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Fair Equivalents and Market Prices: Bankruptcy Cramdown Interest Rates

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FAIR EQUIVALENTS AND MARKET PRICES: BANKRUPTCY CRAMDOWN INTEREST RATES

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INTRODUCTION

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

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

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

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

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

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

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

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

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

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

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

[3] *Id.* § 1129(a)(8).

[4] *Id.* § 1126(c).

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

[6] 11 U.S.C. § 1141.

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

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

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

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

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

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

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[8] *See id.* ¶ 1129.03[4][a][ii].

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

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

[11] Momentive was an affiliate of the lead debtor, MPM Silicones, LLC. As a consequence, the case is reported under the name of the affiliate. *See In re* MPM Silicones, LLC (*Momentive*), No. 14-22503-rdd, 2014 WL 4436335 (Bankr. S.D.N.Y. Sept. 9, 2014), *aff'd*, 531 B.R. 321 (S.D.N.Y. 2015), *appeal docketed*, No. 15-1771 (2d Cir. filed June 1, 2015).

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

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

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

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

A. The History of "Fair and Equitable"

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

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

[14] *See* 11 U.S.C. § 1129(b)(1).

[15] *Id.* § 1129(a)(3).

[16] *Id.* § 1129(a)(7).

[17] *Id.* § 1129(a)(9).

[18] *Id.* § 1129(a)(11).

[19] *Id.* § 1129(b)(1).

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

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

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

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

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

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

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

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

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

[24] *See* § 77(g), 47 Stat. at 1479.

[25] *Id.*

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

[27] 299 U.S. 24 (1936).

[28] *Id.* at 27.

[29] *Id.*

[30] 308 U.S. 106 (1939).

[31] *Id.* at 115.

2. Incorporation of Prior Equity Receivership Practice

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

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

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

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

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

3. "Fair Equivalents" of Value Under the Statute

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

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[32] *Id.*

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

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

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

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

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

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

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

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

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

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

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

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

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

[40] 318 U.S. at 564.

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

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

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

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

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

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

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

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[41] *Id.* at 565.

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

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

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

4. The 1978 Code

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

[50] *Id.*

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

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

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

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

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

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

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

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

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

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

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

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

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

[60] Or, in the context of an equity interest, delivery of property equal in value to the interest.

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

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

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

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

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

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

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

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

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

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

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

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

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

1. Don't Pay Too Little

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

2. Don't Pay Too Much

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

3. Don't Expect Precision

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

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

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

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

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

II. THE PROCESS OF PROPERTY VALUATION IN NONCONSENSUAL CONFIRMATION

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

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

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[70] ASWATH DAMODARAN, INVESTMENT VALUATION: TOOLS & TECHNIQUES FOR DETERMINING THE VALUE OF ANY ASSET 4 (3d ed. 2012); *see also* ARTHUR KEOWN ET AL., FINANCIAL MANAGEMENT: PRINCIPLES & APPLICATIONS 751 (6th ed. 2012) ("[N]o single dollar value exists for a company.").

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

[72] *Id.*

[73] *Id.*

[74] *See* 11 U.S.C. § 502(a) (2012).

[75] *See id.* § 506(a).

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

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

A. Valuing Income Producing Property

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

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

1. Present Value Analysis

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

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

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

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

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

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

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

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

2. Present Value Analysis and § 1129(b)

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

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

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

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

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

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

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

3. Present Value and Finance

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

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

B. Valuing Debt Issued in Reorganizations

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

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

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

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

[87] *Id.* at 36.

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

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

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

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

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

III. *TILL* AND DISCOUNT RATES

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

A. Till v. SCS Credit

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

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

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

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

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

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

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

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

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

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

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

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[95] *Id.* at 479–80.

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

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

B. Till *and Chapter 11*

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

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

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

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

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

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

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

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

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

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

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

C. Till*'s Reference to Efficient Markets*

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

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

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

102 *Id.* at 333.

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

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

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

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

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

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

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

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

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

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

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

109 *Id.*

1. Is There a Market for Cramdown Debt?

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

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

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

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

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

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

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

[112] *Id.* at 476.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

b. "Efficient" as Understood by Economists

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

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[118] *Till*, 541 U.S. 479–80.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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126 *Id.* at 298–300.

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

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

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

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

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

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

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

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

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

[133] 529 F. Supp. 2d 644, 748 (S.D. Tex. 2006); *see also* Thomas S. Green, Comment, *An Analysis of the Advantages of Non-Market Based Approaches for Determining Chapter 11 Cramdown Rates: A Legal and Financial Perspective*, 46 SETON HALL L. REV. 1151, 1172–75 (2016).

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

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

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

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

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

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

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

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

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

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

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

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

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

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

IV. *MOMENTIVE* AND CHAPTER 11

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

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

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

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

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

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

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

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

[142] *Id.*

[143] *Id.*

[144] *Id.*

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

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

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

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

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

A. The Debtor

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

B. The Secured Parties

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

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

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

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

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

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

152 *Id.* at 28.

153 *Id.* at 24.

154 *Id.* at 25.

155 *Id.* at 24–25.

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

C. Confirmation and Cramdown

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

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

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

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156 *Id.* at 25.

157 *Id.*

158 *Id.* at 27 (noting Apollo owned a "significant portion of the Second Lien Notes").

159 Notice of Filing of Certain Exhibits to Disclosure Statement for Joint Chapter 11 Plan of Reorganization for Momentive Performance Materials Inc. & Its Affiliated Debtors at 43, Exhibit C, *In re* MPM Silicones, LLC (*Momentive*), No. 14-22503-rdd, 2014 WL 4436335 (Bankr. S.D.N.Y. June 11, 2014), *aff'd*, 531 B.R. 321 (S.D.N.Y. 2015), *appeal docketed*, No. 15-1771 (2d Cir. filed June 1, 2015), 2014 WL 2917134, at *43.

160 *See Momentive*, 2014 WL 4436335, at *10.

161 Disclosure Statement for Joint Chapter 11 Plan of Reorganization for Momentive Performance Materials Inc. & Its Affiliated Debtors, *supra* note 141, at 26–28.

162 *See* 7 COLLIER ON BANKRUPTCY, *supra* note 7, ¶ 1129.04[2][a].

163 *See Momentive*, 2014 WL 4637175, at *10.

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

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

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

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

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

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

166 *Id.*

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

168 *Id.* at 35–36.

169 *Id.*

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

171 *Id.*

D. Till *Adopted; Market Spurned*

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

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

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

So what was the goal? As Judge Drain noted:

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

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

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

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

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

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

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

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

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

178 *Id.* at *26.

179 *Id.* The court quoted the Supreme Court: "We note that if the Court could somehow be certain a debtor would complete his plan, the prime rate would be adequate to compensate any secured creditors forced to accept cramdown loans." *Id.* (quoting *Till*, 541 U.S. at 479 n.18).

180 *Id.*

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

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

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

Judge Drain rejected this argument.[188]

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

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181 *Id.*

182 *Id.* at *27.

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

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

185 *Id.* at *28.

186 *Id.* at *29.

187 *Id.*

188 *Id.*

189 *Id.*

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

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

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

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190 *Id.* at *30.

191 *Id.* at *31.

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

193 *Id.* at *31–32.

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

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

196 *Id.*

197 *Id.*

198 *Id.*

199 *Id.* at *34.

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

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

V. POLICY CONSIDERATIONS IN SELECTING A DISCOUNT RATE

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

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

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

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

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201 *Id.*

202 11 U.S.C. § 1129(b)(2)(A)(i)(II) (2012).

203 *See supra* section II.B.

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

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

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

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

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

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

[205] *Id.* cmt. 6.

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

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

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

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

2. Protecting Restrictions on Potential Overpayment

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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[218] *Id.* at 237.

[219] *Id.* at 234.

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

3. The Role of Precision and Expectations

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

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

B. Not Irrebuttable, But Not Irrelevant Either

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

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

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

[223] *Id.* at *11.

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

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

[226] *Id.* at 5–6.

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

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

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

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

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

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

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

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

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

[232] 496 B.R. at 13.

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

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

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

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

As the Third Circuit noted:

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

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

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

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

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

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

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

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

CONCLUSION

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

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

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

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

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

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

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

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