creditors to present evidence about the appropriate risk adjustment. Unlike the other approaches proposed in this case, the formula approach entails a straightforward, familiar, and objective inquiry, and minimizes the need for potentially costly additional evidentiary hearings. The resulting prime-plus rate also depends only on the state of financial markets, the bankruptcy estate's circumstances, and the loan's characteristics, not on the creditor's circumstances or its prior interactions with the debtor. The risk adjustment's proper scale is not before this Court. The Bankruptcy Court approved 1.5% in this case, and other courts have generally approved 1% to 3%, but respondent claims a risk adjustment in this range is inadequate. The issue *467 need not be resolved here; it is sufficient to note that courts must choose a rate high enough to compensate a creditor for its risk but not so high as to doom the bankruptcy plan. Pp. 1961-1962.

Justice THOMAS concluded that the proposed 9.5% rate will sufficiently compensate respondent for the fact that it is receiving monthly payments rather than a lump sum payment, but that 11 U.S.C. § 1325(a)(5)(B)(ii) does not require that the proper interest rate reflect the risk of nonpayment. Pp. 1965-1968.

(a) The plain language of § 1325(a)(5)(B)(ii) requires a court to determine, first, the allowed amount of the claim; second, what is the property to be distributed under the plan; and third, the "value, as of the effective date of the plan," of the property to be distributed. This third requirement, which is at issue here, incorporates the principle of the time value of money. Section 1325(a)(5)(B)(ii) requires valuation of the *property,* not valuation of the *plan.* Thus, a plan need only propose an interest rate that will compensate a creditor for the fact that had he received the property immediately rather than at a future date, he could have immediately made use of the property. In most, if not all, cases, where the plan proposes simply a stream of cash payments, the appropriate risk-free rate should suffice. There may be some risk of nonpayment, but § 1325(a)(5)(B)(ii) does not take this risk into account. Respondent's argument that § 1325(a)(5)(B)(ii) was crafted to protect creditors rather than debtors ignores the statute's plain language and overlooks the fact that secured creditors are compensated in part for the nonpayment risk through the valuation of the secured claim. Further, the statute's plain language is by no means debtor protective. Given the presence of multiple creditor-specific protections, it is not irrational to assume that Congress opted not to provide further protection for creditors by requiring a debtor-specific risk adjustment under § 1325(a)(5). Pp. 1965-1967.

(b) Here, the allowed amount of the secured claim is $4,000, and the property to be distributed under the plan is cash payments. Because the proposed 9.5% interest rate is higher than the risk-free rate, it is sufficient to account for the time value of money, which is all the statute requires. Pp. 1967-1968.

STEVENS, J., announced the judgment of the Court and delivered an opinion, in which SOUTER, GINSBURG, and BREYER, JJ., joined. THOMAS, J., filed an opinion concurring in the **1955 judgment, *post,* p. 1965. SCALIA, J., filed a dissenting opinion, in which REHNQUIST, C.J., and O'CONNOR and KENNEDY, JJ., joined, *post,* p. 1968.

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Opinion

Justice STEVENS announced the judgment of the Court and delivered an opinion, in which Justice SOUTER, Justice GINSBURG, and Justice BREYER join.

*468 To qualify for court approval under Chapter 13 of the Bankruptcy Code, an individual debtor's proposed debt adjustment plan must accommodate each allowed, secured creditor in one of three ways: (1) by obtaining the creditor's acceptance of the plan; (2) by surrendering the property securing the claim; or (3) by providing the creditor both a lien securing the claim and a promise of future property distributions (such as deferred cash payments) whose total "value, as of the effective date of the plan, ... is not less than the allowed amount of such claim."[1] The third alternative is *469 commonly known as the "cram down option" because it may be enforced over a claim holder's objection.[2] *Associates Commercial Corp. v. Rash,* 520 U.S. 953, 957, 117 S.Ct. 1879, 138 L.Ed.2d 148 (1997).

Plans that invoke the cramdown power often provide for installment payments over a period of years rather than a single payment.[3] In such circumstances, the amount of each installment must be calibrated **1956 to ensure that, over time, the creditor receives disbursements whose total present value[4] equals or exceeds that of the allowed claim. The proceedings in this case that led to our grant of certiorari identified four different methods of determining the appropriate method with which to perform that calibration. Indeed, the Bankruptcy Judge, the District Court, the Court of Appeals majority, and the dissenting judge each endorsed a different approach. We detail the underlying facts and describe each of those approaches before setting forth our judgment as to which approach best meets the purposes of the Bankruptcy Code.

I

On October 2, 1998, petitioners Lee and Amy Till, residents of Kokomo, Indiana, purchased a used truck from Instant Auto Finance for $6,395 plus $330.75 in fees and taxes. *470 They made a $300 downpayment and financed the balance of the purchase price by entering into a retail installment contract that Instant Auto immediately assigned to respondent, SCS Credit Corporation. Petitioners' initial indebtedness amounted to $8,285.24-the $6,425.75 balance of the truck purchase plus a finance charge of 21% per year for 136 weeks, or $1,859.49. Under the contract, petitioners agreed to make 68 biweekly payments to cover this debt; Instant Auto-and subsequently respondent-retained a purchase money security interest that gave it the right to repossess the truck if petitioners defaulted under the contract.

On October 25, 1999, petitioners, by then in default on their payments to respondent, filed a joint petition for relief under Chapter 13 of the Bankruptcy Code. At the time of the filing, respondent's outstanding claim amounted to $4,894.89, but the parties agreed that the truck securing the claim was worth only $4,000. App. 16-17. In accordance with the Bankruptcy Code, therefore, respondent's secured claim was limited to $4,000, and the $894.89 balance was unsecured.[5] Petitioners' filing automatically stayed debt-collection

activity by their various creditors, including the Internal Revenue Service (IRS), respondent, three other holders of secured claims, and unidentified unsecured creditors. In addition, the filing created a bankruptcy estate, administered by a trustee, which consisted of petitioners' property, including the truck. [6]

***471** Petitioners' proposed debt adjustment plan called for them to submit their future earnings to the supervision and control of the Bankruptcy Court for three years, and to assign $740 of their wages to the trustee each month. [7] App. to Pet. for Cert. 76a-81a. The plan charged the trustee with distributing these monthly wage assignments to pay, in order of priority: (1) ****1957** administrative costs; (2) the IRS's priority tax claim; (3) secured creditors' claims; and finally, (4) unsecured creditors' claims. *Id.,* at 77a-79a.

The proposed plan also provided that petitioners would pay interest on the secured portion of respondent's claim at a rate of 9.5% per year. Petitioners arrived at this "prime-plus" or "formula rate" by augmenting the national prime rate of approximately 8% (applied by banks when making low-risk loans) to account for the risk of nonpayment posed by borrowers in their financial position. Respondent objected to the proposed rate, contending that the company was "entitled to interest at the rate of 21%, which is the rate ... it would obtain if it could foreclose on the vehicle and reinvest the proceeds in loans of equivalent duration and risk as the loan" originally made to petitioners. App. 19-20.

At the hearing on its objection, respondent presented expert testimony establishing that it uniformly charges 21% interest on so-called "subprime" loans, or loans to borrowers with poor credit ratings, and that other lenders in the subprime market also charge that rate. Petitioners countered with the testimony of an Indiana University-Purdue University Indianapolis economics professor, who acknowledged that he had only limited familiarity with the subprime auto lending market, but described the 9.5% formula rate as "very reasonable" given that Chapter 13 plans are "supposed to be ***472** financially feasible." [8] *Id.*, at 43-44. Moreover, the professor noted that respondent's exposure was "fairly limited because [petitioners] are under the supervision of the court." *Id.*, at 43. The bankruptcy trustee also filed comments supporting the formula rate as, among other things, easily ascertainable, closely tied to the "condition of the financial market," and independent of the financial circumstances of any particular lender. App. to Pet. for Cert. 41a-42a. Accepting petitioners' evidence, the Bankruptcy Court overruled respondent's objection and confirmed the proposed plan.

The District Court reversed. It understood Seventh Circuit precedent to require that bankruptcy courts set cramdown interest rates at the level the creditor could have obtained if it had foreclosed on the loan, sold the collateral, and reinvested the proceeds in loans of equivalent duration and risk. Citing respondent's unrebutted testimony about the market for subprime loans, the court concluded that 21% was the appropriate rate. *Id.,* at 38a.

On appeal, the Seventh Circuit endorsed a slightly modified version of the District Court's "coerced" or "forced loan" approach. *In re Till,* 301 F.3d 583, 591 (C.A.7 2002). Specifically, the majority agreed with the District Court that, in a cramdown proceeding, the inquiry should focus on the interest rate "that the creditor in question would obtain in making a new loan in the same industry to a debtor who is similarly situated, although not in bankruptcy." *Id.,* at 592. To approximate that new loan rate, the majority looked to the parties' prebankruptcy contract rate (21%). The court recognized, however, that using the contract rate would not "duplicat[e] precisely ... the present value of the collateral to the creditor" because loans to bankrupt, court-supervised debtors "involve some risks that would not be incurred in a ***473** new loan to a debtor not in default" and also produce "some economies." *Ibid.* To correct for these inaccuracies, the majority held that the original ****1958** contract rate should "serve as a presumptive [cramdown] rate," which either the creditor or the debtor could challenge with evidence that a higher or lower rate should apply. *Ibid.* Accordingly, the court remanded the case to the Bankruptcy Court to afford petitioners and respondent an opportunity to rebut the presumptive 21% rate. [9]

Dissenting, Judge Rovner argued that the majority's presumptive contract rate approach overcompensates secured creditors because it fails to account for costs a creditor would have to incur in issuing a new loan. Rather than focusing on the market for comparable loans, Judge Rovner advocated the Bankruptcy Court's formula approach. *Id.,* at 596. Although Judge Rovner

noted that the rates produced by either the formula or the cost of funds approach might be "piddling" relative to the coerced loan rate, she suggested courts should "consider the extent to which the creditor has already been compensated for ... the risk that the debtor will be unable to discharge his obligations under the reorganization plan ... in the rate of interest that it charged to the debtor in return for the original loan." *Ibid.* We granted certiorari and now reverse. 539 U.S. 925, 123 S.Ct. 2572, 156 L.Ed.2d 601 (2003).

II

The Bankruptcy Code provides little guidance as to which of the rates of interest advocated by the four opinions in this case-the formula rate, the coerced loan rate, the presumptive contract rate, or the cost of funds rate-Congress had in mind when it adopted the cramdown provision. That provision, 11 U.S.C. § 1325(a)(5)(B), does not mention the term "discount rate" or the word "interest." Rather, it simply ***474** requires bankruptcy courts to ensure that the property to be distributed to a particular secured creditor over the life of a bankruptcy plan has a total "value, as of the effective date of the plan," that equals or exceeds the value of the creditor's allowed secured claim-in this case, $4,000. § 1325(a)(5)(B)(ii).

That command is easily satisfied when the plan provides for a lump-sum payment to the creditor. Matters are not so simple, however, when the debt is to be discharged by a series of payments over time. 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. The challenge for bankruptcy courts reviewing such repayment schemes, therefore, is to choose an interest rate sufficient to compensate the creditor for these concerns.

Three important considerations govern that choice. First, the Bankruptcy Code includes numerous provisions that, like the cramdown provision, require a court to "discoun[t] ... [a] stream of deferred payments back to the[ir] present dollar value," *Rake v. Wade,* 508 U.S. 464, 472, n. 8, 113 S.Ct. 2187, 124 L.Ed.2d 424 (1993), to ensure that a creditor receives at least the value of its claim. [10] We think it likely that ****1959** Congress intended bankruptcy judges and trustees to follow essentially the same approach when choosing an appropriate interest rate under any of these provisions. Moreover, we think Congress would favor an approach that is familiar in the financial ***475** community and that minimizes the need for expensive evidentiary proceedings.

Second, Chapter 13 expressly authorizes a bankruptcy court to modify the rights of any creditor whose claim is secured by an interest in anything other than "real property that is the debtor's principal residence." 11 U.S.C. § 1322(b)(2). [11] Thus, in cases like this involving secured interests in personal property, the court's authority to modify the number, timing, or amount of the installment payments from those set forth in the debtor's original contract is perfectly clear. Further, the potential need to modify the loan terms to account for intervening changes in circumstances is also clear: On the one hand, the fact of the bankruptcy establishes that the debtor is overextended and thus poses a significant risk of default; on the other hand, the postbankruptcy obligor is no longer the individual debtor but the court-supervised estate, and the risk of default is thus somewhat reduced. [12]

***476** Third, from the point of view of a creditor, the cramdown provision mandates an objective rather than a subjective inquiry. [13] That is, although § 1325(a)(5)(B) entitles the creditor to property whose present value objectively equals or exceeds the value of the collateral, it does not require that the terms of the cramdown loan match the terms to which the debtor and creditor agreed prebankruptcy, nor does it require that the cramdown terms make the creditor subjectively indifferent between present foreclosure and future payment. Indeed, the very idea of a "cramdown" loan *precludes* the latter result: By definition, a creditor forced to accept such a loan would prefer instead to foreclose. [14] Thus, a court ****1960** choosing a cramdown interest rate need not consider the creditor's individual circumstances, such as its prebankruptcy dealings with the debtor or the alternative loans it ***477** could make if permitted to foreclose. [15] Rather, the court should aim to treat similarly situated creditors similarly, [16] and to ensure that an objective economic analysis would suggest the debtor's interest payments will adequately compensate all such creditors for the time value of their money and the risk of default.

III

[1] These considerations lead us to reject the coerced loan, presumptive contract rate, and cost of funds approaches. Each of these approaches is complicated, imposes significant evidentiary costs, and aims to make each individual creditor whole rather than to ensure the debtor's payments have the required present value. For example, the coerced loan approach requires bankruptcy courts to consider evidence about the market for comparable loans to similar (though nonbankrupt) debtors-an inquiry far removed from such courts' usual task of evaluating debtors' financial circumstances and the feasibility of their debt adjustment plans. In addition, the approach overcompensates creditors because the market lending rate must be high enough to cover factors, like lenders' transaction costs and overall profits, that are no longer relevant in the context of court-administered and court-supervised cramdown loans.

[2] Like the coerced loan approach, the presumptive contract rate approach improperly focuses on the creditor's potential use of the proceeds of a foreclosure sale. In addition, although the approach permits a debtor to introduce some evidence about each creditor, thereby enabling the court to tailor the interest rate more closely to the creditor's financial circumstances and reducing the likelihood that the creditor ***478** will be substantially overcompensated, that right comes at a cost: The debtor must obtain information about the creditor's costs of overhead, financial circumstances, and lending practices to rebut the presumptive contract rate. Also, the approach produces absurd results, entitling "inefficient, poorly managed lenders" with lower profit margins to obtain higher cramdown rates than "well managed, better capitalized lenders." 2 K. Lundin, Chapter 13 Bankruptcy § 112.1, p. 112-8 (3d ed.2000). Finally, because the approach relies heavily on a creditor's prior dealings with the debtor, similarly situated creditors may end up with vastly different cramdown rates. [17]

****1961** **[3]** The cost of funds approach, too, is improperly aimed. Although it rightly disregards the now-irrelevant terms of the parties' original contract, it mistakenly focuses on the creditworthiness of the *creditor* rather than the debtor. In addition, the approach has many of the other flaws of the coerced loan and presumptive contract rate approaches. For example, like the presumptive contract rate approach, the cost of funds approach imposes a significant evidentiary burden, as a debtor seeking to rebut a creditor's asserted cost of borrowing must introduce expert testimony about the creditor's financial condition. Also, under this approach, a creditworthy lender with a low cost of borrowing may obtain a lower cramdown rate than a financially unsound, fly-by-night lender.

IV

[4] The formula approach has none of these defects. Taking its cue from ordinary lending practices, the approach begins ***479** by looking to the national prime rate, reported daily in the press, which reflects the financial market's estimate of the amount a commercial bank should charge a creditworthy commercial borrower to compensate for the opportunity costs of the loan, the risk of inflation, and the relatively slight risk of default. [18] 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 that 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. Some of this evidence will be included in the debtor's bankruptcy filings, however, so the debtor and creditors may not incur significant additional expense. Moreover, 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 information absent from the debtor's filing (such as evidence about the "liquidity of the collateral market," *post,* at 1973 (SCALIA, J., dissenting)). Finally, many of the factors relevant to the adjustment fall squarely within the bankruptcy court's area of expertise.

Thus, unlike the coerced loan, presumptive contract rate, and cost of funds approaches, the formula approach entails a straightforward, familiar, and objective inquiry, and minimizes the need for potentially costly additional evidentiary proceedings. Moreover, the resulting "prime-plus" rate of interest depends only on 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, **1962 the *480 prime-plus or formula rate best comports with the purposes of the Bankruptcy Code. [19]

We do not decide the proper scale for the risk adjustment, as the issue is not before us. The Bankruptcy Court in this case approved a risk adjustment of 1.5%, App. to Pet. for Cert. 44a-73a, and other courts have generally approved adjustments of 1% to 3%, see *In re Valenti,* 105 F.3d 55, 64 (C.A.2) (collecting cases), abrogated on other grounds by *Associates Commercial Corp. v. Rash,* 520 U.S. 953, 117 S.Ct. 1879, 138 L.Ed.2d 148 (1997). Respondent's core argument is that a risk adjustment in this range is entirely inadequate to compensate a creditor for the real risk that the plan will fail. There is some dispute about the true scale of that risk-respondent claims that more than 60% of Chapter 13 plans fail, Brief for Respondent 25, but petitioners argue that the failure rate for *approved* Chapter 13 plans is much lower, Tr. of Oral Arg. 9. We need not resolve that dispute. 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, after considering all creditors' objections and receiving the advice of the trustee, the judge is persuaded that "the debtor will be able to make all payments under the plan and to comply with the plan." *Ibid.* Together with the cramdown 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 necessitatean *481 "eye-popping" interest rate, 301 F.3d, at 593 (Rovner, J., dissenting), the plan probably should not be confirmed.

V

The dissent's endorsement of the presumptive contract rate approach rests on two assumptions: (1) "subprime lending markets are competitive and therefore largely efficient"; and (2) the risk of default in Chapter 13 is normally no less than the risk of default at the time of the original loan. *Post,* at 1969. Although the Bankruptcy Code provides little guidance on the question, we think it highly unlikely that Congress would endorse either premise.

First, the dissent assumes that subprime loans are negotiated between fully informed buyers and sellers in a classic free market. But there is no basis for concluding that Congress relied on this assumption when it enacted Chapter 13. Moreover, several considerations suggest that the subprime market is not, in fact, perfectly competitive. To begin with, used vehicles are regularly sold by means of tie-in transactions, in which the price of the vehicle is the subject of negotiation, while the terms of the financing are dictated by the seller. [20] In addition, there is extensive **1963 federal *482 [21] and state [22] regulation of subprime lending, which not only itself distorts the market, but also evinces regulators' belief that unregulated subprime lenders would exploit borrowers' ignorance and charge rates above what a competitive market would allow. [23] Indeed, Congress enacted the Truth in Lending Act in part because it believed "consumers would individually benefit not only from the more informed use of credit, but also from heightened competition which would result from more knowledgeable credit shopping." S.Rep. No. 96-368, p. 16 (1979). [24]

Second, the dissent apparently believes that the debtor's prebankruptcy default-on a loan made in a market in which creditors commonly charge the maximum rate of interest allowed by law, Brief for Respondent 16, and in which neither creditors nor debtors have the protections afforded by Chapter 13-translates into a high probability that the same debtor's confirmed Chapter 13 plan will fail. In our view, however, 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 *483 many risky plans, but the solution is to confirm fewer such plans, not to set default cramdown rates at absurdly high levels, thereby increasing the risk of default.

Indeed, as Justice THOMAS demonstrates, *post,* at 1966 (opinion concurring in judgment), the text of § 1325(a)(5)(B)(ii) may be read to support the conclusion that Congress did not intend the cramdown rate to include *any* compensation for the risk of default. [25] That reading is consistent with a view that Congress believed Chapter 13's protections to be so effective **1964 as to make the risk of default negligible. Because our decision in *Rash* assumes that cramdown interest rates are adjusted to "offset," to the extent possible, the risk of default,

520 U.S., at 962-963, 117 S.Ct. 1879, and because 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. Justice THOMAS' reading does emphasize, though, that a presumption that bankruptcy plans will succeed is more consistent with Congress' statutory scheme than the dissent's more cynical focus on bankrupt debtors' "financial instability and ... proclivity to seek legal protection," *post,* at 1969.

Furthermore, the dissent's two assumptions do not necessarily favor the presumptive contract rate approach. For one thing, the cramdown provision applies not only to subprime ***484** loans but also to prime loans negotiated prior to the change in circumstance (job loss, for example) that rendered the debtor insolvent. Relatedly, the provision also applies in instances in which national or local economic conditions drastically improved or declined after the original loan was issued but before the debtor filed for bankruptcy. In either case, there is every reason to think that a properly risk-adjusted prime rate will provide a better estimate of the creditor's current costs and exposure than a contract rate set in different times.

Even more important, if 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).

Justice SCALIA identifies four "relevant factors bearing on risk premium[:] (1) the probability of plan failure; (2) the rate of collateral depreciation; (3) the liquidity of the collateral market; and (4) the administrative expenses of enforcement." *Post,* at 1973. In our view, any information debtors have about any of these factors is likely to be included in their bankruptcy filings, while the remaining information will be far more accessible to creditors (who must collect information about their lending markets to remain competitive) than to individual debtors (whose only experience with those markets might be the single loan at issue in the case). Thus, the formula approach, which begins with a concededly low estimate of the appropriate interest rate and requires the creditor to present evidence supporting a higher rate, places the evidentiary burden on the more knowledgeable ***485** party, thereby facilitating more accurate calculation of the appropriate interest rate.

If the rather sketchy data uncovered by the dissent support an argument that Chapter 13 of the Bankruptcy Code should mandate application of the presumptive contract rate approach (rather than merely an argument that bankruptcy judges should exercise greater caution before approving debt adjustment plans), those data ****1965** should be forwarded to Congress. We are not persuaded, however, that the data undermine our interpretation of the statutory scheme Congress has enacted.

The judgment of the Court of Appeals is reversed, and the case is remanded with instructions to remand the case to the Bankruptcy Court for further proceedings consistent with this opinion.

It is so ordered.

Justice THOMAS, concurring in the judgment.
This case presents the issue of what the proper method is for discounting deferred payments to present value and what compensation the creditor is entitled to in calculating the appropriate discount rate of interest. Both the plurality and the dissent agree 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." *Ante,* at 1958; *post,* at 1968. Thus, the plurality and the dissent agree that the proper method for discounting deferred payments to present value should take into account each of these factors, but disagree over the proper starting point for calculating the risk of nonpayment.

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 ***486** *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. It is for this reason that I write separately.

I

"It is well established that 'when the statute's language is plain, the sole function of the courts-at least where the disposition required by the text is not absurd-is to enforce it according to its terms.' " *Lamie v. United States Trustee,* 540 U.S. 526, 534, 124 S.Ct. 1023, 1030, 157 L.Ed.2d 1024 (2004) (quoting *Hartford Underwriters Ins. Co. v. Union Planters Bank, N. A.,* 530 U.S. 1, 6, 120 S.Ct. 1942, 147 L.Ed.2d 1 (2000)). Section 1325(a)(5)(B) provides that "with respect to each allowed secured claim provided for by the plan," "the value, as of the effective date of the plan, of property to be distributed under the plan on account of such claim [must] not [be] less than the allowed amount of such claim." Thus, the statute requires a bankruptcy court to make at least three separate determinations. First, a court must determine the allowed amount of the claim. Second, a court must determine what is the "property to be distributed under the plan." Third, a court must determine the "value, as of the effective date of the plan," of the property to be distributed.

The dispute in this case centers on the proper method to determine the "value, as of the effective date of the plan, of property to be distributed under the plan." The requirement that the "value" of the property ****1966** to be distributed be ***487** determined "as of the effective date of the plan" incorporates the principle of the time value of money. To put it simply, $4,000 today is worth more than $4,000 to be received 17 months from today because if received today, the $4,000 can be invested to start earning interest immediately.[1] See G. Munn, F. Garcia, & C. Woelfel, Encyclopedia of Banking & Finance 1015 (rev. 9th ed.1991). Thus, as we explained in *Rake v. Wade,* 508 U.S. 464, 113 S.Ct. 2187, 124 L.Ed.2d 424 (1993), "[w]hen 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." *Id.,* at 472, n. 8, 113 S.Ct. 2187.

Respondent argues, and the plurality and the dissent agree, that the proper interest rate must also reflect the risk of nonpayment. But the statute contains no such requirement. The statute only requires the valuation of the "property to be distributed," not the valuation of the plan (*i.e.,* the promise to make the payments itself). Thus, in order for a plan to satisfy § 1325(a)(5)(B)(ii), the plan need only 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 the property. In most, if not all, cases, where the plan proposes simply a stream of cash payments, the appropriate risk-free rate should suffice.

Respondent here would certainly be acutely aware of any risk of default inherent in a Chapter 13 plan, but it 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 ***488** a debt. Suppose, for instance, that it is currently time A, the property to be distributed is a house, and it will be distributed at time B. Although market conditions might cause the value of the house to fluctuate between time A and time B, the fluctuating value of the house itself has nothing to do with the risk that the debtor will not deliver the house at time B. The value of the house, then, can be and is determined entirely without any reference to any possibility that a promise to transfer the house would not be honored. So too, then, with cash: the value of the cash can be and is determined without any inclusion of any risk that the debtor will fail to transfer the cash at the appropriate time.

The dissent might be correct that the use of the prime rate,[2] even with a small risk adjustment, "will systematically undercompensate secured creditors for the

true risks of default." *Post,* at 1968.[3] This systematic undercompensation might seem problematic as a matter of policy. But, it raises no problem as a matter of statutory interpretation. Thus, although there is always some risk of nonpayment when A promises to repay a debt to B through a stream of payments over time rather than through an immediate lump-sum payment, **1967 § 1325(a)(5)(B)(ii) does not take this risk into account.

This is not to say that a debtor's risk of nonpayment can never be a factor in determining the value of the property to be distributed. Although "property" is not defined in the Bankruptcy Code, nothing in § 1325 suggests that "property" is limited to cash. Rather, " 'property' can be cash, notes, stock, personal property or real property; in short, anything of value." 7 Collier on Bankruptcy ¶ 1129.03[7][b][i], p. 1129-44 (rev. 15th ed.2003) (discussing Chapter 11's cramdown provision). And if the "property to be distributed" *489 under a Chapter 13 plan is a note (*i.e.,* a promise to pay), for instance, the value of that note necessarily includes the risk that the debtor will not make good on that promise. Still, accounting for the risk of nonpayment in that case is not equivalent to reading a risk adjustment requirement into the statute, as in the case of a note, the risk of nonpayment is part of the value of the note itself.

Respondent argues that "Congress crafted the requirements of section 1325(a)(5)(B)(ii) for the protection of *creditors,* not debtors," and thus that the relevant interest rate must account for the true risks and costs associated with a Chapter 13 debtor's promise of future payment. Brief for Respondent 24 (citing *Johnson v. Home State Bank,* 501 U.S. 78, 87-88, 111 S.Ct. 2150, 115 L.Ed.2d 66 (1991)). In addition to ignoring the plain language of the statute, which requires no such risk adjustment, respondent overlooks the fact that secured creditors are already compensated in part for the risk of nonpayment through the valuation of the secured claim. In *Associates Commercial Corp. v. Rash,* 520 U.S. 953, 117 S.Ct. 1879, 138 L.Ed.2d 148 (1997), we utilized a secured-creditor-friendly replacement-value standard rather than the lower foreclosure-value standard for valuing secured claims when a debtor has exercised Chapter 13's cramdown option. We did so because the statute at issue in that case reflected Congress' recognition that "[i]f 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." *Id.,* at 962, 117 S.Ct. 1879.

Further, the plain language of the statute is by no means specifically debtor protective. As the Court pointed out in *Johnson, supra,* at 87-88, 111 S.Ct. 2150, § 1325 contains a number of provisions to protect creditors: A bankruptcy court can only authorize a plan that "has been proposed in good faith," § 1325(a)(3); secured creditors must accept the plan, obtain the property securing the claim, or "retain the[ir] lien[s]" and receive under the plan distributions of property which equal *490 "not less than the allowed amount of such claim," § 1325(a)(5); and a bankruptcy court must ensure that "the debtor will be able to make all payments under the plan and to comply with the plan," § 1325(a)(6). Given the presence of multiple creditor-specific protections, it is by no means irrational to assume that Congress opted not to provide further protection for creditors by requiring a debtor-specific risk adjustment under § 1325(a)(5). Although the dissent may feel that this is insufficient compensation for secured creditors, given the apparent rate at which debtors fail to complete their Chapter 13 plans, see *post,* at 1969, and n. 1, this is a matter that should be brought to the attention of Congress rather than resolved by this Court.

II

The allowed amount of the secured claim is $4,000. App. 57. The statute then requires **1968 a bankruptcy court to identify the "property to be distributed" under the plan. Petitioners' Amended Chapter 13 Plan (Plan) provided:

> "The future earnings of DEBTOR(S) are submitted to the supervision and control of this Court, and DEBTOR(S) shall pay to the TRUSTEE a sum of $740 ... per month in weekly installments by voluntary wage assignment by separate ORDER of the Court in an estimated amount of $170.77 and continuing for a total plan term of 36 months unless this Court approves an extension of the term not beyond 60 months from the date of filing the Petition herein." App. to Pet. for Cert. 77a.

From the payments received, the trustee would then make disbursements to petitioners' creditors, pro rata among each class of creditors. The Plan listed one priority claim and four secured claims. For respondent's secured claim, petitioners proposed an interest rate of 9.5%. App. 57.

Thus, petitioners proposed to distribute to respondent a stream of cash payments equaling respondent's pro rata share of $740 per month for a period of up to 36 months. *Id.,* at 12.

***491** Although the Plan does not specifically state that "the property to be distributed" under the Plan is cash payments, the cash payments are the only "property" specifically listed for distribution under the Plan. Thus, although the plurality and the dissent imply that the "property to be distributed" under the Plan is the mere *promise* to make cash payments, the plain language of the Plan indicates that the "property to be distributed" to respondent is up to 36 monthly cash payments, consisting of a pro rata share of $740 per month.

The final task, then, is to determine whether petitioners' proposed 9.5% interest rate will sufficiently compensate respondent for the fact that instead of receiving $4,000 today, it will receive $4,000 plus 9.5% interest over a period of up to 36 months. Because the 9.5% rate is higher than the risk-free rate, I conclude that it will. I would therefore reverse the judgment of the Court of Appeals.

Justice SCALIA, with whom THE CHIEF JUSTICE, Justice O'CONNOR, and Justice KENNEDY join, dissenting.

My areas of agreement with the plurality are substantial. We agree that, although all confirmed Chapter 13 plans have been deemed feasible by a bankruptcy judge, some nevertheless fail. See *ante,* at 1962. We agree that any deferred payments to a secured creditor must fully compensate it for the risk that such a failure will occur. See *ante,* at 1958. Finally, we agree that adequate compensation may sometimes require an " 'eye-popping' " interest rate, and that, if the rate is too high for the plan to succeed, the appropriate course is not to reduce it to a more palatable level, but to refuse to confirm the plan. See *ante,* at 1962.

Our only disagreement is over what procedure will more often produce accurate estimates of the appropriate interest rate. 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 ***492** that, in practice, this approach will systematically undercompensate secured creditors for the true risks 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.

****1969** I

The contract-rate approach makes two assumptions, both of which are reasonable. First, it assumes that subprime lending markets are competitive and therefore largely efficient. If so, the high interest rates lenders charge reflect not extortionate profits or excessive costs, but the actual risks of default that subprime borrowers present. Lenders with excessive rates would be undercut by their competitors, and inefficient ones would be priced out of the market. We have implicitly assumed market competitiveness in other bankruptcy contexts. See *Bank of America Nat. Trust and Sav. Assn. v. 203 North LaSalle Street Partnership,* 526 U.S. 434, 456-458, 119 S.Ct. 1411, 143 L.Ed.2d 607 (1999). Here the assumption is borne out by empirical evidence: One study reports that subprime lenders are nearly twice as likely to be unprofitable as banks, suggesting a fiercely competitive environment. See J. Lane, Associate Director, Division of Supervision, Federal Deposit Insurance Corporation, A Regulator's View of Subprime Lending: Address at the National Automotive Finance Association Non-Prime Auto Lending Conference 6 (June 18-19, 2002) (available in Clerk of Court's case file). By relying on the prime rate, the plurality implicitly assumes that the *prime* lending market is efficient, see *ante,* at 1961; I see no reason not to make a similar assumption about the *sub*prime lending market.

The second assumption is that the expected costs of default in Chapter 13 are normally no less than those at the ***493** time of lending. This assumption is also reasonable. Chapter 13 plans often fail. I agree with petitioners that the relevant statistic is the percentage of *confirmed* plans that fail, but even resolving that issue in their favor, the risk is still substantial. The failure rate they offer-which we may take to be a conservative estimate, as it is doubtless the lowest one they could find-is 37%. See Girth, The Role of Empirical Data in Developing Bankruptcy Legislation for Individuals, 65 Ind. L.J. 17, 40-42 (1989) (reporting a 63.1% success rate). [1] In every one of the failed plans

making up that 37%, a bankruptcy judge had found that "the debtor will be able to make all payments under the plan," 11 U.S.C. § 1325(a)(6), and a trustee had supervised the debtor's compliance, § 1302. That so many nonetheless failed proves that bankruptcy judges are not oracles and that trustees cannot draw blood from a stone.

While court and trustee oversight may provide some marginal benefit to the creditor, it seems obviously outweighed by the fact that (1) an already-bankrupt borrower has demonstrated a financial instability and a proclivity to seek legal protection that other subprime borrowers have not, **1970 and *494 (2) the costs of foreclosure are substantially higher in bankruptcy because the automatic stay bars repossession without judicial permission. See § 362. It does not strike me as plausible that creditors would *prefer* to lend to individuals already in bankruptcy than to those for whom bankruptcy is merely a possibility-as if Chapter 13 were widely viewed by secured creditors as some sort of godsend. Cf. Dunagan, Enforcement of Security Interests in Motor Vehicles in Bankruptcy, 52 Consumer Fin. L.Q. Rep. 191, 197 (1998). Certainly the record in this case contradicts that implausible proposition. See App. 48 (testimony of Craig Cook, sales manager of Instant Auto Finance) ("Q. Are you aware of how other lenders similar to Instant Auto Finance view credit applicants who appear to be candidates for Chapter 13 bankruptcy?" "A. Negative[ly] as well"). The better assumption is that bankrupt debtors are riskier than other subprime debtors-or, at the very least, not systematically *less* risky.

The first of the two assumptions means that the contract rate reasonably reflects actual risk at the time of borrowing. The second means that this risk persists when the debtor files for Chapter 13. It follows that the contract rate is a decent estimate, or at least the lower bound, for the appropriate interest rate in cramdown. [2]

The plurality disputes these two assumptions. It argues that subprime lending markets are not competitive because "vehicles are regularly sold by means of tie-in transactions, in which the price of the vehicle is the subject of negotiation, while the terms of the financing are dictated by the seller." *495 *Ante,* at 1962. [3] Tie-ins do not *alone* make financing markets noncompetitive; they only cause prices and interest rates to be considered *in tandem* rather than separately. The force of the plurality's argument depends entirely on its claim that "the terms of the financing are dictated by the seller." *Ibid.* This unsubstantiated assertion is contrary to common experience. Car sellers routinely advertise their interest rates, offer promotions like "zero-percent financing," and engage in other behavior that plainly assumes customers are sensitive to interest rates and not just price. [4]

**1971 *496 The plurality also points to state and federal regulation of lending markets. *Ante,* at 1962-1963. It claims that state usury laws evince a belief that subprime lending markets are noncompetitive. While that is one *conceivable* explanation for such laws, there are countless others. One statistical and historical study suggests that usury laws are a "primitive means of social insurance" meant to ensure "low interest rates" for those who suffer financial adversity. Glaeser & Scheinkman, Neither a Borrower Nor a Lender Be: An Economic Analysis of Interest Restrictions and Usury Laws, 41 J. Law & Econ. 1, 26 (1998). Such a rationale does not reflect a belief that lending markets are inefficient, any more than rent controls reflect a belief that real estate markets are inefficient. Other historical rationales likewise shed no light on the point at issue here. See *id.,* at 27. The mere existence of usury laws is therefore weak support for any position.

The federal Truth in Lending Act, 15 U.S.C. § 1601 *et seq.,* not only fails to support the plurality's position; it positively refutes it. The plurality claims the Act reflects a belief that full disclosure promotes competition, see *ante,* at 1963, and n. 24; the Act itself says as much, see 15 U.S.C. § 1601(a). But that belief obviously *presumes* markets are competitive (or, at least, that they were noncompetitive only because of the absence of the disclosures the Act now requires). If lending markets were not competitive-if the terms of financing were indeed "dictated by the seller," *ante,* at 1962-disclosure requirements would be pointless, since consumers would have no use for the information. [5]

As to the second assumption (that the expected costs of default in Chapter 13 are normally no less than those at the *497 time of lending), the plurality responds, not that Chapter 13 *as currently administered* is less risky than subprime lending generally, but that it *would* be less risky, if only bankruptcy courts would confirm fewer risky plans. *Ante,* at 1963. Of course, it is often quite difficult to predict which plans will fail. See Norberg, Consumer Bankruptcy's New Clothes: An Empirical

Study of Discharge and Debt Collection in Chapter 13, 7 Am. Bankr.Inst. L.Rev. 415, 462 (1999). But even assuming the high failure rate primarily reflects judicial dereliction rather than unavoidable uncertainty, the plurality's argument fails for want of any reason to believe the dereliction will abate. While full compensation can be attained either by low-risk plans and low interest rates, or by high-risk plans and high interest rates, it cannot be attained by *high*-risk plans and *low* interest rates, which, absent cause to anticipate a change in confirmation practices, is precisely what the formula approach would yield.

The plurality also claims that the contract rate overcompensates creditors because it includes "transaction costs and **1972 overall profits." *Ante,* at 1960. But the same is true of the rate the plurality prescribes: The prime lending rate includes banks' overhead and profits. These 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. See *Koopmans v. Farm Credit Services of Mid-America, ACA,* 102 F.3d 874, 876 (C.A.7 1996). The plurality's criticism might have force if there were reason to believe subprime lenders made exorbitant profits while banks did not-but, again, the data suggest otherwise. See Lane, Regulator's View of Subprime Lending, at 6. [6]

*498 Finally, the plurality objects that similarly situated creditors might not be treated alike. *Ante,* at 1960-1961, and n. 17. But the contract rate is only a presumption. If a judge thinks it necessary to modify the rate to avoid unjustified disparity, he can do so. For example, if two creditors charged different rates solely because they lent to the debtor at different times, the judge could average the rates or use the more recent one. The plurality's argument might be valid against an approach that *irrebuttably* presumes the contract rate, but that is not what I propose. [7]

II

The defects of the formula approach far outweigh those of the contract-rate approach. The formula approach starts with the prime lending rate-a number that, while objective and easily ascertainable, is indisputably too low. It then adjusts *499 by adding a risk premium that, unlike the prime rate, is neither objective nor easily ascertainable. If the risk premium is typically small relative to the prime rate-as the 1.5% premium added to the 8% prime rate by the court below would lead one to believe-then this subjective element of the computation might be forgiven. But in fact risk premiums, if properly computed, would typically be substantial. For example, if the 21% contract rate is an accurate reflection of risk in this case, the risk **1973 premium would be 13%-nearly two-thirds of the total interest rate. When the risk premium is the greater part of the overall rate, the formula approach no longer depends on objective and easily ascertainable numbers. The prime rate becomes the objective tail wagging a dog of unknown size.

As I explain below, the 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. See *Bank of America,* 526 U.S., at 457, 119 S.Ct. 1411 ("[T]he best way to determine value is exposure to a 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.

*500 The plurality defends the formula approach on the ground that creditors have better access to the relevant information. *Ante,* at 1964-1965. But this is not a case where we must choose between one initial estimate that is too low and another that is too high. Rather, the choice is between one that is far too low and another that is generally reasonably accurate (or, if anything, a bit too low). In these circumstances, consciously choosing the less accurate estimate merely because creditors have better information smacks more of policymaking than

of faithful adherence to the statutory command that the secured creditor receive property worth "*not less than* the allowed amount" of its claim, 11 U.S.C. § 1325(a)(5)(B)(ii) (emphasis added). Moreover, the plurality's argument assumes it is plausible-and desirable-that the issue will be litigated in most cases. But the costs of conducting a detailed risk analysis and defending it in court are prohibitively high in relation to the amount at stake in most consumer loan cases. Whatever approach we prescribe, the norm should be-and undoubtedly will be-that the issue is not litigated because it is not worth litigating. Given this reality, it is far more important that the initial estimate be accurate than that the burden of proving inaccuracy fall on the better informed party.

There is no better demonstration of the inadequacies of the formula approach than the proceedings in this case. Petitioners' 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." App. 43. 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 and trustee oversight do not prevent at least 37% of 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 ***501** costs of collection in that market. *Id.,* at 44-45. In light of these devastating concessions, it is ****1974** impossible to view the 1.5% figure as anything other than a smallish number picked out of a hat.

Based on even a rudimentary financial analysis of the facts of this case, the 1.5% figure is obviously wrong-not just off by a couple percent, but probably by roughly an order of magnitude. For a risk premium 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. Whether he is indifferent-*i.e.,* whether the risk premium added to the prime rate is adequate-can be gauged by comparing benefits and costs: on the one hand, the expected value of the extra interest, and on the other, the expected costs of default.

Respondent was offered a risk premium of 1.5% on top of the prime rate of 8%. If that premium were fully paid as the plan contemplated, it would yield about $60.[8] If the debtor defaulted, all or part of that interest would not be paid, so the expected value is only about $50.[9] The prime rate itself already includes some compensation for risk; as it turns out, about the same amount, yielding another $50.[10] ***502** Given the 1.5% risk premium, then, the total expected benefit to respondent was about $100. Against this we must weigh the expected costs of default. While precise calculations are impossible, rough estimates convey a sense of their scale.

The first cost of default involves depreciation. If the debtor defaults, the creditor can eventually repossess and sell the collateral, but by then it may be substantially less valuable than the remaining balance due-and the debtor may stop paying long before the creditor receives permission to repossess. When petitioners purchased their truck in this case, its value was almost equal to the principal balance on the loan.[11] By the time the plan was confirmed, however, the truck was worth only $4,000, while the balance on the loan was $4,895. If petitioners were to default on their Chapter 13 payments and if respondent suffered the same relative loss from depreciation, it would amount to about $550.[12]

****1975** The second cost of default 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 ***503** *foreclosure* value because collateral markets are not perfectly liquid and there is thus a spread between what a buyer will pay and what a seller will demand. The foreclosure value of petitioners' truck is not in the record, but, using the relative liquidity figures in *Rash* as a rough guide, respondent would suffer a further loss of about $450.[13]

The third cost of default consists of the administrative expenses of foreclosure. While a Chapter 13 plan is in effect, the automatic stay prevents secured creditors from repossessing their collateral, even if the debtor fails to pay. See 11 U.S.C. § 362. The creditor's attorney must move the bankruptcy court to lift the stay. § 362(d). In the District where this case arose, the filing fee for

such motions is now $150. See United States Bankruptcy Court for the Southern District of Indiana, Schedule of Bankruptcy Fees (Nov. 1, 2003) (available in Clerk of Court's case file). And the standard attorney's fee for such motions, according to one survey, is $350 in Indiana and as high as $875 in other States. See J. Cossitt, Chapter 13 Attorney Fee Survey, American Bankruptcy Institute Annual Spring Meeting (Apr. 10-13, 2003) (available in Clerk of Court's case file). Moreover, bankruptcy judges will often excuse first offenses, so foreclosure may require multiple trips to court. The total expected administrative expenses in the event of default could reasonably be estimated at $600 or more.

I have omitted several other costs of default, but the point is already adequately made. The three figures above total $1,600. Even accepting petitioners' low estimate of the plan failure rate, a creditor choosing the stream of future payments instead of the immediate lump sum would be selecting an alternative with an expected cost of about $590 ($1,600 multiplied by 37%, the chance of failure) and an expected ***504** benefit of about $100 (as computed above). No rational creditor would make such a choice. The risk premium over prime necessary to make these costs and benefits equal is in the neighborhood of 16%, for a total interest rate of 24%. [14]

Of course, many of the estimates I have made can be disputed. Perhaps the truck will depreciate more slowly now than at first, perhaps the collateral market is more liquid than the one in *Rash,* perhaps respondent can economize on attorney's fees, and perhaps there is some reason (other than judicial optimism) to think the Tills were unlikely to default. I have made some liberal assumptions, [15] but also some ****1976** conservative ones. [16] When a risk premium is off by an order of magnitude, one's estimates need not be very precise to show that it cannot possibly be correct.

In sum, the 1.5% premium adopted in this case is far below anything approaching fair compensation. 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.

***505** III

Justice THOMAS rejects both the formula approach and the contract-rate approach. He reads the statutory phrase "property to be distributed under the plan," 11 U.S.C. § 1325(a)(5)(B)(ii), to mean the proposed payments *if made as the plan contemplates,* so that the plan need only pay the risk-free rate of interest. *Ante,* at 1966 (opinion concurring in judgment). I would instead read this phrase to mean the right to receive payments that the plan vests in the creditor upon confirmation. Because there is no guarantee that the promised payments will in fact be made, the value of this property right must account for the risk of nonpayment.

Viewed in isolation, the phrase is susceptible of either meaning. Both 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. Context, however, supports my reading. The cramdown option which the debtors employed here is only one of three routes to confirmation. The other two-creditor acceptance and collateral surrender, §§ 1325(a)(5)(A), (C)-are both creditor protective, leaving the secured creditor roughly as well off as he would have been had the debtor not sought bankruptcy protection. Given this, it is unlikely the third option was meant to be substantially *under*protective; that would render it so much more favorable to debtors that few would ever choose one of the alternatives.

The risk-free approach also leads to anomalous results. Justice THOMAS admits that, if a plan distributes a note rather than cash, the value of the "property to be distributed" must reflect the risk of default on the note. *Ante,* at 1966-1967. 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. There is no conceivable reason why Congress ***506** would give secured creditors risk compensation in one case but not the other.

Circuit authority uniformly rejects the risk-free approach. While Circuits addressing the issue are divided over *how* to calculate risk, to my knowledge all of them require some compensation for risk, either explicitly or implicitly. See *In re Valenti, supra,* at 64 (treasury rate plus 1%-3% risk premium); *GMAC v. Jones,* 999 F.2d 63, 71 (C.A.3 1993) (contract rate); *United Carolina Bank v. Hall,* 993 F.2d 1126, 1131 (C.A.4 1993) (creditor's rate for similar **1977 loans, but not higher than contract rate); *In re Smithwick,* 121 F.3d 211, 214 (C.A.5 1997) (contract rate); *In re Kidd,* 315 F.3d 671, 678 (C.A.6 2003) (market rate for similar loans); *In re Till,* 301 F.3d 583, 592-593 (C.A.7 2002) (case below) (contract rate); *In re Fisher,* 930 F.2d 1361, 1364 (C.A.8 1991) (market rate for similar loans) (interpreting parallel Chapter 12 provision); *In re Fowler,* 903 F.2d 694, 698 (C.A.9 1990) (prime rate plus risk premium); *In re Hardzog,* 901 F.2d 858, 860 (C.A.10 1990) (market rate for similar loans, but not higher than contract rate) (Chapter 12); *In re Southern States Motor Inns, Inc.,* 709 F.2d 647, 652-653 (C.A.11 1983) (market rate for similar loans) (interpreting similar Chapter 11 provision); see also 8 Collier on Bankruptcy, ¶ 1325.06[3][b], p. 1325-37 (rev. 15th ed. 2004). Justice THOMAS identifies no decision adopting his view.

Nor does our decision in *Rash,* 520 U.S. 953, 117 S.Ct. 1879, 138 L.Ed.2d 148, support the risk-free approach. There we considered whether a secured creditor's claim should be valued at what the debtor would pay to replace the collateral or at the lower price the creditor would receive from a foreclosure sale. Justice THOMAS contends that *Rash* selected the former in order to compensate creditors for the risk of plan failure, and that, having compensated them once in that context, we need not do so again here. *Ante,* at 1967. I disagree with this reading of *Rash.* The Bankruptcy Code provides that "value shall be determined in light of the purpose of the valuation and of the *507 proposed disposition or use of [the] property." 11 U.S.C. § 506(a). *Rash* held that the foreclosure-value approach failed to give effect to this language, because it assigned the same value whether the debtor surrendered the collateral or was allowed to retain it in exchange for promised payments. 520 U.S., at 962, 117 S.Ct. 1879. "From the creditor's perspective as well as the debtor's, surrender and retention are not equivalent acts." *Ibid.* We did point out that retention entails risks for the creditor that surrender does not. *Id.,* at 962-963, 117 S.Ct. 1879. But we made no effort to correlate that increased risk with the difference between replacement and foreclosure value. And we also pointed out that retention benefits the debtor by allowing him to continue to use the property-a factor we considered "[o]f prime significance." *Id.,* at 963, 117 S.Ct. 1879. *Rash* stands for the proposition that surrender and retention are fundamentally different sorts of "disposition or use," calling for different valuations. Nothing in the opinion suggests that we thought the valuation difference reflected the degree of increased risk, or that we adopted the replacement-value standard *in order to compensate* for increased risk. To the contrary, we said that the debtor's "actual use ... is the proper guide under a prescription hinged to the property's 'disposition or use.' " *Ibid.*

If Congress wanted to compensate secured creditors for the risk of plan failure, it would not have done so by prescribing a particular method of valuing collateral. A plan may pose little risk even though the difference between foreclosure and replacement values is substantial, or great risk even though the valuation difference is small. For example, if a plan proposes immediate cash payment to the secured creditor, he is entitled to the higher replacement value under *Rash* even though he faces no risk at all. If the plan calls for deferred payments but the collateral consists of listed securities, the valuation difference may be trivial, but the creditor still faces substantial risks. And a creditor oversecured in even the slightest degree at **1978 the time of bankruptcy *508 derives no benefit at all from *Rash,* but still faces some risk of collateral depreciation. [17]

There are very good reasons for Congress to prescribe full risk compensation for creditors. Every action in the free market has a reaction somewhere. If subprime lenders are systematically undercompensated in bankruptcy, they will charge higher rates or, if they already charge the legal maximum under state law, lend to fewer of the riskiest borrowers. As a result, some marginal but deserving borrowers will be denied vehicle loans in the first place. Congress evidently concluded that widespread access to credit is worth preserving, even if it means being ungenerous to sympathetic debtors.

* * *

Today's judgment is unlikely to burnish the Court's reputation for reasoned decisionmaking. Eight Justices are in agreement that the rate of interest set forth in the

debtor's approved plan must include a premium for risk. Of those eight, four are of the view that beginning with the contract rate would most accurately reflect the actual risk, and four are of the view that beginning with the prime lending rate would do so. The ninth Justice takes no position on the latter point, since he disagrees with the eight on the former point; he would reverse because the rate proposed here, being above the risk-free rate, gave respondent no cause for complaint. Because I read the statute to require full risk compensation, and because I would adopt a valuation method that has a realistic prospect of enforcing that directive, I respectfully dissent.

All Citations

541 U.S. 465, 124 S.Ct. 1951, 158 L.Ed.2d 787, 51 Collier Bankr.Cas.2d 642, 43 Bankr.Ct.Dec. 2, Bankr. L. Rep. P 80,099, 04 Cal. Daily Op. Serv. 4224, 2004 Daily Journal D.A.R. 5841, 17 Fla. L. Weekly Fed. S 282

Footnotes

* The syllabus constitutes no part of the opinion of the Court but has been prepared by the Reporter of Decisions for the convenience of the reader. See *United States v. Detroit Timber & Lumber Co.,* 200 U.S. 321, 337, 26 S.Ct. 282, 50 L.Ed. 499.

1 11 U.S.C. § 1325(a)(5). The text of the statute reads as follows:

"§ 1325. Confirmation of plan

"(a) Except as provided in subsection (b), the court shall confirm a plan if-

.....

"(5) with respect to each allowed secured claim provided for by the plan-

"(A) the holder of such claim has accepted the plan;

"(B)(i) the plan provides that the holder of such 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 claim is not less than the allowed amount of such claim; or

"(C) the debtor surrenders the property securing such claim to such holder...."

2 As we noted in *Associates Commercial Corp. v. Rash,* 520 U.S. 953, 962, 117 S.Ct. 1879, 138 L.Ed.2d 148 (1997), a debtor may also avail himself of the second option (surrender of the collateral) despite the creditor's objection.

3 See *Rake v. Wade,* 508 U.S. 464, 472, n. 8, 113 S.Ct. 2187, 124 L.Ed.2d 424 (1993) (noting that property distributions under § 1325(a)(5)(B)(ii) may take the form of "a stream of future payments").

4 In the remainder of the opinion, we use the term "present value" to refer to the value as of the effective date of the bankruptcy plan.

5 Title 11 U.S.C. § 506(a) provides:

> "An allowed claim of a creditor secured by a lien on property in which the estate has an interest ... is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property, ... and is an unsecured claim to the extent that the value of such creditor's interest or the amount so subject to setoff is less than the amount of such allowed claim. Such value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest."

6 See §§ 541(a), 1306(a).

7 Petitioners submitted an initial plan that would have required them to assign $1,089 of their wages to the trustee every month. App. 9. Their amended plan, however, reduced this monthly payment to $740. App. to Pet. for Cert. 77a.

8 The requirement of financial feasibility derives from 11 U.S.C. § 1325(a)(6), which provides that the bankruptcy court shall "confirm a plan if ... the debtor will be able to make all payments under the plan and to comply with the plan." See *infra,* at 1962.

9 As 21% is the maximum interest rate creditors may charge for consumer loans under Indiana's usury statute, Ind.Code § 24-4.5-3-201 (1993), the remand presumably could not have benefited respondent.

10 See 11 U.S.C. § 1129(a)(7)(A)(ii) (requiring payment of property whose "value, as of the effective date of the plan" equals or exceeds the value of the creditor's claim); §§ 1129(a)(7)(B), 1129(a)(9)(B)(i), 1129(a)(9)(C), 1129(b)(2)(A)(i)(II), 1129(b)(2)(B)(i), 1129(b)(2)(C)(i), 1173(a)(2), 1225(a)(4), 1225(a)(5)(B)(ii), 1228(b)(2), 1325(a)(4), 1228(b)(2) (same).

11 Section 1322(b)(2) provides:

> "[T]he plan may ... modify the rights of holders of secured claims, other than a claim secured only by a security interest in real property that is the debtor's principal residence, ... or leave unaffected the rights of holders of any class of claims."

12 Several factors contribute to this reduction in risk. First, as noted below, *infra,* at 1962, a court may only approve a cramdown loan (and the debt adjustment plan of which the loan is a part) if it believes the debtor will be able to make all of the required payments. § 1325(a)(6). Thus, such loans will only be approved for debtors that the court deems creditworthy. Second, Chapter 13 plans must "provide for the submission" to the trustee "of all or such portion of [the debtor's] future ... income ... as is necessary for the execution of the plan," § 1322(a)(1), so the possibility of nonpayment is greatly reduced. Third, the Bankruptcy Code's extensive disclosure requirements reduce the risk that the debtor has significant undisclosed obligations. Fourth, as a practical matter, the public nature of the bankruptcy proceeding is likely to reduce the debtor's opportunities to take on additional debt. Cf. 11 U.S.C. § 525 (prohibiting certain Government grant and loan programs from discriminating against applicants who are or have been bankrupt).

13 We reached a similar conclusion in *Associates Commercial Corp. v. Rash,* 520 U.S. 953, 117 S.Ct. 1879, 138 L.Ed.2d 148 (1997), when we held that a creditor's secured interest should be valued from the debtor's, rather than the creditor's, perspective. *Id.,* at 963, 117 S.Ct. 1879 ("[The debtor's] actual use, rather than a foreclosure sale that will not take place, is the proper guide ...").

14 This fact helps to explain why there is no readily apparent Chapter 13 "cram down market rate of interest": Because every cramdown loan is imposed by a court over the objection of the secured creditor, there is no free market of willing cramdown lenders. Interestingly, the same is *not* true in the Chapter 11 context, as numerous lenders advertise financing for Chapter 11 debtors in possession. See, *e.g.,* Balmoral Financial Corporation, http://www.balmoral.com/bdip.htm (all Internet materials as visited Mar. 4, 2004, and available in Clerk of Court's case file) (advertising debtor in possession lending); Debtor in Possession Financing: 1st National Assistance Finance Association DIP Division, http://www.loanmallusa.com/dip.htm (offering "to tailor a financing program ... to your business' needs and ... to work closely with your bankruptcy counsel"). Thus, when picking a cramdown 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.

15 See *supra,* at 1957 (noting that the District Court's coerced loan approach aims to set the cramdown interest rate at the level the creditor could obtain from new loans of comparable duration and risk).

16 Cf. 11 U.S.C. § 1322(a)(3) ("The plan shall ... provide the same treatment for each claim within a particular class").

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

18 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.

19 The fact that Congress considered but rejected legislation that would endorse the Seventh Circuit's presumptive contract rate approach, H.R. 1085, 98th Cong., 1st Sess., § 19(2)(A) (1983); H.R. 1169, 98th Cong., 1st Sess., § 19(2)(A) (1983); H.R. 4786, 97th Cong., 1st Sess., § 19(2)(A) (1981), lends some support to our conclusion. It is perhaps also relevant that our conclusion is endorsed by the Executive Branch of the Government and by the National Association of Chapter Thirteen Trustees. Brief for United States as *Amicus Curiae;* Brief for National Association of Chapter Thirteen Trustees as *Amicus Curiae.* If we have misinterpreted Congress' intended meaning of "value, as of the date of the plan," we are confident it will enact appropriate remedial legislation.

20 The dissent notes that "[t]ie-ins do not *alone* make financing markets noncompetitive; they only cause prices and interest rates to be considered *in tandem* rather than separately." *Post,* at 1970. This statement, while true, is nonresponsive. If a market prices the cost of goods and the cost of financing together, then even if that market is perfectly competitive, all we can know is that the *combined* price of the goods and the financing is competitive and efficient. We have no way of determining whether the allocation of that price between goods and financing would be the same if the two components were separately negotiated. But the only issue before us is the cramdown interest rate (the cost of financing); the value of respondent's truck (the cost of the goods) is fixed. See *Rash,* 520 U.S., at 960, 117 S.Ct. 1879 (setting the value of collateral in Chapter 13 proceedings at the "price a willing buyer in the debtor's trade, business, or situation would pay to obtain like property from a willing seller"). The competitiveness of the market for cost-*cum*-financing is thus irrelevant to our analysis.

21 For example, the Truth in Lending Act regulates credit transactions and credit advertising. 15 U.S.C. §§ 1604-1649, 1661-1665b.

22 Usury laws provide the most obvious examples of state regulation of the subprime market. See, *e.g.,* Colo.Rev.Stat. § 5-2-201 (2003); Fla. Stat. Ann. § 537.011 (Supp.2004); Ind.Code § 24-4.5-3-201 (1993); Md. Com. Law Code Ann. § 12-404(d) (2000).

23 Lending practices in Mississippi, "where there currently is no legal usury rate," support this conclusion: In that State, subprime lenders charge rates "as high as 30 to 40%"-well above the rates that apparently suffice to support the industry in States like Indiana. Norberg, Consumer Bankruptcy's New Clothes: An Empirical Study of Discharge and Debt Collection in Chapter 13, 7 Am. Bankr.Inst. L.Rev. 415, 438-439 (1999).

24 See also H.R.Rep. No. 1040, 90th Cong., 1st Sess., 17 (1967) ("The basic premise of the application of disclosure standards to credit advertising rests in the belief that a substantial portion of consumer purchases are induced by such advertising and that if full disclosure is not made in such advertising, the consumer will be deprived of the opportunity to effectively comparison shop for credit").

25 The United States, too, notes that "[t]he text of Section 1325 is consistent with the view that the appropriate discount rate should reflect only the time value of money and not any risk premium." Brief for United States as *Amicus Curiae* 11, n. 4. The remainder of the United States' brief, however, advocates the formula approach. See, *e.g., id.,* at 19-28.

1 For example, if the relevant interest rate is 10%, receiving $4,000 one year from now is the equivalent to receiving $3,636.36 today. In other words, an investor would be indifferent to receiving $3,636.36 today and receiving $4,000 one year from now because each will equal $4,000 one year from now.

2 The prime rate is "[t]he interest rate most closely approximating the riskless or pure rate for money." G. Munn, F. Garcia, & C. Woelfel, Encyclopedia of Banking & Finance 830 (rev. 9th ed.1991).

3 Of course, in an efficient market, this risk has been (or will be) built into the interest rate of the original loan.

1 The true rate of plan failure is almost certainly much higher. The Girth study that yielded the 37% figure was based on data for a single division (Buffalo, New York) from over 20 years ago (1980-1982). See 65 Ind. L. J., at 41. A later study concluded that "the Buffalo division ha [d] achieved extraordinary results, far from typical for the country as a whole." Whitford, The Ideal of Individualized Justice: Consumer Bankruptcy as Consumer Protection, and Consumer Protection in Consumer Bankruptcy, 68 Am. Bankr.L.J. 397, 411, n. 50 (1994). Although most of respondent's figures are based on studies that do not clearly exclude unconfirmed plans, one study includes enough detail to make the necessary correction: It finds 32% of filings successful, 18% dismissed without confirmation of a plan, and 49% dismissed after confirmation, for a postconfirmation failure rate of 60% (*i.e.,* 49% / (32% + 49%)). See Norberg, Consumer Bankruptcy's New Clothes: An Empirical Study of Discharge and Debt Collection in Chapter 13, 7 Am. Bankr.Inst. L.Rev. 415, 440-441 (1999). This 60% failure rate is far higher than the 37% reported by Girth.

2 The contract rate is only a presumption, however, and either party remains free to prove that a higher or lower rate is appropriate in a particular case. For example, if market interest rates generally have risen or fallen since the contract was executed, the contract rate could be adjusted by the same amount in cases where the difference was substantial enough that a party chose to make an issue of it.

3 To the extent the plurality argues that subprime lending markets are not "*perfectly* competitive," *ante,* at 1962 (emphasis added), I agree. But there is no reason to doubt they are *reasonably* competitive, so that pricing in those markets is *reasonably* efficient.

4 I confess that this is "nonresponsive" to the argument made in the plurality's footnote (that the contract interest rate may not accurately reflect risk when set jointly with a car's sale price), see *ante,* at 1962, n. 20; it is in response to the quite different argument made in the plurality's text (that joint pricing shows that the subprime lending market is not competitive), see *ante,* at 1962. As to the *former* issue, the plurality's footnote makes a fair point. When the seller provides financing itself, there is a possibility that the contract interest rate might not reflect actual risk because a higher contract interest rate can be traded off for a lower sale price and vice versa. Nonetheless, this fact is not likely to bias the contract-rate approach in favor of creditors to any significant degree. If a creditor offers a promotional interest rate-such as "zero-percent financing"-in return for a higher sale price, the creditor bears the burden of showing that the true interest rate is higher than the contract rate. The opposite tactic-inflating the interest rate and decreasing the sale price-is constrained at some level by the buyer's option to finance through a third party, thus taking advantage of the lower price while avoiding the higher interest rate. (If a seller were to condition a price discount on providing the financing itself, the debtor should be entitled to rely on that condition to rebut the presumption that the contract rate reflects actual risk.) Finally, the debtor remains free to rebut the contract rate with any other probative evidence. While joint pricing may introduce some inaccuracy, the contract rate is still a far better initial estimate than the prime rate.

5 The plurality also argues that regulatory context is relevant because it "distorts the market." *Ante,* at 1963. Federal disclosure requirements do not distort the market in any meaningful sense. And while state usury laws do, that distortion works only to the benefit of debtors under the contract-rate approach, since it keeps contract rates artificially low.

6 Some transaction costs are avoided by the creditor in bankruptcy-for example, loan-origination costs such as advertising. But these are likely only a minor component of the interest rate. According to the record in this case, for example, the average interest rate on new-car loans was roughly 8.5%-only about 0.5% higher than the prime rate and 2.5% higher than the risk-free treasury rate. App. 43 (testimony of Professor Steve Russell). And the 2% difference between prime and treasury rates represented "mostly ... risk [and] to some extent transaction costs." *Id.,* at 42. These figures suggest that loan-origination costs included in the new-car loan and prime rates but not in the treasury rate are likely only a fraction of a percent. There is no reason to think they are substantially higher in the subprime auto lending market. Any transaction costs the creditor avoids in bankruptcy are thus far less than the additional ones he incurs.

7 The plurality's other, miscellaneous criticisms do not survive scrutiny either. That the cramdown provision applies to prime as well as subprime loans, *ante,* at 1964, proves nothing. Nor is there any substance to the argument that the formula approach will perform better where "national or local economic conditions drastically improved or declined after the original loan was issued." *Ibid.* To the extent such economic changes are reflected by changes in the prime rate, the contract rate can be adjusted by the same amount. See n. 2, *supra.* And to the extent they are not, they present the same problem under either approach: When a party disputes the presumption, the court must gauge the significance of the economic change and adjust accordingly. The difference, again, is that the contract-rate approach starts with a number that (but for the economic change) is reasonably accurate, while the formula approach starts with a number that (with or without the economic change) is not even close.

8 Given its priority, and in light of the amended plan's reduced debtor contributions, the $4,000 secured claim would be fully repaid by about the end of the second year of the plan. The average balance over that period would be about $2,000, *i.e.,* half the initial balance. The total interest premium would therefore be 1.5% x 2 x $2,000 = $60. In this and all following calculations, I do not adjust for time value, as timing effects have no substantial effect on the conclusion.

9 Assuming a 37% rate of default that results on average in only half the interest's being paid, the expected value is $60 x (1 - 37% / 2), or about $50.

10 According to the record in this case, the prime rate at the time of filing was 2% higher than the risk-free treasury rate, and the difference represented "mostly ... risk [and] to some extent transaction costs." App. 42 (testimony of Professor Steve Russell); see also Federal Reserve Board, Selected Interest Rates, http:// www.federalreserve.gov/releases/ h15/ data.htm (as visited Apr. 19, 2004) (available in Clerk of Court's case file) (historical data showing prime rate typically exceeding 3-month constant-maturity treasury rate by 2%-3.5%). If "mostly" means about three-quarters of 2%, then the risk compensation included in the prime rate is 1.5%. Because this figure happens to be the same as the risk premium over prime, the expected value is similarly $50. See nn. 8-9, *supra.*

11 The truck was initially worth $6,395; the principal balance on the loan was about $6,426.

12 On the original loan, depreciation ($6,395 - $4,000, or $2,395) exceeded loan repayment ($6,426 - $4,895, or $1,531) by $864, *i.e.,* 14% of the original truck value of $6,395. Applying the same percentage to the new $4,000 truck value yields approximately $550.

13 The truck in *Rash* had a replacement value of $41,000 and a foreclosure value of $31,875, *i.e.,* 22% less. 520 U.S., at 957, 117 S.Ct. 1879. If the market in this case had similar liquidity and the truck were repossessed after losing half its remaining value, the loss would be 22% of $2,000, or about $450.

14 A 1.5% risk premium plus a 1.5% risk component in the prime rate yielded an expected benefit of about $100, see *supra,* at 1973-1974, so, to yield $590, the total risk compensation would have to be 5.9 times as high, *i.e.,* almost 18%, or a 16.5% risk premium over prime.

15 For example, by ignoring the possibility that the creditor might recover some of its undersecurity as an unsecured claimant, that the plan might fail only after full repayment of secured claims, or that an oversecured creditor might recover some of its expenses under 11 U.S.C. § 506(b).

16 For example, by assuming a failure rate of 37%, cf. n. 1, *supra,* and by ignoring all costs of default other than the three mentioned.

17 It is true that, if the debtor defaults, one of the costs the creditor suffers is the cost of liquidating the collateral. See *supra,* at 1975. But it is illogical to "compensate" for this risk by requiring all plans to pay the full cost of liquidation (replacement value minus foreclosure value), rather than an amount that reflects the possibility that liquidation will actually be necessary and that full payments will not be made.

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