The "Cramdown" Interest Rate in Chapter 12 Bankruptcy

Roger McEowen (roger.mceowen@washburn.edu) – Washburn University School of Law
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Overview

In the context of Chapter 12 (farm) bankruptcy, unless a secured creditor agrees otherwise, the creditor is entitled to receive the value, as of the effective date of the plan, equal to the allowed amount of the claim. Thus, after a secured debt is written down to the fair market value of the collateral, with the amount of the debt in excess of the collateral value treated as unsecured debt which is generally discharged if not paid during the term of the plan, the creditor is entitled to the present value of the amount of the secured claim if the payments are stretched over a period of years.

What does "present value" mean? It means that a dollar in hand today is worth more than a dollar to be received at some time in the future. It also means that an interest rate will be attached to that deferred income. But, what interest rate will make a creditor whole? A recent decision involving a farming operation in the state of Washington is a good illustration of how courts address the issue.

"Cramdown" and Present Value

When a farmer files a Chapter 12 bankruptcy, the law allows the "cramdown" of a secured creditor if the farmer reorganization plan provides that the secured creditor gets to retain the lien that secures the claim and the value, as of the effective date of the plan, of property to be distributed by the trustee or the debtor under the plan on account of the claim is not less than the allowed amount of the claim. *11 U.S.C. §1225(a)(5)(B)(i)-(ii).* The real issue is what "not less than the allowed amount of the claim" means. That's particularly true when the rule is applied in the context of cash payments that are to be made in the future. In that instance, a value must be derived as of the plan's effective date, that is discounted to present value. Present value is the discounted value of a stream of expected future incomes. That stream of income received in the future is discounted back to present value by a discount rate.

The determination of present value is highly sensitive to the discount rate, which is commonly expressed in terms of an interest rate. Several different approaches have been used in Chapter 12 bankruptcy cases (and nearly identical situations in Chapters 11 and 13 cases) to determine the discount rate. Those approaches include the contract rate – the interest rate used in the debt obligation giving rise to the allowed claim; the legal rate in the particular jurisdiction; the rate on unpaid federal tax; the federal civil judgment rate; the rate based on expert testimony; a rate tied to the lender's cost of funds; and the market rate for similar loans.

Supreme Court Decision

In 2004, the U.S. Supreme Court, in, addressed the issue in the context of a Chapter 13 case that has since been held applicable in Chapter 12 cases. *Till v. SCS Credit Corporation, 541 U.S. 465 (2004).* In *Till,* the debtor owed $4,000 on a truck at the time of filing Chapter 13. The debtor proposed to pay the creditor over time with the payments subject to a 9.5 percent annual interest rate. That rate was slightly higher than the average loan rate to account for the additional risk that the debtor might default. The creditor, however, argued that it was entitled to a 21 percent rate of interest to ensure that the payments equaled the "total present value" or were "not less than the [claim's] allowed amount." The bankruptcy court disagreed, but the district court reversed and imposed the 21 percent rate. The United States Court of Appeals for the Seventh

Circuit held that the 21 percent rate was "probably" correct, but that the parties could introduce additional concerning the appropriate interest rate.

On further review by the U.S. Supreme Court, the Court held that the proper interest rate was 9.5 percent. That rate, the Court noted, was derived from a modification of the average national loan rate to account for the risk that the debtor would default. The Court's opinion has been held to be applicable in Chapter 12 cases. *See, e.g., In re Torelli, 338 B.R. 390 (Bankr. E.D. Ark. 2006); In re Wilson, No. 05-65161-12, 2007 Bankr. LEXIS 359 (Bankr. D. Mont. Feb. 7, 2007); In re Woods, 465 B.R. 196 (B.A.P. 10th Cir. 2012).* The Court rejected the coerced loan, presumptive contract rate and cost of funds approaches to determining the appropriate interest rate, noting that each of the approaches was "complicated, impose[d] significant evidentiary costs, and aim[ed] to make each individual creditor whole rather than to ensure the debtor's payments ha[d] the required present value." A plurality of the Court explained that these difficulties were not present with the formula approach. The Court opined that the formula approach requires that the bankruptcy court determine the appropriate interest rate by starting with the national prime rate and then make an adjustment to reflect the risk of nonpayment by the debtor. While the Court noted that courts using the formula approach have typically added 1 percent to 3 percent to the prime rate as a reflection of the risk of nonpayment, the Court did not adopt a specific percentage range for risk adjustment.

Subsequent Cases

Since the Supreme Court's *Till* decision, the lower courts have decided many cases in which they have attempted to apply the Till approach. Indeed, the Circuit Courts have split on whether the appropriate interest rate for determining present value should be the market rate or a rate based on a formula. For example, in a relatively recent Circuit Court case on the issue, the Second Circuit held that a market rate of interest should be utilized if an efficient market existed in which the rate could be determined. *In re MPM Silicones, L.L.C., No. 15-1682(l), 2017 U.S. App. LEXIS 20596 (2nd Cir. Oct. 20, 2017).* In the case, the debtor filed Chapter 11 and proposed a reorganization plan that gave first-lien holders an option to receive immediate payment without any additional "make-whole" premium, or the present value of their claims by utilizing an interest rate based on a formula that resulted in a rate below the market rate. The bankruptcy court confirmed the plan, utilizing the formula approach of *Till*. The federal district court affirmed. On further review, the appellate court reversed noting that *Till* had not conclusively specified the use of the formula approach in a Chapter 11 case. The appellate court remanded the case to the bankruptcy court for a determination of whether an efficient market rate could be determined based on the facts of the case.

Recent Washington Case

A recent case from the state of Washington is a good illustration of how a court can use the Till opinion to fashion an interest rate suitable to the debtor's particular farming operation. In *In re Key Farms, Inc., No. 19-02949-WLH12, 2020 Bankr. LEXIS 1642 (Bankr. D. Wash. Jun. 23, 2020),* the debtor was a family farming operation engaged in apple, cherry, alfalfa, seed corn and other crop production. The parents of the family owned 100 percent of the debtor, the farming entity. In 2014, the debtor changed its primary lender which extended a line of credit to the debtor that the father personally guaranteed and a term loan to the debtor that the father also personally guaranteed. The lender held a first-priority security interest in various real and personal property to secure loan repayment. The debtor became unable to repay the line of credit and the default caused defaults on the term loan and the guarantees. The lender sued to foreclose on its collateral and have a receiver appointed.

The debtor then filed Chapter 12 bankruptcy and proposed a reorganization plan where it would continue farming under 2020-2024 in accordance with proposed budgets through 2024. The plan provided for repayment of all creditors in full. The plan proposed to repay then lender over 20 years at a 4.5 percent interest rate (prime rate of 3.25 percent plus 1.25 percent). The lender opposed plan confirmation. A primary issue was what an appropriate cramdown interest rate would be.

The court looked at the unique features of the debtor to set the rate. Indeed, in determining whether the reorganization plan was fair and equitable to the lender based on the facts, the court noted the father's lengthy experience in farming and familiarity with the business and that the farm manager was experienced and professional. The court also noted that the parents had extensive experience with crop insurance and that they were committing unencumbered personal assets to the reorganization plan. The court also noted the debtor's shift in recent years to more profitable crops, a demonstrated ability to manage around cash flow difficulties, and that the lender would be "meaningfully oversecured." The court also determined that the debtor's farming budgets appeared to be based on reasonable assumptions and forecasted consistent annual profitability.

However, the court did note that the debtor had a multi-year history of operating losses in recent years; was heavily reliant on crop insurance; was engaged in an inherently risky business subject to forces beyond the debtor's control; had no permanent long-term leases in place for the considerable amount of acreage that it leased; could not anticipate how the Chinese Virus would impact the business into the future; and proposed a lengthy post-confirmation obligation (30 years) to the lender. Accordingly, the court made an upward adjustment to the debtor's proposed additional 1.25 percent to the prime rate by increasing it by at least 1.75 percent. The court scheduled a conference with the parties to discuss how to proceed.

Conclusion

The interest rate issue is an important one in reorganization bankruptcy. the market rate, as applied to an ag bankruptcy, does seem to recognize that farm and ranch businesses are subject to substantial risks and uncertainties from changes in price and from weather, disease and other factors. Those risks are different depending on the type of agricultural business the debtor operates. A market rate of interest would is reflective of those factors.