Determining The Appropriate Interest Rate Under Till in a Bankruptcy Proceeding

C. Paul Wazzan
DETERMINING THE APPROPRIATE INTEREST RATE UNDER TILL IN A BANKRUPTCY PROCEEDING

Abstract
The determination of the appropriate rate of interest in a bankruptcy proceeding is guided by the United States Supreme Court’s decision in *Till v. SCS Credit Com.* which establishes a formula approach and states one should begin with the Prime Rate and then consider: 1) the circumstances of the bankruptcy estate; 2) the nature of the security; 3) the duration of the reorganization plan; and 4) the feasibility of the reorganization plan. The Supreme Court decision does not specify exactly what these four factors consist of. This paper attempts to superimpose economic principles on the *Till* decision and provide legal scholars and practitioners with a formal (though not necessarily exhaustive) list of economic variables to consider under each factor.

C. Paul Wazzan, Ph.D.*

Keith Mendes*

Gabriel Green, Esq.**

* Berkeley Research Group, LLC. Wazzan is corresponding author and can be reached at 310-499-4919 or pwazzan@brg-expert.com.
** Archer Norris PLC.
TABLE OF CONTENTS

I. INTRODUCTION...........................................................................................................1

II. CIRCUMSTANCES OF THE ESTATE..................................................................5
    A. Market rates as a starting point .................................................................5
    B. Characteristics of the borrower ...............................................................6
    C. Industry considerations ...........................................................................6
    D. Initial loan terms provided to the debtor, pre-bankruptcy .....................6
    E. Type of loan .............................................................................................7
    F. Post confirmation ability of the borrower ...............................................8
    G. Lender returns and yields .......................................................................8
    H. Lender offered terms .............................................................................8

III. NATURE OF THE SECURITY ......................................................................9
    A. Characteristics of the project and project specific risks ......................10
    B. Status of project ....................................................................................10

IV. DURATION OF THE REORGANIZATION PLAN ..................................11
    A. Term and duration of the loan ..............................................................12
    B. Term structure of interest rates ...........................................................12

V. FEASIBILITY OF THE REORGANIZATION PLAN ................................14

VI. A BRIEF DISCUSSION OF TEMPORAL ISSUES TO CONSIDER
    UNDER TILL ..................................................................................................17

VII. CONCLUSION .............................................................................................18
I. INTRODUCTION

The principles outlined in this paper are generally applicable to any bankruptcy proceeding requiring the determination of a post-bankruptcy interest rate, but we ground our exposition in a real estate setting in order to facilitate the discussion. In such a setting, borrowers (e.g., developers or property owners/managers) typically obtain loans from commercial banks in order to finance the capital requirements of their projects (e.g., the development, construction or renovation of properties). These loans are typically secured by the project itself and the future cash flows from the project (e.g., rents or sales) are expected to be sufficient to service the loan.\(^1\)

Interest rates on these types of loans are typically indexed to the Prime Rate or the London Interbank Offered Rate (“LIBOR”).\(^2\)

In the event that the debtor defaults on the loan and seeks non-liquidation bankruptcy protection under the United States Bankruptcy Code, the debtor (referred to as the “debtor in possession” or “DIP”) is required to submit a restructuring plan with the

\(^1\) The loans are sometimes further guaranteed by the personal assets of the borrower. These are known as “recourse” loans, because the lender has recourse to a third party in the event that the borrower defaults.

\(^2\) The Prime rate is defined as the base rate for corporate loans offered by the nation’s largest banks. The Prime rate is closely related to the Federal Funds rate set by the Federal Reserve. In very simple terms, the Federal Funds rate is the rate at which banks essentially lend to each other on an overnight basis. Consequently, the Prime rate accounts for overall market risk and is a general measure of the cost of funds (which would include, for example the state of the overall economy) whereas added percentage or basis points would typically reflect the project specific risk. The LIBOR rate is formally defined as the rate at which an individual Contributor Panel bank could borrow funds, were it to do so by asking for and then accepting inter-bank offers in reasonable market size, just prior to 11.00 London time. See, e.g., Bodie, Zvi, Alex Kane, and Alan J. Marcus, Investments, 3d Ed. Irwin, 1996.
Court (“Plan”), which then is subject to challenges and/or approval by the creditors of the debtor’s estate. Ultimately, it is up to the Court to make an independent determination as to the feasibility of the proposed Plan and decide whether the Plan has met all the requirements for confirmation. The Court’s confirmation decision often hinges on whether the Court finds a reasonable assurance of commercial viability. If a Plan is deemed feasible, or commercially viable, the DIP will be allowed to retain possession of the property and continue to operate it pursuant to the Court-confirmed Plan.

One important element of most Plans is typically the restructuring of the outstanding debt, including the determination of a new interest rate on that debt. Frequently, the interest rate is not one that can be observed or obtained in the regular markets – the DIP is already in bankruptcy and, consequently, a commercial loan is very likely unfeasible. In other words, there is generally no observable market for loans to companies in bankruptcy. The Court, therefore, requires expert analysis to determine what would be a new appropriate interest rate for the outstanding debt assuming the Plan is accepted and the company emerges from bankruptcy. For those Plans that are confirmed, which contain a new interest rate on the debt, the lender, as a creditor of the estate, is then forced to accept the new interest rate – commonly referred to as a “crammed down” or “cram down” loan on the lender. This paper focuses on this particular aspect of a restructuring (i.e., non-liquidation) bankruptcy proceeding, where a Court is put in the position of determining whether a proposed

---

3 See, e.g., In re Martin, 66 B.R. 921, 925 (Bankr. Mont. 1986).
4 See, e.g., In re Trail’s End Lodge 54 B.R. 898, 904 (Bankr. D. Ver. 1985); Kane v. Johns-Mansville Corp., 843 F.2d 636, 639 (2nd Cir. 1988); In re WCI Cable Inc., 282 BR 457, 486 (Bankr. D. Or. 2002); In re Brice Road Dev. 25 LLC., 392 BR 274,283 (BAP 6th Cir. 2008); In re Aceguia, 787 F.2d 1352, 1364 (9th Cir. 1986).
reduced post-bankruptcy interest rate on an outstanding debt is appropriate and confirmable.

Generally the appropriate interest rate for a loan is informed by market factors (e.g., systematic risk and market rates) and the risk adjusted cost of funds for the specific project (idiosyncratic or non-systematic risk). These types of analyses form the basis of much of modern finance and can be found in most discussions of risk adjusted costs of capital and the determination of appropriate discount rates. In the event of a Bankruptcy proceeding, however, there is typically no observable market rate.

The Supreme Court provides guidance to addressing this issue in *Till v. SCS Credit Com.*, 541 U.S. 465, 124 S.Ct. 1951, 309 19 B.R. 1951 (2004) which states:

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

Ultimately, while *Till* outlines a general framework of factors (often referred to as the “formula approach” or “formula rate”) it does not provide specificity as to what

---

variables should be considered under each of these factors, nor how the cram down rate should actually be computed. This lack of specificity has led some courts to reject the formula rate in favor of other methods including the coerced loan rate, the presumptive contract rate, and the cost of funds rate.\textsuperscript{6} Moreover, the variables or parameters that make up “the circumstances of the estate” are likely to be quite varied. A recent court decision stated the following:

(Expert’s) testimony was more credible and consistent with Till guidelines. Expert considered factors such as the DIP's property was a high-end project, in operation with a high level of occupancy (98%). He amortized the initial Bank loan which ironically was set at prime plus .25%, even though a series of modifications (except for the final two). He considered the long time history of the builders and the continuity of management. Moreover, he gave consideration to the three (3) year terms of the reorganized loan-saying the shorter the term, the lower the interest rate. An inflationary factor was minimal, due to prime rate which set consideration of such factor. Lending practices of the Bank were considered, loan to value ratio and debt service ratio, for which he made adjustments. This list is not inclusive, but is sufficient to indicate a careful consideration of all factors in accordance with the Till formula, and then concluded the plan repayment...was feasible due to the financial condition of the DIP.\textsuperscript{7}

Setting aside the ongoing legal debate, and consistent with the formula approach advocated by Till, in the following sections we apply economic rigor to the Till decision in order to provide legal scholars and practitioners with a specific list of variables to consider under the formula rate approach (not all of which are

\textsuperscript{6} For a discussion of these methods see the dissenting opinion issued by Justice Stephens. Opinion of Stevens, J. SUPREME COURT OF THE UNITED STATES No. 02—1016 LEE M. TILL, et ux., PETITIONERS v. SCS CREDIT CORPORATION ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT [May 17, 2004].

\textsuperscript{7} In re: Caviata Attached Homes, LLC, USBC District of Nevada, Case 09-52786-gwz Doc 152 Entered 04/12/10 15:56:22, Memorandum Decision.
necessarily required for each analysis) and the reasoning behind each variable and how it might affect the determination of the post-bankruptcy interest rate.

II. CIRCUMSTANCES OF THE ESTATE

The term “circumstances of the estate” is not defined by the Supreme Court but can be reasonably taken to encompass any issue that will impact the debtor’s ability to service the loan, or affects the risk of the loan.\(^8\) The characteristics then of the borrower as well as factors affecting risk should be considered under this first factor.

A. Market rates as a starting point

Commercial bank loans are often colloquially described as “story loans” in that a lender needs to hear the complete story behind the planned borrowing in order to determine an appropriate interest rate. Nevertheless, generally available rates for comparable loans, for comparable projects, for comparable borrowers are likely to be a good indicator of the market’s current assessment of the appropriate risk adjusted interest rate. These rates, or approximations, can sometimes be obtained through direct discussions with banks. In our experience, banks typically indicate that the final rate will depend on the characteristics of both the debtor and the completed project and that pro-forma financials play a significant role in the determination of the final interest rate. Use of this benchmark data in conjunction with the Prime Rate may allow the practitioner to determine a starting point for the analysis.

\(^8\) See, e.g., Honorable Michael G. Williamson, United States Bankruptcy Court Tampa, Florida American Bankruptcy Institute, *Determining Cram Down Interest Rates Post-Till.*
B. Characteristics of the borrower

The characteristics of the borrower, and ultimately its guarantors, are important factors. For example, if the borrower is a well-established developer with a substantial history of successfully completing projects the risk may be considered to be less than that for a relative novice. Similarly, borrowers that have shown the historical ability to adapt their business model to changing environments may also pose less risk. Moreover, one should consider if the guarantors (in the event that the loan has recourse) are sufficiently able to retire the loan in part or in full. Where the guarantee is strong, the risk can be considered as reduced.

C. Industry considerations

The overall state of the industry in which the borrower operates can be informative. For example, if the borrower is a developer of commercial office space and the industry is projecting two years (from the present) of worsening demand, then the risk could be considered as increasing. The converse would also be true. This analysis can be done on a local level, state level and/or nationwide level – depending on the specifics of the particular loan. Such analyses might also consider an evaluation of the current quantity and quality of the debtor’s competition plus the potential for new entrants.

D. Initial loan terms provided to the debtor, pre-bankruptcy
Before one can consider the factors affecting risk, it may be useful to determine the risk as initially defined by the lender pre-bankruptcy. Interest rates are set on a case by case basis based on various factors included but not limited to: existing relationships with the borrower, credit history/rating, nature of the project, (e.g., building type, projected income) market competition, and size of the loan. The terms obtained prior to the bankruptcy are likely to be informative as to the perceived risk. For example, if the initial loan was made at Prime plus 1%, one might consider that the project specific risk equates to 1%. Implicit in this assumption is that the Prime Rate accounts for overall market risk.

E. Type of loan

Some loans are inherently riskier due to the nature of the project being funded by the loan. For example, certain construction loans involve numerous factors such as the project being completed in the expected time frame, being completed at the expected cost, and the borrower securing long term financing for the project upon completion. Other asset-based loans or long term financing (e.g., for a completed building) may not carry these risks and may therefore warrant a lower interest rate – all things being equal. Interest only loans with balloon payments require the debtor to have or create the financial capacity to make more than just the monthly payments, which presents additional risk to the lender. In short, the type of loan will factor into a determination of the appropriate interest rate.

---

9 This is consistent with information obtained from the CNB website: “At Cal National, we understand that a “one-size-fits-all” approach to commercial lending just doesn’t work. We employ real people to make loan decisions and customize financing to suit your financial needs. We offer fixed and adjustable rate financing at competitive rates and flexible terms.” http://www.calnational.com/commercial-real-estate/. Accessed 2/22/2010.
F. Post confirmation ability of the borrower

The impact the pending reorganization has on the debtor’s ability to borrow money, secure debt, and sell property should be taken into consideration. If the reorganization will strip the debtor of its future sources of or ability to raise capital, then the debtor poses a greater risk than one who will retain those abilities.

G. Lender returns and yields

[should there be a mention why reviewing the lender’s characteristics is ok for the formula approach, i.e., is not relegated to just use in the coerced loan or cost of funds approach?] A review of the lenders publicly available financial records (e.g., SEC or FDIC filings) can yield important information related to what types of returns the lender expects to earn on made loans. Rates to consider are what the lender is offering on certificates of deposit and money market rates. These are important benchmarks as banks essentially convert demand deposits into longer term loans and earn the spread.

H. Lender offered terms

Loan terms for contemporaneous non-bankruptcy projects are often available directly from the actual pre-bankruptcy lender or various competing lenders and can be directly observed. For example, a review of terms being offered by the lender might
indicate that commercial real estate loans greater than $25 million were available under the following terms:

- Property Type: Office, Retail, Industrial, Self Storage
- Loan Fee: 1%
- Loan Amount: $500,000- $25,000,000+
- Term: 10 years
- Amortization: 25 years
- Loan To Value Ratio: 75%
- Debt Service Coverage Ratio: 1.25
- Recourse: Recourse
- Libor +2%
- Processing Fee: $750 or 10bps, whichever is greater
- Third-party Fees: Actual, to be determined (environmental, title, closing costs, etc.)
- Prepayment Fee: Varies by Program

These terms may reasonably be considered by the expert in determining the rate. For example, if the post-bankruptcy loan conforms to the above stated conditions then it’s unlikely (barring other complicating factors) that the post-bankruptcy terms would be much different.

III. NATURE OF THE SECURITY
Till indicates that the collateral used to secure the loan should be carefully considered. Such an evaluation encompasses the value of the collateral relative to the loan and assesses the risks associated with the collateral itself.

A. Characteristics of the project and project specific risks

The collateral is typically the property itself. Issues to consider include the project’s status relative to its competition (e.g., in construction one might consider whether the project is high or low end, occupancy rates, rental rate trends, rental rates relative to market averages).

B. Status of project

The current status of the project will factor into risk. Consider a situation where the developer/operator of a parking lot has seen revenues fall because of unrelated temporary road construction. Demand for parking is expected to be unchanged -- the cars simply cannot access the lot for the moment. Consequently, one may expect the risks to be somewhat mitigated by the fact that the economics of the loan are basically unchanged – they are simply subject to a one-time temporary delay.

Similarly, all things being equal, a construction project that is completed or near completion may be considered as relatively less risky than a project in an earlier stage of development.

C. Loan to Value Ratio
The loan-to-value (“LTV”) ratio measures the outstanding amount of the loan against the lower of either the price or the appraised value of the collateral. A borrower with a higher loan-to-value ratio has committed less of its own equity towards the project and the lender is subject to greater risk from unforeseen price movements (e.g., the value of the collateral may fall).

D. Liquidity of the collateral

Liquidity is defined as the capacity of an asset to be converted easily and with minimum loss into cash. U.S. Treasury issues (including Bonds, Notes and Bills) are generally considered the benchmark liquid investment. A liquid market is one in which there is enough activity to satisfy both buyers and sellers. The liquidity of the collateral used to secure the loan is an important element in the determination of risk. For example, if the loan was used for the development of a condominium project and supply currently exceeds demand, one might consider the collateral to be illiquid. Conversely, if the loan was used to acquire capital equipment that is easily sold, then one might consider the collateral to be liquid. This analysis is important as it will determine the ability of the lender to recover their funds (by transforming the collateral into cash) within a short period of time. The longer it takes, the greater the risk to the lender that the asset may become impaired in some way.

IV. DURATION OF THE REORGANIZATION PLAN
This element of the Till decision encompasses risks and other factors that are associated with the length of the plan.

A. Term and duration of the loan

All things being equal, loans of shorter duration have lower interest rates. This is readily observed in mortgage rates (e.g., 30 year loans have higher associated interest rates than 5 year loans) and treasury markets where T-bills (maturities up to one year) have lower yields than T-notes (maturities between two and ten years) which have lower yields than T-Bonds (maturities between 20 and 30 years). This is due, in part, to the uncertainty of future events as well as inflation risk. In other words, investors must be compensated for tying up their money for longer periods of time.

The cram down interest rate should therefore reflect the expected or effective duration of the loan. For example, suppose the actual loan (pursuant to the reorganization plan) matures in three years. This would set the maximum duration but not necessarily the expected duration. It may be that the debtor, with some degree of probability, could refinance or sell the property (and pay off the loan) prior to the maturity date.

B. Term structure of interest rates

The term structure of interest rates is a standard metric used in bond valuation and in the analysis of the market for fixed income securities. It is constructed by observing yields against respective maturity dates of benchmark (e.g., US Treasuries) fixed-
income securities. To illustrate, Table 1 shows US treasury yields in February 2010:\(^{10}\):

<table>
<thead>
<tr>
<th>Date</th>
<th>1 mo</th>
<th>3 mo</th>
<th>6 mo</th>
<th>1 yr</th>
<th>2 yr</th>
<th>3 yr</th>
<th>5 yr</th>
<th>7 yr</th>
<th>10 yr</th>
<th>20 yr</th>
<th>30 yr</th>
</tr>
</thead>
<tbody>
<tr>
<td>2/1/2010</td>
<td>0.05</td>
<td>0.10</td>
<td>0.17</td>
<td>0.35</td>
<td>0.86</td>
<td>1.44</td>
<td>2.18</td>
<td>3.12</td>
<td>3.68</td>
<td>4.45</td>
<td>4.66</td>
</tr>
<tr>
<td>2/3/2010</td>
<td>0.04</td>
<td>0.10</td>
<td>0.17</td>
<td>0.33</td>
<td>0.88</td>
<td>1.41</td>
<td>2.17</td>
<td>3.11</td>
<td>3.67</td>
<td>4.42</td>
<td>4.55</td>
</tr>
<tr>
<td>2/8/2010</td>
<td>0.05</td>
<td>0.10</td>
<td>0.17</td>
<td>0.35</td>
<td>0.88</td>
<td>1.44</td>
<td>2.40</td>
<td>3.16</td>
<td>3.73</td>
<td>4.49</td>
<td>4.62</td>
</tr>
<tr>
<td>2/9/2010</td>
<td>0.04</td>
<td>0.09</td>
<td>0.16</td>
<td>0.32</td>
<td>0.80</td>
<td>1.34</td>
<td>2.29</td>
<td>3.06</td>
<td>3.62</td>
<td>4.39</td>
<td>4.53</td>
</tr>
<tr>
<td>2/10/2010</td>
<td>0.03</td>
<td>0.10</td>
<td>0.17</td>
<td>0.31</td>
<td>0.77</td>
<td>1.28</td>
<td>2.23</td>
<td>3.00</td>
<td>3.59</td>
<td>4.36</td>
<td>4.51</td>
</tr>
<tr>
<td>2/18/2010</td>
<td>0.04</td>
<td>0.12</td>
<td>0.17</td>
<td>0.32</td>
<td>0.79</td>
<td>1.30</td>
<td>2.26</td>
<td>3.03</td>
<td>3.62</td>
<td>4.38</td>
<td>4.52</td>
</tr>
<tr>
<td>2/25/2010</td>
<td>0.05</td>
<td>0.12</td>
<td>0.18</td>
<td>0.34</td>
<td>0.84</td>
<td>1.37</td>
<td>2.32</td>
<td>3.08</td>
<td>3.67</td>
<td>4.44</td>
<td>4.58</td>
</tr>
<tr>
<td>3/3/2010</td>
<td>0.06</td>
<td>0.11</td>
<td>0.19</td>
<td>0.38</td>
<td>0.91</td>
<td>1.44</td>
<td>2.39</td>
<td>3.14</td>
<td>3.72</td>
<td>4.51</td>
<td>4.65</td>
</tr>
<tr>
<td>3/13/2010</td>
<td>0.05</td>
<td>0.11</td>
<td>0.18</td>
<td>0.38</td>
<td>0.91</td>
<td>1.45</td>
<td>2.39</td>
<td>3.15</td>
<td>3.73</td>
<td>4.54</td>
<td>4.69</td>
</tr>
<tr>
<td>3/22/2010</td>
<td>0.04</td>
<td>0.10</td>
<td>0.18</td>
<td>0.35</td>
<td>0.84</td>
<td>1.38</td>
<td>2.35</td>
<td>3.11</td>
<td>3.69</td>
<td>4.52</td>
<td>4.66</td>
</tr>
<tr>
<td>3/26/2010</td>
<td>0.04</td>
<td>0.10</td>
<td>0.18</td>
<td>0.34</td>
<td>0.82</td>
<td>1.36</td>
<td>2.32</td>
<td>3.08</td>
<td>3.66</td>
<td>4.49</td>
<td>4.63</td>
</tr>
<tr>
<td>4/17/2010</td>
<td>0.07</td>
<td>0.10</td>
<td>0.18</td>
<td>0.35</td>
<td>0.87</td>
<td>1.42</td>
<td>2.40</td>
<td>3.16</td>
<td>3.74</td>
<td>4.55</td>
<td>4.70</td>
</tr>
<tr>
<td>5/2/2010</td>
<td>0.07</td>
<td>0.10</td>
<td>0.18</td>
<td>0.37</td>
<td>0.90</td>
<td>1.47</td>
<td>2.46</td>
<td>3.23</td>
<td>3.79</td>
<td>4.61</td>
<td>4.74</td>
</tr>
<tr>
<td>5/9/2010</td>
<td>0.06</td>
<td>0.11</td>
<td>0.20</td>
<td>0.39</td>
<td>0.95</td>
<td>1.51</td>
<td>2.48</td>
<td>3.24</td>
<td>3.78</td>
<td>4.58</td>
<td>4.71</td>
</tr>
<tr>
<td>5/22/2010</td>
<td>0.06</td>
<td>0.11</td>
<td>0.19</td>
<td>0.37</td>
<td>0.91</td>
<td>1.48</td>
<td>2.47</td>
<td>3.25</td>
<td>3.80</td>
<td>4.60</td>
<td>4.73</td>
</tr>
</tbody>
</table>

The term structure is often graphically represented with a “yield curve” which essentially measures the market’s expectations of future interest rates given current market conditions. For example, inflationary expectations can be inferred from the curve. The yield curve is effectively a snapshot of investor’s beliefs. Figure 1 represents the yield curve derived from the observed yields shown in Table 1:


Accessed on February 23, 2010. The yield curve is a graph that plots the relationship between yields to maturity and time to maturity for bonds of the same asset class and credit quality. The plotted line begins with the spot interest rate, which is the rate for the shortest maturity; and extends out in time, typically to 30 years.
It is readily apparent from Figure 1 that annual spreads are approximately 0.50% from 1 year through 7 year with annual spreads decreasing significantly thereafter. These rates are consistent with a standard and normal upward sloping yield curve where investors expect to earn higher returns for assets with longer maturities. In other words, the time value of money is approximately .50% per annum. The relevance of the yield curve is in its use to assess inflation risk. If inflation risk is high, then the cram down interest rate, all things being equal, should be higher. Conversely, low inflation risk, all things being equal, would result in a lower interest rate.

V. FEASIBILITY OF THE REORGANIZATION PLAN
As a final point, the bankruptcy code entitles the creditor to a present value of the stream of future payments that equals or exceeds the value of the creditor’s claim. While *Till* states that the rate decided upon does not need to meet the pre-bankruptcy terms (which is the idea behind the cram down) it should not allow businesses to have the opportunity to enter into outlandish deals that an otherwise solvent debtor would not be able to obtain. In short, the creditor should get a fair rate, but it should be a rate that allows the reorganization plan to succeed.

A. Reasonableness of underlying assumptions

A reorganization plan usually requires the debtor to provide pro-forma financial projections and a schedule of when the amount in question will be repaid and the source of the funds used for debt service. The more Plans that are grounded in fact and supported by reasonable assumptions pose less of a risk than plans based on overreaching expectations. Items for consideration include, but are not limited to, consideration of the local market, general economic conditions, recent historical earnings, incorporating the characteristics of the collateral, and allowing room for unforeseen expenses. For example, a plan properly incorporating local housing trends/forecasts into the projected earnings of a high-end apartment complex will have a greater chance of success, and pose less risk, than a plan requiring a 50% increase in sales despite recent quarterly decreases and a poor economic outlook to barely cover the proposed debt service. Measuring the accuracy of recent financial projections may also provide insight into the reasonableness of the underlying assumptions.
B. EBITDA

Earnings before interest, taxes, depreciation, and amortization ("EBITDA") is a widely used measurement for the cash flow produced by the continuing operations of a business. A plan using pro-forma financials with a relatively larger estimated EBITDA indicates the debtor is generating greater earnings through its normal course of business and presents less risk.

C. Debt service coverage

Absolute earnings also need to be measured in context against the amount of the loan. The debt service coverage ratio measures the net operating income, as determined in the plan, in terms of the scheduled debt service over a specific period of time (monthly, quarterly, annually, etc.). A higher debt service coverage ratio indicates the debtor has more financial resources to commit to the repayment of the loan, and thus indicates reduced risk. A debt service coverage ratio of at least 1.0 is required if the debtor is to pay the proposed debt service amount.

D. Determine rates allowable by the Plan

Once a proper reorganization plan has been created, a sensitivity analysis can be conducted to determine whether the cram down interest rate will satisfy the NPV criteria but also allow the debtor enough margin for error such that the probability of another default is minimized. If the maximum allowable rate determined by the Plan is less than a rate that would properly compensate the lender, the Plan should be
scraped or reworked. Conversely, simply because the Plan can accommodate certain interest rates does not mean those rates are appropriate for the debtor.

VI. A BRIEF DISCUSSION OF TEMPORAL ISSUES TO CONSIDER UNDER TILL

The determination of the cram down interest rate takes place during the bankruptcy proceeding, but is clearly meant to reflect the appropriate post-bankruptcy interest rate. *Till* clearly states that the coerced loan approach is not acceptable.\(^{11}\) In a recent case in which one of the author’s participated, the Court noted:

The Court finds and concludes that the testimony of (lender’s expert) for the purposes of determining the applicable interest rate for the treatment of Class I under the plan is not appropriate because (lender’s expert) bases his report upon a coerced loan approach, contrary to the decision of *In re Till*, 541 U.S. 465, 124 S. Ct. 1951, 158 L. Ed. 2d 787 (2004), made arbitrary adjustments in increments of 150 basis points without explanation and beyond the parameters set forth in Till, made improper calculations as to the loan-to-value ratio and the debt service to income ratio, and determined that the plan was unfeasible based upon the application of his own unreasonably high interest rate. The Court finds and concludes that the testimony of C. Paul Wazzan, Ph.D., the Debtor's expert, is persuasive regarding the applicable interest rate in this case. Dr. Wazzan considered the applicable factors under Till, and provided a reasonable explanation for his conclusion.\(^{12}\)

\(^{11}\) There are two variations of the coerced-loan theory. In the first variation, courts “treat any deferred payment of an obligation under a plan as a coerced loan, and the rate of return with respect to such a loan must correspond to the rate that would be charged or obtained by the creditor making a loan to a third party with similar terms, duration, collateral and risk.” *Bank of Montreal v. Official Committee of Unsecured Creditors (In re American HomePatient, Inc.)*, 2005 WL 1949548 (6th Cir. Aug. 16, 2005), the Sixth Circuit. In the second variation the interest rate in a cram down is the same as the creditor would receive if it could foreclose and reinvest the proceeds in loans of equivalent duration and risk. See, e.g., *Koopmans v. Farm Credit Servs.*, 102 F.3d 874, 875 (7th Cir. 1996).

\(^{12}\) In re Caviata Attached Homes, LLC., Case 09-52786-gwz Doc 153 Entered 04/12/10 15:59:09, Findings of fact and conclusions of law and order.
In other words, the interest rate determination is not meant to be affected by the debtor actually being in bankruptcy. The analysis should carefully consider the impact of this temporal shift on the final rate.

VII. CONCLUSION

The determination of the appropriate rate of interest in a bankruptcy proceeding is guided by *Till v. SCS Credit Com.* which states one should begin with the Prime Rate and then consider: 1) the circumstances of the estate; 2) the nature of the security; 3) the duration of the reorganization plan; and 4) the feasibility of the reorganization plan. Insofar as the Supreme Court decision does not explore the economic variables that actually comprise each of the factors, this paper attempts to superimpose economic principles on the *Till* decision to provide legal scholars and practitioners with a formal (though not necessarily exhaustive) list of those economic variables.